

Monthly Performance % - as at 31 October 2012

	NAV	October	YTD	AUM
Offshore Feeder	US\$10.44	-1.42%	-4.48%	US\$14M
Topix - Topix Return is in USD unhedged using WM London 4pm close		-2.02%	-1.93%	

The manager's report is later than normal this month as we have been traveling in Japan and Europe for much of the past two weeks. The delay has been fortuitous in one sense as the big news broke last week (Nov 14th) when Prime Minister Noda announced the dissolution of the Diet and set December 16th as the date for a lower house election. With his party's opinion polls ratings in the cellar and under constant pressure from all sides to call an early election, it was not a complete shock, but Japan market participants have grown so sceptical that no one reacts until something is confirmed and before their nose.

Three days since the announcement however, and we find that the Topix index is up almost 6% while the Yen has fallen to levels not seen since late April (81.2/\$). Had the Yen already peaked? It is worth noting that the Yen was at Y77/\$ one year ago and peaked at Y76/\$ at the start of February. Perhaps of equal – if not greater – importance is that since the start of June this year, the Korean Won has strengthened from 15.1/Y to 13.4/Y and in that period, Hyundai Motors is down over 9% while Toyota (in Yen) is up more than 12%. This is more than just coincidence in our view.

Immediately after the Diet dissolution was announced, the media began reporting a number of economic targets and policies attributed to Mr Abe, leader of the LDP and likely next prime minister. The market has reacted favourably because the central plank of the LDP's economic policies is to bring Japan out of deflation (and deflationary expectations) into modest inflation. Their original inflation target was 1.5% but last week this was apparently upped to 3%. The higher target is more a symbol of their aspiration rather than reality, but the market likes the idea and the apparent determination. We feel that persistent deflation is the single biggest contributor to the weak equity market and the unbelievable contrast between returns on Japanese debt and equity. Just how a new government led by Mr Abe is going to achieve inflation is yet to be detailed, but a much more accommodative Bank of Japan is definitely a big part of the plan. Mr Shirakawa – the current BoJ Governor – retires at the end of next March so his successor will take up the position with high expectations and under considerable political pressure to print money (not a practice that central banks like to admit to, but common amongst major central banks these days). If a new government is able to move expectations from deflationary to inflationary, there will be fireworks in Japan's capital markets.

The table below shows companies that have issued 5 year straight bonds and what coupon they pay on these contrasted with the dividend yield a buyer of their equity currently receives. Someone lends money to them at 0.3% pa and receives an IOU to get their original 100 back while the same 100 in the shares receives 5% in dividends but takes the risk that the shares might fall in the next five years.

Ticker	Name	Yield Spread	Dividend Yield	Corp. Bond Yield
7912	Dai Nippon Printing Co. Ltd.	5.6%	6.1%	0.5%
4911	Shiseido Co. Ltd.	4.9%	5.1%	0.2%
6724	Seiko Epson Corp.	4.9%	5.4%	0.5%
6472	NTN Corp.	4.9%	5.2%	0.3%
4502	Takeda Pharmaceutical Co. Ltd.	4.8%	5.1%	0.3%
8001	Itochu Corp.	4.8%	5.3%	0.5%
5201	Asahi Glass Co. Ltd.	4.8%	5.0%	0.3%
4568	Daiichi Sankyo Co. Ltd.	4.6%	5.0%	0.3%
8086	Nipro Corp.	4.6%	5.4%	0.8%
8031	Mitsui & Co. Ltd.	4.6%	5.2%	0.6%
9437	NTT DoCoMo Inc.	4.5%	4.8%	0.3%
8058	Mitsubishi Corp.	4.4%	4.8%	0.4%
8053	Sumitomo Corp.	4.4%	5.0%	0.6%
4631	DIC Corp.	4.3%	4.7%	0.4%
9504	The Chugoku Electric Power Co. Inc.	4.2%	4.9%	0.6%
8002	Marubeni Corp.	4.2%	4.8%	0.5%
4523	Eisai Co. Ltd.	4.1%	4.4%	0.2%
8078	Hanwa Co. Ltd.	4.1%	4.5%	0.5%
9502	Chubu Electric Power Co. Inc.	4.1%	4.7%	0.6%
3861	Oji Holdings Corporation.	4.0%	4.4%	0.4%

Source: Bloomberg, I/B/E/S, Factset, GS Global ECS Research

The shares can fall 26% before the bond return matches that of the equity over the five year holding period but deflationary expectations have made this seem a fair bet. The bond investor will (almost certainly) never get back more than his original investment plus 0.3% pa in interest, while the equity investor, in inflationary conditions, should expect to receive rising dividends and a higher share price – recalling that most Japanese companies only pay out 30% of their profits as dividends.

Signs that higher equity yields are attracting domestic buying are evident in the performance of the J-REIT market this year. The Topix REIT index is up 27% YTD against a broad market gain of 5% and the individual ownership of the J-REITS is between 40-50% and rising. Financial conditions have eased and the REITs can borrow at around 1%pa, and still acquire properties that are immediately earnings accretive to their shares. Importantly, quite a lot of the REITs have been able to raise equity and are doing so largely by placing this with Japanese individual investors. It is a welcome change.

Japanese individuals have shunned the domestic equity market for years – only finding enthusiasm for shares when the speculative Mothers market for small caps was running between 2003 and 2005 – but their buying of J-REITs is the first sign that domestic investors will buy shares for a high and stable Yen income stream. With many other high quality sectors in the market now trading on dividend yields of 4-5%, we would not be surprised if the individual appetite for equities starts to spread beyond the REITs. Telcos and banks both offer "utility" characteristics and should be attractive to individuals in our view. We are overweight in these stocks, and expect to see yields falling as prices rise when deflation is slayed.

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Optimal FUND MANAGEMENT

Recent 3 month Fund Exposure

% of NAV in	Aug 12	Sep 12	Oct 12
Long Stock Positions	93.27	89.29	89.38
Index Futures	-	-	-
Net Exposure	93.27	89.29	89.38

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	25.01%	46.47%
Total no. of positions	27	

Top Five Positions

Benesse Holdings Inc
Mitsubishi Estate Co Ltd
Sumitomo Mitsui Financial Group Inc
Sumitomo Mitsui Trust Holdings Inc
Aeon Co Ltd

Winners

Seria Co Ltd
Mitsubishi Estate Co Ltd
Sumitomo Mitsui Trust Holdings Inc
Unipres Corp
Daihatsu Motor Co Ltd

Losers

Nippon Television Network Corp
NTT Docomo Inc
Hitachi Ltd
Komeri Co Ltd
Mitsubishi UFJ Financial Group Inc

Sector Exposure as at 31 October 2012

	Longs		Longs
Consumer Discretionary	32.77%	Industrials	21.41%
Consumer Non-Discretionary	6.09%	Information Technology	3.66%
Financials	21.72%	Telecommunications	3.73%

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

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	Topix [*] YTD
(Inception September 2004)														
2012	2.84	2.31	1.04	-1.81	-9.47	3.97	-1.30	-1.79	1.73	-1.42			-4.48	-1.93
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

* Topix Return is in USD unhedged using WM London 4pm close

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