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CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENT

BULLISH ON JAPAN

May 2004

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Bullish on Japan

We have commented in the recent past on the notable improvement in Japanese economic conditions, as well as the relatively attractive multiples for which Japanese shares can be bought.[1] Recent evidence lends credence to the theory that Japan is indeed in the midst of a sustainable recovery. The 12.9% pullback in the market from April 26 to May 17, meanwhile, served to make valuations more attractive following the more than 50% run-up in Japanese shares over the last 13 months.

Perhaps the most encouraging sign to emerge from Japan's recent rally is the widespread buying by investors: of the 1,524 companies in the broad TOPIX Index for which we have returns data, a stunning 1,443 have posted a positive return for the 13-month period ended April 30. This indicates the current recovery is more broad-based than past upturns, which have been export-led and thus vulnerable to external shocks.

A further positive has been the outperformance of the banking sector. From April 2003 through April 2004, the TOPIX bank sector index soared a whopping 120.8%, more than double the 50.5% rise of the overall TOPIX. (See Table A.) This is noteworthy not only because it suggests the extremely important sector may have finally turned the corner, but also because it stands in stark contrast to the relative *under*performance of the sector during prior Japanese rallies. In the five rallies since Japan's bubble burst, the banking sector rose an average of 32.8%, but lagged the average 36.4% gain of the TOPIX over the same periods. In fact, the banking sector has lagged the overall TOPIX during the past three rallies, in retrospect perhaps an indication that all was not well despite a rising market.

Other data reinforce our basis for optimism. For example, in order to measure the performance of expensive shares relative to their cheaper peers for the 13-month period ended April 2004, we sliced the TOPIX into quartiles based on price-to-earnings (P/E) ratios, and included a fifth group of roughly equal size for companies with negative earnings. While all groups have posted strongly positive returns, the stocks with the lowest P/Es and those with negative earnings have outperformed to a considerable degree. (See Table B.) Further, this pattern has been a fairly persistent theme throughout the rally. As we have noted before, it is typical for value stocks and companies whose earnings have suffered the most during an economic downturn to perform the best in subsequent recoveries.

Investors' risk appetites, meanwhile, seem to have returned with a vengeance. The JASDAQ, for example, has outperformed the TOPIX by more than 75% over the past 13 months (see Table C), while takeover bids have soared: offers totaling ¥1.1 trillion were tendered in 2003, roughly *ten times* the ¥114 billion tendered the year before. We also uncovered an interesting shift in the rally's composition when we compared the performance of large-cap shares relative to smaller stocks. (See Table D.) While small- and large-cap shares have performed similarly for the 13 months ended April 2004, with a 55.5% gain for small caps versus a 50.0% rise for large caps, small caps have dramatically outperformed since the start of 2004. For the nine months ended December 2003, large-cap stocks returned an annualized 45.9%, versus 32.9% for small caps, while since the start of the year small caps have posted an eye-popping AACR of 98.1% versus

[1] For details, see our October 2003 Global Market Comment: *What Should We Do About the Japanese Equity Rally?*

large-cap stocks' 44.0% return. The disparity has become even more pronounced in the past two months: in March and April, small caps rose at an astonishing annual rate of 161.9%, versus the 68.7% AACR posted by large caps. Notably, this is quite different from the pattern evidenced during Japan's 1999-2000 rally, when small caps peaked a full six months (July 1999) before large caps. Whether the recent fervor for small caps marks an unhealthy speculative binge or a welcome return to risk-taking by investors—or even simply the recognition of value in beaten-down small-cap shares—is difficult to say. Nevertheless, it *may* be significant that the composition of the rally has changed so dramatically over the last few months.

Other indicators tend to support the view that this time really *is* different for Japan. Recently released first quarter GDP figures, for example, paint a picture of a recovery increasingly driven by consumers and corporate capital expenditures, rather than government spending and exports, as has been the case in the past. In other words, observers who chalk the Japanese recovery up solely to growing demand from China are, in our view, badly mistaken. Prices also seem to have stabilized, while employment is steadily increasing and corporate bankruptcies falling. (See Table E.) In addition, while bad debts remain an issue, the situation seems to be improving as banks become more open about the extent of the problem and corporations continue to deleverage. Furthermore, while valuations may look high on a stand-alone basis, it is notable that only one year ago Japanese equities had a negative P/E. (See Table F.) Corporate earnings, meanwhile, are soaring (see Table G), and considering their low starting point have much room to grow; analysts are boosting profit estimates at a furious clip.

Two obstacles to any prospective equity market rally—the liquidation of cross-share equity holdings by banks and insurers, and equity sales related to the return of government pension assets managed by corporate pension funds—appear to have been largely resolved, thus removing a significant amount of selling pressure from the market. In addition, signs of asset reflation are beginning to appear: real estate prices seem to have stabilized, while golf club membership prices, after many long years of decline, are once again on the rise. Added to all this is the Ministry of Finance's March decision to scale back its intervention in currency markets, a strong sign officials no longer believe an artificially cheap currency is necessary to support the economy.

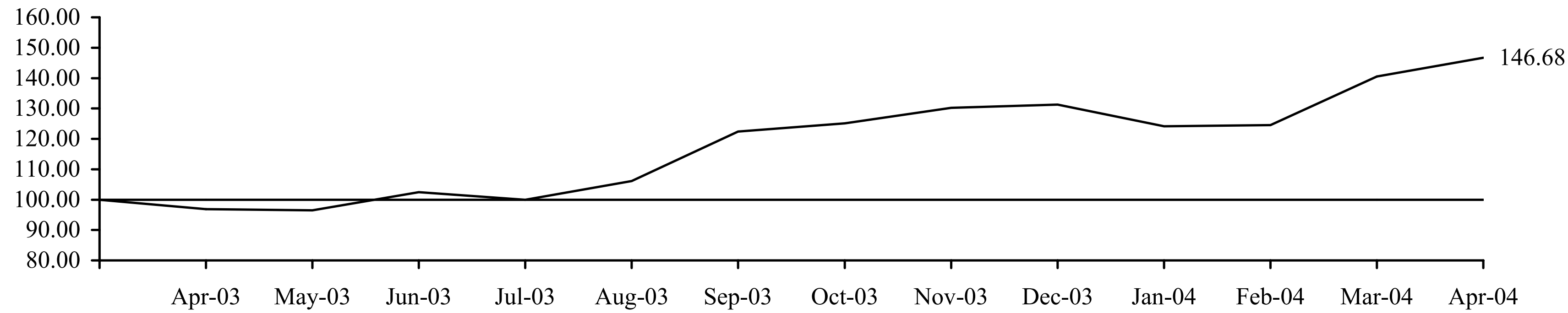
Overall, we believe recent data add to the evidence that Japan is in the process of turning the corner. While the strong performance of small caps and negative earners *could* be a sign of aggressive punting by speculators, it could also indicate a renewed appetite for risk among investors confident the economy is truly on the mend. Although valuations are less attractive than at the start of the rally, they remain relatively low compared to other global markets, and if projected earnings growth comes to pass, multiples could fall even while equities continue to rise. The sharp drop in Japanese shares since the end of April, therefore, represents an opportunity for investors to add to or establish new positions at more favorable prices. That is not to say that investing in Japan is without risk; a synchronous global downturn or a significant slowdown in China could torpedo markets, and the notoriously fickle Mr. And Mrs. Watanabe could once again decide to snap their wallets shut. But such risks, while present, seem less ominous than in the past. It is worth remembering that bull markets tend to suffer violent sell-offs early on when investors are still skeptical; it is only after many years of consistently rising prices that investors become conditioned to "buy the dips." The recent rally, furthermore, has taken place largely without the help of Japanese investors (see Table H); if and when they decide to jump back into the market, equities could post further gains.

In sum, we continue to be struck by the strength and durability of the Japanese recovery, as well as by the remarkable antipathy global investors seem to harbor toward the country. While some fund managers have stepped up Japanese equity purchases over the past few months, most investors seem convinced it is only a matter of time before the Nikkei wilts once again. Indeed, the recent drop in Japanese shares brought predictable media stories about the inevitable end to Japan's latest recovery attempt. This contrasts sharply with media coverage of the U.S. market fall, for example, which most observers felt quite sure would be short-lived and also (many claimed) presented an excellent buying opportunity. To us, Japanese equities now embody a highly attractive combination of factors; while we have up to this point suggested investors choose managers who seek to add value through bottom-up stock selection, we would now feel comfortable placing funds with managers who closely track the major Japanese indices. In short, the risk-reward equation in Japan seems quite favorable, and we believe the country currently represents an attractive investment destination for equity investors.

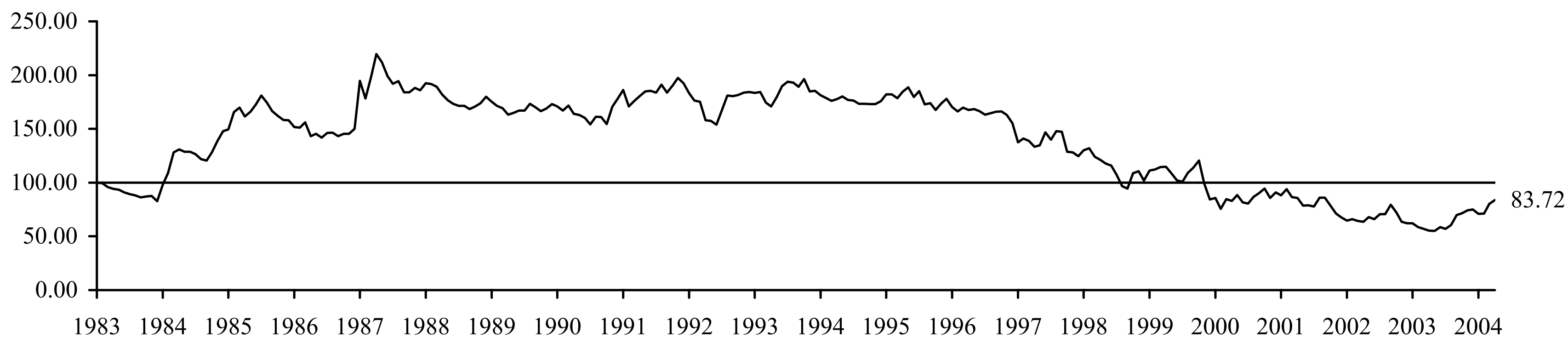
Table A

JAPANESE BANKING SECTOR RELATIVE TO THE TOKYO STOCK EXCHANGE

April 1, 2003 - April 30, 2004



February 1, 1983 - April 31, 2004

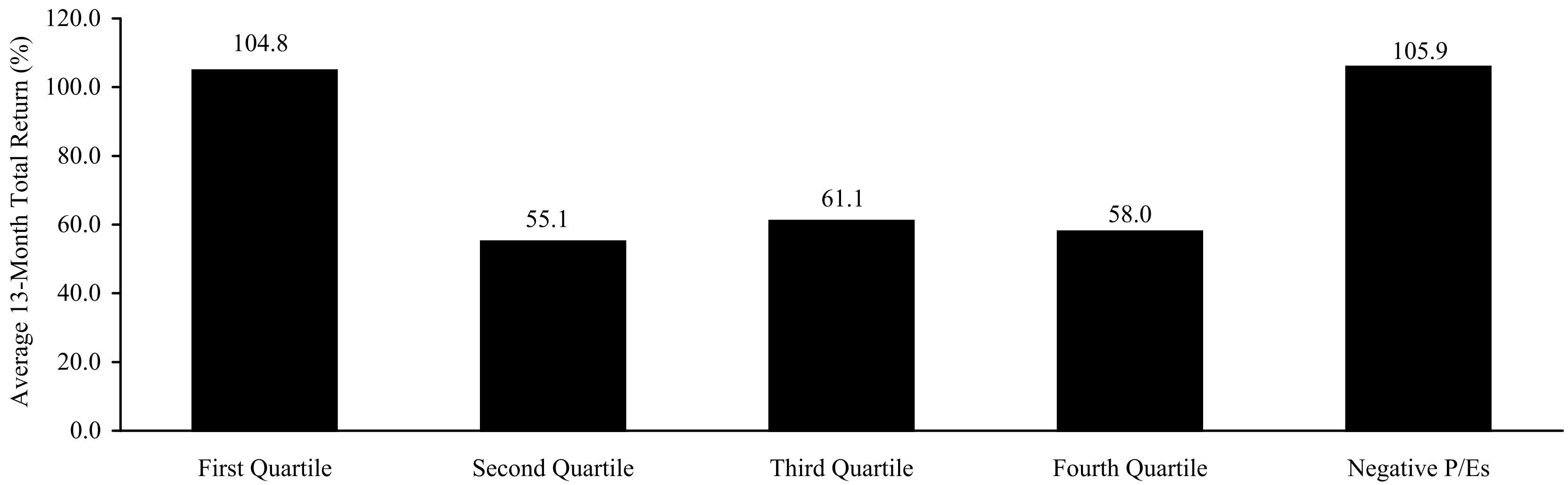


Source: Thomson Datastream.

Table B

TOKYO STOCK EXCHANGE 13-MONTH TOTAL RETURNS FOR PRICE-TO-EARNINGS QUARTILES

As of April 30, 2004



	Quartile			
March 31, 2003	1	2	3	4
Average P/E Ratio	9.4	16.8	25.2	107.2
P/E Range	0.0 - 13.7	13.7 - 20.2	20.3 - 33.0	33.1 - 1,687.5

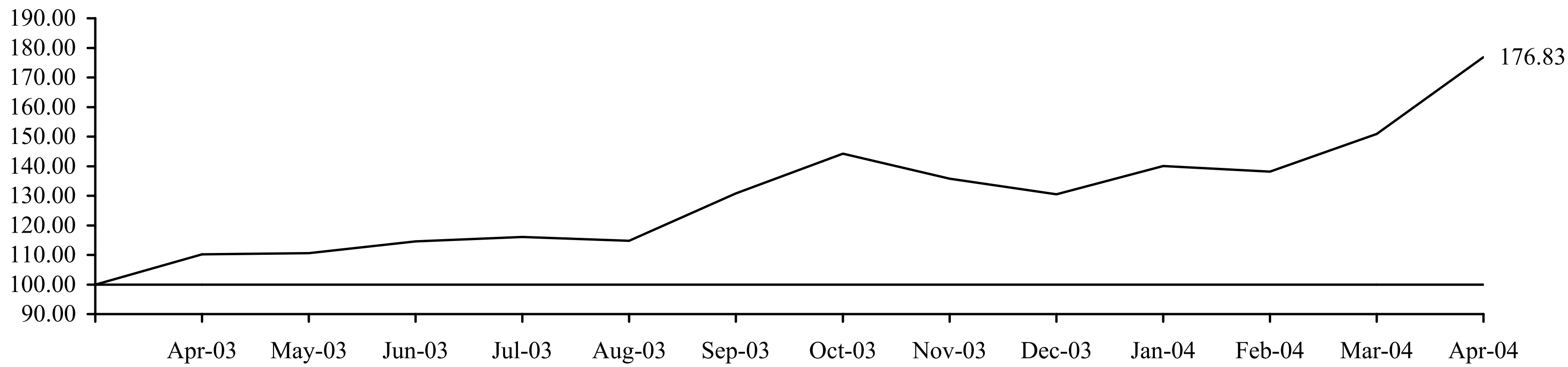
Sources: Factset and Thomson Datastream.

Notes: Twenty-four companies were excluded because they did not have P/E and/or a 13-month total return. Companies with negative P/E ratios were not taken into account to calculate the quartiles. P/E ratios are as of March 31, 2003, while Tokyo Stock Exchange Index constituents are as of March 31, 2004. Total 13-month return through April 30, 2004, for the Tokyo Stock Exchange Index is 52.0% and the average 13-month total return through April 30, 2004, for all companies is 69.7%. All data are in local currency.

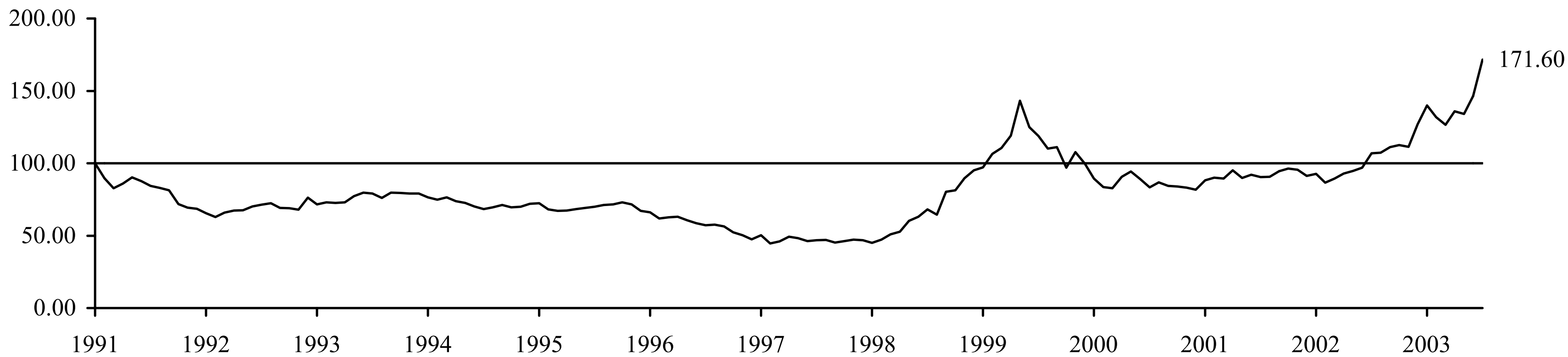
Table C

JASDAQ RELATIVE TO THE TOKYO STOCK EXCHANGE

April 1, 2003 - April 30, 2004



November 1, 1991 - April 30, 2004

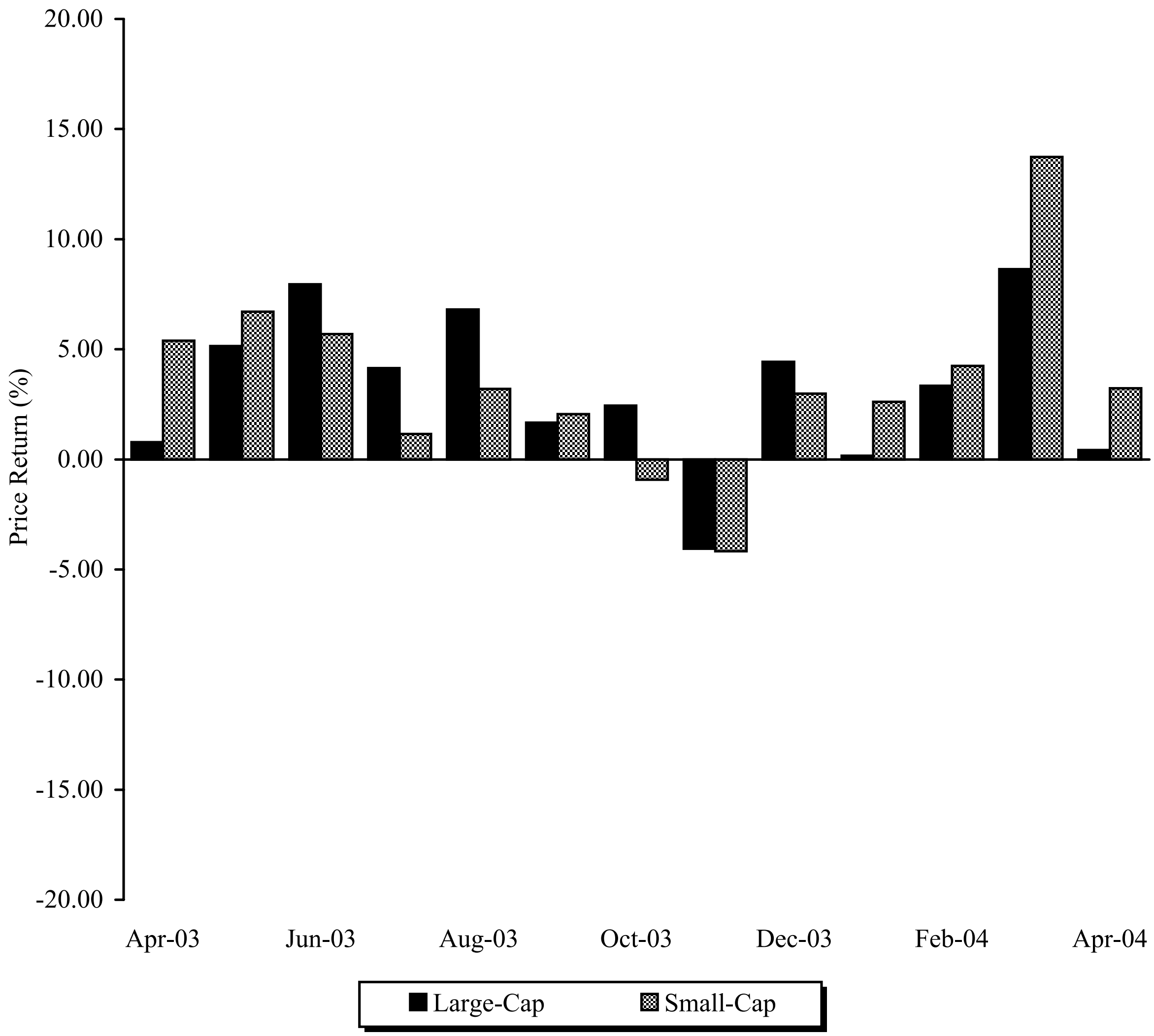


Source: Thomson Datastream.

Table D

COMPARATIVE PERFORMANCE OF LARGE- AND SMALL-CAP EQUITIES IN THE TOKYO STOCK EXCHANGE

April 1, 2003 - April 30, 2004



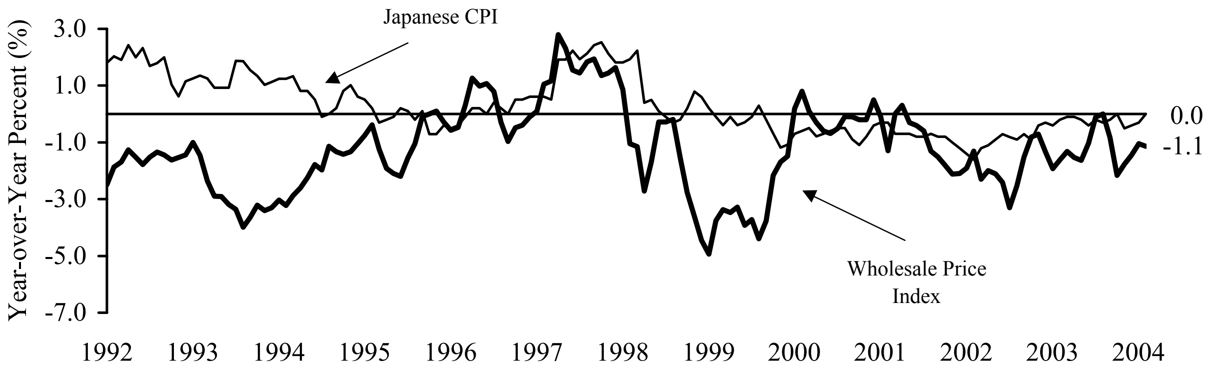
Source: Thomson Datastream.

Note: All data are in yen.

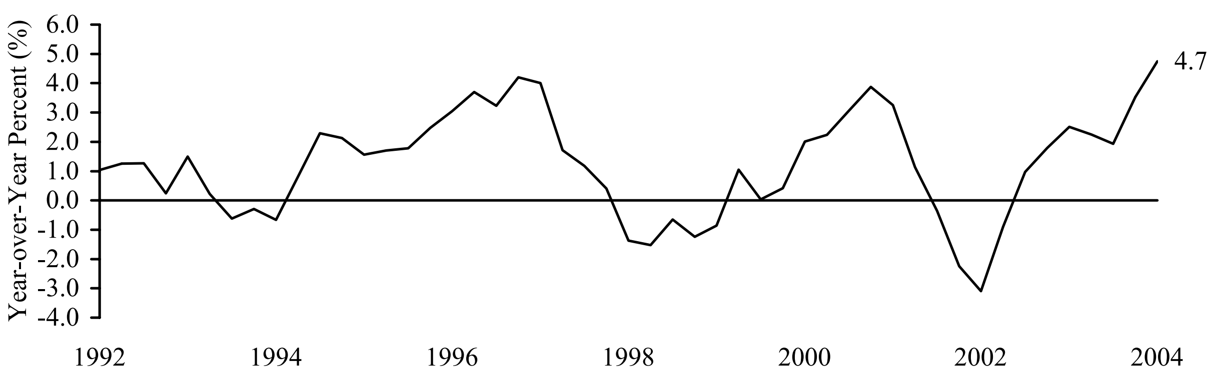
Table E

ECONOMIC INDICATORS

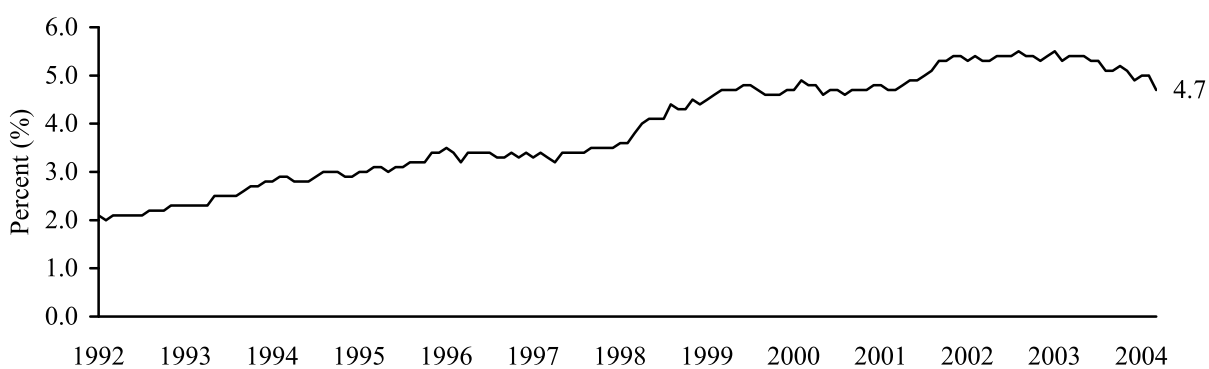
Japanese Wholesale Price Index and Japanese Consumer Price Index
1992-2004



Japanese Real Gross Domestic Product
First Quarter 1992 - First Quarter 2004



Japanese Unemployment Rate
January 31, 1992 - March 31, 2004



Source: Thomson Datastream.

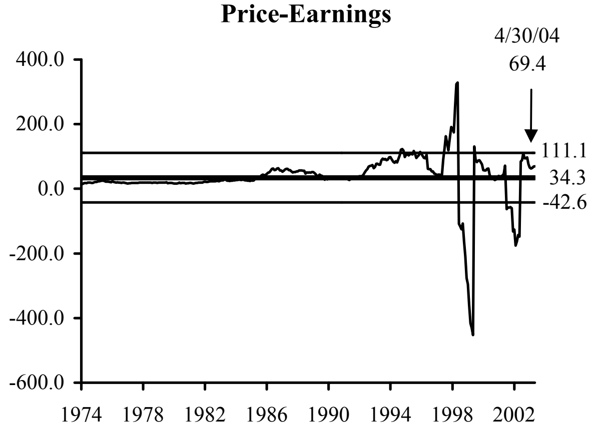
Notes: Japanese Wholesale Price Index and Japanese Consumer Price Index data are as of February 29, 2004. Japanese real GDP and unemployment data are seasonally adjusted.

Table F

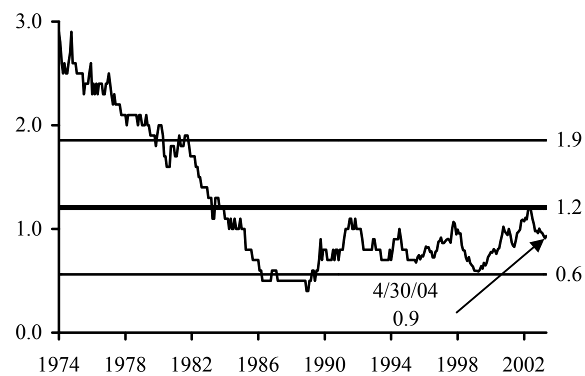
MSCI JAPAN VALUATIONS

December 31, 1974 - April 30, 2004

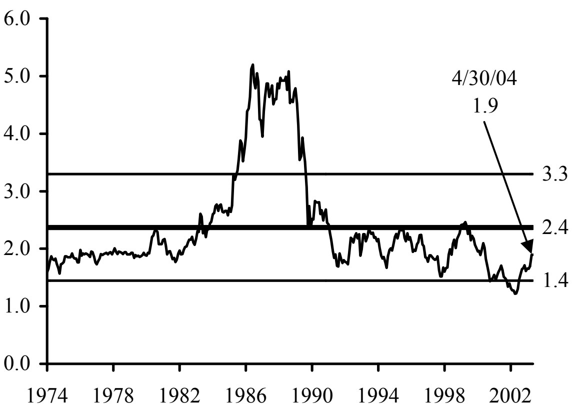
Price-Earnings



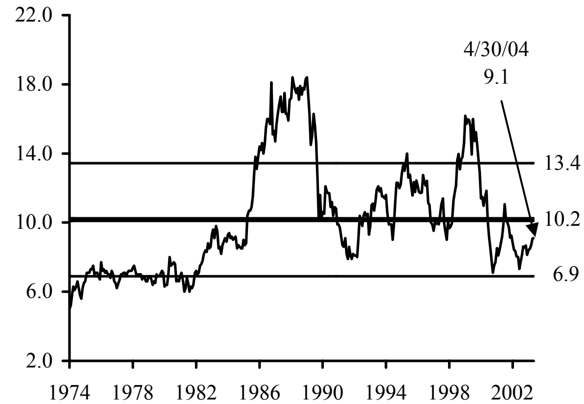
Dividend Yield (%)



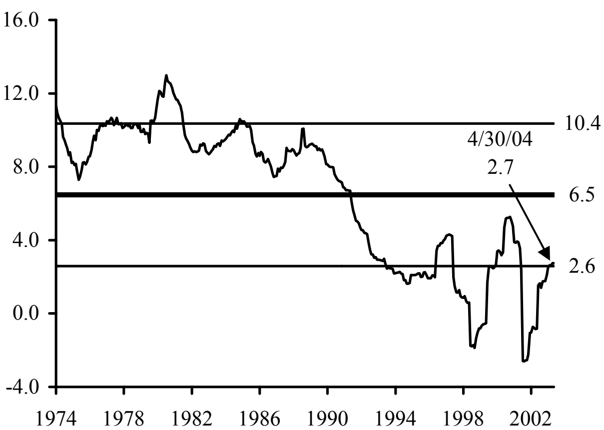
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: ROE is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio.

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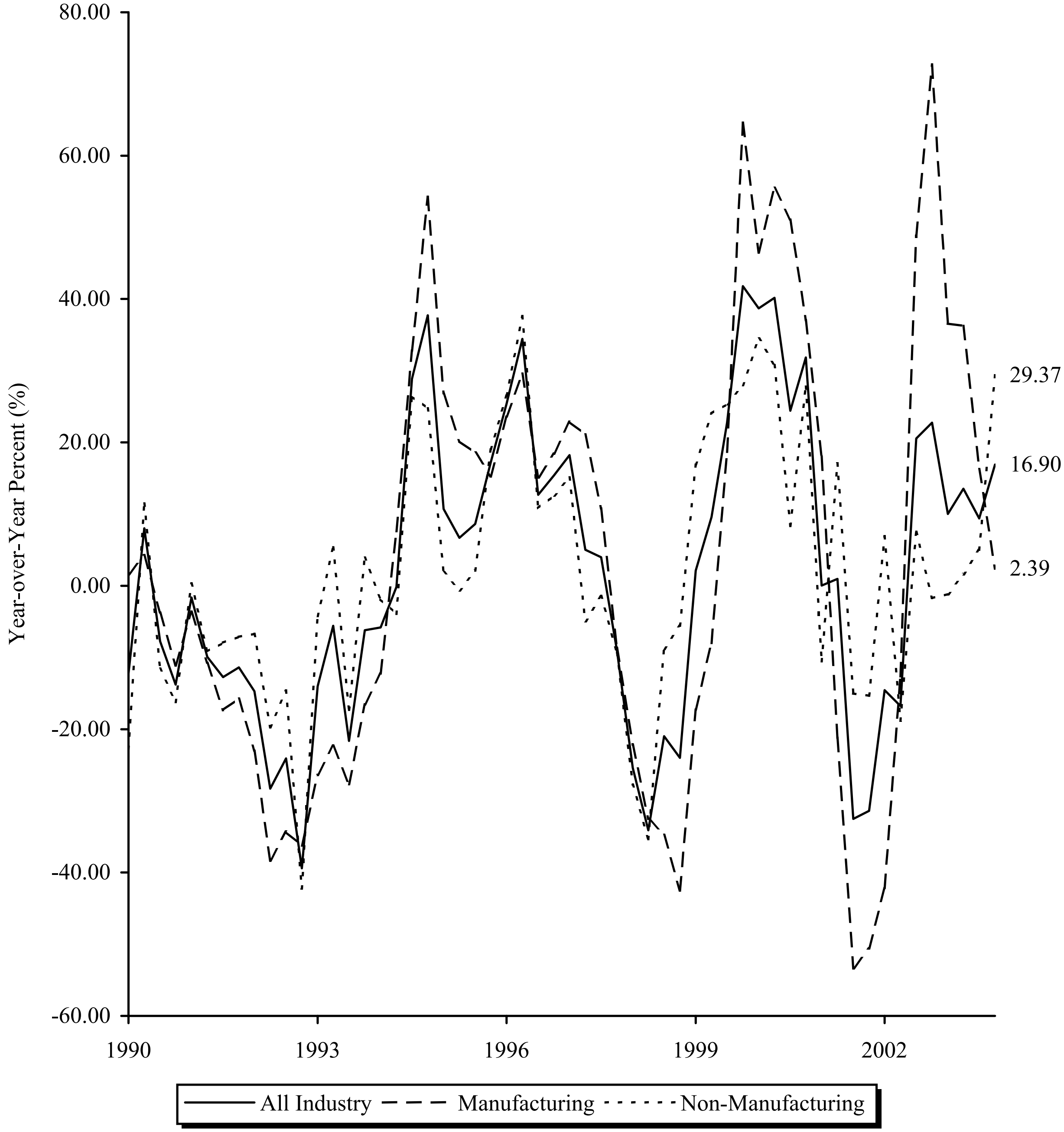
Table G

CURRENT PROFIT GROWTH OF JAPANESE CORPORATIONS

First Quarter 1990 - Fourth Quarter 2003

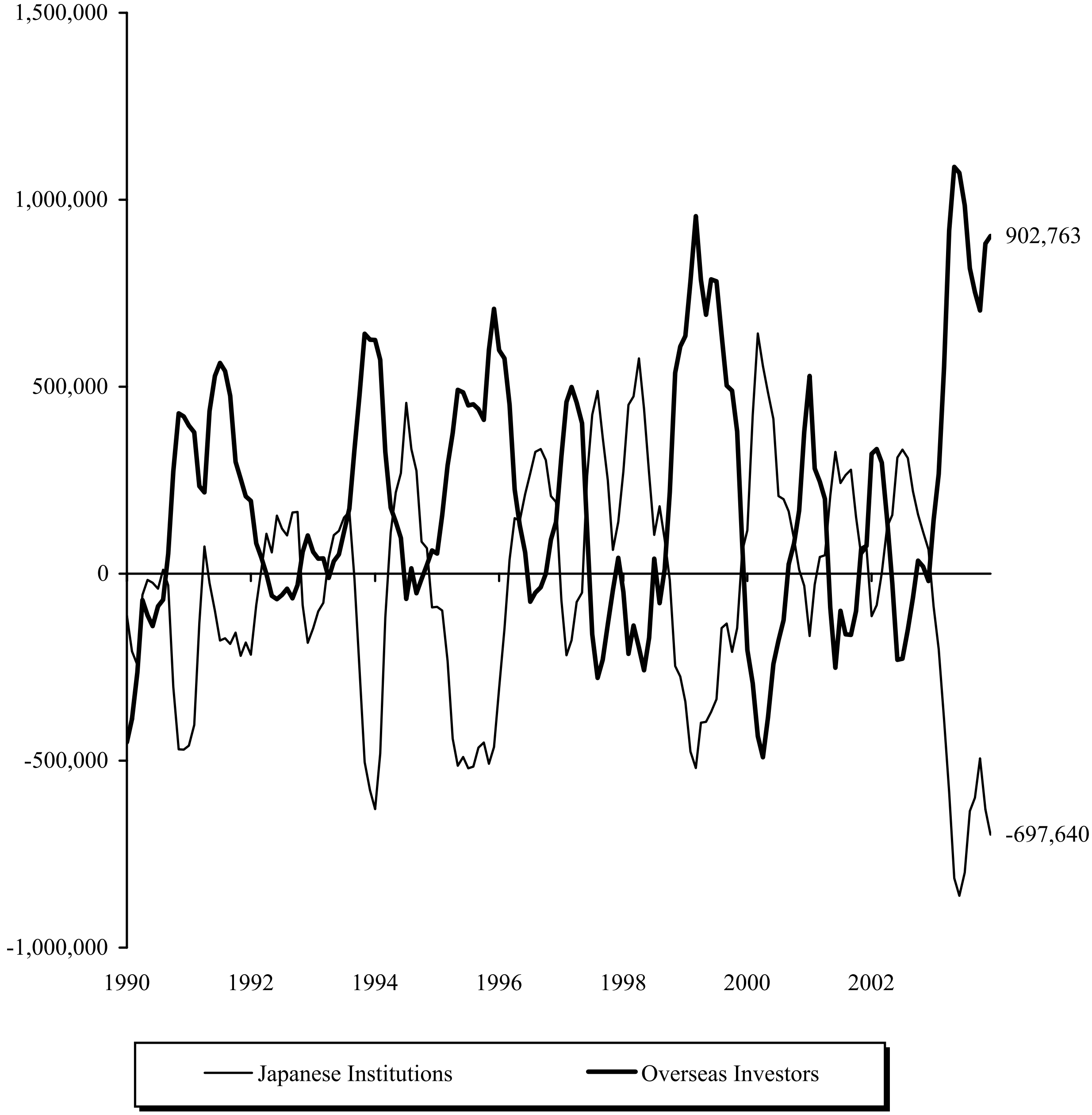


Source: Ministry of Finance Japan.

Table H

NET PURCHASES OF JAPANESE EQUITIES BY INVESTOR

1990-2004



Sources: Morgan Stanley Research and Tokyo Stock Exchange.

Notes: Data represent the sum of weekly data within each month and therefore may not correspond with calendar month-end values. Graph represents rolling five-month averages. Data for 2004 are through April 30.