

Why invest in Japan now I.

Near-Term Incentives

▪ Economic Recovery - sluggish but positive

Propelled by unprecedented global fiscal and monetary stimulus, we believe that the global economy will continue to pick up over the coming months but that the rate of growth will slacken as the effects of the stimulus wear off and the balance sheet adjustment in the West proves to be protracted. Sluggish export demand from the West will impact Japanese growth as will subdued growth in domestic demand. Currently we are expecting GDP growth in Japan of 1% in 2010 following a decline of around 3.8% in this fiscal year. However, looking ahead, there is considerable upside potential related to future growth in emerging markets and Asia in particular. Certainly Japan is well placed to benefit from the growth in Asian demand; it is a major supplier of the capital goods and is in the right neighbourhood.

▪ Valuations - attractive

Having fallen heavily in the fiscal year ended March 2009, we expect earnings growth to rebound strongly in the current year, rising 24%, to be followed by another strong rise the year after. Under this scenario, the market would trade on a relatively modest forward PER of 20x. On a PBR basis, in the first quarter the market as a whole was trading at a discount to book but share price appreciation has pushed the PBR back over 1x. However, at around 1.2x Tokyo's PBR still compares favourably to other major markets. Using yield gap analysis, Japanese equities continue to offer good value with the dividend yield on TOPIX now standing around 2.0% compared to the yield on 10-year government bonds of 1.3%. Overall the valuation picture for the market remains attractive, certainly relative to history but also relative to other markets.

Why invest in Japan now II.

Longer-Term Incentives

- **Corporate Restructuring – an ongoing theme**

This is the key to unlocking the value that currently exists in the Japanese market. In general Japanese companies have not looked to maximise shareholder returns above all other considerations. Market share, employee welfare and corporate relationships have mattered as much as pure profitability. However this situation is changing and companies are gradually becoming more focussed on shareholder value. Dividend growth and the growth in share buybacks are evidence of this trend as is the inexorable rise in corporate mergers and acquisitions.

Encouragingly, the key shareholder yardstick, the return on equity (RoE), of Japanese companies is increasing. However at less than 10% at the peak of the cycle, the market RoE is still well below global averages. On the other hand this low figure does highlight the potential for improvements in the future. Simple changes such as reducing corporate cash holdings would go a long way in improving shareholder returns and the doubling of RoE from current levels is readily achievable. Growing shareholder activism will doubtless play an increasing part in this process and the Pension Fund Association of Japan, for example, has announced that it will only support company management where the RoE is above 8%. This is an approach shared by Nomura Asset Management which has instituted a similar rule.

Why invest in Japan now III.

Conclusions

There are good reasons to believe that Japanese equities represent an attractive investment opportunity at present. On a number of key measures, the market is cheap against its history and on global comparisons. In particular, the current dividend yield relative to bonds would point to the market having reached its floor. Of course valuations are underpinned by corporate earnings and we expect profits growth to remain positive. Over the longer-term, a powerful catalyst for an upward re-rating of the market is corporate restructuring which promises improving shareholder returns. We believe the potential is huge.

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