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OAM Asian Recovery Fund

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Dear Fellow Shareholder,

A tricky year

I started last year's Chairman's statement by saying that "Asia ex Japan equities lagged US equities by quite a wide margin" and added that "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". I said that "our strong view is that this period of underperformance of Asia ex Japan versus US equities is unlikely to last much longer". The first few months of the year provided us with optimism that five years of lagging returns in Asia were over. In April, the Fund's NAV/share passed the $100 milestone for the first time, to end the month at $101.48. From there, Asian equities corrected severely, with the Fund's benchmark, the MSCI Asia free ex Japan (US$) index dropping by more than 25% from late April to early September. Even though the Fund's NAV held up far better than the markets in which it invests during this severe correction, a number of clients remarked that when they opened their third quarter statements, they quickly stuffed them back into the envelope!

The severe correction in Asian equity markets in the second and third quarter was caused largely by a pair of policy mistakes by China. The first was its futile attempts to support the domestic A-share market after it collapsed from a ridiculously overvalued level. The second was the atrocious timing by the Peoples Bank of China (PBOC) in widening the RMB trading band. The timing was bad because it came on the heels of China's ham-fisted attempt to prop up its stock market, and a month or so prior to the Federal Reserve's decision on whether to raise interest rates for the first time in nine years. Until recently, China's policy implementation was viewed as almost flawless, so these two policy errors unnerved investors. All this came on the back of pre-existing concerns about Chinese economic growth slowing.

In last year's Chairman's statement, I pointed out that 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. Case in point is the MSCI China index which started 23 years ago and is now 40% lower today than at its starting point in spite of China being the fastest growing major economy in the world over that period.

The primary determinant of future equity market returns is current valuations. Last year, I discussed the Cyclically Adjusted P/E (CAPE) as a useful tool for estimating future stock market returns. According to Research Affiliates, the CAPE for Chinese equities is now 12, compared to 25 for US equities, which leads them to expect a much higher USD unhedged return from investing in Chinese equities than in US equities. We share that conclusion. At the end of September, we viewed the sell-off as way overdone and my wife added to her investment in the Fund at what appeared to be attractive valuations for the Fund's underlying investments.

The following chart shows the Price/Book ratio of the MSCI Asia free ex Japan index since OAM Asian Recovery Fund's inception 17 years ago. Currently, the price/book ratio is close to its lowest level during the past 20 years, and is more than 20% below its average for the period. This is in stark contrast to US equities which are currently valued in the top decile of valuations over the past century on most equity valuation measures.

<u>Performance in the context of strong headwinds</u>

Last year, the Fund's NAV/share fell by 5.2%. Relative to a decline of 11.3% in the Fund's benchmark, the MSCI Asia ex Japan (US$) index, we are satisfied with what was a relatively robust performance by the Fund last year. Both markets and currencies hurt returns as the table below shows for the 10 largest components by market as measured by the Fund's benchmark. It is interesting that China, the subject of much angst by investors, was the only major market in Asia to post a positive return in USD last year, albeit barely.

Country	Index	Market return	Currency return	USD return
Hong Kong	Hang Seng	-7.2%	0.1%	-7.1%
China	CSI 300	5.6%	-4.4%	1.0%
Taiwan	TAIEX	-10.4%	-3.7%	-13.7%
South Korea	KOSPI	2.4%	-7.2%	-5.0%
India	SENSEX 30	-5.0%	-4.7%	-9.5%
Singapore	Straits Times	-14.3%	-6.6%	-20.0%
Thailand	SE Thai	-14.0%	-8.7%	-21.5%
Malaysia	KLCI	-3.9%	-18.6%	-21.8%
Indonesia	Jakarta Comp	-12.1%	-10.2%	-21.1%
Philippines	PSEi	-3.9%	-4.7%	-8.4%

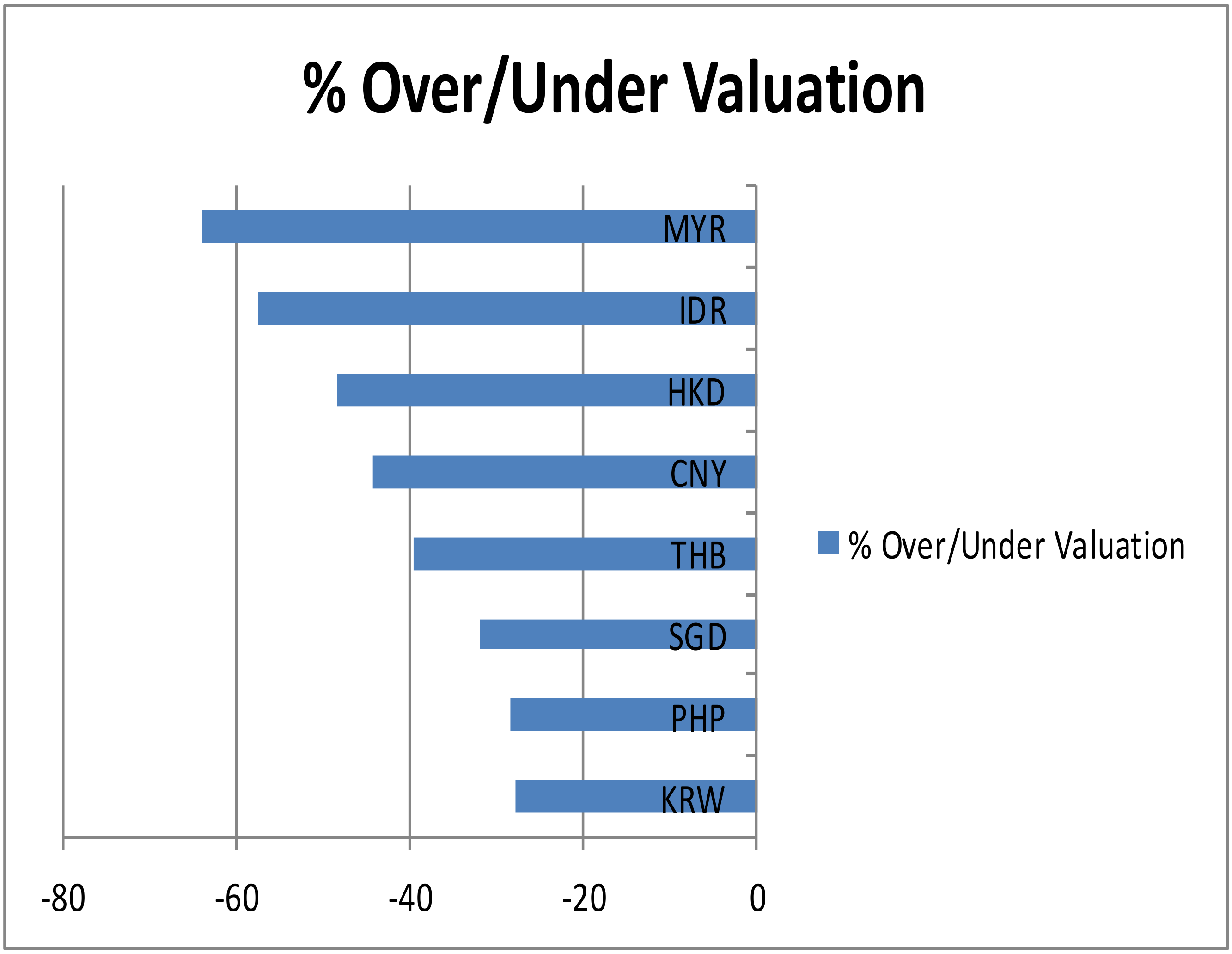
During the 17 years since inception, the Fund's performance is truly impressive. Its NAV compounded at 13.9% per annum during these 17 years, rising nine-fold, while the MSCI Asia ex Japan (US$) index rose by 143% or 5.4% per annum. The benchmark figures used for comparison do not include dividends. 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.

It is interesting to see how poorly Asian equity markets performed in the past 5 years, and that they are still more than 25% below their pre-crisis peak of October 2007, more than 8 years ago. As the table below shows, the Fund has performed reasonably well during this less than lacklustre period when we were faced with strong headwinds.

Date	MSCI Asia ex Japan (US$) index	Fund NAV/share
October 2007	683.34	$66.29
December 2010	567.35	$78.55
December 2015	499.94	$90.98

Currency valuation versus momentum

Yet again, currency weakness against the US Dollar hurt returns of Asian equities last year. We reiterate our belief that Asia ex Japan currencies are fundamentally undervalued versus the US Dollar on a purchasing power parity (PPP) basis. This bar chart is based on the Big Mac index so it excludes India where beef is not eaten for religious reasons. Based on my experience of spending money in India, the Indian rupee looks as undervalued as any of these Asian currencies shown in the bar chart below.



The strength of the US Dollar has all the hallmarks of a late stage bull market, typified by momentum traders all on the same side of what now appears to be a crowded trade. Our strong view is that the US is a dominant world power whose dominance is in decline, much as happened to Britain during the decline of the British Empire. On a PPP basis, China's economy is already slightly larger than the US economy.

In July, The Economist wrote that "the 'exorbitant privilege' that goes with being the issuer of the dominant currency would ebb for America. Because there is so much demand for dollar assets – more than 60% of all global central-bank reserves are held in dollars – America and companies based there can sell bonds for higher prices than they could otherwise. Since bond yields move inversely to prices, this means it costs less for Americans to borrow – so it is easier for the government to fund its deficits and for firms to raise money. How much is this exorbitant privilege worth? Researchers found that yields in US 10-year Treasury bonds were as much as a percentage point lower in the 2000s thanks to the dollar's status. America is also able to issue all its debt in dollars. The currency mismatch that often triggers debt crises in smaller economies is thus off the cards; the Federal Reserve can simply print more dollars to pay off the government's liabilities. The benefits add up to $100 billion a year for America, estimates the McKinsey Global Institute."

In late November, the IMF agreed to add the Chinese yuan (RMB) to its reserve currency basket, the SDR. The addition will take effect in October 2016. One of the precursors to being added to the reserve currency basket was for China to show that it is liberalising its exchange rate. This was one of the principal explanations for China's widening of the RMB trading band a few months earlier. Inclusion in the SDR was very important for China's leadership, partly because of the exorbitant privilege that accompanies being the world's dominant reserve currency, but also because this opportunity for inclusion in the SDR only happens once every five years. The argument follows that China is likely to be on its best behaviour this year as the RMB is phased into the SDR. Currently, 93% of global fx reserves are in held in the current four components of the SDR: the US Dollar, euro, Sterling and Japanese yen. Only 1% of global fx reserves are currently held in RMB, a portion that is likely to grow significantly over time given that the RMB will have a 10.9% weight in the SDR.

It is interesting to see what happened to the $:£ rate when the last transition of reserve currency status took place. In 1925, the $:£ rate was $4.87. Britain had readopted the gold standard. The high value of the pound placed considerable pressure on the trade and capital account, resulting in a "run on the pound". The UK left the gold standard in 1931, and £ quickly dropped to $3.69. Post-war, Britain was heavily indebted to the USA. Despite a soft loan agreement with repayments over 50 years, £ remained once again under intense pressure. In 1949 £ again devalued to $2.80. In 1967 another balance of payments crisis developed in the British economy with a subsequent devaluation to $2.40. In 1976, the British government was forced to borrow from the IMF and £ fell against the $ to a low of $1.63.

Our view is that the US Dollar is a currency in long-term decline. This chart of the US Dollar Index over the past 50 years illustrates this long-term decline that we think is already underway. It also suggests that the US Dollar rally is probably in its late stages.

The most recent quarterly letter from GMO entitled "Just How Bad Is Emerging, and How Good Is the U.S.?" is worth reading. This is the link:

https://www.gmo.com/docs/default-source/research-and-commentary/strategies/gmo-quarterly-letters/just-how-bad-is-emerging-and-how-good-is-the-u-s-and-give-me-only-good-news!.pdf?sfvrsn=6

In particular, the author, Ben Inker, discusses today's valuation of emerging market currencies in a historic context and the question of whether an investor in emerging markets should hedge currency risk. Suffice it to say that we share similar views, but he supports his argument with empirical data that is complementary to our analysis which is based on PPP and reserve currency status.

In last year's Chairman's statement, I said that " I do have some concerns about "tail risks" in China and the renmimbi (RMB) and did explore buying out-of-the-money put options on the offshore RMB late last year, but it proved to be a more complicated hedge than I anticipated so we decided against doing so." Last year, the RMB fell by 4% against the US Dollar. Even if we had bought out-of-the-money put options on the offshore RMB, it is doubtful whether we would have made money on the puts because (a) they need to be out-of-the-money to be attractively priced and in order to minimise the "insurance premium" so at least some of the options that we considered buying would still be out-of-the-money and therefore worthless, (b) it is more difficult and expensive to buy options that expire in more than a year so the options might have expired by now and we would need to buy more "insurance", and (c) unlike most investments that we consider, options decay in value over time.

There are a number of very smart people such as Felix Zulauf, Russell Napier, and John Burbank who argue that the RMB will have a substantial further devaluation this year. There is also an excellent interview with Mark Hart on Real Vision TV explaining his bearish position on the RMB. The arguments in favour of a substantial further RMB devaluation this year are powerful, but the arguments against are timing, the likelihood that the PBOC (China's central bank) will be intervening with its $3.3 trillion in reserves to prevent a steep slide, and if the US Dollar weakens instead of strengthens, it will relieve devaluation pressure on the RMB since the RMB is loosely pegged to the Dollar. On balance, we decided not to buy out-of-the-money puts on the RMB, though I acknowledge that it is a difficult call.

Portfolio activity

Turnover in the Fund last year was exceptionally low. This was due to the Fund's low cash level. The Fund received inflows from final liquidation distributions by three closed-end funds totalling just over $0.5 million; $1.35 million in capital returns from ASM Asia Recovery Fund which is in orderly wind-down; and $1.35 million from a return of capital by Pacific Alliance China Land.

Given the difficulties that we experienced with ARC Capital, a closed-end fund whose former investment manager is under the same parent as the manager of Pacific Alliance China Land (PACL), we decided to reduce our exposure by selling 2 million shares of PACL for $4 million. PACL has been a very good investment for the Fund and we believe that its manager, Pat Boot, is an excellent manager of real estate funds who has compiled a strong track record. The Fund retains an investment in 3.6 million PACL shares worth $7 million so there was also an element of portfolio management in our decision to reduce the size of this holding. We think that PACL is likely to return about $3.5 million to us in the first half of this year and possibly make another large distribution later this year. We are confident that the Fund will ultimately receive more than $5 million in distributions and sales proceeds from this investment in excess of our cost during a relatively short holding period.

The Fund's only investment this year was a $3 million subscription to an ASEAN fund that focuses on the growth in consumer spending in the region. We had a relatively small investment in this fund that we always intended to increase. As the previous table showed, the ASEAN markets and currencies have been the weakest in Asia this past year. This fund's holdings have an average P/E of 9 times this year's estimated earnings which we think is far too cheap. The fund's NAV/share is up 3 ½ times in its 11 years since inception, compounding at more than 12% per annum in US Dollars. During the past 18 months, its NAV/share fell by 20%. We think this $7 million investment is poised to do well from here.

ARC Capital

It has been a long, hard road being an investor in ARC Capital. In late 2014, the former investment manager of this closed-end fund bought 50.1% of its shares in the market and then called an EGM to replace the entire Board of Directors. Prior to the accumulation of their controlling stake, we were the largest shareholder with a 13.7% stake. In order to protect our investment, I led a group of large minority shareholders in retaining legal counsel. As it turned out, 2 of the 3 directors who were nominated by the former manager and subsequently appointed turned out to be far more independent than we feared and ultimately did an excellent job for shareholders. The third new director was in our view hopelessly conflicted and he was removed by a Board resolution.

During the past 15 months, I spent hundreds of hours trying to protect and recover value from this investment. It also entailed the Fund contributing towards legal expenses. There were a number of worrying developments last year. ARC Capital's broker was replaced, the shares were suspended at the end of June because the audited financial statements were not published within the six month deadline, its NOMAD resigned, and at the eleventh hour, a replacement NOMAD was not appointed, resulting in ARC Capital's shares being de-listed from the AIM market in London in October. An announcement by ARC Capital on 15th October of its de-listing alluded to "ongoing discussions between certain shareholders of the Company to explore the possibility of a potential future acquisition of all the Company's ordinary shares".

In early January, ARC Capital requisitioned an EGM for shareholders to vote on a merger than would result in the minority shareholders being paid US$0.57 per share and the shares being cancelled. From the end of June to year end, the shares were valued by the Fund in calculating its NAV at the last traded price of US$0.265 per share. We expect the EGM result to be an overwhelming vote in favour and we will know the result in time to finalise the Fund's NAV at the end of January. This should result in an uplift in the value of this investment from $0.265 per share at the end of December to $0.57 per share at the end of January. The Fund owns over 31 million shares of ARC Capital so this should be helpful in offsetting losses elsewhere so far this month caused by very weak markets. After a lot of work, this is a very satisfying outcome. In mid-February, the Fund expects to receive $17.8 million from selling its ARC Capital shares.

Stable assets

The Fund had $271 million in net assets at yearend after receiving $11 million in subscriptions and $21 million in redemptions during the year.

Only about 1% of the Fund's net assets are currently in cash. This will increase to 7% once the ARC Capital cash is received. Some of this is earmarked for a new investment in what we believe is a very high quality investment, with strong predicable cash flows that is priced at a more than 10% free cash flow yield. We also have some of the cash earmarked to add to an existing investment in a listed closed-end fund with an excellent track record that is trading at a historically wide discount to NAV.

<u>The case for investing in Asia</u>

After five years of headwinds, it is important to remember why we think that OAM Asian Recovery Fund will continue to be a good long-term investment.

1. Today, we are starting from historically attractive equity valuations and undervalued currencies. These two points were elaborated on in greater detail in this letter. Empirical evidence shows that starting valuations are the most important determinant of future returns. China is the current focus of investors' concerns, but it is also the source of deepest value. The Fund has an investment of $15 million in an Asian smaller companies fund that has 75% of its assets invested in HK-listed smaller companies. As the pair who manage this fund noted recently, from a valuation perspective, China businesses listed in Hong Kong are going for a song. Their portfolio of companies is deeply undervalued and currently trades at an average valuation of 4x ex-cash P/E, 1x book and 5% dividend yield. More than 50% of their portfolio companies also have very defensive balance sheets with net cash averaging 50% of their market capitalisation. We have rarely, if ever, seen valuation metrics this attractive on a portfolio basis.
2. While I would advocate an index approach to investing in the highly competitive US equity market, indices in Asia do not capture the region's growth. A large proportion of the listed equities in China and India are either inefficiently run, value destructive businesses, or state-controlled companies, the two being pretty much synonymous! In particular, we think that shares in well-run companies that serve Asian consumers are likely to continue being long-term winners in spite of their valuations being higher than Asian market averages. The rise of the local consumer in the emerging world looks almost certain, in a very uncertain world, to be a multi-decade event. Consumer branded franchises have proved to be durable, profitable, compounding machines in the developed world over several decades which is one of the reasons why Buffett gravitates to these businesses. The emerging world is no different. Take Desnoes & Geddes (D&G), owner of Red Stripe, a brand born on our doorstep. Shareholders of D&G made 25 times their investment in US Dollar terms over the past 20 years, or 18% per annum, in spite of Jamaica having little or no economic growth and numerous currency devaluations over the past two decades.
3. Asia's superior economic growth is likely to be sustained through hard work; clever and ambitious people; high savings rates and rising standards of living which will drive consumption growth; infrastructural improvements such as new highways, high-speed trains, airports and ports that reduce the time to travel from A to B; and productivity improvements borne from the ability to make efficiency improvements from technology and processes that already exist We have spent many years building a network of excellent investment managers in Asia and understanding their investment processes. The Fund's directors have each met all or most of these investment managers and share my positive views of them. In an effort to bring "Asia to you", we have invited a number of our managers whenever they will be travelling within a few hours' flight from Cayman to visit us and explain their investment approach to our Cayman clients and other clients who are able to visit for these presentations.

The major risks of investing in the Fund are largely related to timing in my view. The US equity market is valued at such a historically inflated level that a collapse in the US market could happen any time and this would likely be contagious to other equity markets globally. The other risk which is somewhat related is that quantitative easing (QE) is an experiment which is without historic precedent so we do not know its ultimate after-effects. What is clear is that a lot of this “excess money” has been invested foolishly in financial markets. Some has been invested in equity markets, but much more in debt which is artificially cheap as a result of QE. While we don’t think this is the case with the underlying companies in which the Fund has invested, there is a saying on Wall Street that when the paddy wagon pulls up, they take the good girls with the bad! Our “sleep at night” reassurance is that the investment arithmetic works for our investments, and since they have strong balance sheets, our companies will more than likely gain market share during any period of duress.

Desmond Kinch, CFA
Chairman