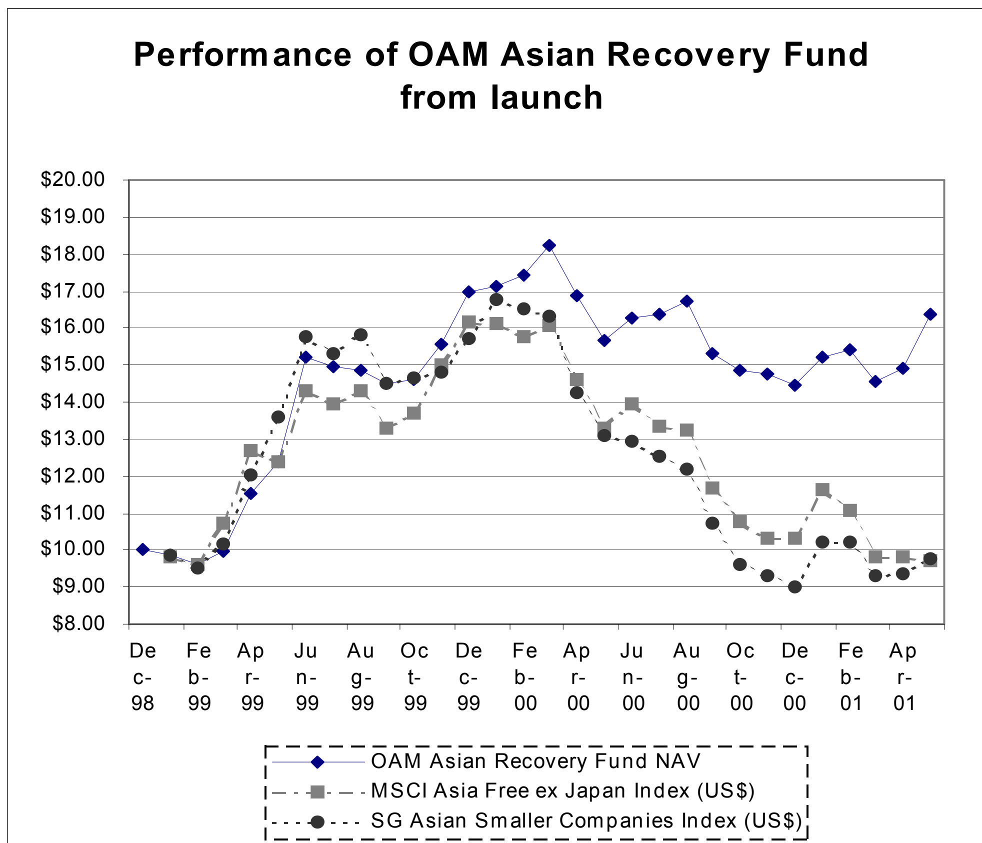
25th January, 2002 **OAM Asian Recovery Fund**

Chairman's statement for the year ended 31st December, 2001

Dear fellow shareholders,

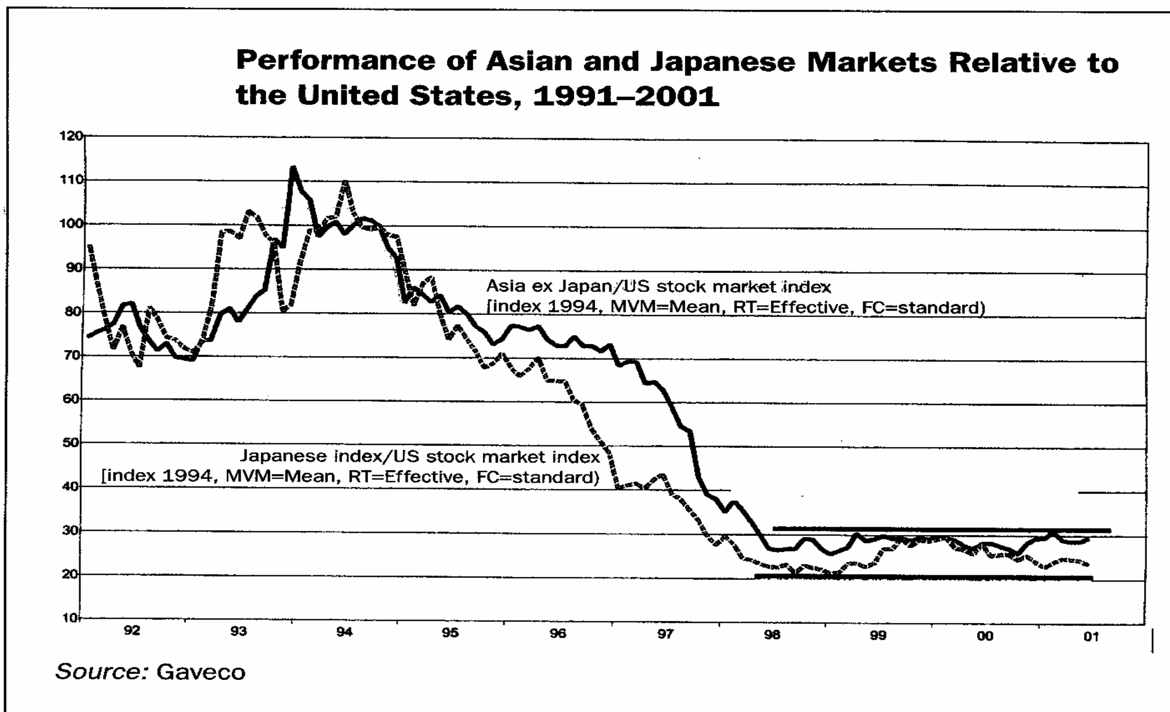
For the third consecutive year, OAM Asian Recovery Fund outperformed its benchmark, the MSCI Asia free ex Japan Index (US$), by a substantial margin. In the 3 years since launch, the Fund increased its net asset value (NAV) per share by 78.1%, beating Asian equity market indices by more than eighty percentage points. This performance ranks OAM Asian Recovery Fund as the top performing offshore fund investing in Far East ex Japan equities in the three years ended 31st December, 2001 out of the 219 such funds in Standard & Poor's Fund Services (www.funds-sp.com) data base. OAM Asian Recovery Fund has also been awarded a 5-star rating by Standard & Poor's Fund Services. A 5-star rating is awarded to the top 10% of funds in each category which have the highest risk-adjusted return over the past 3 years. The chart above shows the performance of OAM Asian Recovery Fund since launch relative to the MSCI Asia free ex Japan Index (US$) and the SG Asian Smaller Companies Index (US$). It is clear from this chart that, however risk is measured, the Fund has not taken on additional risk to achieve these outstanding results.



OAM Asian Recovery Fund was launched on 31st December, 1998. It was Overseas Asset Management's first fund. There were several reasons why we launched the Fund. One reason was that in the previous nine years, we achieved results which were far superior to most international and emerging market funds. When prospective clients asked to see our track record, we had no audited investment performance results to show. Up to that point, all clients' assets were in segregated accounts. Another reason for the launch was that we felt that Asian equity markets were extremely depressed following the Asian financial crisis of 1997-98, and as a result were likely to provide investors with high investment returns. When the Fund was launched, I told clients that my personal objective was to increase

the Fund's NAV per share fivefold within 10 years. I pointed out that returns of this magnitude were achieved following previous financial crises in Latin America in the early '80's and in the U.K. in the mid'70's. So far, the Fund's return exceeds 20% per annum which puts the Fund's performance to date ahead of my target.

Enough bragging about the past. As shareholders, you want to know about the Fund's future prospects. One thing I can say with certainty: the Fund will not improve its ranking during the next 3 years. More often than not, funds which lead investment performance tables subsequently post disappointing results. Put it down to hubris on the part of investment managers. Maybe it is a case of regression to the mean. Whatever the cause, I am acutely aware of the phenomenon. Investment management deals to a large extent with anticipating the future which is unknown. It is therefore a humbling profession; one which deals with probabilities rather than certainties. Bearing in mind these caveats, I remain confident about the Fund's future. As the chart below shows, the Asian recovery has barely begun.



Equities in Asia ex Japan are still very cheap, both relative to their past history and relative to U.S. equities in particular. Most foreign investors and Asian institutional investors have limited exposure to Asian equities. Those investors who have returned to Asia following the 1997-98 exodus of capital, have for the most part tiptoed into Asian markets and bought the large capitalisation index constituents. These companies were the winners of the past in Asia – mainly banks, telecoms and property companies. They are also likely to be the losers of the future in Asia as these markets are deregulated, opened to foreign competitors, and crony capitalism comes to an end. Meanwhile, many smaller companies, which include many of Asia's future winners, are ignored and hence their shares remain cheap.

I was impressed by a presentation made by Robert Froehlich a few years ago at an annual conference of the Association of Investment Management & Research (AIMR). Froehlich spoke about using demographics to make money in the stock market. He argued that future demographic trends were known with relative certainty because the people who comprised these demographic groups were already born. Froehlich said that the two major demographic trends of the next 30 years would be the graying of the population in the developed world, and the growth of the 18-35 year age group in Asia. He went on to say that the pharmaceutical industry would grow rapidly, mirroring the growth in the number of people aged over 65 in the developed world. In relation to Asia, he said that the continent would enter the 21st Century with over a billion consumers aged 18-35, and that this demographic group, which he dubbed the "Asian rollerblade generation", would consume far more than their parents. Froehlich therefore recommended that investors buy shares in multinational consumer goods companies which generate significant sales and earnings in Asia.

While I found Froehlich's speech of great value, I was less impressed with his conclusions. The reason was that the shares of most pharmaceutical companies and multinational consumer goods companies with successful Asian operations sold at P/E's of more than 30 (and still do). The share prices of these companies already reflected expectations of future growth generated by riding these demographic trends. On the other hand, many leading "pure play" Asian consumer brands which are likely to have faster sales and earnings growth than multinational consumer goods companies sold for P/E's of less than 10.

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. Indeed, in pre-announcing its expectations for the fourth quarter last year, Coke said that it expects case sales in Asia to grow by 13%. By comparison, it expects case sales to grow by 2-3% in North America. As I said in the Fund's interim report, savings rates in China and much of South East Asia are around 40% even though per capita income is much lower than in the U.S.. This ratio has only one way to go. Over time, as confidence builds in Asia and per capita income rises, savings rates will almost certainly fall. As a result, consumer spending in Asia will likely outpace economic growth in the region, which itself is likely to outpace economic growth in the West as economic convergence continues after its brief but sharp break in 1997-8.

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. Compare this with Lotte Chilsung and Vitasoy, two of Asia's leading soft drink brands which are underlying holdings in the Fund. Lotte Chilsung is Korea's leading soft drinks company with a 41.5% market share, up from 36.3% in 1999. Last year, Lotte Chilsung's share price tripled. Yet its shares sell at a P/E of 8.5. Lotte Chilsung clearly remains relatively obscure to most investors even though its annual sales are approaching US$1 billion.

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 has 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.

Lotte Chilsung and Vitasoy are not isolated examples of cheap consumer brands in Asia. Many of the companies which dominate markets serving Asian consumers sell at similar valuations. These market leaders usually earn high returns on capital invested and generate ample free cash flow, allowing them to grow their earnings per share at double digit rates without having to rely on external capital for expansion. They are therefore survivors, regardless of whether Asia experiences another financial crisis. This is not to suggest that investing in OAM Asian Recovery Fund is risk-free. Asia could experience problems this year if the Japanese yen continues to weaken, precipitating competitive devaluations in North Asia. Likewise, Asian economies, particularly the export component, could be hurt if U.S. consumer spending declines sharply rather than recovers as the consensus currently expects. Both these scenarios are meaningful risks in my view.

The presence of these short-term risks makes it difficult to predict how OAM Asian Recovery Fund will perform this year. On balance, mainly because valuations of the underlying holdings remain low, I think that the Fund is likely to post good results again this year. On a five year view, I am more confident in predicting that the Fund will produce a compound annual return in the double digits, a return which I think will be difficult to achieve in most financial markets in the next five years.

Desmond Kinch
Chairman