MONTHLY REPORT TO SHAREHOLDERS OF OPTIMAL JAPAN TRUST

Optimal FUND MANAGEMENT

Monthly Performance % - *as at 31 May 2018*				
	NAV	**May**	**YTD**	**AUM**
A$ Series 1	A$ 9.629	0.83%	-2.63%	A$7M

In the May 4th edition of Grant's Interest Rate Observer, Jim Grant, the estimable founding editor of the eponymous fortnightly tells us: "The difference between bonds and stocks is that corporate managements are out to elevate the latter (to which group they themselves belong), even at the expense of the other." That is clearly true in the United States and the other Anglo-Saxon financial markets and usually true in the developed markets of continental Europe. It is not however, an accurate depiction of Japan's corporate world, or that in a number of the other markets in Asia.

Our experience has been that corporate managements in Japan are focused in the main on making sure they dutifully meet their obligations to their creditors as stocks is not a group to which they belong. This situation is changing slowly with the introduction of Government-led efforts to improve corporate governance and shareholder returns, but in the vast majority of cases, the senior management own so few shares in the companies they run, that the rise or fall in the share price will have minimal impact on the way they live, or will spend their retirement. Finding exceptions to this rule is the task of the active investor in Japan and is an area we focus heavily upon.

As a rule of thumb, we like to find companies where the founder still owns a significant stake in the shares. Studies in various markets have concluded that founder companies (however defined) tend to produce better returns than that of their relevant stock index, and our own experience in Japan backs this up. Where there is no founder, or major shareholder, in charge of the business, one needs to form a view as to whether one's minority interest will be well looked after by management. Actions – as evidenced though the historical financial ratios – will tell you a lot, but as any investor knows, the best returns often come from companies where there is change afoot, taking the company from bad to better, or perhaps decent to excellent. This is the job that an active stock picker in Japan now faces, and the good news is that there is a groundswell of support for change, and this trend will be in place for quite a long time. It is coming from a very low base after all.

The Fund's positive return for May is welcome, as we have had a stuttering first few months to the year, but it would be remiss of us to pass over the large contribution to the total return that came from our position in Tokai Carbon. The shares had risen from Y270 to Y750 in the year leading up to our visit on August 21st 2017 and as any value investor knows, it is very difficult to buy a stock which has almost tripled in the prior year. Nevertheless, we felt confident that the earnings recovery was still not well known and that even at Y750, the shares were cheap with a PBR based on CY2016 book value of 0.8x. Due to conditions for their mainstay carbon black and graphite electrodes as well as expenses associated with staff cuts and general cost cutting, CY2016 saw the company report an operating loss of almost Y10bn. This year, the consensus is that their operating profit will reach Y64bn and EPS will reach almost Y240. Since we bought our stake in late August 2017, the shares have rallied to over Y2100 and trade at almost three times book value.

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The company is in the cyclical businesses of producing carbon black – where they are the world's ninth largest producer – and graphite electrodes. Carbon black is mainly used in the production of vehicle tires and world demand is in excess of current supply as the major producers have chosen not to invest in new capacity. Operating profit margins at both Cabot Corp of the US (biggest) and Orion Engineered Carbons of Luxembourg (third biggest) are at their highs and Tokai Carbon believes that 10% is a "good sustainable" level.

Where the cyclical story becomes more secular is in the graphite electrode division. Graphite electrodes are an essential element in the production of steel using the electric arc method as opposed to blast furnaces. China is the world's largest steel producer and the industry consists of a few large blast furnace makers along with many smaller makers who are often using outdated, inefficient methods and producing a lot of pollution in the process. If one believes that the Chinese people – and therefore the Chinese government – are serious about reducing environmental pollution, and in the process having a more profitable and efficient steel industry, there is an inevitable move towards closure of small blast furnaces in favour of less polluting, modern electric arc furnaces. The global graphite electrode industry is concentrated with Japan's Showa Denko now in top spot following its acquisition of SGL (Germany) and Tokai Carbon in 5th place behind Graftech International and two Indian producers. To produce graphite electrodes requires needle coke (stay with me) and there is a global shortage of needle coke capacity. The production of this is a dirty business and cannot be increased quickly. This needle coke shortage is limiting any increase in supply of graphite electrodes and thus the latter's price is going up. When we visited Tokai Carbon in August 2017, they were selling GE at $2,500-3,000/MT whereas the current price is thought to be at $10,000/MT. The unwillingness of industry to invest is part of the reason why supply/demand is now so tight, but rising demand is also due to long term changes in China to a less polluting industrial policy. For this reason, we continue to believe the shares are attractive, in spite of the re-rating in book value over the past year.

On our recent visit to Japan, we were struck by the obvious presence of loads of foreign tourists. It seems that every "undiscovered" Japanese restaurant in Tokyo is now easily found on Chinese, Taiwanese and Korean gourmet traveler sites and even the Okura Hotel has resorted to the nasty western practice of raising room rates. Following the success in lifting annual foreign visitor numbers from under 7mn when PM Abe took office, to 30mn now, the government has stated its new goal is to get 60mn tourists by 2030. If this is to happen, the 30mn extra visitors will need to go further afield than Tokyo, Kyoto, Fukuoka and Osaka, but given the first class communications and transportation infrastructure across regional Japan, this is not an impossible dream. It will require more, and more varied, accommodation choices however, as the current stock of rooms is not great and we suggest there should be opportunities for investors, public and private, to profit from this new source of demand. this new source of demand.

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Recent 3 month Fund Exposure			
% of NAV in	Mar 18	Apr 18	May 18
Long Stock Positions	95.92	98.68	93.72
Short Stock Positions	-3.24	-2.97	-6.39
Index Futures	-	-	-
Index Options	-	-	-
Net Exposure	92.68	95.71	87.33

Optimal FUND MANAGEMENT

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

Position Concentration	Top 5	Top 10
Longs	31.97%	53.78%
Shorts	-6.39%	-
Total no. of positions	27	

Top Five Positions
Mitsubishi UFJ Financial Group Inc
Tokai Carbon Co Ltd
SMC Corp
Hitachi Ltd
Horiba Ltd

Winners
Tokai Carbon Co Ltd
Horiba Ltd
Hazama Ando Corp
Murata Manufacturing Co Ltd
Nishimoto Co Ltd

Losers
Mitsubishi UFJ Financial Group Inc
Mitsui OSK Lines Ltd
Mazda Motor Corp
Izumi Co Ltd
Kasai Kogyo Co Ltd

Sector Exposure *as at 31 May 2018*	Longs	Shorts	Net
Consumer Discretionary	22.35%	-3.30%	19.05%
Consumer Non-Discretionary	4.89%	-	4.89%
Energy	3.44%	-	3.44%
Financials	10.47%	-	10.47%
Futures	-	-	-
Health Care	-	-3.09%	-3.09%
Industrials	18.31%	-	18.31%
Information Technology	14.21%	-	14.21%
Materials	16.54%	-	16.54%
Telecommunications	3.51%	-	3.51%

Performance Contribution	Longs	Shorts	Futures	Other	FX Forwards	Total
May 2018	1.35%	-0.20%	-	0.02%	-0.34%	0.83%

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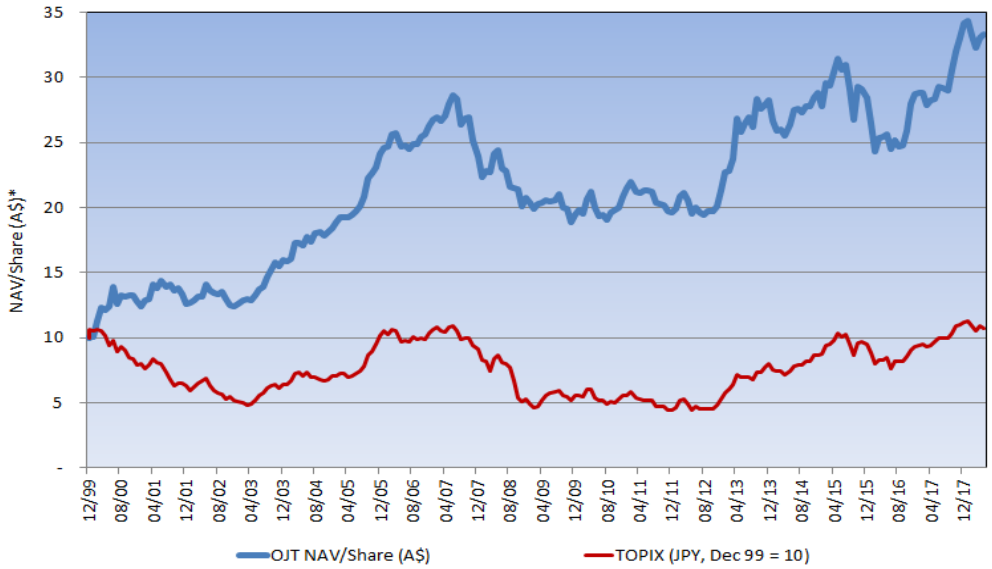
Portfolio Performance as of *31 May 2018*



* Total Return - NAV grossed up to include reinvestment of Distributions

Historical Returns – Distribution Reinvested

Optimal Japan Trust Net Monthly Returns in AUD %

Annual Distributions

Year to Jun 00 *A$1.4158*	***Year to Jun 01*** *A$0.8989*	***Year to Jun 02*** *A$0.8983*	***Year to Jun 04*** *A$0.4713*
Year to Jun 05 *A$1.4218*	***Year to Jun 06*** *A$1.2446*	***Year to Jun 07*** *A$2.4179*	***Year to Jun 14*** *A$2.8013*
Year to Jun 15 *A$0.2631*	***Year to Jun 16*** *A$0.5317*	***Year to Jun 17*** *A$3.0706*	

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
Series 1 (Inception August 2002)													
2018	0.42	-3.21	-2.83	2.25	0.83								-2.63
2017	0.41	-0.12	-3.13	1.31	0.22	3.19	-0.10	-0.69	5.44	4.56	3.12	3.58	18.94
2016	-6.82	-8.23	4.34	0.12	0.80	-4.38	2.94	-1.87	0.07	4.76	7.73	2.91	1.08
2015	-3.51	6.35	-0.72	3.61	3.41	-2.69	1.03	-6.01	-7.96	9.34	-0.53	-2.30	-1.37
2014	-5.91	-2.71	0.37	-1.68	3.12	4.40	0.27	-1.02	1.90	-0.08	2.37	1.32	1.92
2013	6.42	0.75	3.82	12.97	-3.76	2.58	1.72	-2.82	8.21	-2.62	1.03	1.57	32.71
2012	1.16	4.87	1.46	-2.87	-4.99	2.53	-1.80	-1.06	1.17	0.39	1.73	6.05	8.41
2011	3.38	2.12	-3.46	-0.54	0.90	0.09	-0.36	-3.94	-0.74	-0.09	-2.54	-0.29	-5.57
2010	1.95	-1.53	5.74	2.76	-5.91	-3.24	0.49	-1.96	2.89	0.97	1.34	3.89	7.03
2009	-1.74	-2.15	1.91	0.47	0.84	-0.46	0.28	2.59	-4.87	-0.66	-5.15	3.02	-6.14
2008	-6.67	2.21	-0.67	6.20	1.34	-5.91	-0.83	-5.34	-0.09	-0.44	-6.38	3.22	-13.41
2007	1.99	0.55	-1.03	1.35	3.45	2.28	-1.01	-6.98	1.88	0.35	-6.70	-4.69	-8.88
2006	1.82	0.43	3.86	0.35	-4.05	0.18	-0.79	1.43	0.13	2.10	0.77	2.49	8.85
2005	2.74	2.02	0.07	-0.14	0.99	1.47	2.01	3.68	6.81	1.36	2.41	4.38	31.38
2004	-0.33	1.24	7.11	0.15	-1.14	3.93	-2.22	4.01	0.23	-1.21	1.30	1.51	15.15
2003	1.80	1.98	0.41	-0.10	2.55	3.48	1.54	5.20	3.86	3.55	-1.67	3.06	28.63
2002									1.68	-4.38	-3.66	-0.42	-6.73

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