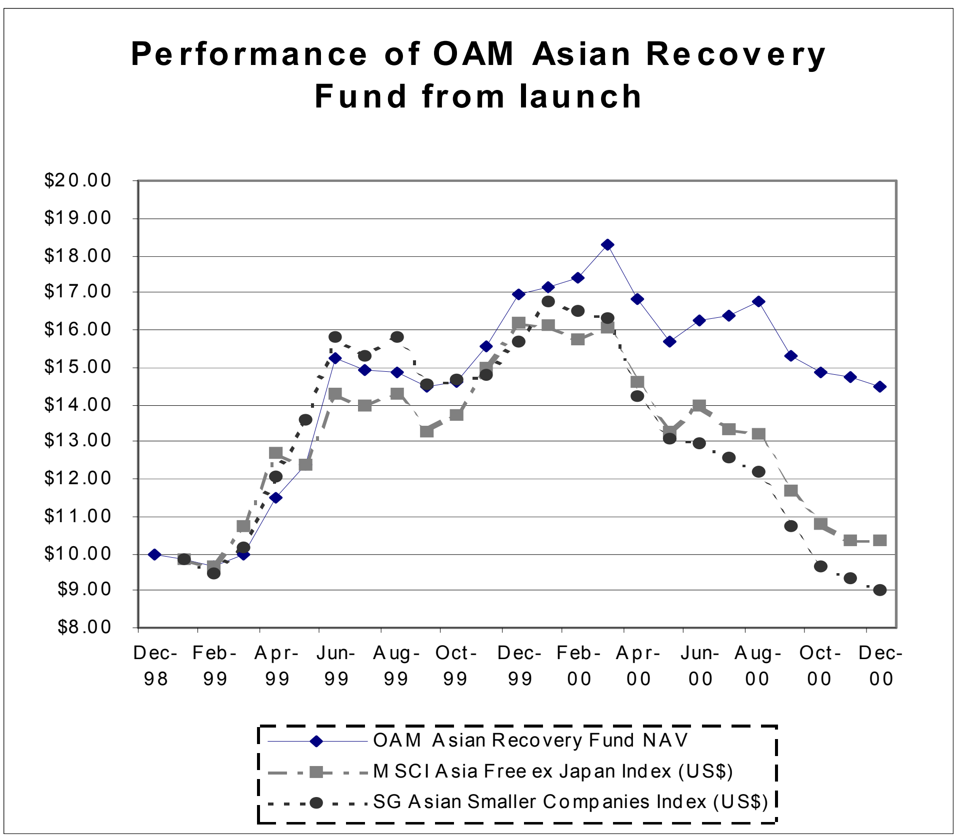
OAM Asian Recovery Fund

Annual report for 2000

Chairman's statement

In last year's Chairman's statement, I made the following comments about my expectations for OAM Asian Recovery Fund in 2000:

"The return this year will be lower than last year's return! Beyond that, it is difficult to make predictions. This year, I would be happy with a 20% NAV return for the Fund. More to the point, such a return should be achieved, barring turmoil this year in world financial markets. Earnings growth in Asia is very strong as economies recover and many companies focus on return on capital. Valuations of many Asian companies are still reasonable, particularly smaller companies geared towards the Asian consumer which comprise a large proportion of the Fund's assets. Though I believe that valuations are excessive in most of the Asian technology and telecommunications sector which now comprises just over a third of most Asian stock market indices, these sectors are sparsely represented in the Fund. …. In my view, the biggest risk of an external shock is the bursting of the huge technology/internet/telecom bubble. This bubble is most prevalent in the U.S. where speculation in the equity markets has become so ubiquitous that a bursting of the bubble will likely push the U.S. economy into recession, much like the speculative hangover in Japan ten years ago caused a deep recession there. Shock waves from this would be felt globally."



Unfortunately, the year 2000 was beset by turmoil in world financial markets and a 20% target NAV return for the Fund was thwarted. Within a few months of issuing a warning in last year's Chairman's statement, the huge technology/internet/telecom bubble started to burst. This was the principal cause of the ensuing turmoil in global financial markets. OAM Asian Recovery Fund survived this turmoil to the extent that it suffered less than half the loss by benchmark Asian equity indices, largely due to its focus on value investing and avoiding the hype surrounding much of the technology, media and telecom (TMT) sectors. The investment objective expressed in the Fund's prospectus was to exceed the return on the Fund's benchmark which is the MSCI Asia free ex Japan Index (US$). During the year ended 31st December, 2000, the Fund's NAV per share fell by 14.9% versus a fall in its benchmark of 36.3%. The Fund's directors also compare the Fund's performance against the SG Asian Smaller Companies Index (US$) since a large proportion of the Fund's assets are invested in listed Asian smaller companies. During the year, this index declined by 42.5%. The Fund therefore outperformed both benchmark indices by comfortable margins. According to S& P Micropal, OAM Asian Recovery Fund's investment performance in 2000 was in the top 5% of offshore Far East ex Japan equity funds in its universe of over 200 such funds which it monitors. This follows a stellar maiden year for the Fund in 1999. Micropal requires a 3-year track record before it will accord a rating to a fund. If the Fund can maintain its excellent track record in 2001, it stands a good chance of being awarded a coveted 5-star rating from Micropal.

In December 1998 and January 1999, I wrote to clients of Overseas Asset Management and recommended that they invest in the Fund to take advantage of the very low valuations in Asia. In those letters, I stated that my personal objective was for the Fund's NAV to reach US$50.00 per share within 10 years of launch. If this objective is reached in exactly 10 years from launch, shareholders would earn a compound return of 17.5% per annum from launch. In last year's Chairman's report, I wrote that as a result of the exceptional return earned by the Fund during its first year, the target 10 year NAV return had declined from 17.5% per annum to 12.8% per annum going forward, bearing in mind my target of US$50.00 per share. This year's decline in Asian markets increases the target return for the next 8 years, bearing in mind my $50.00 target, to 16.7% per annum. The decline of Asian stock markets back to levels approaching the depths of the Asian financial crisis has provided investors with a second chance to buy Asian equities at valuations which I believe will rarely ever be this low.

The five core funds which were identified in the prospectus - Arisaig Asian Small Companies Fund, CAM-GTF Ltd., Overlook Investments L.P., Target Asia Fund, and Value Partners "A" Fund - still comprise over 90% of the Fund's assets. During the past year, Arisaig Asian Small Companies Fund received some redemption requests from its institutional shareholders. This brought its number of shares outstanding below its 20 million share cap. The Fund took advantage of this to subscribe for additional shares in this fund which had been capped and was closed to further subscriptions during late 1999/early 2000 when Asian markets were much higher. It is a perverse and infuriating feature of investment management that clients add money when returns (and share valuations) are high and withdraw money when returns (and share valuations) are low. This example shows that institutional investors are not immune to these irrational forces. Arisaig Partners recently stated in a portfolio update that there is considerably more upside than downside in Asian markets given how cheap and under-owned Asian equities are as an asset class at current levels. They added that Asian equities are at valuation lows and local and foreign investors have long since panicked out of Asian markets; the same can not be said for NASDAQ and technology stocks. Arisaig attributes much of the malaise this year in Asian stock markets to inflation-obsessed Asian central banks squeezing liquidity to sterilise their huge trade surpluses of the past two years. With U.S. interest rates now likely to fall, the liquidity situation in Asia should improve.

After returning 111.5% in 1999, Arisaig Asian Small Companies Fund's NAV per share declined by 31.0% in 2000. This was largely due to losses on its holdings in high P/E Indian software companies, Taiwanese integrated circuit designers, and some Hong Kong and Korean fledgling technology companies. In last year's Chairman's statement, I highlighted this risk when I wrote that "of the five core funds, Arisaig is the least sensitive to valuations. Over 40% of the portfolio consists of companies which sell at price earnings (P/E) ratios of more than 20 times this year's estimated earnings. Many of these higher valuation companies are Indian software companies and Taiwanese technology companies. These investments are not replicated elsewhere in the fund's portfolio, and it could be argued strongly that this is the future of Asia." Belatedly, Arisaig acknowledged this error and trimmed its exposure to these high P/E, technology companies. Technology companies now account for only 10% of the assets of Arisaig. The portfolio is now concentrated in lower P/E companies which are largely geared to domestic consumption which should be far less vulnerable to a proverbial U.S. hard landing. The weighted average P/E of Arisaig's portfolio is currently 11 times 2001 estimated earnings which is about half the earnings growth rate estimated this year for the portfolio.

CAM-GTF's strategy of investing in well-managed companies with earnings growth of more than 20% but selling on low P/E's did not insulate this fund from weak Asian markets in 2000. After returning 108.4% in 1999, CAM-GTF's NAV per share declined by 22.2% in 2000. Many of CAM-GTF's companies are beneficiaries of the long-term growth in outsourcing of manufacturing and assembly of technology components to Asian companies. Some of these companies may be vulnerable to a possible hard landing of the U.S. economy. Colin Lee and Siew Kheng are monitoring their holdings very closely for any signs of earnings growth being affected by a slowdown in demand, particularly in the U.S.. At this stage, they remain confident that their holdings on a portfolio weighted average basis can grow their earnings in 2001 by more than 20%. The weighted average P/E of CAM-GTF's portfolio is currently 8 times estimated earnings in 2001, a compelling number given the earnings growth rate of the portfolio's holdings.

Overlook Investments L.P. has been the most disappointing performer of the five core investments in the Fund's portfolio. After being a laggard performer in 1999 with a 42.6% return, Overlook Investments L.P.'s return in 2000 was –21.8%. In October 2000, Richard Lawrence of Overlook Investments wrote: "The work in the trenches showed a continuation of strong earnings and cash flows across the portfolio. Year to date, our earnings are running ahead of our estimates and net profit growth should comfortably exceed 25%. It is accurate to say that we have been far more pleased with the business performance of our companies than with their share prices or the macroeconomic environment. Our prime concern remains the deteriorating overseas demand. …. However, unlike in 1997 when Asia was economically imbalanced, Asia is exceptionally cost competitive and well positioned to weather a storm. …. The weak stock market performance in the quarter highlighted the fragile confidence of the Asian investor. Retail investors in Asia, like everywhere else, are proving to be poor contrarian investors. …. The good news is that close examination of our portfolio shows plenty to be excited about. Our companies are financially stronger than at any time in recent memory and are prepared to withstand whatever the global markets direct at them. The valuation of the portfolio is near our historic low and offers attractive growth and cash yield. This combination will reward us as momentum shifts back to Asia." Of the five core holdings in the Fund, I believe that Overlook Investments L.P. has the most undervalued portfolio of companies. The weighted average P/E of its portfolio is less than 5 times estimated 2001 earnings. Although this has been a disappointing investment so far, I believe that Overlook Investments L.P. will blossom in the near future. To paraphrase a fellow investment manager, investment management is like gardening: when one owns a portfolio of undervalued companies, no one knows when any individual holding will blossom, but like a garden, if the portfolio is well managed, the results over time will be pleasing.

N.L.Teng continues to do a remarkable job managing Target Asia Fund. Target Asia Fund is still sufficiently small for N.L.Teng to practice his unique blend of value investing in undiscovered special situations in South East Asia. Target Asia Fund was launched in September 1996, about nine months before the start of the Asian financial crisis. Since the Fund's launch, its benchmark, the MSCI Far East free ex Japan Index (US$) has declined by 48.0%. Against this backdrop, Target Asia Fund has earned a net compound return for its shareholders of 23.8% per annum. After earning a return of 70.3% in 1999, Target Asia Fund was one of the few funds which was able to preserve its prior year gains in 2000, recording a small increase in NAV of 1.4%. In the past two years, Target Asia Fund's assets have grown from around US$15 million to US$40 million. This is the only fund which is managed by N.L.Teng and he is one of the fund's largest shareholders. In my view, N.L.Teng's style of investing can only continue to achieve these superb results with a relatively small asset base which allows him to be nimble. It is difficult to determine where this threshold lies, beyond which investment returns will be affected. Unlike Arisaig Asian Small Companies Fund and Overlook Investments L.P., Target Asia Fund does not have a cap on subscriptions which is a concern. The one mitigating factor is N.L.Teng's large personal investment in the fund which aligns his interest as manager with those of the fund's shareholders.

Value Partners "A" Fund returned 38.0% in 1999 which made it one of the poorer performing investments in the Fund's portfolio in its maiden year. In 2000, this fund performed superbly, being one of the few Asian equity funds to make money for its shareholders, gaining 10.3%. A large part of this gain resulted from the fund investing about 10% of its assets in Chinese "B" shares listed in Shanghai and Shenzhen. Chinese "B" share prices on average roughly doubled in 2000. However, even after such strong share price moves, most "B" shares still sell for less than half the price of "A" shares of the same company. The key difference between the "A" and "B" shares is that the "A" shares trade in renmimbi and are restricted to domestic Chinese investors and the "B" shares trade in US$'s and HK$'s and are restricted to foreign investors. China is the only stock market in the world where foreign shares trade at a large discount to local shares; usually it is the other way around. Chinese authorities and regulators recently made comments which suggest that the "A" and "B share markets are likely to be merged within the next few years. Since the "A" share markets are about 50 times larger in capitalisation than the "B" share markets, most of any arbitrage between the two share classes is likely to come from further increases in "B" share prices.

Most of the remaining companies in Value Partners fund are Hong Kong-listed smaller capitalisation companies, with over half of these having their principal exposure to the booming Chinese economy. The share prices of most of these companies are still trading near record low valuations. The Dow Jones Hong Kong Small-Cap Index fell by 67.2% from its launch on 31st December, 1993 to 31st October, 2000 which illustrates the share price battering taken by these companies. From November, 2000, Dow Jones stopped compiling this Index due to lack of investor interest. This must be the ultimate contrarian buy signal for this ignored asset class, particularly when in November alone, controlling shareholders of three Hong Kong-listed smaller capitalisation companies, Ng Fung Hong, Winsor, and Sime Darby Hong Kong, decided to take their companies private by buying out minority shareholders at big premiums to the quoted price. Ultra-cheap Hong Kong-listed smaller capitalisation companies, a speciality of Value Partners, are abundant and many of these companies also appear in the portfolios of the Fund's other four core holdings. Even after doing well for shareholders in 2000, the weighted average P/E of Value Partners Fund is 7, the dividend yield is 6.5%, and earnings growth is double digit.

The Fund's remaining investments are two closed-end funds, Siam Investment Fund which invests in Thai smaller companies and Taj Performance Fund which invests in Indian smaller companies. In my view, the cheapest companies in Asia with sound fundamentals are Hong Kong and Thai listed smaller companies. Siam Investment Fund, managed by Gene Davis who is highly regarded in Bangkok, gives the Fund additional exposure to this cheap asset class. Moreover, the share price of Siam Investment Fund, at which this investment is carried on OAM Asian Recovery Fund's balance sheet, is at a more than 40% discount to the net asset value (NAV) of Siam Investment Fund. In 2000, Siam Investment Fund paid a dividend of US$1.00 per share (20% of the current share price) which, when factored in, makes this investment look better. This fund has a policy of paying out dividends as gains are realised and also has a liquidation vote in 2006. Over time, this will gradually eliminate the fund's huge discount to NAV. In 2000, the SET Index of Thai companies fell by more than 50% in US$'s and is now down 90% from its peak of seven years ago. At these share prices, most Thai companies look like compelling bargains.

The holding in Taj Performance Fund has been a disappointing investment. While the companies held by this fund look undervalued, there seem to be few catalysts in place for their revaluation which is probably a vital criteria in India's huge stock market where there are thousands of listed companies. This fund currently trades at a 20% discount to NAV. Since it is due to liquidate in April next year, there should be some appreciation in this investment during the next fifteen months as the share price discount to NAV is eliminated.

During the year the Fund redeemed its small holding in Atlantis Asian Recovery Fund. As I indicated in last year's Chairman's statement, I met with Henry Ho, the manager of this fund, during my trip to Hong Kong. I left that meeting unimpressed by Ho's depth of knowledge of the companies in which he invested. Shortly thereafter, the Fund redeemed its shares in Atlantis Asian Recovery Fund at a loss.

In concluding this report to fellow shareholders, I am extremely positive about the Fund's prospects this year. I view the decline in Asian equities prices back to near their crisis lows as offering investors a "second bite at the cherry". These valuations will not last. The Fund's portfolio is selling at a P/E of about 8 times this year's estimated earnings and at less than half this year's estimated growth in earnings for the portfolio assuming that the Asian recovery remains intact. Moreover, the Fund owns a collection of the best companies in a group of countries which together have half the world's population. Where else in the world can one build a portfolio of first-class companies at such a low valuation? For the sake of comparison, even after its 50% decline from its peak, the NASDAQ 100 index still sells at a P/E of 79 times estimated earnings.

Desmond Kinch.

15th January, 2001.