Overseas Asset Management

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14th January, 2011

OAM European Value Fund

Dear fellow shareholder,

The past year

2010 was a good year for the Fund. Its net asset value (NAV) per share increased by 20.1% in US Dollars – more in Euro terms. By comparison, the Fund's European equity index benchmark, the MSCI Europe (US$) index increased by only 2.7%. In last year's Chairman's statement, I said:

"The indiscriminate selling of last year has given way to more orderly markets that are now valued much closer to what we believe is fair value. European equity valuations are no longer very compelling; nor are they expensive. Shareholders should not expect stunning returns again this year. However, valuations are sufficiently compelling that we think the probability of making money for shareholders this year is quite favourable. ….. All our investments are soundly financed and are survivors regardless of whether we have emerged from a V-, L-, U-, or W-shaped recession. On balance, I think we should be reporting another good year this year, though nothing like last year and volatility cannot be ruled out."

On balance, the Fund performed better than I expected at this time last year. In a few instances, I think we were lucky.

I alluded in last year's statement to the possibility of volatile markets. Indeed, European markets were volatile. It was a year of two halves. In the first half, the Euro and stock markets globally were depressed by sovereign debt concerns in Greece and the threat of contagion spreading to other peripheral European countries as well as concerns that the world was about to enter a double-dip recession. We saw no evidence of economic slowdown from the companies we own and therefore held firm and invested cash at very attractive prices during the summer. In the first half of last year, the Fund's NAV per share fell by 10.5%, while in the second half, it rose by 34.2%. There is a lesson in this result: let volatility be your friend, not your enemy. Those clients who redeemed from the Fund during the first half of last year when markets were falling sold at a low point for the Fund while those who subscribed during this depressed period generated a very nice return over a short period of time.

As in prior years, the Fund had net subscriptions during the year: $18 million in subscriptions and $8 million in redemptions. The Fund now has net assets of $150 million which we think is a good size. It is small enough to allow us to hunt without constraints in our traditional fishing grounds while being sufficiently large to keep the expense ratio low. On this latter point, the Fund's expenses were US$127,000 last year which is only 0.10% 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.

The Fund's history so far

The Fund now has an 8-year track record. This track record is far more important than what the Fund did last year. In some years, we had good luck and/or a favorable market environment, whilst in other years, we had the inverse. Over time, good luck and bad luck cancel one another and markets tend to mean revert from their peaks and troughs. During the past 8 years, Fund shareholders more than tripled their money, generating a compound return of 15.8% per annum. Meanwhile, the Fund's European equity index benchmark, the MSCI Europe (US$) index increased by less than 70% or a compound annual return of 6.8%. Of equal importance, the Fund's performance was for the most part consistently good: it beat its benchmark in 7 of 8 years and it generated a positive return in 7 of 8 years.

It is close to impossible to find a US equity fund that has generated a return over the past 8 years of nine percentage points per annum more than the index with the level of consistency that our Fund achieved. To test this hypothesis, we searched the more than 9,000 US equity funds listed on Bloomberg to find out how many beat the S&P 500 index by nine percentage points or more per annum over the past 10 years. We found thirteen such funds. Of these, only five beat the benchmark and made money in 8 or more of the past 10 years. Good luck in finding and investing in a US equity fund that does that over the next 10 years!

It is therefore fair to conclude that the US stock market remains far more efficient and competitive than European stock markets. Long may that remain the case! The signs are that this is likely to remain so. Trying to persuade investors to put money into a European equity fund is a "hard sell". I find that encouraging: it suggests that there is little or no "hot money" in European equities chasing attractive past returns.

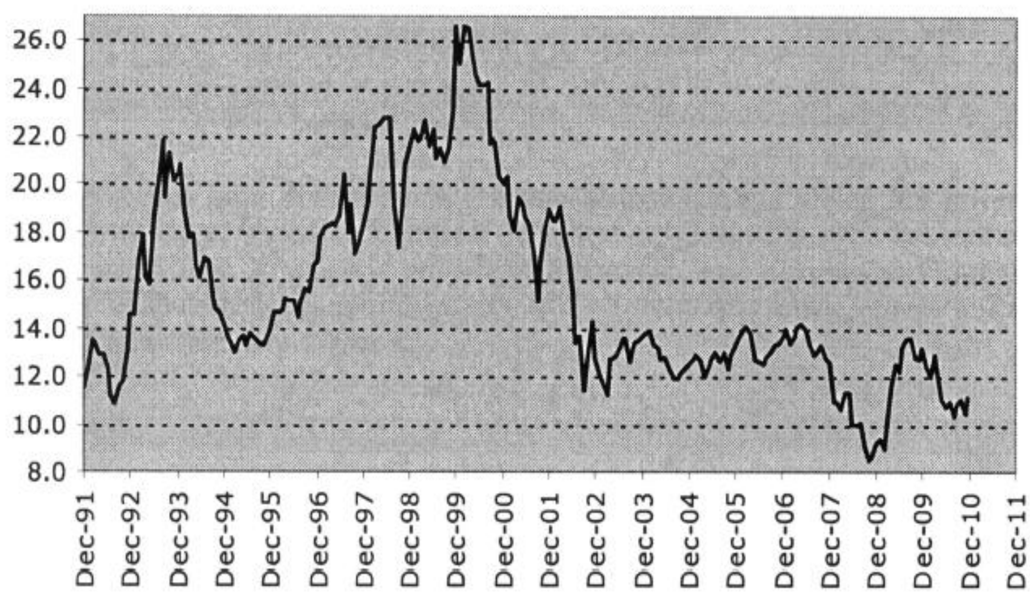
The investment opportunities in European family holding companies and European smaller companies remain two of the best-kept secrets in the financial world. British Empire Securities Investment Trust offers the closest traded vehicle to what we do in the European holding company sector. During the past 15 years, its NAV per share in both Sterling and US Dollar terms increased nearly 7-fold, generating a compound return inclusive of dividends for shareholders of about 13% per annum. Meanwhile, JP Morgan European Smaller Companies Trust, in which the Fund owns shares, increased its NAV per share 9-fold during the past 15 years, generating a compound return for shareholders of just over 15% per annum. As a measure of the asset class' neglect, JP Morgan European Smaller Companies Trust's shares trade at a historically wide 16% discount to NAV in spite of its fantastic track record.

Current valuations

As shareholders are aware, we divide the portfolio into four segments: two of which (investment holding companies and closed-end funds) we value based on their discount to NAV, and two (market leaders and deep value companies) that we value based on P/E. A comparison of the fund fact sheets for this year with last year shows that average discount to NAV of our investment holding companies and closed-end funds narrowed in the past year, although they remain a bit wider than average historically. Meanwhile, the average P/Es of our operating businesses are almost identical to where they were last year. This suggests that our companies had strong earnings growth last year with more expected this year which is indeed the case.

The average P/E of our operating businesses is currently about 12 times this year's estimated earnings which is about the same as the average P/E of the European equity market. However, we think our portfolio of companies is of much higher quality in terms of balance sheet strength and likely future earnings growth. The chart below from Petercam suggests that European equities are cheap on both a historic and absolute basis.

DJ Eurostoxx 12m forward PER



Source: Petercam and JCF

Our view is that European equities are not quite as cheap as the chart above suggests because profit margins globally are at historically high levels. Nevertheless, looking at European equities on a price/sales valuation basis which eliminates the cyclicality of profit margins suggests that European equities are selling at a bit below their 15-year average (which is as far back as the data for the MSCI Europe index goes on Bloomberg).

The other aspect of valuation that is important is currency. Those who pay close attention to our quarterly fund fact sheets will see that we changed the currency exposure pie chart to show the Fund's *functional currency exposure* as best we can possibly estimate it. Functional currency exposure is the share of earnings or assets of our investments that are denominated in various currencies. We recently estimated that about one-third of the Fund's assets in the case of holding companies or closed-end funds or earnings in the case of market leaders and deep value companies are denominated in euros. In early November, we hedged about 40% of this exposure back to US Dollars by selling forward US$20 million worth of euros for a year when the spot rate was US$1.39: €1.00. The reason why we hedged part of our euro exposure was because the euro was more than 15% above purchasing power parity (PPP - an estimate of fair value) which is around 1.20. The chart below shows how the euro:US Dollar rate (and prior to 1999, the European Currency Unit (ECU) –an artificial basket currency used by member states of the EU) moved in relation to Bloomberg's estimate of PPP over the past 20 years.

While we are concerned that the euro is still overvalued against the US Dollar, it was only about 10% overvalued on a PPP basis at year end. Furthermore, net of the currency hedge, we think that the Fund only has about 20% exposure to the euro on a functional currency basis. The Fund has an additional 12.5% functional currency exposure to sterling. We think that sterling is trading around fair value against the US Dollar on a PPP basis. The chart below shows how the sterling:US Dollar rate moved in relation to Bloomberg's estimate of PPP over the past 20 years.

We think that barring a global stock market decline this year or a significant recovery in the US Dollar, we should be able to make a respectable return for shareholders this year.

The Risks

In last year's Chairman's statement, I outlined three risks for European equities as follows:

1. "There are a few risks that we think are not fully appreciated by investors. Firstly, we think that the risk of further banking problems are quite high, particularly amongst European banks. European banks still have too much leverage and do not seem to have owned up to many of their problem assets. Instead, they seem to be pursuing a strategy of growing their balance sheets so that they are deemed too big to fail."

Since then, we have not changed our view of large European banks. We would also include large insurance and reinsurance companies whose financial statements we think have "black-box" characteristics. Nevertheless, the Fund has about $15 million (10% of NAV) invested in six financial companies but these are profitable niche banks or insurers whose financial statements we understand and with which we are happy to do business without being reliant on them having to be bailed out under the guise of being considered too big to fail. Moreover, they are well-run, have balance sheets that will not require capital raising to meet the new Basel III rules, and they are in a position to take advantage of competitors' weaknesses in the current financial environment. Four of these companies, Hiscox plc, Close Brothers Group, RAB Capital and Paris Orleans, account for 8% of the Fund's NAV.

I have discussed Hiscox and Close Brothers extensively in the past so I will add a few words on RAB Capital plc and Paris Orleans. RAB Capital's current assets, consisting primarily of cash, and available-for-sale investments, consisting primarily of investments in their own funds, less all liabilities are £92 million. This is about 60% higher than its current market capitalisation of £57 million. In other words, RAB is worth more dead than it is alive at today's valuation. However, we think that Philip Richards and Michael Alen-Buckley who still own 50% of this hedge fund manager can resurrect the business. Two good things happened at RAB last year. Their RAB Energy Fund was one of the top performing hedge funds in the world last year with a 54% return (after returning 86% the year before). This performance will generate handsome performance fees and likely attract new money to the fund. The other positive event was that RAB was able to attract two top-performing fund managers from Park Place Capital where they managed a successful long-short European equity fund. The fund they managed will also move from Park Place to RAB.

Paris Orleans is a new investment for the Fund. This is the listed holding company of the Rothschild family. It owns a controlling interest in the Rothschild banking business and a portfolio of private equity as well as a few listed investments. A few years ago, Paris Orleans' shares were trading at around NAV. Today, they are trading at a 47% discount to estimated NAV. We think that Rothschild's banking business will thrive as clients are attracted to their strong balance sheet and independent investment banking advice for which they are renowned. In spite of Paris Orleans' discount to NAV widening significantly during the past few years, the company still has an excellent track record of generating returns for its shareholders. Over the past 15 years, Paris Orleans shareholders earned a compound return of 16% per annum, compared to 12% per annum earned by Hiscox shareholders, 11% per annum earned by Close Brothers shareholders, and 1% per annum over the 14 years since inception for the Bloomberg European Banks and Financial Services Index, all measured in US Dollars. We funded the purchase of Paris Orleans with the sale proceeds of Financiere de L'Odet, Vincent Bollore's holding company, which was sold at a handsome gain.

2. "….. Another risk that we think is underappreciated is sovereign risk. Many commentators use the acronym PIGS to refer to the weak sovereign debtors of Europe: Portugal, Italy, Greece, and Spain. We think that Italy, Spain and Portugal will be fine. Accordingly, the Fund has an investment in the March family investment holding company (one of the wealthiest families in Spain), the Espirito Santo family investment holding company (one of the wealthiest families in Portugal), and investments in the holding companies of the Agnelli, Pesanti, de Benedetti, and Caltagirone families (amongst Italy's

wealthiest families). We are more worried about Ireland, and particularly Greece, and accordingly have no exposure to either market. We also have no exposure to Eastern European including the Baltic and Balkan states, most of which we think are facing similar problems."

In the first half of last year, we changed our view on Portugal and Spain and sold our two investments there. We think Portugal will be the next country to be bailed out by the ECB, possibly followed by Spain. However, we stick to our view that Italy will get by without ECB support. There are multiples reasons for this view. Italy did not have a housing bubble like Spain or Ireland, or huge budget deficits like Greece, Portugal or Spain. Unlike Greece, Ireland and Portugal where 80% or more of their sovereign debt is held by foreigners, only about 45% of Italy's foreign debt is held by foreigners. In essence, though Berlusconi may be hated by the international media, he has done a good job of keeping Italian government spending under control. In fact, on a cyclically-adjusted basis, it is estimated that Italy is running a small surplus. In our March 2010 newsletter to clients, we cited a Bank for International Settlements (BIS) report which projected the growth in government debt in various developed countries to factor in the effect of unfunded pension and health care liabilities. According to the BIS estimates, on this all-inclusive basis, Italy's finances are in better shape than nearly any other developed economy including Germany.

We have nearly $17 million (11%% of NAV) invested in five Italian companies. Our largest investment in Italy is Exor preferred shares which accounts for nearly 5% of the Fund's NAV. The Exor pref share price rose 164% last year in euro terms. In December, we sold 10% of our holding but we still think the shares are undervalued, albeit not to nearly the same extent that they were last year. Exor still trades at a 35% discount to NAV while the pref shares trade at a 24% discount to the ordinary shares. Moreover, if Sergio Marchionne can come close to his targets in the next four years, both Fiat and its recent spin-off, Fiat Industrial, which together account for 70% of Exor's NAV should generate very high returns for their shareholders.

Our other large Italian investment is Italmobiliare which is the Pesanti holding company that controls Italcementi. Like Fiat, Italcementi has a successful track record in faster growing emerging markets where it makes a significant portion of its group profit. Italmobiliare has a strong balance sheet with net cash and its shares are particularly attractive, selling at a 48% discount to NAV. We also like the fact that the savings shares that we own sell at a 32% discount to the ordinary shares in spite of them paying a higher dividend. One of the other attractions of owning Italian savings shares that is worth mentioning is that their dividends are only subject to 12.5% withholding tax. In the case of Italmobiliare savings shares, we collect a more than 5% dividend yield while we wait for a recovery in the global cement business and for the holding company's discount to NAV to narrow.

3. ". ….. The other risk that we think is underappreciated is that the euro and sterling could weaken against the US Dollar. Sentiment against the US Dollar seems to be universally negative which is often a classic sign of a trough. Most measures of purchasing power parity also suggest that the euro and sterling are overvalued against the Dollar. Therefore, we are considering hedging part of the Fund's euro and sterling exposure. We are likely to do this through forward sales of euros and sterling."

As already mentioned, we hedged part of the euro currency risk and during the year, we reduced the Fund's exposure to euro earnings and assets and increased its exposure to US Dollars. We no longer think that sterling is overvalued.

Sector biases

Apart from our geographic bias – no PIGS – we have some strong sector biases within the Fund. As already mentioned, we have 10% of the Fund invested in niche financial services companies. We think that we understand financial services and know which firms are the quality operators. However, we often struggle to make sense of the financial accounting and in such cases take a wide berth. Another reason for our significant exposure to the sector is that we think the companies that we own are cheap – in our view they represent examples of "the baby being thrown out with the bathwater".

In total, four market sectors account for nearly half the Fund's net assets. The other three sectors are listed private equity funds, agriculture, and autos. Private equity is the biggest area of exposure. Including a bit of exposure through family investment holding companies, about $26 million or 17% of NAV is invested in private equity, principally through ten listed private equity funds. On average, we think that our private equity funds are trading at a 34% discount to fair market value (FMV). Meanwhile through our involvement in the Greenpark funds and data provided by Cogent Partners, private equity fund interests are trading in the secondary market at about a 15% discount to FMV. Usually the discounts to FMV in the listed market and the secondaries market track one another quite closely, sometimes with a bit of a lag. We expect some corporate action in the listed private equity fund market this year which should narrow discounts to FMV much closer to those in the secondaries market if this happens.

We have $17 million or 11% of NAV invested in agriculture companies, half of which is invested in Yara International and the other half in three Luxembourg-listed palm oil companies. We have long been bullish on agricultural commodity prices so I will not reiterate the reasons for our bullish stance other than to say that grain inventories are close to record lows in terms of days of consumption. It will not take much disruption to grain output to drive prices even higher. What makes the situation worse is that there is little set-aside land available for cultivation today. There is a close correlation between agricultural commodity prices, particularly corn, and nitrogen fertilizer prices. Yara is the world's biggest nitrogen fertilizer company. There is little unused fertilizer capacity in the world today. China, the world's biggest producer of urea, uses coal as the raw material for most of its urea production. Even before the floods in Australia started to curtail exports of coal, urea production in China has been declining since July in response to higher coal prices, and an increased focus on energy efficiency and emissions. We think that China could become a net importer of nitrogen fertilizer far sooner than most people expect. To crown this bullish scenario, Yara shares are undervalued relative to its US-listed peers as well as on an absolute basis. The shares are currently valued at 11 times this year's estimated earnings, about 10 times what the company has indicated are likely "through-the-cycle" earnings, but we think that if urea averages US$400 per tonne this year – close to where it trades currently and versus a peak price in the summer of 2008 of $800 per tonne – Yara's earnings per share estimates for this year will need to be revised up by about 50%.

Our palm oil businesses are obscure, yet not small companies that own extensive palm oil and rubber plantations and refineries in Indonesia and West Africa. From our conversations with people in the palm oil business, these companies are considered "best in class". The rubber price is at a record high because of booming Chinese auto demand and supply disruptions, mainly in Thailand. Palm oil prices are up strongly in the past year because of booming Asian demand due to rising living standards and Asians eating more protein in their diet. Palm oil is the cooking oil of choice in Asia. Investors in Asia have recognized the bullish prospects for palm oil and rubber plantations. The Indonesian- and Malaysian-listed plantations currently trade at about 20 times 2010 estimated earnings, while the Singapore-listed producers trade at even higher valuations. Our Indonesian palm oil company trades at 11 times estimated 2010 earnings and pays an 8.5% dividend yield that is only subject to 15% withholding tax, while our African plantation group trades at 6.5 times estimated 2010 earnings and pays a more than 6% dividend yield. The third company is a holding company that owns a controlling stake in the other two companies and it trades at an attractive discount to NAV. All three companies have net cash on their balance sheets and they have done a fabulous job of generating high returns for their shareholders – over 20% compound annual returns in US Dollars over the past 15 years in all three cases. Last year, their share prices rose by about 80% on average and none of these three companies has any following by research analysts.

The last area of sector concentration for the Fund is autos. We have three investments in the European auto sector totaling $12.5 million or 8.5% of the Fund's NAV. The largest is Exor which derives 70% of its value from its stakes in Fiat and Fiat Industrial. Fiat Auto makes nearly all its profit in Brazil where it is the market leader with about a 25% market share. The rest of its profit comes from Ferrari. Fiat is run by Sergio Marchionne. I struggle to think of anyone I would rather have working for us as shareholders. Fiat Industrial makes most of its profit from its 90% shareholding in CNH (Case New Holland) which makes tractors and combine harvesters and is doing well because of strong farm economics. We think that Fiat was a case where investors were focusing on its European auto business which is very depressed while ignoring its very profitable business in rapidly growing emerging markets.

Our other two holdings in the sector are Volkswagen and Société Foncière Financière. In Volkswagen, Europe's largest car manufacturer, we saw a similar situation to what we saw at Exor – a company selling at an attractive discount to the sum of its parts, a very profitable emerging markets business, and a very profitable luxury brand. Volkswagen is the market leader in China with about a 17.5% market share. It is difficult to determine precisely, but it looks like once you factor in parts shipped from Germany, Volkswagen makes nearly half its profit in Asia ex Japan, primarily China. Meanwhile, the Audi brand is performing extremely well and there are waiting lists of over three months for some of its models. We like the Audi business model whereby they build most of their cars on Volkswagen chassis which saves on costs due to the huge economies of scale. This allows Audi to sell its cars at a lower price than similar BMW and Mercedes models while as a devout Audi aficionado, I think the quality is better. Again, it is difficult to be precise, but we think that Audi contributes nearly half of Volkswagen group profits. In July, we bought Volkswagen's ordinary shares. Historically, and as is the case with Exor, Fiat and lots of other companies, the ordinary shares which have voting rights usually sell at a premium to the non-voting preferred shares. In July, we bought the ordinary shares at a 10% discount to the prefs and in spite of the Volkswagen ordinary share price rising more than 50% since we bought them less than six months ago, the ordinary shares still trade at a 10% discount to the prefs and at a P/E of 9 times this year's estimated earnings.

Société Foncière Financière is the holding company of the Peugeot family. Its shareholding in PSA Peugeot Citroen, Europe's second largest car manufacturer, accounts for 70% of its NAV. PSA Peugeot Citroen generates a smaller proportion of its earnings than Fiat or Volkswagen from rapidly growing emerging markets. About a third of its sales are in emerging markets. However, this is a very cheap stock that is down more than 50% from its peak in 2007. Foncière trades at a 45% discount to NAV and its principal investment, Peugeot Citroen trades at 6 times this year's estimated earnings and only about 0.1 times sales if the value of its stake in listed French car parts company, Faurecia, is excluded.

Greater depth

As shareholders are aware, Georgie is responsible for managing part of the Fund's assets and her bonus is based on the performance of these investments. I am pleased to report that Georgie's bonus following year end was very good and it is being paid in shares of OAM, the Fund's investment advisor. At year end, Georgie was managing about 21% of the Fund's assets. It is expected that this proportion will stay roughly the same this year. In February, Mills joined us and is training as an analyst. In June, she sat and passed Level 1 of the CFA exams – no mean feat given that the pass rate was 42% and this is her first experience in the investment industry. Mills has already started to make strong contributions to OAM, focusing on assignments that I have given her to analyse companies for the Fund. Meanwhile Natalie, with help from Sheila, runs our back office operations smoothly.

This allows me more time out of the office. While some shareholders may view this as a bad thing, I see it as a very good thing. For most of the past 21 years, almost everything at OAM has revolved around me. This is no longer true. We now have far greater depth and resources. Time away from the office has given me more time to read and research new ideas without the inevitable disruptions of office life. From mid-May to early July, I spent nearly two months in England. During that period, I researched four new investment ideas which have all been very profitable for the Fund. One company was Volkswagen and three are based in London where I met with their senior management. This was one of the most prolific periods of investment idea generation for me in a long time. I plan to spend the same period in England this summer, hopefully with similar results.

Desmond Kinch, CFA
Chairman