

# The Bank of Japan's injection of

When the March 11 Tohoku earthquake and tsunami and the subsequent crisis at Fukushima nuclear power plant burst into the news headlines, Japan was suddenly the focus of global attention.

Within the international hedge fund community, this was arguably the first serious attention the country had been paid in a long time. Natural and nuclear disasters grabbed the headlines, but few had shown interest in the Japan investment story.

It seems Japan's is a tale of continued slow decline thanks to stalemate party politics and unfavourable demographics, not least its aged population. In terms of attracting investor attention, Japan has to jostle with the razzle-dazzle of prodigious year-on-year economic growth in China and India. Yet investors who think Japan's day is done, and who sideline it are missing out on a cadre of stellar fund managers producing solid, steady returns.

The question is not: "What are the prospects for Japan's economy?" It is: "What are the prospects for corporate earnings?" In this regard Japan is a very attractive market, says Richard Whittall, portfolio manager of the FPP Japan Fund.

"People are mistaking prospects for the Japanese economy with the Japanese stock market," he says. "When I look at Japan I see one mega-theme which is Japanese corporates refocusing their business models to stellar markets from developed markets and at the same time reducing their exposure in Japan. This trend is underpinning corporate profits and offsetting the low growth prospects of Japan."

"Japan is also interesting because it's so out of favour. While China and India in an almost

Unfazed by natural disasters, a handful of dedicated Japan enthusiasts swear by the hidden alpha in an economy that has not yet had its day

Pavlovian way excites investors, Japan is the reverse. Thus whole swathes of firms do not get any analyst coverage. It's bizarre that Maruti Suzuki has 59 analysts covering it whereas, according to Bloomberg, the parent company Suzuki only has 22."

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In the aftermath of the Tohoku disaster, much business editorial coverage was devoted to musings on whether or not this would lead to any real systemic change in the country, specifically in terms of its political system. Japan-savvy industry observers think the answer is no, but they note that unlike the inaction that followed the 1995 Kobe earthquake, this time around the Bank of Japan took steps to change the monetary base.

"The BoJ's response has been much better and they have been buying exchange-traded funds and real estate investment trusts in the market," notes Whittall. Similarly, fellow Japan veteran Mike Trace, who together with Bertrand de Mil advises the Start 22 Fund launched a year ago, has been following the BoJ's actions closely.

"The BoJ has injected liquidity into the system, and the current account balance is back to the level seen at its peak in 2003. Back then, the liquidity injection was maintained until the end of 2005, and the stock market surged 137% from the lows in 2003," he says. "The BoJ always injects funds at the fiscal year-end, but if they maintain current account balance close to 2003's we think the market will go up like a rocket."

Regardless of the direction of the market as a whole, opportunities offered by a plethora of individual stocks are what makes the market exciting and rewarding to many Japan hedge fund managers. Trond Hermansen (Sector Zen Fund, see p10, John Stewart (Henderson Japan

Absolute Return Fund), David Baran (SFP Value Realization Fund), Brian Heywood (Taiyo Fund) and Peter Tasker (Arcus Japan Fund) use different ways to construct their funds but are all prime examples of Japan funds that rely on individual stock picking to generate returns.

One of the most exciting themes has to be Japanese companies expanding their overseas markets. While Japanese brands have been household names in consumer electronics and autos, other firms in diverse industries are waking up to the potential of markets beyond their own shores, and the well-known brands are capitalising on their global reputation to make inroads into new markets.

"More and more Japanese companies are gearing themselves to emerging economies," says Whittall. "Take Daihatsu, for example. Now 40% of its profits are from Indonesia versus zero five years ago. Honda has by far the biggest market share in motorbikes in Indonesia, Malaysia, India, Thailand and the Middle East."

There is a whole generation crossing the US\$5,000 per capital income threshold all over the world at a pace never seen before. Whereas in the 1970s there were only 12 countries with GNP growth of over 3% and all of them were developed countries, last year there were 130 countries worldwide growing in excess of 3% a year. 'The rise of the rest' is a theme that Japanese corporations are well positioned to take advantage of.

"Japanese companies have such low expectations of the government [to effect change to the domestic economy] and they have no choice but to expand overseas. Hoshizaki International, for example, makes refrigerated display cabinets, and has a huge market share in Japan. Management has said that they expect zero growth for their business in Japan — their prospects in the coming 10 years are in emerging markets, Latin America and Europe," says Whittall.

Closer to home, China's domestic consumption story continues to be a positive one for Japanese brands, and for the managers who can identify the right companies to back. High-street names such as Family Mart and Fast Retailing (the owner of clothing retailer Uniqlo) and brands like cosmetics giant Shiseido are some high-profile examples of a much broader trend of Japanese exporters pursuing the China theme.

# liquidity could help funds soar



Mike Trace



Richard Whittall



Atsuko Tsuchiya

"I think we'll see a diversification of performance by individual stocks and the managers who outperform will need to chase companies with good fundamentals," says Atsuko Tsuchiya, president and chief executive officer of Tokyo-based Atom Capital Management, sub-advisor to the Japan-focused event driven Atom Japan Alpha Fund.

"I try to find ideas through themes and in 2011 they could be overseas or domestic-related. One example is the global thirst for smart phones and tablet devices will also play to Japanese technology manufacturers' strengths both at home and abroad." Domestically, Tsuchiya is also paying close attention to Japanese firms that can benefit from a demand for alternative power sources and low power consumption devices.

"Even before the Tohoku earthquake I was looking into power names, for example in liquefied natural gas and solar energy, and also companies producing power generation products. Until now with the rising oil prices, it was not beneficial to have their own in-house power generators but now it serves as a business contingency plan, and some of the suppliers are small and not widely covered." Related to this theme are companies which manufacture LED lights or components which should also benefit as people try to minimise power consumption.

Indeed, the thousands of small, under-researched Japanese firms are another significant strength of the Japan market. As many as 60% of Japanese companies trading below book, versus just 6% in the US, and many are unloved or ignored by analysts. Managers who are prepared to dig deep to find gems, or to work together with company management to help them reach their share price potential, as is the case with Taiyo and Symphony for exam-

ple, can capitalise on analysts' indifference.

At the same time, the large number of multiple listings of different divisions of the same firm is unsustainable, and offers plenty of op-

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portunities for event-driven managers like Atom. "The Nikkei trades at one time price-to-book, that's the lowest in the developed world. Companies with low PE multiples and good cash flow offer good potential for corporate action, and I expect despite the March disaster that more corporate action will be announced," says Atsuko. "Moreover, the Tokyo Stock Exchange needs to limit or decrease the number of listings that are subsidiaries of listed companies, and from an event-driven perspective this is positive."

Although Japan seems perfectly suited to value-oriented managers, they are not the only managers making the most of Japan's unique investment environment. Alithion Capital Management's Akira Yaku has been running a heavily trading-based strategy in Japan since 2008. The fund typically changes the portfolio on a daily, if not hourly basis, constantly tinkering with the 100 to 110 long and short plays, as well as index futures and op-

tions, to capture irrational price fluctuations.

"We are high-frequency traders so execution costs are very important, and Japan is second only to the US as one of the best markets in the world in terms of stock lending and execution costs," he says.

"After March 11 the market has been more volatile, which means more opportunities for trading. Ours is quite a new type of Japan fund and I think our style is very fitting for the Japan market where there are so many event driven opportunities intra-day."

No-one doubts that the March 11 disaster, and the ongoing struggle to get Fukushima under control, will continue to have reverberations throughout the Japan market, whether it is in short-term parts and energy supply issues for manufacturers, companies being distracted from restructuring plans by more immediate and pressing problems of day-to-day management, or negative impact on the tourism sector. But these are short-term phenomena, and beyond that, the outlook as far as Japan managers is concerned, ranges from cheerful to all-out maximum bullish.

And while foreign institutional investors may continue to need some persuading to look again at Japan, their domestic counterparts are taking an increasing interest in hedge funds, says Akira. Trace, too has seen more interest from Japanese institutions.

"By all normal standards investors should be increasing equities and reducing bonds. The latter have done well in a 20-year environment of deflation in Japan but that's coming to an end," says Trace. "If deflation is ending that's key, because a strong currency won't be killing the Japan equity market. If we do get an end to deflation and Japanese domestic investors become interested, then Japan hedge funds could explode on the upside this year."

## Performance: AsiaHedge Japan Long/Short Equity Index vs TOPIX

