Overseas Asset Management

Overseas Asset Management (Cayman) Ltd.
3rd Floor Bayshore Mall South Church Street
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

20th January, 2009

OAM Asian Recovery Fund

Dear fellow shareholder,

Last year, OAM Asian Recovery Fund's NAV per share fell by 41.5%. By comparison, the Fund's principal benchmarks, the MSCI Asia free ex Japan (US$) index and MSCI Asia ex Japan Small Cap (US$) index, fell by 53.7% and 59.4% respectively. In last year's Chairman's statement, I warned shareholders that equity valuations in China and India were at "bubble-like" levels and we accordingly significantly trimmed our exposure there. In addition, in last year's Chairman's statement, I noted that "3 ½ years ago, the P/E ratio of the MSCI Asia free ex-Japan index was 35% lower than the P/E of the MSCI World Index. Today, the Asian ex-Japan P/E is 10% above the world average." I went on to say: "This aggregate measure of valuations in the region masks the huge divergence in valuations throughout the region. During the past four years, India's stock market has risen fivefold in USD while China's stock market has risen fivefold in the past two years. The rest of Asia in contrast has, for the most part, quite attractively valued stock markets and corporate balance sheets are very strong." What I failed to appreciate is that in a brutal bear market, everything falls in price irrespective of relative valuations. Chinese and Indian stock markets fell a bit more than the rest of Asia and this partly accounts for the Fund's relative outperformance. However, our significant exposure to Asian smaller companies hurt performance as is evident from the performance of the Fund's two benchmark indices.

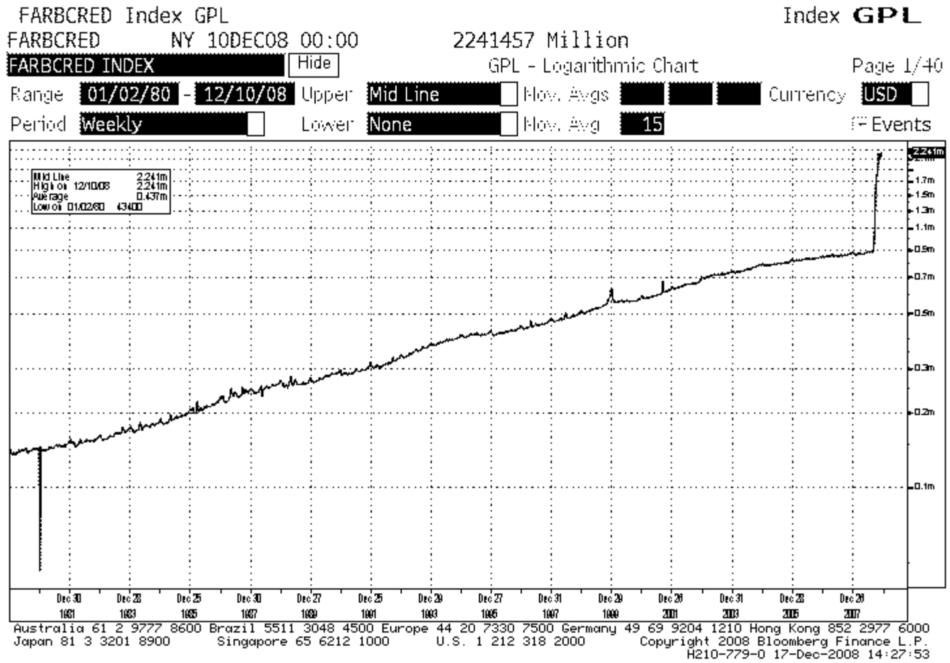
As in the aftermath of the Asian financial crisis, we think that this financial crisis is presenting us with one of the greatest investment opportunities that we are likely to see in my lifetime. OAM Asian Recovery Fund was launched a few months after Asian equity markets bottomed in the 1997/8 financial crisis. The Fund just had its tenth anniversary. Since inception, the Fund returned its shareholders a multiple of more than 3.7 times their initial investment, equivalent to a 14.1% compound annual return. By comparison, during the past 10 years, the MSCI Asia free ex Japan (US$) index and MSCI Asia ex Japan Small Cap (US$) indices returned 40.4% (3.4% per annum) and 41.3% (3.5% per annum) respectively, while the S&P 500 index of US equities returned -26.5% (-3.0% per annum). This shows the importance of being invested in the right asset class and in selecting the right investment manager(s). We think the next ten years are likely to result in a similar ranking of the relative performance of the Fund versus its benchmark and the US equity market, though the numbers will differ.

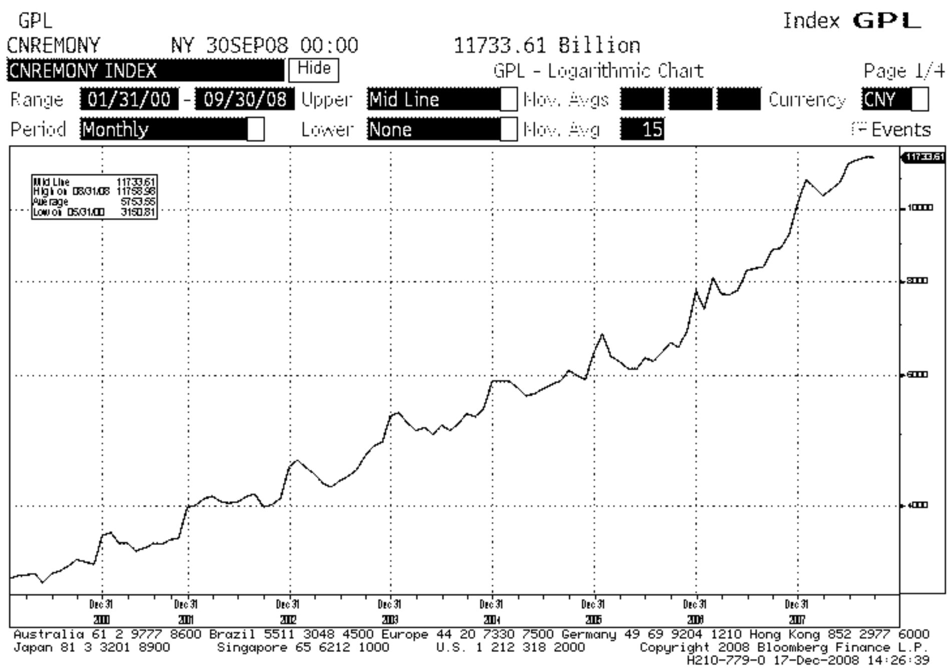
Amidst all the noise, we think there is a powerful structural shift in power from the West to the East with China at the epicentre of this shift to greater Eastern influence in terms of political, economic and financial power. It is likely to take at least five years for consumers in the housing bubble countries (namely the US, UK, Spain, Ireland and Australia) to rebuild their savings and adjust their personal balance sheets to the reality that they cannot depend on Asian buying of US Government and agency securities to offset spending beyond their means, exemplified by the large US and UK current account deficits. Meanwhile, savings rates across most of Asia ex Japan average around 30%. Therefore, a typical American consumer might earn US$40,000 per annum and spend $40,000. If this consumer increases his savings rate from 0% in 2007 to 8% in 2010, on the same income, his spending decreases by 8% over three years. Meanwhile, if a typical Asian consumer earns US$10,000 and his income rises by 15% between 2007 and 2010 and his savings rate falls from 30% to 25%, his spending increases by 23%. Since consumer spending accounts for about 70% of the US economy and nearly 50% of Asian economies, it is easy to see how the relative strength of the Asian consumer versus his Western counterpart favours Asian growth. It is also important in a global context to appreciate that China, India, South Korea, Taiwan, Hong Kong and the investable ASEAN countries are home to nearly half the world's population and have a combined population that is ten times higher than the US population.

Asian banks are also in much better shape than during the 1997/8 financial crisis and relative to Western banks today. In most Asian countries (Korea being a notable exception), capital adequacy ratios are around 12% and loan/deposit ratios are comfortably below 100%. Asian banks which held fewer mortgage-backed securities than banks in the US and Europe had $31 billion of writedowns and losses since the start of 2007. That compares with $678 billion for US banks and $295 billion for European financial institutions. As a result, few Asian banks have any need to raise new capital and they are not reliant on capital markets or inter-bank lending to provide them with wholesale funding. Asian corporate balance sheets are also very strong on the whole as CEOs and wealthy families learnt bitter lessons during the 1997/8 Asian financial crisis. In this respect, it seems somewhat unfair that peak-to-trough, Asian indices have declined as steeply during this bear market as they did during 1997/8, and by significantly more than the US stock market. In fact, in local currency terms, the decline in Asia is a bit steeper than in 1997/8.

Whereas the Western world's governments and central banks seem to be competing with one another to see who can provide the biggest bailouts and print money the fastest (quantitative easing is the term they use), Asian governments do not need to resort to the printing press to finance a boost in infrastructural spending. Asian governments and sovereign wealth funds in the region have accumulated US$2-3 trillion in foreign exchange reserves, some of which is likely to be invested locally in infrastructural projects in coming years. Since most Asian governments have relatively balanced budgets, they have plenty of scope to stimulate their economies through government spending without risking the devaluation of their currencies or crowding out of private investment. Consequently, Asia seems much better positioned than the West to navigate this difficult global economy by stimulating consumer and government spending to offset shrinking exports. As the world emerges from this recession, they are also less likely to be adversely affected by inflation and currency devaluation than the likes of the US and UK whose central banks nearly tripled the size of their balance sheets in the last three months of 2008.

After Britain abandoned the gold standard in the 1930's so that it could print more money to pay off its debts and the US overtook the UK as the world's economic superpower, the US Dollar strengthened from 5:1 against Sterling prior to World War II to nearly 1:1 over the next 50 years. I expect to see a similar or more rapid strengthening of Asian currencies versus the US Dollar in the future. This is likely to happen for a number of reasons: relative economic growth being much higher in Asia than in the US; more disciplined creation of money by Asian central banks than by the US Federal Reserve; and Asian currencies start from a point of extreme undervaluation. To put these points in perspective, the first chart below shows that after increasing its balance sheet by a fairly steady 7% per annum until September 2008 (close to the rate of nominal GNP growth), the US Federal Reserve nearly tripled its assets during the past four months by effectively printing money. The second chart below shows the growth in broad money supply issued by the People's Bank of China which continues to grow at a fairly steady rate of 16% per annum (close to the rate of nominal GNP growth).





The table below shows the most recent survey by the Economist magazine of the price of Big Macs in the US versus various Asian countries which supports the third reason set out above for Asian currency strength.

Big Mac prices in:		Local currency	In USD	Undervaluation
USA	US$	3.57	$3.57	
China	RMB	12.5	$1.83	-49%
Hong Kong	HK$	13.3	$1.72	-52%
Taiwan	NT$	75	$2.28	-36%
South Korea	KRW	3200	$2.41	-32%
Singapore	S$	3.95	$2.71	-24%
Malaysia	MYR	5.5	$1.54	-57%
Thailand	Baht	62	$1.78	-50%
Indonesia	IDR	18700	$1.67	-53%

As I wrote to clients in last month's newsletter, "the S&P 500 index of large US equities currently sells on a valuation of 19 times trailing earnings and a 3.2% dividend yield. Earnings are currently depressed because the US economy is in recession. However, even if we calculate a "normalised P/E" for the S&P 500 using 50-year average profit margins, the normalised P/E is still about 15. Major bull markets do not begin from such valuation levels. What I think is more likely to happen is that the next major bull market will be in Asia ex Japan. Valuations there are at levels similar to those that prevailed in the US in 1974 and 1938. The average P/E of the underlying holdings in OAM Asian Recovery Fund is about 6 and the average dividend yield is about 8%." These are stunningly low valuations and particularly relative to the yields on long-term Asian government bonds. The table below shows the P/E, dividend yield and yield on government bonds in various Asian markets according to Bloomberg.

Market	P/E	Div yield	10-yr Gov't bond yield
Hong Kong	11	4.6%	1.4%
Singapore	9.5	5.5%	1.9%
Taiwan	11.5	6.2%	1.5%
South Korea	10.5	2.3%	4.6%
Malaysia	11	6.1%	3.3%
Thailand	7.5	6.5%	2.4%
Indonesia	6.5	10.3%	11.3%

The reason why OAM Asian Recovery Fund has a significantly lower P/E and higher dividend yield than the large capitalisation regional indices is because the Fund, on an underlying basis, owns smaller and medium-sized companies. The share prices of many smaller listed companies in Asia have been sold indiscriminately, in many cases on very low volume. Their share prices have been crushed. For instance, in a report by JP Morgan on 23rd September (prior to the worst of the indiscriminate selling), they wrote that "Hong Kong small caps underperformed large caps by 25% in the past 12 months, and currently trade at 6.7x forward P/E, the lowest for the past 15 years." They added that "share buybacks in Hong Kong have reached a historical high. In 2008 YTD, about 10% of Hong Kong-listed companies have conducted share buybacks. The total value of these transactions reached HK$11 billion in 2008 YTD, which is more than double the amount in any of the previous 10 years." Since this report was written, the Hang Seng HK Small Cap Index declined a further 35%. These large share buybacks show that company insiders think that their shares are significantly undervalued. It also illustrates that their balance sheets are robust, thereby allowing them to use cash to buy back shares and enhance shareholder value. To illustrate how cheap many small cap Asian stocks are today, we just allocated more money to a specialist Asian small cap fund manager whose portfolio is trading at an average P/E of 5 and an average dividend yield of 8%. Nearly

20% of his fund's assets are invested in companies that are selling for less than net cash on their balance sheet. We have also seen significant insider buying in many of our underlying holdings. This is encouraging but it also highlights the very real risk that insiders may try to take their companies private at these ridiculously low valuations. We are about to go to Court in Singapore to protect the Fund's shareholders from being "squeezed out" of their shares at a huge discount to fair value in a company in which the Fund directly owns shares.

The recent disclosure that Bernard Madoff ran a Ponzi scheme of up to US$50 billion for many years and the fact that many of his investors were funds-of-funds or hedge funds set up specifically to invest with him have raised huge questions about the viability of the fund-of-funds model. We raised these questions about funds-of-funds in a different sense in the past by pointing out that the layering of fees makes it very difficult for a fund-of-funds to provide added value for its investors. Since OAM Asian Recovery Fund is largely a fund-of-funds, we have recently been asked by some clients about our due diligence procedures in light of the Madoff fiasco. The first point to make is that Bernard L. Madoff Investment Securities LLC used Friehling & Horowitz, an auditor operating out of a 13-by-18 foot location in an office park in New York City's northern suburbs. The auditor signed off on Madoff's annual financial statements. Friehling & Horowitz only had three employees: one partner in his late 70s who lives in Florida, a secretary, and one active accountant. OAM Asian Recovery Fund has investments in 15 offshore funds, 5 listed closed-end funds trading at attractive discounts to NAV (three of which are just awaiting final liquidation dividends), two listed investment holding companies that are trading at huge discounts to NAV(one is effectively an Asian late-stage venture capital fund and the other owns a huge tract of beachfront land and industrial estates near Singapore), and one (since de-listed) operating business that we purchased at a discount to net cash which was briefly referred to at the end of the previous paragraph. Six of these are audited by PwC, eight by Ernst & Young, six by KPMG, one by Deloitte, and one by Chiene & Tait (a large Scottish accounting firm).

The second point to make is Bernard Madoff had no independent administrator or custodian. OAM Asian Recovery Fund does its own administration. However, the Fund was set up this way to save shareholders money and because there are other checks and balances in place. The Fund has an independent custodian, Royal Bank of Canada Trust Company (Cayman) Ltd., and the Fund's financial statements have been audited by KPMG since inception. The 15 offshore funds in which the Fund owns shares all have independent administrators and custodians. Ten of these use HSBC as their administrator, registrar and custodian; one uses Citibank as its administrator and registrar and Goldman Sachs as its custodian; one uses UBS as its custodian, administrator and registrar; and one uses Citco as its administrator and registrar and Deutsche Bank as its custodian. The remaining two funds are limited partnerships that do not need a custodian: one is a China distressed debt fund that is audited by Ernst & Young and we have a client on the Board; and the other is an Asian mezzanine debt fund that is audited by KPMG and administered by Horwath First Trust, a large accounting firm in Singapore.

The final point is that we have added enormous value for our shareholders, in spite of being largely a fund-of-funds. We have invested in funds that most of our shareholders could never have accessed, even with the information and knowledge that we accumulated over 20 years. Some of these funds no longer take new money, even from existing shareholders. Over the past ten years, we have provided our shareholders with an attractive return and have beaten our benchmark indices by about 11 points per annum. Such a margin of outperformance is rare in the fund management industry and almost unheard of in the fund-of-funds business.

The Fund started last year with over US$18.4 million (9.5% of net assets) in cash, raised mainly from redemptions of our China-centric funds in October 2007, and ended the year with about US$5.7 million (4.8% of net assets) in cash. We were too early in reinvesting much of this cash primarily in Asian smaller company funds, two closed-end funds trading at attractive discounts to NAV, and a Singapore-listed company that owns large tracts of beachfront land. We also increased our holding in the Singapore-listed operating business that was selling for less than net cash so that we owned more than 10% of the shares subject to the tender offer and put ourselves in a position where we would not be subject to a mandatory squeeze-out at the offer price. We also paid capital calls to the Asian mezzanine debt fund which is now more or less fully called. We expect to get back more than $5 million this year in distributions from our investments which we think we can put to very good use while keeping a comfortable buffer to meet redemption requests which were minimal last year.

Following my trip to Asia in October, we redeemed shares in two funds for aggregate proceeds of $5 million, one a Korean fund and the other a Thai fund. Following significant declines from their peak NAVs, it takes a lot to justify redeeming shares in a fund at this point in the market cycle because we are giving up a free ride in terms of no performance fees until the fund recovers to its peak NAV – a point that few investors seem to appreciate. In the case of the Korean fund, the manager closed its office in Korea and proposed to continue managing the fund from Singapore. That decision, along with concerns about consumer debt levels and capital adequacy ratios of banks in Korea led us to redeem our shares in that fund. The Thai fund had experienced large redemptions and I had concerns about its largest holding. In addition, the manager started moving the fund into larger companies and proposed accelerating this process after smaller companies had underperformed by such a wide margin and now appeared to offer much better value.

We reinvested the proceeds in three Asian smaller company funds in which the Fund already owned shares. One fund increased its NAV nearly ten-fold during the past 10 years and has been closed to subscriptions for several years. The manager thinks there is now good value on offer in Asian equities and recently re-opened the fund to limited subscriptions by existing shareholders. The second fund is managed by someone that I have known for more than 10 years who has most of his net worth invested in the fund. That is the same fund that I mentioned earlier in this letter where nearly 20% of his fund's holdings are selling for less than net cash. The third fund is about 25%-owned by the manager, Board members, and shareholders in the management company. The average P/E of the holdings in that fund is 6 and the average dividend yield is 9%.

The Fund has rewarded its original shareholders with a 14% compound annual return over the last ten years. I believe that the Fund is capable of producing similar returns for its clients over the next ten years. I am wary of making short-term forecasts, but given the extreme cheapness of current Asian equity valuations and currencies as well as the extreme negativity of investment sentiment today, I think it is likely that I will be reporting decent returns to you this time next year.

Desmond Kinch, CFA
Chairman