**Overseas Asset Management (Cayman) Ltd.**
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

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**OAM European Value Fund**

Dear Fellow Shareholder,

Last year was a good year for European equities as worries about the PIIGS (Portugal, Italy, Ireland, Greece and Spain) and the state of European bank balance sheets abated. The MSCI Europe (US$) index rose 20.1% last year while the Fund's NAV per share rose 19.4% to end the year at $40.10. During the year, the Fund's NAV surpassed its previous peak in mid-2007. Before you pat us on the back, remember the old saying "Don't confuse brains with a bull market". Our Fund's NAV per share quadrupled in its 11 years since launch which is equivalent to a compound annual return of 13.5% per annum. That is a more impressive statistic given that the period encompassed the worst global financial crisis since the Great Depression followed by sovereign debt worries and severe banking problems that led many to question whether the European Union would survive. During the 11 years, the MSCI Europe (US$) index rose by 102.5% or 6.6% per annum.

**A team-managed approach**

For the first 5 years of the Fund's existence, I managed the Fund more or less exclusively. Over time, I allocated an increasing proportion of the Fund's assets to Georgie and Camilla to manage. They had responsibility for their own portfolios of stocks within the European fund. They would either generate their own investment ideas; I would suggest that they look at a particular company or group of companies, or I would ask them if they would like to take over responsibility for certain companies that I had researched and followed up to that point. Over time, I reduced the portion of the Fund for which I was responsible to the point where, at the end of August, I was responsible for about 55% of the Fund's assets with the rest split between Georgie and Camilla.

In September, Georgie left OAM and Camilla was due to go on maternity leave in early December – she went on maternity leave in late November as her baby arrived 10 days early. We thank Georgie for her contributions during her 6 ½ years at OAM. Given these changes, we have taken the opportunity to reassess the management structure of the Fund. Going forward, OAM European Value Fund will be a team-managed fund that plays to our collective strengths supported by an appropriate remuneration and incentive structure.

OAM has grown in both assets under management and employees since I set up the original remuneration and incentive structure. It no longer seems to best support the way in which I wish the firm to evolve. Salaries of

investment professionals at the firm were largely determined by the amount of money someone managed, and formulaic bonuses which were linked to the performance of an individual's portfolio. I prefer that the assets of the Fund be managed collectively, taking advantage of everyone's expertise in each investment idea and how the investments fit into the overall composition of the Fund. It is important that ideas flow freely with open discussion on investment ideas and that everyone is a "multi-tasker" as people have differing workload demands that vary over time. My vision for OAM has always been that those with more experience should spend a significant amount of their time mentoring those who are at an earlier stage of their career. In other words, OAM should be a collegiate environment.

As longstanding clients know, I believe that incentives are extremely important in business, as is alignment of interest. Private firms where employees have an opportunity, over time, to acquire ownership in the firm have historically been the most successful investment management firms. After some discussion of the problems with the previous way of managing the Fund and the old bonus scheme, we decided to move to a team-managed approach and discretionary yearend bonuses, payable after some tenure here in shares of OAM.

**Moving forward, a more concentrated portfolio**

A fund focused on quality over quantity of investments promotes discipline to fully review holdings and focus the Fund on our highest conviction ideas. At the start of last year, the Fund had 57 holdings. By the end of August, this had increased to 65. Since mid-September, we have been reviewing one company a week. At the end of each week, we have an open discussion in the office of that company with a conclusion of whether we should add, hold or sell the investment. The Fund is now down to 51 holdings and we have resolved that we wish to cap the number of holdings at 50. In doing our review of each company, we have supplemented our usual analysis by looking at certain aspects of each company in much more detail, and in some cases from a different angle than we have in the past.

One way in which we have gone into deeper detail is to look at a company's free cash flow generation over a multi-year period. We like free cash flow generative businesses (like our own) and our more robust method of analysing free cash flow over several years gives us a better idea of which businesses are truly superior.

Another way in which we have gone into deeper detail is to better understand a company's competitive environment and the market forces at work, in an effort to get a better idea of a company's pricing power for its products or services.

One way in which we have increasingly looked at each company is to use a private equity like approach and figure out "how much would we have to pay at the current share price to buy the entire business on an unleveraged basis?" We start out by adding debt to the market capitalisation of the company, or deducting cash, and then make various adjustments such as adding unfunded defined pension benefit liabilities to get enterprise value (EV). We then need to estimate normalised earnings on an after-tax basis using a normalised tax rate, excluding any one-off items, and excluding any interest income or expense. There are often various adjustments that are unique to each company which need to be made when estimating what we refer to as the "unleveraged P/E" and our team is learning more with each company that we review.

The reason why we think it is important now to be looking at companies in this way is because we think that central banks in the developed world have artificially manipulated interest rates across the entire yield curve at levels that are too low to be sustainable. If that is the case, then more leveraged companies will implicitly be

overvalued by the market and cash-rich companies will be undervalued, other things being equal. We have always had a strong preference for investing in companies with little or no debt, but this approach will push us even more strongly in that direction.

This is worth exploring in more detail. In March, William Poole, the former President of the St. Louis Fed gave a presentation at a CFA Institute Symposium on what he calls the "great central banking unwind". This is an excerpt from his presentation (the emphasis in bold is mine):

"The central bank policies and fiscal disequilibrium in [the United States and Europe] are unlike any circumstances they have endured in the past; **it is uncertain how the massive easing of the last five years is going to affect the developed nations' economies as well as the global economy. The world is in uncharted territory.**"

No one knows how more than 5 years and counting of quantitative easing will play out in markets. What we do know is that interest rates in the developed world cannot fall any further: ultimately they have to increase, but no one knows when. I feel confident in saying that interest rates will increase, possibly significantly, in a matter of years rather than decades. This is what we refer to as an asymmetric bet, but one to which markets in many respects are implicitly attributing even odds of rates increasing or decreasing.

To illustrate why we think our unleveraged P/E approach to valuing businesses is important and why we think it is an asymmetric bet, I will provide you with the following example. Let us take two companies, A and B, that have identical sales and operating earnings (EBIT or earnings before interest and tax). The shares of both companies trade at a P/E of 15. The only difference between the two companies is that Company A has net debt of €600 million and Company B has net cash of €300 million. The shares of Company B are clearly a lower risk investment which most investors would acknowledge. The table below should be self-explanatory.

| **Amounts in € millions** | **Company A** | **Company B** |
|---|---|---|
| Sales | 1,000 | 1,000 |
| EBIT | 100 | 100 |
| Net debt/(cash) (c) | 600 | (300) |
| Interest @3% on debt and 0 on cash | (18) | 0 |
| Net profit @ 30% tax (b) | 57.4 | 70 |
| Market capitalisation (a) | 861 | 1,050 |
| P/E (a/b) | 15 | 15 |

We would also argue that the shares of Company B are also substantially cheaper than Company A. There are two ways of supporting this argument, both of which are illustrated in the tables below. The first is to estimate what would happen to earnings at each company if interest rates rose by 400 basis points to 7% for debt and 4% for cash. Interest rates cannot fall by 400 basis points so the outcome of future changes in interest rates is asymmetric. Following such an increase in interest rates, the share price of Company A would have to fall by 29% while that of Company B would have to increase by 12% for both companies to continue to be valued at a P/E of 15.

| Amounts in € millions | Company A | Company B |
|---|---|---|
| EV (a+c) | 1,461 | 750 |
| Interest @7% on debt and 4% on cash | (42) | 12 |
| Net profit @ 30% tax | 40.6 | 78.4 |
| Change in net profit due to interest rate increase | -29% | +12% |

The second supporting argument is to estimate the unleveraged P/E – this is how most private equity investors buying an entire business would determine a company's valuation. The amount of leverage added or cash removed from a business is purely a capital structuring decision. Virtually all investors and analysts are looking at the P/E when determining whether a company's shares are cheap or expensive, whilst we are not aware of many who are using our unleveraged P/E approach. This suggests that we are being given close to even odds in betting on Company B compared to Company A. We think this will help us in our objective to outperform European equity markets in coming years.

| Amounts in € millions | Company A | Company B |
|---|---|---|
| EV (d) | 1,461 | 750 |
| Net profit with no leverage (EBIT x (1-tax rate)) (e) | 70 | 70 |
| Unleveraged P/E (d/e) | 21 | 11 |

Camilla, Rob and I are now managing the European fund jointly. Kia who joined in September just took the CFA Level I exam and is a trainee analyst who will understudy us. Natalie is taking the CFA Level I exam in June. We have recently recruited someone who will join us in March to work alongside Natalie and share her administration duties.

**Disaggregating investment returns**

In my Chairman's statement for OAM Asian Recovery Fund, I explained that I often use the following formula for disaggregating a fund's investment return:

Investment return = Dividends + Earnings growth +/- P/E re/de-rating + Currency appreciation

The formula can also be used for understanding the source of stock market returns. Last year, European stock markets rose by more than 20%. However, the return was solely due to an improvement in sentiment which drove P/Es higher. In fact, as we shall see, corporate earnings in Europe are expected to have declined slightly last year.

In my Chairman's statement for OAM European Value Fund two years ago, I did a similar exercise to demonstrate how a change in sentiment can affect P/Es and discounts to NAV of the Fund's holdings and lead to negative returns even in a year when intrinsic value, whether it be earnings or NAV, increases. Of the four components of investment return, only the dividend yield can be predicted with any degree of certainty. Clients sometimes ask me what our Asian or European fund will return during the next year. This exercise illustrates the difficulty of giving any such estimate.

Applying a similar methodology to what I used in my Chairman's statement two years ago, we did an attribution analysis whereby we show the capital appreciation from each of the four segments of the Fund's portfolio and the implied earnings or NAV growth. The results are shown in the table below.

| Category | At 1 January 2013 | | | At 31 December 2013 | | | **Capital appreciation** | **P/E rerating** | **Implied earnings growth** |
|---|---|---|---|---|---|---|---|---|---|
| | P/E | Dividend yield | % Fund assets | P/E | Dividend yield | % Fund assets | | | |
| Market leaders | 9.3 | 3.2% | 23.7% | 11.8 | 3.3% | 23.3% | 19.3% | 26.9% | -6.0% |
| Deep value shares | 9.7 | 2.9% | 12.2% | 11.4 | 3.2% | 16.4% | 17.9% | 17.5% | 0.3% |

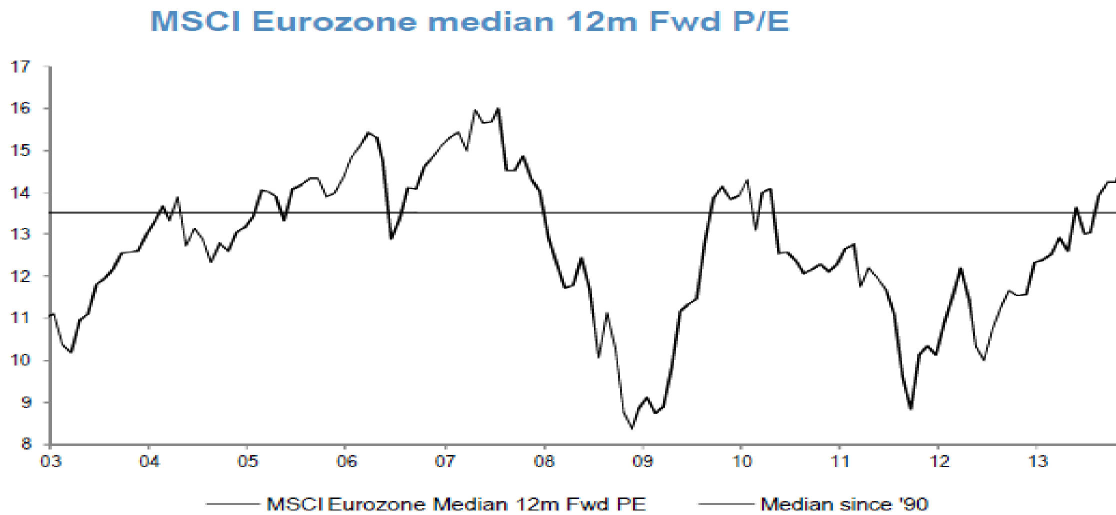
| Category | At 1 January 2013 | | | At 31 December 2013 | | | **Capital appreciation** | **Discount rerating** | **Implied NAV growth** |
|---|---|---|---|---|---|---|---|---|---|
| | Discount to NAV | Dividend | % Fund | Discount to NAV | Dividend | % Fund | | | |
| Closed-end funds | -34.0% | | 26.4% | -30% | | 24.4% | 21.8% | 6.1% | 14.9% |
| Investment holding co's | -42.0% | 3.6% | 27.2% | -40% | 3.1% | 14.4% | 20.8% | 3.4% | 16.7% |

What we have done in this analysis is to exclude the currency effect and dividends from the investment return of each of the four segments of the portfolio to derive the capital appreciation element. The two components of capital appreciation are re-rating and earnings or NAV growth. As the table shows, earnings growth was essentially zero so all last year's capital appreciation came from an increase in the average P/E of the operating companies. The re-rating effect in the portion of the portfolio that we evaluate on an asset value basis was less for two reasons. The first is that the listed equity portion of the closed-end funds and investment holding companies owned by the Fund appreciated during the year, almost certainly faster than the underlying earnings of those listed companies. The other reason is that there were several sales of investment holding companies whose discounts to NAV narrowed during the year and a few purchases of investment holding companies that were trading at wider discounts to NAV.

**Current valuations**

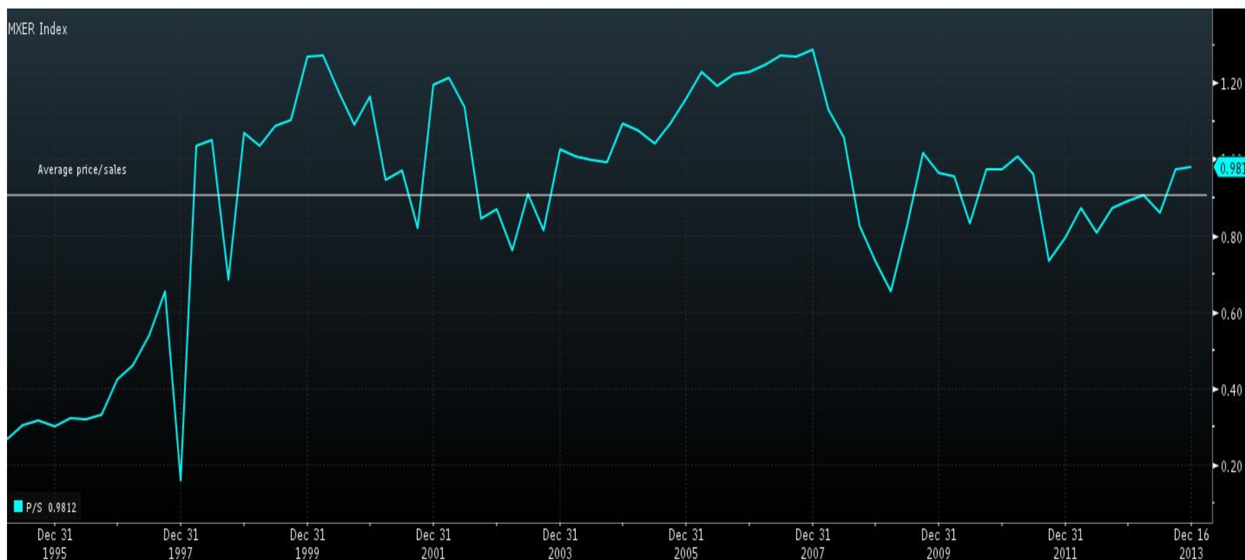
In last year's Chairman's statement, I wrote that "European equity valuations are almost identical to where they were at the end of 2002 on the basis of the Price/Sales ratio" and "the average P/E ratio of our operating businesses is just over 9 on a dollar-weighted average basis and the average discount to NAV of our asset-based investments is nearly 40%." These were very attractive valuations. Today, as is evident from the table above, valuations are less attractive. This does not mean that European equities are overvalued or that the Fund's holdings are fully valued; far from it. What it means is that the valuation pendulum has swung from clear undervaluation to somewhere close to fair value. The pendulum may continue to swing into overvalued territory but we are not counting on momentum to give us attractive returns. For the market as a whole, we need to see decent earnings growth to justify continued investment returns from European equities. Fortunately the Fund has a large portion of its assets invested in companies that we think are likely to be re-rated in time, whether through trading at a higher P/E or a lower discount to NAV.

The chart below suggests that European equities are currently about 10% overvalued.



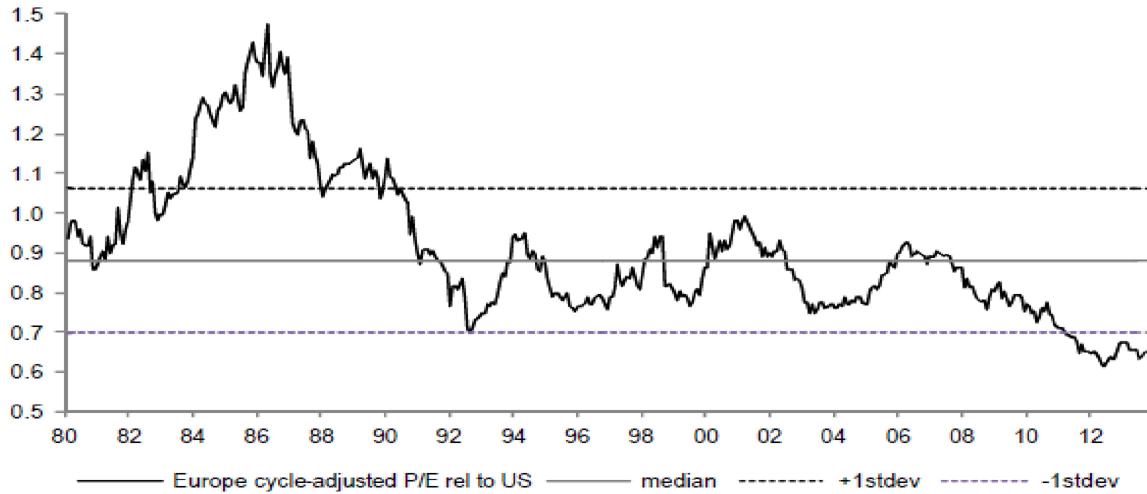

Source: IBES

We prefer to look at the Price/Sales ratio as it adjusts for the cyclicality of profit margins. On this basis, as the chart below of the Price/Sales ratio of the MSCI Europe index shows, European equities currently look about fairly valued.




Source: Bloomberg

Whereas net profit margins of large US companies are almost 10% which is the highest ever since World War II, net profit margins of large European companies are much lower at less than 7%. This is why European equities look more reasonably valued on a Price/Sales basis. If we use cyclically-adjusted P/Es, equities in Europe look very cheap compared to the US. The chart below uses the average 10-year earnings as the denominator in calculating the P/E of European equities relative to US equities.

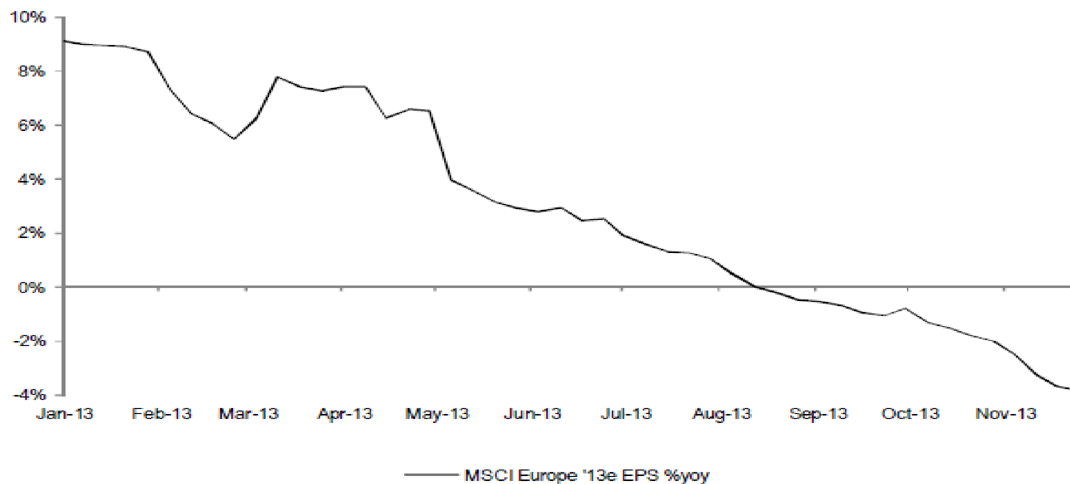



Source: Datastream, *price divided by 10-year average EPS

Within Europe, there are huge differences in cyclically-adjusted P/Es. In Italy, the cyclically-adjusted P/E is currently less than 10 compared to nearly 15 in the UK, nearly 19 in Germany, and almost 25 in the US. For the Eurozone as a whole, it is less than 15.

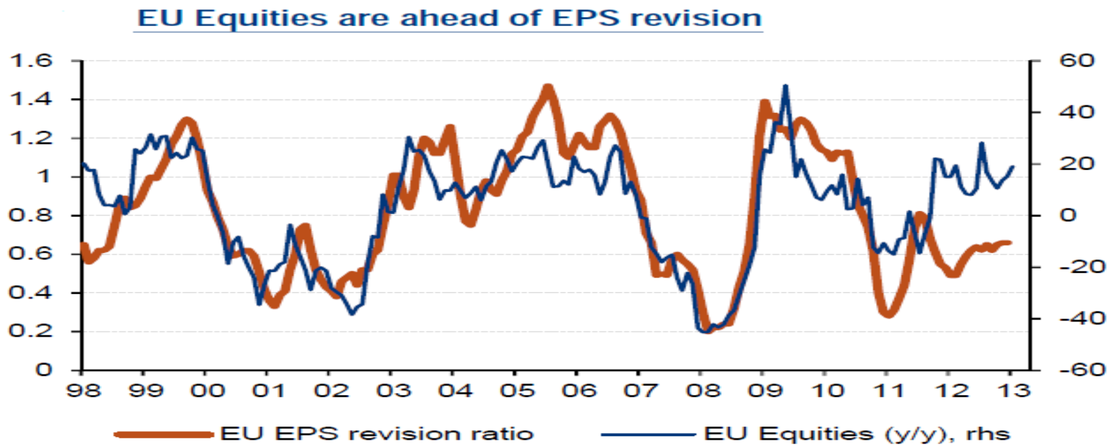
**Earnings growth**

The most important source of return for equities over the long-term is earnings growth, or in the case of closed-end funds or investment holding companies, NAV growth. It is therefore slightly concerning that for European equity markets as a whole, earnings growth expectations last year started out at around +10% and ended the year at about -4% (see chart below). This mirrors what we saw in the Fund's portfolio as shown in the table where we disaggregated Fund returns into returns derived from P/E re-rating and earnings growth.

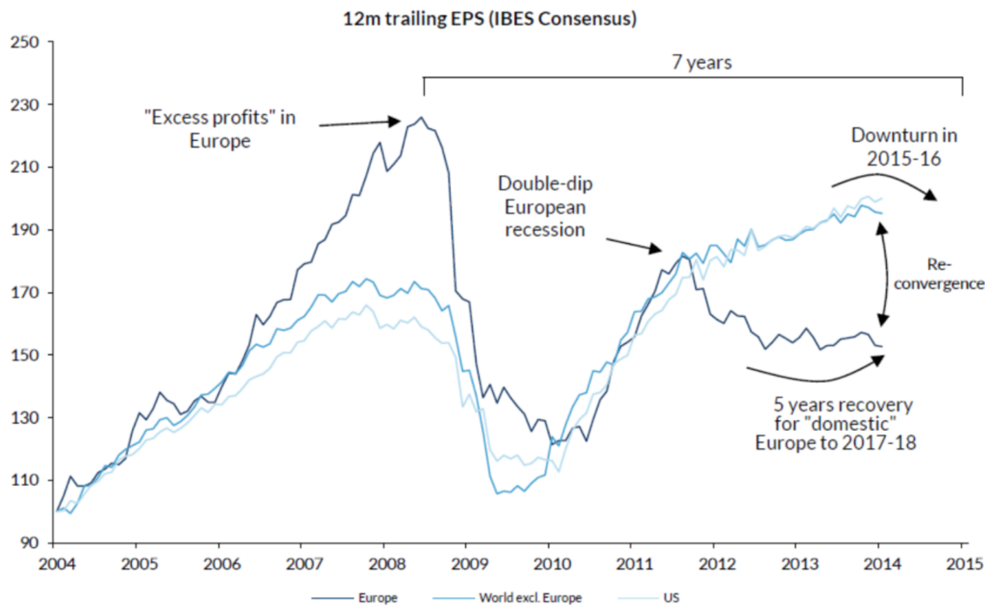



Source: IBES

Last year's investment return was a purely sentiment-driven affair that resulted in all developed market equities being re-rated. The chart below is worrying in that it suggests that European equity prices have advanced too far relative to earnings.

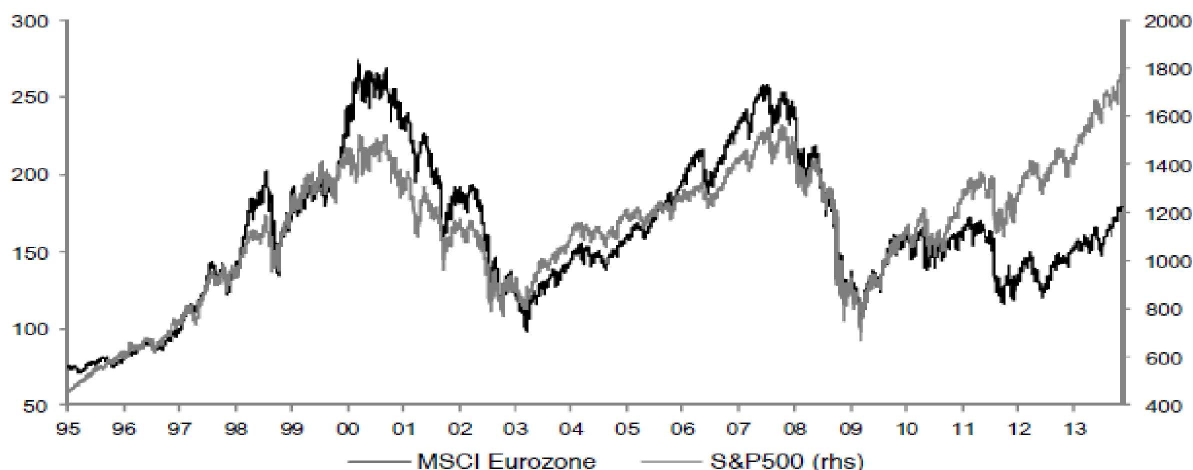



Longer term, it appears that European corporate earnings have a lot of scope for catching up with US corporate earnings. US net profit margins are roughly 50% higher than those in Europe. Until a few years ago, there was a close correlation between US and European corporate earnings as the chart below shows.




As European corporate earnings recover, we expect European equities to outperform US equities and close the gap in performance that developed over the past few years. Whilst US equity indices (the lighter coloured line) have passed their 2007 peak that was established prior to the global financial crisis, European equities (the darker line) are still more than 25% below their peak in 2007.

**MSCI Eurozone vs S&P500**




Source: Datastream

**Currency exposure and hedging**

In forming a view of whether European currencies are over- or under-valued we look at purchasing power parity. We also look at how these currencies have historically traded relative to estimates of their purchasing power parity as the Swiss Franc and Norwegian Krone for example have always looked expensive in purchasing power parity terms for various sound reasons. We also estimate the Fund's functional currency exposure by estimating the split of each company's earnings or assets by currency. For instance, a Luxembourg-listed palm oil producer will generate 100% of its earnings in US Dollars. We then take a view as to whether we should hedge all or part of the Fund's functional currency exposure. This decision is determined by the amount of currency exposure we have and whether we think any major non-USD currency to which the Fund is exposed is over- or under-valued.

The Fund's major non-USD currency exposure is euros and sterling. Most estimates of purchasing power parity suggest that sterling is only slightly overvalued while the euro is estimated to be a bit more than 10% overvalued currently versus its purchasing power parity. The Fund therefore sold forward $25 million in euros in October 2012 for a year to hedge part of its euro exposure. During 2013, the euro appreciated a few percent against the dollar so in October 2013, the Fund closed its $25 million forward sale and sold forward $40 million of euros for another year. In the past, the Fund's currency hedging activities have contributed positively to investment returns but last year, they cost the Fund about $1.5 million or 0.7%. However, it is important to bear in mind that the Fund only hedged part of its euro functional currency exposure so the hedge effectively reduced the positive currency contribution to returns last year from about 1.1% to 0.4%, calculated on a functional currency exposure basis.

**A more concentrated portfolio**

During the year, we added to some of the Fund's largest holdings where we had a higher level of conviction that they should provide the Fund with attractive returns. We also established some new holdings in the Fund in what we think are good businesses selling at cheap valuations. The Fund's four largest holdings are now Yara International, Barco, Volkswagen/Porsche, and Dragon Oil, all of which we added to during the year, and which each account for 4% of the Fund's net assets. Importantly, all these companies are essentially debt-free.

I have written about Yara extensively in the past so the only thing I will add to past commentary is that the short-term outlook for Yara is not particularly rosy. The reason is overcapacity in nitrogen fertiliser production in China, and China's lowering of export tariffs which increases the supply of Chinese urea on the world market. That has depressed urea prices to an average of $340 per tonne last year and may result in even lower prices this year. Yara is expected to earn about NOK 25 per share in 2013, putting the shares on about 10 times 2013 earnings. Although this is a cyclical agricultural chemical business, it is highly free cash flow generative and the company is extremely well run. On a "through-the-cycle" basis, we think the shares are selling at less than 10 times average earnings. We therefore feel very comfortable maintaining it as the Fund's largest holding.

Barco also has an uninspiring short-term earnings outlook. It is the world market leader in digital projectors which are mainly used in cinemas, but also increasingly for corporate presentations. They are also the world leader in healthcare diagnostic displays where high resolution is necessary and digital displays for control rooms, defence and aerospace contractors, and simulators. In spite of its global leadership in these niche markets, Barco had disappointing performance from 1999-2009. Eric Van Zele, who joined Barco in 2009, has done a fantastic job of turning the company around. From 2010-2012, Barco beat analysts' estimates each year. Last year, earnings are expected to have declined by about 5% if we exclude a one-off gain that was recorded in 2012. The biggest challenge for Barco this year will be in its entertainment division due to the period of transition to digital projectors in cinemas coming to an end in developed markets. There is however a significant replacement market that is building and Barco is in the late stages of developing laser projectors which is the next leap in projection technology. The company also has a rapidly growing corporate audio-visual market within its entertainment division as well as global market leadership in its other three, smaller divisions. We think Barco's shares are cheap at 9 times 2013 estimated earnings.

There is little to add to the Volkswagen/Porsche story beyond what I wrote in last year's letter other than to report on 2013's performance. The two main profit centres, Audi and China, continued to perform strongly with deliveries up by 7% and 17% respectively in the first eleven months of last year compared to the previous year. Volkswagen continues to generate cash whilst still reinvesting heavily in new models and to expand capacity, particularly in China. We think the company will end the year with close to €15 billion in net cash. The shares remain cheap at 9 times 2013 estimated earnings.

In the latter part of the year, we added significantly to the Fund's holding in Dragon Oil after doing a thorough analysis of the company. The biggest risk with Dragon Oil has always been political risk as its only producing assets are a series of offshore wells in shallow water in the Turkmenistan portion of the Caspian Sea from which they pump crude oil under the terms of a Production Sharing Agreement (PSA) with the Turkmenistan government. This PSA was negotiated in 2000 and since then, Dragon Oil has increased production rapidly, in the process generating a compound annual return for shareholders of more than 30% per annum. It is a well-managed company. The CEO has a doctorate in petroleum engineering from Stanford University and served in 2007 as President of the International Society of Petroleum Engineers. The company has been a good corporate citizen in Turkmenistan and built a desalination plant to improve access to potable water, a polyclinic, and refurbished a local school.

One point that I noted to Mills, Rob and Kia during our discussion of this company is that it falls into a similar category of companies in which we have successfully invested in the past that operate in politically high-risk emerging markets using first world management and technology. Such companies that come to mind are the Socfin companies that own palm oil and rubber plantations in Indonesia, Cambodia and West Africa; Antofagasta

Holdings which is controlled by the Ludsic family in Chile which we owned in the 1990's and sold at a good profit far too early; Financiere de l'Odet which we also sold far too early at a large profit which is Vincent Bollore's investment holding company that owns ports, railways and other logistics assets in West Africa; and Kinnevik which is controlled by the Stenbeck family which we sold last year at a decent profit, only to then watch it nearly double in price.

Dragon Oil has nearly $1.5 billion in net cash on its balance sheet, net of cash set aside for future abandonment and plugging of wells. This cash, equivalent to more than 30% of the market capitalisation of the company, is held outside Turkmenistan. Not only does the cash reduce the risk of investing in Dragon Oil but it also results in the company's shares looking very cheap if we look at it in relationship to its enterprise value (EV). We think that Dragon Oil's shares are currently trading at just over 5 times earnings on an unleveraged basis. In November 2009, Emirates Oil which is the national oil company of Dubai offered 455p per share or a valuation of $3.9 billion (for 100%) to buy the rest of Dragon Oil which they did not already own. That takeover attempt failed but it is interesting to note that the offer price valued Dragon Oil on an unleveraged basis at 13 times 2009 earnings. Since then, the world is more stable financially, Dragon Oil's oil production has increased by more than 50%, oil prices are higher, the company's freely available net cash has increased from just over $800 million to nearly $1.5 billion, and net profit has more than doubled. Meanwhile the share price today is barely higher than the takeover offer price four years ago. We therefore think that Dragon Oil's shares are significantly undervalued.

We think that in addition to owning Dragon Oil shares at a large discount to their intrinsic value, we are also likely to see that intrinsic value grow for a number of reasons. Firstly, they are generating prodigious free cash flow, some of which they are paying to shareholders as dividends and some for buying back and cancelling shares. In 2012, they bought back 4.5% of their outstanding shares which increased Emirates Oil's ownership to 54%. Secondly, they are expecting to increase their oil production in the Caspian Sea by 15% this year and again next year, but will still have sufficient reserves to last another 20 years. Thirdly, they have several promising exploration permits in Tunisia, Iraq, Afghanistan and Egypt. Fourth, they currently have a construction contract out for tender to build a gas treatment plant that would allow them to extract and sell gas condensate that they currently either flare or give to the Turkmenistan government. That project is expected to have a short payback period. Finally, if Iran sanctions are lifted so that Iran can resume selling oil, it is likely that Dragon Oil would be able to sell its oil through oil swaps with Iran as they previously did at a much lower discount to Brent oil prices than they currently get marketing their oil through Baku.

The next two largest holdings are the Socfin companies and Casino Guichard, a new holding that was added in 2013, which each account for 3% of the Fund's net assets. There is little to add to what I wrote in last year's Chairman's statement on the Socfin companies other than to say that the share prices of Socfinasia fell 10% and Socfinaf by 15%, both in US Dollar terms, while Socfin's share price rose slightly. Palm oil and rubber prices were lower on average in 2013 than in 2012 but palm oil prices have started to recover of late due to relatively low global inventories and mandates that are being introduced from this year in Indonesia for bio-diesel to have 10% palm oil. It is interesting to note that the share price of Okomu, a palm oil plantation company listed in Nigeria, which is 66%-owned by Socfinaf doubled last year. The value of its Okomu shareholding now accounts for two-thirds' of Socfinaf's market capitalisation; yet Okomu only contributes a quarter of Socfinaf's profits.

Casino is a large French supermarket chain that is controlled by the Naouri family. The company trades under the Casino, Monoprix, Franprix, Leader Price, Spar and Vival brands in France. What has gone largely unnoticed is that in the past ten years, Casino has gone from earning virtually no profits outside France to the point where

it now generates about two-thirds' of its earnings in emerging markets where the demand for modern grocery retail formats is growing rapidly. In Thailand and Vietnam, through its Big C chain (which recently bought Carrefour's stores there), they are the leading supermarket retailer. They also control Exito which is the leading supermarket chain in Colombia and Pão de Açúcar which is the leading supermarket chain in Brazil. Casino's shares trade at a slight premium to European equities with a P/E of about 15 times 2013 estimated earnings. However, we think their shares are undervalued because the likely future earnings growth from their Latin American and Asian businesses are not yet recognised. This is partly because last year, growth was masked by weak currencies in those markets.

We read a number of reports by Arisaig Partners who manage one of the funds in which OAM Asian Recovery Fund has had a very successful investment for the past 15 years. Arisaig has a very thorough research process for understanding and analysing consumer businesses in emerging markets. Their track record is excellent and they own shares in Big C in their Asian fund and Exito and Pão de Açúcar in their Latam fund. The market value of Casino's controlling stakes in these three listed companies and in Mercialys, their French-listed property holding company, imply a low residual value for the French supermarket business. That is the value attraction of investing in Casino. The growth proposition comes from its Asian and Latam businesses which we think is the more compelling part of the investment thesis.

The next two largest holdings are Italmobiliare and Dolphin Capital which each account for 2.5% of the Fund's net assets. I presented Italmobiliare as an investment idea at the annual Santangel's conference in New York in October and it was the subject of a recent client newsletter so I will not embellish any further. Our investment in Dolphin Capital is split between their ordinary shares and their convertible debt. The convertibles pay a semi-annual interest coupon of 7% per annum tax-free and mature in March 2016. In March last year, Dolphin Capital tendered for the convertible bonds at par. We decided to hold onto the convertible bonds as we think that they will either mature and be paid off as bonds, generating a 7% annual return from the date of the tender offer to maturity, or they will generate a higher return if Dolphin's share price rises to the point where conversion into equity is attractive. Last year, Dolphin's share price rose by nearly 50% and is now only 13% below the exercise price for the convertibles.

The Fund has five other holdings that each account for more than 2% of the Fund's net assets: APEN, Ashmore Global Opportunities, ASTM, Close Brothers, and Danieli. I covered Ashmore Global Opportunities in last year's Chairman's statement. Last year, Ashmore made three capital distributions which returned nearly $3 million to the Fund. We reinvested about $2.5 million by purchasing more shares in the market. The shares currently trade at a 26% discount to NAV. We expect further substantial returns of capital from Ashmore this year.

Close Brothers is a longstanding shareholding. It consists of a very profitable bank that is engaged in niche lending in the UK; Winterfloods (with whom we do business) which is the leading market maker in the UK; and an investment management division. Currently, the banking division is contributing the majority of the group's profits, generating a return on equity of more than 20% in markets that the high street clearing banks have largely abandoned. During the past ten years, a period that was difficult for banks, Close Brothers shareholders have generated a compound annual return of 12% per annum whilst Barclays and Lloyds lost money for shareholders and HSBC generated a paltry 3% compound annual return.

APEN is a new holding that was accumulated this year. We are now the fourth largest shareholder with 4% of the company, while GP Investments, Latin America's largest private equity fund, own 27% and Fortress and

Newbury Partners each own 13%. APEN is a Swiss-listed fund of private equity funds that was managed by AIG. During and after the financial crisis, they had over-commitment problems and a weak manager which made matters worse. In May, GP, Fortress and Newbury announced a deal to buy AIG's shares in APEN as well as new APEN shares at a price that is slightly higher than APEN's current share price. The effect of these transactions was to reduce the debt in APEN. They also announced that APEN will divest its existing portfolio over time and concentrate on private equity investments in emerging markets, focusing on co-investments and secondary transactions. The management contract was taken over by GP for a fixed annual fee equivalent to about 2% of today's net assets over the next five years and a performance fee of 10% on any increase of the NAV (after reaching a hurdle rate of 5%). In spite of these changes and a better alignment of interest with shareholders, APEN's shares currently trade at around a 50% discount to NAV. We think this is because few investors are aware of the company and trading liquidity in the shares is limited.

ASTM and Danieli are two new shareholdings this year. We regard both as undervalued Italian gems. ASTM is the Gavio family holding company that controls SIAS, the Italian-listed company that owns motorways in northern Italy. ASTM consists principally of a 63% shareholding in SIAS and a net cash balance of about €360 million following the sale of its stake in Impreglio. SIAS was spun off from ASTM and listed separately in February 2002, with ASTM retaining a controlling shareholding. It is a good business as it is cash generative and they have consistently been able to increase tolls. Since it was listed in 2002, ASTM and SIAS have generated compound annual returns for shareholders of around 10% per annum while the Italian stock market declined 40% during the period. The returns of ASTM and SIAS tracked one another closely until the end of 2010, but then ASTM underperformed SIAS by a wide margin, largely because of the acquisition of the Impreglio stake. Last year, ASTM sold its Impreglio stake at a profit and part of the underperformance has since been reversed. However, for a cash-rich holding company of this quality, we think that ASTM's shares are significantly undervalued at a 42% discount to NAV.

Danieli is one of only three major manufacturers globally of highly efficient electric arc furnaces for making steel. They have niches in high growth markets such as mini-mills and recycled steel. Their plants and rolling mills are technically advanced, giving them pricing power compared to lower-cost producers of less efficient steel-making plants. The company is controlled and managed by the Danieli family who own 66% of the company. It is a highly free cash flow generative business that has converted about 70% of its earnings into free cash flow during the past 10 years. This has enabled the company to repurchase shares and pay dividends as well as grow the business significantly. Danieli has over €800 million of net cash on its balance sheet, but we exclude about half of this net cash position when calculating the company's EV to take account of provisions and negative working capital that arises from them being them paid up-front for some orders that are being fulfilled. After making this adjustment, we estimate that Danieli is currently valued at an unleveraged P/E of less than 7. We own the company's savings shares which trade at a 35% discount to the ordinary shares. Over the past 10 years, the company tripled its sales, increased operating margins, and accumulated large sums of cash, resulting in Danieli savings shareholders generating a compound annual return of 28% per annum.

**Significant sales during the year**

As alluded to earlier, several of the Fund's holdings were sold during the year, either on valuation grounds or because they did not meet our qualitative criteria of strong free cash flow or a strong competitive position following closer analysis. In some instances, valuation of a company looked high on an unleveraged P/E basis compared to its P/E. In a few instances, we compared the shares of two companies in similar industries, both of

which were held by the Fund, and unanimously concluded that one was a clearly superior business than was selling at a lower unleveraged P/E, so we sold the other holding.

During the year, we sold the Fund's entire holding in three companies about which I wrote in last year's Chairman's statement: Exor, ASM International, and Aker. In the case of Exor which we have discussed several times in the past, we sold the shares for three reasons: the preferred shares that we owned were merged into ordinary shares on a 1 for 1 basis as we anticipated, thereby eliminating the preferred share discount to the ordinary shares; the company's share price discount to NAV declined to less than 30% whilst we were able to buy shares in other well-run Italian holding companies like Italmobiliare and ASTM at around a 50% discount to NAV; and we had concerns about Brazil's economy and currency which is Fiat's most profitable market. As it turned out, we sold too soon, but we made a profit of about $5.5 million on our investment or a multiple of about 4 times. I give great credit to John Elkann, Gianni Agnelli's grandson, who has displayed an incredible grasp of business and capital allocation for someone so young.

We sold ASM International because the value-unlocking splitting of the company into two entities, ASM Pacific and ASM International's front-end semiconductor manufacturing business was executed in a less than ideal manner. After the share price recovered following the market's initial disappointment, we sold our shares as the discount to intrinsic value fell to the low 'teens. We walked away with a profit of about $4 million on our investment in the company.

During the year, we also sold the remainder of the Fund's holding in Aker, a Norwegian family-controlled company, at a profit of about $2.5 million. We had some concerns about Aker and its largest investment, shares in Aker Solutions, after having a long conversation with one of their competitors. The share price discount to NAV also narrowed, making it less attractive relative to other opportunities.

Finally, we sold the Fund's holding of Raven Russia preferred shares which I discussed in last year's Chairman's statement. We still like the business and own the ordinary shares, but the running yield on the preferred shares following 50% capital appreciation fell to 8% which no longer met the Fund's absolute return objective and we had concerns about how preferred shares which are effectively perpetual-dated bonds with a fixed coupon would react in a scenario of rising interest rates.

Last year, we accepted tender offers or takeover bids for our holdings in Henex, BIP Investments, and Archipelago Resources at prices that resulted in attractive returns for the Fund. In the case of Henex, we felt that ultimately the Boel family would take the company private. We still own shares in Sofina, the other listed Boel family holding company which currently trades at a 32% discount to NAV. The Fund's holding in Henex was twice the size of the Sofina holding, reflecting our conviction that Henex shares, though less liquid, were cheaper.

The sale of our shareholding BIP Investments is an example where our engagement with a company's Board to release underlying value to shareholders can sometimes yield results. In December 2012, I wrote to BIP's Board of Directors, pointing out that the company's share price discount to net asset value (NAV) had drifted out to 42%. Over the past 10 years, the discount to NAV at which the company's shares trade had ranged between 20% and 40% more than 95% of the time. Since about 25% of the company's net assets consist of cash, I argued that it made sense for the Company to repurchase shares of the company for cancellation. In September, the company tendered for its shares at a 25% premium to its share price and we exited at a decent profit.

Archipelago Resources was a legacy shareholding in an Indonesian gold mine (which I once visited to verify its existence!) that we received as an in-specie distribution from a closed-end fund in which we owned shares that was liquidated some time ago. In July, we increased the size of our shareholding in Archipelago by about half after its share price had dropped by around a third due to weakness in the gold price. In September, we received a takeover offer from the controlling shareholder in Indonesia at a 50% premium to our buying price two months earlier. It is rare that we are this lucky in getting instant gratification!

**Conclusion**

The Fund now has $240 million in net assets after receiving $28 million in subscriptions and $8 million in redemptions during the year. About $50 million or 21% of the Fund's assets are currently in cash, of which a minimum of $4 million is needed as collateral for the currency hedge. This is by far the highest cash position that the Fund has ever held. It is reflective of:

1. The recent portfolio review discussed earlier and which is ongoing has resulted in the sale of several of the Fund's holdings.
2. European equity valuations are about 20% higher than they were a year ago and are now roughly around fair value. The Fund's Board resolved after the big hit to the Fund's NAV during the global financial crisis that in future, the Fund would raise cash levels in response to changes in the European equity market valuations using the Price/Sales ratio as a guide. Cash of about 20% feels roughly about right for where we are in the equity valuation cycle.

The problem with holding large amounts of cash is that cash earns very close to zero and so as long as the returns of the Fund's equity holdings are positive, cash dilutes the Fund's overall return. However, cash is useful to take advantage of opportunities when market prices decline sharply and it acts as a buffer that avoids the need to sell securities if the Fund has large net redemptions, neither of which we anticipate in the near-term but neither of which can be ruled out. In order to mitigate this dilution of returns from sitting on large amounts of cash, we recently wrote to the Fund's shareholders outlining a proposal that will be voted on in two weeks. We are proposing to invest up to about 10% of the Fund's net assets in packages of restructured European debt, similar to those invested in by OAM Debt Recovery Fund. Since then, I received several calls and e-mails from shareholders who are concerned that this represents a massive change in the Fund's mandate. Nothing could be further from the truth. To put it in perspective, the proposals affect a maximum of about 10% of the Fund's net assets. One shareholder was concerned that the Fund is turning into a balanced fund which can hardly be considered the case given the maximum proportion of the Fund that we are proposing to invest in non-equity related securities.

Another shareholder expressed concern that we are switching the Fund's investment objective to achieve an absolute return target. The Fund has always had a dual objective of beating its benchmark, the MSCI Europe (US$) index, on a risk-adjusted basis over the long-term as well as an absolute return target. When the Fund was launched, it had an absolute return objective of providing a return over the first five years at least three times higher than the yield of 5-year US Treasury bonds which at the time yielded 3.2%. In last year's Chairman's statement, I wrote that "a realistic objective is to provide the Fund's shareholders with a return that is at least five times higher than the current yield on 10-year US Treasuries" which at the time yielded 1.75%. Over the Fund's life, we have exceeded both these absolute return objectives and beaten the benchmark by quite a wide margin.

As an aside, had we broadened the mandate of OAM Asian Recovery Fund in 2000 to allow us to invest in two closed-end bond funds we identified that were trading at huge discounts to NAV on the Osaka exchange, the Fund would have avoided losing money that year or reduced the losses significantly. The Fund's track record would have been even better as a result.

We are very simply asking shareholders to give us the flexibility to broaden the Fund's investment strategy to allow us to "park" some of the Fund's excess cash in non-equity market correlated investments that we are confident can deliver an absolute return that exceeds the Fund's absolute return objective. OAM has some experience in allocating money to the manager that we are proposing to use for these non-equity correlated European investments. Importantly, we have seen strong cash flows coming back quickly. We will still have cash available for opportunities as they arise and a buffer to meet what we have historically experienced in terms of our largest net redemptions during any one year period. One of the risks of the proposal is that the Fund may have significant amounts of cash tied up in non-equity correlated investments at a time when equity bargains abound. This opportunity cost is somewhat mitigated by the fact that although the total commitment to these strategies may be as much as $25 million, it is likely that only a fraction of that amount will be deployed during most of the commitment period given the likely pattern of capital calls and distributions. If equity markets correct sharply in the short-term, it is likely that we could abandon this proposal and instead deploy the Fund's cash in equities at bargain valuations. It is anticipated that these non-equity market correlated investments will slightly reduce the volatility of the Fund's returns. The Fund continues to have a restriction of not investing more than 20% of its net assets in unlisted securities. Historically all these unlisted assets have had fixed lives or a visible exit and the intention is that will remain the case.

As a parting note, the Fund's directors and their immediate families either own or have direct responsibility for nearly 20% of the Fund's shares, an investment worth nearly US$50 million. You can therefore be assured that we take a very serious interest in the Fund and the way that it is managed. As we like to say, "we eat our own cooking"! We expect the same from the people running the companies in which we invest.

Desmond Kinch, CFA

Chairman