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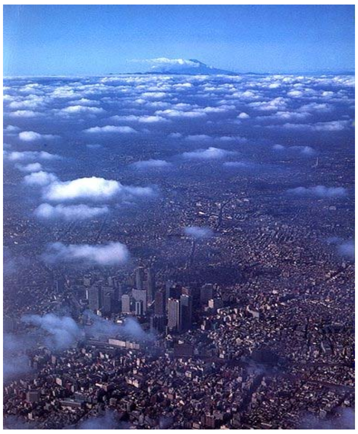

Views from the Far East
Part One: Japan

November 2006

The remit

Your intrepid investment managers have been on tour again, garnering views and scouting for investment opportunities in the Far East corner of the world. Tokyo was the first stop, so we donned our hard hats and headed for earthquake city.

Lost in translation or just plain lost!

The Japanese don't make it easy for foreigners to find their way around Tokyo - why should they. Therefore, jetlagged and disorientated, I found myself yearning for a compass or a sniffer dog as I emerged from the underground to a city full of indistinguishable buildings and very few English words. Even the sun would not show itself through the haze to give me a clue as to which direction was North. The directions guided me to find an office next to a Tully's coffee house. Clearly Gaijins like me get lost here regularly.

It is easy to lose your way trying to understand the Japanese stockmarket too. This year, Japanese stocks have been shunned by global investors leading to a massive net outflow of capital. Japan was harder hit than other stockmarkets and has not recovered as well. Local fund managers and brokers point to world events such as the Korean missile launch, the invasion of Lebanon by Israel, and increased tension regarding Iran, but these geopolitical risks are applicable to other markets too. Perhaps the early signs of slowing growth in Japan had more of an impact. Either way, the positive news indicating an end to deflation was not enough to outweigh other concerns. Perhaps Japan and its investors experienced a small crisis of confidence in the light of the false dawns over the past 15 years.

The breakdown of performance this year tells a further story. The Topix 100 index of large companies initially rose, by almost 10% in the year to April, then fell to -10% at the low point, and then recovered to edge into positive territory for the year to date. In comparison, the Topix Small Cap index still languishes at -13% for the year to date. This is partly explained by the actions of foreign hedge fund managers, who were forced to unwind massive holdings in smaller companies and buy back large companies to cover short positions they had taken. Also smaller investors had large positions in small and mid caps using margin accounts, and suffered several painful rounds of margin liquidation. Not good for Mrs Watanabe's confidence.

Heroes and zeroes

Many investment managers have been caught out by the polarity of performance by company size this year, and now find themselves significantly underperforming the major indices. In fact any strategy which has incurred a large deviation from the Topix 100 is likely to have been punished. Small and mid cap stocks have continued to be sold in favour of price momentum found in large defensive blue chip stocks. It has been a tough year for bottom up investors, as top down macro themes have dictated market movement.

So it was with a small amount of trepidation, that I entered the offices of one fund manager who focuses strictly on bottom up investing. The heavy red and black décor of the office was enough to bolster anyone's confidence, but the fund has had the uncomfortable experience of losing 43% so far this year. You would have to have a very long time frame indeed to be content with falls like that! After all, the fund will have to rise 72%

to get back to square one. The manager always invests for growth and has no regard for the benchmark, and never adjusts his strategy based on market conditions. In general we would applaud this approach, but it struck me that, especially in a market like Japan, it is vital to keep a keen eye on the risk exposure of your fund. After all, whatever the market, we focus on risk adjusted returns.

What's big in Japan

There is no doubt that Japan is in the midst of experiencing significant change. After 15 years of structural recession, with several false dawns in that time period, the sun really does seem to be rising. Whichever measure you look at, inflationary trends show an end to deflation and a recent BOJ survey shows that expectations of inflation are positive too. Koizumi's reforms have finally broken the back of the structural recession. The new prime minister Abe will have to show that he is able to continue to drive reform if he is to win the election in July next year, but the early signs are positive. The Abe administration is geared toward growth and place a high priority on capital investment and R&D.

So from the top down the picture is now more positive. Third quarter GDP growth rose at an annualised 2%, and the current expansion exceeds the Izanagi Boom of 1965-70 as the longest in the post war era. Property prices have strengthened, bank lending is rising, and unemployment is at a 15 year low.

Asameshi mae: a piece of cake, an easy task

So is Japan's recovery a fait a compli? That evening, enjoying a quick cocktail overlooking the city, I wondered if I should be nervous being 45 floors up in the city of earthquakes. Or should I be nervous of the sashimi I was presented? I'm told Fugu (blow fish) is no longer a risk in Japan. Then I considered what risks face Japan's economic recovery.

Fugu 1

Japan is slowing down after the faster growth experienced last year. Japan's growth is as ever in part dependent on the performance of the global economy, but more specifically the US, directly and indirectly through export markets in China and the rest of Asia. Clearly the emphasis is now less than has historically been so, and more weight is now put on the domestic recovery. It is suggested that a US slowdown may impact the Japanese GDP growth by 1-2%, although a US recession would clearly have a greater effect. Although it is expected that the US will slowdown, we are expecting resilience, and the fact that China is stimulating internal demand is a positive for Japan too.

Fugu 2

The pace of interest rate movements in Japan is also a risk. The initial rise in interest rates was widely anticipated. Although interest rates have risen, the inflation has gone up by more, so real rates are still close to zero. Any impact now would come from the speed of tightening from here, risking a further slow down in Japan's recovery.

Fugu 3

Another threat is currency strength. Many years of falling prices in Japan have made exporters more competitive, but the yen's cheapness is a further boost. The trade weighted yen value has fallen to its lowest level since 1982. This is despite the lack of currency intervention of 2003-4, and the yen now floats freely. Recently, the 'carry trade' has taken responsibility for the weakness, as assets are borrowed in cheap yen to buy higher yielding investments elsewhere. However, at the first sign of falling interest rates, the yen should rise sharply as carry trades are unwound. We expect the yen to strengthen back towards purchasing parity in next few years.

Fugu 4

The last significant concern is sentiment. Can we rely on the man on the street to perpetuate the recovery that has so tentatively started? It is obvious walking around the streets of Tokyo that the Japanese are different. They take style, tidiness and etiquette to a whole new level. And it seems the Japanese do enjoy baffling foreigners. So, baffled as I walked from meeting to meeting, I wondered about the current state of the Japanese psyche. The stereotypical Japanese have become less workaholic and materialistic than in the past and are now more focused on quality of life. Also, as a result of deflation, Japan is no longer the most expensive city in the world, so the cost of living has fallen considerably. We expect the Japanese to spend as wages rise, and this is crucial as the consumer now accounts for 50% of GDP. The individual must start spending, but must also help rescue the stockmarket. The large institutions have a low target for equity ownership at around 35-45%, and only tend to adjust the target every 3-4 years, hence it will require the individual investor to provide significant buying. However, as mentioned many investors got their fingers burned in the recent sell off. In the past, the

Japanese attitude to shares is that they see them as one way bet. So as soon as the stockmarket rally resumes, once Japanese investors start to participate, we can expect another bubble!

Japanese dramatics

So if this is not the final chapter of an old Japanese tragedy, then what can we expect? Studies in the US show that there are significant stockmarket gains to be made in the years following an end to deflation. In fact these were the best times to be invested. Deflation tends to make equities exceedingly cheap as investors shun stocks in favour of government bonds. Corporate earnings suffer as the prices at which firms can sell goods decline, while many of their business costs remain fixed. Hence Japanese companies have had to survive through an extended era where price rises cannot be passed on. Those that have survived should be robust and well managed.

Normal is good

So the Japanese economy is normalising, and the investment case is not based on an expectation that GDP will rise, but based on the ongoing restructuring of corporates. Companies have significant room to improve corporate governance, and many companies have significant cash holdings and need an outlet for that cash. Companies are increasing the dividend payout ratio and some are buying back stock, enhancing shareholder returns.

Alongside changes in structure of business, the reduction of bad debts, and reduction of cross shareholdings, M&A is increasing and there is massive potential for consolidation. Indeed in August Japan experienced the first hostile bid between blue chips. More interesting was the fact that the aggressor was traditional Japanese firm, and even more interesting was that the advisor was not a foreign bank, but Nomura. For a local bank to advise on a hostile bid carries significant risk when relationships count for so much in Japan.

The potential for corporate performance to improve in Japan is clear, where elsewhere in the world margins and return on investment are already high. In Japan leverage is low and margins are low. There are significant opportunities for companies to boost margins. Indeed the fall out of expensive retiring baby boomers will reduce company labour bills. Measures to extend work beyond retirement, and more women coming to work may provide some flexibility in the labour market, but low immigration provides little support. Hence the labour market is shrinking. This has the added benefit that younger wage earners will start to get wage rises. This will hopefully encourage consumption. There are early signs that this process has already started. Wages for employees 20-29 have also surged 15% year on year according to Mitsubishi research. In addition, from 2007-9 the number of new young employees will drop. The birth rate is chronically low and population has started to decline. There was a big cheer when the news broke that a new royal baby had been born. It is expected that there may be a baby boom as parents seek to provide potential partner for the baby prince!

A damp squib?

You have to get up pretty early if you want to catch the action at the world's biggest fish market in Tokyo, but as I walked around the assorted sealife I wondered whether investors have missed the boat if they had not invested in Japan two years ago. Fund managers and brokers agree, that we are currently experiencing a downcycle in the early stage of a long upward trend. What they are less in agreement about is how to be positioned for the next stage of the recovery. And it is the polarity of opinion that is most interesting. Up until this year, small caps had outperformed large for 5 years, and historically, various sections of the market tend to outperform for periods of 5 years or so. Studies therefore suggest that we are due an extended period of underperformance for small cap managers. Clearly this is information that fund managers whose strategy is currently focused on small caps would rather not hear. There is another reason why large caps are in demand and that is higher dividends. Japan's ageing population needs income from investments. Hence the launch of several mutual funds focused on dividend yield has supported large caps.

Zen investing

It was refreshing to get a view from a head of strategy at a Japanese broker, who has less incentive than fund managers who will always have a tendency to talk up their own strategy, although who can blame them. Our head of strategy has a much more balanced view. Companies have been excessively pessimistic about earnings growth projections, with projections relatively unchanged since beginning of the year. However, at the beginning of the year there was concern about raw materials prices and labour costs, but companies have been able to fully offset these costs with higher than expected growth. Companies are being too conservative in their estimates, due to concerns over higher input costs. In previous upturns, companies weakened cost controls and this impacted on profitability, but there is more pressure on management to keep control of costs this time.

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So there are plenty of reasons to be positive about Japan. More efficient resource allocation, restructuring and consolidation should allow higher earnings to be achieved going forward. In normal market conditions the Japanese market has rewarded growth in earnings. Hence we expect the market to revert to a focus on fundamentals at some point as earnings growth comes through and investors begin to evaluate individual companies rather than just playing a defensive game. The setback in stockmarket in the first half of the year provided a correction in valuation of stocks. The Japanese market is not much more expensive than the US, where traditionally Japanese valuation multiples have been far higher than elsewhere. In addition, the cost of capital is clearly very cheap. Hence we expect a recovery in stocks at some point as the sell off has gone too far.

More sake

However, despite the benign environment, there is still an evident lack of catalysts for a market rally. We expect investor sentiment around the globe to respond favourably to firmer signs of a soft landing for the US economy. In Japan the focus will be on determining whether the current deterioration in economic indicators in a short term phenomenon or whether the economy has reached peak. We expect that the earnings season will bring revisions which will act as a catalyst for the next rally. Hence we expect export related sectors such as auto and electronics to maintain strength whilst the yen is weak, and domestic demand related sectors to lead the rally. However, Mr Watanabe might need a little more sake to bolster his courage to consume and invest.

In summary, we consider Japan to be an essential piece in the Mosaic investment strategy for at least the next 5 years, although we also anticipate a rocky ride.

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