Kimura Dreamvisor Newsletter Summary 26th December 2006

January to March looks favourable to buy unpopular mid small caps

Small caps performance always improves in second half.

Large caps represented current fiscal year core investment, although overbought by foreign investors, leading stocks remained strong. On the contrary small caps (which are traded at 80 % by Japanese individuals) showed strong performance in 2005 second half (nor to mention IPO’s high price) only to be sold off in bulk after Livedoor shock (in addition earnings were revised downward due to financial statement new set of rules). Still now small caps recovery has been very limited. Despite the fact that main indexes came back close to April’s high individuals are still leaking their wounds. This year’s trading volume was sluggish which is partly due to the absence of individual’s quick rotational buying and selling, it could even be said they were temporarily frozen to death.

Due to foreigners entering Christmas holidays season, trading volume decreased further on the 25^{th}, buying concentrated on large steel companies. Small caps group was dragged into that flow and experienced limited strength for the past two weeks. Probably investor’s return increased due to steel stocks jump, which in turn allowed investors to buy into laggard mid size stocks.

Those changes just cannot be ignored. On a seasonal basis stocks selection flow always change a lot in forth quarter, previously unpopular stocks start to show significant improvement. This is a well-known pattern, whatever the reason small capitalisation or low Pe, such stocks always deliver above market average performance during that period. During fourth quarter I will usually appear much more in medias. Investors who successfully made money on large caps investments usually take notice of small caps relative under-valuation and shift money. Mid small caps performance worsen from summer, bottoming out in early autumn and then show excellent performance. For those reasons large institutional investors buy orders increase and most investors feel confident considering the attractive valuation ratios. Then at some point stocks become overbought and volume start decreasing, finally the risk reward ratio falls abruptly. Investors start to jitter and throw away holdings. In the end despite a strong earnings background, supply demand balance deteriorates and buyers run away.

Institutional investors start rebuilding portfolios in autumn. Numerous foreign investors close the accounts in late November, early December. Most stocks were bought on the back of strong analyst recommendations and such stocks are at risk of being sold heavily should next fiscal year forecasts not be in line with previous expectations.
Large caps positions are usually rolled over forward but it is different for small caps. Small caps show heavy turnover and performance will be disastrous if the buy timing is wrong.

Positive factors usually surge in January march period for unpopular stocks.

I recall that stock prices are formed according to buy/sell stance taken by investors depending of the information flow at their disposal. Earnings information can be instantly gained from Nikkei or Japan companies' handbook but as most investors remain sidelined the information is not immediately and accurately reflected in stock price. In most cases stock prices often form on large securities houses reports or other medias like TV/newspapers.

This flow of information cannot lead to 'fair value' price, most investors make their judgement according to market trend or stock price trend therefore stock price usually diverts from fair value. Fair value itself changes according to investor's standards. Stock price are originally formed through conflicting opinions (orders) and very often balance is reached by chance, this is a highly unstable equilibrium therefore it would be false to consider this as the 'appropriate price'.

Said in other words although I pay attention to stock price formation environment and actual price I believe it is a big mistake to trust it blindly because stock prices overreact to news and are heavily influenced by herd instinct. Of course the equation: stock price never lie (or discount everything) = chart does not lie is also totally unfounded. Bad technical analysts misused Charles Dow (the Dow foundator) words 'stock price average weaves all information'.

But let's go back to previous subject, what is the common factor behind fourth quarter (January- March) stocks showing good performance? According to past 17 years data low-priced stocks dominate. On the reverse it is highly advisable to avoid high priced stocks. Then mid to small caps are more advisable. In addition low Pe, low PBR stocks are advisable. Anything cheap is advisable. Stocks that showed poor performance in the third quarter (October-December) are more prone to register a strong rebound. Said in other words it is advisable to take profit on current high performers.

What does that mean? In a word stocks bought heavily and highly priced (based on both Per & PBR) will show poor performance and stocks previously totally ignored by investors will register a good performance. In fact fourth quarter always bring a flow of earnings, dividiends, free issues, M&A news and stocks that looked top heavy easily react to positive news flow. More hassle and less speed.

This was my last one for calendar year 2006. Have a nice end of the year.