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Mid term earnings season will peak by mid November, who dares win.

Yen historic implied volatility trend may be clearly downward but don't forget that the sleeping beauty always expect the Prince's kiss.

Recent steep Yen reversal pattern has surprised players (see Kimura Dreamvisor Newsletter 31st October 2006) but is clearly explained by position squaring mechanisms. Considering Yen US $ rates differential remain high at 5 % and that another Japanese rate hike is not in the cards for the immediate future Yen will remain top heavy. Nevertheless this brutal Yen reversal pattern must recall traders that Yen implied volatility, although trending downward historically, could abruptly self-reverse itself should the right incentives be set in place. I personally believe this will happen at some point in the future.

I do not share the concern raised in foreign medias regarding recent slowdown of Japanese household consumption (down 6 % YOY in September). This has close to zero chances of translating into a sustainable slowdown, just a pause. It is also true that consumer prices august calculation change lowered inflation figure reducing incentive for consumers to spend more now.

During my never-ending roaming of Japanese financial press I bumped into an interesting article published in Nikkei Financial Daily 31st October scramble section regarding a famous rule used by global pension fund managers; the '130/30' used to deal with companies managed poorly or loosely. According to this rule rather than buying 100 Stocks buy 130 and sell short the remaining 30 stocks balance. Depending on risk appreciation level there are variations such as '120/20, '140/40'. When a stock is weak applying the partial short selling strategy looks more efficient than holding progressive selling. For the past 5 years or so individual stocks performance has been closely linked to main indexes and it became difficult to outperform main indexes. As a result the above-mentioned long /short rule scheme has expanded worldwide to 305 billion US $ which is quite a figure.

By law most Japanese pension funds are forbidden to sell short, therefore this is the turf of European or American pension funds managers. However on a global diversification basis Japanese equities can also become potential targets. US State Street Global Advisers has 30 billion 800 million US $ under management. Out of this 705 million US $ for Japan alone and 30 % of this seemingly dedicated to long/short selling. Stocks targeted for short selling purpose are ranked according to standard growth and valuation ratios. The article quotes Arlin Rockfeller in charge of global portfolio management saying 'we target stocks highly valued but with unclear earnings prospects or stocks impacted by market negative sentiment'.

This can only further add pressure on Japanese companies management to reform themselves. US Jacob Levy Equity Management has been publishing research on the '120/20' strategy for the past nine years and has 4 billion US $ balance dedicated to this technique alone. Some forward thinking onshore Japanese asset managers have also been using the long/short strategy like Sparx for example through its well know onshore Sparx long short equity fund, I am always keeping a close eye on Sparx market activity as we share the same philosophy for Japanese value investment.

However the article recalls that during the Enron scandal short selling did not succeed in changing management, therefore this ended as a lesson.

We are approaching mid term earnings season and the Nikkei looks top heavy. Analysts usually keep a close eye on advance indicators to gauge earnings progression: the Revision Index. RI is calculated by subtracting downside revisions form upside revisions (positive mean more upside revisions, negative means the contrary). 27Th of October RI based on Nomura 400 excluding financials was –1,7 % (negative for the 6th week in a row). RI was still positive by mid July and turned negative mid September. Last year same date RI was already positive. Sectors revising down are mostly electrical, precision tools, machinery, and retail. Sectors revising up are mostly chemicals, housing, real estate, and construction but as a whole downside revisions take precedence. Analysts adjust simultaneously for example Hitachi and Sony disappointed but interim earnings peak is mid November therefore RI has good chances to turn positive again. The key point relates to companies' conservative estimates for the second half as they have done for the first half, conservative at first stage then revising upward at later stage. At least this is my scenario based on Japanese corporate practices.

Now what to buy?

A few words on the large caps front.

(6752) Matsushita deserves further comments. Analysts reactions to mid term earnings varied from 'as expected' to 'above expectations' however the majority share the view that industrial environment is tough and it will be difficult for Matsushita to surprise on the upside for the full fiscal year.

Matsushita stock key point will be mid January 07 when new medium term business plan announcement is expected. I believe this new business plan core point is how to use the cash position accumulated by Nakamura Kunio predecessor. By the end of march Matsushita had 1 trillion 442 billion Yen net cash at hand, this figure probably increased by a further 9 billion Yen by September end. The cash will certainly be used to incorporate minority owned strategic listed subsidiaries but almost certainly to buy spare parts makers in order to deepen Matsushita industrial model integration and improve Return Over Equity (ROE).

A word on (6502) Toshiba: listed subsidiary (5213) Toshiba ceramics announced recently an MBO. Don't be fooled, parent company Toshiba's hand is clearly behind the move. Large electronic conglomerates are currently revamping their strategy and Toshiba's choice is to focus on its core expertise strengthening semiconductors and nuclear energy business fields. Toshiba ceramics spin- off is part of the plan. Toshiba took advantage of year 2001 IT crisis to differentiate itself from other Japanese electronic makers and invested 8 trillion Yen in its core semiconductor business to finally buy US Westinghouse for 490 billion Yen. Regarding Toshiba non-strategic businesses although they divested air conditioning activity the reform plan was making few progresses up to now. However strategy clearly entered a new phase with the divestiture of a core subsidiary like Toshiba Ceramics (current Toshiba CEO came from Toshiba Ceramics) and purchase of WH. Toshiba management target is to clearly identify current income sources ; management was quoted joking ' if we succeed in rising our share price we could eventually buy ourselves out! '. MBO supported by Private equity (PE) funds are on the rise in the industrial sector and an increasing number of large companies are seriously considering MBO as an appropriate reform tool..

(7203) Toyota will become the first ever Japanese company to secure a 2,2 trillion Yen consolidated operating profit for march 2007 (expected). As a consequence it is no big surprise to notice that transportation sector ranks high in Japanese mutual funds asset allocation. Toyota has its own asset management arm in Japan marketing several mutual funds all focused on Chubu economy. The core fund being *Toyota Group Equities mutual fund* made of 19 listed Toyota subsidiaries covering 8 industrial sectors : apart from Toyota motor itself representing 50 % of the NAV following stocks are included :

(6901) Denso
(6201) Toyoda industries corporation
(8015) Toyoda Tsusho
(7259) Aisin Seiki
(6473) JTEKT corp
(7262) Daihatsu motor
(3116) Toyoda Boshoku corp
(7276) Koito mfg
(7221) Toyoda auto body corp
(6995) Tokai Rika
(7283) Aisan industry
(7223) Kanto Auto Works
(3553) Kyowa leather
(6470) Taiho Kogyo
(5992) Chuo Spring
(7205) Hino motors
(8761) Aioi insurance

The fund obviously outperformed TOPIX since its launch in 2003.

Value can also be found with Japanese major trading houses. As Kiyoshi Kimura stated previously Japan is certainly leading the world in energy-conserving technologies and Japanese companies are currently increasing efforts to provide such technologies to hungry energy China. China has seen a huge jump in power consumption due to unstoppable economic growth. For example (8053) Sumitomo corp. and (5233) Taiheiyo Cement will supply energy saving technologies for Chinese cement plants. Chinese authorities have placed utmost priority on energy saving and are requesting Japanese support. Sumitomo Corp and Taiheiyo cement subsidiary Taiheiyo Engineering (Tokyo Edogawa-Ku) will start a common subsidiary by current fiscal year end. Sumitomo corp. is currently stepping up support for developing countries to curb their CO_2 emissions within the framework of the 'Kyoto treaty'. Mitsubishi heavy is forging alliance with Chinese power utilities companies for its wind energy technology. 90 % of Chinese energy consumption comes from coal and crude oil; China is desperate to lower traditional energy sources dependence. In March Chinese authorities set up the 11th 5 year plan aiming at lowering by 20 % energy consumption by 2010. Japan accumulated energy saving technologies since the first oil shock in the 70's and back in September Keidanren head visited China to set a precise cooperation framework for environmental and energy conservation cooperation.

Regardless of the size there will be numerous Japanese companies taking advantage of this particular business field.

Pascal Jeannenot