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OAM Asian Recovery Fund

14th January, 2021

Dear Fellow Shareholder,

The Fund's NAV/share increased by 15.4% last year. By comparison, the Fund's benchmark, the MSCI Asia ex Japan (US$) index, rose by 22.5% last year. Whilst the absolute return was strong, the Fund's return relative to its benchmark was disappointing. This was largely attributable to the Fund's underlying investments being very different to the benchmark.

During the 22 years since inception, the Fund's NAV compounded at 12.9% per annum, rising more than fourteen-fold, while the MSCI Asia ex Japan (US$) index rose 310% or 6.6% 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.

Geographic diversification & divergence

The benchmark is very concentrated with a quarter comprising four large technology companies. Over 80% of the benchmark is in North Asia, with 51% in China/HK where we have 37% of our assets, 16% in South Korea where we have only 3% exposure, and 14% in Taiwan where we have 7% of our assets. Last year, North Asian markets were the strongest markets in Asia, with the MSCI Korea (US$) index rising 42%, the MSCI Taiwan (US$) index rising 37%, and the MSCI China (US$) index rising 27%. Our underexposure to these markets relative to the index hurt our relative performance last year, but as I will explain, our overweight exposure to India and the ASEAN region ought to stand us in good stead going forward. We think the Fund's broader geographic exposure and lower exposure to a few mega-cap companies positions it better for higher future returns and at lower risk than the market index. For the time being, the self-reinforcing effect of flows into major equity index funds and ETFs and the concomitant closet-indexing by many investors makes active stock selection a frustrating endeavour.

Currently, 44% of OAM Asian Recovery Fund's assets are invested in Greater China, consisting of China, Hong Kong and Taiwan. It is widely acknowledged that China, Hong Kong and Taiwan handled the Covid pandemic very well, and these markets, along with South Korea which also handled Covid well, achieved the highest returns in Asia last year. About 23% of the Fund's assets are currently invested in the Indian sub-continent, almost exclusively in India, which is double the benchmark exposure. Last year, the MSCI India index returned

13.9%. India handled COVID less well, but there were relatively few deaths from the pandemic. The Fund has about 23% of its assets invested in the ASEAN region, which is almost triple the benchmark exposure. Like India, the ASEAN region, with the exception of Singapore and Vietnam, handled COVID less well than Greater China. Last year, the Indonesian market fell 10.3%, the Vietnamese market rose 13.2%, and the Philippines market fell 4.3%. These are the three ASEAN markets where we have the largest exposure. All market performance figures cited are in US dollars.

Greater China

Over 70% of the Fund's exposure to Greater China is through funds managed by three managers: Value Partners, Overlook, and Arisaig. The Fund allocated money to these three managers since its inception 22 years ago. During the Asian financial crisis in 1998, I spent about two months in Asia on two trips through the region trying to identify upcoming super-investors in Asia. Five managers made the list and three of them have remarkably managed to grow their assets under management from around $100 million each at the time to billions today and still maintain superb performance. I refer to them as our holy trinity. If you ever meet any of these super-investors, please buy them a drink! These three managers still manage over 40% of the Fund's assets today.

Value Partners was founded by Cheah Cheng Hye. He remains a friend who I try to have lunch with whenever I visit Hong Kong. Cheng Hye remains as engaged today as he was 22 years ago. He built Value Partners into one of the largest investment managers in Asia and the manager is now listed on the Hong Kong Stock Exchange. We invested just over $2 million in his flagship Value Partners Classic A Fund (the A shares are no longer available for subscription) in tranches from 1999-2002. As the investment became too large, we redeemed $8 million in tranches from the fund between 2017-20. In 2008, shortly after its inception, we invested $3 million in Value Partners Taiwan Fund. We redeemed $2 million from that fund last year. The value of our remaining investment in the two Value Partners funds is $56 million.

Overlook was founded by Richard Lawrence. We invested just over $3 million in his fund in tranches from 1999-2006. As Overlook grew, Richard brought in talented stock pickers who became partners, namely, James Squire and Leonie Foong. In February 2018, Overlook decided to return $1 billion to its limited partners because they felt that their assets under management were getting too large, something few managers have ever done. We received a distribution of $7.5 million. In 2016, Overlook launched a second partnership to invest in China Yangtze, in which they are the largest foreign shareholder. We invested $4 million at launch, and at year end we redeemed $3 million from this second partnership. The value of our remaining investment with Overlook in its two partnerships is $42 million.

Arisaig Partners was founded by James Alexandroff, Lindsay Cooper and Torquil McAlpine. We invested less than $4 million in tranches with Arisaig from 1999-2004. James, Lindsay and Torquil built a remarkable team at Arisaig as their assets under management grew. Some of these talented individuals later left to start their own firms – we dub them Arisaig cubs - and we backed four of them, all successfully. The original founders are now retired, and the current partners are spread around the world, with the locus remaining in Singapore. Arisaig's depth of research into the companies they own and the few sectors in which they invest is second to none. This has enabled them to be remarkably successful at identifying the future leading consumer brands in Asia. In recent years, most of these leading consumer names started looking increasingly expensive.

Based on our valuation concerns and the risks surrounding retirement by the founders (which they planned very carefully and well), we redeemed just over $19 million in tranches from 2013-2020. Our worries proved misplaced as the value of the Fund's remaining investment in Arisaig Asia Consumer Fund is over $35 million.

Our next largest exposure to Greater China is through our investment in a small cap value fund that has over 60% of its assets invested in Hong Kong-listed small caps. We have nearly $15 million invested in this fund and have made very little return over the roughly 7 years we have been a shareholder, but that is not surprising given that both small cap and value have been deeply out of favour in Asia for much of the past decade. During the past 7 years, the MSCI Hong Kong Small Cap index nearly halved. However, this fund's portfolio is trading at exceedingly attractive valuations with an average P/E of 7, a dividend yield of 6.9%, and ROE of 19%.

India

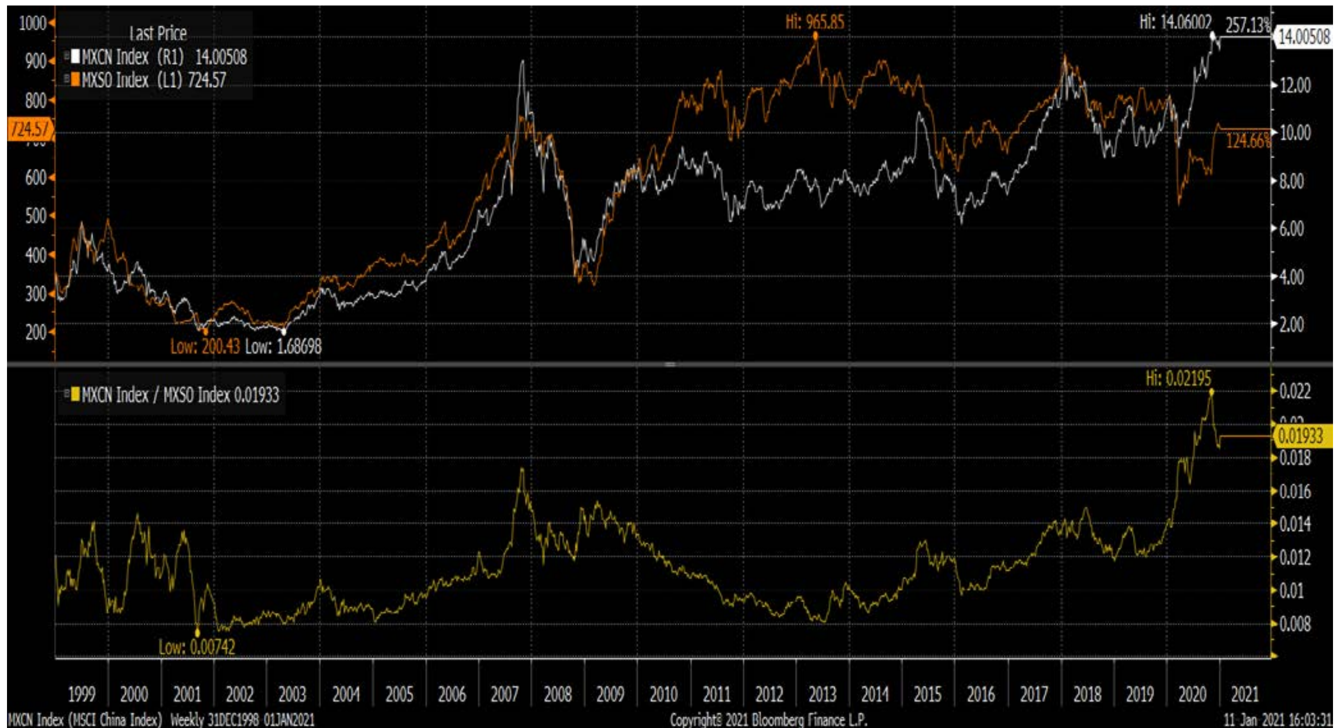
Valuations in India are not as compelling as in the rest of Asia, and this has generally been the case throughout the Fund's life. But we think the earnings of the companies that we own there, particularly in the fast moving consumer goods (FMCG), retail, and financial sectors, are likely to grow rapidly for at least the next decade. Our view is that India is likely to go through uncomfortable periods for investors, but as with China, the die was cast about 30 years ago and the changes that are likely to vastly improve the living standards of India are probably irreversible. Growth slowed in India during the past few years, but we think this is a pause rather than a reversal. India is already the world's fifth biggest economy with a GDP of about $3 trillion and it is widely expected that GDP should more than double by 2030, making it the world's third or fourth biggest economy by the end of this decade.

In 1990, India operated under the Raj licence system under which businesses had to operate based on licences granted by the government, excluding the private sector from participation in many industries. In 1990, the waiting list to get a telephone landline was 8 years. Today, 350 million Indians have smartphones. In 1991, India's foreign exchange reserves fell to 3 weeks of imports and India was forced to post its gold reserves as collateral with the IMF in order to get an emergency loan. This led to a change in the government and a liberalisation of the economy led by its new Finance Minister, Manmohan Singh. These changes were almost as significant as the changes made in China by Deng Xiaoping at the same time. Since 1991, India's GDP has grown more than ten-fold in US dollar terms from less than $300 billion to over $3 trillion. Even in the past 6 years since Modi was elected, the changes have been monumental. The India base rate for lending has dropped from 10% to 7.4% and the corporate tax rate from 38.95% to 25.2%. All this good news has been lost on the stock market. During the past 10 years, the MSCI India (US$) index essentially went sideways, returning 3% per annum inclusive of dividends while the S&P 500 index returned 14% per annum over the same span. Over the 10 years prior to that, the MSCI India (US$) index returned 19% per annum while the S&P 500 index returned 1% per annum over the same span. Today, the value of every listed company in India is less than the market capitalisation of Amazon and Tesla.

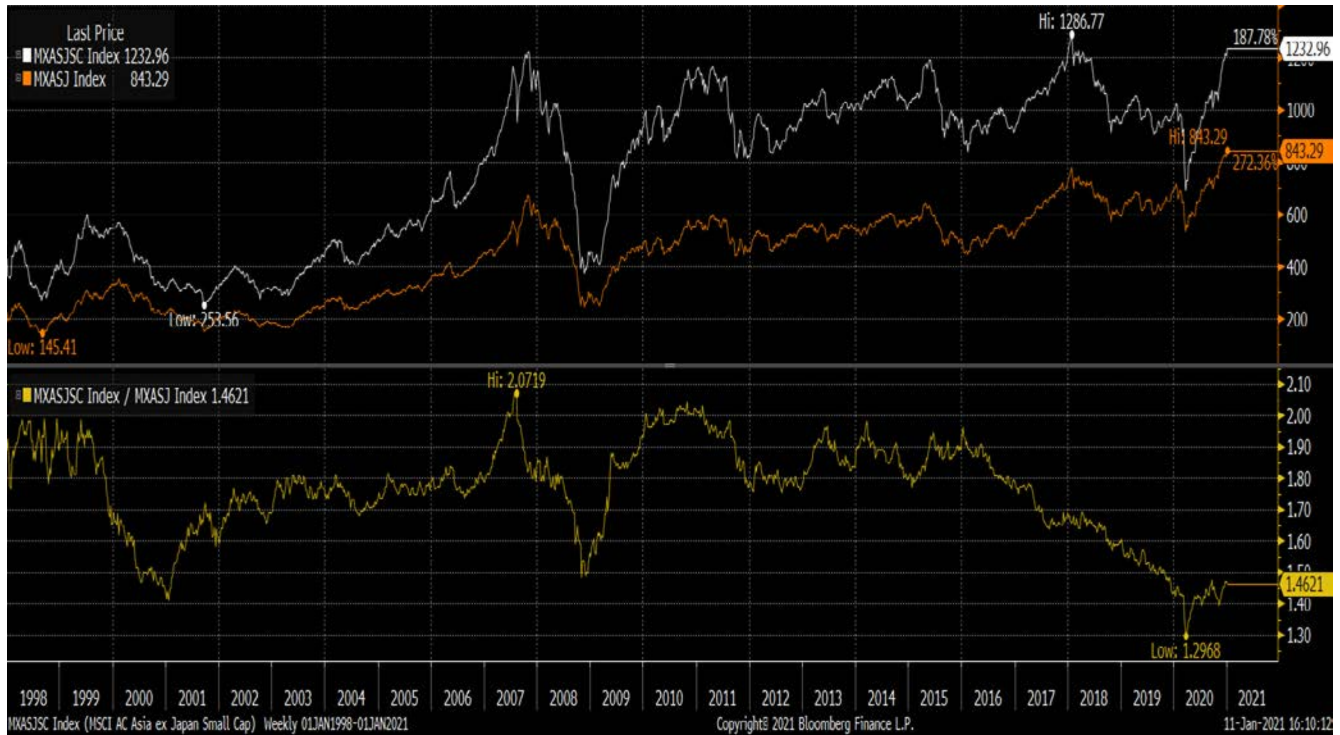
Our exposure to India is primarily through our investment in Arisaig Asia Consumer Fund, two funds founded by former heads of Arisaig's Indian office, and one other manager based in Mumbai. By sector, we are principally exposed to the leading consumer brands and the financial sector, both of which we think have long runways for future growth starting from a relatively low base.

ASEAN

The chart below shows the historic performance of the MSCI China index (orange line) versus the MSCI ASEAN index (white line) since the Fund's launch at the end of 1998. The yellow line at the bottom shows the relative performance of the MSCI China index to the MSCI ASEAN index which hit a record at the end of November before sharply reversing. This chart starkly illustrates the sharp divergence between the two indices last year. Whilst our ASEAN exposure (ex Vietnam) was a drag on performance last year, we think it will be a significant contributor to future performance given equity valuations in that region.



The biggest bargains in Asia today are available in the ASEAN region, particularly in the small and mid-cap segments of the market where many companies have been shunned by investors for several years while their profits continued to grow. Over the past 7 ½ years, the MSCI Philippines Small Cap index fell 50% while the MSCI Indonesia Small Cap index fell 60%. As the chart on the following page of the MSCI Asia ex Japan Small Cap index (white line) versus the MSCI Asia ex Japan index (orange line), and of the relative performance (yellow line below) shows, Asian smaller companies underperformed their larger brethren significantly over the past 10 years. This is probably a result of the growth of index investing. The index has never been this concentrated, and the dominant tech companies feel very much like a crowded trade. Over the long term, empirical data from more established markets like the US which span multiple decades show that smaller companies have historically outperformed larger companies. We expect this pattern to apply to Asia in coming decades.



<u>Microsoft or ASEAN markets?</u>

We bought shares in Microsoft 10 years ago for a pension plan for which we had the mandate to manage their US equity portfolio. We paid $26/share which was less than half the price where the shares peaked nearly 11 years earlier during the first internet boom. In 2010/11, Microsoft earned $22.4 billion. At $26/share, we were paying just 7 times Microsoft's earnings, after excluding the cash on its balance sheet. In 2019/20, Microsoft earned $44.7 billion. During the past 9 years, Microsoft's earnings roughly doubled, compounding at 8% per annum. Microsoft's share price rose more than 8-fold to $222. Yet, the opposite happened in the 11 years preceding when Microsoft's earnings more than doubled, compounding at 8% per annum, while the share price halved.

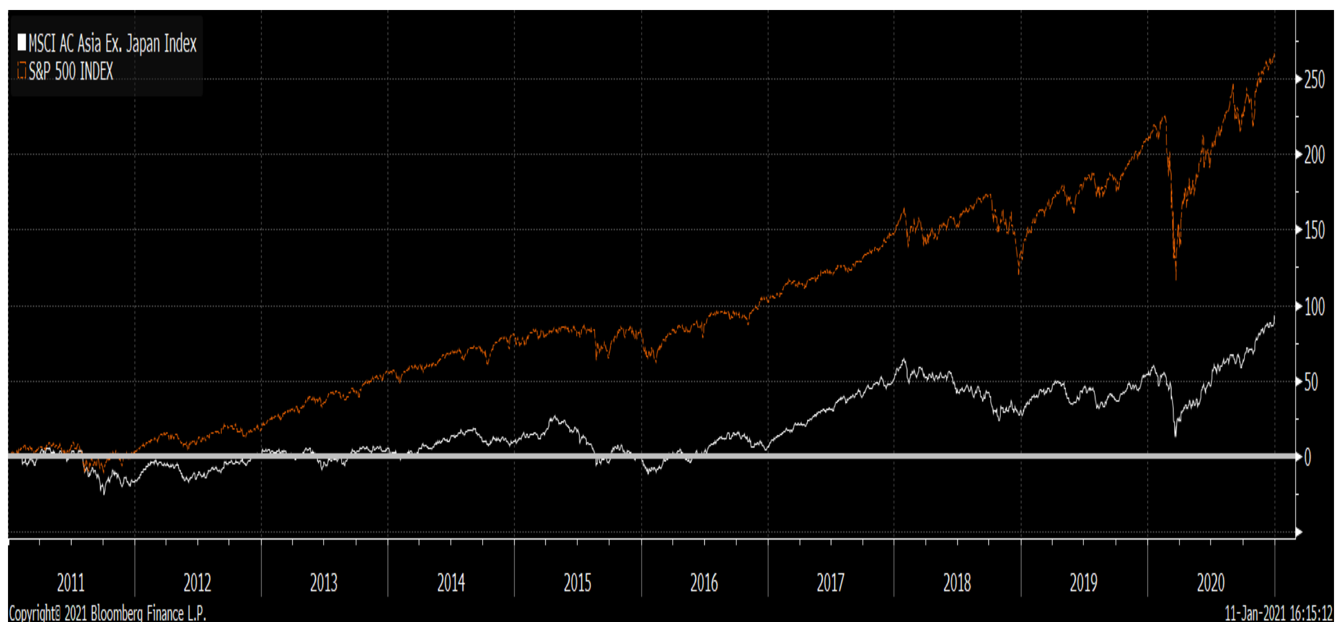
Why am I discussing Microsoft in this letter? The reason is simple. It vividly illustrates the contrast between a good company and a good investment. Microsoft now has a market capitalisation of roughly $1.7 trillion which is about the same as the market cap of all ASEAN markets (Singapore, Malaysia, Indonesia, Thailand, the Philippines and Vietnam). Microsoft is a wonderful company and a beneficiary of "work from home" during COVID-19. Yet, the company has $150 billion in annual sales while the ASEAN region has a combined GDP of over $3 trillion and about 10% of the world's population in what is arguably one of the world's most economically dynamic regions.

In my Chairman's statement to this Fund's shareholders 19 years ago, I made a similar argument. In that letter, I wrote:

"An excellent example of a multinational whose share price already discounts future growth is Coca Cola. Warren Buffett remarked in a recent Berkshire Hathaway annual report that one of the reasons why he is so confident that Coke will be earning substantially more money in 20 years is because Coke sells 425 eight-ounce servings per capita in the U.S. while in China they only sell 7 servings per capita. Buffett argued that as living standards in Asia rise, servings of Coke per capita in China would increase substantially. I

agree with this premise." But I added, "The problem with Coke as an investment is that its shares sell at a P/E of 29 even though Coke's share price has declined by nearly 50% during the past 3 ½ years." I then contrasted it with Vitasoy, an underlying holding in the Fund that benefited in a more direct way from the growth of China but at a much cheaper valuation. I wrote: "Vitasoy produces and markets the leading soya milk drink in Hong Kong which is the soft drink of choice for a large portion of Hong Kong's Chinese community. Vitasoy has a 50% share of the non-carbonated soft drinks market in Hong Kong. It is also expanding into China where it recently built production facilities in Shanghai and Shenzhen. The China operations are currently loss-making as Vitasoy builds its distribution network around these major cities. Vitasoy can easily finance these expansion costs and short-term losses as it still has no debt and about HK$200 million in cash on its balance sheet, while its Hong Kong business is highly cash generative. The losses resulting from international expansion obscure the true profitability of the business. Even so, Vitasoy's shares sell at a P/E of 9 and yield more than 6%. Unlike the U.S. where there is 30% withholding tax on dividends, the Fund collects Vitasoy's dividends free of any withholding tax."

Since then, Coke shareholders generated a compound annual return of 7%, nearly quadrupling their investment inclusive of reinvested dividends. Vitasoy shareholders generated a compound annual return of 23%, increasing the value of their investment more than 50-fold inclusive of reinvested dividends. Vitasoy's market cap 19 years ago was HK$1.2 billion (US$155 million) which was 1/800th of Coke's market cap at the time. Its low P/E, small market cap, and ability to grow its business significantly in a large untapped market provided scope to make this kind of return. Stocks and stock markets move in long cycles between cheap and expensive. It is impossible to say when investors' attention will return from the US tech behemoths to long ignored emerging markets, but after a decade of Asia ex Japan equities generating a low return while earnings continued to grow, we think that we are near a major turning point in market leadership – see chart below of the comparative returns of the MSCI Asia ex Japan index (white line) compared to the S&P 500 index (orange line) over the past 10 years.



The strong outperformance of US equities has pushed their valuation on a Cyclically-Adjusted P/E (CAPE) to 34, which is double the long-term average, and we think it bodes ill for future returns. By comparison, the

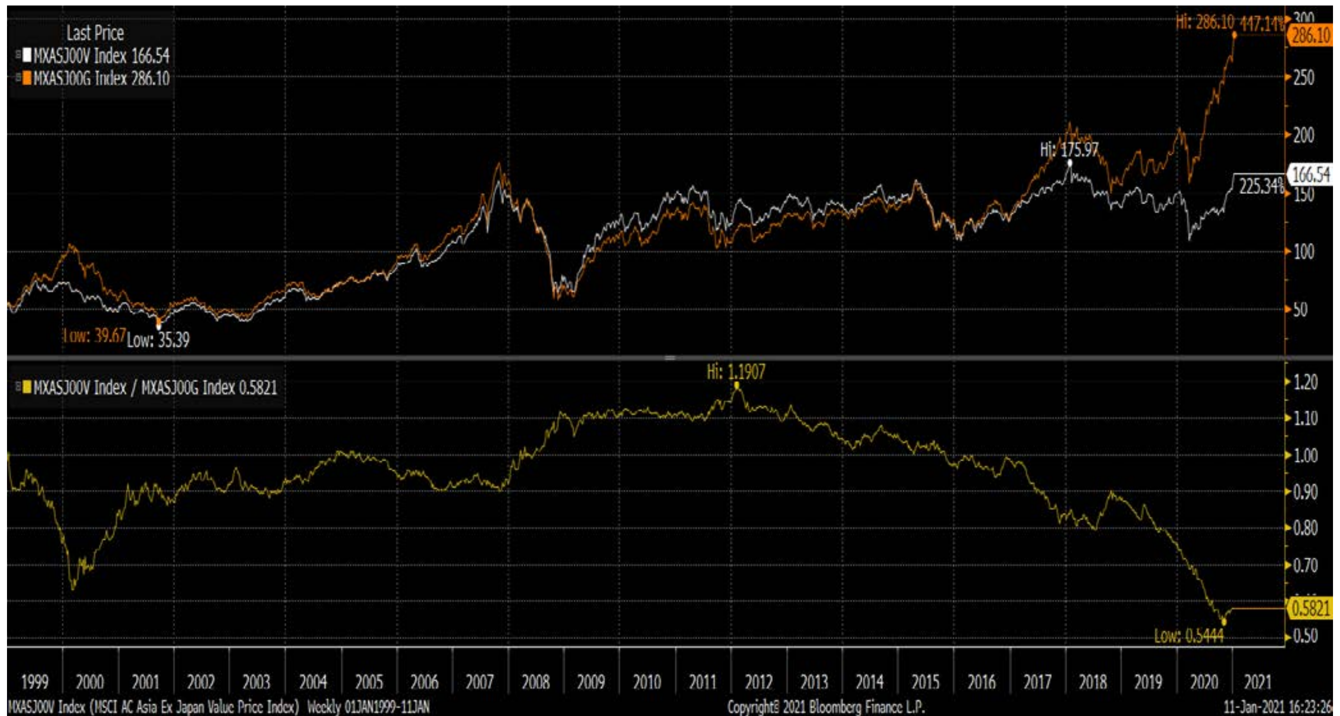
CAPE for Hong Kong equities where there is a reasonable historic data set is 13, compared to a historic average for that market of 18. Similarly, the CAPE for Singapore is 11, compared to a historic average of 20. Subsequent 10-year returns from markets trading at a CAPE of close to 10 have historically been high. This illustrates the bifurcation in the valuation of stock markets globally, and of likely future return prospects.

Growth or value?

Unlike our European fund, this Fund is not wedded to a value approach. We allocate most of the Fund's assets to managers who we think are exceptional and we have no control over how they invest, though we do get a strong understanding of their investment process before committing capital. In the first decade of the Fund's existence, it had a strong value bias. However, in the past decade that shifted to much more of a growth bias. We noted this shift over the past decade by what I referred to earlier as our holy trinity of managers. We also allocated money to Arisaig cubs who all firmly fall into the growth investing camp which contributed to the Fund having more of a growth bias.

There are good reasons to be circumspect about the long-term outperformance of value versus growth in emerging markets. Often, what appears to be statistically cheap is cheap for a reason. These reasons typically include: state-controlled companies prioritising the goals of their controlling shareholder over those of minority shareholders; promoters of listed companies behaving like pirates; and other forms of poor corporate governance. We do however think it is possible with thorough research to exclude these "cheap for a reason" value stocks and build portfolios of better than average businesses at very low valuations.

The chart below shows the performance of the MSCI Asia ex Japan Value index (white line) versus the MSCI Asia ex Japan Growth index (orange line) since the Fund's inception.



We think that value stocks in the region now look exceptionally cheap, but with the caveats stated above. Recent research by Jefferies shows that the relative P/E of the most expensive quintile (growth) to the

cheapest quintile (value) is 3 standard deviations above average. According to the same paper by Jefferies, when companies in the region are sorted by decile using P/E, from 2003 to mid-2018, the average P/E of the most expensive decile was 2.5-4 times that of the cheapest decile. Today, that multiple has risen to 9. Our most likely destination for new capital will therefore be smaller value stocks in ASEAN which is the intersection of the three factors that we think are likely to provide the highest future returns in the region at today's prices.

Changes to the portfolio

Last year, the Fund received about $3 million from three funds in which it is invested that are liquidating their assets on an orderly basis. It also received interest and dividends of about $0.75 million on its cash balance and from the two high yielding Hong Kong listed equities it holds. We also sold the Fund's holding in Vietnam Enterprises Investments Ltd., a London-listed closed-end fund at a nice profit when the discount to NAV at which its shares traded narrowed to 10%, raising $3.5 million. We also redeemed a total of $19 million from 6 open-ended funds in which we have been longstanding shareholders. This was partly for portfolio management reasons and less happily for the necessity of raising cash to pay redemptions – more on that below.

Outlook

During the year, I was unable to travel to Asia, but between numerous Zoom & Teams calls and written reports provided by the managers we have selected to manage the Fund's assets and the few companies in which we are invested on the basis of them being deep value investments, we are excited by the Fund's long-term prospects. However, we think it is unlikely that the Fund will generate the kind of return over the next 7-10 years that it achieved over the past 22 years. However, even generating half this return would increase the Fund's NAV to $250 by the end of this decade which we think is a reasonable objective. In the context of the prospect for very low or negative returns for financial assets over the rest of this decade, we think this is a very attractive investment.

We share Jeremy Grantham's view, most recently expressed in his piece "Waiting for the Last Dance", that the long US equity bull market is now an epic bubble that will ultimately be recorded as one of the great bubbles in financial history (https://www.gmo.com/americas/research-library/waiting-for-the-last-dance/). His view is that value investing and emerging market equities are the places to hide and generate decent returns. Over the next 7 years, his firm, GMO, is forecasting real returns for US large cap equities of negative 6.6% per annum over the next 7 years, i.e. a loss of more than 25% over 7 years assuming inflation of 2.2% per annum, and a real return of +5.6% per annum for value equities in emerging markets, i.e. a return of nearly 70% over the next 7 years using the same assumption. This inflation assumption may prove too low as discussed in my Chairman's statement for OAM European Value Fund, in which case these forecast absolute returns would be higher. The key points though remain (i) the enormous gap in forecast asset class returns, and (ii) GMO's track record when identifying a large range of forecast returns for different asset classes and ranking them has been good over a long period of time.

We think there are a lot of similarities between now and the dot com boom which peaked in March 2000. We had similar concerns back then about the US equity market. These concerns proved well-founded as the S&P 500 returned 1% per annum inclusive of dividends in the decade from 2000-09. Over the same period, OAM Asian Recovery Fund returned 13.5% per annum, and that was on the back of returning 69% in 1999 which was its first year from launch. Asian equities were trading at generational bargain valuations when we

launched the Fund at the end of 1998, but less so at the start of 2000. Nevertheless, valuations were still reasonable in Asia ex Japan at the time, whereas they were unreasonable in large cap US equities, and particularly so in the technology sector. The same pertains today.

Above average redemptions during the year

The Fund had $322 million in net assets at year end. During the year, there were $2 million in subscriptions and $30 million in redemptions. This is the seventh consecutive year that the Fund has had net redemptions. The low level of subscriptions is a function of us not marketing, instead relying entirely on word of mouth referrals from happy clients. The high level of redemptions is due to two specific factors.

In late April, the Cayman Islands Government amended the National Pension Regulations to give companies and individuals an option to stop making contributions to pension plans and to make withdrawals from their pension plans, but these changes were not applicable to civil servants' pension schemes. The net effect of this was that about US$500 million, or a third of private sector pension assets was withdrawn from Cayman pension plans last year. This change in regulations resulted in $9 million in redemptions from the Fund by two domestic pension plans.

The other major factor that resulted in large redemptions was the decision by a longstanding client to move their corporate and trust structures from Cayman to the US. The torrent of new regulations passed in Cayman in recent years finally became too much for these clients and they are moving to a lighter touch regulatory regime. Hopefully, the regulatory pendulum in Cayman has reach its limit as it has been very costly to us. Last year, we had $9 million in redemptions by the clients who were forced to redeem from the Fund as a result of moving their structures to the US, even though the beneficial owners are non-US Persons. We are anticipating the remainder of redemptions from these clients totalling about $14 million to take place in the next few months. The Fund has about $11.5 million in cash and will be receiving $7 million from redeeming two investments immediately after year end so there will be ample cash to pay these pending redemptions and leave a buffer.

A rant about regulation

I wish to make a few observations about the current regulatory landscape. It has become increasingly clear that much of the regulation imposed upon Cayman is nothing more than an attempt to stifle offshore business competition, in the process creating an unlevel and unfair playing field. Examples of this include the following specific examples. The US signed FATCA bilateral agreements with countries around the world that are mostly non-reciprocal, and then refused to sign up to the multilateral CRS agreement. US financial institutions are now marketing their competitive advantage of not being required to do any tax reporting to most countries. Meanwhile, the EU, from which Cayman derives very little financial services business, has imposed very complex and time-consuming regulatory obligations upon Cayman, the result of which is that we are seeing totally transparent businesses, including some with a physical presence here, moving from Cayman to Luxembourg and Dublin to avoid the time-consuming regulatory burden of remaining in Cayman, with no extra tax take for the EU or its members.

It is also clear that the current regulatory landscape is not supportive of small, simple investment boutiques such as ours. In spite of our unblemished legal and regulatory track record over more than 31 years, there is no potential for us to earn our way to a simpler regime through good behavior. Nor is any allowance made for the fact that we take on less than a handful of new clients each year, we know them very well, and we

make a limited number of investments that we own for the long-term. Yet we are treated the same as a fund that invests in exotic derivatives or one that uses leverage, shorting and other risky strategies, or funds that trade constantly. The onslaught of new regulation forces companies to either abdicate responsibility for knowing their clients by outsourcing to a thriving industry of service providers rather than getting to know their clients well, or spend an inordinate amount of time reading and understanding the myriad of new laws, regulations, guidance notes and rules at the expense of trying to create economic value for its clients and the firm. We spent tens of thousands of dollars on such service providers to satisfy the new rules and I estimate that about half the total hours spent at OAM during the past few years has been spent on legal, regulatory and compliance issues. Meanwhile, repeat offenders are allowed to continue conducting business, loopholes for circumventing regulations persist, and the crooks continue to launder their ill-gotten proceeds, to a large extent in the countries that have played a major role in imposing these regulations upon us.

Alignment of interest

The manager, the Fund's directors and their wives in aggregate now own 18% of the Fund's shares, and entities which they manage or of which they are a director own an additional 5% of the Fund so our interests are closely aligned with yours. We seek the same alignment of interest from the managers to whom we allocate funds to manage.

Desmond Kinch, CFA
Chairman