Overseas Asset Management

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OAM Asian Recovery Fund

Dear fellow shareholder,

The past year

2010 turned out better than we expected for the Fund. While we expected it to be a positive year, we did not expect it to be quite so stellar. The Fund's net asset value (NAV) per share increased by 30.3%. By comparison, the Fund's principal benchmark, the MSCI Asia free ex Japan (US$) index rose 17.1%. After receiving net subscriptions for the past two years, the Fund had net redemptions during the year of $21 million, comprising $32 million of redemptions and $11 million of subscriptions. We think that a large part of these redemptions resulted from the psychological impact of the Fund reaching its previous all-time high NAV and after the pain of the 2007-9 drawdown, some shareholders decided that they wanted to "take some chips off the table". We are pleased that clients redeemed at a time of relative strength and ample liquidity, rather than when markets are depressed and illiquid. For the record, I think it is important to state that neither my wife, OAM, nor any member of my immediate family redeemed a single share of the Fund last year, or have they ever done so, and in aggregate, we remain the Fund's largest shareholder.

As in the case of OAM European Value Fund, but to a lesser extent, last year was a year of two halves. The Fund's NAV per share increased by 5.4% in the first half of the year and by 23.6% in the second half.

The Fund currently has net assets of nearly US$250 million. We have no difficulty investing this amount of money employing the Fund's investment strategy. The Fund had 5% of its net assets in cash at year end. Its expenses were less than US$80,000 last year which is less than 0.04% of average net assets. We pride ourselves on keeping Fund expenses low and keeping portfolio turnover low as high turnover imposes an additional hidden cost that impedes long-term performance. Bear in mind that Overseas Asset Management only charges the Fund a nominal annual investment advisory fee of $1,000: our standard fees are charged in clients' segregated accounts so that there is no "double-dipping" in terms of charging clients fees at two levels. Shareholders should also bear in mind that there are also fees charged by the underlying managers to whom we have allocated money. However, these fees and expenses charged by managers are reflected in the Fund's net returns.

The Fund has historically had very low turnover. Last year, turnover was higher than average, mainly as a result of Target Asia Fund winding up and returning about $2 billion to its shareholders. We invested in

Target Asia Fund at the end of 1998 when it had net assets of less than $10 million and added to our investment over time. We received $21.4 million back from Target Asia Fund last year, realising a gain of more than $15 million for the Fund's shareholders. In November, I had dinner with the manager of Target Asia Fund, N.L. Teng, and thanked him for making our clients so much money over the past 12 years.

Apart from the liquidation of our shareholding in Target Asia Fund, we redeemed $4 million from our largest investment which has done extremely well. We still had an investment at year end of nearly $32 million or 13% of the Fund's NAV invested in that fund in which we have been a shareholder for the past 12 years. We also reduced our investment in two London-listed closed-end Asian equity funds whose discounts to NAV had narrowed significantly during the year, realising $6.5 million in proceeds at very handsome gains. We also received $2 million in distributions during the year from four listed closed-end funds and two limited partnerships.

During the year, the Fund made four new investments: $2 million was invested in an open-ended Asian fund; $2.5 million in two London-listed closed-end funds that were trading at large discounts to NAV; and $4 million in a London-listed fund of Asian hedge funds that was trading at a low teens discount to NAV. The latter will likely wind up this year and we have already sold half the investment so far this year at a nice profit. We also added $3.5 million to our investment in two open-ended funds with excellent track records; invested another $0.5 million in the company that owns 65 square miles on the north coast of Bintan, just off the coast of Singapore; as well as adding nearly $1 million to an investment we have in an Australian-listed closed-end fund that was trading at a large discount to NAV. Before year end, we tendered all our shares in the latter fund at a 15% discount to NAV and will receive over $2 million in proceeds next month, realising a nice profit over a fairly short period.

The Fund's history so far

We think that the Fund's long-term track record is of far greater importance than its track record in a single year. The Fund just completed its 12th anniversary. In those 12 years, the Fund's NAV per share increased more than 7.8 times, generating a compound return of 18.7% per annum. By comparison, the Fund's Asian equity index benchmark, the MSCI Asia free ex Japan (US$) index did not even triple during the period, generating a compound return of 8.8% per annum. The Fund therefore beat the return of its benchmark by a remarkable 10 percentage points per annum over 12 years. As I explained in the Chairman's statement for OAM European Value Fund, such a track record is almost impossible to find in the US equity fund universe. This is a testament to the inefficiency of Asian equity markets: it is far easier to find equity securities in Asia that are trading at a significant discount to fair value than it is in the US.

It is never wise to look at a fund's return in isolation. It is always necessary to find out how much risk was taken to generate such a return. The Fund is not allowed to use leverage and almost always has a cash component on a look-through basis of about 15% on average over time. It also has at least another 10% of NAV invested in long/short equity funds and debt funds that should be far less volatile than equity markets. Therefore, on a crude basis, if there was no value-added from our stock and manager selection, the Fund's NAV should increase by about 75% of the market index during up-markets and decline by about 75% of the market index decline during down markets. The Fund had 10 out of 12 years with positive returns while the index only had 8 years with positive returns. During the positive years for the market, the arithmetic average return for the index was 34% while the Fund's average return in those years was 29%. Therefore, the Fund captured about 85% of the gains during the years in which the market had positive returns. In the four years when the market had negative returns, the Fund outperformed the index in each of those years with an average loss of 6% versus a loss of 26.5% for the index.

Others with more mathematical and computing skills than me have done more sophisticated risk/return analyses than the relatively simple analysis that I show above. Every analysis that I have seen of the Fund's historic performance gives the same result. The Fund produced a significantly higher return than nearly all other Asian equity funds over the past 10 or more years with less risk than either its benchmark or competing funds.

Current valuations

The chart below shows that CLSA's universe of 763 Asia ex-Japan companies under their research coverage is now trading at 12.6 times 2011 estimated earnings, assuming 17.2% earnings growth in 2011, which is in line with the long-term average since 1995 of 12.4. This suggests that equity valuations in Asia ex Japan are fair. It is also very close to the average P/E of 13 that the underlying equities in our Fund were valued at year end.

CLSA Asia ex-Japan universe 12-month forward PE

Source: CLSA evalu@tor

P/E as a valuation measure ignores the fact that profit margins globally are close to a cyclical high. On a Price/Sales basis which we feel is a better measure of market valuation since it adjusts for the cyclicality of profit margins, Asian equities appear to be currently valued at about 10% above fair value. The Price/Sales ratio of the MSCI Asia free ex Japan index ended the year at 1.31. This compares to a long-term average of 1.2 and a historic range of about 0.8-1.6. While Asia ex Japan equity valuations appear to be a bit on the expensive side, they are by no means in the danger zone where we would raise significant amounts of cash.

The other important aspect of valuation is whether Asian currencies are cheap or expensive. We continue to believe that over the long-term, Asian currencies will appreciate significantly against the US Dollar, perhaps adding a few percentage points a year of return on average over the next 5-10 years. On a purchasing power parity basis, Asia ex Japan has some of the most undervalued currencies in the world. In the short-term, any reversal of the hot money flows to Asia or the imposition of any type of capital controls in Asia would likely weaken Asian currencies.

Sector and country exposure

We have been fortunate to have established relationships with a group of managers in Asia who are exceptional in talent, highly ethical, and with whom it is a pleasure to do business. With only a couple of exceptions, these managers have delivered what they targeted, and what we expected of them.

The two managers who have not delivered as expected are a manager of a China distressed debt fund and a manager of an ASEAN mezzanine debt fund. In both cases, the managers are ethical, but they have had to deal with less than ethical debtors. Outside Hong Kong and Singapore, the legal system in Asia ex Japan is cumbersome or inefficient when it comes to resolving conflicts between creditors and debtors. Our lesson from this experience is that investing in Asian high yield debt is much riskier and less rewarding than we thought. Fortunately, we have less than $6 million in aggregate or just over 2% of NAV currently invested in these two funds, although our investments in the two funds were about double this when we made the investments. Both funds are structured as limited partnerships with fixed lives. The China distressed fund will wind up and return all capital to its limited partners this year, while we have about four years left in the ASEAN mezzanine debt fund. While we have not lost money in either fund, the opportunity cost in terms of what we could otherwise have done with this money is millions of dollars. It looks like the China distressed fund will barely deliver a positive return while the ASEAN mezzanine debt fund is likely at this stage to deliver a high single digit internal rate of return (IRR). Our intention when we made these investments was to try to generate a return similar to what we generated from our investments with equity fund managers in the region but with much lower volatility. We have learned our lesson and are unlikely to make any new investments in Asian debt funds for the foreseeable future.

Within the Fund, we have clear sector and country biases. The Fund has had a strong bias towards companies serving the Asian consumer. Confirmation of a similar bias is one of the principal factors that we seek when selecting managers. As I have explained many times in the past, the reason for this bias towards Asian consumer stocks is that Asia ex Japan savings rates are very high and the region's per capita incomes are in the "sweet spot" on the so-called S-curve. This is where per capita income reaches a critical level when a large middle class emerges and consumption increases rapidly, the retail sector develops and the service sector begins to take off. As a result, consumption is likely to increase significantly as a proportion of Asian economies. To put this in perspective, consumer spending as a percentage of GDP currently ranges from about 35-55% in the region compared to about 70% in the US today.

Existing or potential clients often ask me why they should not just buy an Asia ex Japan exchange-traded fund (ETF) and pay lower fees. The problem with the ETF approach in Asia is that consumer stocks are poorly represented in Asian equity indices because most of these companies are still relatively small, while the index is heavily weighted in banks, real estate, petrochemicals, steel, cement, insurance and telecoms – sectors in which the Fund has little invested. We think that during the next few years, it may be even more important than in the past to have lots of exposure to companies serving the Asian consumer and little exposure to the index heavyweight sectors. If the Fund's track record compared to the index is not sufficient proof, skeptics should also take a close look at the expense ratios of these funds. It is not enough to rely on an ETF fact sheets to determine the total expense ratio. For instance, when I looked at two large Asia ex Japan equity ETFs, I found that their total expense ratio was significantly in excess of the total expense ratio stated on the fact sheet. In one case, it was well over 1% per annum which corresponded exactly to the annual underperformance of the ETF versus its benchmark. This analysis also ignores brokerage fees to buy and sell an ETF.

Invariably when I speak to clients, they are very bullish on China & India. While I do not dispute the positive long-term prospects for both markets, the Fund is deliberately very underweight both China and India. We have only 4% of the Fund's NAV invested in India. This is because the Indian stock market stands out as being expensive. Whereas all other markets in the region trade at 10-15 times this year's estimated earnings, the Indian stock market trades at 18 times this year's estimated earnings.

The case of China is more complicated so I will explain our stance there in more detail in the following paragraphs. The Fund has 15% of its NAV invested in China and 13% of NAV in Hong Kong. This is well below the weighting of the Fund's benchmark, and almost all this China and Hong Kong exposure is to companies serving the Chinese consumer.

Risks

The equity market risks in Asia, particularly in China, have increased considerably in the past couple of years. I have been warning for some time about problems brewing in China. For instance, in my Chairman's statement five years ago, I wrote:

"In China, all the banks are state-owned and many loans are made without any regard to whether they might be repaid. This results in terrible misallocation of capital to projects which have no likelihood of earning a return on capital, far less making a payback. In many capital intensive industries such as steel and cement where the only barrier to entry is access to capital, there is huge overcapacity. With much higher oil prices, increasing interest rates, and wage inflation increasing, companies operating in industries that are plagued by overcapacity have found it impossible to pass on their higher costs to customers through price increases. Chinese-listed companies also have possibly the worst track record in Asia for corporate governance. As I have told a few people: if you want to cure yourself of your obsession to get rich by investing in China, try being a minority shareholder in a Chinese company."

Again, in last year's Chairman's statement, I reminded shareholders of the rising risks in China when I wrote:

"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 massive government stimulus package introduced by China in response to the global financial crisis has increased the risks. Apart from the issues of overcapacity, mal-investment, and poor bank lending standards mentioned in previous missives, China also suffers from lack of transparency. Lots of investors seem to be taking hair-trigger investment decisions based on the release of government statistics which are notoriously unreliable and in many cases do not make arithmetic sense and then extrapolate these statistics to try to determine future government policy. While this strikes me as being a poor investment strategy, it does highlight the point that China's future economic growth is very dependent on government policy. Therein lays one of the biggest risks of investing in China.

The other big risk that I see for the region is higher inflation. Food prices have increased significantly in the past year and this has a bigger impact in Asia than the West given its relatively lower per capita income. That may have a negative impact on discretionary income remaining for non-food consumption. In China and the city states of Hong Kong and Singapore, the spillover from loose monetary policy has led to real estate speculation that has created bubbles in high-end residential property markets. The governments of these countries have so far tried to tackle this through targeted credit controls. However, there is a possibility of the blunter instrument of significant interest rate hikes being used, though this seems unlikely as long as hot foreign money is flooding into the region. There is also a possibility that, albeit a low probability one, some countries may impose limited capital controls to deter hot foreign money from forcing up the value of their currency – China of course already has capital controls. Meanwhile, China has been trying to gradually cure the problem of domestically-driven mal-investment by gradually tightening bank lending quotas and higher bank reserve requirements, so far with little success. As a result of these risks, and the struggle between bulls and bears, I expect Asian equity market volatility to be quite high.

There is one other issue that is likely to have a long-term effect on inflation within China, the rest of the region, and globally. That is the maturing of China's population and the secular ending of the 20-year period of migration of Chinese workers to the coastal cities where nearly all China's manufacturing plants that produce goods for export are located. China's population growth and seeming endless supply of workers willing to work for next to nothing is ending. This is a result of the introduction of its one-child policy in 1978. This demographic trend intersects with the end of massive migration to the coastal regions. When I started investing in the region just over 20 years ago, Guangdong province had a population similar to Britain. Since then, its population has nearly doubled to around 110 million, but appears to be stabilizing around that level. "Everyday Low Prices" at Wal-Mart were a result of more and more goods being sourced from China where they were assembled by workers being paid very low wages. Thus, for the past 20 years, China exported deflation to the West. In future, I expect China to export inflation to the West. Wages in China are growing rapidly – the incidents last year at Hon Hai's subsidiary, Foxconn, are a precursor of the kind of wage increases that are likely to become more widespread in future. While this will be bad for exporters, manufacturers, heavily indebted capital intensive businesses (because of the link between inflation and interest rates), and banks (because of the likely impact of falling profit margins and higher interest rates on the ability of corporate borrowers to service debt), this is another reason why debt-free companies serving the Asian consumer should do well.

As I mentioned in a client newsletter at the end of November, I recommended Michael Pettis as a speaker at Fidelity's Cayman Business Outlook. I had dinner with Michael this week and listened to his excellent presentation yesterday. He is a professor at Peking University's Guanghua School of Management. In his presentation, Michael clearly explained why the accepted view in the West that China is a perpetual growth machine is wrong. In next month's newsletter, we will provide a synopsis of his arguments and the investment implications if he is correct. It concerns me that the view of a "two-speed world" with China followed by India and Brazil being the hare and the West being the tortoise is now universally accepted as being the gospel truth. Let us hope that this does not end like Aesop's fable.

What to do?

With risks in China rising but valuations in the region of the Fund's portfolio reasonable, it is difficult to know what to do. Timing is critical, but critically difficult to get right. I raised this point with Michael Pettis when we had dinner. I suggested that it could take three months or three years for China's growth rate to slow dramatically. His view was that it will not happen in three months, but is more likely to happen after the Chinese leadership changes in October next year.

Since we have avoided the sectors in China where I fear that there is likely to be permanent destruction of capital, focused on companies with very strong balance sheets, and have a portfolio that is reasonably valued, we are not increasing cash in the Fund significantly. However, we are not currently looking for any new investments for the Fund and we will be selling investments as they become fully valued with the objective of raising cash as Asian markets climb higher, which we think is likely even though the risks are now higher than they were a year ago.

The main reasons why we think Asian markets will continue to climb are:

1. Valuations are reasonable with an average P/E of 13 times this year's estimated earnings and a Price/Sales ratio for the index of 1.3. To put this in perspective, I became nervous about US equity valuations around the first quarter of 1997. At that time, the S&P 500 index was selling at about 20 times earnings that were later reported for 1997. Even though valuations looked expensive then, the S&P 500 returned 100% over the next three years as momentum from the bull market pushed equity valuations to the stratosphere. By these standards, or the standards of other bubbles, Asian equity market valuations are not at bubble levels.
2. The secular bull market in Asia ex Japan equities started in the fourth quarter of 1998. Historically, bull (and bear) markets in equities and commodities have lasted 15-20 years. It would be very atypical of financial history for the current Asian equity bull market to end so soon or at these valuation levels.

To borrow a well-worn stock market phrase, our view is that Asian equities will climb a wall of worry.

Desmond Kinch, CFA
Chairman