



January 20, 2012

Dear clients and colleagues,

**Tsunami, nuclear incident and a robust currency:**

Japan definitely had its toughest year post WW2. And just when Japanese companies were on the path to recovery, Thailand was hit with devastating floods. As a result, many Japanese companies with operations in Thailand were forced to close temporarily. The negative impact was confirmed when Japan's industrial production sank by 2.6% in November. On the currency front, the overvalued Yen pushed Japanese manufacturers to relocate their production facilities outside Japan in an attempt to regain some competitiveness. Despite this negative chain of events, Japanese equity markets outperformed 23 out of 24 developed countries last year.

So how do we see the land of the rising sun going forward?

Now that valuations have come down, we find many small Japanese stocks to be relatively cheap in comparison to overseas competitors. Within the developed small cap market, Japan certainly has the biggest disconnect between its share price valuations and its fundamentals. To a certain extent, this disconnect can be explained by the lack of information and research available on smaller Japanese companies and also from the fact that few overseas investors considered this market.

Japan isn't immune from the current global economic slowdown. A substantial 60% of Japan's exports are directed toward Asian countries, with China alone accounting for 25% of total exports. Europe is China's biggest export market, leaving Japan vulnerable to a possible European recession. Furthermore, Japan, like most developed economies, would have to overcome serious structural problems to ensure the long term sustainability of its economy. With its high labor cost and high corporate tax rates, Japan is losing competitiveness vis-à-vis its Asian neighbours. Its ageing society is threatening a decline in household savings while its huge national debt limits Government action.

We like to believe that in every tough situation lie opportunities.

Japan could tackle these issues by engaging in a transformation of its industries. The proportion of its exports and imports to its economy is less than 15%, which is a third of that of Germany. Traditional industries such as automobile and electronics have been successful in expanding outside Japan. Despite this, we think that many companies are still too domestically oriented. Japan has a lot to gain by being more active in overseas markets. Its capacity to innovate combined with the quality of its products makes it very attractive globally.

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Some companies have already begun to address this issue. According to the analytic research firm Dealogic, more than 600 foreign companies were acquired by Japanese companies in 2011, which spent close to US\$80B - more than twice the amount spent in 2010. Japan is clearly taking advantage of its strong currency to expand its presence abroad. We expect this trend to continue.

On the domestic front, Japan can stimulate its internal industries to foster new growth opportunity. For instance, the country can apply its advanced technologies to the solution of environmental problems. Another area of opportunity may come from its aging society, signaling a growing need for health care services. The contribution of the Japanese tourism industry to its national economy is relatively small compared to other countries, and tourist spending is weak. We feel that tourism should be a greater priority for the Ministry of Land. All these examples would allow the country to generate new domestic demand.

At the industry level, we anticipate that environmental, engineering and capital goods companies should benefit from reconstruction related-demand. We also continue to see good opportunities within retail, real estate, health care and technology. Our investment themes, such as demographic, alternative energy or consumption, are well represented within Japan.

With current valuations looking appealing and the likelihood of better than expected 2012 earnings, Japanese small caps could still offer a positive surprise in 2012.

Regards,

The Global Alpha Team

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