OAM

OAM Asian Recovery Fund
The Pavilion Cricket Square
PO Box 597 Grand Cayman KY1-1107 Cayman Islands
T 345 949 8787 345 949 8780 F 345 949 7760
E info@oam.com.ky www.oam.com.ky

OAM Asian Recovery Fund

15th January, 2024

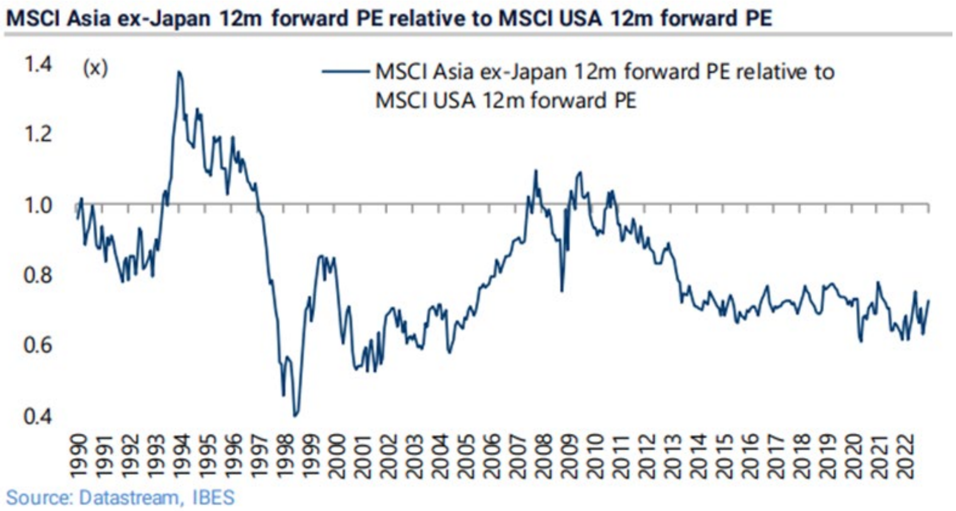
Dear Fellow Shareholder,

The Fund's NAV/share rose by 7.3% last year compared to the MSCI Asia ex Japan (US$) index, the Fund's benchmark, which increased by 3.6%. During the 25 years since inception, the Fund's NAV increased more than 14-fold, compounding at 11.3% per annum, while the MSCI Asia ex Japan (US$) index roughly tripled, compounding at 4.7% per annum. The benchmark figures used for comparison do not include dividends. However, we estimate that if dividends (net of withholding taxes) are included, the benchmark's return would increase by less than 2 ½ percentage points per annum.

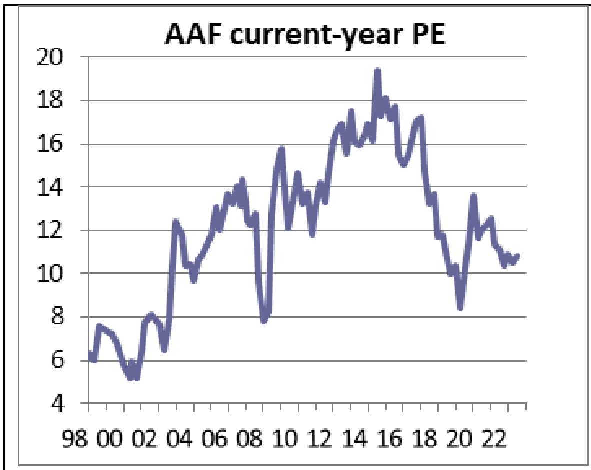
The importance of patience

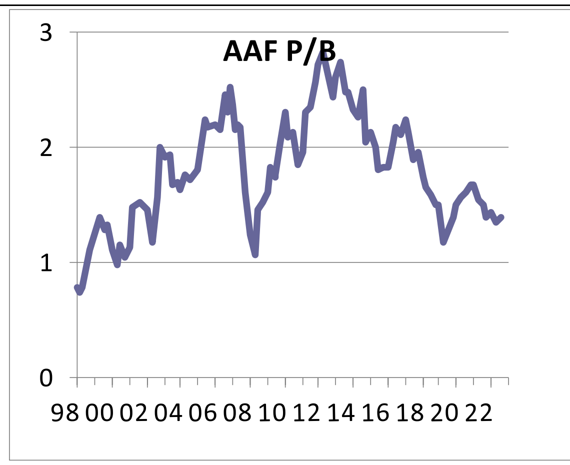
This track record shows the power of compounding, the importance of patience, and the rewards for investing where the masses are afraid to venture. This was the case when we launched OAM Asian Recovery Fund close to the depths of the Asian financial crisis a quarter century ago. As the largest shareholders in the Fund, my wife and I benefited more than anyone else from this patience and compounding. Before patting myself on the back too hard, I will share what is probably the biggest mistake of my investment career. About 30 years ago, I visited Guyana where I bought shares in Demerara Distillers, the maker of El Dorado rum, at a P/E of less than 3. The Chairman and CEO was Yesu Persaud, a very nice man and a clever businessman in a country that experienced extreme socialism, massive currency devaluation and a sapping brain drain. I did well with my Demerara Distillers investment and sold way too early. Yesi Persuad had a dream to start an indigenous Guyanese bank as the only bank left in Guyana at the time was Scotiabank and they needed competition. I agreed to invest less than US$50,000 in capital in Demerara Bank which bought me a roughly 3% shareholding as I recall. After a few years, I sold the shares at a small profit. Today, Guyana's economy is booming and equity valuations are extremely high. Had I held these shares for the past 30 years, I would have made well over 300 times my money in US Dollars, not including dividends.

Today, sentiment towards Asia is negative, and particularly so for China. US equities have really been the only game in town for the past decade or more. Interest in Asian equities outside of Asia is limited. I have been saying for a while that Asian equities are overdue a sustained period of outperformance relative to US equities, and the chart on the following page of the relative P/E of Asia ex-Japan equities to US equities shows why.

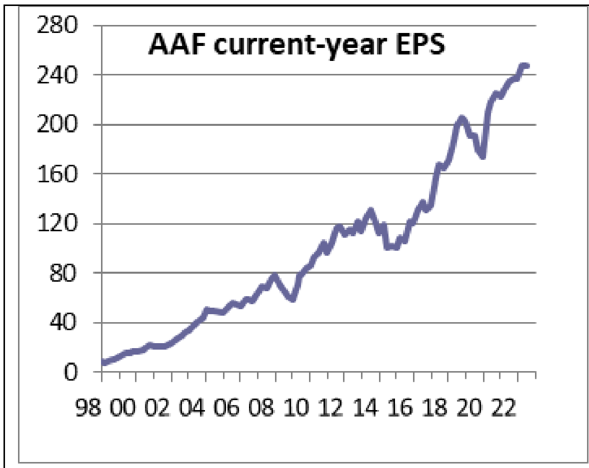


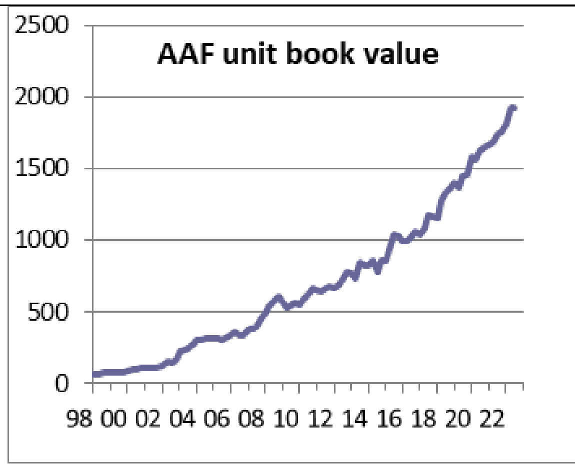
Asian equities are undeniably cheap compared to US equities. The problem is that we have no way of forecasting when sentiment will change. Recently, Claire Barnes, who I regard as one of the best investment managers in Asia, did an interesting analysis of her Apollo Asia Fund in which our Fund is an investor (cost: $4m; market value: $18.3m). The lifespan of her fund roughly mirrors the lifespan of our Fund. As the charts below show, there has been a lot of volatility in the average valuation of her fund's holdings. The past 10 years have been particularly brutal with the average P/E of her fund's holdings declining from 17.5 to 10.8 and the average P/B (price/book ratio) declining from 2.6 to 1.4.





By comparison, earnings of the portfolio companies grew consistently, and book value even more steadily. Earnings per share (EPS) for the portfolio grew from roughly $115 to $258 during the past decade, while book value per share (BV) increased from roughly $767 to $1,927. The impact of the compression in valuations during the past 10 years resulted in the investment return being way below the compound growth in earnings and book value (plus dividends, less fund expenses) of 11-12% per annum. In contrast, the valuation expansion during the prior decade resulted in investment returns of way above 12% per annum. The prior decade's experience (2003-13) in Asia of valuation expansion is similar to what happened to US equities this past decade (2013-23), whereas Apollo Asia's experience of valuation compression this past decade mirrors what our Fund and nearly all investors in Asian equities experienced during the past decade. Most investors in Asian equities did worse than our Fund's shareholders as our Fund continues to outperform comparable ETFs (and most other funds) investing in the region. A decade may seem like a long time, but please note what I said about the importance of patience! As the late Charlie Munger said, "The big money is not in the buying or the selling, but in the waiting." Fundamentally, the companies we invested in are on the same growth track. Any minor slowdown in growth in US Dollars is largely currency-related as earnings growth in local currency is translated to US Dollars.





What is the right geographic split?

This is a question to which we have paid scant attention in the past. Our investment process has always been very much bottom-up, that is investing in the best businesses in Asia ex Japan at a reasonable valuation, irrespective of their address. Russia's invasion of Ukraine and the spotlight this cast on geopolitical risk changed that perspective. The thought that our exposure to equities doing business in a country could need to be written down overnight to zero, even if the business is doing fine as is the case for most Russian businesses, changed the risk/return equation. This thinking has been applied to China, as well as Hong Kong and Taiwan to a slightly lesser extent. Some investors dubbed China uninvestable, and the legendary Warren Buffett sold his large investment in TSMC shortly after he bought it because of the company's address.

This is the current breakdown of the Fund's benchmark index, the MSCI Asia ex Japan index, and the rough breakdown by economic size of the Asian countries and regions in the way we look at the Fund's geographic mix. Ignoring geopolitical considerations, a neutral stance for our Fund would be to have around 60% invested in Greater China, around 15% in India, and just over 10% each in ASEAN and South Korea. The problem with this so-called neutral stance is that in an extreme scenario, no matter how low the risk, if Greater China exposure had to be written down to zero, you would not want 60% of your Fund's assets invested in that region.

Region/country	Benchmark composition	Share of Asia ex Japan economy
Greater China	58%	67%
Indian sub-continent	18%	13%
ASEAN	10%	13%
South Korea	14%	7%

We work on the premise that our clients only have a small but still significant portion of their assets invested in the Fund. My wife and I have about a quarter of our total assets invested in the Fund, but this high allocation is reflective of our strong view that Asian equities are likely to outperform most other equities or other investment options over the next decade or more. If any of our clients, other than our Asian clients who have a deserved home bias, have more than a quarter of their total assets invested in the Fund, they probably ought to reduce their exposure. With this as our assumption in terms of clients' overall risk, the Fund's Directors resolved shortly after Russia's invasion of Ukraine to limit its exposure to each of the three main geographic regions in which the Fund invests – Greater China, India and ASEAN – to a maximum of 40%. While we think the risk of China being "cancelled" in the same way as Russia is very low, the risk remains, so this policy was implemented to control risk to a tolerable level. The quid pro quo is that if Greater China outperforms the Fund's benchmark, which we think has a higher probability of occurring, the Fund is likely to underperform its benchmark by being heavily underweight that region.

This analysis shows the interplay between risk and return. The reasons why we think China and Hong Kong (HK) equities could outperform the Fund's benchmark, and possibly by a substantial margin, are twofold. Firstly, sentiment towards China is very negative, particularly by US and, to a lesser extent, European investors. Many US investors have gone so far as to sell all their China investments. Even a slight improvement in sentiment could lead to enough foreign buying to push up those indices strongly. Secondly, valuations of Hong Kong and Chinese equities are very low, both by historic standards and relative to other equity markets globally. For instance, our two deep value holdings in Hong Kong paid record dividends last year. COSCO Shipping International, which still sells for less than net cash on its balance sheet, paid dividends (free of withholding tax) of HK$0.34 last year which represented a nearly 14% yield on its share price at the start of last year, plus they repurchased shares in the market. The shares returned 37% last year inclusive of dividends. Swire Pacific sold its Coca Cola bottling business in the western US and paid HK$1.864 in dividends last year to B shareholders which represented a nearly 21% yield on its share price at the start of last year, plus they repurchased shares in the market and its share price rose. Its shares still sell at a more than 70% discount to NAV. We are seeing strong insider buying, record levels of share buybacks, and entire privatisations of listed businesses (an average of 11 annually over the past 3 years vs an average of 4 annually in the 6 years from 2013-18) in Hong Kong, all hallmarks of an undervalued stock market.

We have data on the Hang Seng Index (HSI) of HK equities going back 50 years. Last year was the fourth consecutive year that the HSI provided a negative return, a first in history. Over the past 50 years, there were two periods – 1981-83 and 2000-02 - when the HSI had three consecutive years of negative returns. Following each period, the HSI generated four or five consecutive years of positive returns, roughly tripling during those subsequent periods. Such is the power of reversion to the mean in financial markets.

Bear markets are a time for sowing

The Fund's benchmark index, the MSCI Asia free ex-Japan (US$) index, peaked in February 2021 and has since declined by 33%. The MSCI China (US$) index peaked at the same time and has fallen even further by 57%. Our Fund held up better, declining by 10.5% from its peak in October 2021. Earnings have grown during that period, so the decline has been entirely due to valuations falling to what we think are attractive levels that ought to lead to decent future returns. Rather than panicking during declines, this is the best time to invest capital. We have identified three Asian funds to which we intend to allocate new capital in due course.

During the Fund's quarter of a century history, there have been five major Asian bear markets. The rebounds from the first three were powerful, with 5-year compound annual returns from the bottom of 19-25% per annum. The following table shows the decline in the Fund's benchmark index during each bear market and the subsequent 5-year return from the bear market low.

Bear market duration	Peak to trough decline	Subsequent 5-year return from low
Feb 2000 – Sept 2001	-57%	+204%
Oct 2007 – Nov 2008	-66%	+168%
Apr 2015 – Jan 2016	-32%	+143%
Jan 2018 – Mar 2020	-36%	So far, +24% from 03/20 low to 01/24
Feb 2021 – Oct 2022	-46%	So far, +19% from 10/22 low to 01/24

If the 5-year return from the two most recent bear market lows is within the range of subsequent returns from the prior three bear market lows, the benchmark would need to roughly double during the next 15 months from current levels following the 4th bear market low, unlikely in my view. A more realistic return target if valuations in Asia recover to around long-term market averages and are within the range of the first three rebounds from bear market lows this century would result in an annualised return for the index of 19-27% during the next 46 months from current levels following the 5th bear market low.

The sample size is too small to have high confidence that future returns will be within that range. However, this section of the letter to shareholders illustrates the depth of the bear market that Asian equity markets already endured, of which we think many of the Fund's shareholders are unaware. It also illustrates why deep bear markets such as these are a better than average time to invest capital. The past century of US stock market history provides a larger sample size and reaches the same conclusion. No one ever knows when a market has truly reached bottom, but declines of this magnitude have historically provided excellent entry points.

Good time to take a contrary view

A few weeks ago while having lunch with an investment manager friend, he asked me what the catalyst is likely to be for non-US equities to finally outperform US equities for a sustained period. My answer was that I had no idea. It is very difficult to identify a catalyst that changes a major market trend, often even retrospectively. The prices of equity, bond, currency and commodity markets tend to move in long cycles. Even real estate prices show a similar tendency. My observation is that the price of real estate in many markets tends to move roughly sideways, sometimes for a decade or more, and suddenly fundamentals, cheapness relative to competing assets, increasing attention from potential buyers, the start of momentum in rising prices, or some combination of these factors causes prices to rise from their slumber.

The oceanfront real estate market in Little Cayman, the smallest of the three Cayman Islands, is a market with which I am very familiar. For two decades from 2000-2019, the price of land there went more or less sideways. Yet, Cayman's population grew by about 70% during that period and oceanfront land prices on Grand Cayman roughly tripled. The fundamentals were strong. Few investors were paying attention. Then, during the past four years, oceanfront land prices in Little Cayman soared.

Today, Asian equities are cheap relative to US equities. Most investors have paid little attention, and many have actively shunned them. Yet, as the Apollo Asia charts show, the fundamentals are strong. The MSCI ASEAN index is no higher today than it was at the end of 2009. Yet, ASEAN's GDP more than doubled (in US Dollars) since then. Eventually share prices need to catch up with fundamentals and competing assets. The long down cycle of Asian equities underperforming US equities looks ripe for reversal as the chart on the following page of the MSCI Asia ex Japan index relative to the S&P 500 index illustrates.

<u>Continued strong relative performance … but frustrating net outflows</u>

The Fund currently has net assets of $284 million and less than $2 million in cash which we need to keep on hand as a buffer so investment in the new opportunities we identified will depend on whether we get net inflows to the Fund or sell any of our existing investments. Unlike the demand for most other items, the demand for stocks usually falls when share prices decline, and vice versa. In other words, there is a strong human tendency to follow momentum and buy what has increased in price recently and sell what has declined in price or appreciated more modestly. This makes no sense, and we try to guide our clients to do the opposite.

During the year, the Fund received $1 million in subscriptions and paid out $20 million in redemptions. This is the ninth year during the past ten years that the Fund had net redemptions. This is frustrating given the Fund's continued strong relative performance. In each of the first two decades this century, the Fund's NAV per share significantly outperformed the competing ETF (AAXJ) which tracks the Fund's benchmark index. So far this decade, the same has happened. Empirical evidence shows that 90-95% of equity investment managers underperform their benchmark over 10 years which is why there has been a move by many investors from active to passive investing. Few funds have achieved the feat of beating the index two consecutive decades and counting. Whilst our Fund's relative performance has been superb, in absolute terms, its returns have been mediocre, and disappointing compared to US equity returns. There is no sign of the Fund's net outflows reversing until Asian equities outperform US equities on a sustainable basis. There were tentative signs in late 2022 that this might be starting to happen, but the trend started to falter a year ago and Asian equities underperformed US equities by a wide margin again last year.

Over the very long-term, equity prices follow earnings per share (EPS). Yet, over a decade, the two can diverge widely when Price/Earnings (P/E) ratios expand or contract as shown in the Apollo Asia charts. These cycles of P/E expansion and contraction are probably so long because momentum (the tendency to buy what has gone up a lot recently, and vice versa) stretches valuations to extremes distant from equilibrium or fair value. Russell Napier teaches a course in financial history that shows these long cycles of expansion and contraction using several important measures of valuation of the US equity market going back to the late 19th century. It is clear from these long-term charts that US equities are close to an extreme high in historic valuation terms. Asian equities (apart from India), in contrast, look inexpensive. Now feels similar to 2002/03 in comparing Asian to US equity markets – see preceding charts. That is too far in the past for most investors to recall. I suggested that if the recovery from the current Asian equity bear market is similar to the recovery from prior Asian bear markets, Asian equities could realistically generate annualised returns in the 20s over the next 4 years, i.e. more than double in price. That may sound outlandish, but it is exactly what happened to Asian equities from the end of 2002.

<u>TSMC's new Arizona fab</u>

It is useful to remind the Fund's shareholders why I am so bullish on Asia's long-term prospects relative to the rest of the world. I am reminded of this every year when I spend 3-4 weeks in Asia talking to investment managers and business leaders, but unless you visit Asia frequently, it is easy to forget, especially given negative Western media coverage.

One of the Fund's largest underlying investments is TSMC (Taiwan Semiconductor Manufacturing Company). The world consumes more than a trillion semiconductor chips annually. TSMC is the world's largest producer of semiconductors, producing more than half of those trillion-plus chips, and nearly all the most advanced ones. This reliance on a single company for one of the key inputs into manufactured products globally concerns the US. President Biden, partly in response to this concern and partly for political means, boasted that the CHIPS and Science Act which was passed in 2022 would boost US manufacturing and give high paying jobs to union workers. The Act will provide $52.7 billion in loans, grants and other incentives, and billions more in tax credits for manufacturers to produce semiconductor chips in the US. In late 2022, TSMC, under pressure from the US Government broke ground on a $40 billion semiconductor fabrication foundry in Arizona, a crucial swing state in the upcoming US Presidential elections. TSMC has sought up to $15 billion in funding from the US Government, but objected to some US conditions.

Currently, roughly 12% of semiconductor chips produced globally are made in the US, down from 37% in 1990. TSMC's founder, Dr. Morris Chang, was and remains deeply sceptical that the US can re-establish itself as a leader in semiconductor manufacturing and effectively told Nancy Pelosi during her visit to Taiwan that these efforts were doomed to failure. He has further elaborated in interviews that expanding chip production in the US is an "expensive, wasteful exercise in futility" because manufacturing chips in the US would be 50% more expensive than in Taiwan. One TSMC engineer describes Taiwan's secret sauce as follows:

"Compared to software engineers in the US, even at the best companies here, engineers are paid quite badly," he said. "But compared to other industries in Taiwan the pay is good. So, if you work for a big electronic company after a few years, you'll be able to get a mortgage, buy a car. You'll be able to get married. So, people suck it up." He went on to describe a six-day week which began each day with a meeting at 07:30 and would usually last until 19:00. He would also be called in on Sundays or holidays if there was a problem at the plant.

This year, TSMC delayed plans to start semiconductor manufacturing at its Arizona plant from early 2024 to 2025 - when in 2025 they won't say - blaming a lack of skilled labour. The company had to fast-track visas for 500 Taiwanese workers to get the skilled labour needed to equip the facility. The Arizona Pipe Trades 469 union petitioned against TSMC's visa applications. As Peter Wennink, the CEO of ASML Holding NV, one of the world's largest semiconductor equipment companies explained:

"People don't seem to realize that when we start building those fabs across the globe, that skill has been refined over the last couple of decades in only a few places on the planet—predominantly in Taiwan and in Korea and a bit in China," said Wennink. "Getting access to the requisite skills and skilled workers to keep the construction plan on time is a challenge."

Then there is the problem of packaging and testing the chips produced at the Arizona fab. It is likely that these chips will ultimately still have to be shipped to Taiwan for packaging which defeats the objective of reducing US reliance on Taiwan. Most of the facilities where packaging processes are outsourced are in Asia, with 107 in Taiwan and 111 in China, which is where at least 81 percent of global chips are assembled, packaged, and tested. TSMC is unlikely to build a packaging facility in the US unless it is heavily subsidised by the US Government because the economies of scale are lacking. When the Arizona fab is fully operational, it will produce 600,000 wafers per year compared to the roughly 18 million wafers TSMC is expected to produce this year.

My money remains on Asia trouncing the US over the coming decades. Hard work, sacrifice, a strong educational bedrock especially in maths and science, and other virtues found in Asia are likely to trump a sense of entitlement and massive subsidies paid for with borrowed money. At the end of this month, I am subscribing for shares in the Fund and adding to what is already my wife's and my largest single investment.

Desmond Kinch, CFA
Chairman