Overseas Asset
Management

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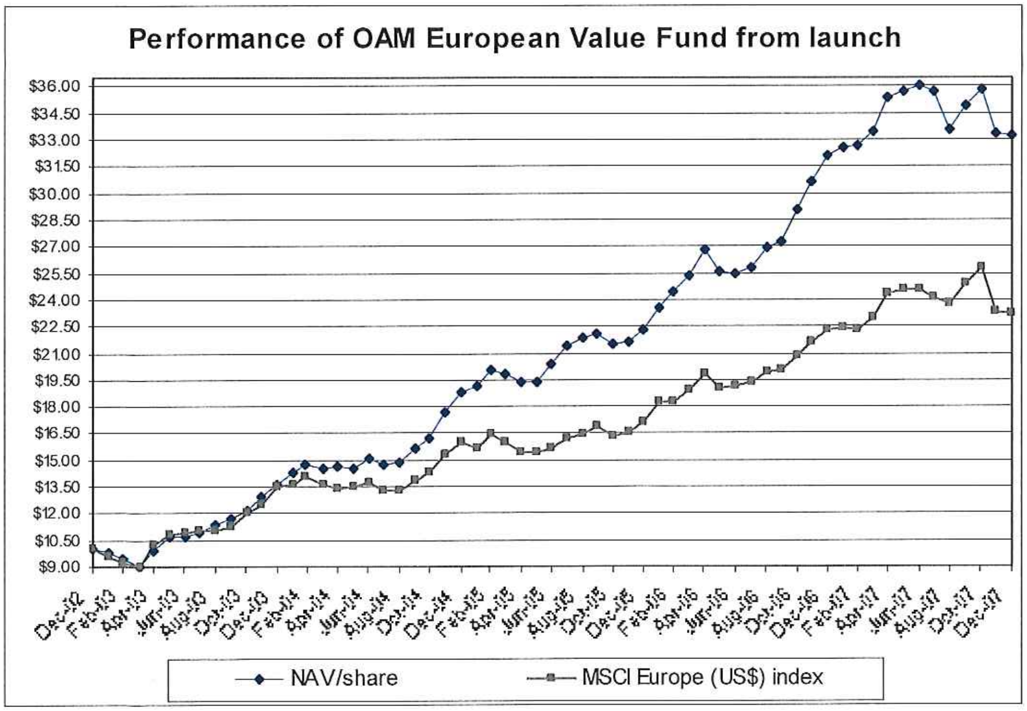
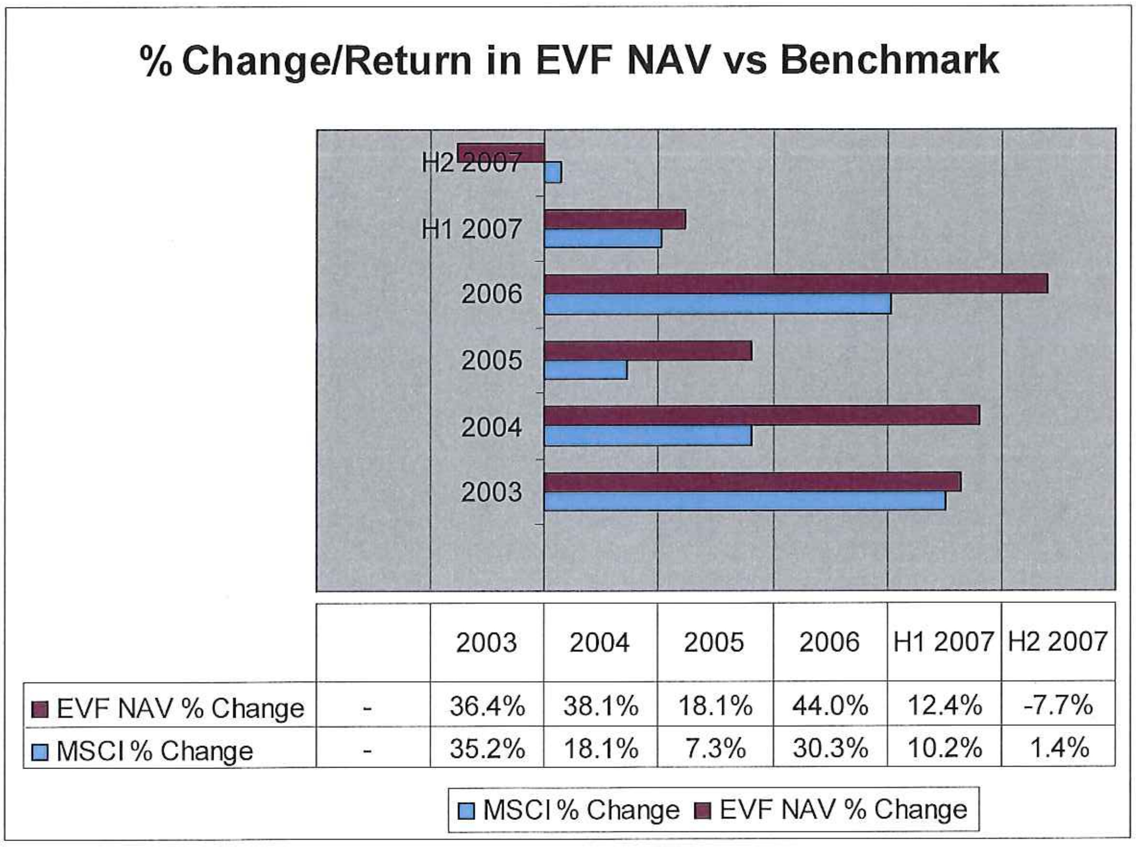
2nd January, 2008 **OAM European Value Fund**

Dear fellow shareholder,

Last year, OAM European Value Fund's NAV increased by 3.7%. By comparison, the Fund's principal benchmark, the MSCI Europe (US$) index, increased by 11.8%. This is the first year in the Fund's five years of existence that it has underperformed its benchmark. Over the past five years, the Fund's NAV has increased by 232.4% (27.2% per annum) versus 149.5% (20.1% per annum) for the MSCI Europe (US$) index.



Although none of the Fund's holdings were directly impacted to any meaningful degree by the US sub-prime crisis, sentiment towards many of our holdings was severely dented by the turmoil in financial markets. This change in sentiment took place in the second half of the year. Value managers such as us seem to have been particularly hard hit by this change in sentiment. According to an article in the Financial Times in late November, "value" has underperformed by 5-percentage points since 20th July. That is a huge margin of underperformance over a short space of time. We were not immune to the decline in value stocks. This is starkly illustrated in the bar chart below which shows that the Fund was ahead of its benchmark during the first half of the year, but lost money in the second half. The past six months was a very demoralising period. It would be easy to conclude that I would have better off taking a six month sabbatical during the second half of 2007. However, I think this is the wrong conclusion. Investing is a bit like insurance underwriting. If you stick to the same disciplined approach, over time you should generate a decent return. Some periods will be worse than expected; some will be better than expected. As an investor or underwriter, you have no way of predicting when losses will result. I am also consoled by the fact that we have suffered other similar periods of short-term underperformance but over the long-term, our disciplined value approach has outperformed passive benchmarks by a wide margin.



% Change/Return in EVF NAV vs Benchmark

		2003	2004	2005	2006	H1 2007	H2 2007
🟥 EVF NAV % Change	-	36.4%	38.1%	18.1%	44.0%	12.4%	-7.7%
🟦 MSCI % Change	-	35.2%	18.1%	7.3%	30.3%	10.2%	1.4%

There were four principal reasons why we lost money and underperformed our benchmark in the second half of the year. The most important reason appears to be the Fund's investment in three construction related businesses: Heijmans NV, Permasteelisa S.p.A., and Italmobiliare savings shares. During the past six months, the value of these three holdings declined by about US$5 million or 5% of the Fund's NAV. At the end of June, these three holdings accounted for about 13% of the Fund's NAV. Only about 4% of European benchmark indices are in construction. Investors extrapolated weakness in US residential construction to most European construction companies. Since the end of June, Heijmans' and Italmobiliare's share prices fell by 40-45% while Permasteelisa's fell by a comparatively modest 35%. We think these share price reactions are unjustified and we accordingly added to two of these holdings prior to year end at prices that should result in extraordinary returns for our shareholders. Importantly, I have visited all these companies in recent years and think that I understand their businesses very well.

Heijmans had three earnings estimate downgrades this year, all related to large contracts on which the company bid in 2005 that should be completed in the middle of next year. The competitive situation at the time was such that the company structured these bids in a way that restricted their ability to pass on raw material and sub-contractor cost increases. These issues have since been addressed. The problems are of a one-off nature and should not affect profits after mid-2008. At the current share price, Heijmans' shares sell for 7 times 2008 estimated earnings, 1.3 times book value (which understates the value of their land bank in The Netherlands), 0.15 times sales and a 6% dividend yield. This is far too cheap for what I regard as a generally well-managed company. Heijmans' longer term track record is impressive. Over the past 15 years, the company has compounded its EPS by 14% per annum while paying a generous dividend.

Italmobiliare was the Fund's second largest holding at the end of May. In June, we sold a third of the Fund's holding partly because of the size of the holding and partly because the discount to NAV had declined to a historically low level of around 17%. The discount to NAV widened to as high as 39% less than six months later when we added to the Fund's holding and currently stands at 33%. There is a second level of discount in that the savings shares trade at a 27% discount to the ordinary shares, up from 20% in June, even though the savings shareholders by law must be paid a higher dividend than the ordinary shareholders. There is a third level of discount in that Italmobiliare's principal holding is a controlling shareholding in Italcementi, the fifth largest cement producer in the world. Italcementi's share price has fallen sharply, mainly due to sentiment, and it now sells at around 8 times 2008 estimated earnings. In addition, Italcementi's 77% shareholding in Ciments Francais and 55% shareholding in Suez Cement are now worth significantly more than its market capitalisation. On our analysis, Italcementi is selling at a more than 30% discount to the sum of its parts. This valuation is far too cheap for a company that makes 40% of its profits in booming emerging markets including India and China where they own the dubiously named Fuping Cement. Italmobiliare is an excellent company. Even after its recent sharp share price fall, it has produced a compound annual return for shareholders of more than 16% per annum over the past 15 years.

Permasteelisa, a debt-free company, is the world's leading designer and manufacturer of exterior curtain walls for high-end buildings. For instance, they designed and built the curtain wall for landmarks such as the Sydney Opera House and the Guggenheim Museum in Bilboa. Its shares currently sell at 8 times 2008 estimated earnings and 0.3 times sales. Permasteelisa's order book is extremely strong even though it has been turning away work. Given the long lead time of important landmark buildings that use their high-end exterior cladding and interior finishes, there is a two to three year lead time between Permasteelisa taking an order and completing a contract.

The company has only had one contract cancelled in its 30-year history. This gives Permasteelisa good visibility in terms of revenues. As long as they can execute the work without too many problems, earnings growth should be strong in coming years.

The secondary reason for the poor relative performance of the Fund is because part of its strategy is to invest in European family-controlled holding companies trading at wide discounts to NAV. During the past six months, for no rational reason, the average discount to NAV of our holding companies widened from 31% to 40%. This widening of discounts to NAV, not including any impact from a change in value of the underlying assets, cost us about $4 million (4% of NAV) during the past six months. We currently have 34% of the Fund's net assets invested in holding companies. The widening of discounts to NAV in this sector has provided us with an opportunity to add two well-managing holding companies to the portfolio in recent months. We have virtually every listed European holding company modeled in Excel and we daily update our estimate of NAV through a link to Bloomberg. From this we derive the estimated discount to NAV. This provides us with a disciplined way of investing in a market niche where we think that we have a huge competitive advantage. This is borne out by our long-term results. During the past five years, we have earned a compound annual return of 35% per annum on the assets invested in this market niche.

The third reason for the poor relative performance is that discounts to NAV of three of the investment trusts we own widened substantially in the second half. We lost just over US$2 million (2% of NAV) due to a widening of discounts to NAV of our investment trust holdings during the past six months. We have taken advantage of currently wide discounts to NAV to add to these holdings. We now have 10% of NAV invested in our three largest investment trust holdings: Prelude Trust, RAB Special Situations and Blue Planet Growth & Income Investment Trust. Prelude Trust's discount to NAV widened during the past six months from 20% to 36%, RAB Special Situations' discount widened from 12% to 18%, and Blue Planet's discount widened from 19% to as high as 35% before settling at a 16% discount at year end.

Prelude Trust is managed by Esprit Capital Partners, one of Europe's leading venture capital firms. Apart from the discount to NAV, Prelude has a few attractions. Firstly, European venture capital funding has been declining for several years. Less competition for deals is likely to lead to higher returns down the road – hopefully Skype is the first of many very successful European venture capital exits (Draper Fisher Jurvetson that backed both Skype & Hotmail bought a stake in Esprit Capital Partners in August). Secondly, Prelude has some attractive investments that look likely to be realised in the next year or two that should result in a healthy uplift in its NAV. Finally, shareholders are likely to get a free ride in terms of not having to pay performance fees unless the Trust's return is stunning.

Blue Planet Financials Growth & Income Trust is managed by Kenneth Murray who is its largest shareholder with a nearly 30% stake. This closed-end fund has achieved stunning results. Over the past 5 years, its fully diluted NAV per share has increased by 123% versus 45% for its benchmark which is the MSCI World Financials Index (£). The wide discount to NAV makes no sense because it has a "sister" fund that charges much higher hedge fund-type fees and trades at NAV. The Trust also has half its assets in cash reflecting the manager's bearish view of the financial sector, so the discount to NAV of the invested portion is nearly 30%. Furthermore, the Trust has a continuation vote in 3 ½ years.

RAB Special Situations has only one asset, shares in an open-ended fund of the same name. The fund had a short-term setback because it bought a stake in Northern Rock before it hit rock bottom. Performance this year has suffered, though it is still positive. Longer term, its track record is excellent. In October, Barrons ranked it as the top performing hedge fund in the world over the past three years. The manager, Philip Richards, invests in fledgling companies with huge potential, often in the mining sector. He extracts favorable terms for the fund. Given that the identical underlying fund has monthly subscriptions at NAV, and given the fund's superlative track record, there is no good reason for the current 18% discount to NAV other than the observation that RAB is not flavour of the month with investors given their minor mishap investing in Northern Rock.

Over the next five years, shareholders are highly unlikely to see the Fund's NAV per share triple again. Nevertheless, I remain confident that the Fund should be able to generate a return that is attractive relative to cash deposit rates and most equity index returns. In looking through prior spreadsheets that show P/E's, dividend yields and discounts to NAV, I have to go back to late 2004 to find similarly attractive valuations in the Fund's portfolio. There is a valid argument that P/E's should be relatively depressed because there is a reasonable chance that corporate earnings (the "E" in the P/E) are likely to disappoint and may well decline this year. In contrast, since most of the assets held by our holding companies and investment trust are listed, the NAV on which discounts are based are not subject to the same estimation uncertainty as earnings. The discount to NAV is a more accurate measure of sentiment. When sentiment is depressed and discounts to NAV are wide, the prospects for future returns are more favorable, and vice versa. The wide level of discounts to NAV of our holdings today ought to bode well for future returns.

However, European currencies appear to be significantly overvalued based on my recent travel experiences. Most estimates of purchasing power parity suggest that Sterling and the Euro are about 25% overvalued against the USD. It is also worrying that sentiment seems to be universally negative against the US Dollar. Magazine covers which are a famous contrary indicator add to these worries that the US Dollar may recover against European currencies. Within the same week at the end of November, the Economist cover had the headline "The Falling Dollar" and the Der Spiegel magazine cover, one of Germany's leading magazines, portrayed the US Dollar as a plunging aircraft heading towards certain death.

For the first time, the Fund's Board has considered partially hedging the Fund's Euro exposure. However, we feel that since this represents a departure from our approach to managing the Fund in the past, we should at least advise shareholders that we may potentially start hedging part of the Fund's Euro exposure. Based on our initial consultation with Fund shareholders, we have received opposing views from two shareholders. One felt strongly that we should use currency hedging; the other said that he uses the Fund partly for currency diversification. If we do hedge currency exposure, it will only be a partial hedge of our Euro exposure because there is already a natural hedge in that a lot of our companies' earnings or net assets are in US Dollars or Dollar-linked currencies. Our investigations of the costs of hedging lead us to the conclusion that if we do hedge, the best way is by doing a currency swap with the Fund's custodian, Royal Bank of

Canada (RBC). This would be done at the forward rate which reflects interest rate differentials between the two currencies and RBC would charge 0.01% of the value of a swap every time it is put in place which would likely be every three to six months if we decide to hedge. We therefore would like feedback from any shareholders with strongly held views on the subject.

Desmond Kinch
Chairman