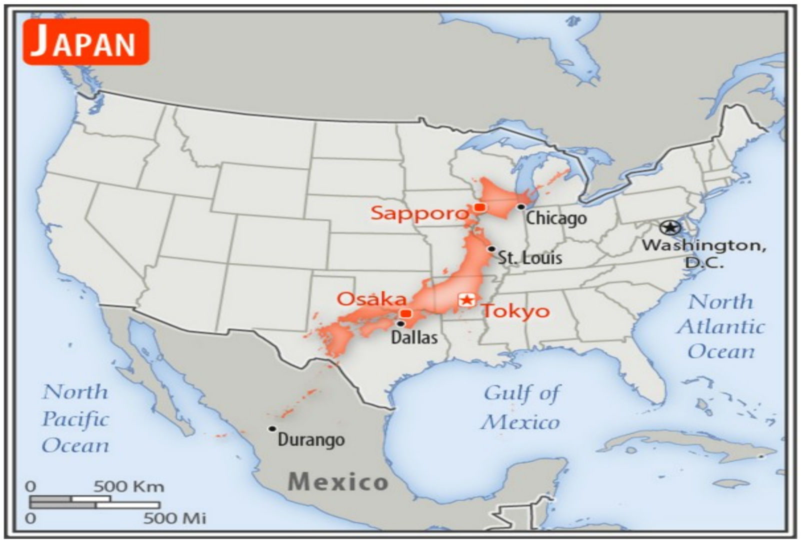
Rising Sun

"Japan's very interesting. Some people think it copies things. I don't think that anymore. I think what they do is reinvent things. They will get something that's already been invented and study it until they thoroughly understand it. In some cases, they understand it better than the original inventor."
- Steve Jobs

In the spring of 2009, my wife and I packed up our bags and exchanged our fairly routine lives in New York City for one of adventure in Tokyo, Japan. My employer at that time, The Royal Bank of Scotland was looking to increase its presence and build up market share in the Asia Pacific region, and Tokyo happened to be the regional hub for my business line. Upon our departure, the duration of the assignment was set at two years, but that was later extended finally concluding well into year five.

I'll never forget the first day we arrived in our new home. It was the evening of April 1st and my wife and I were very exhausted from our travels both physically and emotionally. It was raining of course, and to top it off we were also coming down with the flu. Our taxi driver from Narita Airport spoke no English, which we unfortunately had not prepared for, so after getting a little lost in central Tokyo, he eventually dropped us off at our temporary housing accommodations in Roppongi. Although this city neighborhood is known as the most foreigner friendly, we did not feel that way at the time, as both my wife and I contemplated staying



Source: CIA World Factbook Figure 1.

Figure 2.

Figure 3

inside our apartment that evening rather than search for a place to eat. Ultimately hunger prevailed over fear and we braved the trip outside.

Much has changed since that day. We ended up becoming more than comfortable living in Tokyo and luckily had the best group of local and international friends anyone could have ever hoped for. With that said, as a foreigner living in Japan, one is never fully integrated into the population, which possibly leads to a more critical eye than would otherwise be the case. For all their peculiarities, I find the people of Japan to be among the most impressive this world has to offer. According to the CIA World Factbook, the agricultural landmass of Japan accounts for only 12.5% of its total versus 44.5% for the United States, while its area is approximately equal in size to the state of Montana (Figure 1), yet they are the third largest economy in the world. The Japanese are organized, highly educated, technologically advanced and easily the most polite people I have ever met.

Quarter to date performance of the Japanese stock market on the other hand has been among the worst out there. According to data from The Wall Street Journal, the Nikkei 225 index closed down 12.0% as of March 31st and has continued lower in the days since. It is likely that the sell-off is primarily due to recent strength in the Japanese Yen. However, putting this into context using the exchange rate low made in October 2011 (Figure 2), we see a very different picture as the Nikkei 225 index has rallied 93% from this point (Figure 3). Of course, foreign investors would have had to hedge their currency exposure to realize anything close to those gains given that the USD/JPY exchange rate declined approximately 46% from that same point. Fortunately, hedging out the associated currency risk is easy to accomplish.

David Kotok of Cumberland Advisors recently wrote an article "Why We Are Overweight In Japan" that makes a strong case for long-term investors to either initiate or increase exposure to the Japanese stock market. I strongly agree with his analysis and have listed his main points below.

- Japanese companies are cheap from a valuation perspective providing an earnings yield between 6-7%.
- Bank of Japan's policy of zero or lower interest rates will likely be in place for the rest of the decade as they are committed to getting inflation up to their 2% target.
- Prime Minister Shinzo Abe has been moving the country away from a passive defensive posture dependent on the United States to a more active one. This should lead to increased military and associated technology expenditures.
- Japanese taxpayers will be financing this budget deficit at a rate of 0%.

I understand many people disagree with the above analysis and are more focused on Japan's aging demographics and structural inefficiencies. All true, but also all well known and likely priced into their market. What is not and cannot be priced into markets are the future surprises - good or bad - whatever they may be. With the value of the Nikkei 225 having been cut by more than half since the index highs were made in December 1989, I believe owning Japanese shares is a good bet to have on the books, not only from a stand alone basis but also within the framework of a prudently managed, well diversified portfolio.

When it comes to international investing many investors prefer to ignore the benefits of global diversification and choose to concentrate investments in their home market. According to Princeton University Economics Professor Burton G. Malkiel, "One of the best-documented behavioral biases in investing is called 'The Home Country Bias.' Despite the availability of well-regarded and highly profitable corporations located throughout the world, investors tend to limit their investments to those companies domiciled in their own country. At one time, a survey of institutional investors in France found that 97% of their equity investments consisted of French companies despite the fact that France represented only 3% of the world's total equity capitalization. Such a bias is found all over the world. British investors prefer British companies, Japanese investors prefer Japanese companies, and U.S. investors prefer companies domiciled in the United States. Despite the substantial risk-reducing benefits of international diversification, investors all over the world exhibit a home country bias."

Looking back it is easy to find instances where global diversification disappointed, as markets tend to crash at the same time. Although short-term crashes can be painful, managing an investment portfolio should be likened to a marathon rather than a sprint. Slow and steady wins the race while long-term returns are far more important to wealth creation.

Sincerely,

Justin Kobe, CFA
Founder & Portfolio Manager
