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CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENT

JAPAN: STILL TIME TO GET IN?

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Japan: Still Time to Get In?

"The only reason to invest in the market is because you think you know something others don't." – R. Foster Winans

When we first turned bullish on Japan back in May 2004, it was a relatively contrarian call.[1] Since that time, however, the story has become much more mainstream, as equity prices have risen sharply and most economic data, while still somewhat sluggish, have turned positive. Indeed, the *Economist*, the *Financial Times*, *The Wall Street Journal*, and *Barron's* have all recently published largely positive pieces on Japan and its prospects for recovery. Despite the strong price appreciation and broadening investor bullishness, our conclusion remains the same: we still believe Japan represents value not only on an absolute basis, but also relative to other developed markets. Even though equity prices are significantly higher than they were 18 months ago, corporate earnings have risen even faster, while the economy appears to be on a somewhat more secure footing. Further, much of the heavy lifting necessary to facilitate a continued rise in corporate earnings—paying down debt and the selling of cross-shareholdings, to name two prominent examples—has already been completed, laying the groundwork for what we expect to be a multi-year secular upturn for Japanese shares. The fact that others are waking up to the Japan story does not negate it; at worst, it may indicate that some of the low-hanging fruit has already been picked. In sum, the underlying assumptions that caused us to turn bullish in the first place are still intact, and we therefore remain bullish on Japan.

Reasons for Optimism

In our May 2004 report, we cited the outperformance of bank shares, value stocks, and companies with negative earnings as reasons for optimism. Outperformance of the banking sector, which had been a notable laggard in previous "recoveries," is a critically important sign that the recovery has staying power. Moreover, value stocks and companies with negative earnings are expected to outperform during an economic recovery. These trends remain intact (Tables A and B).

Corporate earnings news has also been positive, while some economic conditions have improved. Indeed, while corporate revenues remain about 5% below their 1997 peak, revenues of large corporations are rising at their fastest clip since the early 1990s, and the ratio of profits to sales is at its highest level *ever*. Consumption and capital investment also appear stronger than they have in quite some time: both weathered small dips last year and quickly bounced back into positive territory. Even land prices, which have been in continuous decline for nearly 15 years, have recently shown signs of revival.

However, the Japanese economy has *not,* as of yet, shown conclusive evidence of a secular upturn; all it has shown is a bounce off a very low bottom that may or may not be the beginning of something significant. As Japan bears point out, the overall Japanese economy remains sluggish, with much of recent

[1] Please see our May 2004 Global Market Comment: *Bullish on Japan,* as well as our September 2004 Global Market Comment: *Japan: Still Bullish.*

growth financed by a drawdown in the saving rate, which has roughly halved (to 7.2%) since the early 1990s. Further, the country's poor demographics, high concentration of manufacturing businesses, and huge public sector debt overhang are significant headwinds to overcome. However, such issues are widely known, and therefore likely discounted in share prices; indeed, if any of these are less problematic than feared (if, for example, the country continues to allow more foreign nationals to stay and work on a permanent basis, as it has recently begun to do), share prices could benefit.

Which Recovery Do You Mean?

As Bridgewater Associates eloquently pointed out in a recent piece, the improvement in Japanese corporate fundamentals has come about not because of a general improvement in the economy, but rather *in spite of the lack of one.* More specifically, corporate earnings are at record highs because companies have expanded their margins by reducing operating costs and using excess cash flow to pay down debt, even as sales, despite their recent uptick, remain below late 1990s levels (Table C). This expansion, moreover, has come in both the manufacturing (which is export focused) and non-manufacturing (mostly domestic) sectors, which should quell fears that the recent improvement is entirely due to rising exports to China and the United States (Table D). Put simply, corporate Japan is in excellent position to participate in an economic recovery, and less vulnerable to a downturn than in the recent past. Combined with the low base from which earnings are rising, this could make for a potent combination *if* the recovery continues. If not, the substantial restructuring undergone by corporate Japan should serve to limit the downside.

The bears also point out that the recent move in equity markets has been entirely driven by non-Japan investors; domestic institutions have been net sellers since mid-2003. This is not *necessarily* a bad omen, however. While it could be argued Japanese investors "know" something that is keeping them from buying shares, it could also be the case that it is difficult to be a dispassionate observer of one's own equity markets, and thus the non-participation by Japanese investors may signal nothing more than an extreme case of caution that has evolved through the bitter experience of the past decade-and-a-half. To wit, non-Japan investors realized Japanese equities were in a bubble in the late 1980s, far before domestic investors got the message. Indeed, it could be argued that the non-participation by Japanese institutions should not be viewed as a negative, but rather that it represents pent-up demand that will eventually come into the market. Life insurers, for example, had only 8.6% of their ¥187.6 trillion (US$1.7 trillion) in assets invested in domestic equities as of June 30, compared to 22% in 1990. Clearly, even a small shift toward equities could put significant upward pressure on the market.

We would also note that, even after recent purchases, global ex U.S. developed equity managers remain underweight Japan. According to Cambridge Associates data, such managers held 19.1% of assets in Japanese equities as of June 30 (the most recent available), compared to Japan's 21.8% weight in EAFE.

The Winds of Change

Finally, a few words about the recent election landslide for Prime Minister Junichiro Koizumi and his party are in order. While we do *not* believe this will result in an immediate overhaul of the country's dysfunctional giant postal system—considering how deeply ingrained the institution is in Japanese society, reform will likely be quite gradual—we do believe it represents something of a watershed moment for Japan. In short, the election not only presents a clear mandate for change, a glaring missing ingredient in prior Japanese "recoveries," but also signals that Japanese citizens are finally recognizing the need for reform. This recognition has also showed up in other areas, such as the country's grudging acceptance that its long-standing policy of "lifetime employment" was ill-suited to today's global economy. In true Japanese fashion, this recognition has not resulted in any sort of quick fix—i.e., mass layoffs or wage cuts—but rather in a gradual change in the composition of workers. In 1990, for example, "non-regular" workers, a category made up of part-timers and others on temporary contracts (and thus cheaper than regular workers), made up 18.8% of the labor force; today the figure is 30%. As a result, personnel costs have dropped sharply as a percentage of corporate profits and sales, and are at their lowest level *ever* as a percentage of selling and general administrative expenses.

Valuations

We consider Japanese equities to be fairly valued. While price-to-earnings (P/E) multiples remain high relative to those of other developed markets (the current P/E is 22), they have come down significantly in recent years due to sharply rising earnings (Table E). High P/E multiples may still represent fair value, however, given the low level of earnings and potential for strong growth. Indeed, despite their recent rise, profits have essentially gone nowhere over the past 15 years. Since peaking at the end of 1989, real Japanese corporate profits rose only 20.5% through June (in nominal terms, earnings rose 30.7%); over the same period, U.S. real corporate earnings rose 79.4% (176.7% in nominal terms). Thus, particularly in light of the corporate restructuring discussed above, it is certainly conceivable that Japanese corporations will continue to grow profits at a rapid rate. We would also note that just as secular bear markets tend to take equities down to very undervalued levels before hitting bottom, secular bulls typically drive stocks significantly above fair value before peaking. Therefore, it is possible Japanese P/Es could remain high through a period of rapid price appreciation.

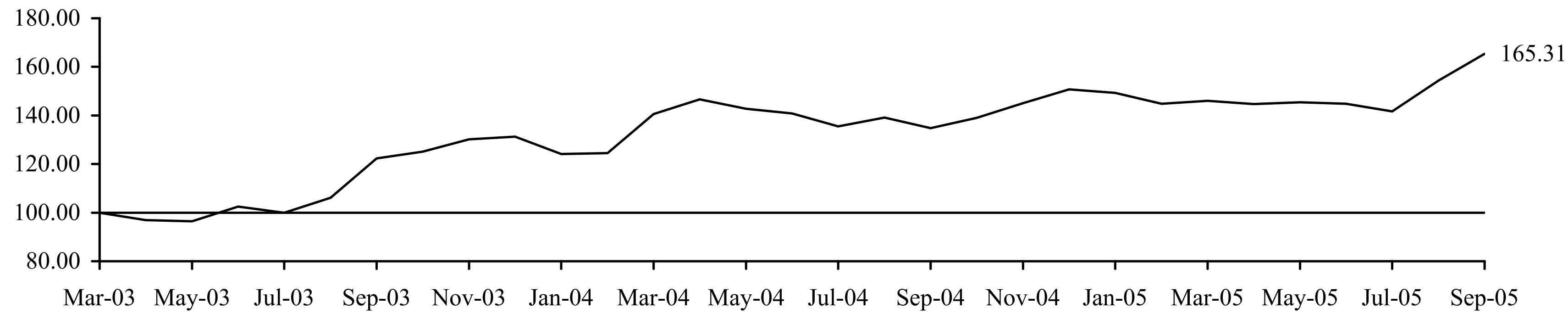
Other valuation measures appear to be in line with global norms. Price-to-book and price-to-cash earnings ratios, for example, are not only lower than their historical averages, but also lower in Japan than in the United States or EAFE ex Japan. While dividend yields remain low, this is hardly a surprise in a country where long-term government bond yields are well below 2%; continued rising profits, meanwhile, could well spur companies to return more money to shareholders. In short, most valuation measures outside of P/Es point to a market that is on the cheap side of fairly valued, while P/Es themselves are more reasonable than they have been in decades. We would also note that while small caps have outperformed over much of the rally (Table F), it is arguably the case that small caps were undervalued relative to large caps prior to their recent run (Table G), and that this has simply represented a case of reversion to the mean. Thus, we are agnostic on the *relative* prospects for small- and large-cap equities going forward.

In sum, we continue to believe Japan is in the early stages of a long-term secular upturn. While risks remain, this recovery looks increasingly real, and the outlook for corporations is far more promising than at any time since the bubble burst. Put simply, we are still bullish.

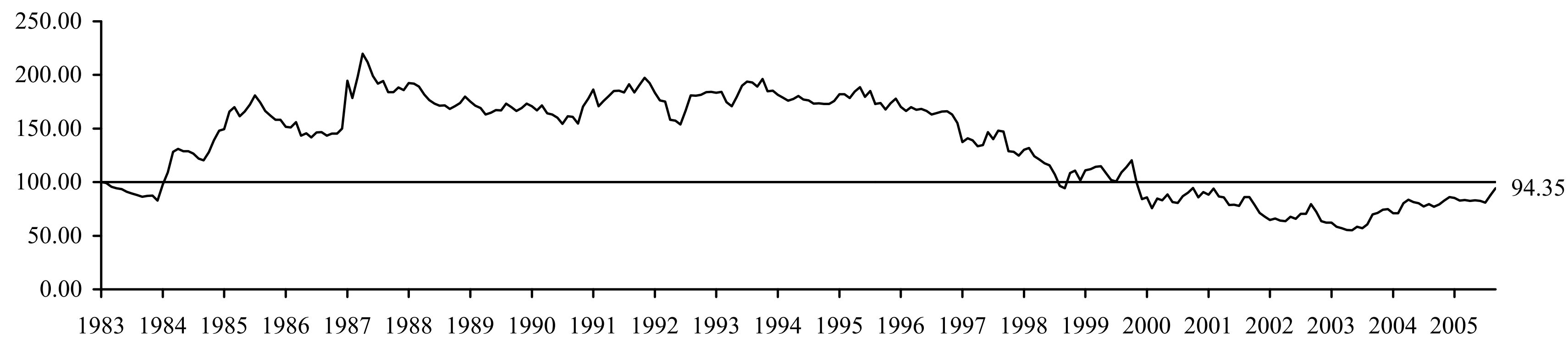
Table A

JAPANESE BANKING SECTOR RELATIVE TO THE TOKYO STOCK EXCHANGE

April 1, 2003 - September 30, 2005



February 1, 1983 - September 30, 2005

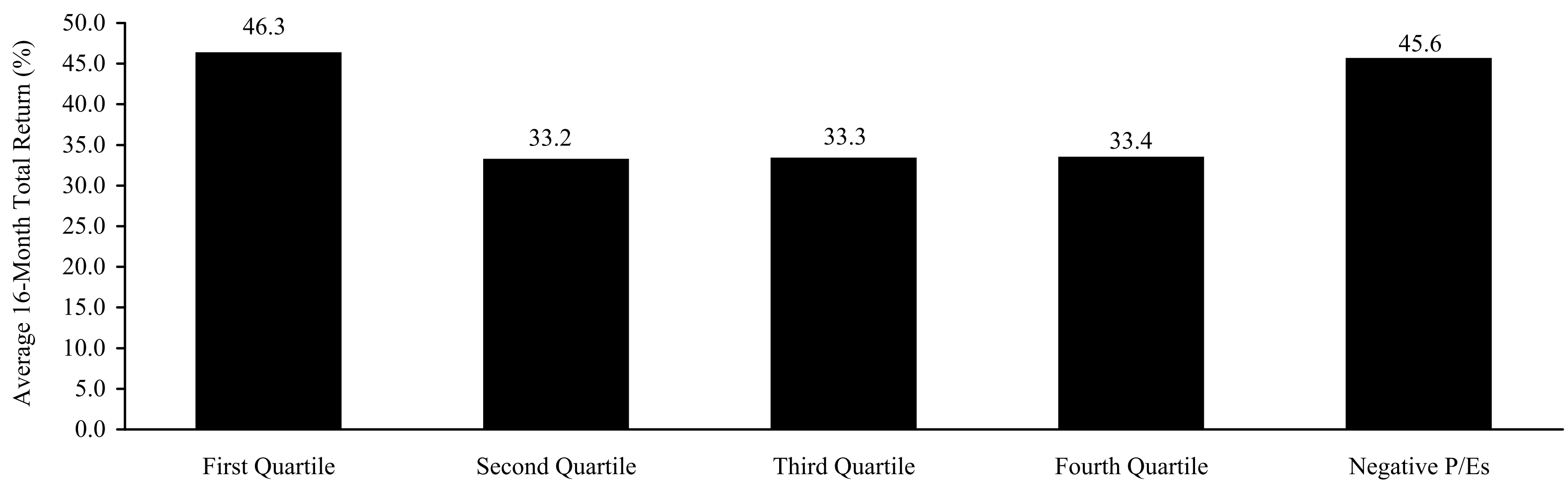


Source: Thomson Datastream.

Table B

TOKYO STOCK EXCHANGE 16-MONTH TOTAL RETURNS FOR PRICE-TO-EARNINGS QUARTILES

As of September 30, 2005



	Quartile			
September 30, 2004	1	2	3	4
Average P/E Ratio	11.8	18.5	25.0	72.7
P/E Range	0.1 - 15.6	15.6 - 21.4	21.4 - 30.1	30.2 - 744.4

Sources: Factset and Thomson Datastream.

Notes: Thirty-two companies were excluded because they did not have P/E and/or a 16-month total return. Companies with negative P/E ratios were not taken into account to calculate the quartiles. P/E ratios are as of September 30, 2004, while Tokyo Stock Exchange Index constituents are as of September 30, 2005. Total 16-month return through September 30, 2005, for the Tokyo Stock Exchange Index is 26.0% while the average 16-month total return through September 30, 2005, for all companies is 36.5%. All data are in local currency.

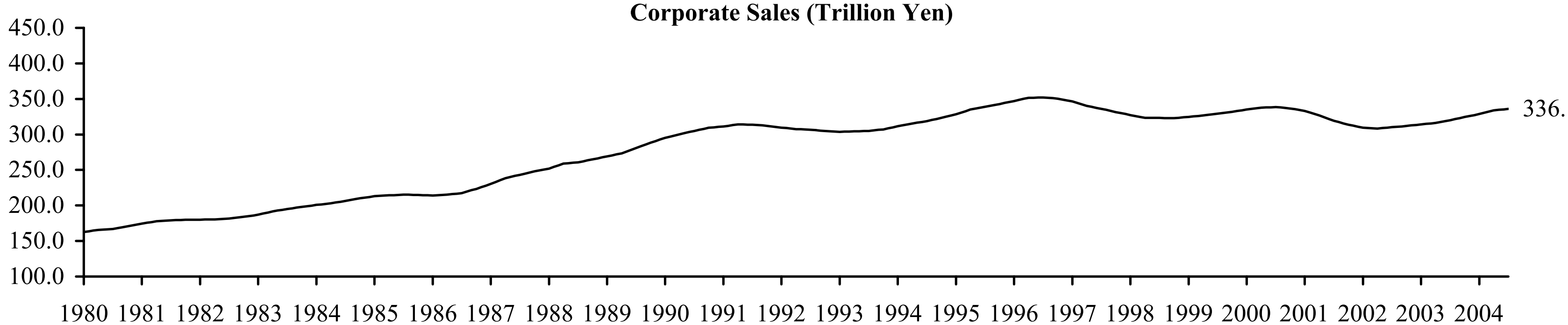
Table C

SALES AND EARNINGS OF JAPANESE CORPORATIONS

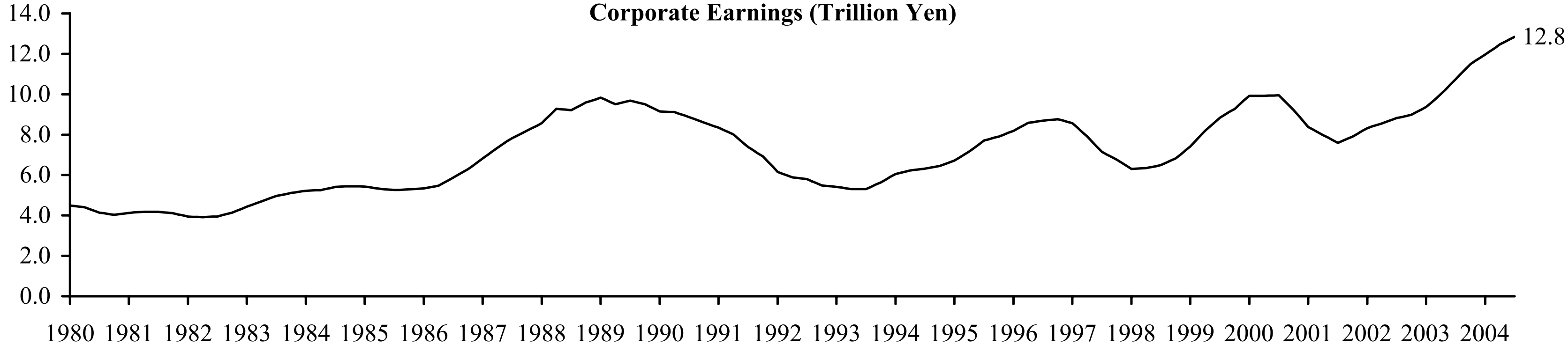
December 31, 1980 - June 30, 2005

12-Month Moving Averages

Corporate Sales (Trillion Yen)



Corporate Earnings (Trillion Yen)



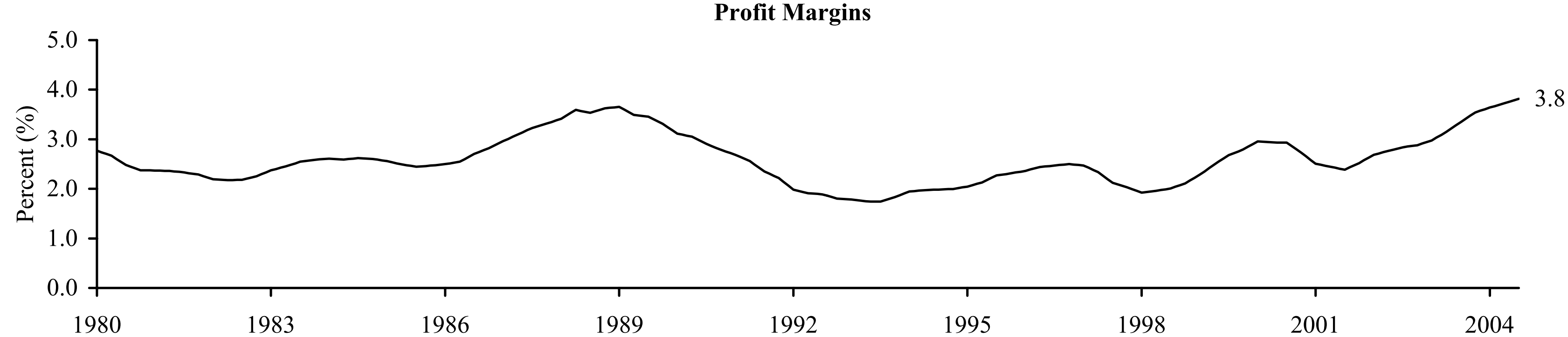
Source: Bridgewater Associates, Inc.

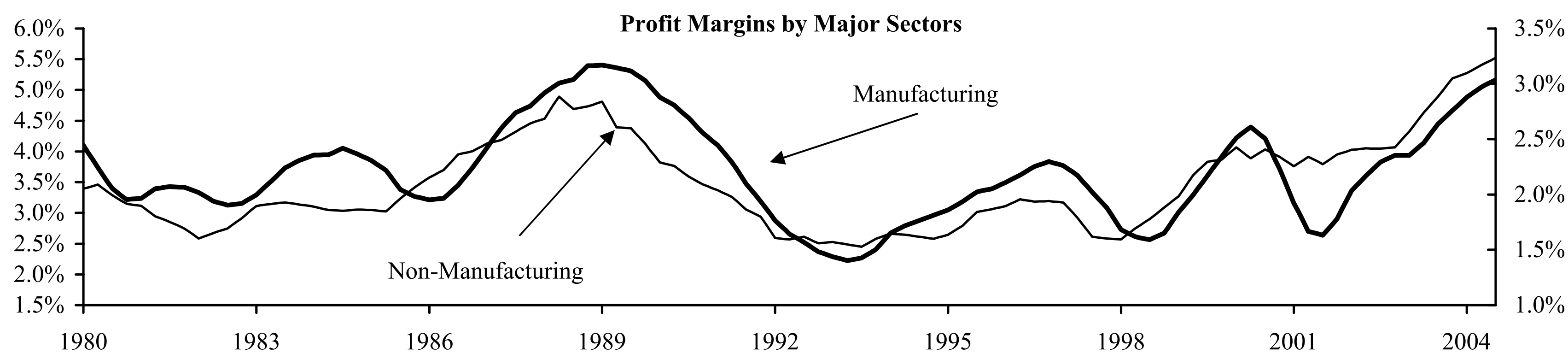
Table D

JAPANESE CORPORATE PROFIT MARGINS

December 31, 1980 - June 30, 2005

12-Month Moving Averages





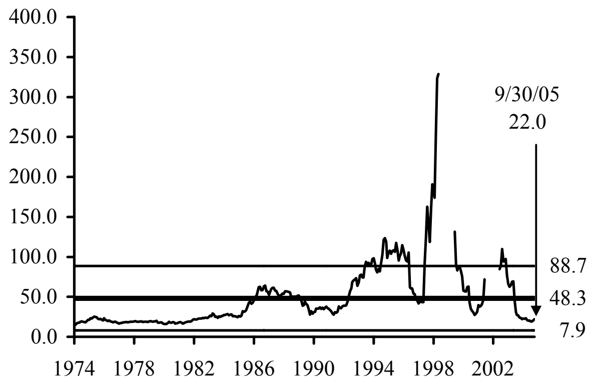
Source: Bridgewater Associates, Inc.

Table E

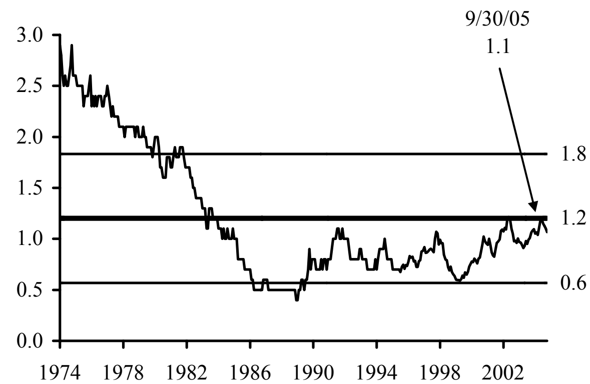
MSCI JAPAN VALUATIONS

December 31, 1974 - September 30, 2005

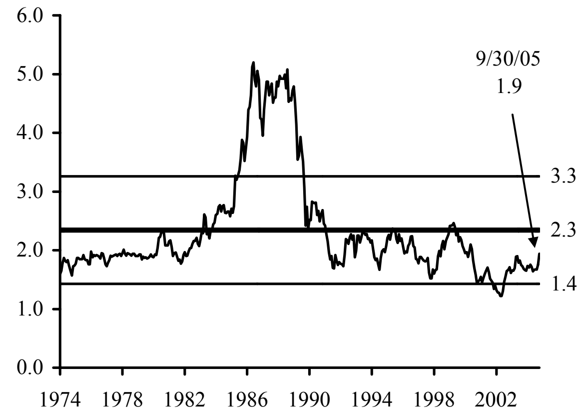
Price-Earnings



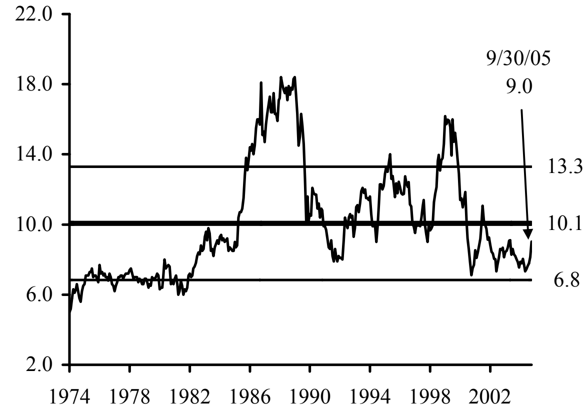
Dividend Yield (%)



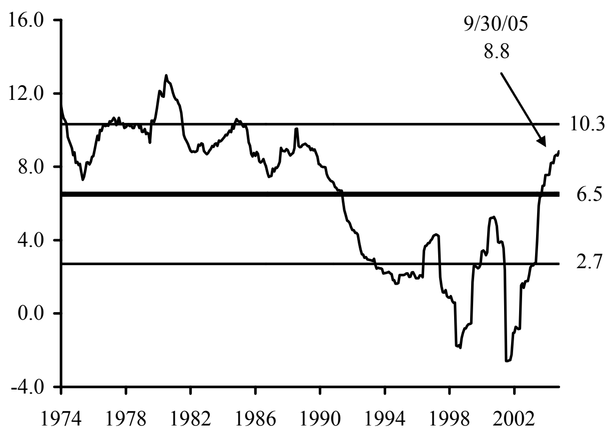
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)



Mean
One Standard Deviation

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 P/B ratio. Earnings per share is calculated by dividing the price index by its P/E ratio. Gaps in the P/E graph represent periods for which negative P/Es have been removed.

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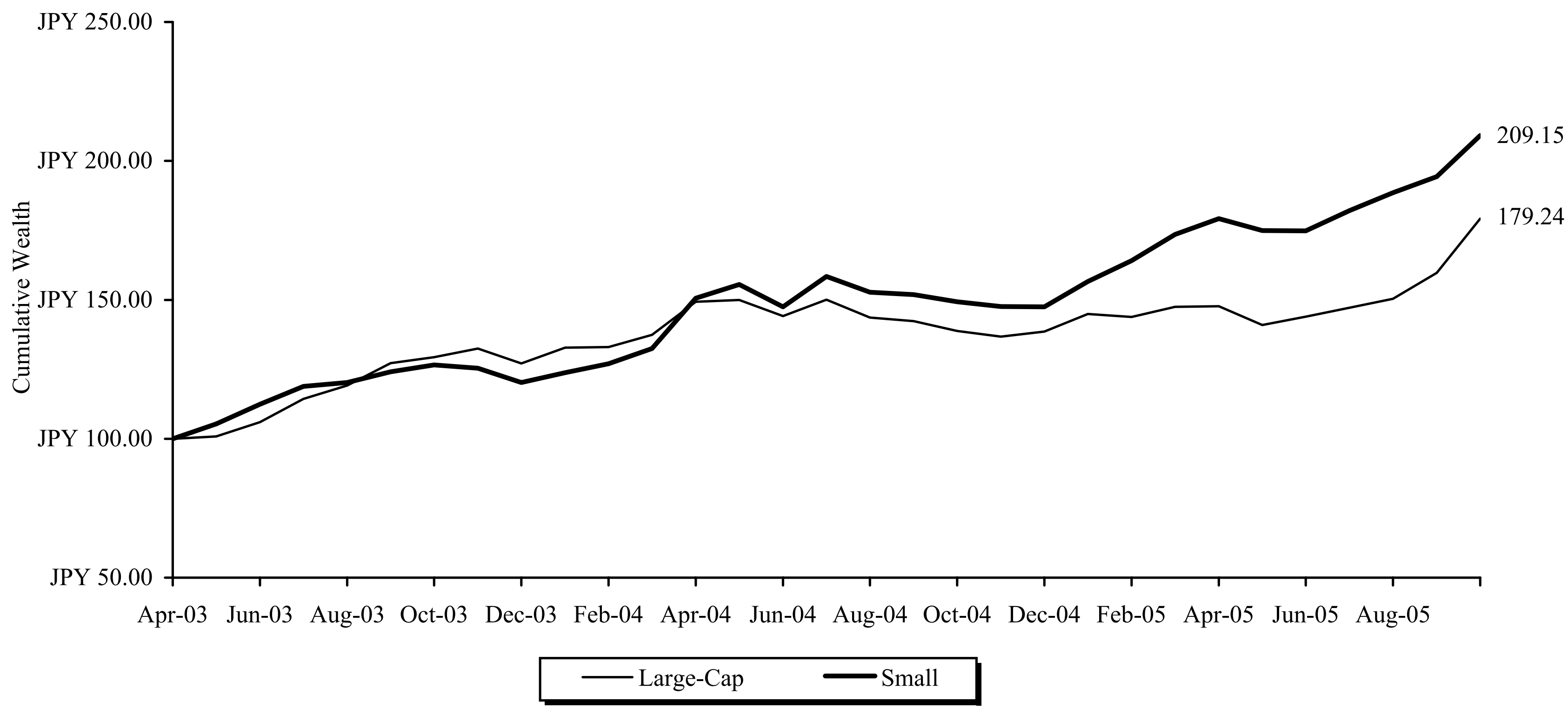
Table F

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

April 1, 2003 - September 30, 2005

Cumulative Wealth
(March 31, 2003 = ¥100)



Source: Thomson Datastream.

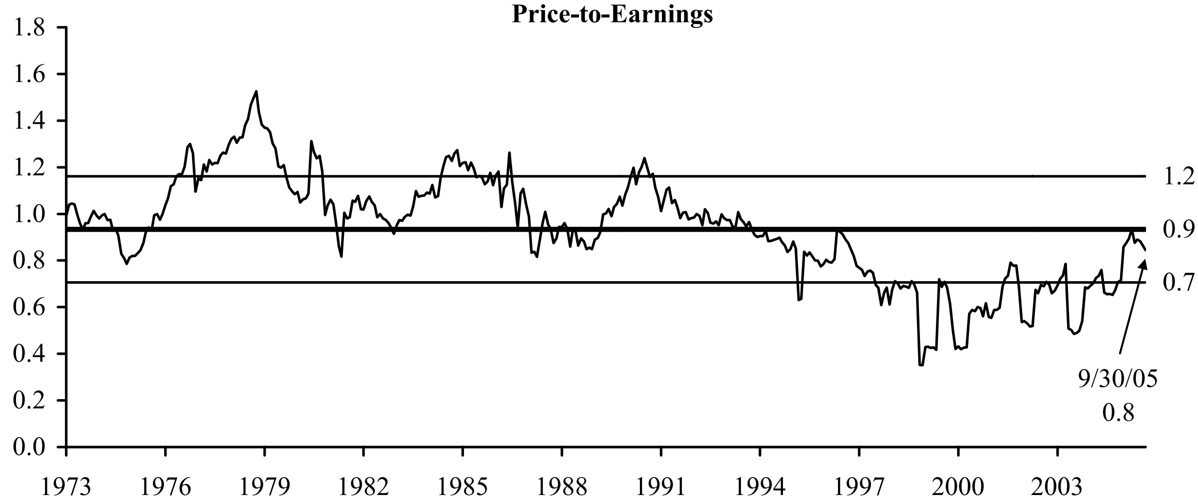
Note: All data are in yen.

Table G

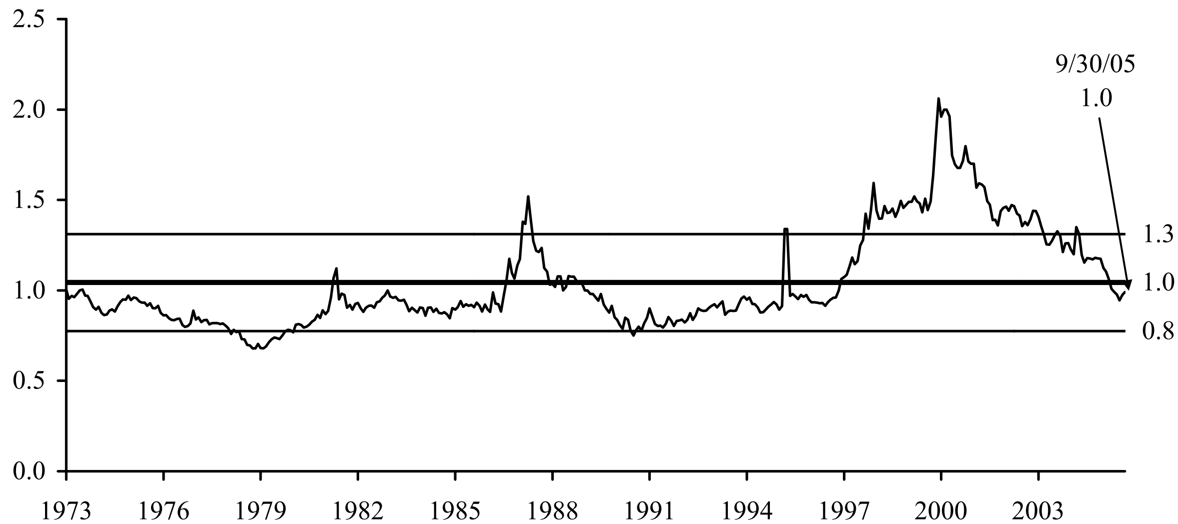
TOKYO STOCK EXCHANGE SMALL RELATIVE TO TOKYO STOCK EXCHANGE LARGE-CAP

January 31, 1973 - September 30, 2005

Price-to-Earnings



Dividend Yield (%)



Source: Thomson Datastream.

Note: Data for price-to-earnings and dividend yields are calculated by Thomson Datastream.