Long Term investment (5)

Global markets smell like the 70's but Japan's ahead of the curve.

Why? Because Japan's resilience to inflationary pressures has been shaped through painful decennial deflationary experience. This turns out to be a *relative* advantage now. Back in July Nikkei managed to fall for 12 consecutive days in a row (something that had not happened in more than half a century) and has remained directionless since then. Worldwide equity markets valuations are low everywhere but on comparative basis Japanese equity market is very oversold by historical standards. Japanese companies continue taking advantage of large cash at hand to aggressively reduce free float. Between January and July companies bought back Y2 Trillion. An increasing number of listed companies are seen buying back up to 5 % of their treasury stock. When Japanese companies do not cancel treasury stock they use it for overseas acquisitions, by august end overseas acquisitions had increased 3 times YoY at Y4 Trillion 560 billion mostly in manufacturing sector. Japanese companies overseas sales contribution reached 45 % by March end, which is a new historic high. During early 90s such aggressive move engineered by US companies led to long Bull Run. 40% of Japanese listed companies are debtless (this survey was conducted by Nikkei at march end based on 1,595 listed companies consolidated balance sheet). Nomura recently published an interesting chart comparing TOPIX with ROE accumulated value from 1985 to present. It clearly shows that back in 2003 TOPIX was oversold relative to ROE accumulated value (bubble peak 1989 was exact opposite). Same applies today. But who's going to buy this time? Foreign money flows have all but dried up which leaves *again* runaway individuals and domestic institutions in command.

The long, long case (part 8). You had been warned.

Yen Euro bubble finally started to deflate. As expected fast. Victory by default as Europe pulled the trigger by shooting herself in the foot and going straight into recession. As I speak most professionals *still* continue to see Japanese currency as some kind of global risk aversion barometer that is herd instinct total misconception. Next decade money flows reversal already started. However as I insisted so many times on *japoninvestissements* the complexity of the equation means Japanese currency implied volatility reversal cannot translate into one-way bet. Japanese savings pool long-term diversification deeply rooted need keeps colliding with Yen implied volatility reversal.

Anyway whether you are a sole 'kimono' trader or a seasoned Forex professional twice you had the opportunity to make lots of money on Euro-Yen parity this summer Once when the Yen hit first bottom in November 07, second when it tested 'stupid' double bottom late July 08. In addition recent fiscal reforms allowing Japanese companies to repatriate foreign subsidiaries earnings/dividends tax-free (to avoid double taxation) support momentum. Based on MOF data Japanese foreign entities have an estimated Y15Trillion parked offshore. As I previously stated on this website Japanese fiscal authorities too are supporting the Yen flows turnaround.

Speaking about money flows Japanese onshore asset management industry recent trends *versus* Yen behavior is worth looking at.

Onshore investment trusts universe rapid expansion peaked late October 07; slowdown has since been confirmed. Just a temporary slowdown in my view. Compared to US and Euro asset management markets Japan is still registering healthy trend.

Back in April (first month of the new fiscal year) total onshore publicly distributed equity investment trust AUM had recovered to Y61 Trillion 309b level. First time since January that equity Investment Trust universe had regained the 60 trillion level mostly due to global markets recovery, assets under management kept above this level for May, June, and July but finally gave up in August decreasing to 59,6 trillion yen. This said publicly distributed equity type investment trusts absolute number surpassed 3000 level in July (first time ever). The same logic can apply to privately placed equity type investment trusts as number reached 2,519 level in august and keeps (albeit slowly) rising. Basically foreign stocks allocation decrease was balanced by shift to fixed income. From January to June market leader Kokusai Global Sovereign Investment Trust registered Y600b net money inflow, which is no small money.

This said equity investment trusts suffered heavy net money outflows since new fiscal year start. August net inflow (published the 11th September, Y 260b) was down 82,8% YoY and down 55,9 % on a monthly basis. Since April ETF suffered largest net outflow due to lingering doubts surrounding structured products based on linked bonds. Same applies for previously ultra-popular Chinese equities investment trusts; AUM balance plunged to Y 602b by July end down 52 % form October 07 peak. However BRICS investment trusts fallout also mean relief for individual investors by putting downward pressure on ever-rising trust fees in Japan but that is no consolation for capital loss.

Net money inflow dramatically slowed since October 2007 but I think long term picture remain unchallenged as proven by recent MOF announcement that securities investment overseas by Japanese investors outpaced non resident's investment in Japanese markets in fiscal 2007, prompting the balance of Japan's next external assets to hit yet another record high of 250.22 trillion yen at the end of last fiscal year (all asset classes).

Foreign securities buying absolute level is a key component supporting Yen historical implied volatility breakeven point.

Large established players lost market share but boutique style asset managers registered positive money inflows. Speaking about newcomers in the industry I previously saluted them but omitted to mention two of them were seeded by pioneer Atsuto Sawakami (done now). Sawakami San has been raising his profile in local financial medias; this can probably be explained by his new publication 'Long Term Investment at your pace' (or something like that). Selling direct to the Japanese retail investor bypassing the traditional multi-layer Japanese distribution system is attracting industry's attention. Japanese Long-Term Individual investors outperforming professionals is new feature in Japan.

I recently spotted a very interesting discussion panel on Nikkei's daily 'inside market'. Panel discussion was focused on individuals's constant runaway from their own equity market. I already raised this subject several times on *japoninvestissements,* the answer remains the same: psychological and cultural reasons lie at the root of the problem. Japanese individuals troubled relationship with money goes back to Edo period, money investment 'beautifulness' never reached consensus among individuals. The long lasting tradition of having first money parked idle in bank accounts remains deeply rooted in the collective psyche. Japanese companies notoriously restricted free-float (no more than 2 to 3 % of all outstanding shares in some cases) trading has always been left in the hands of a happy few. However considering Japanese individual average income target is usually around 3 % (first objective) and if possible 5 % clearly the sole alternative left is to diversify in equities investment because neither bank deposits, nor Japanese fixed income can provide such returns. For those reasons and others I do believe there is still hope to see individuals back in action.

Sub-prime last stopgap was Europe. Not Japan as many had anticipated!

All in all sub prime casualties remain limited in Japan relative to Europe and United states. 20th of May Nikkei revealed that for the end of last fiscal year (March 2008) the six largest Japanese banks announced net consolidated earnings down 34 % at Y1 trillion 860 billion the second year of straight decline. If we include other financial institutions (stockbrokers, insurance companies) the grand subprime related loss equal Y 1 trillion 600 billion (US$15b) based on new accounting rules it was sure to rise later. It did! 6th of June FSA revealed the grand total had increased to Y2 trillion 574 billion (US$) but 98,9 % of losses originated from foreign securitized assets. Anyway out of the $387bn in credit losses those global banks have so far reported since the start of 2007 European banks suffered $200bn, US banks $166bn according to Washington based Institute of International Finance. Japanese banking system registered very limited damage. The same six top banking group are expected to see combined net profit rise 13 % for current fiscal year. The three biggest have Tier 1 ratio above 7 %. Question is what are Japanese banks going to do with this global relative strength. Japanese corporations have already been on foreign acquisition spree and it is reasonable to expect some action by Japanese mega-banks.

Now what to buy?

Loss appraisal ratio (which indicates potential loss on stocks bought through margin trading) is back again in extreme negative territory (-19,6 *to* –20 %) usually a solid indicator of an oversold market. This coupled to TOPIX deviation from historical ROE accumulated value does make Japanese equities really oversold compared to other markets.

J-REITS; hidden value?

Back in early summer some foreign analysts have been pointing to J-REIT as a potentially interesting investment target. TSE J-REIT index already halved. After hitting 2600 high back in June 2007, the index touched a first bottom in March 08 went up 10% and plunged again toward 1,100 (down 50 % from peak). Market fall led to large spread between Japan long-term rates and J-REIT average yield. J-REIT average yield is now well above 5% (cap rate down 0.2 YoY). Japanese institutional investors started to buy again targeting pure income return. Residential housing related REITS offer higher dividend yield compared to offices related REITS although balance sheet is generally weaker. Analyst tend to focus on housing REITS backed by financially solid sponsors like (3226) Nippon Accommodation Real estate Fund (Mitsui Real Estate) offering stable cash flows.

Not a few J-REITS trades at 50 % NAV discount (the equivalent of low PBR for equities), in theory those can be purchased for less than underlying cash.

Time to time sponsor change can be positive like the case of Frontier Real Estate Investment Trust when Mitsui Real estate bought previous sponsor (Japan Tobacco) rights. Money is still channelled into J-REIT universe but at slower pace. 23rd of June Nikkei edition titled REITS: hidden value overlooked by investors? Downward pressure on rents increased recently and credit squeeze is affecting real estate sector plagued by recent high profile bankruptcies (Urban). Simple valuation calculation is not enough to really appreciate underlying risk. Case by case.

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