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OAM Asian Recovery Fund

Dear Fellow Shareholder,

Last year was not a great year for Asian markets, other than Japan in which we do not invest, or for that matter emerging equity markets in general. Returns in emerging markets have been poor for the past three years, a fact of which most non-professional investors are blissfully unaware. Our Fund has generated respectable returns over the past three years, but it has been difficult to compete against US equities in the investment return sweepstakes during this period. It is important to bear in mind that the MSCI Asia ex Japan (US$) index was 3% lower at yearend than three years prior, while the MSCI Emerging Markets index declined by 13%, whereas the S&P 500 index of US equities has risen nearly 50% during the same period.

Against this backdrop, the Fund's NAV per share rose 5.2% compared with a rise of 0.7% in the MSCI Asia ex Japan (US$) index. This marks the twelfth year of positive returns in the Fund's 15 year history. During its 15 year history, the Fund returned 814% or 15.9% per annum to shareholders compared with a return of 169% or 6.8% per annum for its benchmark, the MSCI Asia ex Japan (US$) index.

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, I wrote: "If the Fund achieves a return of 12.5% per annum going forward, the NAV would reach $100 per share in 8 years." In last year's Chairman's statement I wrote: "I am sticking to my $100 NAV target by the end of this year. If it takes a year to achieve, that would imply a 15% return this year. We make no promises, but we aim to please!" Well, in this instance, we didn't please, but at least we didn't miss by a mile! During the past 8 years, the Fund returned 11.3% per annum which I think is still a more than respectable result given that the starting point was just prior to the start of the global stock market crisis that saw most Asia ex Japan market indices halve in US Dollar terms.

Currency considerations

Part of last year's weak performance was due to the weakness of most currencies in South East Asia and India. Currency depreciation, principally in Indonesia and India, reduced the Fund's NAV by about 4%. We are not overly concerned by this currency weakness as all Asia ex Japan currencies appear to be fundamentally undervalued versus the US Dollar on a purchasing power parity basis. The table below shows the price of a Big Mac in local currency, the equivalent in USD, and the implied exchange rate if a Big Mac cost the same in each country as it does in the US compared to the recent spot rate.

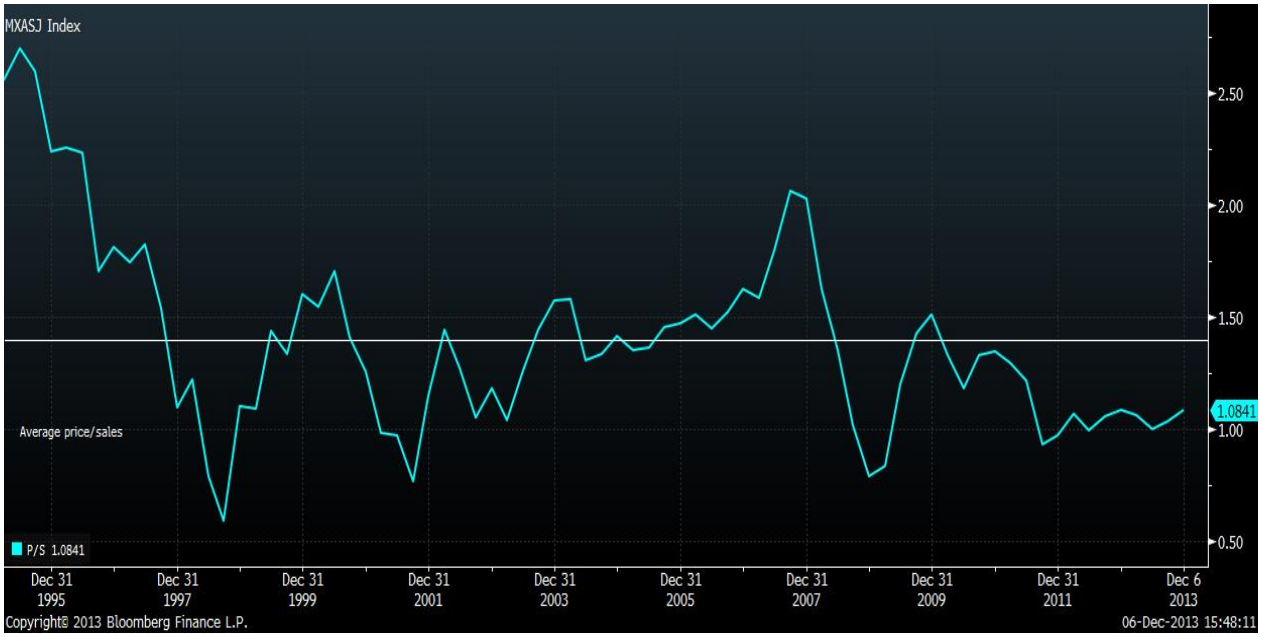
Asia (per USD)	% Over/Under Valuation	In Local Currency	In Base Currency	Implied PPP	Spot Rate
Singapore Dollar	-20.7	4.53	3.61	0.99	1.25
South Korean Won	-24.13	3661.35	3.46	803.52	1059.07
Chinese Renminbi	-41.5	16.24	2.67	3.56	6.09
Thai Baht	-41.7	85.54	2.66	18.77	32.2
Philippine Peso	-45.98	108	2.46	23.7	43.88
Indonesian Rupiah	-50.3	27076.21	2.26	5942.11	11957
Hong Kong Dollar	-51.91	16.99	2.19	3.73	7.75
Malaysian Ringgit	-52.48	6.98	2.17	1.53	3.22

Source: Bloomberg

This is a useful estimate of a currency's over- or under-valuation, popularised by the Economist magazine. Another reason why we are unconcerned by last year's currency weakness in Asia is that Asia ex Japan governments on the whole are employing much more prudent and sustainable fiscal and monetary policies than are developed, richer nations. Furthermore, there is already evidence that currency devaluations in the region are improving competitiveness. For instance, the Indonesian rupiah fell by nearly 20% last year which will make its commodity exports far more competitive (and valuable in local currency terms).

A discussion on valuations

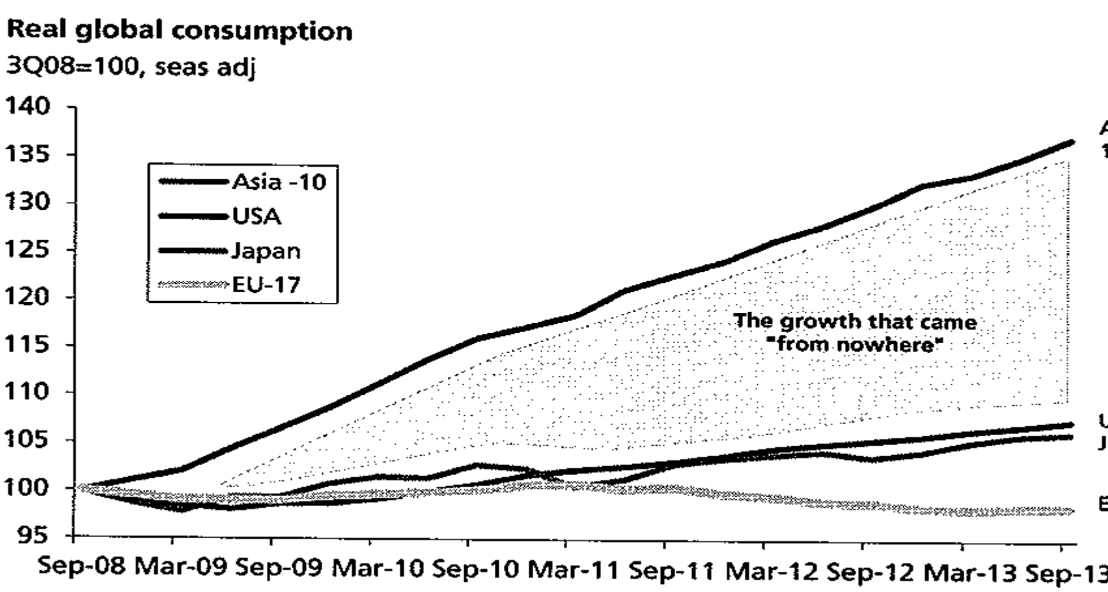
This time last year, the average P/E ratio of the Fund's holdings was 17 times estimated 2012 earnings. Currently, the Fund's average P/E is 16 times estimated 2013 earnings. This contraction in the P/E ratio is in contrast to the US and European equity markets where returns of 20-30% were driven almost entirely by a P/E re-rating while earnings growth in those more mature markets stagnated last year. This suggests that value on offer in Asia ex Japan has improved since a year ago, and almost certainly since three years ago. The chart below shows the Price/Sales ratio of the MSCI Asia ex Japan index.



Source: Bloomberg

As the chart shows, Asia ex Japan equity markets are trading near the bottom end of their historic valuation range over the past 20 years, and more than 20% below their historic average.

Within Asia, there remain huge divergences in valuations. In broad terms, Hong Kong and China, and to a slightly lesser extent South Korea, Taiwan, Vietnam, Singapore and Malaysia still look like relatively cheap markets while Thailand, the Philippines and Indonesia, even after last year's losses, albeit mostly due to a decline in their currencies, still look more expensive. India is somewhere in the middle. Companies serving the Asian consumer continue to command a valuation premium, deservedly so in our view (see chart below).



Source: DBS Bank

We still shy away from managers who invest in Chinese banks, Chinese or Indian state-controlled companies, real estate development or property companies, and most export manufacturers. These companies are typically trading at discounts to book value or net asset value or at low multiples of earnings, but they have a long history of value destruction for shareholders. We would rather pay higher valuations and invest in companies where the people running the business have "skin in the game", clear accounting and reporting to shareholders, a track record of value creation for shareholders, and a long runway for future growth in earnings and cash flows. This explains why the P/E of our Fund's holdings is a bit higher than the overall Asia ex Japan market.

Portfolio activity

Turnover in the Fund last year was relatively low. During the year, we reduced five of the Fund's holdings. Two of these are Singapore-listed holding companies where we decided to sell because of corporate governance concerns in one case, and in the other case because a major acquisition changed the investment merit of the company from our perspective. We raised about US$7 million from these two sales during the first few months of the year, but still have a small residual holding in one company which we will sell at the right price when markets are stronger – the rest of the other holding was sold after yearend.

We also sold $3 million of our holding in a fund in which we have owned shares for the past 15 years. That fund's NAV per share fell by 17% last year with the decline taking place in two stages: from April-June and again in October. The decline in that fund's NAV was almost wholly attributable to its large holding in DBA Telecom (more on that below). We felt uncomfortable with the fund's concentration in that single investment, a bit late as it turned out, and reduced our exposure after the first write-down in the value of its holding in DBA Telecom. We still have a $22 million investment in that fund and are very comfortable with their other holdings.

The fourth reduction in a holding was not a sale, but rather two pro-rata mandatory share repurchases by ARC Capital, a closed-end fund that we received during the year as part of their managed liquidation of the fund. ARC Capital is a listed private equity fund that invests in Chinese companies serving consumers in that massive, rapidly growing market. The fund's manager is Pacific Alliance, a well-respected manager based in Hong Kong. We own 19 million shares of ARC Capital, making us the fund's second largest shareholder. After deducting the proceeds of the two share repurchases from our cost, the average cost of our holding is US$0.28 per share while the share price is currently US$0.55 per share. The fund's NAV per share was US$0.89 per share which we think is a good estimate of what we are likely to receive during the remaining two years of the fund's liquidation. As the fund is likely to distribute the liquidation proceeds in several tranches, we think the return on this investment is likely to continue to be very good.

The fifth reduction in a holding was the first liquidation dividend from ASM Asia Recovery Fund which returned 15% of the value of our investment just prior to yearend. The fund has a very respectable track record, generating a return for its shareholders of 12.4% per annum over 11.5 years, with significantly lower NAV declines than equity market indices during major market declines. However, due to huge redemption requests, the fund suspended redemptions and is winding down on an orderly basis over three years. During the wind-down period, the fund expects to continue delivering attractive returns.

Earlier in the year, the Fund invested another $2.5 million in shares of Vietnam Resource Investments (VRI), bringing our shareholding to nearly 3 million shares at a cost of $6.5 million. We own 12% of VRI which essentially has just one asset, 15% of Masan Resources which owns one of the largest tungsten mines in the world which is in the late stages of development. Normally speaking, we would not make such a large investment on an underlying basis in a single company for the Fund, particularly in something such as a mine. The mitigating factor that offset this risk is that VRI had a put option to sell its shares of Masan Resources to Masan Group in exchange for Masan Group shares. Masan Group also had a call option to buy the 15% of Masan Resources from VRI that it did not already own. The call option was the cheaper option for Masan. As we predicted, Masan Group exercised the call option and has already paid VRI over $40 million with a similar final amount due in a few weeks. We received a distribution of $4.3 million from VRI just prior to yearend and expect to receive a final distribution from VRI of about $5.5 million in the next few months, following which VRI will be liquidated. Considering our average investment holding period for VRI is less than 2 years, this looks like it will be a very good investment. It illustrates well the attraction of the "end games" that we play in some of these obscure closed-end-end funds that have a catalyst to realise NAV.

We also invested $6 million during the year in Kubera Cross-Border Fund, another closed-end listed private equity fund that is in liquidation, adding to a small existing holding in the fund. Kubera invests in Indian private equity. This has been one of our least successful investments to date but we are still reasonably confident that we will make money on the investment. We are the largest shareholder in Kubera with a shareholding of 18 million shares or 16% of the fund. We like the fact that the manager co-invested 9% of each of its private equity deals alongside the fund. We also like the Chairman who has done a good job of looking after shareholders in other listed closed-end funds that invest in South East Asian markets. Our average cost to date is US$0.45 per share while the share price is $0.31. However, the NAV per share, following a significant write-off of an investment prior to yearend, is $0.56. More than 75% of this NAV is accounted for by their investment in two companies which are performing well. Another 20% of NAV is accounted for by cash and a tax refund that Kubera expects to receive this year. We think they will realise close to the current NAV and return it to shareholders in multiple distributions over the next two years. If we are right, the return on this investment going forward would be very good but only respectable compared to the Fund's cost.

Apart from a few portfolio changes alluded to in last year's Chairman's statement and the one change discussed in the next section, the only other purchase was an investment of about $1 million in a closed-end fund that invests in Vietnam at an average cost of $0.35. The share price is up about 30% since we made the investment but the shares still trade at a more than 25% discount to NAV. The fund has a wind-up vote in 2016 and the manager has suggested that the Board will probably recommend open-ending the fund as an alternative to having a wind-up vote. Open-ending or wind-up would give us an exit at NAV.

The Asian consumer

When navigating an airplane, there is something known as "gross error check". When using visual flight rules, the pilot will look at his map to see where he thinks he is on the map and compare it to what is seen on the ground as an accuracy check, taking particular note of any prominent landmarks. Over the years, I have developed a number of gross error checks that I use in investing to test whether an investment conclusion is at least roughly right. One of these is using the following formula to disaggregate investment returns:

Investment return (before fees and expenses) = Dividends + Earnings growth +/- P/E re/de-rating + Currency appreciation

If we rearrange the formula, to derive earnings growth, we get the following formula:

Earnings growth = Investment return -/+ P/E re/de-rating - Dividends - Currency appreciation

The formula is not perfect as it makes no adjustment for portfolio changes. However, the only way to have a portfolio with higher earnings growth than the formula above implies is to sell lower P/E stocks with lower earnings growth (usually after they have disappointed investors) and replace them with higher P/E stocks with higher earnings growth. Clearly such a portfolio rebalancing strategy is not sustainable and would end in tears.

At yearend, the Fund had $51 million invested in three Asian funds that focus entirely on owning shares in Asia ex Japan's best consumer franchises. All three funds have been excellent investments for the Fund. The potential problem is that Asian consumer companies are being increasingly viewed as "one-way bets" and the valuations of many of these companies reflect that view. I find it eerily reminiscent of the Nifty Fifty US companies in the early 1970's though valuations of Asian consumer companies now are not as extreme as the Nifty Fifty US companies back then. Up to this point, I have rationalised owning these high P/E companies (on a look-through basis) by the fact that if they achieve 15% earnings growth on a fairly consistent basis, either their high P/Es will "burn off" quickly, or their share prices will rise in line with earnings as high, consistent earnings growth justifies their high P/Es. However, what happens if earnings growth disappoints? I suspect the P/E de-rating would be quite savage unless it is a temporary slowdown.

My concerns have been rising of late because the average P/Es of each of these three funds increased last year to 23 times 2013 estimated earnings for the lowest, to 34 times for the fund with the highest average P/E, even though they only returned -3% to +1% last year. Each of the three funds says that the weighted average earnings growth of their companies was 13-17% last year. However, when we calculate earnings growth for each of the three funds' portfolios using the methodology above, we get a resulting earnings growth figure of +2% to -10%.

Just prior to yearend, we gave notice to redeem $5 million from the fund where the average P/E of the holdings is 34. The Fund received the redemption proceeds just after yearend. We still have a remaining investment in the fund of $23 million which represents pure profit as we have more than recouped our original cost on this investment. We have enormous regard for the investment manager but to paraphrase

Howard Marks of Oakmark and Jeremy Grantham of GMO, the price you pay really matters to the subsequent investment return.

China's Third Plenum

This past year, investors seem to be obsessed with the question of "Is China's economic growth slowing?" In my view, that is the wrong question to ask. From 1993 to 2012, China's per capita GDP grew from $517 to $6,076, a growth rate of 13% per annum on a per capita basis or 10% per annum in real terms. This is a chart of the MSCI China index which shows that it declined by about 50% from the end of 1993 until late 2013.

One of the main reasons why one of the highest economic growth rates in the world did not translate into superior stock market returns was poor corporate governance. A related fact is that a large part of China's corporate landscape is dominated by state-controlled companies – all China's banks are state-controlled as are the majority of companies in many other industries. The other problem, which is also partly related to the issue of state-control in much of China's corporate landscape, is that much of the investment that has taken place in China in recent years has been unproductive, and the problem is getting worse. As Michael Pettis, my favourite commentator on China (who I persuaded to visit Cayman to speak to the annual Fidelity Cayman Business Outlook conference three years ago), recently wrote for Bloomberg:

"GDP growth rates over the next few years of 7.5%, or even 7%, will be impossible to achieve. Until now, such gaudy statistics have been produced by ballooning investment. With so much of that investment now creating less economic value than debt, China has experienced an unsustainable expansion in credit. The country is perilously vulnerable to a chaotic adjustment. This cannot continue. Growth will drop to well below 7% one way or another because credit growth must slow sharply. Ultimately, though, GDP growth rates are the wrong target. For China to successfully rebalance its economy toward a healthier and more sustainable model, the measure that really matters is how fast median household income is growing.

Why? Consider what it means for China to rebalance. With household consumption at an astonishingly low 35% of GDP, in order to raise that figure to even 50% of GDP within a decade - still by far the lowest proportion of any major economy in the world - consumption growth would have to exceed GDP growth by close to four percentage points every year. An average annual growth rate of 7.5%, in other words, would require growth in consumption to exceed 11%. How could China possibly get citizens to start spending that much faster? In fact, consumption now contributes less to GDP growth in China than it did during the first half of 2012.

It is now widely understood that the reason for China's very low household consumption share is the very low household income share of GDP, which, at around 50%, is among the lowest ever recorded. To raise that figure while maintaining GDP growth of 7.5%, or even 6%, would require a ferocious surge in Chinese household income, even as China and the world slow down. This will be impossible to achieve without a continued, and very dangerous, surge in debt. As a number of prominent Chinese economists have noted, it is not the GDP growth rate that matters for ordinary Chinese people. Ordinary Chinese, like people everywhere, do not care about their per-capita share of GDP. They care about their real disposable income.

In recent decades, real disposable income has grown at well above 7% a year, which, although much lower than China's GDP growth rate, is nonetheless a tremendous feat. This is the growth rate that must be maintained. Beijing's policies should aim for average annual growth in household income of 6 or 7%. This would ensure social stability and would continue to drive China's economy forward. It implies, however, that if China is to rebalance meaningfully, GDP must grow by "only" 3-4%, which - although low by recent Chinese standards - is consistent with rapid growth in the income of ordinary Chinese and a real and sustained rebalancing of the Chinese economy, as well as consistent with almost zero investment growth."

There are tentative signs that China is moving in the direction prescribed by Pettis. At the Third Plenum held in November, China's leadership pledged amongst other reforms to reduce the role of state-owned enterprises (SOEs) in the economy; they will require SOEs to pay out higher dividends; and they will allow more efficiently run smaller businesses to compete against SOEs in certain previously restricted areas. The jury is still out, but at least China's leadership is "talking the talk". We now have to see whether they "walk the talk".

The DBA Telecom debacle

The Fund's largest investment at the start of 2013 was an investment in a fund that we have owned for 15 years (since the Fund started). That investment was worth nearly $31 million at the start of last year. The NAV per share of the fund compounded at more than 15% per annum in the first 14 years that we owned it. Last year, the fund's NAV per share declined by 17%. A large proportion of that decline was due to the fund's loss on its largest investment, DBA Telecom, which accounted for 22% of the fund's NAV at 31st December 2012. Therefore, on an underlying basis, the Fund had nearly US$7 million invested in DBA Telecom.

In early June 2013, DBA Telecom's shares were suspended due to their audit being delayed. The company's share price declined by 60% over a few months before their suspension from trading on the Hong Kong Stock Exchange at the company's request. Trading in the shares of DBA Telecom will continue to be suspended until publication of the company's audited financial statements for the year ended 31st December 2012, which are now expected to be released in late March 2014 along with the results for the first half of 2013. The fund, in which we have an investment, carried the investment in DBA Telecom at the share price at which they were suspended. In July, we redeemed US$3 million from our investment in the fund. In October DBA Telecom reported that its CFO resigned, a very worrying sign. On the basis of that news, the fund decided to further write down DBA Telecom by about 65% from its suspension price to its net cash per share. The result of the DBA Telecom debacle was that the Fund lost about US$5.8 million last year or about 2% of its NAV.

At its written down valuation, DBA Telecom now accounts for only about 3% of the fund's net assets (and about 0.2% of our Fund's NAV). The fund's manager does not believe that DBA Telecom is a major fraud and has reviewed with us the reasons why they reached that conclusion. Our in-house accounting and auditing guru, Rob, thinks the balance of probability is in the other direction after doing his own analysis. We should know the truth in a few months. The manager also provided us with a detailed analysis of each of the fund's largest holdings following DBA Telecom's trading suspension. We are very comfortable with its largest holdings. The fund manager, his wife and his family own about 50% of the fund's shares and have not sold a single share in the past year. There is therefore no question about alignment of interests.

Conclusion

In May, one or more of the Fund's non-executive directors and I will be visiting the managers who look after the Fund's assets. The Fund now has $287 million in net assets after receiving $28 million in subscriptions and $13 million in redemptions during the year. This is the first year of net subscriptions to the Fund during the past four years. About 13% of the Fund's assets are currently in cash (inclusive of the $5 million in redemption proceeds from one of our funds received just after yearend).

We just invested $3.5 million in an AIM-listed closed-end fund that has a continuation vote next year. The Fund has had an investment in this closed-end fund for some time. It has been a very good investment with its NAV compounding at 16% per annum since its launch six years ago, returning capital to shareholders along the way. In addition to being a well-managed fund, the shares appear to be mispriced as we added to the Fund's position at a 28% discount to NAV. This investment will reduce the cash balance once the trade settles next week. The Fund is also subscribing $3 million at the end of this month to a fund whose holdings we think are very cheap. The average P/E of the fund's holdings is less than 7 times this year's estimated earnings. The Fund already has an investment in the fund of $24 million which compares with our cost of $6 million, with shares in the fund being purchased between 2004 and 2008. The fund's manager increased his investment in the fund at yearend which we like to see.

The Fund has historically had low exposure to the Indian market. We have struggled in the past to identify good Indian fund managers. In October, while I was in New York, I met with a fund manager who I had last met about 12 years ago in Mumbai. He looked after the Indian investments for a fund in which we have invested for the past 15 years, before leaving to join a well-known global hedge fund group. Just over five years ago, he set up his own investment management firm and has compiled an excellent track record investing in Indian equities. We are completing our due diligence on this fund and anticipate investing $10 million in the fund. If that investment takes place at the end of this month, along with the two other purchases discussed, the Fund's cash balance will decline to $20 million or 7% of net assets.

We remain positive on the outlook for the Fund. If we look at the components of investment return, we come to the following conclusions. The look-through dividend yield of the Fund's holdings is just over 3%. Since withholding tax rates on dividends in Asia ex Japan are relatively low, we already have a return from dividends alone that beats cash and bond returns. The other components of investment return are earnings growth, change in the P/E, and currency changes versus the US Dollar. As I pointed out earlier in this letter, valuations on a Price/Sales ratio are historically low (as is the P/E for most Asian markets), and Asian ex Japan currencies look fundamentally undervalued. Therefore, these two factors should contribute positively to returns going forward. As long as our managers do a good job of selecting the right companies, which they have done for the past 15 years, earnings growth ought to be the largest contributor to the Fund's investment returns over the next ten years.

Desmond Kinch, CFA

Chairman