Overseas Asset Management

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OAM Asian Recovery Fund

Dear Fellow Shareholder,

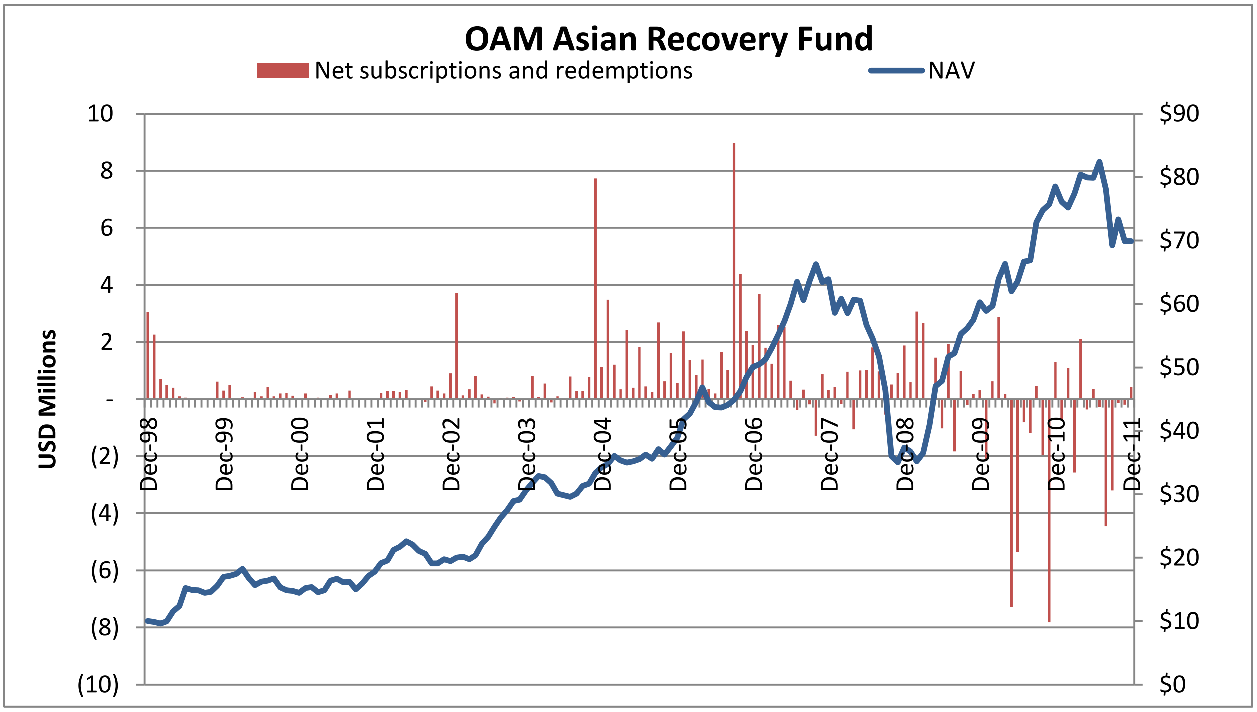
Performance

Last year was not a vintage that equity market investors will remember with fondness. In spite of strong economic growth in the region, Asian stock markets fell, in some cases quite significantly. While earnings increased, valuations decreased faster – by more than 20% - resulting in a negative return for equity investors. Most Asian currencies also declined against the US Dollar, thereby exacerbating negative equity market returns in US Dollars. The Fund does not hedge currency exposure because Asia ex Japan currencies are undervalued on a purchasing power parity basis and Asian government finances are in better shape than most other government finances so we think they will likely appreciate against the US dollar over the long-term.

In 2011, the Fund's benchmark, the MSCI Asia free ex Japan (US$) index declined by 19.2%. The Fund's NAV per share held up better, declining by 11.0%. Since the Fund's inception 13 years ago, the MSCI Asia free ex Japan (US$) index returned 6.4% per annum. Given that we launched the Fund at a time of extreme distress and ultra-low valuations, this is a surprisingly low return. We think that part of the explanation lies in valuations at the end of the period (today) being also low. The other part of the explanation, we believe, is that Asian indices do a poor job of capturing the economic growth of the region due to their composition. The Fund has historically done far better than the index, returning 16.1% per annum since inception, and giving shareholders since launch a sevenfold return on their investment. Furthermore, as I have pointed out in previous Chairman's statements, this superior return has been generated with less risk/volatility than the benchmark index.

Subscriptions and redemptions

Again this past year, the Fund had net redemptions. As I said last year, we would prefer to receive redemptions during times of strength rather than weakness. The chart below shows the Fund's net subscriptions and redemptions since inception.



It is clearly evident that once the Fund's NAV recovered to above $60 and reached a new high water mark, some clients decided to redeem part of their shareholding. I suspect that the psychology behind this decision went something along these lines. After suffering a 40% temporary loss on their investment in the Fund, some clients decided that they did not want to experience another loss of that magnitude, even if it did turn out to be temporary. They therefore decided to get out while they were ahead. Following the recent global stock market correction, historically attractive valuations are on offer in Asia and we are therefore holding relatively low levels of cash. If we have several million dollars in redemptions, we will need to sell one or more of our holdings which we can do with relative ease, but we are reluctant to hold more cash than we think is needed to cover a "normal" amount of redemptions.

An important point to mention is that my wife and OAM have never redeemed a single share of the Fund and in aggregate remain the Fund's largest shareholder. We remain confident about the Fund's future prospects. This raises another issue. I strongly believe that alignment of interest between a fund's manager and its shareholders is extremely important and overlooked too often by investors. We insist on the same from the Asian fund managers to whom we have allocated money. We also look for this alignment of interest of managers and directors with shareholders of companies in which we invest.

It is such an elementary part of good common sense, but as someone once told me common sense is remarkably uncommon.

Europe and China are the major uncertainties

Where could it all go wrong? There is an undeniable risk that European politicians could bicker to the extent that Italian bond yields are pushed to a level that forces Italy to default. If that happens, the European Union in its present form will be history. That is a scary prospect that would have severe negative repercussions on global financial markets. The fact that it is such a scary prospect and everyone knows it makes it an unlikely outcome in my view. Nevertheless, it is a possibility and is therefore a risk that cannot be ignored.

The other big risk in my view is China. My concerns are somewhat tempered by the fact that I have been reiterating these same China risks for the past nine years – go back and read past annual Chairman's statements. About a year ago, I met with Michael Pettis and listened to his arguments about why China's economic growth will slow significantly. His arguments are compelling, but importantly, the slowdown he expects will be in the export and investment sectors, while China's Government is likely to be successful in shifting growth towards domestic consumption. This plays well towards our investment strategy for the Fund. The risk is that such a transition could be painful, particularly to China's banks, and this could hurt China and possibly broader Asian markets.

This risk appears to be partially discounted in share prices. For instance, the China H share index is trading at close to a record low P/E of around 8.5. Historically, the index P/E has ranged from 8 to 28. However, 40% of the index is comprised of China state-owned banks and another 15% in Chinese insurance companies. The financial statements of Chinese banks belong in the same library as Alice in Wonderland. There is a huge amount of off-balance sheet lending taking place in China which will probably come back to haunt China's banks, and lending growth has been high in recent years while recorded non-performing loans are a low percentage of assets which seems unlikely to be true. Since all Chinese banks are state-controlled, there is no real danger of them going bust, but it seems unlikely that they will prove good investments, much to the chagrin of owners of China ETFs.

There is a saying about one of the largest securities firms in the West: "Making money for our clients is one of our top 10 priorities: you guess which one!" The same probably applies to shareholders of China's state-controlled enterprises. As Anthony Bolton who manages Fidelity China Special Situations plc said in a recent interview with the Financial Times:

"My problem with some of the big state-owned enterprises is that it is difficult to work out what the motivation is, and where shareholders rank in terms of their priorities. But I think I can find companies that are very definitely run for shareholders. At many of these, the chairman or chief executive is the biggest shareholder in the company, so evaluating him or her is important."

Why the S Curve is important

Let us take the example of Nestle Pakistan. Think of all the risks of investing in Pakistan over the past 10 years: corruption, currency devaluation, a major earthquake in Kashmir, the persistent threat of war with India, constant skirmishes on its western border with Afghanistan, rocky relations with the US Government, the assassination of Benazir Bhutto, and devastating floods. Yet, an investor in Nestle Pakistan over the past 10 years would have generated a return of 32.6% per annum inclusive of reinvested dividends measured in US Dollars. This equates to multiplying your investment nearly 17 times in just 10 years. There were three sources of that return: earnings growth, dividends, and P/E revaluation. The main contributor to returns was earnings growth. Between 2000 and 2010, Nestle Pakistan's revenue in US Dollars increased from US$110 million to US$1.25 billion while earnings per share (EPS) increased from 11 cents to $1.06. Breaking down the three components of Nestle Pakistan's 10-year return we get the following result:

	Cumulative growth	Contribution to annual return
EPS growth	864%	25.4%
P/E revaluation	40%	3.4%
Dividends		3.8%

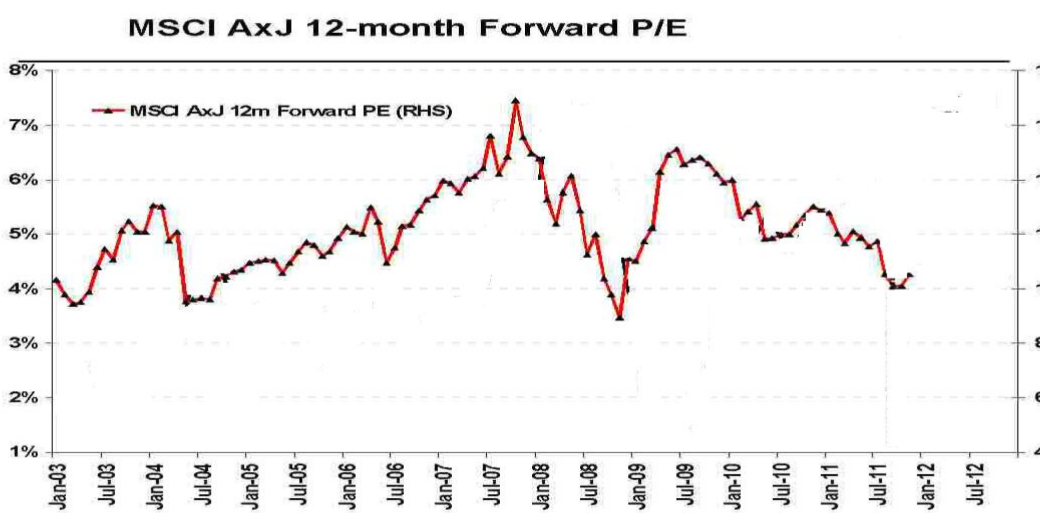
This example tells an important story. It is the story of the growing importance of Asia's massive population entering what they define as the middle class where they start using everyday consumer products that we in the West take for granted. Even after Nestle Pakistan has already achieved such stunning growth, the company still only sells 8 of Nestle's 28 billion dollar brands in Pakistan. Nestle's annual sales per capita in Pakistan are currently $7 – in India, with a similar GDP per capita to Pakistan, Nestle's annual sales per capita are around $1. As people in countries like India and Pakistan improve their living standards, more people buy Nescafe coffee and Kit Kat chocolate bars. India and Pakistan currently have GDP per capita of $1,000-1,500. In countries like Thailand and Colombia with a GDP per capita of $5,000-6,000, annual consumption of Nestle products is currently running at around $16 per capita. In Brazil, with a GDP of $11,000 per capita, annual consumption of Nestle products is $40 per capita. In the developed world, annual consumption of Nestle products typically averages around $60-70 per capita. As is evident from this example, the rapid growth in consumption of branded consumer goods takes place when GDP per capita climbs from $1,000 to $10,000. This is what is referred to as the S curve. Asia ex Japan is in the sweet spot of the S curve and will remain there for the next 20 years or so. This is the wave that we are trying to ride with OAM Asian Recovery Fund.

The other important point that we have learned from observing the likes of Nestle, Unilever, Coca Cola, L'Oreal, Danone, Kraft, MacDonalds, Wal-Mart, Tesco and other dominant consumer goods companies, fast food restaurant chains and supermarket retailers, is that the strong tend to get stronger. They tend to gain market share and improve their margins over time. They also have useful attributes as businesses such as low capital intensity, high free cash flow generation, and various barriers to entry that make them enduring businesses. Warren Buffett identified these traits in the US stock market and this helped him to generate superior returns for his shareholders. However, in many senses, there is an even bigger opportunity to generate returns from investing in these dominant consumer businesses in Asia ex Japan over the next 20 years. It is difficult, if not impossible, for us to calculate what percentage of the Fund's assets are invested in Asian consumer businesses, but we know that it is a high figure and it is several times higher than the percentage of such companies that are represented in benchmark indices. Moreover, with poor prospects for most of Asia's export sector, and concerns about a residential real estate bubble in China, we are gradually increasing our exposure to managers who focus on investing in companies that serve the Asian consumer.

Valuations

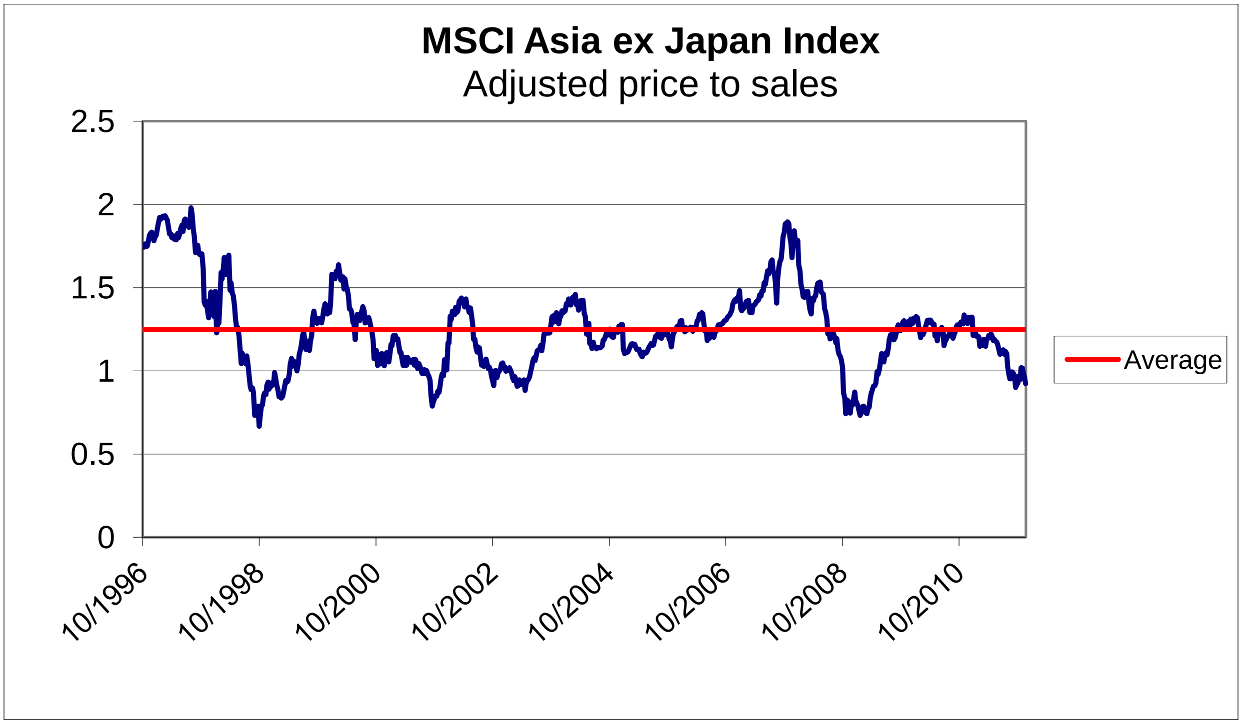
For sound reasons, Asian consumer companies sell at higher valuations than banks, real estate developers, and Asian manufacturing exporters. We would therefore expect the average P/E of the Fund's holdings to be higher than the average P/E of the benchmark Asian indices. This sounds like heresy coming from a "dyed in the wool" value investor. However, we think that it is worth paying a premium for better quality, visibility and likely growth in earnings at the companies the Fund owns on an underlying basis. There are structural reasons why cheap manufacturing, exports and massive investment are unlikely to be the primary drivers of Asian growth going forward. Deleveraging in the West will lead to tepid demand growth for imports from Asia. Asian growth has been too skewed by heavy investment spending, much of it mal-investment in half-empty residential buildings and poorly thought-out infrastructural spending, particularly in China. The Chinese Government is acutely aware of these facts and is implementing measures to redirect economic growth towards consumption.

We think that valuations in Asia ex Japan are currently cheap. The chart below shows how low P/E's are on a historic basis.



Source: MSCI, FactSet, Morgan Stanley Research. Fwc P/E data as of Nov 2, 2011

We estimate that the Fund's holdings sell at 11.2 times 2012 estimated earnings and a dividend yield of 3.8%. The Fund is therefore paying a very small premium to the market P/E for what we think are vastly higher quality earnings. We prefer to look at Price/Sales when trying to determine whether a market is cheap or expensive because this removes the cyclicality of profit margins. On this basis, Asia ex Japan equities look cheap.



Moving away from long/short or debt funds

Close observers of the Fund's performance will have noted that even though the Fund has historically outperformed Asian markets by a wide margin, the Fund's NAV per share has been less volatile than the benchmark index. We have in the past deliberately tried to reduce volatility and downside risk by investing in Asian long/short equity funds and Asian debt funds. By and large, this has been a failure. Yes, it did reduce volatility and while we did not lose money in these funds, they generally proved to be "dead money". The opportunity cost of what we could have made if we had allocated that money to our other fund managers measures in the millions. We have learned our lesson and we are sticking to our core competency of allocating money to managers with a proven ability to invest in companies at attractive valuations, generally with a bias towards Asian consumer companies and smaller companies that are overlooked and undervalued.

In the next few months, we expect to receive just over $2 million from DAC China Distressed Fund, a fund that invested in Chinese non-performing loans. If so, we will barely get our money back from this fund which is winding up after seven years. It appears that the rule of law is too weak and works too slowly in China to make it possible for this manager to make money even on non-performing loans with collateral that were purchased for cents on the dollar.

Just after year end, we received $8.3 million from Clairvoyance Asia Fund which is a long/short Asian technology sector fund that suffered massive redemptions. This was the case of a fund that formerly had a good track record but which grew too large to be able to nimbly buy and sell the shares of the smaller and medium-sized Asian technology companies where it built its track record. I had expressed concerns about the firm's rapid growth in assets under management on a previous trip to Asia. The lesson here is to be more persistent when instinct tells us that a firm is managing too much money. While we made money on this investment, these funds could have been better allocated elsewhere. This fund has now agreed to cap its assets under management, focus on one fund and not manage any segregated accounts, and it will also reduce its management and performance fees. W e may therefore re-invest about $3.5 million in the fund as we believe the manager has a high likelihood of returning to its pre-2010 track record. The manager has agreed to respect our previous high water mark on any subscriptions that we make to the fund this year.

We have already identified a home for a large portion of these redemption proceeds. We are allocating $5 million to a relatively new fund managed by an investment professional who I have known and respected for some time. His fund is small and is focused purely on Asian consumer stocks. As an early investor making a significant investment in the fund, we will be purchasing shares that pay no performance fees. Our move away from debt and long/short funds towards more long-only consumer focused equity funds may increase the Fund's volatility slightly. However, we do not expect much of an increase in volatility because the earnings of consumer companies tend to be a lot more stable than the overall market which usually results in their share prices falling less during downturns. More importantly, we expect the new holding to provide a significantly higher return over the long-term than the funds which are returning us money.

Conclusion

Since the Fund's launch at the start of 1999, we have been trying to do two things. The first is to allocate money to managers who we know and trust and who we think have the ability to select a portfolio of Asian equities, usually of smaller and medium-sized companies, that are mispriced on Asia's primarily retail-driven stock markets. Unlike the US which is a more sophisticated and efficiently-priced institutionally-driven market, Asian markets are driven more by irrational greed and fear, hot money flows in and out of markets, and many smaller companies' share prices are still driven by market gossip rather than fundamental analysis. The second thing we have done from the start is to focus on the rise of the Asian consumer and allocate money to managers who focus on investing in companies that serve the Asian consumer. We have strayed from these two areas, but only at the margin. Now, we are refocusing on these two objectives which have served us well over the years.

The Fund has served its shareholders well over the years and I hope you will stick with us for many more years and profit from riding this powerful wave that I expect to continue delivering attractive riskadjusted returns. When we launched the Fund at the end of 1998 at a NAV/share of $10, I told clients that my personal objective was to increase the NAV/share to $50 in ten years. As it turned out, we did it in eight years. In my Chairman's statement written in January 2006, a year before reaching the $50/share target, I wrote:

"Going forward, I think that a return similar to last year's return of 13.8% is a more realistic objective than the 21.4% compound rate of return that has been achieved over the past seven years since the Fund's inception. If the Fund achieves a return of 12.5% per annum going forward, the NAV would reach $100.00 per share in 8 years."

The $100 target that I set six years ago means that the Fund's NAV/share would have to increase by 43% over the next two years for the target to be achieved. Though this is an ambitious target and one that should not form the basis for your return expectations over the next two years, I still believe that it is a realistic personal objective given the current level of valuations and my expectations for earnings growth.

Desmond Kinch, CFA
Chairman