Overseas Asset Management

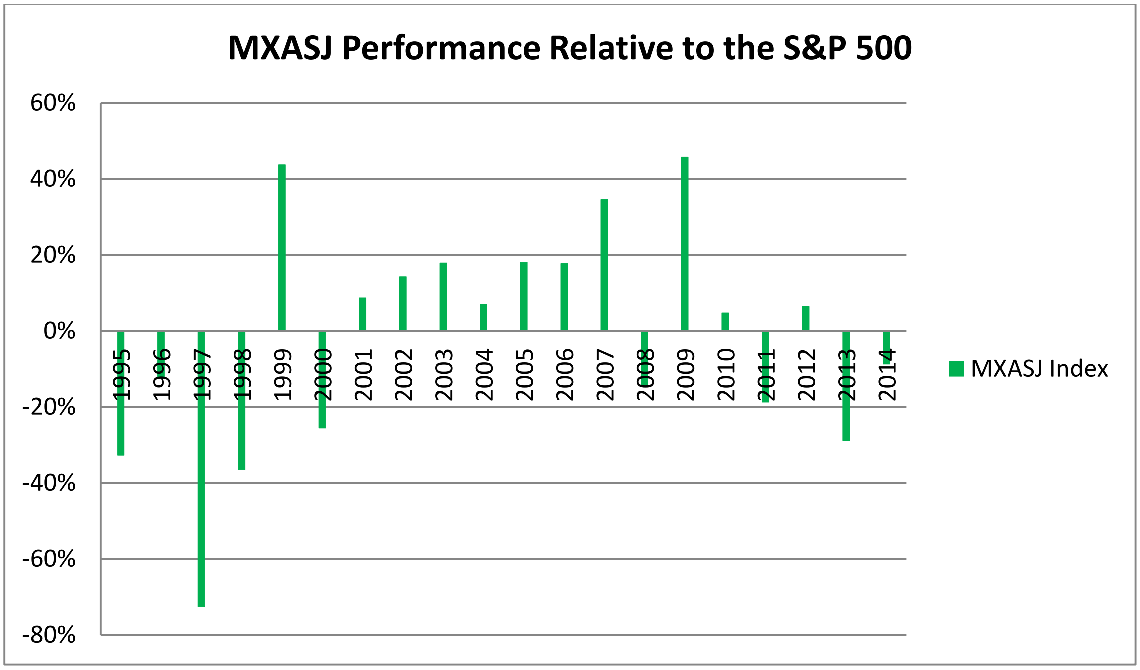
Overseas Asset Management (Cayman) Ltd.
The Pavilion Cricket Square
PO Box 597 Grand Cayman KY1-1107 Cayman Islands
T 345 949 8787 345 949 8780 F 345 949 7760
E info@oam.com.ky www.oam.com.ky

OAM Asian Recovery Fund

20th February, 2015

Dear Fellow Shareholder,

Last year, Asia ex Japan equities lagged US equities by quite a wide margin. We are starting to see concern from clients who observed the double digit return of US equities last year, against which our returns paled in comparison. We have endured periods like this before, but the last extended period like this was in the late 1990's. There is no question that the US Dollar is currently very popular and non-US equities are deeply unpopular after a long period of underperformance - see the chart below of relative return (including dividends) of the Fund's benchmark, the MSCI Asia free ex Japan (US$) index, versus the S&P 500 index of US equities. Our strong view is that this period of underperformance of Asia ex Japan versus US equities is unlikely to last much longer. GMO shares this view and explained the rationale in their most recent quarterly letter, "Ditch the Good, Buy the Bad and the Ugly" (see www.gmo.com). We share the same conclusion, but in addition to equity valuations, we think that investor psychology and the purchasing power parity of currencies strongly suggest that the tide is ebbing for US equities versus non-US equities.



The MSCI Asia ex Japan (US$) index rose 2.2% last year while the Fund's NAV per share increased by 5.1% to end the year at $96.02. During the 16 years since inception, the Fund's NAV compounded at 15.2% per annum, while the MSCI Asia ex Japan (US$) index rose by 6.5% 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. As clients are aware, we charge investment management fees at the segregated account level rather than within each fund so returns cited are before investment management fees. It is to clients' benefit that we charge fees in this way as any performance fees are charged on the return generated in the client's account rather than on the performance of each fund.

Equity valuations and expected future returns

CAPE is the abbreviation for Cyclically Adjusted P/E. It is also referred to as the Shiller P/E, named after the esteemed Yale economist who brought it to the attention of the investing world. CAPE serves a very useful function in that it blunts the effect of cyclically high or low current earnings in measuring equity market valuations. Instead, it takes the average of the past 10 years' earnings as the denominator (the "E") in the P/E. Empirical research has shown that there is a high correlation between the current CAPE and future 10-year equity market returns. In recent years, this empirical research has spread from a study of US equity market 10-year returns to other markets so that we now have a body of research that covers most major equity markets.

It turns out that most investors have been investing all along in emerging markets for the wrong reasons. Recently, I was asked to serve on a board that oversees a local government pension scheme. The person who asked me to join the board thought that it would be useful for me to provide my macroeconomic views to the other board members. I responded, loosely paraphrasing Warren Buffett, by saying that economic forecasters make fortune tellers look good. I went on to say that even if you are able to identify an economic forecaster with a consistently good long-term track record (and I don't know any), it would not necessarily help because there is no strong correlation between economic growth and stock market returns; in fact, empirical evidence shows that there has historically been a weak negative correlation. I then went on to cite the case of the MSCI China index which started 22 years ago and is more than 30% lower today than its starting point in spite of China being the fastest growing major economy in the world over that period.

Research Affiliates LLC (www.researchaffiliates.com) has done a huge amount of research on CAPE and expected future returns in equity markets around the world, and has generously shared its research results on its web site which I highly recommend. Based on their research, they estimate that US equities will return 0.4% per annum in real (inflation-adjusted) terms over the next 10 years. GMO (www.gmo.com) also publishes their estimated real return estimates for various asset classes over the next 7 years. They currently estimate a real return for large US equities of -1.8% per annum and +3.8% per annum for emerging market equities. The reason for such a low expected real return of US equities is because they have such a high starting valuation: CAPE is currently 27.1. Emerging market equity valuations are much more attractive, hence their higher expected return. Research Affiliates expects real 10-year returns of 7.3%, 6.8%, 7.1%, and 6.1% per annum respectively in US Dollar terms from making currency-unhedged investments in equity markets in China, India, Indonesia and Thailand. This is partly because of relatively low starting valuations and partly because of cheap currencies.

Investor psychology

Economics 101 teaches us that as the price of something rises, demand falls and vice versa. In the stock market, the opposite seems to occur, that is until the pendulum reaches an extreme level of undervaluation or overvaluation. It is impossible to pinpoint exactly those turning points, but we have a pretty good idea based on valuation disparities and degrees of greed or fear being displayed by investors of roughly where the pendulum is at any given time. As I like to say, it is better to be roughly right that precisely wrong. Rob Arnott, the founder of Research Affiliates recently said in an interview with Bloomberg:

''There is a flight to safety and the snapback from that, when it comes, will reward the value investor handily. You also see a huge spread between the comfort markets, the United States at a Shiller P/E ratio of 27 times earnings, and the fear markets, emerging markets, where a fundamental index in emerging markets is currently at a Shiller P/E ratio of 10.5. My goodness, 60% discount to the S&P 500. That's startling. Why would it trade at such a vast discount? Because people are afraid. Fear breeds bargains. You cannot have a bargain in the absence of fear."

In terms of the flight to safety, we can see this in the prices of London properties, US equities, and sovereign bonds in developed markets which are all viewed as boltholes from the fear that pervades emerging markets. We prefer to buy fear than follow the crowd into over-owned and overpriced assets.

Currency considerations

Last year, currency weakness against the US Dollar hurt returns of Asian equities. The Malaysian Ringgit and New Taiwan Dollar fell by about 6%, the Singapore Dollar fell by 5%, while the Chinese Renmimbi, Indian Rupee and Indonesian Rupiah each fell by about 2%. We continue to believe that Asia ex Japan currencies are 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	-26.55	4.53	3.35	0.99	1.35
South Korean Won	-26.82	3661.35	3.33	803.52	1097.96
Thai Baht	-42.52	85.54	2.62	18.77	32.65
Chinese Renminbi	-42.94	16.24	2.6	3.56	6.24
Philippine Peso	-46.54	108	2.44	23.7	44.34
Hong Kong Dollar	-51.9	16.99	2.19	3.73	7.75
Indonesian Rupiah	-53.03	27076.21	2.14	5942.11	12650
Malaysian Ringgit	-56.82	6.98	1.97	1.53	3.55

Source: Bloomberg

It is noteworthy that the Indian Rupee is not included in the table. This is because beef is not a staple of the Indian diet for religious reasons. I have my own informal version of the Big Mac index: the Five Star Hotel index. In May last year, one of our non-executive directors and I visited Mumbai to meet with investment managers. We stayed at the Taj Mahal Palace hotel, an iconic 5-star hotel with a view from our rooms of the Gateway of India. Our corporate room rate, including a sumptuous buffet breakfast, was INR 8,500 per night, equivalent to US$140 a night. As a matter of interest, I checked room rates at the Holiday Inn on Miami Beach (hardly a 5-star hotel) on Expedia for the same dates and the rate was roughly $300 per night without breakfast included.

Momentum may currently be in favour of the US Dollar, but I would rather have my money invested in assets denominated in undervalued Asian currencies. I do have some concerns about "tail risks" in China and the Renmimbi and did explore buying out-of-the-money put options on the offshore Renmimbi late last year, but it proved to be a more complicated hedge than I anticipated so we decided against doing so.

Portfolio activity

Turnover in the Fund last year was again relatively low. During the year, we received a liquidation distribution of $5.2 million from Vietnam Resource Investments, and another $0.4 million after year end, concluding a very successful investment in that closed-end fund. We also received $1.3 million from ASM Asia Recovery Fund which is being liquidated on an orderly basis, and which so far has delivered a more than 10% per annum IRR to date. At year end, we had an investment of $5.6 million remaining in this fund. We received another $2.5 million during the year from two closed-end funds or limited partnerships that are in liquidation, and $0.8 million from selling the rest of our shares in two Singapore-listed holding companies that I mentioned in last year's Chairman's statement. We also sold the rest of our shareholding in Value Partners Group for US$2.2 million, the manager of two of the funds in which we are invested, nearly doubling the value of our investment over a three year holding period.

In August, we redeemed $5 million each from two funds in which we have had an investment for the past 16 years. I mentioned both funds in last year's Chairman's statement. In the case of one, I said last year that "Just prior to year end, 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 year end. 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." Last year, the NAV per share of that fund climbed steadily during the year, so we made a further redemption of $5 million, due to concern with valuations of the fund's holdings. We think that this is an extremely well-managed fund and we were rewarded again last year with that fund's NAV per share rising by more than 15%, and at year end continued to have a holding that is worth over $20 million.

The other fund from which we made a $5 million redemption in August was the fund that took a huge write-off from the DBA Telecom debacle described in last year's Chairman's statement. That fund's NAV per share increased by less than 3% last year.

On the purchase side of the ledger, there were three significant new investments, two of them with Indian managers, and one with a Kuala Lumpur-based manager who invests in companies serving the ASEAN consumer. As I mentioned in last year's Chairman's statement:

"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."

After completing our due diligence, we invested $10 million with this manager at the end of February. By year end, this investment had risen in value to $14 million. We were introduced to another manager who we spent a few hours with in Mumbai in May. I went into the meeting sceptical that we would place any funds with this manager, but left very impressed. At the end of August, after completing the rest of our due diligence, we invested $5 million with that manager. At year end, the value of that investment had increased in value more than 15% in just four months.

Our investment in the ASEAN-focused fund of $5 million at the end of August has fared less well to date and was down 13% at year end. However, I am not concerned, and we may add to this investment later this year. This fund has a more than 10 year track record and has compounded its NAV per share by more than 14% per annum. The founder is still the fund's biggest investor and the fund is not much larger than $50 million in assets, remarkable considering its track record. The following is extracted from the fund's most recent monthly newsletter.

"As you all know a large part of Malaysia's state revenue is from oil. But Malaysia is much more than a Venezuelan-style petro-economy. Last month's trade numbers show a continued surplus, much of which is derived from electronics exports. It remains an easy place for foreign manufacturers to invest and the weaker Ringgit will only have enhanced its attractiveness. …. Slowdowns in Asia are not like slowdowns in the West. In bad times here, companies still open new stores; they just perhaps grow the number in a given year by 5%, not 10%. There are many towns without a modern mall or even supermarket, let alone fashion stores and other essentials (KFC, McDonald's, etc). …. I was at a conference in Bangkok last week. It is obvious that the PRC tourists are back and spending big. At the conference the cosmetics company Beauty told me their 2014 18% same store sales growth was driven largely by Chinese visitors. In January the Malaysian authorities, anxious not to miss out, reduced visa requirements for PRC tourists. ASEAN governments in need of tourist $$ now roll out the red carpet so the Chinese can come and buy products made in China to take home. …. And we all know about the crumbling of the Indonesian economy due to the drop in commodity prices. So it might come as a surprise that FDI grew 13.5% last year and domestic direct investment was up 21%. A lot of the surge happened after the election, reflecting confidence in the new president. Indonesia's 2014 electricity sales grew 10% and are forecast to grow 6% in 2015. Presumably a combination of industrial demand and some people getting the stuff for the first time led to the growth. …. The fund's weighted average PE for 2015 is 10.5x with an ROE of 20%. If we take out our two large-caps the PE falls to 8.9x."

Last year, we added $3 million at the end of January as alluded to in last year's Chairman's statement to a fund whose holdings were trading at an average P/E of less than 7 times estimated earnings. The NAV per share of that fund rose 16% last year, increasing the value of our investment in the fund to over $31 million. At the end of July, we added $5 million to our investment in an Asian small cap fund. That fund had disappointing performance last year, with its NAV per share losing 8%, but its track record over 7 ½ years remains impressive. This investment currently has a market value of $14 million and its holdings are trading at an average P/E of just over 6, price/book of 0.7x, and a dividend yield of 5%.

During the year, we added to our investment in four closed-end funds at what we felt were attractive discounts to NAV. The largest of these was a further investment of $6.5 million in a closed-end fund that invests in Chinese property. 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 more than 14% per annum since its launch seven years ago, returning capital to shareholders along the way. In July, the fund's shareholders voted to change the Company's investment policy to restrict new investment solely to support existing investments, and to focus future investment management on the realisation of its portfolio and the return of net realisation proceeds to shareholders. This month, the fund is returning 8.5% of net assets to shareholders on a pro-rata basis, and the manager expects the majority of assets to be realized in the next 18 months, with the remainder realized within a further 1-3 years. Yet the shares still trade at a 25% discount to NAV. Our other additions during the year to our portfolio of deeply discounted closed-end funds were $2.5 million (net of a distribution received) to ARC Capital which I will discuss shortly; and $1.5 million each to a Vietnam equity fund and an Indian private equity fund. The latter is in orderly liquidation and the former has a continuation vote next year. Both funds trade at deep discounts to NAV. We also initiated a new investment of $1.6 million in a closed-end fund that invests in Asia at a more than 40% discount to NAV. There is currently no catalyst in place that would cause the discount to NAV to narrow, but the insiders have been heavy buyers of their shares at these prices.

Finally, we made an investment of nearly $1 million in a Hong Kong-listed company at a price where the company's net cash exceeds its entire market capitalisation. The company has been profitable every year for the past 10 years, and in its more than 20 years as a public company, it has delivered a compound annual return to shareholders of 7% per annum, virtually equivalent to the return of the Hang Seng index, suggesting that this company is not a serial value destroyer. From time to time, we have made similar discount to net cash investments with good results.

India

The Indian equity market as expressed by the S&P BSE 500 index rose by 34% last year. The Indian equity market is not cheap so we would not be surprised if the market has a meaningful correction this year. Nevertheless, we are very excited by what we see in India. Both Narendra Modi, the new Prime Minister, and Raghuram Rajan, who became Governor of the Reserve Bank of India about 18 months ago, are very impressive. Good political leadership and stewardship of the central bank are critically important in emerging markets. Over the years, I have seen the effects of good leadership and bad leadership, and the effect that it has is huge in emerging economies. I would go so far as to say that Modi is likely to be as transformational for India as Maggie Thatcher was for Britain 35 years ago. The big difference is that India has over 1.25 billion people. Our problem with investing in India was the difficulty in identifying good managers. We resolved this problem and have 13% of the Fund's net assets, up from 6% a year earlier, invested in Indian equities.

ARC Capital

Since 2009, we have had an investment in ARC Capital, a closed-end fund listed on the AIM market in London. The fund has private equity investments in China and has been in orderly liquidation since early 2012. I am limited in what I am willing to say about this investment but several things have happened in the past year which had a very negative impact on the share price. These events are a matter of public record, but since this investment may lead to litigation brought by us, I am unwilling to say much in this public forum. Even though this investment accounted for only about 2% of the Fund's NAV at the end of January, I have spent hundreds of hours dealing with this investment during the past three months, including working several weekends. Along with other shareholders in aggregate owning 31.7% of the fund's shares, we have engaged Cayman counsel and Leading Counsel in London to advise us. Shareholders in the Fund can rest assured that we will do the right thing. As a client once remarked to me, I must have overdosed on the ethics component of the CFA programme. We have three CFA Charterholders at OAM and two enrolled in the CFA programme, and I served as a past President of the Cayman chapter of the CFA Institute, so as you can tell, we take our ethical responsibilities very seriously.

Last year, the Fund's investment in ARC Capital cost it nearly $5 million or about 1.7% of NAV. In January, the value of the investment fell by a further $2.2 million. The share price fall in January took place on total trading volume during the month of less than $200,000. The valuation of our investment in ARC Capital at the current share price fails to reflect anything close to the aggregate value of cash on its balance sheet, receivables and claims, and contingent assets. As long as the current Board of Directors of the fund acts in accordance with their duties, we think that we are likely to recover significantly more than the current valuation of this investment. I therefore regard it as a store of future returns.

China

It is interesting, and worrying, that both last year and the year before the Fund took a hit from an investment in China that went badly wrong. We have always invested with managers who had investments in China with wide open eyes, fully aware of the weak rule of law, corruption, and low level of ethical behaviour by Chinese businessmen. I remember a lunch that I had 2 ½ years ago with Cheah Cheng Hye, the founder of Value Partners Group; Anthony Bolton, the manager of Fidelity China Special Situations plc; and John Dyke, one of our non-executive directors. At the time, Anthony Bolton's new China fund had seen its share price drop by 40% over the prior two years. At the lunch, Bolton who was regarded as one of the leading investment managers in Europe from 1990-2010, lamented the fact that he had underestimated the degree of corruption and poor business practices in China. He said that he resorted to hiring private investigators to do background research on the principals of companies before investing in them. Since then, the performance of his fund has improved dramatically. At the lunch, Cheah Cheng Hye remarked on the importance of having a deep network to root out the crooked promoter from the honest businessman. Over the past 16 years, the Fund's investment of $2.1 million in his Value Partners Classic Fund has grown to a value of over $31 million at year end.

It is interesting that Overlook Investments, in which the Fund has had an investment for 16 years (cost: $3.1 million; market value: $25.1 million) has reallocated more than half its assets to Greater China. They attribute this to "attractive valuations, the discovery of impressive companies, the acceleration of economic reforms, and the maturing of corporate behaviour". In their most recent letter to investors, they described the rationale for their recent investment in China Yangtze Power Company (CYPC) that owns the Three Gorges Dam, a 25,000 megawatt hydroelectric dam on the Yangtze River as follows:

"CYPC supplies approximately 3% of China's electricity. The company is also the largest supplier of renewable energy and the largest hydroelectric utility in China, as well as one of the largest hydroelectric generators in the world. Within the next 12 months, it should further increase its generating capacity by an additional 56% through the acquisition from its parent company of a 70% stake in two recently completed, upstream dams. It is the lowest cost provider of electricity in China, its electricity is constantly renewable through the dam, and it has a product for which demand is rising due to smog-clogged cities across China. And just as importantly, since the dam is fully constructed and the principal raw material (water) is essentially free, the cost of producing electricity from the Three Gorges Dam is largely fixed and stable, subject only to annual fluctuations of rainfall upriver. Three Gorges currently sells its electricity at Rmb0.22/kWh. The current average wholesale price of electricity in China is approximately Rmb 0.38/kWh with 75% of the electricity being generated by coal-fired power plants that bear no cost of their carbon dioxide or PM 2.5 particulate emissions, which cause untold health hazards to the citizens of the PRC. The attraction of CYPC's cash flow is further augmented by the dam's minimal maintenance capex requirements. Maintenance capex for the last three years has averaged less than 5% of gross cash flow, leaving 95% of cash flow as free cash flow to be allocated between the retention by the company for future growth, repayment of debt and payment of dividends to shareholders. If CYPC is considered as a REIT or property investment company, then the two highest quality real estate assets we know of in Asia are The Link REIT and Hong Kong Land. They sell at an EBITDA/Enterprise Value yield of 4.17% and 4.67%, respectively. CYPC sells at an EBITDA/Enterprise Value yield of 9.65% on current market and 12.49% on the Partnership's cost. CYPC is also an interesting stock in terms of future growth. When CYPC buys two additional, fully functioning dams from its parent in 2015, if structured correctly, this acquisition should be accretive to EPS and EBITDA/share. Our estimates suggest CYPC's EPS and EBITDA/share, excluding minority interests, should grow from 2013 to 2018E at an annual compound rate of 9.6% and 18.5%, respectively. This is augmented by a current yield of 3.5%."

Stable assets

The Fund had $296 million in net assets at year end after receiving $16 million in subscriptions and $21 million in redemptions during the year. Both subscriptions and redemptions are well within the 10% of net assets limit that we hope to maintain. The total redemptions are distorted by a single redemption by a client at the end of November of nearly $7 million. That redemption was made by a client who opened an account with us in 1995 with $600,000 and added and subtracted from the account over the years. The client invested in all the OAM funds, with the exception of the OAM Debt Recovery Fund. Over the ensuing 20 years, the client made slightly over $15 million in realised gains in his account with us and generated a return of 13.3% per annum, net of all fees and expenses. That is better than the return generated by Warren Buffett's Berkshire Hathaway over the same period. The client is moving to a jurisdiction this year where it will no longer make sense for him to be invested in the Fund which was the reason for the redemption late last year.

Only about 3% of the Fund's net assets are currently in cash. That tells you something about what we think of the prospects for the Fund.

In May last year, one of the Fund's non-executive directors, Peter Dutton, joined me on a trip to Hong Kong, Singapore, Vietnam, Malaysia, Thailand and India to meet the fund managers and some of the directors of the funds in which we are invested. These trips are particularly useful for the Fund's directors to understand the underlying investments and the nature of our relationships with the fund managers. That is very important from the point of view of dealing with the "what if I get hit by a bus" risk. Each of the Fund's directors has visited Asia with me at least once to meet the fund managers to whom we have entrusted money. I think it is fair to say that Peter came away very impressed with the quality of the managers, with one notable exception that was previously discussed.

Desmond Kinch, CFA

Chairman