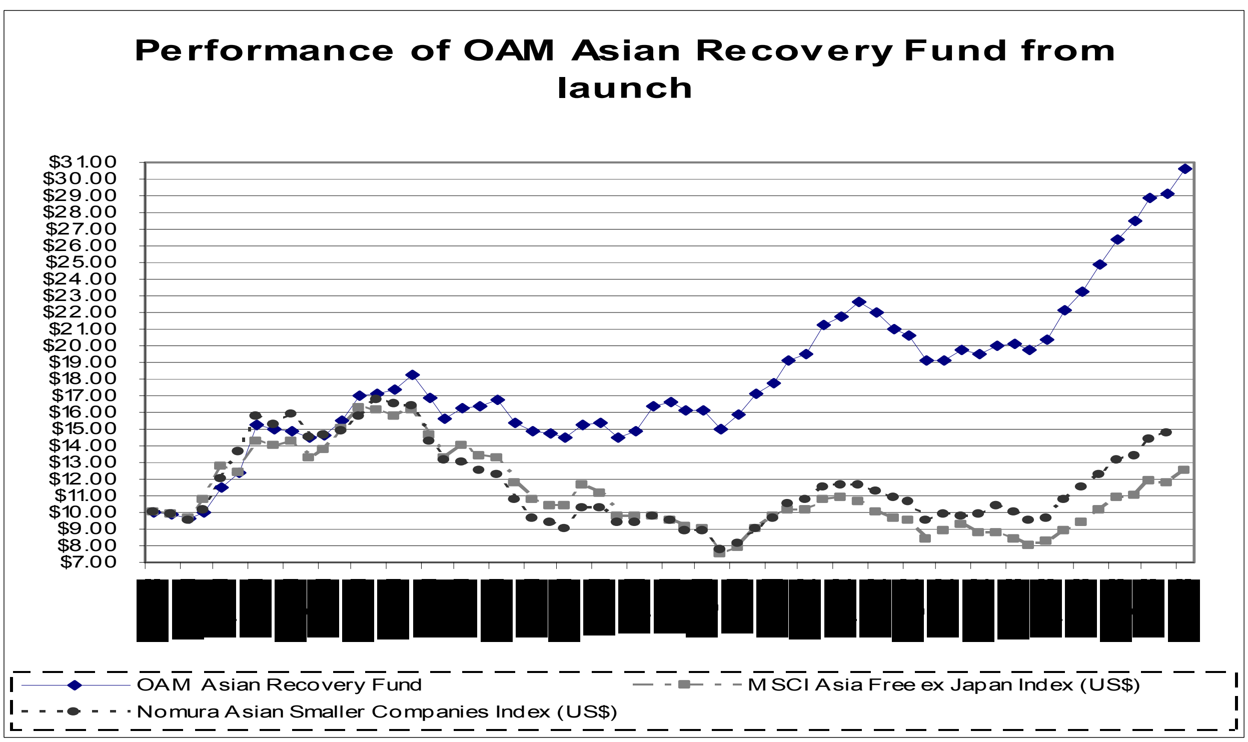
OAM Asian Recovery Fund

9th January, 2004

Chairman's statement

Last year, I wrote: *"I anticipate another good year for the Fund. Asia ex Japan has many positive attributes that are absent elsewhere in the world. The Fund has a few additional strengths relative to a passive investment in the region that should continue to drive the Fund's historic outperformance. Low stock market valuations in the region top my list of positives attributes. I estimate that the average P/E ratio of the Fund's holdings on a look-through basis is about 8 and the average dividend yield is nearly 5%. Moreover, dividends in Asia are either free of withholding tax or subject to low rates of withholding tax. In general, the Fund's underlying holdings have little debt, and in many cases, the companies are cash rich.*

I am pleased to report a fifth consecutive year of outperformance by OAM Asian Recovery Fund. Last year, the Fund's NAV per share increased by 57.6% while its benchmark, the MSCI Asia Free ex Japan Index (US$) rose by 42.7%. Since its launch five years ago, the Fund's NAV per share increased by 206.3% versus an increase of 24.4% by the MSCI Asia free ex Japan Index (US$). The Fund's performance since inception relative to its benchmark is impressive.

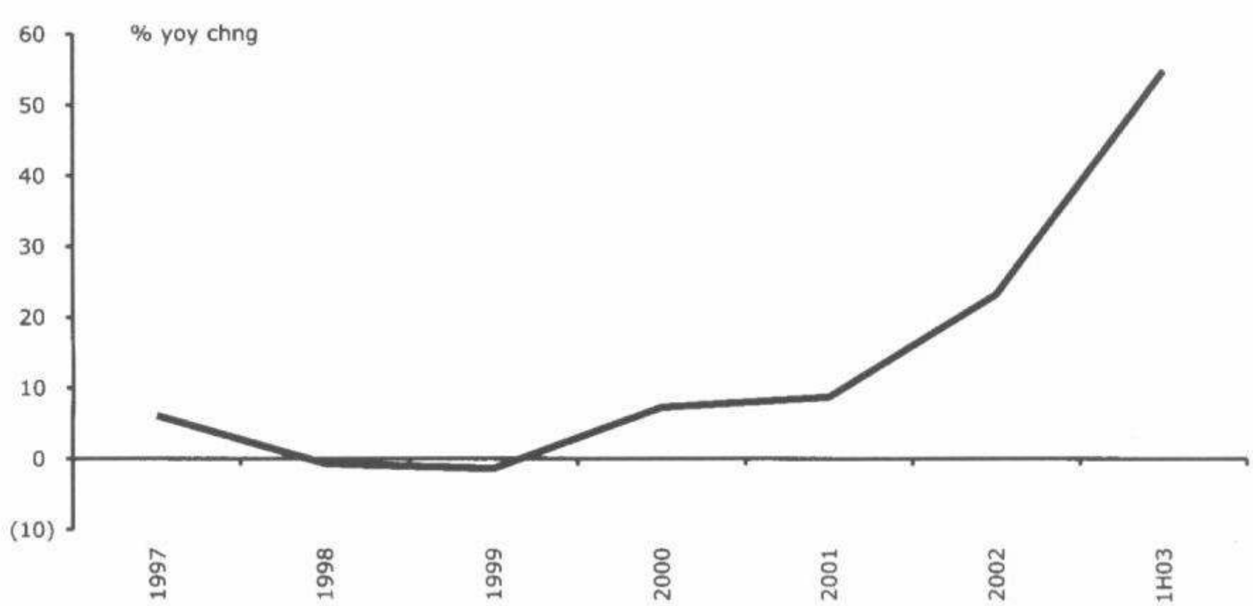


This chart suggests that the Fund's NAV may be heading for a major correction. Though the possibility of a correction of say 15% (such as the one experienced in 2000 after the Fund's fabulous run in 1999) can not be ruled out, I would be very surprised and disappointed if the Fund had a correction larger than this. Today, I estimate that the Fund's average P/E is about 11 times 2003 earnings, falling to around 10 times this year's expected earnings. These are still attractive valuations. One should also bear in mind that Asian stock markets have only recovered part of their losses incurred during the Asian financial crisis. At year end, the MSCI Asia Free ex Japan Index (US$) stood at 255. Ten years earlier the index was at 434. Contrast this situation to the U.S. where the S&P 500 index ended the year at 1112 versus 466 ten years earlier.

Last year I wrote that *"investing in Asia is not without risk. In the past few years, China's economy has been a shining beacon in a relatively depressed world. The economy is booming. This boom and China's sidestepping of the Asian financial crisis in 1997-8 may sow the seeds of a coming bust. Too much money has been invested in China to try to take advantage of this boom and to get access to China's population of over a billion people. There are enormous construction booms taking place in China's cities, mainly along its coastline. I worry that this may result in due course in "see-through" buildings and unfinished projects like those seen across Asia at the end of the Asian financial crisis. Asian manufacturers have also expanded production rapidly to take advantage of the outsourcing boom. This may be starting to reach the point of overinvestment, much like in the technology and telecoms sectors in the late '90's."*

The situation in China today is worse than when I wrote about this looming danger a year ago. The rate of growth in capital expenditure in China has accelerated as the chart below illustrates.

Figure 11 **China's Industrial Investment Growth, 1997–2003**



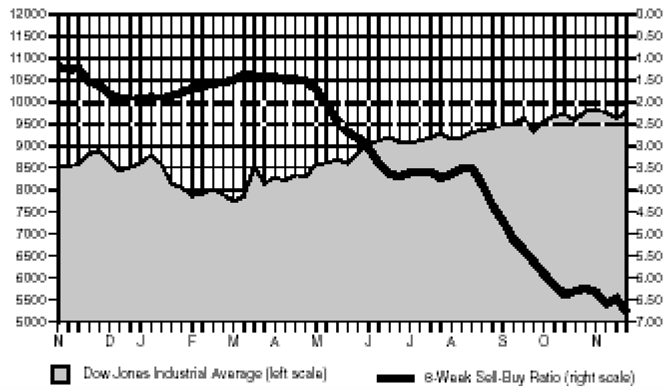
Source: ABN-AMRO Asia/Pacific Strategy and Economics

There are many examples of industries that suffer today from huge overcapacity. Vacancy rates are increasing, yet huge amounts of new property development are taking place in China's coastal cities and Beijing. Furthermore, there is evidence that China is building inventories of industrial metals and oil which would exacerbate the effect of any slowdown on commodity prices and producers. China could well be Asia's bugbear this year.

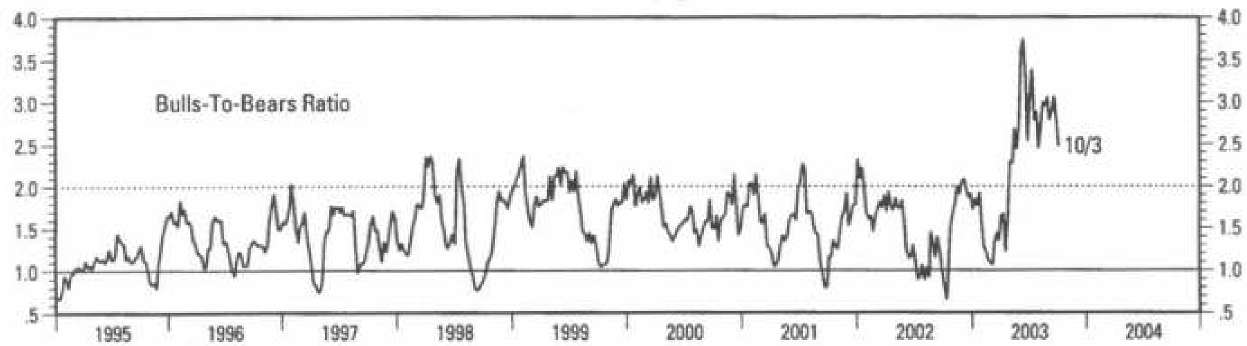
Last year, I wrote that *"another risk is North Korea. The sabre-rattling between the U.S. and North Korea is likely to result in periodic falls in the Korean market. The Fund has significant exposure to South Korea, mainly because of the attractive valuations available in that market."* My view of South Korea has changed since last year. After talking to a few knowledgeable people in Korea recently, I reached the conclusion that Westerners' perception of the North Korean risk, formed in large part by reporting in the Western media, is far higher than the real risk. In addition, South Korean small and mid-cap consumer stocks stand out as offering exceptional value with several decent companies there selling at P/E's of less than 5. This is an area to which we are likely to allocate subscription inflows this year.

I concluded last year's section on risk in my Chairman's statement by saying*: "The other risks to Asia are external. Many intelligent people worry about Japan. Its dysfunctional banking sector and deflation remain huge problems thirteen years after their stock market and real estate bubbles burst. These problems are well documented and no "hot money" is left in Japan. With little risk of capital flight, Japan's stock market indices might decline further, but probably in a gradual, orderly manner. If Japan seriously addresses its banking problem and deflation, its stock market could become one of the best performing markets in the world. The bigger external risk in my view is the U.S. stock market. Valuations in the U.S. are still rich with P/E's in the high 20's using realistic earnings estimates that factor in the costs of options issuance and realistic pension fund accounting assumptions. Economically, the U.S. stands on shaky ground. Two-thirds of its economy is accounted for by consumption. So far, the American consumer has been relatively resilient in spite of suffering huge stock market losses. Consumption is being supported by credit card debt, and to an even greater extent by the withdrawal of equity in their homes. There has been an enormous boom in the U.S. in the refinancing of mortgages. As interest rates declined, Americans refinanced their mortgages at lower rates and in the process increased the size of their mortgages which became cheaper to service at lower interest rates. There is limited scope for interest rates to decline further in the U.S."*

Today, the biggest single risk is the U.S. stock market. Valuations in the U.S. stock market are even higher today than they were a year ago. The mortgage refinancing boom ended in June, 2003 when 10 year Treasury bond yields, on which most fixed rate mortgages are based, bottomed at 3.1%. Today 10 year Treasuries yield 4.25%. While company insiders are unloading their shares hand over fist, U.S. stock market punters are more bullish than ever before. A year ago, there were about 1.5 insider sales for every insider buy as the Argus Vickers chart of the insider sell-buy ratio shows. Today, there are more than 7 insider sales for every purchase by a company insider. This is the highest 8-week average in the 32 years that Argus Vickers has been collecting data. By value, insider sales exceed purchases by more than 20:1. Meanwhile, the Investors Intelligence Sentiment Index for Stocks shows that there are roughly 3 bulls for every bear. The last time punters were this bullish was prior to the stock market crash in 1987. The charts on the following page show this divergence in opinions between the smart money and the not so smart.



Investors Intelligence Sentiment Index for Stocks, 1995–2003



Source: Ed Yardeni, www.prudential.com/yardeni

Today, the Fund is fully invested with US$42 million in assets. This year, the Fund could probably comfortably handle about US$10 million in net inflows. We are estimating inflows of about $3 million to the Fund this year from a new Cayman Islands multi-employer pension plan client which should leave sufficient capacity for existing clients and our typical annual level of new business. In any event, shareholders should feel assured that the Fund's directors will not accept subscriptions if it would dilute the quality of the Fund's existing portfolio.

When OAM Asian Recovery Fund was launched 5 years ago, I told clients that, based on the historical returns from investing in stock markets at the end of major financial crises, I expected the Fund's NAV per share to increase five-fold in 10 years. This equated to a 17.5% compound annual return. So far, the Fund has achieved a more than 25% compound annual return. I am pleased for our shareholders. It is always gratifying to see intelligent risk takers rewarded handsomely. For the next five years, I am still very comfortable with my goal of the NAV reaching $50.00 per share. Though I think that shareholders need to scale back their expectations going forward, this goal still represents a compound annual return of more than 10% per annum over the next 5 years. This is a very healthy return which I feel confident in stating, few investors will match. However, shareholders should be prepared for a volatile ride as risks with U.S. equity market valuations and China pervade.

Desmond Kinch
Chairman