

Monthly Performance % - as at 31 August 2018

| | NAV | August | YTD | AUM |
|--------------|-----------|--------|--------|-------|
| A\$ Series 1 | A\$ 7.865 | -2.76% | -7.31% | A\$9M |

A little Chinese gold dust goes a long way – for some

China is a massive country with a big impact in many areas, not all of which is welcomed by those impacted. The US government of Donald Trump is hoping to reduce what they see as a negative impact from China's trade policies and other governments (like Australia's) are seeking to reduce the risk of political damage from information gathering by barring Chinese telecoms companies from tendering for government contracts for telco network infrastructure. The real impact of China's actions is more nuanced and only the passing of time will allow us to judge whether these actions helped or hurt.

The impact of Chinese demand, be it real, projected or imaginary, is definitely felt in equities markets and fortunately it is often in association with higher prices. We, like most people, like higher share prices. In this letter we will mention a few companies (Japanese and Chinese) which are all definitely affected by Chinese demand and dreams, and will show how the associated market gold dust is not distributed evenly or, in our view, fairly on every stock.

We have mentioned *Tokai Carbon* in a previous letter. It has been one of our best investments over the past year. This is a low profile but successful maker of carbon black (it goes into auto tires), fine carbon and graphite electrodes – which is where China comes in. But first, some basic facts relating to Tokai Carbon as an investment: the market cap is US\$4bn, and the shares trade on a PER for the current year of 6x. The company's return on assets (RoA) is 28% this year, the RoE is 42%, while the PBR is 2.3x. Some might explain the cheap valuation by the fact that this is a company in a cyclical business so at times of high profitability, it only commands a lowly rating because profits will fall with the next economic down cycle. That is partly true, but the fact that the Chinese government wants a cleaner steel industry with more modern, electric-arc furnace steel production will create demand for Tokai Carbon's graphite electrodes and keep pricing high. It will reduce the cyclical nature of Tokai Carbon's profits and provide a cushion to earnings in the years ahead. A sixfold rise in this year's operating profits notwithstanding, precious little investment gold dust remains on the shares now, but with Chinese demand real and sustainable, we believe it will attract more and expect the shares to perform well.

Another Japanese company that we like and which has done a fantastic job selling to Chinese consumers is *Pigeon*. Pigeon is

Japan's leading maker of milk bottles for babies as well as other items related to feeding. The company has a market cap of US\$6bn, and its shares trade on a PER of 42x. Over the past six years, the shares have risen ninefold, the company's operating profits have grown from Y5bn to Y20bn and the OP margin has jumped from 8.2% to 20%. The rise in profits and profitability is impressive (the RoA is 21%), but simple arithmetic tells us that the shares have been significantly re-rated with the price rise overshadowing the increase in profits. We admire the company and think they have done, and continue to do, a great job in positioning themselves as the producer for loving, aspiring parents who want the best for their baby. Chinese sales have grown rapidly over the past few years and this year will account for about 35% of the company's total – exceeding their Japan sales for the first time. They also have meaningful sales in Singapore and in the US (after an acquisition) and with perfect hindsight, we wish we had been prepared to pay 20 times that the shares used to trade at before the Chinese gold dust landed in 2013 and took the shares to PER levels of more than 40x that we now see. While the shares seem over-valued to us, we can't deny that the China impact has been real and very positive.

The third example of China's gold dust effect is *Shiseido*. In this instance, we remain very dubious of the valuation as it factors in many future years of projected benefits from Chinese demand in spite of this being a company which has had a peak Operating Profit Margin (OPM) of only 8.4% over the past 20 years and has actually lost money at the operating level in 5 of those years. Admittedly, they are projected to achieve a record 11% OPM in the current year, but for all that, the shares (with a market cap of US\$27bn) trade on 39x PER, 6.5x PBR and with a return on assets of only 9.3%. By the standards of most companies, an RoA of 9% is good, but most companies do not sell for 39 times their profits. The share of sales going to China is estimated at not quite 17% in the current year, rising to 18% in 2020. As for Operating Profits, China will represent almost 20% of the company total this year and remain steady at that level in the coming two years. Sales growth in China is solid without being spectacular and profitability is good (13%) but well below the level that they get from sales in Japan. With competition from the global cosmetics giants, Japanese rivals (like Pola Orbis and Kanebo) and local Chinese makers, we are doubtful if the rosy sales and profit forecasts will be met and believe the shares are over-priced.

At the absolute extreme of the gold dust rainbow is the Chinese

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company *Meituan Dianping*. This company will list in Hong Kong soon (September 20th) and using the indicative price range expected for the IPO, it will be valued at almost US\$55bn. The company, described as an online food delivery-to-ticketing platform, aims to help consumers “eat better, live better”. After the astounding business and share market success of companies such as Amazon, TenCent, Alibaba, Facebook, Uber and many others, it would be foolish to think that Meituan Dianping’s shares are destined to disappoint, but with an operating loss forecast for this year of RMB 11bn (US\$1.6bn), an assumption of a near tripling of sales over the coming three years and an operating profit of only RMB23.6bn(US\$3.5bn) in 2021, it is clear that the IPO’s underwriters are wearing rose coloured glasses. The gold dust is thick on the ground around this one.

There is great dispersion among stocks now with many investors willing to trade ecommerce and disruptive technologies at almost any valuation while cyclical or value stocks get cheaper regardless of their profits and prospects. As we saw in 1999, these market dispersions can go to crazy extremes, and we do not see the same insanity today that was evident then, but eventually bubbles burst, the tide goes out, we realise that the emperor wears no clothes and prices adjust.

We just have to make sure we catch the next *Pigeon* before the gold dust has arrived.

In the middle of August we took to the task of restructuring the fund’s investments in line with the expanded Japan and Asia mandate. This was in an atmosphere of increased volatility and heightened fears over the deepening trade war between the US and China. With such unpredictability, many investors appear afraid of their own shadows and react with haste at the merest whisper of any news. The backdrop provided an interesting period in which to be accumulating names. By the end of the month, we had added eight new names to the portfolio while also adding to high conviction positions in our Japan book. Our goal in building the non-Japan Asia portion of the fund has been to look through the short-term and accumulate holdings in superior companies with great long-term prospects at attractive prices. One such example is Xiabuxiabu Catering.

Xiabuxiabu Catering is a Hong Kong-listed company that operates casual hot pot restaurants in mainland China. The company is owned and operated by a highly motivated management team with the founder, Kuang-Chi Ho, the largest shareholder at over 41% of equity outstanding. Alignments of interest are particularly strong, but minority shareholders are afforded some added protection through the strength of the governance in the company and its dividend policy.

The company’s competitive advantage is its brand positioning, vertical integration, asset-light approach and its attractiveness to landlords as a source of foot traffic. All of this provides it with a defensible moat in a highly competitive market and

SYDNEY: Level 5, Wyoming, 175 Macquarie St, Sydney NSW 2000 **Phone:** 61 2 8239 3300 **Fax:** 61 2 8239 3333 **Email:** optimal@optimalasia.com

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affords it a market leading operating margin. The hub and spoke model works exceptionally well in the hot pot restaurant format and, vitally, ensures a standardised and high-quality product. The firm is highly cash generative, has no debt on its balance sheet and can expand new store openings funded purely through cash generation. New stores are typically breakeven in less than three months and are fully paid back within two years. The company currently operates around 700 stores and is looking to expand to 1000 stores over the coming years, while continually refreshing its existing footprint. Xiabuxiabu also aggressively targets new growth avenues, such as home delivery services, new store formats and the integration of WeChat technology into its facilities. The latter serves to lower costs and smooth the whole customer experience, providing seamless bookings, payment and instant sharing of content on social media. The company anticipates growth greater than 30% this year, yet it demands a material valuation discount to its peer group in China.

Xiabuxiabu, despite its purely domestic Chinese business, has not been able to escape the market’s turbulence. During the month, the company announced positive quarterly results that were not in-line with an over ambitious street’s short-term expectations but painted a good long-term picture for the company. The market reacted with predictably as investors who were looking for any reason to pare back exposure to China sold aggressively. This weakness allowed us to begin our holding at a valuation that is highly attractive given the overall operating quality of the business, our alignment with the founder shareholder and its long-term growth prospects.

Important change to Optimal Japan Trust

In light of the increasing importance of Asia to Japan, we have broadened the Fund’s investment mandate from Japan-only to one which covers all of Asia. This allows us to capitalise on the extensive research we have undertaken to identify Asia’s best managed and most attractively valued businesses and in selectively adding these to the fund, we expect to improve the fund’s overall return and quality. Japan will remain the Fund’s core and major focus.

As a result, the Fund’s name has changed to **Optimal Japan and Asia Trust**. We have a new Trust Deed and Information Memorandum which formalise these changes, and will send them out to anyone wishing to invest.

We have lowered the Fund’s performance fee from 20% to 15% with all other major terms remaining the same.

Please contact us for more information and join the Optimal team investing in this improved version of the Fund.

Recent 3 month Fund Exposure

| % of NAV in | Jun 18 | Jul 18 | Aug 18 |
|-----------------------|--------|--------|--------|
| Long Stock Positions | 92.19 | 86.28 | 82.03 |
| Short Stock Positions | -3.57 | -3.42 | -2.28 |
| Index Futures | - | - | - |
| Index Options | - | - | - |
| Net Exposure | 88.62 | 82.86 | 79.75 |

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 | 28.09% | 50.46% |
| Shorts | -2.28% | - |
| Total no. of positions | 21 | |

Top Five Positions

| |
|------------------------------------|
| SMC Corp |
| Hitachi Ltd |
| Mitsubishi UFJ Financial Group Inc |
| Tokai Carbon Co Ltd |
| JX Holdings Inc |

Winners

| |
|-------------------------------------------|
| Taiwan Semiconductor Manufacturing Co Ltd |
| Teijin Ltd |
| Royal Holdings Co Ltd (short) |
| Ayala Corp |
| CK Hutchison Holdings Ltd |

Losers

| |
|------------------------------------------------------|
| Xiabuxiabu Catering Management China Holdings Co Ltd |
| Horiba Ltd |
| Kasai Kogyo Co Ltd |
| Hitachi Ltd |
| Nishimoto Co Ltd |

Sector Exposure as at 31 August 2018

| | Longs | Shorts | Net |
|-------------------|--------|--------|--------|
| Consumer Disc | 17.81% | -2.28% | 15.53% |
| Consumer Non-Disc | 2.16% | - | 2.16% |
| Energy | 5.06% | - | 5.06% |
| Financials | 9.23% | - | 9.23% |
| Industrials | 14.66% | - | 14.66% |
| Technology | 23.19% | - | 23.19% |
| Materials | 9.92% | - | 9.92% |
| Telecom | - | - | - |

Country Exposure as at 31 August 2018

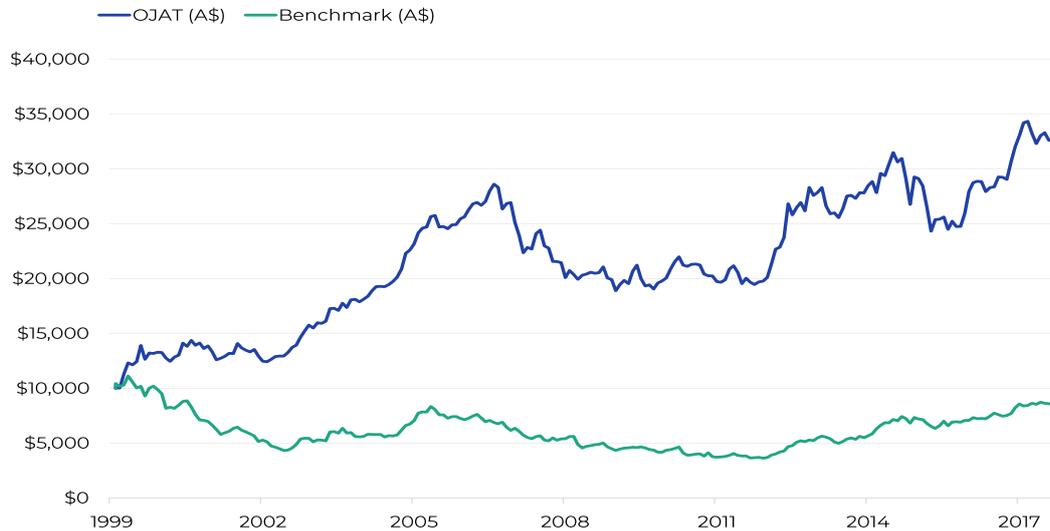
| | Longs | Shorts | Net |
|-------------------|--------|--------|--------|
| Hong Kong / China | 17.70% | - | 17.70% |
| India | - | - | - |
| Japan | 53.36% | -2.28% | 51.08% |
| Philippines | 3.67% | - | 3.67% |
| Singapore | 3.49% | - | 3.49% |
| South Korea | - | - | - |
| Taiwan | 3.81% | - | 3.81% |
| Thailand | - | - | - |

| Performance Contribution | Longs | Shorts | Futures | Other | FX Forwards | Total |
|--------------------------|--------|--------|---------|-------|-------------|--------|
| August 2018 | -2.44% | 0.17% | - | 2.82% | -3.31% | -2.76% |

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Portfolio Performance as of 31 August 2018



Note: The benchmark from 20 December 1999 through 10 August 2018 was the Topix Index, thereafter it will be the MSCI AC Asia Index.

Historical Returns – Distribution Reinvested

Annual Distributions

Optimal Japan and Asia Trust Net Monthly Returns in AUD %

| | | | |
|------------------------------------|------------------------------------|------------------------------------|------------------------------------|
| 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 to Jun 18 A\$1.3383 |

| 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 | -2.06 | -0.06 | -2.76 | | | | | -7.31 |
| 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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