JAPON INVESTISSEMENTS

NEWSLETTER 7th november 2006 http://japoninvestissements.free.fr

Fund managers at crossroad to discount next promising sectors weighting.

My hart goes with prospective value researchers but do not rely solely on dividend yield.

Apart from foreign investors (recently up to 60 % trading market share) onshore investment trust are active too. According to 2 of November TSE market share statistics (TSE, OSE, NSE first and second sections) investment trust bought net 23,9 billion Yen in October, from April to October they bought cumulated 1 trillion 159 billion Yen which is + 40 % compared to the previous fiscal year same period. Institutionalisation of individual's money is progressing as expected. Japanese onshore fund performances are improving too. This can be checked according to QUICK. QBR Investment trust performance index. Since 2003 when Nikkei 225 found historic bottom at 7,600 active type mutual funds outperformed TOPIX registering twice TOPIX performance (exactly 2.07 x TOPIX). Active managed equities mutual funds creation exploded since Japanese city banks were allowed to distribute back in 1996. However selection of sectors and stock picks are even more important. Again it is quite easy to analyse distribution of TSE 33 industrial sectors weighting by mutual fund type. By the end of September against 14 % weighted average for banking and electricals sector funds had 16,3 % in electricals and 8,3 % in banks. The largest asset manager's flagship funds have substantially increased banking sector weighting (see my newsletter dated). Nikkei 225 found bottom the 18th of July at 14,437 and looking at industrial sector rise by the 2 of November; banking sector rose only + 8,3 % under performing TOPIX (+ 13,2 %). Banking sector obviously lags electrical sector index (+11,4 %) and auto sector index (+19,9 %). Within flagship onshore funds Nikko Asset 'JIPANG' has the largest weighting in banking sector and performance is therefore lower than other leading funds like Nomura Asset 'BIG Project-N' or Daiwa asset 'Active Nippon' who increased electricals or auto sector weighting.

Although better look at it in a prospective way: many fund managers believe that Japanese banking sector has untapped upside potential. In that sense cyclical global blue chips, which led Japanese indexes recovery, may soon be swapped for large earnings potential mega banks (something also previously mentioned in my newsletter dated 12th of September). BOJ mentioned in the most recent statement that core adjusted inflation should slowly continue its up trend, base rate increase has been all but postponed since summer end but door is still opened for a second shot next calendar year. Fund managers are just discounting in advance the benefit of bigger margins for banks. However current market sentiment is half hearted which leaves a dilemma for asset allocation. As such global blue chips overweighing has paid off and is easier to justify for subscribers.

Going deep inside mid term earnings season

According to Nikkei consolidated current earnings still show double-digit growth at current stage and keep tracking higher. However looking deeper into earnings details it seems clear that numerous companies revised down second half estimates On the second of November there were only 519 companies having announced September interim earnings, 90 % of those, that is 514, had revised up compared to previous interim estimates. Companies revising more than +10 % upward represent 10 % of this total. Not only did September interim earnings were better but also full fiscal year estimates are better than previous fiscal year

This said by retrieving real mid term earnings from current fiscal full year expectations you have second half estimates and picture is slightly different. Out of 514 companies having revised upward mid term earnings 218 also revised up full fiscal year estimates but the full upward revision scale was already achieved by mid term. In the end you have more than 15 companies revising down second half. By summing companies who left current full year estimates unchanged but revised down second half we then reach up to 70 % of the 514 companies. The market can only take notice of this. The stock price of 54 companies went down just after earnings announcement. Among 13 companies, which announced better forecasts, 11 rose 1 went down which makes a good 90 % win/win game. However this hit rate goes down to 70 % for companies revising down second half and further down to 50 % for companies keeping forecasts unchanged. It looks than companies are more conservative on expected sales volume due to price hikes plus weakening of the industrial environment.
(3401) Teijin has always been one of my favourite larges caps (but historically I was much too soon for proper timing): part of Teijin foreign consolidated subsidiaries are 3 to 4 months late to announce July September quarter. This led to second half downside revision. However I also do believe that is the usual standard archconservative pattern meaning such companies will eventually revise up at some point. This said not everything can be put on Japanese companies conservatism.

Dividend yield is not enough to pick value stocks

Regarding high yield stock prices in Japan, as Kiyoshi Kimura mentioned in *his 17th october newsletter*. The dividend yield in itself is not sufficient.

Obviously sectors such as maritime transport, utilities and oil companies offer a higher than average dividend yield ranging from 1,71 to

1,90 % expected on march 07. TSE average expected dividend yield is 1,2 %. Usually those stocks fall after September interim dividend cash in. However maritime transport sector for example show substantial resiliency: by the 7th November closing maritime transport sector index had rose + 10 % since September end. The core reason behind such resilience is the near continuous inflow of money from domestic high yield stocks funds. By October end the cumulated Net Asset Value of onshore high yield specialized investments trust was 1 trillion 300 billion Yen a twofold increase compared to last fiscal year.

However this can also lead to a potential trap.

The Nikkei Financial Daily 7th November reports: If you had built a sample portfolio of 100 stocks having above average dividend yield and comparing them to the Nikkei 225 from December 05 then up to march the portfolio would have outperformed Nikkei 225. However from April high yield stocks went down alongside the whole market and by October end registered an 8 % fall under performing Nikkei 225 (+ 2 %).

Dividend yield should not be taken as the only screening tool, the risk is to have a portfolio overweighed in consumer loan companies or mid size brokerage stocks for example. Those two sectors, especially the consumer loan business field, experienced severe downside revisions recently and investors woke up to the fact that dividends themselves could be lowered. Looking at Nomura Asset Japanese high yield equities open fund core holdings are mostly large caps such as Toyota, Nissan, and Canon, Nippon steel. (Stable earnings and clearly stated dividend target).

In that sense Kiyoshi Kimura is right to sustain that high yield dividends stocks are bought as risk avoidance investments that translates in a somewhat negative approach (no risk exempt). This said when a whole sector is battered as much as the consumer loan business sector has been selective picks can then translate into value opportunities.

By the 7th of November (according to Nikkei daily calculation) main Indexes PE multiples are slightly beating previous fiscal year valuations

Index	Previous fiscal year (x)	march 07 (E) (x)
Nikkei 225	20,53	19,72
Nikkei 300	20,64	20,26
Nikkei 500	20,42	20,31
1st section	21,08	20,38
2cd section	23,90	17,40
JASDAQ	38,02	21,93

Now what to buy?

It is tempting to select stocks from the battered consumer loan business (nicknamed 'Sarakin' in Japan) leaders like (8564) Takefuji, (8572) Acom or (8574) Promise. However consumer loan finance business is dying away due to recent regulation shake-up and legal consequences. I would advise to look at other non-banking financials stocks less exposed to non collateral consumer loan business like (8585) Orient Finance , (8584) JACCS, (8588) Central Finance.

Historically when a whole Japanese industrial sector went deep into crisis opportunity knocked for the discerning mid to long term investor and this could be the case again for the battered sector however select properly the target.

On the mid caps front

Screening TSE 2cd section, JASDAQ, MOTHERS listed stocks according to the following criteria's 1- Pe multiple < 15x, PBR< 1.5 x, current full fiscal year expected earnings growth above + 20 % and 25 days trading volume moving average above 1 million stocks then you easily found stocks having gone down 60 % or more. Investment trusts mostly rebalanced their portfolios with large caps, which partly explain the relative value of mid caps. The retail sector has been particularly left aside. By the 14th November July September official GDP figures should be announced with consumption slowdown confirmation. However considering current full fiscal year forecasted Pe multiples for JASDAQ and TSE second sections buying opportunities are numerous, especially in the retail sector.

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