MONTHLY REPORT TO SHAREHOLDERS OF OPTIMAL JAPAN ABSOLUTE LONG FUND

Monthly Performance % - *as at 29 May 2015*

	NAV	May	YTD	Strategy AUM
Offshore Feeder	US$17.372	5.27%	16.83%	US$67M
Topix Return is in USD unhedged using WM London 4pm close		1.33%	14.88%	

As we head towards mid-year, it is a pleasure to be able to report that the market (Topix) return YTD is almost 19% at the end of May. May's gain of 5% might pale beside the February return of 7.6%, but is a great month by any standard and once again, the banking sector was among the best. For those who were investing in Japan a decade or so ago, it is hard to avoid finding similarities with that period leading up to the market peak in mid 2007. From the low reached in the Spring of 2003 until the June 2007 peak, Topix rose by 130%, while Topix has jumped 135% since just prior to Mr Abe's second term as PM began in Autumn 2012.

The starting valuation levels were however, quite different, with the Topix PBR only 0.9x in late 2012 against 1.25x in March 2003. Apart from taking comfort from valuations being cheaper now than in mid 2007, the other major difference has been the impact of currency movements in each period. In the earlier bull market, there was only a negligible difference between the Yen return and the unhedged USD return, meaning that most investors enjoyed the boom in Japanese equities. The current market has been very different however, and an unhedged USD investment has been respectable, rather than spectacular. By a quirk of fate, the USD return from an investment in the Topix index (from 11 October 2012 to 29 May 2015) has been 48% while that from the S&P 500 index has been 47%. These are returns that are more than respectable but a long way from the spectacular 135% return in Yen. Most of the difference between the Topix Yen and USD return came in the six months following Abe's election ending May 2013 and then again in the last quarter of 2014. This year, the Yen/$ rate has been largely stable, but happily, the market has continued to move strongly upwards. As we mentioned last month – and as Mr Kuroda seemed to endorse last week – the Yen does not "need" to weaken any further. On balance however, the authorities would prefer marginal weakness to any real strength and will adjust policy to that end if needed.

Much has been written about the push to improve the RoE of Japanese companies. High RoEs usually generate better returns in the long run, and as equity investors we are in favour of the increased broad commitment to boosting RoEs. An interesting piece from Daiwa Securities (*The Suzuki Report – 2 June 2015*) compares the return on equity of the Topix index and the S&P 500 index since 1980 and looks into the three factors that produce the final number.

Asset turnover in both the USA and Japan has fallen from more than 1x in 1980 to 0.75x in CY 2014. The bulk of the decline came in the 1980s, but for the past two decades, the level has not changed much.

Corporate leverage, represented as assets divided by shareholders' equity, is very similar with the S&P at 2.74x to the Topix 2.57x, although in 1980, Japanese companies were leveraged 5.0x to the US 2.5x.
The real difference lies in profit margins. The S&P 500 net income margin is 7.86% (up from 6% in 1980) while that of Topix is 4.34% (up from 2.5% in 1980). Net income is an after tax number, so differing tax rates will impact the figure, but the report is silent on this as a major factor. US companies are in aggregate, more profitable, and this is by far the biggest factor in explaining the difference between the S&P's RoE of 16% and that of the Topix at 9.1%.

Much is made of Japanese companies' cash piles, and certainly the RoE could be boosted by cutting these low margin cash reserves, but that will not boost Japanese RoEs to the levels of their US counterparts. The real focus has to be operating margins and we believe that these will rise as a result of the common goal of improving governance as well as the greater use of automation (and robots) in place of labour. For the time being however, it is perfectly natural that US companies should trade at higher PBRs to those of the Japanese, though that premium will erode over time.

The task for Japanese companies is to lift their profit margins and investors will pay a premium to own businesses that maintain high profit margins. The hard part is in predicting which companies will be able to maintain their high margins, and that gets us into the value and growth arena again. Year-to-date, there is a clear contrast between the sectors that performed well in the first quarter (largely defensives such as drugs and food) and the leaders in the second quarter so far (financials being preeminent). Our performance has improved in line with this shift, but it was nice to have non-financials taking the top two spots in May. The best return came from DMG Mori Seiki, one of the world's largest machine tool makers which is merging with DMG Mori AG (formerly Gildermeister) of Germany to create the world's biggest company in the sector. Not far behind was Tokyo Electron which had fallen sharply at the end of April when their friendly merger with Applied Materials (USA) was cancelled due to regulatory objections. It rallied 20% in May but still sits 20% below where it traded in late February. With asset turnover of 0.77x, leverage of only 1.37x and net income margin of 11%, we expect that this one is likely to be a shareholder's friend in years to come.

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Recent 3 month Fund Exposure

% of NAV in	Mar 15	Apr 15	May 15
Long Stock Positions	93.91	94.68	94.22
Index Futures	-	-	-
Net Exposure	93.91	94.68	94.22

Optimal FUND MANAGEMENT

Should you wish to make an enquiry about the Optimal Japan Absolute Long Fund, please see our website www.optimalasia.com or contact us by email at optimal@optimalasia.com.

Position Concentration

	Top 5	Top 10
Longs	27.35%	48.89%
Total no. of positions	31	

Top Five Positions

Sumitomo Mitsui Financial Group Inc
Mitsubishi Estate Co Ltd
Mizuho Financial Group Inc
Mitsubishi UFJ Financial Group Inc
Nomura Holdings Inc

Winners

Mori Seiki Co Ltd
Tokyo Electron Ltd
Sumitomo Mitsui Financial Group Inc
Mizuho Financial Group Inc
Mitsubishi UFJ Financial Group Inc

Losers

Toshiba Corp
H.I.S. Co Ltd
Sun Frontier Fudousan Co Ltd
Tsukui Corp
Shinmaywa Industries Ltd

Sector Exposure *as at 29 May 2015*

	Longs		Longs
Consumer Discretionary	11.31%	Health Care	-
Consumer Non-Discretionary	-	Industrials	25.27%
Energy	3.37%	Information Technology	15.44%
Financials	38.83%	Materials	-

Historical Returns- *Optimal Japan Absolute Long Fund Monthly Returns in USD (before Performance Fees) %*

(Inception September 2004)

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	Topix* YTD
2015	-2.45	8.82	-0.37	4.95	5.27								16.83	14.88
2014	-6.55	-3.03	-0.52	-3.07	3.71	4.69	0.57	-1.38	2.91	-0.65	3.38	0.96	0.40	-5.25
2013	4.19	1.40	5.18	15.67	-5.74	1.13	0.45	-3.56	8.91	-0.35	2.62	2.14	35.00	24.60
2012	2.84	2.31	1.04	-1.81	-9.47	3.97	-1.30	-1.79	1.73	-1.42	-0.57	5.68	0.37	5.01
2011	1.31	3.89	-9.20	1.72	-0.51	1.02	3.69	-6.40	-3.98	2.70	-4.91	0.83	-10.34	-14.55
2010	2.58	0.19	4.19	1.88	-8.25	-3.15	3.36	-2.39	5.77	3.79	0.36	8.26	16.65	13.67
2009	-5.28	-11.56	3.78	4.75	9.49	2.12	3.11	4.76	-3.58	-2.26	-2.78	-0.38	0.38	2.85
2008	-6.00	2.60	0.15	4.21	1.40	-9.57	-3.85	-7.26	-5.49	-5.14	-4.01	8.78	-22.95	-28.24
2007	1.50	3.69	-1.88	0.33	1.71	1.49	1.27	-4.97	2.18	-1.04	-5.37	-6.57	-7.97	-6.37
2006	3.57	1.22	3.55	2.74	-4.40	-1.32	-1.55	-0.29	-1.51	3.73	1.48	1.94	9.14	0.94
2005	1.61	2.05	-3.83	-0.47	-1.81	-0.58	1.17	6.66	9.32	-0.75	3.25	8.64	27.25	24.59
2004									-1.60	-1.32	6.18	2.52	5.70	8.16

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