COMMENTARY

December 9, 2009

Dear clients and colleagues,

We have spent the last two weeks in Japan to attend the Nomura investment forum in Tokyo as well as visiting more than 10 companies on site in Nagoya, Kobe, Tochigi and Tokyo. In total we met more than 40 companies. The conference was mostly attended by Japan equity managers, further highlighting our previous comment about the Asia ex Japan attitude. What came out of most of the presentations was the long term vision of most Japanese companies, their clear business plan for the mid to long term, their prudence with regards to overseas expansion and finally the strength of their balance sheet and their good cost structure which means that they are very well positioned for the recovery.

Let us share some of our observations about Japan.

First, there are a lot of pessimistic news reports in the western Medias about Japan, from an aging and declining population, to a lack of growth, lack of competitiveness, deflation, debt levels, etc.

We would like to state a few facts, especially compared to the Canadian economy:

Japan is the 2nd largest economy of the World.

Its population of 130 million people has one of the highest purchasing power in the World. The Japanese consumer market is the 2nd largest in the World, more than 3 times the size of the Chinese consumer market.

There are 30 million people who are less than 24 years old.

The Country is well known as a leader in industries such as automobile and electronics. Lesser know is that Japan is also the World leader in the fields of environment, alternative energy and energy conservation, areas promised for important growth in the years to come.

Unemployment, following the financial crisis is still relatively low at 5.0%

The median household income is 6.5 million yen a year (C$77 000/yr). Consumption is 61% vs 72% in the US and savings is 18% vs 3% in the US.

Japan experienced a burst of the equity and real estate markets bubbles in the early 90's.

Land prices have now declined for 18 consecutive years.

That has had implications to this day affecting the Japanese market and which must be understood when making investments in Japan.

There is little interest in the stock market as well as in the property markets on the part of Japanese people.

As an illustration, below is a breakdown of financial assets for individuals (excluding home property)

	Japan	USA
Cash and deposits	55.2%	14.8%
Insurance and pension	27.2%	28.0%
Investment trusts	3.5%	12.4%
Stocks	7.1%	31.3%
Bonds	3.0%	9.9%
Other	3.7%	4.0%

With this low interest in the stock market by Japanese retail investors, the slow growth in the Japanese population and income and with record low interest rates, there is very little room for multiple expansion in Japanese equity markets.

As a result, an investor seeking investment ideas in Japan must look for earnings growth as a means for price appreciation.

This leaves two types of companies, large Japanese multinationals such as Toyota or Canon, or small cap Japanese companies. Large domestically focused Japanese companies have very little earnings growth potential.

Despite the above, we believe that Japanese earnings growth will surprise on the upside and are generally optimistic about the performance of the Japanese market for the next few years for the following reasons:

- The political landscape is ready for changes and reforms and the population is generally supportive of these changes;
- Banks and the financial system are in a good shape after years of bad debts and restructuring. As an example, the rating of the top 4 Banks has moved from BBB to AA- since 2003;
- Better private non financial debt ratio than in the US and the UK. Currently 140% of GDP in Japan (down from a peak of 170% in 1996), 170% in the US and 220% in the UK (all time high);
- Companies have very strong balance sheet as there is a strong aversion to debt;
- Many companies have restructured following the financial crisis and because of the strength of the Yen, leaving them well prepared for the recovery;
- Many markets are still fragmented and we are seeing more consolidation and M&A;
- Japan is one of the main beneficiaries of Chinese and South Asian growth;
- Japan is a leader in many emerging sector of the economy such as environmental technologies, energy savings and alternative energy;

During our stay, we have met with very dynamic entrepreneurs who are seeking to emulate the previous generation of leaders such as Toyoda (Toyota) and Honda.

We currently own five companies in Japan and had the opportunity to visit them all.
They are in different fields from environmental recycling to medical equipment.
Two are 100% focused on the domestic market and the other three derive a substantial portion of their revenues and profits from international markets.

We came away impressed from our meetings and expect all our companies to more than double earnings in the next 3 to 5 years.

Have a good week.

The Global Alpha team.