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CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENT: JAPANESE EQUITIES: DISCOUNTING ARMAGEDDON

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Japanese Equities:
Discounting Armageddon

It's enough to make even the most diehard contrarian turn tail and run.

Japan never misses an opportunity to disappoint equity investors. The most recent cries of betrayal were heard when Prime Minister Koizumi appointed a conservative to head the Bank of Japan, confounding foreign investors who had desperately hoped for a proponent of inflation targeting or least someone who could think outside the status quo box. Instead, restructuring efforts proceed at a glacial pace, the ruling LDP's grasp of power remains as firm as ever, and fiscal policy continues to fund the party stalwarts with economically unproductive programs. In the meantime, macro conditions continue to deteriorate. Real GDP growth is shrinking, deflation seems intractable, unemployment stands at record highs, consumers are retrenching, and domestic demand has become an oxymoron.

Over the last 18 months, we have continually emphasized the promise of managers who follow bottom-up strategies in Japan. To test the effectiveness of this claim, we examined the returns from the first quarter 2000 to fourth quarter 2002 of Japan-only managers in our universe (n=21). Eleven outperformed the MSCI Japan benchmark (which posted a -23.1% AACR), four by a wide margin. Nearly all of the outperformers have a value tilt and invest in small- to mid-cap equities. They follow a myriad of bottom-up strategies, such as investing in select individual restructuring stories, market inefficiencies, niche areas, companies with extremely strong cash flow and those with irresistible valuations. Managers can add value.

We are not arguing that small- to mid-cap value will continue to outperform, or that Japanese equities in the aggregate are on the verge of finally turning around (especially considering that in the aggregate the market remains overvalued). Rather, our point is that despite the gloom and doom hovering over the Tokyo Stock Exchange, there remains considerable investment potential. Moreover, as *The Bank Credit Analyst* recently noted, the Topix Index has now fallen to levels that are more than two standard deviations below its long-term mean—the mirror image of the market's peak in 1990 when equities sold at more than two standard deviations *above* their long-term mean. In 1990, investors were absolutely certain stocks would climb ever higher. In 2003, investors are more convinced equities have much further to fall. Despite the macroeconomic backdrop, it may be dangerous to underweight Japan, which we remain convinced will *someday* (ah, but when?) become the best-performing developed equity market for an extended period of years. Meanwhile, our advice remains the same: stay invested but implement through managers with coherent bottom-up, stock-selecting strategies.