

March 23, 2012

Dear clients and colleagues,

Last week we attended Daiwa 2012 Annual Investment Conference in Tokyo, with about 300 companies and 1,000 investors participating. Many foreign investors recalled emotionally the March 11 earthquake that happened on the last day of the 2011 conference. They had to rush out of the meetings, the streets were very crowded, and many after-quake shocks kept them outdoors for hours. What surprised them was that the exit out of hotel was very well organized and Tokyo street scene seemed back to normal within a day. It was only when they turned on the TV or walked in empty convenience stores that they realized something much more disastrous had happened.

Indeed, the earthquake coupled with Tsunami killed more than 19,000 people. Tens of thousands of homes and business were destroyed. The following nuclear radiation leakage forced more people fled their homes.

How is Japan one year later?

- **Key manufacturing capacities return to normal.** Most affected factories were reconstructed. Some companies set up new plants in other regions or overseas.
- **Lots of damages still remain.** Today, about 325,000 people stay in temporary housing. While most of the 23 million tons of debris has been gathered into piles, only 6% has been cleared through incineration. Dozens of coastal communities need to be rebuilt. In the many years to come, Japan has to make the radiated land livable again. Daiseiki, one of our holdings, is an important recycler of waste liquids and hazardous materials.
- **The government promised to reduce Japan's reliance on nuclear power.** Before the disaster, nuclear power supplied about 30% of the nation's energy. This should benefit alternative energy companies such as Ormat, the leading geothermal player also in the portfolio.

At the national memorial ceremony a few days ago that marked the one-year anniversary, Prime Minister Yoshihiko Noda pledged to rebuild the nation so it will be "reborn as an even better place." We felt the same confidence and clear vision from the Japanese companies at the conference.

How have Japanese companies changed in the past year?

- **More global.** Having experienced the vulnerability of an island nation, many companies accelerated their global expansion in both sales network and production base. Two years ago, it was common to see a Japanese company targeting only 20% of sales from overseas in 10 years' period, or one focusing only on the domestic market. But this year all of them expressed global interests. Many of them target 50% overseas sales by 2020.

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- **Less conservative.** Japanese companies adopted more western practices and become more flexible. Retrenchment due to business downsizing is no longer badly viewed. Foreign M&As of Japanese companies received more acceptances. Takeovers of foreign companies also get more aggressive.
- **Wider product range.** Japanese companies are well-known for their high-end products. But in order to tackle the slow domestic growth and gain market share in the large global mass market, some started to launch cheaper yet good quality products. E.g. Shiseido and Toto.

We met over 30 Japanese companies at the conference. Regarding the outlook for 2012, all of them expressed optimism, although highlighting the uncertainty of Europe debt issue and China slowdown. Bearing in mind Japan's conservative culture, we consider their views rather bullish.

What do we think about the Japan market?

In the next decade it will continue to be a very important stock market for global investment. Being selective in terms of industry and stock is the way to go. Aging population and weak domestic demand are real. However, opportunities also rise for two types of companies. 1) domestically-oriented companies that benefit from increasing healthcare needs. E.g. medical equipments, pharmaceuticals, and senior housings. 2) globally-oriented companies with strong brands.

We met two existing companies in the Global Small Cap portfolio. Both gave positive feedbacks.

- **Horiba:** A high-tech based measuring equipment company with leading global market share. Over 70% of sales from overseas. A diversified product portfolio in 5 industries (automotive, medical, scientific, environmental and semiconductor), which supports sustainable growth through the economic cycle.
- **Nabtesco:** An equipment provider specialized in motion control technology with leading global market share. Over 70% of sales from overseas. A diversified product portfolio in 4 industries (precision, semiconductor transportation, and aircraft and hydraulic.)

Have a good week.

The Global Alpha team

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