Overseas Asset Management

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OAM Asian Recovery Fund

Dear fellow shareholder,

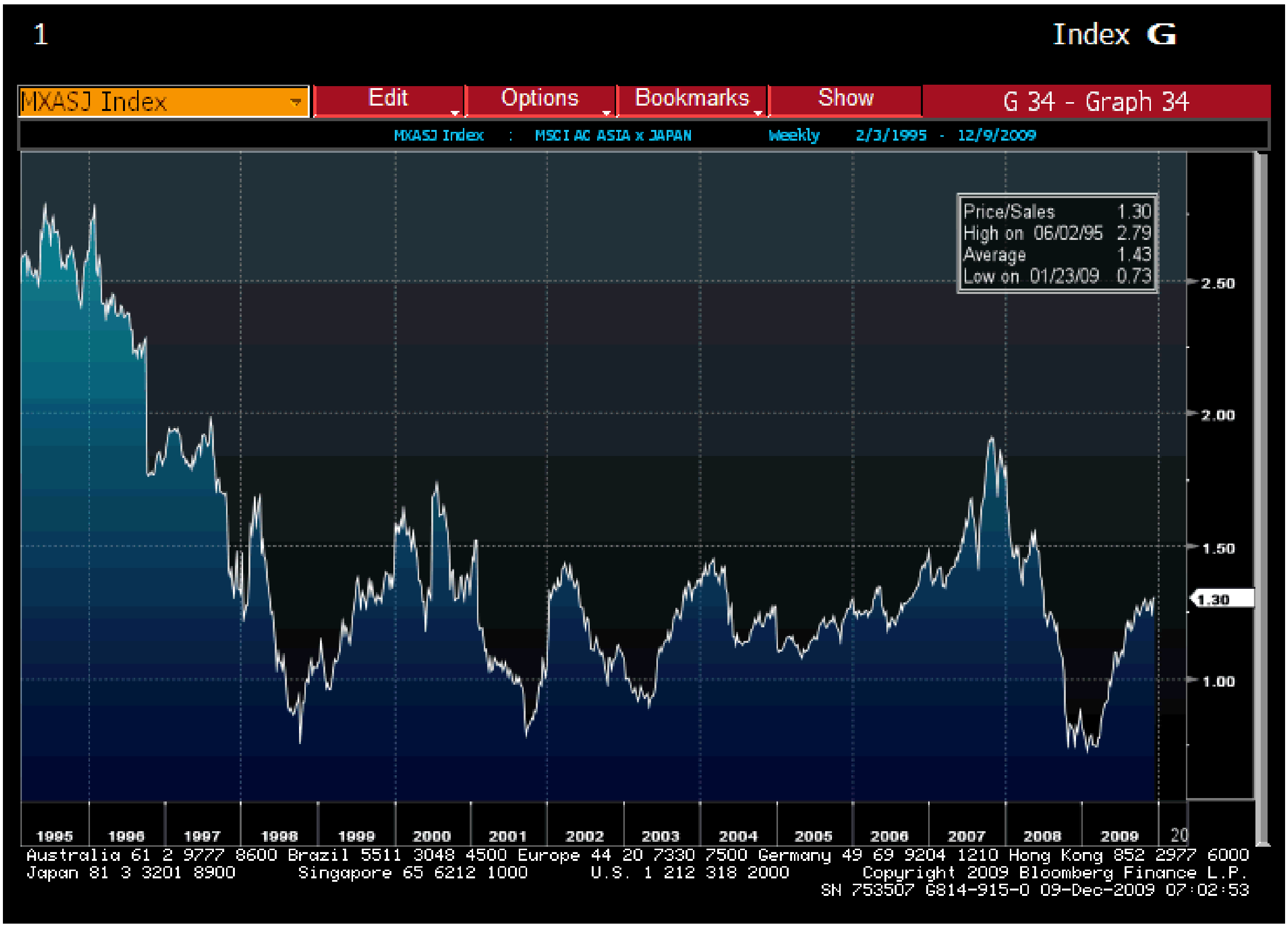
Last year, OAM Asian Recovery Fund's NAV per share increased by 61.3%. By comparison, the Fund's principal benchmark, the MSCI Asia free ex Japan (US$) index rose 68.2%. It is pleasing to report that the Fund again had net subscriptions of US$7.5 million – similar to the prior year's net subscriptions. Our cumulative net subscriptions were more than $6 million in the first four months of the year when valuations were cheapest, so most of the Fund's subscribers made very strong returns. There were only a few redemptions during the year and almost all of these took place in the middle of the year. Therefore, most clients fully participated in last year's rebound. In last year's Chairman's statement, I stated that:

"As in the aftermath of the Asian financial crisis, we think that this financial crisis is presenting us with one of the greatest investment opportunities that we are likely to see in my lifetime. … We think there is a powerful structural shift in power from the West to the East with China at the epicentre of this shift to greater Eastern influence in terms of political, economic and financial power. … It is easy to see how the relative strength of the Asian consumer versus his Western counterpart favours Asian growth. It is also important in a global context to appreciate that China, India, South Korea, Taiwan, Hong Kong and the investable ASEAN countries are home to nearly half the world's population and have a combined population that is ten times higher than the US population. …. It seems somewhat unfair that peak-to-trough, Asian indices have declined as steeply during this bear market as they did during 1997/8, and by significantly more than the US stock market. …. The next major bull market will be in Asia ex Japan. Valuations there are at levels similar to those that prevailed in the US in 1974 and 1938. … These are stunningly low valuations and particularly relative to the yields on long-term Asian government bonds."

The average P/E of the underlying holdings in OAM Asian Recovery Fund was about 8 and the average dividend yield was just under 7% at the start of last year. By year end, the average P/E was about 13 and the average dividend yield about 3.8%. These estimates are based on 2009 estimated earnings which are more or less "in the bag". Based on estimates provided by the fund managers through whom we invest, we reckon that earnings will increase on average by about 15% this year for the underlying companies in the Fund's portfolio. There is no question that Asia is booming. This increase in earnings lowers the Fund's look-through P/E to about 11.5 based on 2010 estimated earnings which we think is an attractive valuation.

Warren Buffett has said on occasion that market capitalisation as a percentage of GDP is a good determinant of whether the US stock market is cheap or expensive. This is more or less the same as the

Price to Sales ratio of the stock market. The advantage of looking at this ratio is that it eliminates the cyclicality of profit margins. It is therefore a good sanity check on whether valuations are cheap or expensive. As the chart below shows, Asian equity valuations as measured by the MSCI Asia free ex Japan index have rebounded from record low valuations a year ago to around fair value.



As we said repeatedly in the past, we think that over the long-term, Asian currencies will appreciate significantly against the US Dollar. On a purchasing power parity basis, Asia ex Japan has some of the most undervalued currencies in the world. Last year, currency helped the Fund's returns to a small extent. We continue to believe that currency gains will be a contributor to the Fund's returns at the margin, perhaps adding a few percentage points a year of return on average over the next 5-10 years.

Since its launch, we have steered the Fund towards managers that favour investing in companies serving the rising Asian consumer. I will not reiterate the arguments why significant increases in consumer spending in Asia ex Japan are a long-term trend that is as close to certain as anything when predicting the future. Given the poor outlook for consumer spending growth in the West, we think it is more important than ever to focus on companies that serve Asian consumers. It is difficult to make a precise estimate, but we reckon the Fund has about 40% of its equity exposure in companies that are geared to Asian consumer spending. By comparison, only about 10% of the benchmark index is comprised of companies that are primarily geared to Asian consumer spending.

Our other big sector exposure is technology. We have 15-20% of the Fund's equity investments on a look-through basis invested in Asian technology companies. Asia has a global competitive advantage in technology from several vantage points: cost of production, education (particularly in electrical engineering), willingness to adopt new technology, and clustering of expertise. Unlike most other sectors of Asian manufacturing, there is fairly tight capacity in technology production (due partly to bursting of the technology bubble ten years ago). Meanwhile, roughly half of global demand for many technology products already comes from emerging markets which are growing far more rapidly than the tapped-out Western consumer markets.

Last year, the Fund underperformed its benchmark. This is not surprising in such a strong year for equity markets. There are a few reasons for this underperformance. On a look-through basis, the Fund had an average of 20% of its assets in cash that earned essentially zero. This was primarily due to the underlying funds in which we invest having large amounts of cash, particularly in the first quarter of this year. While the Fund held a fairly steady cash reserve of about 5% of net assets, on a look-through basis, about 24% of the Fund's assets were in cash during the first quarter of last year. Excluding this look-through cash, the Fund outperformed its benchmark.

In addition, the Fund has 8% of its net assets invested in debt funds that are far more defensive than equities. Last year, these debt funds returned about 6.5%. These three investments generated disappointing returns during the past five years. Two of them are structured as limited partnerships with fixed lives. One expects to return all our capital this year and the other one expects to return about 50% of capital in the first half of this year and start generating higher returns during its remaining five years. The third fund is an open-ended fund that was hit by massive redemptions that are now behind them. After meeting the manager in Hong Kong in October, we believe that this fund will generate good returns going forward.

The Fund has an additional 8% of the Fund invested in two long/short Asian equity funds that have generated fairly consistent, attractive returns. These two investments reduce the Fund's volatility while providing an attractive return to shareholders. Last year, these funds generated an aggregate return of about 19% which, although significantly lower than the Fund and benchmark returns, was still a more than respectable absolute return. Over the past five years, they generated returns of 16% per annum and 25% per annum respectively with their only negative returns during that period being 2008 when they lost 11% and 4% respectively.

Most of the remaining nearly 80% of the Fund's assets are invested in funds managed by boutique fund managers that invest on a long-only basis in Asia ex Japan listed equities. A bit less than half these assets are invested in small-capitalisation Asian companies that I loosely define as having a market capitalisation of less than US$500 million, while most of the remainder is invested in mid-capitalisation Asian companies that I loosely define as having a market capitalisation of between US$500 million and US$5 billion. The market pricing inefficiencies increase as one moves down the market capitalisation scale, but the liquidity of the portfolio also diminishes. Since we are long-term investors and think that we have relatively stable capital and assess funds partly based on the stability of their capital, we favour exploiting market inefficiencies in return for sacrificing some market liquidity. Three of the Fund's investments each account for slightly more than 10% of the Fund's NAV. We have invested in each of these funds for the past 11 years and have very high regard for their managers. Over the past 11 years, two of these funds only had one negative year (2008) for their shareholders and returned 25% and 19% per annum respectively for their shareholders. The third had two negative years (2000 and 2008) and returned 15% per annum for its shareholders over the past 11 years. By comparison, the Fund's benchmark index has experienced four negative years during the past 11 years.

Shareholders should be aware that the Fund has about 5% of its net assets invested in two limited partnerships which have no redemption provisions and in three closed-end funds for which we are awaiting final liquidation dividends. The Fund can invest up to 10% of its assets in such illiquid debt or special situation funds. Since we know our shareholders well and were fairly anomalous in navigating the recent financial crisis with no major redemptions and in fact, we had net subscriptions, we remain comfortable with this position. The Fund is considering making a capital commitment to a limited partnership managed by a firm with an excellent track record which might take the Fund closer to its 10% limit on investments in debt and special situation funds.

In spite of last year's slight underperformance, the Fund's long-term track record remains excellent. During its 11 years since launch, the Fund generated a compound annual return of 17.7% per annum, increasing initial shareholders' investment more than six-fold during the period. By comparison, the Fund's benchmark, the MSCI Asia free ex Japan (US$) slightly more than doubled during the period since launch, generating a compound annual return of 8.1% per annum. According to Bloomberg, the Fund's return puts it in the top 3% of all offshore Asia-ex Japan equity funds during the past 10 years. Moreover, the Fund earned these outstanding returns with less volatility than the index.

There is a growing consensus that Asia ex Japan is the most attractive investment destination. Our contrarian instincts cause us to worry when we see such consensus. From talking to other investors with limited knowledge of Asia, the most common way of foreign investors getting exposure to Asia is to buy an Exchange Traded Fund (ETF). As our track record demonstrates, we have done considerably better in the past than Asian stock market indices which these Asian equity ETFs try to mimic. Going forward, we think that we will continue to do considerably better than Asian equity index ETFs because a large part of Asian ex Japan indices is comprised of companies operating in sectors with huge overcapacity. We think our targeted approach to investing in Asia will fare far better.

We remain positive on the outlook for the Fund but expect more pedestrian returns. Nevertheless, we think the Fund can still generate very attractive risk-adjusted returns relative to other alternatives available to investors. There are a number of risks that concern us and which we are monitoring. The most important of these risks is the possibility of a bubble building in China. We think there is already a bubble in the Chinese property market. China's cities are full of see-through residential and commercial buildings. Bank lending in China increased by nearly 30% last year. We suspect that much of this capital lent by banks has been allocated poorly. The other risk which I think is a global rather than regional risk is a sharp increase in the rate of inflation which would push up long-term interest rates and depress equity valuations. It would also tend to depress the value of Asian foreign exchange reserves which are mainly invested in US government and agency debt. Having cited these risks, we still feel that on balance the outlook for Asia ex Japan equities is more favourable than equities in most other parts of the world.

Desmond Kinch, CFA
Chairman