



C A M B R I D G E A S S O C I A T E S L L C

ASIAN MARKET COMMENTARY

VALUE AND JAPANESE SMALL CAPS

September 2008

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“Value” Has Been a Good Bet in Japan

The outperformance of value stocks in Japan since the beginning of 1975 is striking. The MSCI Japan Value Index outperformed the MSCI Japan Growth Index in 24 of the last 33 years and had an average annual compound growth rate (AACR) of 9.8%, compared with just 3.6% for growth stocks (Table A).¹ And although value did underperform growth in Japan in both 2005 and 2007, it has outperformed this year by almost 600 basis points (bps) through the end of September. By comparison, the oft-remarked on outperformance of value stocks over growth stocks in the United States (as measured by MSCI) from 1975 through 2007 was not much more than 100 bps (AACR of 12.3% versus 11.3%).²

Japanese equities have been cheap for some time (particularly on a relative basis),³ a phenomenon that has reflected abysmal market performance and become even more pronounced in light of the downturn during the third quarter. Within the world of Japanese equities, meanwhile, small caps are especially cheap. Based on our review of several manager portfolios, it appears that Japan fund managers have moved more into the smaller-cap space in the last couple of years and we would expect this trend to continue if current market trends and pricing hold. Indeed, while this sector continues to carry significant risk, there is a good “value-based” case to be made for Japanese small caps.

Some Basics on Japanese Small Caps

In examining Japanese small caps a useful starting point is the Tokyo Stock Exchange’s (TSE) Topix Small Index, which is composed of those stocks listed on the TSE’s First Section that are not included in either the Topix 100 (large cap) or Topix 400 (mid cap) indices. The Topix Small Index presently has 1,194 constituents and accounts for 10.4% of the total market cap of the First Section.⁴ This is similar to the Russell 2000®’s 8.0% weight in the Russell 3000®.

The TSE also contains a Second Section with 463 listed firms. In addition, investors interested in smaller-cap stocks may look at other small-cap exchanges such as Jasdaq (922 constituents) or the TSE’s Mothers Market (192 constituents). All told, 2,771 companies are listed on all of these exchanges (excluding the Topix 500). However, many of these firms are really micro caps, making them unlikely targets of fund managers. For example, Topix Small constituents have a median market capitalization of \$216 million, with individual market caps as small as \$7 million. If we use the U.S. stock market as a guide and limit the universe to Topix Small Index companies with market caps between \$167 million (the lowest capitalization of any Russell 2000® constituent) and \$2 billion (the differentiation point in the United States between small

¹ All performance data are as of September 30, 2008.

² We used MSCI indices to maintain consistency in time periods, value and growth definitions, and number of constituents, but the more popular Russell style indices (which only go back to 1979 and represent a broader range of companies) experienced a similar, though more pronounced, pattern of value outperformance.

³ Please see our November 2007 Market Commentary *Japan: Stay the Course?* and the “Japan” section of our monthly *Notes on Current Valuations*.

⁴ The Topix Small Index thus has 45% more constituents than the MSCI Japan Small Cap Index, which includes 821 firms. Constituent data are as of August 31, 2008.

caps and mid caps) we come up with 722 firms. Another 126 firms within this capitalization range are listed on the TSE Second Section, Jasdaq, and Mothers exchanges. Adding the 180 Topix 400 firms falling within this cap range brings the total to 1,028.⁵

From a sector-based perspective, Japanese small caps are more heavily weighted toward industrials and consumer stocks than are larger stocks, but provide virtually no exposure to utilities or telecommunications (Table B). According to managers, they are less liquid, as we would expect. This is certainly true of TSE Second Section and Jasdaq stocks compared with firms listed on the TSE First Section.

In contrast to the United States, Japanese small caps (as measured by the Topix Small Index) have historically traded at a *discount* to larger caps on a price-earnings (P/E) basis while providing a higher dividend yield (DY) (Table C).⁶ Interestingly, Japanese small caps generally traded at a premium to their larger-cap counterparts prior to 1990 while offering a lower DY. This suggests that the vast underperformance of small-cap stocks after the Japanese bubble was reflected in investor perceptions.⁷ Over the last seven years,⁸ however, Japanese small caps have an AACR of 3.4%, 204 bps more than their larger-cap counterparts. In the dismal market of 2008 small caps (-23.1% total return in yen and -19.0% in US\$) have outperformed larger equities by about 200 bps.

Japanese Small Caps as a Value Play

Japanese small caps have become increasingly cheap. The Topix Small's P/E ratio in 2008 has ranged from 16.4 to 18.9 on a month-end basis, its lowest level in at least seven years. Moreover, while Topix Small stocks are only at their historical average relative to Topix 500 firms (Table C), some 19.5% of Topix Small firms have a P/E ratio of less than 10 (versus 13.2% in the case of Topix 500 firms) while 8.0% have a P/E ratio of less than 7. Many of these firms have market caps of more than \$200 million.

Meanwhile, the 2% DY on Topix Small firms is at a 32-year high. This is partly due to price declines, but the DY has increased 66% over the last two years and 40% over the last 12 months. Higher DYs make small caps look increasingly attractive when compared with the investment alternative of Japanese government bonds (JGBs), suggesting that domestic investors have good reason to move into this space (Table D). Expectations for significant increases in JGB rates are also low. Interestingly, Topix-listed firms with a market cap of less than ¥100 billion (roughly \$1 billion) are, like their larger-cap counterparts, increasingly conducting share buybacks, though not to the same degree. In 2007, 17% of such firms conducted buybacks amounting to at least 1% of shareholder equity, versus 28% of firms with market caps above ¥100 billion.

⁵ The median market cap of Topix 400 firms is about \$2.2 billion.

⁶ This conclusion is based on the relative performance of the Russell 2000® and Russell 1000® indices.

⁷ Our data on small cap performance only date back to 1993, however.

⁸ Our performance data for the Topix 500 (made up of the Topix 100 and Topix 400) and MSCI Japan Small Cap indices begin in November 2001.

In an environment of economic weakness and less certain earnings prospects, investors may place more weight on assets, as reflected by price-to-book (P/B) ratios, than on P/E ratios. As of the end of July, 2,296 listed firms in Japan, about 60% of the total, had P/B ratios of less than 1. Given the Topix's 15.9% decline in the last two months the number is probably higher today. While the P/B ratio for Topix stocks was 1.37 at the end of August, it was especially low for smaller cap issues. The 1,215 stocks with market caps of less than ¥100 billion had a P/B ratio of 0.86, while the P/B ratio on TSE Second Section stocks was just 0.78.

Other Considerations Relating to Japanese Small Caps

A number of other factors, both positive and negative, come into play with respect to Japanese small caps. For example, while Japanese equities have long offered U.S. and European investors the attraction of lower correlations to stocks in those markets, this benefit is even more apparent in the case of Japanese small caps (Table E). A renewed commitment to small caps by domestic investors, who continue to hold massive amounts of liquid assets, meanwhile, would move prices much more than in the case of larger caps.

Indeed, small caps may have a much greater upside than large caps since they would likely benefit more from structural reform than would more efficient larger-cap, export-oriented firms. Assuming that domestic consumption finally increases meaningfully once the economy picks up again, Japanese small caps should benefit disproportionately. It is often forgotten that exports only accounted for 17.6% of Japan's GDP in 2007, although this number has increased significantly since 2001, when it stood at 10.6%.

Of course, there are other, non-value-based factors that caution against excessive optimism concerning Japanese small caps. There are good reasons (originating from conditions both inside and outside Japan) why the Topix Small Index has returned -44.0% since the end of January 2006—and why the TSE Second Section, Jasdaq, and Mothers markets have fared far worse. Several years of record Japanese corporate profits, running through March 2007, did not translate into the significant wage growth and increases in domestic consumption that would have supported domestic-oriented stocks. Small-cap firms have been particularly buffeted by the sharp rise in commodity prices, which they were unable to pass along to their customers. Inefficiencies abound in domestic-oriented firms and investors are more likely than in the case of large, export-oriented firms to be frustrated by a lack of transparency, inefficient use of cash, and relative inattention to shareholder concerns. Relative to larger firms, meanwhile, small caps are perhaps less able to take advantage of distressed conditions overseas.

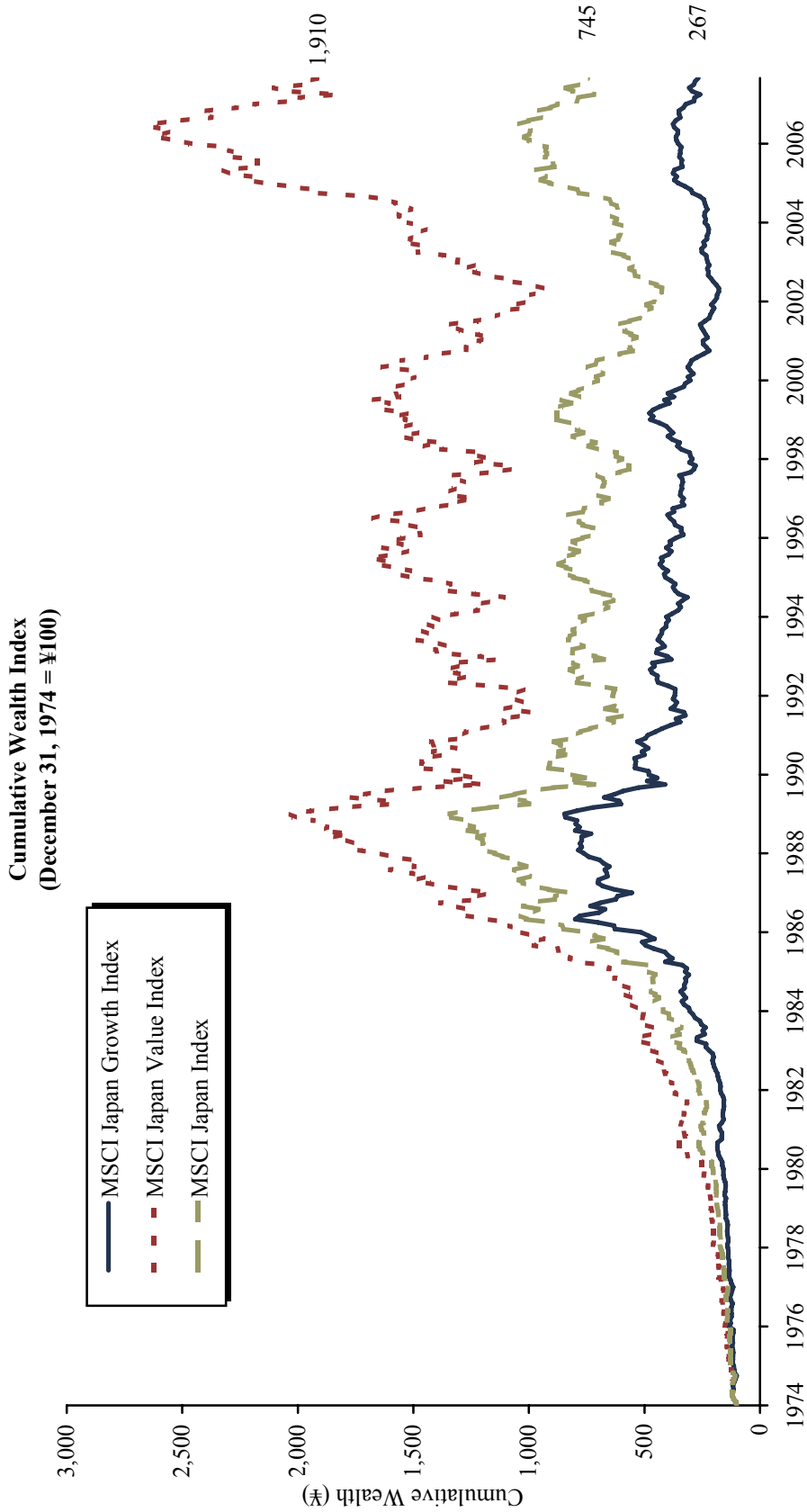
In addition, Japanese individuals are not only reluctant to increase consumption but also wary of equities. They have yet to show the same kind of long-term commitment to the stock market that exists in the United States and other countries. Meanwhile, foreign investors, whose influence on the market is enormous, are frustrated by the slowness of change in Japan and the continued political and bureaucratic impediments to further structural reform. These attitudes hurt small caps more than mid and large caps.

Conclusion

There is no doubt that Japanese small caps are a strong value proposition. However, those managers whose approach is not based strictly on value may well arrive at a different conclusion regarding the attractiveness of this sector. Investors, meanwhile, should understand why some large-cap or cap-agnostic managers have or might be expected to migrate to this space and why staying power is required (much more than in the case of Japanese large caps) if they agree that small caps present good opportunities. Those managers migrating down the capitalization spectrum are moving into a space that others have found difficult, although, for those contrarians among us, the dearth of managers active only in the small-cap space is a positive sign.

Table A
CUMULATIVE WEALTH OF MSCI JAPAN GROWTH AND VALUE INDICES

December 31, 1974 – August 31, 2008



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Total returns for MSCI developed market indices are net of dividend taxes.

Table B
SECTOR COMPOSITION OF MAJOR JAPANESE EQUITY INDICES

As of August 31, 2008

| <u>Sector</u> | <u>MSCI Japan (%)</u> | <u>Topix (%)</u> | <u>MSCI Japan Small Cap (%)</u> | <u>Topix Small (%)</u> |
|----------------------------|-----------------------|------------------|---------------------------------|------------------------|
| Consumer Discretionary | 19.0 | 18.8 | 20.3 | 22.0 |
| Consumer Staples | 5.5 | 6.1 | 9.3 | 10.3 |
| Energy | 1.3 | 1.3 | 0.7 | 1.4 |
| Financials | 18.5 | 18.9 | 18.6 | 11.7 |
| Health Care | 6.3 | 5.8 | 5.1 | 5.8 |
| Industrials | 18.3 | 18.8 | 23.9 | 26.9 |
| Information Technology | 13.9 | 13.3 | 11.1 | 10.3 |
| Materials | 8.4 | 8.4 | 10.4 | 10.6 |
| Telecommunication Services | 3.3 | 3.7 | 0.1 | --- |
| Utilities | 5.5 | 5.0 | 0.5 | 0.9 |

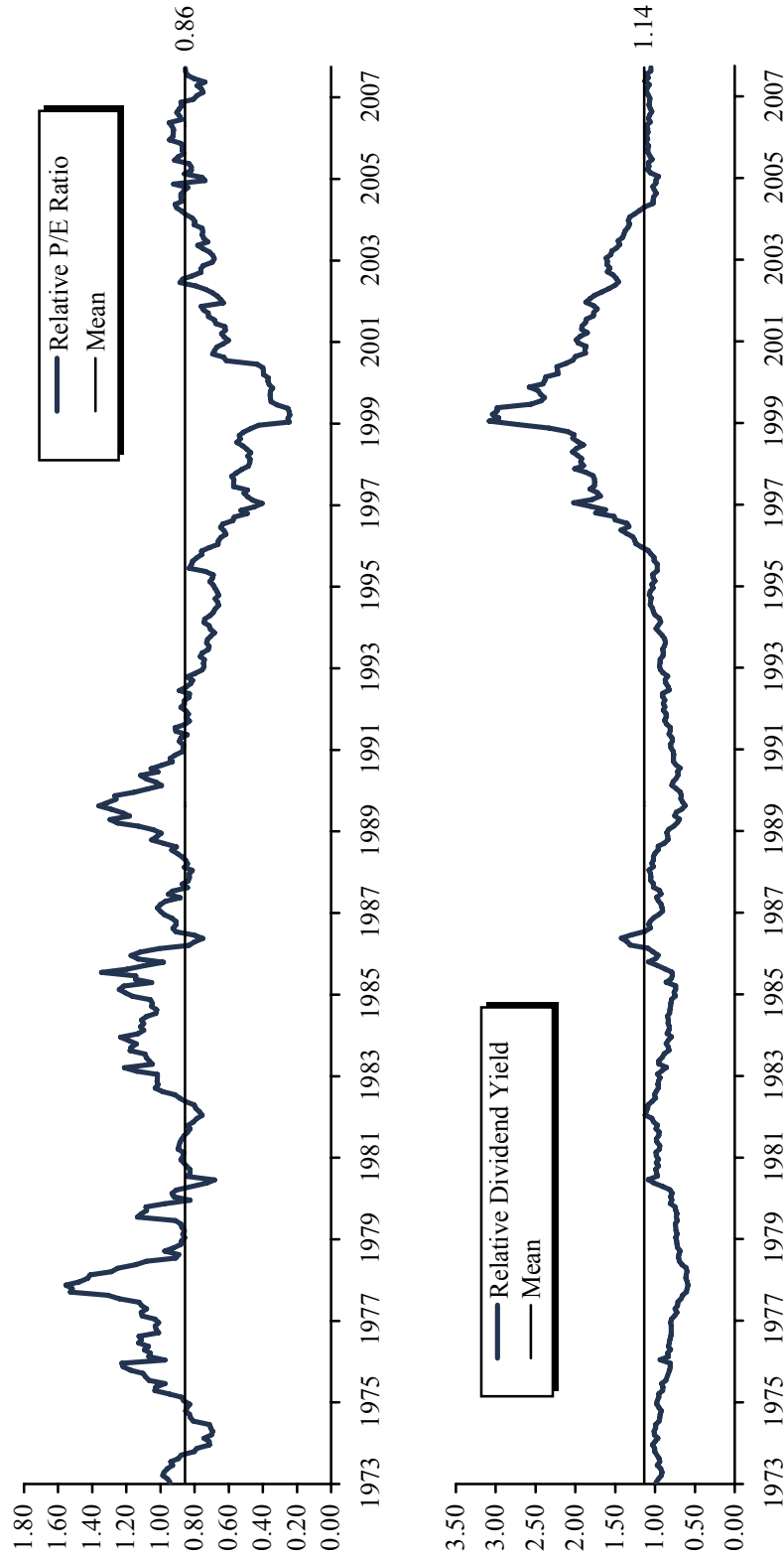
Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.

Note: Sector weights exclude securities without GICS sector classification.

Table C

RELATIVE PRICE-EARNINGS RATIO AND DIVIDEND YIELD FOR THE TOPIX SMALL INDEX VERSUS THE TOPIX 500 INDEX

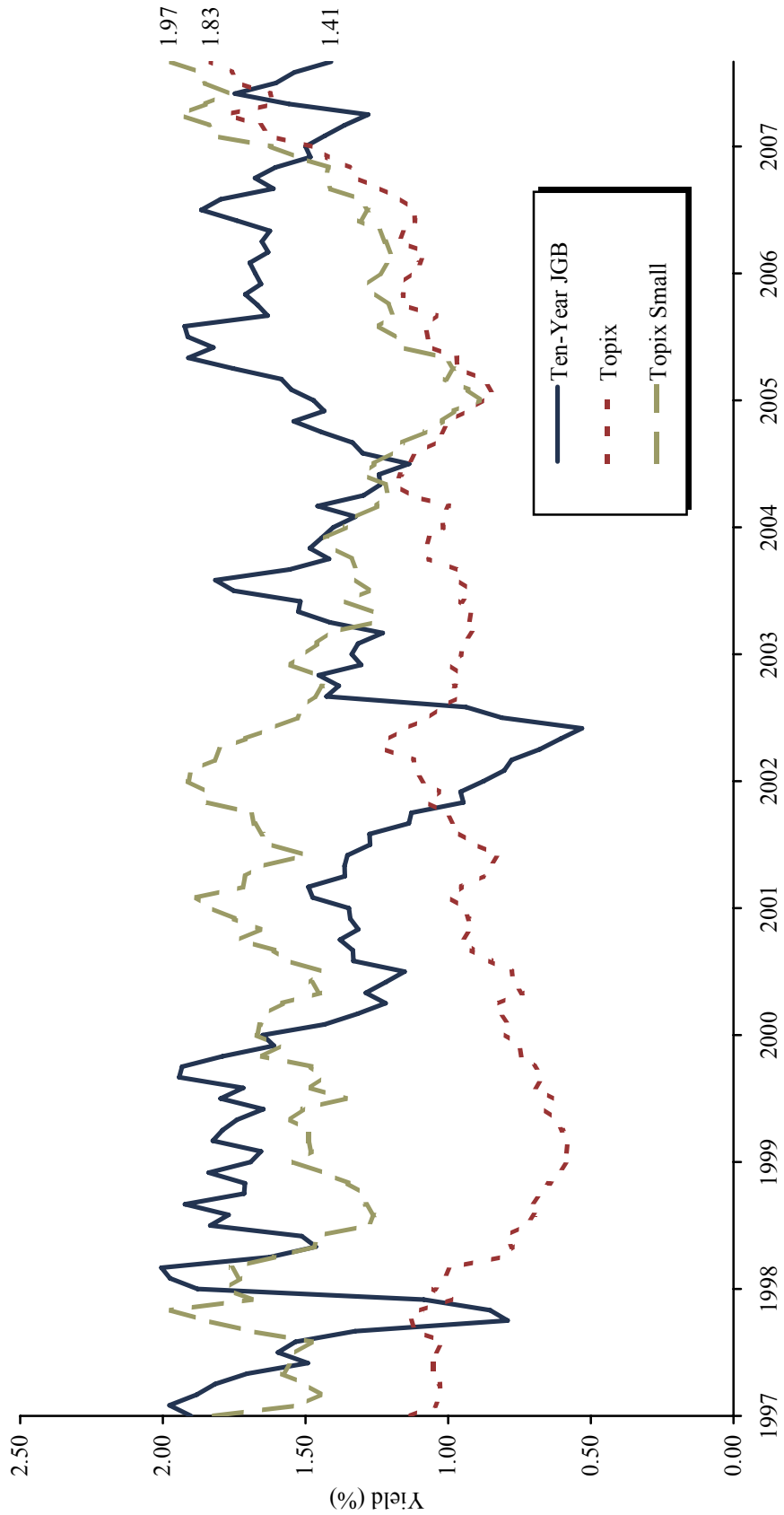
December 31, 1973 – August 31, 2008



Source: Thomson Datastream.

Notes: The Topix 500 Index is made up of the constituents from the Topix 100 and the Topix 400 indices. As of August 31, 2008, the relative price-earnings ratio was 0.86 (identical to the mean) and the relative dividend yield was 1.05.

Table D
TOPIX AND TOPIX SMALL DIVIDEND YIELDS VERSUS TEN-YEAR JAPANESE GOVERNMENT BOND YIELD
December 31, 1997 – August 31, 2008

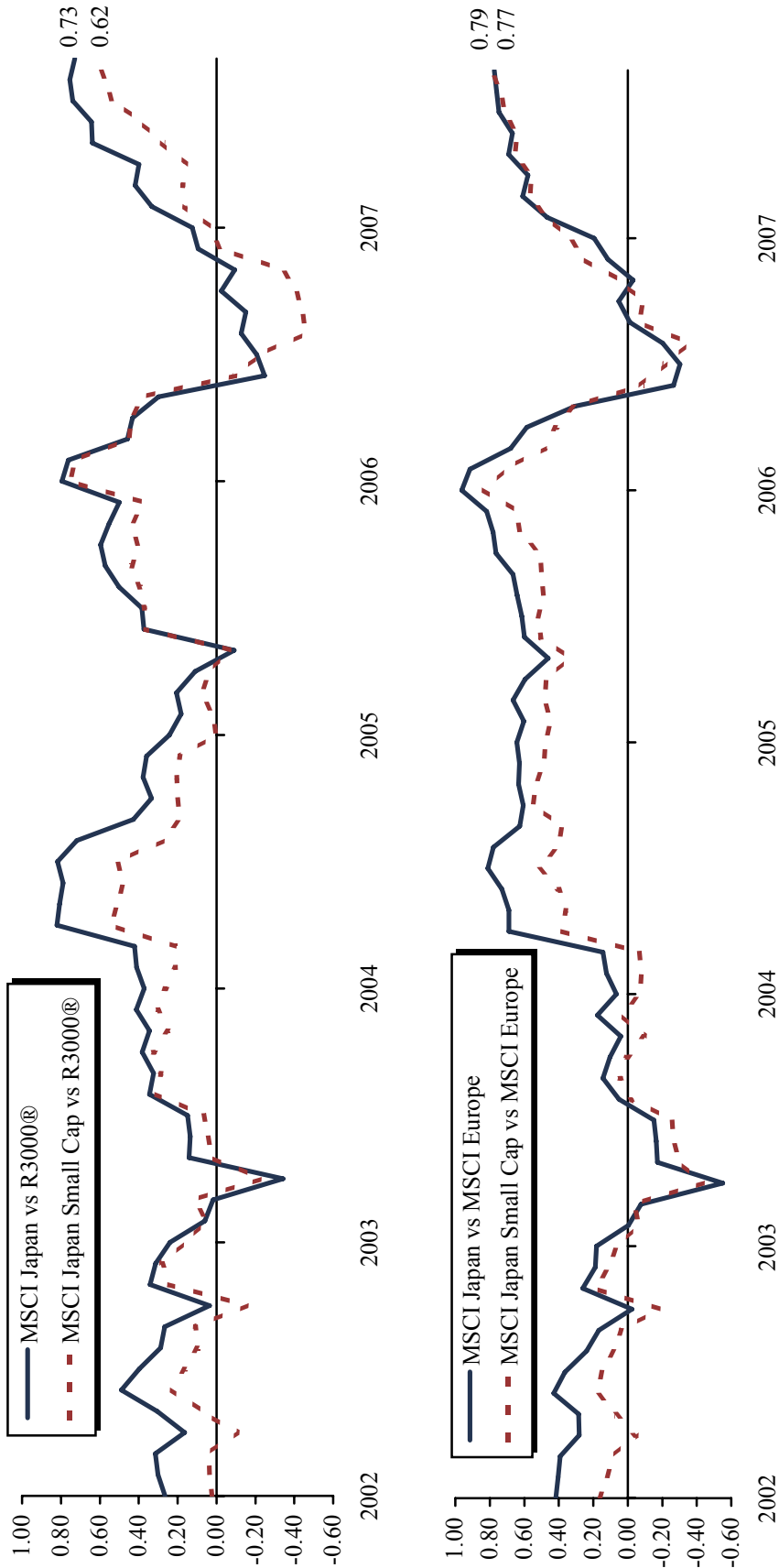


Sources: Bloomberg L.P. and Thomson Datastream.

Table E

ROLLING 12-MONTH CORRELATIONS OF THE MSCI JAPAN AND MSCI JAPAN SMALL CAP INDICES VERSUS THE RUSSELL 3000® INDEX AND THE MSCI EUROPE INDEX

December 31, 2002 – August 31, 2008



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Rolling 12-month correlations are based on total returns. Total returns for MSCI developed market indices are net of dividend taxes.