

October 5, 2012

Dear clients and colleagues,

Every country is unique, yet Japan is certainly one of the outliers in the emerging Asia. On one hand, the country faces numerous challenges: reconstruction following the earthquake, energy crisis after the nuclear accident, yen appreciation, deflation, aging population, and export-sensitive economy. On the other hand, it seems to have all it takes to work well. The population is extremely well educated, hard-working, pro-environment, and pro-society. Many of us may still remember the amazingly disciplined actions taken by those affected by the earthquake. We travel to Japan every year for investment conferences and company visits. Each time we are impressed by the high-quality management, state-of-art technology and strategic vision. In daily experience, we feel a passion for perfection, a passion to satisfy every imaginable human need in embracing innovation. For example, toilet seats are electronically warmed and cleaned, taxi doors swing open automatically, and mirrors remain clear in hot steam. In areas like LED lighting and mobile payments, Japan is almost ten years ahead of the rest of the world.

Unfortunately, Japan is one of the worst performing markets this year, with the Nikkei 225 Index up only 4%. Industrials, the biggest sector in the index (28% weight), suffered from weak demand in Europe and Asia. Domestic consumer sentiment also remains cautious. Japan clearly needs to go through structural reforms.

In July 2012, the Japanese Cabinet announced a comprehensive strategy named Rebirth of Japan. The four key focuses by 2020 are: "Green, Life, Agriculture, and SMEs". On the international front, Japan seeks to leverage its position as a leader in innovation and technology to develop and share solutions with the world. Here are a few highlights.

Green: to realize an innovative energy and environmentally friendly society

- Technology innovation: automobile, transportation, housing, urban development, medical equipment.
- Smart community: distributed energy system, renewable energy, storage batteries.
- Share with the world green technology and energy systems.

Life: to realize the world's leading health, medical care and welfare society

- World leading innovative pharmaceuticals and medical equipment (robot technology, care-giving equipment).
- Most advanced medical services: regenerative medicine, individualized medicine.
- Provide overseas a package of new medical systems and services; medical equipment, care-giving systems.

Agriculture: to double the vitality of regions driven by agriculture, forestry and fisheries industries

- Export of Japanese agricultural, forestry and marine products.
- Sharing Japanese food culture with the world.

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS[®]) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.

SMEs: to double the vitality of small and medium-sized enterprises as region's core

- Make Japan more attractive through the revitalization of SMEs, as well as regional and international exchange programs.

A good strategy and concrete actions are two different subjects. Due to Japan's poor track record of political party turnover, we do question the effective execution of the strategy, as we question our own politicians in Canada. What might be different this time?

1. According to Japanese media, the unprecedented earthquake increased acutely the sense of emergency nationwide, in much the same way as the burning fields of a war-torn land after the World War II.
2. To bring down Japan's high public debt ratio, a new bill was already passed this summer to double the consumption tax rate to 10% by 2015. This is big.
3. Through company research we see many structural changes this year to improve operating efficiency: E.g. In the healthcare industry, the consolidation of dispensing pharmacies is accelerating. The #1 player increases new store openings by +10% a year. In the senior housing industry, government provides subsidies to encourage noninsured care facilities.

Our portfolio is well positioned to benefit from the above initiatives. Many holdings are technology leaders in their niche markets, such as Daiseiki (industrial waste management), Nabtesco (motion control, robot), Disco (dicing, LED), and Horiba (pollution analyzer). Others cater to an aging population and health care industry: Message (senior housing), Nakanishi (dental equipment), and Advance Residence (rental housing). Kamigumi is a logistics leader in imports & exports including agriculture goods. As to SMEs, we invest exclusively in small caps.

Opportunities always come along with challenges. Our goal is to be sector and country neutral, and to outperform each individual market by stock picking. Our Japanese holdings have generated relatively good returns this year. Seven Bank, the largest ATM network operator in Japan, is up 63%; FamilyMart, the third largest convenience store in Japan, +26%; Nakanishi, the world's second largest maker of dental handpieces, +21%; Message, the largest senior housing provider in Japan, +16%. A few export-oriented holdings retreated, but in line with peers. Going forward, we believe domestic leaders in the growing niche markets can still deliver strong results thanks to favorable demographic trends. Exporters with world-class technology and products should benefit from the demand recovery from overseas.

In a sense, Japan is no longer an outlier. Its growth challenges mirror those in many other developed countries: exhausted fiscal policy, near zero interest rate, and aging population. Generating robust growth in such environment is indeed a global challenge. Next week, Tokyo will host this year's IMF and World Bank Annual Meetings. It will be the first such gathering in Japan in almost four decades.

Have a good weekend.

The Global Alpha team

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.