6th January, 2003

OAM Asian Recovery Fund

I am pleased to report a fourth consecutive year of outperformance by OAM Asian Recovery Fund. Last year, the Fund's NAV per share increased by 9.2% while its benchmark, the MSCI Asia Free ex Japan Index (US$) declined by 10.2%. Since its launch four years ago, the Fund's NAV per share increased by 94.4% versus a decline of 12.9% by the MSCI Asia free ex Japan Index (US$). More pertinently, I anticipate another good year for the Fund.

Asia ex Japan has many positive attributes that are absent elsewhere in the world. The Fund has a few additional strengths relative to a passive investment in the region that should continue to drive the Fund's historic outperformance. Low stock market valuations in the region top my list of positives attributes. I estimate that the average P/E ratio of the Fund's holdings on a look-through basis is about 8 and the average dividend yield is nearly 5%. Moreover, dividends in Asia are either free of withholding tax or subject to low rates of withholding tax. In general, the Fund's underlying holdings have little debt, and in many cases, the companies are cash rich. Elsewhere in the world, it is difficult to assemble a portfolio of companies selling at such low valuations. Where this is possible (outside Asia ex Japan), political and economic risk is far higher than in Asia, or the portfolio would contain companies with little or no growth prospects. In my view, the quality of the underlying holdings in the Fund is extremely high. Many of these companies are leaders within the growing niche markets that they serve.

The second major positive is the region's prospects for superior economic growth. Asia ex Japan is playing "economic catch-up" with the developed world. Unlike much of Europe and Latin America, the region is not hampered by socialist government policies. Hong Kong is the sole exception where the revenue-hungry government is beginning to adopt some socialist policies. Given Hong Kong's small size, it is an anomaly in the region that is unlikely to have much effect on Asia ex Japan in general. Economic growth and rising living standards for its people are the mantra of Asian politicians. This economic convergence between Asian livings standards and those of the developed world has many years to run. The work ethic of Asians is legendary. Their determination to work towards a better life makes this goal realistic.

Asia's third positive is that it experienced a deep financial crisis in the recent past that engendered a huge improvement in capital allocation by companies. According to ING the average debt/equity ratio of the more than 400 Asia ex Japan companies in their research universe is 35%. This compares to 70% in Europe and 160% in the U.S. Though there are disappointments from time to time, the overwhelming majority of companies in the Fund's portfolio are generating prodigious amounts of cash and are either reducing debt, returning it to shareholders through dividends and share repurchases, or investing it intelligently to grow their business.

The Fund's key advantage is that it invests in markets that are highly inefficient. The competition when investing in shares outside the main indices in Asia's largest markets is for the most part unsophisticated. This is the only possible explanation for the Fund outperforming its benchmark by more than 100 percentage points in 4 years with a portfolio that has been broadly diversified at all times. Encouragingly, competition does not seem to be increasing. Weak global stock markets and a less than sparkling performance by Asian stock market indices during the past three years has kept most of the more sophisticated foreign investors away. By and large, Asia ex Japan remains off the radar screens of large global investment houses and institutions who only have a few percent of their portfolios allocated to the region. What little money they have invested is concentrated in the large index names. This leaves unsophisticated local punters as the primary competition.

The second key advantage of the Fund is that well over half its assets are invested, on an underlying basis, in companies that serve the Asian consumer. Savings rates across Asia ex Japan average close to 30%. Contrast this with the U.S. where the savings rate is effectively zero and according to the Financial Times, the average household has credit card debts of US$8,000.00. As Asian living standards rise, the saving rate of its people will almost certainly fall as they become more confident about the future. This trend has a long way to run. When superimposed on the region's strong economic growth, it will likely result in booming Asian consumer spending. Asia's relatively young demographic mix will add impetus to this trend. While the Fund is in many ways a play on the coming boom in Asian consumer spending, Asian consumer plays are sparsely represented in the indices. The heavyweights in most Asian indices are still telecoms, banks and property companies. In Korea and Taiwan, steel, plastics, shipbuilding and semiconductors are the heavyweight index components.

There has been one disappointing development in the Fund this year. Two of the five core managers increased their fees. In both cases, I objected strongly but did not withdraw money from either manager. In one case, through a convoluted scheme, the manager effectively re-set the high water mark (HWM) above which they would earn performance fees. I pointed out to the manager that this was no different to executives at a company re-setting the exercise price on their options after the share price has declined. I also devised a solution which would enable them to restructure their fund and achieve their stated primary goal without effectively re-setting their HWM. The manager agreed to retain PricewaterhouseCoopers to examine my suggested solution and any other suggestions, so there is hope that shareholders will not be disadvantaged in this way. Shareholders may wonder why we did not withdraw our investment in these two funds. The short answer is that there are very few superb investment managers in Asia (or anywhere for that matter). Another reason is that several of the managers we use have caps on the amount of money they will manage so as to preserve their competitive advantage. It is therefore a fine balancing act to keep these managers "on their toes" without jeopardising the Fund's ability to place additional cash with them.

During my most recent trip to Asia, one of the Fund's other directors and I met an Asian fund manager who we have been monitoring for some time. This year, we anticipate investing in the manager's fund. This is likely to become the sixth core fund held by OAM Asian Recovery Fund. The average P/E of this new fund is 7 and the after-tax dividend yield of the portfolio is 6%. We are likely to invest $2-4 million in the new fund split between several subscriptions this year, subject to the amount of new money received by OAM Asian Recovery Fund. The new fund adds a 1.8% charge to the subscription price and deducts the same percentage from the redemption price. This is for the benefit of the Fund; it does not go to the investment manager. These charges mitigate the cost to long-term investors of subscriptions and redemptions. As the manager points out, she has made substantial subscriptions to the fund since launch and paid this charge each time and her investment return has been quite satisfactory. Nevertheless, there will be a small short-term negative impact on OAM Asian Recovery Fund's NAV each time we subscribe to shares in this new fund.

Investing in Asia is not without risk. In the past few years, China's economy has been a shining beacon in a relatively depressed world. The economy is booming. This boom and China's sidestepping of the Asian financial crisis in 1997-8 may sow the seeds of a coming bust. Too much money has been invested in China to try to take advantage of this boom and to get access to China's population of over a billion people. There are enormous construction booms taking place in China's cities, mainly along its coastline. I worry that this may result in due course in "see-through" buildings and unfinished projects like those seen across Asia at the end of the Asian financial crisis. Asian manufacturers have also expanded production rapidly to take advantage of the outsourcing boom. This may be starting to reach the point of overinvestment, much like in the technology and telecoms sectors in the late '90's. Longer term, I am very positive on China, so any bust would likely be no more than a "blip", albeit a painful blip. The Fund has significant exposure to China, though not through Chinese listed companies. The main casualties of the problems I see building in China are likely to be the state-owned banks who have been the most guilty offenders in misallocating capital. This looming problem in China will probably not materialize for a few years, but it is an important risk of which we are acutely aware.

Another risk is North Korea. The sabre-rattling between the U.S. and North Korea is likely to result in periodic falls in the Korean market. The Fund has significant exposure to South Korea, mainly because of the attractive valuations available in that market. It is unfortunate that the Bush Administration's foreign policy has destroyed Kim Dae-jung's constructive "sunshine policy" towards North Korea. A more porous border between North and South Korea seemed to be helping, until recently, end the Cold War in this part of the world. On balance, I think that a U.S. attack on North Korea is an outside possibility, but the situation is so fluid that this could change at any time.

The other risks to Asia are external. Many intelligent people worry about Japan. Its dysfunctional banking sector and deflation remain huge problems thirteen years after their stock market and real estate bubbles burst. These problems are well documented and no "hot money" is left in Japan. With little risk of capital flight, Japan's stock market indices might decline further, but probably in a gradual, orderly manner. If Japan seriously addresses its banking problem and deflation, its stock market could become one of the best performing markets in the world. The core of Japan's problem is that it has an aging population. The older majority who control Japan's savings (and the votes) benefit from deflation because it costs them less to live each year. This explains why Japan's politicians have not yet seriously tackled the country's problems and it explains why deflation has continued for so long. The big question is whether the pain has yet reached crisis proportions to provoke a serious and effective response to the problems. There are signs that Japan may have reached this point. A few days ago, the Secretary-General of the LDP, Japan's ruling party, described Japan as being in an emergency situation and that the central bank needs to stimulate inflation. A new governor of the Bank of Japan is due to be announced at the end of this month and will take over in March.

The bigger external risk in my view is the U.S. stock market. Valuations in the U.S. are still rich with P/E's in the high 20's using realistic earnings estimates that factor in the costs of options issuance and realistic pension fund accounting assumptions. Economically, the U.S. stands on shaky ground. Two-thirds of its economy is accounted for by consumption. So far, the American consumer has been relatively resilient in spite of suffering huge stock market losses. Consumption is being supported by credit card debt, and to an even greater extent by the withdrawal of equity in their homes. There has been an enormous boom in the U.S. in the refinancing of mortgages. As interest rates declined, Americans refinanced their mortgages at lower rates and in the process increased the size of their mortgages which became cheaper to service at lower interest rates. There is limited scope for interest rates to decline further in the U.S. In addition, U.S. real estate prices boomed in recent years and are now very high by historic standards relative to the size of the economy and personal incomes. These factors make falling U.S. real estate prices a high probability risk. A decline in U.S. house prices would remove the last prop to U.S. consumer spending, and by extension to the U.S. economy. If this happens, the economic fallout in the U.S. would be far worse than what we have seen in the past two years. I worry about the effect that this would have on a still richly valued U.S. stock market and the repercussions for the rest of the world.

On balance, I still expect a good 2003 for OAM Asian Recovery Fund. Many clients have more money invested in Europe than in Asia, following the recent redemption of our clients' large holdings in Asia Bond & Currency Fund. A better mix would be roughly equal proportions invested in Asia and Europe. In the past, we asked clients to complete a subscription form whenever they invest in OAM Asian Recovery Fund. This makes the rebalancing of clients' portfolios cumbersome. After reviewing the Discretionary Investment Management Agreement that every client signed, the directors concluded that Overseas Asset Management (Cayman) Ltd. has authority to invest cash held in a client's segregated account in the OAM funds. In coming months, we will therefore be investing some cash in clients' accounts in OAM Asian Recovery Fund to rebalance those accounts with relatively low exposure to Asia. In a few cases, clients expressed an aversion to Asia and this has been duly noted. If any client does not wish their portfolio rebalanced in this way, they should contact me.

The Association of Investment Management & Research (AIMR), of which I am a member, requires CFA charterholders to disclose their holdings in any security that they recommend to clients. In accordance with this requirement, my wife, through her investment holding company, owns 42,418 shares of OAM Asian Recovery Fund. In addition, Overseas Asset Management (Cayman) Ltd., which is largely owned by me and my wife, purchased 12,860 shares of OAM Asian Recovery Fund on 31st December, 2002. All directors' dealings in the Fund's shares have been disclosed to the Cayman Islands Stock Exchange in accordance with their Listing Rules. So, in conclusion, I look forward to a prosperous 2003 for OAM Asian Recovery Fund's shareholders.

Desmond Kinch
Chairman