



INVESTOR SELECT ADVISORS

Commentary on the Japanese Market
July 2003

The comments below are by Nick Bullman, Chairman of Investor Select Advisors (ISA), following a recent visit to Japan.

The recovery seen in the Japanese market over the last couple of months begs the question, “is this the start of a new secular bull market or a cyclical uplift in the extraordinary oversold position we saw at the end of the fiscal year?” We do not have the definitive answer. Fortunately as a hedge fund of funds, we do not need to time our entry into the market but to be positioned to protect funds regardless of market direction and to make money where we can. We are, however, in a position to reflect on some of the prevalent views amongst our own managers and make some observations of our own.

Most of our hedge fund managers, whether Japan-based or overseas, are skeptical that much has really changed at the macro or governmental level. The euphoric celebration when Koizumi became Prime Minister on a reform ticket quickly melted away as investors saw that there was little appetite for real progress. That hasn’t changed, so this rally has not been inspired by reform of the domestic political or structural environment. The rally appears to have been precipitated by foreign buying; overseas buyers are structurally underweight Japan and can’t afford to be left behind in a sustainable rally. Foreign buyers are awash with cash, particularly the Americans, who have had their economy primed on low interest rates and loose money in order to jump start an economic recovery. It is hardly surprising that some of that excess cash should find its way into overseas markets but foreign buyers are generally price sensitive and wouldn’t put money into perceived expensive assets.

This is then the difference. Up until now Japan has looked expensive for foreign buyers but many of the restructuring stories in the Japanese corporate sector: debt paybacks, cross shareholding unwinding, subsidiary spin-offs and perhaps most importantly corporate share buy back programs etc , have started to have an effect. Japanese companies look favourably priced amongst their global peers. Top line growth may be hard to achieve but operational gearing means any growth transfers to the bottom line very quickly. This looks like secular change and therefore should be sustainable. However the source of the buying is still predominantly foreigners; many Japanese institutional buyers remain structural sellers. Pension funds are handing back liabilities to the Government, and Banks and Insurance companies continue to unwind cross shareholdings. Only the Government, which was the largest purchaser of securities in the first quarter of this year, and maybe retail are likely purchasers domestically. Corporations who provided much of the impetus for the 1980s rally have all but disappeared.

So who can sustain the rally from here? There is still plenty left in the foreigner’s war chest, and they are still underweight. Estimates put the Nikkei fair value between 10,000-11,000, and one could argue that taking the index back there is a reasonable reaction to the oversold values of March 2003. The question then is can the domestic market pick up the demand, and if not, are we are just in a global liquidity driven bounce which will disappear all too quickly when the money runs out? Cynical from past disappointments we may be, we still recognize much has been achieved in the corporate restructuring of Japan. For that

reason, we believe that we may now, at last, be entering a new more positive secular phase in the Japanese market. We will however keep a close eye on the liquidity situation in the short term.

Below are some thoughts on three possible long-term outcomes for Japan

- 1) Disaster – The general theme behind this view is that Japans bear market just continues with increased deflationary pressure and that essentially Japan just continues to suffer a long and painful financial demise. Important to note that already the 13 year Bear market is one of the longest on record and historically prolonged economic pain leads to social and other unrest. Supporting this view are:
 - a. Japanese Long Term 30 Year Bond yields have been yielding as little as 1%. This pricing reflects a view that may represent capitulation pricing. Effectively, if you cannot expect to get better than 1% per annum for the next thirty years then you should probably not be investing at all!
 - b. Institutions are investing in these long dated low yielding instruments because they view the JGB as a “store of value” i.e., they do not care about the “economic” rationale they just do not want to lose any more principal.
 - c. Japans credit rating is diminishing
 - d. The Government shows no real will to change its policy (the bailing out of Resona Bank as an example)

The net effect of the above is that institutions and individuals who are the holders of wealth in Japan in terms of cash assets will continue to support the failing policies and borrowing requirements of the Japanese government thus pouring good money after bad. Over time this will erode the wealth of the Japanese nation with its inevitable end.

- 2) Imported reflation – The second general theme, (the one that ISA would subscribe to as being the most likely scenario) is that Japan, paradoxically, is already importing US based reflation because of its tacit support of a band within which the Yen will move vis a vis the USD. Effectively, what is being said is that the European Central Bank has decided to allow its currency to strengthen against the dollar through its inability or unwillingness to manage interest rates, the Yen would have shown similar strength were it not for the Bank of Japan’s management of exchange rates and its strong desire not to see the Yen crush its exporters. Whether this turns out to be a policy or a policy through default is immaterial because the net effect is that Japan is defacto reinflating the economy. Reinflation of course would do several things:
 - a. Bond Yields would rise and there would be a potential flood of sellers of JGB’s protecting their Bond portfolio capital.
 - b. The release of this cash would need to find a home and it might (this is a big “might” because it may not) find its way into the stock markets.
 - c. The sign of inflation in Japan would ignite the economy.

- 3) The Bull Story – The third theme may be that we have already entered this new “Bull” phase and that the equity markets are going to move higher on both Foreign and domestic equity buying. (ISA thinks it fair to say that this is an unlikely scenario given the dire position of a number of the constituent companies within the indices.) However company share buy backs are supporting this view.

In conclusion the following is evident:-

- 1) Bond Yields are rising and there is an increasing risk of a sharp downward move in Bond prices in Japan

- 2) A number of companies have started share buy back programs (e.g. Matsushita and Hitachi). This is being driven by high dividend yields relative to JGB yields. The average dividend yield is 2.3% which translates to about 1.8% net of tax. Therefore, companies are preserving cash more efficiently by buying their shares back and avoiding JGB's. It is also the "perfect" time in the business cycle for companies to be making such buy backs and may indicate a change in confidence levels following corporate restructuring.
- 3) The indices will probably not move upwards in a "Bull" phase but trade within a broader band until the economic environment changes trend.

Another very important theme from a hedge fund perspective is that the amount of research being done by traditional banks and brokers has literally collapsed in Japan. Broad estimates are that between 80% and 90% of listed companies are no longer being researched by banks or brokers. That space has been vacated during the past 13 year bear market. As with the physical world, vacuums are quickly filled. Hedge funds have become the primary source of information on the market. (This last point is in our view absolutely critical to the progress of the market.) Alternative investments are and will continue to provide the best "solution" in terms of gaining access to the Japanese financial markets for years to come. The void in research is already providing hedge funds with an excellent source of alpha. In addition, Index Funds may be at a disadvantage in this regard as the broad indices may or may not reflect, if indeed it occurs, the emergence of a Japanese "Nifty-Fifty" or core of stocks that have restructured already and will lead the recovery in Japan.

In summary, we have become more attracted to Japan not because of its recent market trend or its underweight position in many portfolios, although the additional liquidity in the market always is of help, but because there are structural issues, outlined above that lead us to believe there is a good investment opportunity offered to investors in the current climate.

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