

Monthly Performance % - as at 31 August 2012

	NAV	August	FYTD	Strategy AUM
A\$ Series 1	A\$10.24	-1.06%	-2.85%	US\$42M

For global equity investors, it is common knowledge that the Japanese market trades below book value. Moreover, everyone knows that Japanese interest rates are about zero – and have been there for longer than we'd like to recall. We find it odd (very odd) that Japanese investors continue to believe the shares of a company will be a worse investment than holding an IOU from their government which promises to pay them back their principal in ten years and 0.8% in interest payments each year. Unfortunately, this peculiar Japanese strain of pessimism has become less unique, as more countries find their capital markets showing similar characteristics where investors prefer the certainty of low – often sub-inflation – interest rates and capital guarantees than a share of future earnings and a higher dividend yield.

Although we continue to favour equities over bonds, we can accept why the Japanese equity market – in the aggregate - trades on a low Price-to-Book ratio (PBR). There are two reasons why this might be justified. First, with under-leveraged balance sheets and low profit margins, many Japanese companies generate a low return on equity (RoE). If the cost of equity (implied) is higher than the return on equity, then one is suffering from an opportunity cost and the investment is unattractive. That is the theory at least, although it seems counter-intuitive that the implied cost of equity rises in bear markets and thus raises the bar for returns of equity whereas in a raging bull market the implied cost of equity falls and masks the inadequate returns of many companies. Notwithstanding these misgivings, we do prefer bull markets.

The second reason that explains the low PBR is more tangible and deals with the valuation of assets on the balance sheets of Japanese companies. If a company's assets are 100 and its liabilities are 50, then its equity is the residual (50). Given the sad fact that liabilities are rarely overstated, the swing factor in determining the value of equity is the valuation of the company's assets. After prolonged periods of negative or low returns on assets, the assets are written down and equity suffers disproportionately. The highest profile case of this is that of Sharp, which finally came clean on August 2nd and slashed its forecast for the current financial year to March 2013. The company had forecast a net loss of Y30bn but at the Q1 results announcement, this blew out to a forecast loss of Y250bn. Some of this was due to greater operating losses on the LCD TV business, and some was due to costs associated with redundancies, but a sizeable portion was a reduction in asset values. Sharp's net fixed assets at March 2012 were Y872 bn and their stated shareholders' equity was Y 645bn. The market's

confidence in Sharp's valuation of assets was damaged and the shares fell to a near 40 year low.

Other companies in the consumer electronics sector are viewed with scepticism for similar reasons. Operations at companies like Sony, Panasonic, NEC and Fujitsu have been struggling under bloated payrolls, greater Asian competition and a strong Yen, and all trade on PBRs of between 0.5x and 0.75x. Their shares trade where they were at in the 1970s and what has surfaced at Sharp will very likely happen with them too. Sharp's shares trade on 0.37x historic book value, but with the forecast loss this rises to 0.6x. Until they - and the others - demonstrate they can generate a sustainable higher return on assets, it is unlikely that any of these discounts will narrow much.

We have not invested in these companies for many years but we do regard ourselves as value investors and our portfolios demonstrate this preference for value. Unfortunately, value has been underperforming in Japan for the past three years (as it has in Europe and the USA) and perhaps it is this growing awareness that some sectors are not as "cheap" as they seem which has thwarted the market's usual reversion to mean. Perhaps it is as simple as the old explanation of performance that when growth is scarce - as it is in most countries these days – investors pay up for companies that are generating earnings growth while when growth is abundant, cheap (value) stocks come into favour.

The Fund's negative return was due in some part to the continued outperformance of the Nikkei index over the Topix. A significant part of our short position was in Nikkei futures shorts and this contract rose 1.6% while the Topix index fell 0.6%. In addition to this, our long positions marginally underperformed the index in the month - whereas they have outperformed YTD – with financials and industrials detracting most. The Fund's biggest holding is Mitsubishi UFJ Financial which fell almost 7% in August while Hitachi and Sumitomo Electric Industries together accounted for over 50bps negative return. Both these holdings are over 5% and since month-end, both have largely recovered their losses. JX Holdings, Daiichikosho and Shin-Etsu Chemical were the biggest winners and we just took profits in Shin-Etsu at Y4450 after a successful entry below Y4000.

We head to Japan next week for company visits and to try and make sense of the changes in Japanese politics. Our confidence that we will learn something of value from the company meetings is a great deal higher than when it comes to Japanese politics but I hope my low confidence is misplaced and look forward to reporting back in the next monthly.

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Recent 3 month Fund Exposure

% of NAV in	Jun 12	Jul 12	Aug 12
Long Stock Positions	80.22	78.66	79.15
Short Stock Positions	-15.62	-9.07	-13.86
Index Futures	-21.30	-24.71	-23.73
Equity Derivatives	-	-	-
Net Exposure	43.30	44.88	41.56

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Position Concentration

	Top 5	Top 10
Longs	30.71%	50.09%
Shorts	-11.96%	-
Total no. of positions	33	

Top Five Positions

Mitsubishi UFJ Financial Group Inc
Hitachi Ltd
Sumitomo Mitsui Financial Group Inc
Itochu Corp
Sumitomo Electric Industries Ltd

Winners

JX Holdings Inc
Daïichikoshō Co Ltd
Shin-Etsu Chemical Co Ltd
Secom Co Ltd
SBI Holdings Inc (short)

Losers

Mitsubishi UFJ Financial Group Inc
Nikkei Index Futures (short)
Sumitomo Electric Industries Ltd
Hitachi Ltd
Sohgo Security Services Co Ltd (short)

Sector Exposure as at 31 August 2012

	Longs	Shorts	Net
Consumer Discretionary	14.24%	-	14.24%
Energy	4.54%	-	4.54%
Financials	22.09%	-4.61%	17.48%
Futures	-	-23.73%	-23.73%
Industrials	24.54%	-6.24%	18.30%
Information Technology	10.73%	-3.01%	7.72%
Materials	3.01%	-	3.01%

Performance Contribution	Longs	Shorts	Futures	Other	FX Forwards	Total
August 2012	-0.70%	0.06%	-0.54%	0.12%	N/A	-1.06%

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Historical Returns – Distribution Reinvested

Optimal Japan Trust Net Monthly Returns in AUD %

Annual Distributions

Year to Jun 00 *Year to Jun 01* *Year to Jun 02* *Year to Jun 04*
A\$1.4158 *A\$0.8989* *A\$0.8983* *A\$0.4713*

Year to Jun 05 *Year to Jun 06* *Year to Jun 07*
A\$1.4218 *A\$1.24* *A\$2.4179*

Year to June	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	YTD
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The table below outlines the monthly returns of the Trust's Series 1.

2003			1.68	-4.38	-3.66	-0.42	1.80	1.98	0.41	-0.10	2.55	3.48	3.07
2004	1.54	5.20	3.86	3.55	-1.67	3.06	-0.33	1.24	7.11	0.15	-1.14	3.93	29.46
2005	-2.14	4.01	0.23	-1.21	1.30	1.51	2.74	2.02	0.07	-0.14	0.99	1.47	11.24
2006	1.81	3.68	6.81	1.36	2.41	4.38	1.82	0.43	3.86	0.35	-4.05	0.18	25.14
2007	-0.79	1.43	0.13	2.10	0.77	2.49	1.99	0.55	-1.03	1.35	3.45	2.28	15.65
2008	-0.87	-6.98	1.88	0.35	-6.70	-4.69	-6.67	2.21	-0.67	6.20	1.34	-5.91	-19.57
2009	-0.83	-5.34	-0.09	-0.44	-6.38	3.22	-1.74	-2.15	1.91	0.47	0.84	-0.46	-10.84
2010	0.28	2.59	-4.87	-0.66	-5.15	3.02	1.95	-1.53	5.74	2.76	-5.91	-3.24	-5.66
2011	0.49	-1.96	2.89	0.97	1.34	3.89	3.38	2.12	-3.46	-0.54	0.90	0.09	10.32
2012	-0.36	-3.94	-0.74	-0.09	-2.54	-0.29	1.16	4.87	1.46	-2.87	-4.99	2.53	-6.06
2013	-1.80	-1.06											-2.85

The table below outlines the monthly returns of the Trust's Initial Series since its inception in December 1999.

2000						0.58	-0.32	12.76	8.99	-1.53	2.45	11.82	38.99
2001	-9.05	4.02	-0.37	0.90	-0.18	-3.86	-2.34	3.13	1.36	8.47	-2.14	3.96	2.82
2002	-2.87	1.49	-3.58	1.77	-3.89	-5.46	1.10	1.47	2.07	-0.26	7.13	-2.92	-4.54
2003	-1.46	-1.39	2.04	-4.47	-3.65	-0.44	1.80	1.98	0.41	-0.20	2.65	3.97	0.89
2004	1.91	5.90	3.81	3.58	-1.73	3.02	-0.33	1.22	7.01	0.23	-1.20	3.95	30.56
2005	-2.26	4.03	0.82	-1.55	1.65	1.92	2.83	2.05	0.00	-0.14	1.04	1.37	12.22
2006	2.38	4.15	6.71	1.31	2.39	4.30	1.82	0.42	3.79	0.34	-4.04	0.24	26.09
2007	-0.77	1.46	0.13	2.72	0.99	2.62	1.96	0.58	-0.99	1.35	3.47	2.23	16.82
2008	-0.89	-6.99	1.85	0.40	-6.68	-4.73	-6.62	2.17	-0.71	6.19	1.42	-5.97	-19.60
2009	-0.78	-5.37	-0.08	-0.42	-6.38	3.23	-1.74	-2.21	1.90	0.53	0.79	-0.44	-10.82
2010	0.26	2.54	-4.79	-0.72	-5.15	3.05	1.94	-1.54	5.81	2.70	-5.94	-3.25	-5.71
2011	0.47	-1.86	2.84	1.01	1.36	3.86	3.37	2.09	-3.44	-0.51	0.85	0.17	10.44
2012	-0.42	-3.90	-0.79	-0.09	-2.49	-0.27	1.10	4.89	1.47	-2.89	-4.99	2.49	-6.16
2013	-1.71	-1.10											-2.79

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