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CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENT

JAPAN: STILL BULLISH

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Japan: Still Bullish

In May of this year, we wrote a paper detailing the reasons we are bullish on Japan, concluding that the risk-reward trade-off in the country's equity market is quite appealing.[1] However, in recent months some observers have postulated just the opposite: namely, that Japanese shares are overvalued and reflect too much optimism about future corporate profits. We disagree. While Japanese equities are indeed pricing in solid earnings growth, there is reason to believe such growth is achievable, particularly considering profits are coming off a low and long-stagnant base.

The most commonly cited statistic used to support the argument that Japan is overvalued is the price-earnings ratio, which presently is a lofty 27.0 based on the MSCI Japan Index. Even excluding the troubled financial sector, the P/E ratio remains high at 23.5. These statistics give us great pause, as P/E ratios of this magnitude would normally suggest the market is overvalued. However, it cannot be ignored that many companies have low or negative earnings, setting the stage for a significant earnings rebound should corporations continue their path of recovery. Indeed, profit growth of Japanese corporations has recently been quite high (see Table A), while according to Puglisi & Co., analysts expect Japanese profits to rise more than 30% over the next 12 months. While this is certainly a high growth rate by historical standards, it is reasonable if Japan is on a path to a secular bull market, as we believe. Consider the case of the United States in the mid-1980s, for example, when corporate restructuring finally began to pay dividends. U.S. corporate profits (as measured by the S&P 500), which had barely budged from 1979 to 1986, suddenly surged 75% in two years. While we are not suggesting Japan today is all that analogous to the United States in the mid-1980s, the two periods *are* similar in that profits have been stagnant for a long time, while companies finally seem to be shaking off a lengthy malaise and beginning to grow more competitive. Indeed, Japanese earnings are still well below the record levels achieved in 1991, while corporate ROE appears to be on the rise (see Table B).

While we cannot pinpoint the timing of an earnings recovery in Japan, the pieces are in place to allow for such an event. Corporate restructuring and deleveraging continue apace, while selling related to unwinding of cross-shareholdings appears to be largely finished. The problematic banking sector, meanwhile, continues to show nascent signs of life. Indeed, the recent proposal of a bank merger was met not with the usual stonewalling, but rather with another institution stepping up to place its own bid. While hardly rivaling the U.S. LBO craze in the late 1980s, the proposed merger is simply another anecdotal sign the beleaguered Japanese banking sector may finally be on the mend, which would be enormously positive for the economy as a whole.

Other corporate data also show signs of improvement: free cash flow and net profit margins are at record levels, while leverage continues to decline and sales growth has turned positive. Indeed, Japan's debt/equity ratio in fiscal 2003 fell below 1.0 for the first time *ever.* In addition, some observers have speculated the rapid improvement in Japanese corporate finances will increase pressure on managements to return capital to shareholders either through enhanced dividends or share buybacks, although investors

[1] For more details, see our May 2004 Global Market Comment: *Bullish on Japan.*

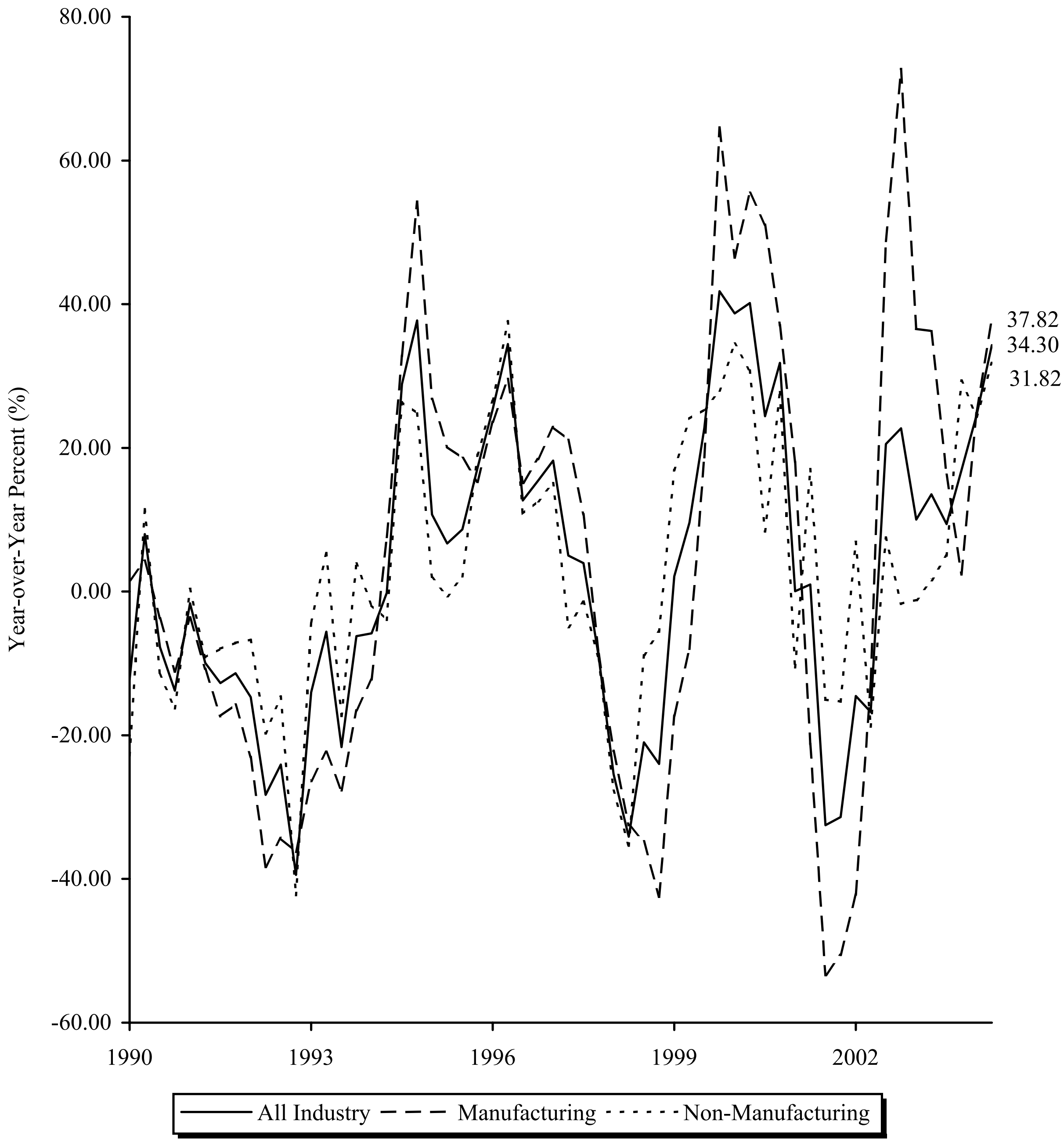
should bear in mind that a short- to medium-term boost in profits will not necessarily lead to increased payout levels.

In aggregate, we continue to believe the outlook for Japanese corporations is more positive than the market reflects. While profits have shown strong growth lately, they remain at depressed levels and should have room for further expansion. Declining leverage, meanwhile, opens the door for firms to grow more aggressively, while cash building on balance sheets will eventually need to go somewhere. Finally, while we believe Japanese equities are attractively valued on their own merits, they are even more so when compared to other developed markets. Consider: on a price-to-cash earnings basis, U.S. nonfinancial equities sell at roughly a 70% premium to their Japanese counterparts, despite the fact that operating ROEs are quite similar. Not only is this gap unlikely to persist indefinitely, but it also indicates that investors continue to hold a relatively low opinion of Japanese equities. We remain bullish on Japan.

Table A

CURRENT PROFIT GROWTH OF JAPANESE CORPORATIONS

First Quarter 1990 - Second Quarter 2004

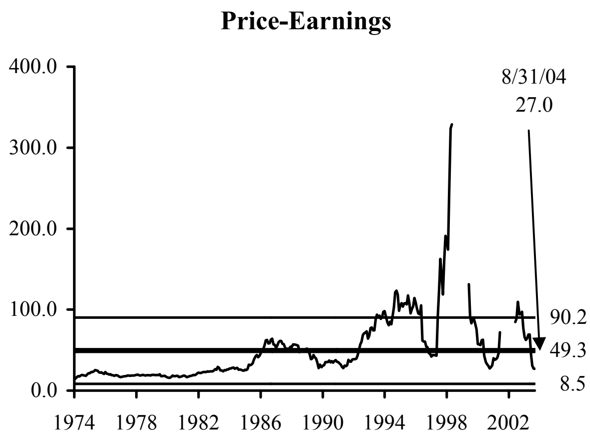


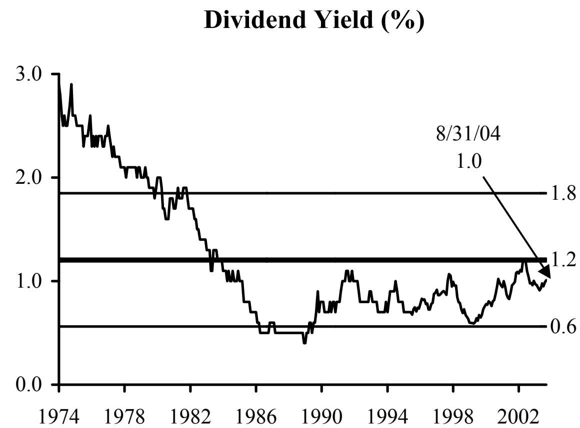
Source: Ministry of Finance Japan.

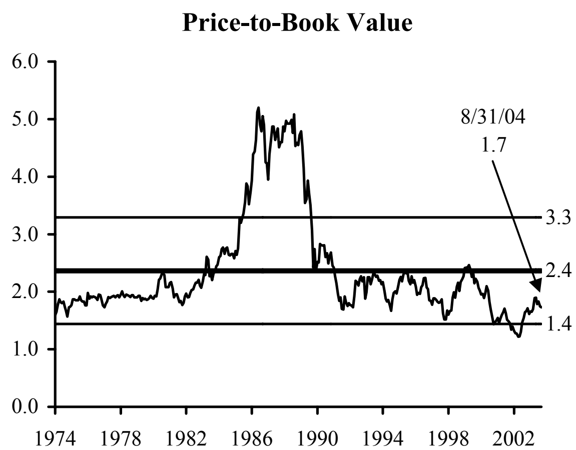
Table B

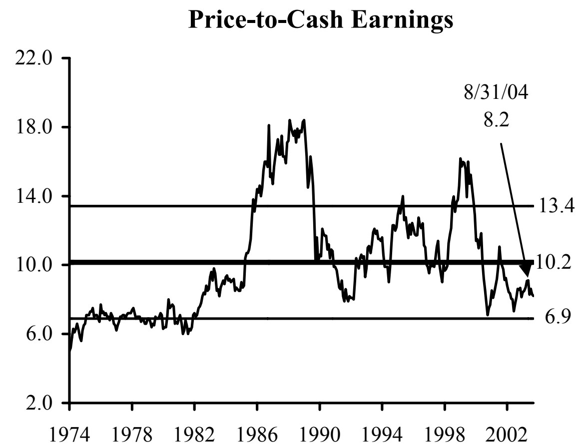
MSCI JAPAN VALUATIONS

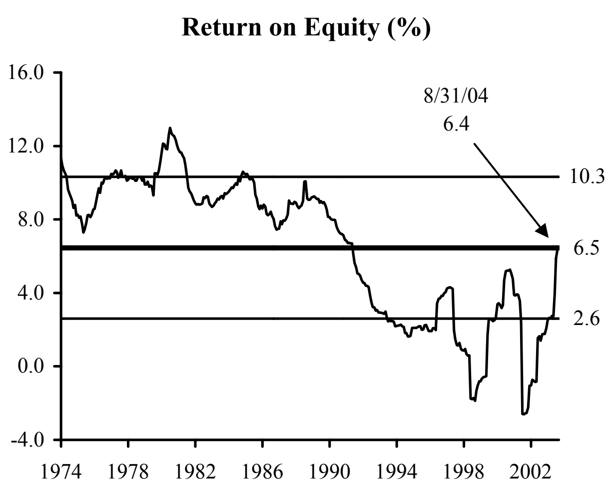
December 31, 1974 - August 31, 2004











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. Gaps in the P/E graph represent periods for which negative P/Es have been removed.

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