COMMENTARY

March 26th, 2010

Quiet but fundamental changes in the Japanese business strategy

Dear clients and colleagues,

In our benchmark of MSCI World Small Cap index, Japan represents an important portion, accounting for about 11% of total index value, 2nd to the US. This week we would like to focus on Japan.

Nikkei 225 index reached its one-year high yesterday. Total return since Mar 1st, 2009 was 48% vs. 62% of S&P 500. The limited laggard could be explained by concerns on political reforms, deflation, and aging population, and partially by lagging of foreign fund inflow. On the other hand, it demonstrated decent strength of Japanese market often over-shadowed by the negative media coverage. We feel positive about Japanese companies due to their leadership position in Asia and strong competitiveness in the global market, particularly supported by the fundamental changes of Japanese business strategy in the past decade.

Let's start with a question. During 2002-2006, the early upswing period of last economic cycle, which stock market outperformed, Nikkei 225 or S&P 500?

The winner is Nikkei 225, with a total return of 71% vs. 24% of S&P 500. Japanese listed companies reported five consecutive years of combined record profit growth. Unfortunately such impressive outperformance was not much caught in the global spotlights, because investors had been much more interested in the emerging market stories. From a long-term perspective, now we are probably getting closer to (rather than far from) the start of another economic early upswing period, which is usually characterized by rising short rates, up-trend stock prices and increasing confidence. We feel that it is important to revisit Japan's evolution and recognize the strength of Japanese companies.

1960s-1980s "Japanese miracle". Its annual GDP growth was 10% average in the 1960s, 5% average in the 1970s and 4% average in the 1980s.

1990s "The lost decade". Economy experienced stagnation after the burst of asset bubble in 1991.

1998 Turning point of Japan's business strategy. Aggressive economic reforms were launched by the government. The post-war growth model was changed from diversification and cost leadership to a focus on core-competence and superior profitability.

2000 Lifetime employment practice started to loosen. Laws began to moderate rigid rules on layoff.

2001-2006 Economic reforms including deregulation and privatization continued under the heading of "Leave it to the market". The profound transformation of regulatory system was aimed at moving away from risk aversion and towards competition.

Although it takes time for the above change to transform the general economy, we already saw a big change at the corporate level. In the past decade, Japan became the global leader in many niche segments of electronics, precision, electric machinery, materials, steel, and pharmaceutical industries.
Following the spin-off of non-core business by large corporations and/or merger with similar niche players, many new companies were created. They became lean, innovative, and increasingly profitable. Many of them have very strong R&D capabilities. Some niche leaders are Nitto Denko (LCD polarizers), Toray and Tejin (advance materials), Tokyo Elktron (semiconductor and LCD technology), Ibiden (printed wiring boards), NDK (crystal oscillators), and JFE (a ferritic steel), etc.

Nabtesco, one of our holdings in the portfolio, is a good example of such new global leader. It was set up in 2003 following the typical spin-off process. Thanks to its unique motion control technology, Nabtesco has dominant market shares in most of its product segments. For example, it has 60% of world market share for the precision reduction gears for robot joints, 50% for brake systems for railroad vehicles, 40% for travelling unites for hydraulic excavators, and 50% for automatic doors for buildings. Increasing exposure to emerging markets is the growth driver of the company. It has about 25% of market share for railway braking equipments in China. The stock of Nabtesco had a total return of 105% since Mar 2009.

In the domestic market, deregulation and privatization created a transparent and competitive business climate, particularly visible in the consumer retail space. We saw the rise of Rakuten (internet shopping mall), Kakaku (website for product and price comparison), Fast Retailing (retailer for casual wear), and Seven & i (convenience store chain). Despite the aging population, Japan still has the 3rd biggest purchasing power in the world. What is more, some retailers and convenience stores are increasing their overseas expansion.

In summary, we see great growth opportunities among Japanese companies. Our visit in Japan last December confirmed the positive view. We were impressed by their technology edge, experienced management, strong balance sheet and clear growth strategy. In the context of weak Japanese economy, stock picking becomes even more important than usual.

Regards

The Global Alpha Team