Overseas Asset Management

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OAM Asian Recovery Fund

24th January, 2017

Dear Fellow Shareholder,

Last year, the Fund's NAV/share increased by 6.8%. This was a respectable outcome. Until the twin surprises of Trump's election victory and India's demonetisation, both on 8th November, our Fund was cruising for a double digit return for the year. During the year, the Fund's benchmark, the MSCI Asia ex Japan (US$) index increased by 2.9%. Whilst Asian currencies were stable last year, there was quite a wide dispersion in market returns, with China being weak, India flat, and Indonesia, Vietnam, Thailand and Taiwan being strong.

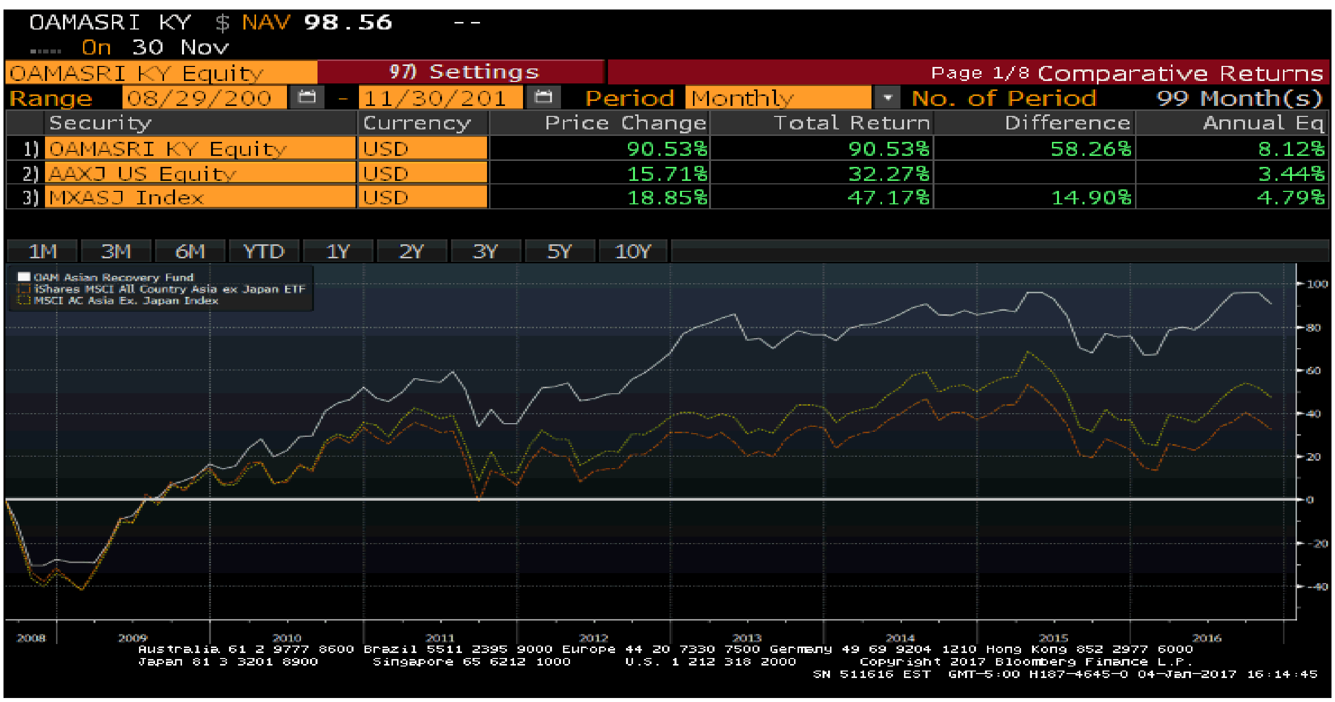
Country	Index	Market return	Currency return	USD return
Hong Kong	Hang Seng	0.4%	-	0.4%
China	CSI 300	-11.3%	-6.5%	-17.1%
Taiwan	TAIEX	11.0%	2.1%	13.3%
South Korea	KOSPI	3.3%	-2.9%	0.3%
India	SENSEX 30	2.0%	-2.6%	-0.7%
Singapore	Straits Times	-0.1%	-2.0%	-2.0%
Thailand	SE Thai	19.8%	0.8%	20.6%
Malaysia	KLCI	-3.0%	-4.3%	-7.2%
Indonesia	Jakarta Comp	15.3%	2.3%	18.0%
Philippines	PSEi	-1.6%	-5.1%	-6.9%
Vietnam	Ho Chi Minh	14.8%	-1.2%	13.4%

During the 18 years since inception, the Fund's performance is truly impressive. Its NAV compounded at 13.5% per annum, rising almost ten-fold, while the MSCI Asia ex Japan (US$) index rose by 150% or 5.2% per annum. The benchmark figures used for comparison do not include dividends. We estimate that if dividends, net of withholding taxes, are included in the benchmark returns, the benchmark returns would increase by around 2 ½ percentage points per annum.

Our Fund versus an ETF

Virtually every business in the world today is threatened with disruption to its business model largely driven by developments in technology. The investment management industry is far from immune to disruption. The proportion of assets that are managed passively in low cost index funds or Exchange-Traded Funds (ETFs) is growing rapidly at the expense of actively managed money as computers replace people. A recent study by S&P Dow Jones Indices found that 99% of US equity funds, 98% of global equity funds, and 97% of emerging market funds underperformed their benchmark net of fees and expenses over the past 10 years. The hedge fund industry is under pressure as many investors conclude that the fee structure of most hedge funds is unjustifiable – read Simon Lack's book "The Hedge Fund Mirage" to better understand this issue. We, however, firmly believe that our fee structure represents good value for money and we can point to our historic returns as proof that we have added enormous value for our clients.

The benchmark index for OAM Asian Recovery Fund is the MSCI Asia free ex Japan (US$) index. If an investor decides to invest passively in equities in the region, the easiest, most liquid, and one of the cheapest ways is to buy the iShares MSCI All Country Asia ex Japan ETF which trades in the US under the symbol AAXJ. That ETF has an annual expense ratio of 0.75%, not vastly different to our annual fees. As the chart below shows, since AAXJ was launched in August 2008, it returned 15% less than the benchmark and 59% less than our Fund, and that is before taking account of the 30% withholding tax that a non-US investor in AAXJ would incur on dividends.

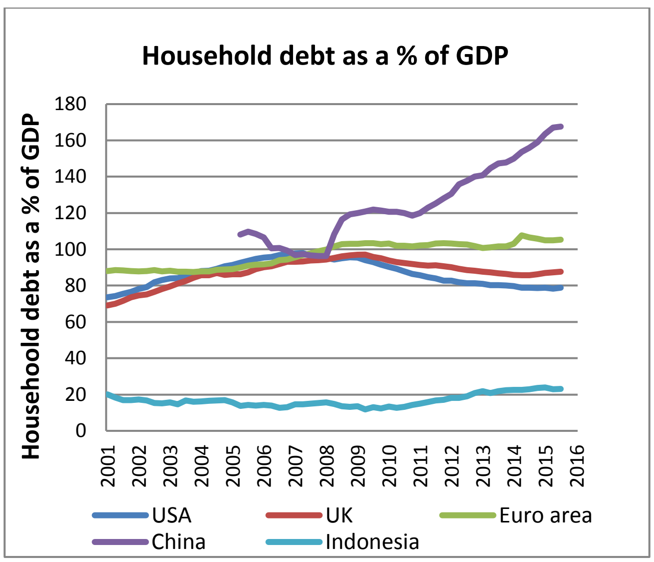


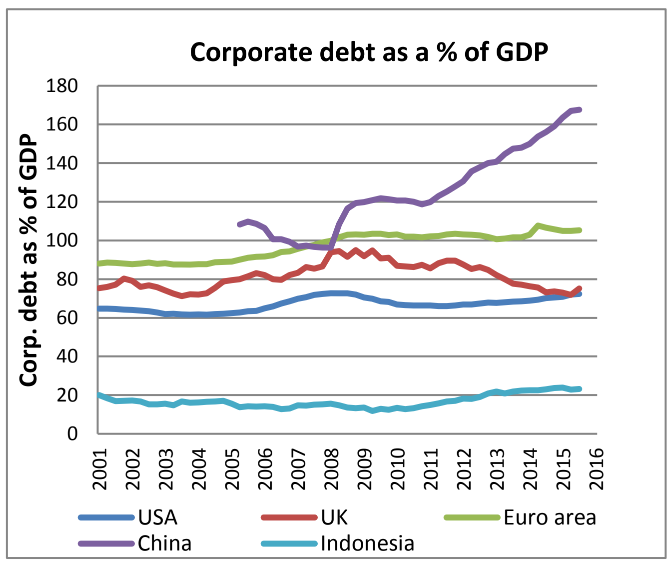
We do not think that Asian benchmark indices reflect the composition of Asian economic activity well, and they certainly do not mirror the rapid rise in Asian living standards. This is why we have long had a bias towards companies that serve the Asian consumer. One of the other ways in which we have beaten the benchmark so handsomely is by selectively choosing to invest in smaller companies which are not a component of benchmark indices. We, and the managers OAM engages, have a tendency to avoid state-controlled companies and favour family-controlled companies. Another way in which we have added value is by having low exposure to the more mature markets like South Korea and Taiwan which comprise a significant part of the benchmark index.

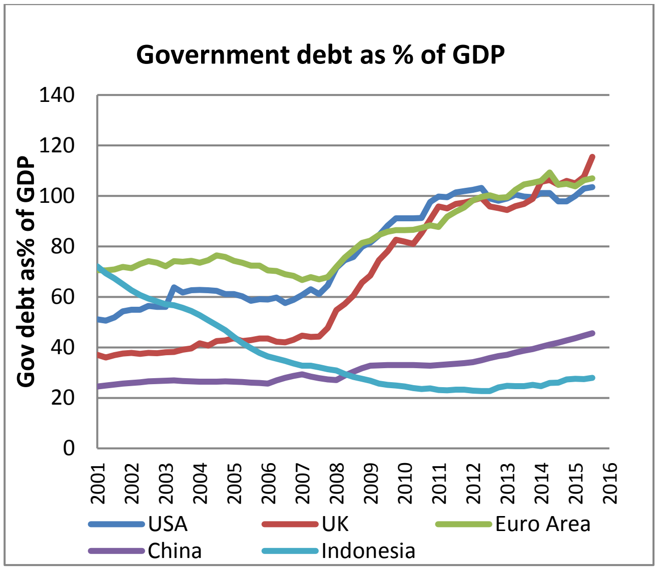
We also invest in countries, such as Vietnam, that are part of our Fund's mandate but which are not part of the benchmark index. Our country exposure is very different to the index. Whilst 58% of the index is invested in Hong Kong, China and Taiwan, we have only 36% invested in Greater China. Meanwhile, we are significantly overweight relative to the index in the Indian sub-continent where we have invested 16% of the portfolio versus 10% for the index, and in ASEAN where we have invested 34% of the portfolio versus 15% for the index. We are very overweight the ASEAN region, with our biggest overweight's versus the benchmark being in Indonesia where we have 10% of the portfolio invested versus 3% for the index, and Vietnam where we have 7% of the portfolio invested versus nothing for the index.

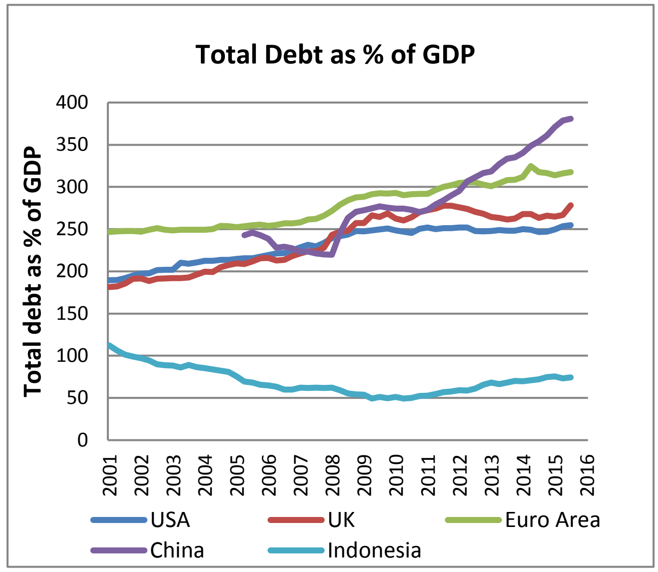
Vietnam has been a big source of gains for us in the past few years. Until five years ago, we had virtually nothing invested in Vietnam. The market was too expensive and there was nothing worth buying there. That changed in late 2011. From its peak in 2007 to its trough at the end of 2011, the Vietnam Ho Chi Minh Index fell by 80% in US Dollars. From mid-2009 to the end of 2011 when other Asian markets were recovering from the Global Financial Crisis (GFC), the Vietnam index halved in Dollars. The share prices of several closed-end Vietnam funds that were launched in the pre-GFC boom collapsed and were trading at wide discounts to NAV, therein presenting us with some great investment opportunities. We invested in a number of these funds which today are still trading at attractive discounts to NAV of 17-22%, albeit not as wide as a few years ago.

Indonesia has been another very profitable market for us. Whilst most of the world suffers from rising debt, whether it is government, household or corporate debt, Indonesia has reduced debt to very manageable levels during the past 15 years as the charts below, plotted based on BIS data, illustrate. These charts also give us good reasons to be cautious about China, as we have been for some time.







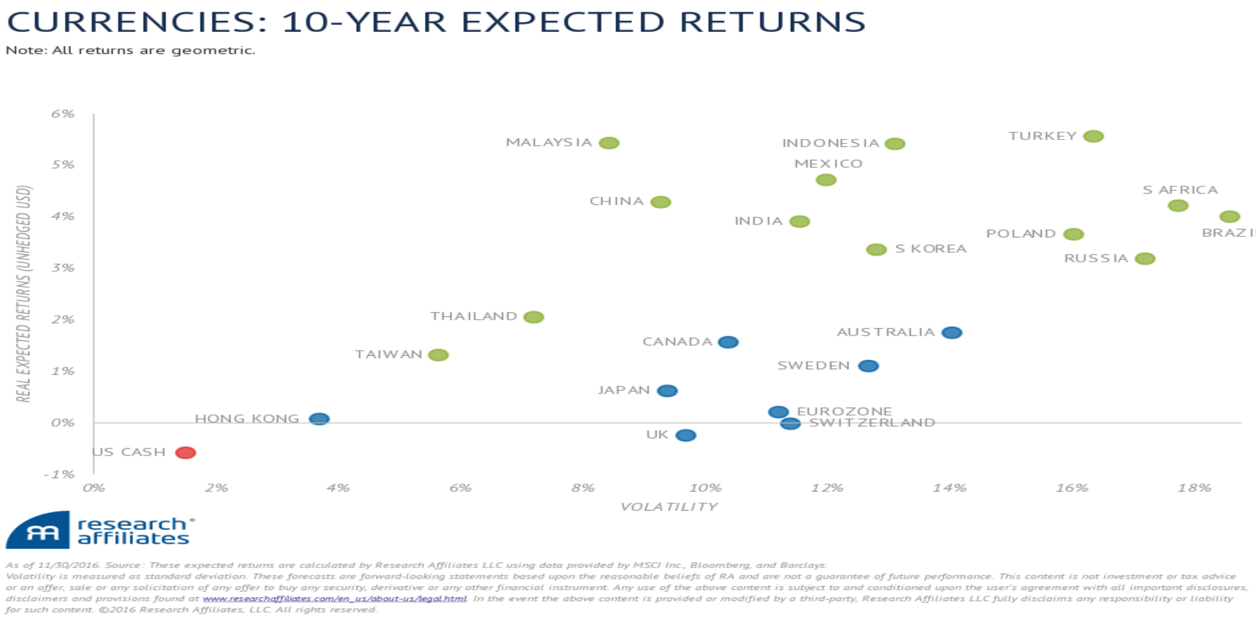


We look at debt as a means of bringing forward future consumption. As debt is reduced over time, spending will be lower than income. Conversely, if debt is low and increases over time, spending will exceed income. We think the scope for strong increases in consumer spending and major infrastructural projects is far greater in Indonesia than most other countries in the world. Likewise, with a quarter the debt burden of Western households, there is scope for Indonesian household debt to increase from current levels.

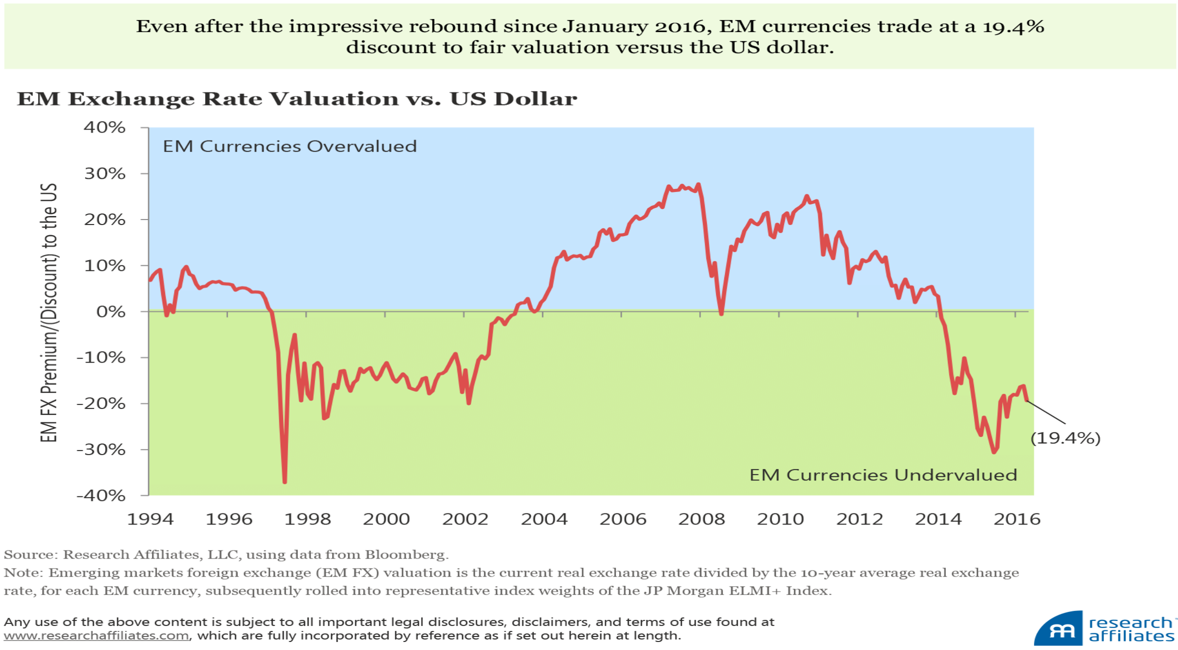
In looking through the underlying Indonesian investments of the Fund, there is one manager through whose fund we have nearly half of our Indonesian exposure. We have $30 million invested in that fund, which has 36% of its assets invested in Indonesia. The average P/E of that fund's holdings is 10 times 2017 estimated earnings and the average dividend yield is nearly 5%. The fund's manager visited Cayman and spoke at our 25th anniversary seminar in April. It was evident that, not only are his fund's holdings cheap, but, their balance sheets are strong, with net cash in most cases. An aspect of the investment case for some of our underlying holdings is that they own very valuable, well-located tracts of land that were bought decades ago at a fraction of today's market value, but which is still reflected on their balance sheets at cost. We also have investments in four other funds that account for our remaining Indonesian exposure. This exposure is largely in the form of a few well-run banks and finance companies with strong balance sheets that are selling at attractive valuations, a couple of Astra subsidiaries (part of the Jardine group), and a few dominant retailers. For instance, we have exposure to the two leading home improvement retailers in Indonesia. Between them, they control 3% of a market with a population of 250 million, while the three leading players in Thailand control 28% of the home improvement retail market.

Currency

As I have pointed out in past letters, Asian currencies are extremely undervalued. It is easy to see this when travelling in the region. In 2015, my wife and I took our children to Asia for the first time. They were amazed at how cheap many items were, and this was before they started haggling in the markets! Over the long-term, I expect real effective exchange rates (REER, or exchange rates adjusted for inflation differentials) to appreciate in Asia. Research Affiliates periodically update their expectations for US Dollar returns from holding various currencies over 10 years. Part of this return expectation is the interest earned on cash in those currencies, but the return expectation is their real return expectation. If we assume a US inflation expectation of 2%, we can add this to the following real return expectations to get nominal return expectations in US Dollars. Based on their analysis, they believe that Asian currencies are amongst the most undervalued in the world today.



Inflation rates in emerging markets are typically higher than in the developed world so I do not necessarily expect Asian currencies to appreciate in absolute terms, though Research Affiliates is more bullish. During the 1997/98 Asian financial crisis, Asian currencies, other than the Chinese yuan, suffered sharp depreciation. Prior to the Asian financial crisis, according to GMO, emerging market currencies were overvalued by more than 1 standard deviation before falling rapidly and becoming undervalued by more than 1 standard deviation. Then from the late 1990's until early this decade, they moved more or less sideways for 10-15 years until they became overvalued by more than 1 standard deviation. For the past 5 years, taking the Indonesian rupiah, the Indian rupee and the Vietnam dong as a mini-sample, they have depreciated by about a third. There are signs of them now stabilising at this level. According to GMO, emerging market currencies are now undervalued by around 1 standard deviation. A recent report by Research Affiliates entitled "The Emerging Markets Hat Trick" paints a similar picture.



There is one exception though that could upset the whole apple cart, and that is China. The Chinese yuan had been very stable or appreciated until a couple of years ago. As China works through its private sector overleveraging and makes its transition towards more of a consumption-driven economy, authorities are allowing the yuan to weaken gradually. During the past 18 months, the yuan has weakened about 10% against the US Dollar – less against the euro. As I pointed out in last year's Chairman's statement it is expensive to hedge the yuan, or most emerging market currencies for that matter, and it would have been difficult to make money hedging the yuan by purchasing put options. The Chinese yuan may continue to weaken gradually, but a sharp devaluation seems unlikely. Persistent current account surpluses and monstrous foreign exchange reserves are not indicative of a country whose currency is under threat of a major devaluation.

Valuation

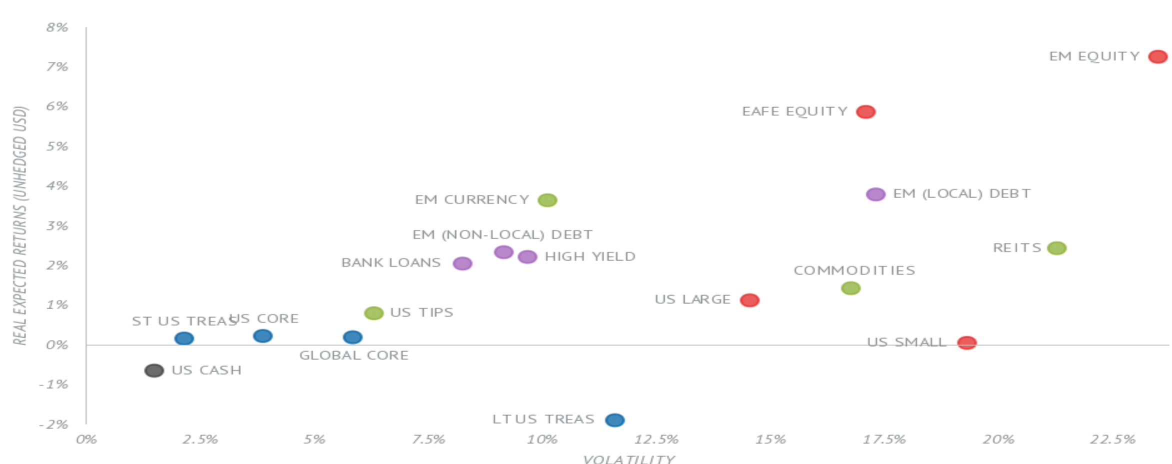
For the past 7 years, emerging market equities have more or less gone sideways. The MSCI Asia free ex Japan (US$) index is only 6% higher than it was at the end of 2009, while the S&P 500 index of US equities has more than doubled during the same period. The result is that US equities now look very expensive based on historical measures while emerging market equities look cheap. The chart below shows the cyclically-adjusted P/E (CAPE) of emerging market indices over the past 12 years.

Source: MSCI, BLS, NBER; Minack Advisors

Research Affiliates, a leading asset allocation firm with over $160 billion in assets that are managed globally using investment strategies developed by them, periodically updates the following chart on their web site. The primary basis for their expected future returns for equity markets around the world is the cyclically-adjusted P/E (CAPE). There is a strong historic correlation between CAPE and equity market returns over the subsequent 10 years. Though returns for most asset classes are projected to be derisory over the next 10 years, the prospect for returns in emerging market equities is enticing.

GLOBAL ASSET CLASSES: 10-YEAR EXPECTED RETURNS

Note: All returns are geometric.



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As of 10/31/2016. Source: These expected returns are calculated by Research Affiliates LLC using data provided by MSCI Inc., Bloomberg, and Barclays. Volatility is measured as standard deviation. These forecasts are forward-looking statements based upon the reasonable beliefs of RA and are not a guarantee of future performance. This content is not investment or tax advice or an offer, sale or any solicitation of any offer to buy any security, derivative or any other financial instrument. Any use of the above content is subject to and conditioned upon the user's agreement with all important disclosures, disclaimers and provisions found at www.researchaffiliates.com/en_us/about-us/legal.html. In the event the above content is provided or modified by a third-party, Research Affiliates LLC fully disclaims any responsibility or liability for such content.

Domestic consumption growth

There has been a considerable re-rating of branded consumer goods franchises globally in recent years. In the developed world, this has been driven in large part by the collapse in interest rates. Many investors paid up for the predictable, steady growth provided by these companies, and in some cases viewed them as attractive bond proxies. The dominant consumer franchises in Asia have seen a similar increase in valuations. Some of these valuations look a bit frothy. Though we have no concerns about the quality of these dominant franchises or the growth in earnings that they will likely deliver, there is a case to be made that the share prices of some of these companies which we own on an underlying basis may move sideways for a few years until earnings growth reduces their valuations to historic averages. For the time being, we think there are better return opportunities outside the few dozen dominant consumer franchises in Asia. In spite of our short-term concerns about the valuation of leading Asian consumer branded goods companies, we wish to retain meaningful exposure to them, as in a world of huge uncertainty, the rise in living standards and rapidly growing size of the Asian consumer sector over the next few decades looks as close as we can get to an almost certainty.

Hong Kong small caps

China may have its challenges in adjusting the principal drivers of its economy and in reducing its private sector debt, much of it held by state-owned enterprises (SOEs). The economy may have a short-term contraction or growth may slow, but its economy is unlikely to contract for more than a few quarters. We would be very surprised if China's GDP growth rate over the next 10 years is not significantly higher than in the developed world. Sentiment towards portfolio investment in China is very negative. Many small cap companies listed in Hong Kong are trading at ex-cash P/Es around 5, dividend yields of 5%, with net cash on their balance sheet. We think this is an area of tremendous opportunity; the Fund has quite a bit of exposure to Hong Kong small and mid-cap companies. The chart below shows the strong historic correlation between the MSCI Hong Kong Small Cap Index and the MSCI Hong Kong Index (the top chart). These diverged sharply in the past two years, and the MSCI Hong Kong Small Cap Index is almost the cheapest it has been relative to the MSCI Hong Kong Index in more than 20 years.

Portfolio activity

In February, we completed the sale of our large shareholding in ARC Capital for $18 million, representing a nearly $10 million uplift from both our cost and where it was valued at its last traded price before the shares were suspended from trading on AIM. This was a satisfactory outcome, but it took hundreds of hours of my time to resolve this very difficult investment. In June, we received a $3.5 million distribution from Pacific Alliance China Land (PACL). PACL's remaining assets have now been sold and we are awaiting wind up of the Special Purpose Vehicles (SPVs) that hold the assets in China, and for the repatriation process to take place. This could take up to two years to complete. We expect to receive two distributions, one this year and a larger one next year, totalling about $6 million from PACL. This has been a very good investment for us, thanks to the excellent investment management of Pat Boot. During the year, we sold most of our investment in Vinaland, a London-listed closed-end fund, at a decent profit, generating proceeds of $5.5 million. We still retain a small holding in this fund. There were some other small sales and distributions during the year totalling $1 million.

On the purchase side of the ledger, our largest investment was $4 million that was invested in a new holding, China Yangtze Power (CYP) through a vehicle called O3G. CYP is the world's largest hydroelectric company. It owns the Three Gorges Dam in China as well as other large hydroelectric dams in the country. In essence, its hydroelectric dams are 100-150 year infrastructure assets that should be able to increase pricing roughly in line with inflation over time. CYP has 22 billion shares outstanding so at its current share price, it has a market capitalisation of roughly RMB 280 billion. This year, CYP should generate about RMB 32 billion in free cash flow. About RMB 14 billion of that will be used to pay dividends – they said that the dividend on this year's earnings will be RMB 0.65/share which is equivalent to a more than 5% yield, subject to only 10% withholding tax. About RMB 8-10 billion will be used for debt repayment and about RMB 8-10 billion will go to retained earnings which over time will likely be used to make acquisitions of other renewable energy generation assets. We think that the shares are far too cheap at a more than 11% free cash flow yield for what is a very high quality collection of assets.

Our other noteworthy investments during the year were our additions to two existing holdings: DWS Vietnam Fund and Scottish Oriental Smaller Companies Investment Trust (SST). We added $4 million to SST whenever its discount to NAV widened to 15%. It is a very well-managed Asian smaller companies fund with a low expense ratio and an enviable track record. We added $3 million to DWS Vietnam Fund which underwent a restructuring later in the year which we largely anticipated, though the details that were announced of how the restructuring is being done are very pleasing to us. The fund has been renamed Vietnam Phoenix Fund and its assets are being split into a closed-end fund that will hold its private equity investments comprising roughly a third of its assets, and an open-ended fund holding its listed securities comprising two-thirds of its assets. We expect to exit the open-ended fund in the next 1-2 years and expect the closed-end to sell all its assets and make distributions during the next 2-3 years. Finally, we made an initial investment of US$1 million in a closed-end fund that is in realisation mode at an attractive discount to NAV.

Stable assets and a portfolio poised to deliver attractive returns

The Fund had $278 million in net assets at year end after receiving $3 million in subscriptions and $17 million in redemptions during the year. During the year, there were typical partial redemptions by clients to fund living expenses, philanthropy, and other expenses and distributions not related to any dissatisfaction with OAM! We have done no marketing, continuing to rely on word of mouth referral from existing clients. This approach, though passive, tends to lead to clients who are more inclined to stick with us. Only about 1.5% of the Fund's net assets are currently in cash.

Some would say that valuation – the price you pay – is the most important determinant of future returns. Others would say that returns follow earnings per share growth. There is truth in both statements. Looking at our portfolio, I feel confident that the Fund's underlying holdings in aggregate tick both these boxes. After 7 years of currency and equity market headwinds in emerging markets, there are indications that the tide may be turning in favour of emerging market equities over US equities. Few assets globally are likely to provide high single digit annual returns to investors over the next 10 years. In the past 7 "lean years" for Asia, the Fund generated a compound annual return for its shareholders of more than 7% so we look forward to seeing what returns can be generated if we have 7 "fat years".

Desmond Kinch, CFA
Chairman