Overseas Asset Management

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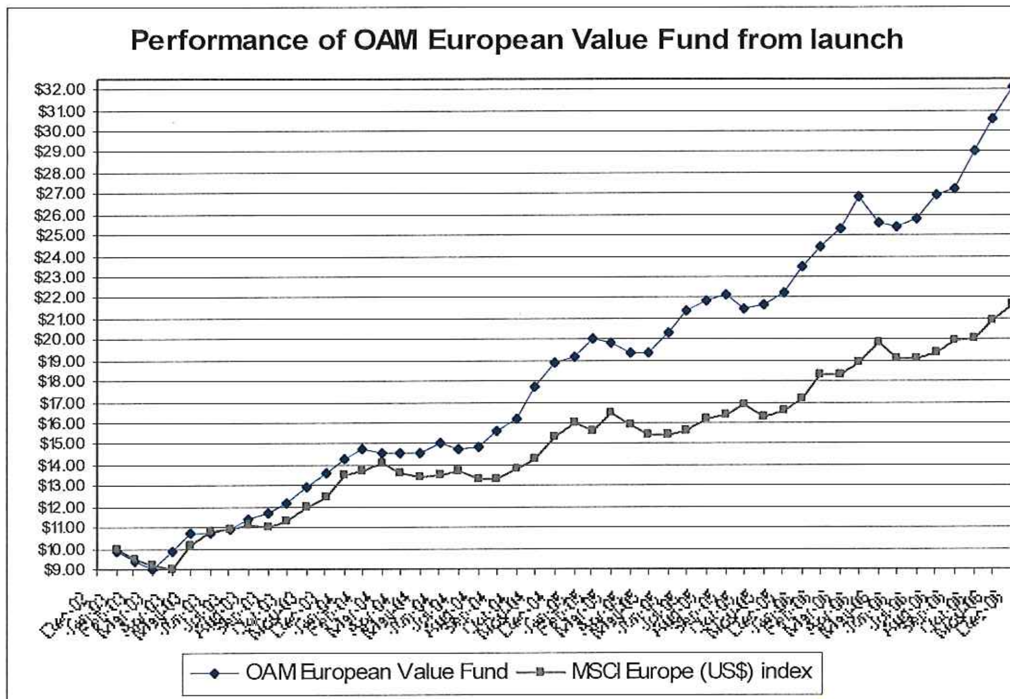
2nd January, 2007 **OAM European Value Fund**

Dear fellow shareholder,

Last year, OAM European Value Fund's NAV increased by 44.1%. By comparison, the Fund's principal benchmark, the MSCI Europe (US$) index, increased by 30.3%. This is the Fund's fourth anniversary and its fourth consecutive year of outperformance. Over the past four years, the Fund's NAV has increased by 220.7% (33.8% per annum) versus 123.2% (22.2% per annum) for the MSCI Europe (US$) index.



Looking back over the last four years, we were helped by a number of positive factors that created a huge tailwind for returns. That tailwind is reflected in the four year compound annual return of 33.8% per annum which is about 24 percentage points higher

than what I regard as sustainable long-term index returns. The favorable tailwind made me look far smarter than I am. For those shareholders who have been OAM clients for less than 10 years, let me point out that they will not always be fortunate enough to have the benefit of tailwinds boosting returns. Longstanding clients will remember the latter half of the 1990's when I struggled to keep pace with US stock market returns, not because of my stupidity, but because of very powerful headwinds confronting the markets in which I invest (certainly relative to the huge tailwind behind the US stock market at that time).

There are four components to European market returns: dividends, earnings growth, P/E revaluation or devaluation, and currency revaluation or devaluation. Over the past four years, the average P/E of the Fund's holdings increased from just under 12 to just under 15. This added about 25% to the total return over the period or 5.7% per annum. During the same period, the Euro appreciated by 26% and Sterling by 22%. Therefore, I reckon that currency added another 5.7% per annum to returns. I would not reckon on either of these factors contributing significantly to returns during the next four years. If I had to guess, I would say that that currency might be a slight negative contributor and P/E revaluation might be a slight positive contributor to European equity index returns. However, that is nothing more than an educated guess based on European currencies being expensive versus the Dollar on a purchasing power parity basis and a sense that valuations are likely to climb a bit higher than a P/E of 15 (which I consider fair value) driven by the weight of private equity money that needs to be put to work in Europe. That leaves the return from earnings growth and dividends which currently yield 3.1% (before withholding tax) according to the Bloomberg Europe 500 index of large European companies to drive returns going forward. This leads me to expect European equity indices to return a bit less than 10% per annum over the next four years.

Fingers crossed, I can continue to add value through stock selection and push the return over 10% per annum. Although the past is not necessarily an indication of the future, I believe it is noteworthy that each of the four segments of the Fund's portfolio (market leaders, investment trusts, holding companies, and deep value) has outperformed the Fund's benchmark since inception. The table below sets out the components of the Fund's historic 4 year return and my best guess of returns for the next 5 years.

Components of Fund's compound annual return	**Past 4 years**	**Est. next 5 years**
Dividends (net of withholding tax)	2.8%	2.5%
Earnings growth	8.0%	6.0%
P/E revaluation/(devaluation)	5.7%	Slightly positive
Currency reavluation/(devaluation)	5.7%	Slightly negative
Stock selection (+/-) *	11.6%	2.0%
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Total return	33.8%	10.5%

* The contribution to return from stock selection is shown net of Fund expenses.

OAM European Value Fund currently has net assets of US$87 million. The Fund holds cash of US$6 million (7% of net assets). New investment ideas are becoming harder to

find. Nevertheless, our traditional hunting grounds of family-controlled investment holding companies trading at wide discounts to NAV, investment trusts and closed end funds trading at wide discounts to NAV, spin-offs, and companies in deeply out-of-favour sectors, or which are statistically cheap and not widely followed form the bulk of our investment ideas. Unlike last year, I will not go into specific details about each of our largest investments. Recently, we have had problems with readers of my newsletters apparently trading in the securities of companies that I have written about. Socfinasia is a prime example. I made some very positive comment about this Fund holding in early November. It is one of the least liquid securities in the Fund. Between 15th and 22nd November, the share price jumped by more than a third on about five times average daily trading volume for no explicable reason. Since this Chairman's statement is posted on the internet, there is even more reason to be careful about what I write.

A broad overview of the portfolio suggests that there is still good value in the Fund's portfolio. The Fund's investments in family-controlled investment holding companies have been by far the biggest contributor to its superior performance since inception. This part of the Fund's portfolio has produced a 46.5% compound annual return during the past four years. I believe that our knowledge and understanding of European holding companies is the principal competitive advantage of this Fund. John Pennink of Asset Value Investors in London is the only other manager that I know who has comparable knowledge and understanding of the sector. He manages over £1.5 billion, primarily for Yale University Endowment and British Empire Securities Investment Trust, a London-listed investment trust that almost always trades at a premium to NAV.

When the Fund was launched, the dollar-weighted average discount to NAV of the holdings in this segment of the portfolio was 42%. Today, the average discount stands at 30% which is still an attractive valuation, and we have 31% of the Fund's portfolio invested in this segment. However, for nearly the past year, all the Fund's sales in this segment of the portfolio have been more liquid shares in some of the larger, more widely followed holding companies, while the purchases have all been less liquid, lesser known names, usually without any analytical coverage. I do not believe that there has been any compromise in quality as the track records of the new holdings are excellent and their balance sheets are strong. There has however been a bit of a reduction in the overall liquidity of the portfolio resulting in it taking longer to accumulate some of these new positions. Liquidity seems to be less of an issue when selling (assuming that we have bought well) as trading volume usually seems to increase markedly when such holdings are "discovered" and new shareholders bid up their share prices.

We are seeing a similar phenomenon in the closed-end fund and investment trust market in which we have long invested for clients. Discounts to NAV exceeding 20% are extremely rare these days except for what I consider junk. Currently, we only have 11% of the Fund invested in this segment, and the dollar-weighted discount to NAV currently stands at 16%. This segment of the portfolio is concentrated in four holdings, each accounting for 2-3% of the Fund's NAV. Only one of these holdings is sufficiently liquid that it could be sold within a day or two without affecting its share price unduly. The other holdings are far less liquid. However, two holdings have automatic or semi-

automatic exits during the next few years in terms of either fixed lives until wind-up or a continuation vote by shareholders.

As is the case in the investment holding company segment, I do not believe that there has been any compromise in quality in this segment of the Fund's portfolio. One entity is managed by one of the world's best private equity managers who unusually (uniquely in my experience of private equity funds) does not charge this entity any performance fees. Moreover, the entity invests in one of the few areas of the global private equity buyout market that I do not consider overcrowded. The largest investment trust holding is a sector fund that is managed by one of the world's top-performing investment managers specialising in that sector. The same manager also manages a hedge fund that charges roughly three times the fees of the investment trust and not surprisingly has seen its performance trail that of the trust. The second largest investment trust holding is managed by one of the most successful UK venture capital managers. European venture capital, which is the sector of the market in which this trust invests, is one of the few areas of financial markets that has been relatively starved of capital in recent years (probably because of "rear-view mirror investing"), which leads me to believe that returns are likely to be quite attractive in coming years. The fourth holding in this segment is a relatively low-risk investment in an investment trust that owns endowment policies purchased in the traded endowment market and held to maturity.

The other half of the Fund's portfolio is comprised of operating businesses which were each purchased because they were trading at a significant discount to what I thought they were worth at the point of purchase. Some of them are spin-offs from larger companies; some are extremely well-managed companies that have relatively predictable earnings and generate large free cash flow; some have recently stumbled but have what I believe are solid business franchises and a cogent plan to recover; while many operate in markets that I think are generally undersupplied with capital and are consequently less competitive. In this latter category, I include a Dutch builder with a valuable land bank (there is an undersupply of residential housing in The Netherlands with instances of students living in converted shipping containers); insurance companies with strong underwriting track records (where sufficient new capital has not yet entered the market, resulting in high premium rates); agricultural commodity producers and suppliers (where there are increasing prospects of shortages due to cultivation not keeping pace with demand and food competing with energy for a limited supply of agricultural commodities); a lender to low income borrowers in the UK that has consistently earned a more than 20% return on equity and compounded its EPS by 15% per annum (largely because the large UK high street banks shun such business); and a couple of niche European technology leaders which have little analytical following but are global leaders in their niche (technology as a sector is interesting because of the fallout from the bursting of the technology bubble five years ago). On a dollar-weighted basis, the operating businesses owned by the Fund trade at an average P/E based on expected 2006 calendar year earnings of about 15.

As shareholders will gather, I am not concerned about the valuation of the Fund's holdings or their quality. However, until market circumstances change, the current

environment where most new investment ideas are less liquid securities could lead the Fund's directors to close the Fund to new investors if cash rises and stays above 15% for more than a few months.

Desmond Kinch
Chairman