As Kimura Kiyoshi pointed out in his 2cd of October newsletter I also strongly believe it is advisable to take a bullish stance.

Why?
A rich dividends harvest at interim stage makes comparison with JGB 10 year's rate stands out!

*On the back of good earnings we had a harvest of impressive mid term dividends (paid on the 25th of September as I earlier mentioned). The total amount of mid-term dividends is forecasted to reach 2 trillion Yen. Highly regarded Expected Dividend Yield Ratio rises to **1.2%**.*
All 1797 listed companies (excluding New growth Markets) total interim paid dividends amount rose +25 % at 2 trillion 80 billion Yen and further dividend increase are expected for interim earnings announced in October November. Within steel sector JFE holding has paid its first interim dividend since 2002, Nippon Steel and Kobe steel paid their first interim dividend since February 1999. Apart from steelmakers large electronic conglomerates increase dividend too: (6502) Toshiba benefited from good semiconductor sales and increased interim DVD payment form 3 to 4.5 yen, (6752) matsushita increased interim dividend 5 Yen to 15 yen.

By dividing full year dividend to stock price TSE first section expected Dividend Yield Ratio is 1.2 %, compared to current fiscal year January 0.9 % this is a 3 points improvement. Nikkei newspaper dated 1st of October published a list ranking Nikkei 225 companies by expected dividend yield: steels and maritime transport are ranking high. (This said the lower the stock prices the higher the D.Y.R and some of the above mentioned cyclical suffered profit taking recently). The most recently launched 10 years JGB yield 1.6 % implying a **0.4 % yield gap** the lowest level for months. Domestic fund managers are already pointing out to the relative attraction of equities relative to fixed income.
Broadly speaking about foreign investors and more specifically analyzing US and Euroland citizens' willingness to invest in Japanese equity market, I have noticed an increasing trend in both markets to buy Japan through ETF's. In fact European and United States individual's money is increasingly channeled through TOPIX or Nikkei based ETF's. Since this could become a hot topic I shall develop the subject in my next newsletter. As a pure bottom up value specialist I dislike such blind investment vehicles but ETF's importance will increase as Japanese economy grows and one cannot ignore the underlying trend.

'Japan' made hedge funds on the move.

Current environment is not that good for hedge Funds. Obviously US Amaranth Advisors huge loss on commodities trading is inviting renewed onslaught from the regulator to step in. In Japan this may also ignite again the 'Villain conspiracy theory' made popular during Yoshiaki Murakami's Fund insider case. Based on Singapore Eureka Hedge Research Japanese equities Long Short strategy funds performance was -4.1 % by august end (underperforming Nikkei 225) however some funds stand out. The Nikkei Financial daily reports that Finoweb Investments set up last autumn by an ex Mizuho Securities salesperson and a global electronics top analyst has its 'Hadoh' (Wave motion) fund ranking number two out of 713 Japanese yen based funds. Usually hedge funds outsource research to securities houses but Finoweb principle is to get the information by their own leg work. They focus on 20 - 30 mid cap stocks ranging form 30 billion to 500 billion Yen capitalization mostly not covered by securities houses. On the reverse they short sale something like 10 popular very large caps at peak level. I share a similar strategy (putting aside the short selling which remain difficult).
Finoweb's Wakabayashi Hideki is doing an in depth research job to find jewels from the market so called 'dark continent' and we are far away from the short term trading image most hedge funds carry with them.
A totally opposite top down type strategy is used by Starts Investments (Tokyo Minato-Ku) although the 'Starts T1 fund' ranked number three in above mentioned panel. This is the classical market neutral strategy through which long and short positions are equalized. Starts Investment philosophy is that one cannot make money out of an unpredictable directionless market. This is not my philosophy and I obviously share Finoweb's views.
To summarize there has been a noticeable increase in the number of long/short strategy hedge funds with full base in Japan herself (traditionally hedge funds marketed in Japan are managed offshore by foreigners). On a monthly basis two to three new players appear on the market and this business field acts like a magnet for asset managers or securities houses best talents.

Now what to buy?

Nikkei 225 may be above 16200 level again but new capital inflow is solely focused on the core large cap blue chips universe which in turn makes mid to small caps universe still heavily underperforming leading indexes.

Looking back at stock picks mentioned in newsletters up to early may 2006 performance is clearly negative for small size caps and mixed to higher for mid caps however I strongly maintain that despite being currently ignored by market participants late cycle services mid cap stocks should be bought on lows.
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Now let's be practical and update previous suggestions made since March 2006:

I believe that (8692) Daiko clearing services which I mentioned already in 29th of May newsletter remain a value investment at that level. PBR : 0.97x, PER : 17,82 x. Stock went down from 2000 Yen late may to 1500 Yen late august and is now stabilized at par with Net Asset Value per stock (1600 Yen). Still a sure value picks. Industrial mid cap stocks targeted by activist foreign shareholders like (6448) Brothers or (7762) Citizen had mixed trends: Brother recently reached a new high for current fiscal year (and still is cheap relative to the whole market). Citizen remains an opportunity.

Within M&A value search field recent suggestions are unchanged: (8067) Tomiya apparel and stocks listed in the PEDY list published in my newsletter 24th and 30th June 2006.

A quick word on recently mentioned IPO's

As earlier mentioned in my newsletter dated 18th September 2006 'highly regarded' (2121) Mixie went down since the successful IPO due to bad supply demand situation on New Growth Markets in general and evident overpricing in particular. Still no interest from my side. On the reverse very large cap IPO (3231) Nomura Real estate (which was also a success as the stock first quoted 11 % above IPO price at 4000 Yen) will probably hold better on the short term due to its sheer capitalization. NRE is worth of interest only for those bullish on Japanese real estate but unwilling to take a big risk.

I am contrarian by nature.

Pascal Jeannenot

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