Kiyoshi Kimura Dreamvisor newsletter summary 18th of April 2006

A free-hand Q & A strategy outline for the market

From autumn of current fiscal year it is possible that the commodities market suddenly goes bear….
The author of this report was recently called by friends I used to work with in the past to give them a market forecast. Following is a free-hand Q & A summary:

Q: is current market strong or weak?
A: frankly speaking the market has been much stronger than I was predicting since last autumn. This said there are some points which need attention. First of all the current bull market has been led by foreign investors. Currently foreign investors are increasing their Japanese shares allocation, should undervaluation sentiment disappear net buying by foreign investors will decrease. If American stocks start to go south impact on Japanese stock market cannot be denied.

Q: hedge fund managers I know are mostly bearish but ….
A: This may be the case of hedge funds managers I knew when we worked in foreign securities houses but recent hedge buying wave is very different, rather than proceeding to fundamental stock picking hedge fund buy very large capitalization stocks like banks for example or even futures. Considering the long term rate increase environment, historic prices for oil and the surge in commodities market it is quite clear that money flows are searching for appropriate targets. Therefore Japanese equities are a target among others. In such case large caps and leading indexes are the main focus of such money flows but such upswings can also lead to quick turnarounds and heavy selling. The reason behind that is that most observers do not believe such economic growth can continue for long.

Q : the consensus is that we are experiencing earnings driven market but I personally forecast profits to decrease for current fiscal year but ?
A: Same for the author of this report. Interest rates have just started to increase and finally we are shifting from an interest rate driven market toward an earnings driven market, in fact I believe we have been experiencing earnings driven market for some time already. Monetary easing has been much longer than anticipated therefore precise timing of the cycle was difficult to analyze, although the author of this report does

believe that world economic cycle is close to a peak. Housing investment in the states has started to slow down consequently from this autumn we should see a slowdown in American economy. This American slowdown would put a break on worldwide investment boom.

However there is still large upside potential for mid small caps

Q: mid small caps is still a good investment?
A: by comparing the PER of small and larges caps there is still a lot of value to be found with small caps. When results are announced there should be a lot of outperformance on this side of the market, at least that is my strong belief. However for the past two years the market low for small caps was around 17th of May, if the larger market sentiment is worsening small caps will certainly suffer but it is my view that this is a perfect timing to buy at lows. Furthermore small caps are usually heavily bought when the economic cycle approaches a peak.
Considering the market cycle for small caps, lows are usually registered between October and January of a Japanese fiscal year; the best equities tend to perform stronger in advance of such cycle. Equities registering lows in January are usually not very liquid and consequently out of the reach of large institutional investors. In addition since the year 2000 IT bubble value equities and small caps equities investment always outperformed. Still now there are very good picks left.

Q: where do you see the upside potential for the average price?
A: for current fiscal year Nikkei 225 top potential should average 18000. This said after April May the Nikkei could even test 20,400-500. If the average price goes up to 1000 ¥ this is not bad. But I do not share the view of the current market consensus that large inflows of money will occur. There are too much uncertainties like ageing population or international balance of payments, this said for those investors willing to take high risks for high return this is not a bad environment.

Q: what is your investment style?
A: My personal strategy is always to balance a pure long strategy at 100 against a short at 50. My main buying strategy will always focus on low PER mid small caps. The short part will always focus on over-popular stocks (read my lips…) and no dividend paying stocks. This is because when the market goes down one has to cover the risk of low liquidity stock buying with appropriate hedging. When the market sentiment is bullish

I reduce my short selling activity, but when the market turns bearish I reduce buying and increase short selling. Currently the 'short selling' part is around 36 % which is obviously high ratio. Last year during the lower house dissolution this 'short selling' ratio was as low as 11 %. For now I am reducing buying positions to 10 % and at the same time increasing the short selling ratio which could eventually reach 50 %.