Lazard Insights
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Summary

# Japan: Is it Really Different This Time?

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## Will New Government Mean Reform?

The Democratic Party of Japan (DPJ) unseated the Liberal Democratic Party (LDP) in the most recent election. This was a historic victory, as the LDP had enjoyed an uninterrupted term of over 50 years. There has been much speculation about the prospect of positive political changes with the DPJ now in charge, but we are less encouraged about the time it may take to achieve these changes. Often, things take longer to complete in Japan than external commentators hope and expect. The internal structure of the DPJ suggests that this trend may continue, as many DPJ members are former socialists and disenfranchised LDP members. We believe that, while the new Prime Minister's comments have been progressive—including his emphasis on the need to encourage families to have more children, and his discussions with China regarding a European Union-type structure for Asia—the party has already been somewhat undermined by regressive comments from cabinet ministers.

In the near term, we believe it is unlikely that the DPJ will hold together long enough to enact long-term structural changes. In fact, a likely outcome could be a fractured two-party system—an internationalist party that is willing to embrace Asia and redefine Japan's role, and an isolationist party that is backward looking and attempting to recapture Japan's former glory.

## Secular Opportunities

Irrespective of the current political climate, Japan does have a number of secular opportunities in both the short and long term:

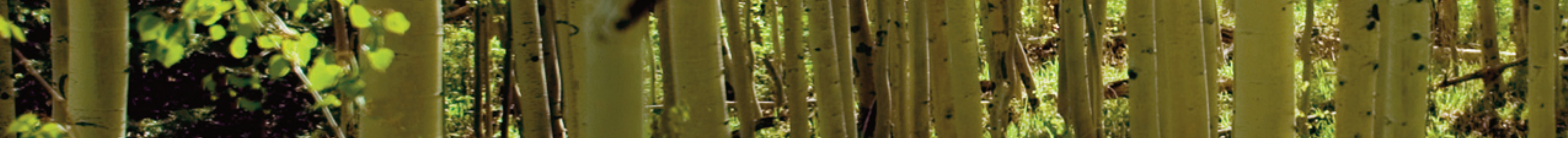
- Unlike Western countries, Japan is actually through the worst of its credit cycle and debt levels are contained.
- Much of the growth in other Asian countries (e.g., China and India) requires intermediate goods, which Japan has an excess supply of and for which it is still competitive. In fact, some segments of the Japanese market are a good proxy for Asian, and especially Chinese, growth, as Japan has displaced the United States as China's largest trading partner.
- Japan is the most energy-efficient major economy in the world and is increasingly exporting its energy technology globally.
- Japan's recent political change could lead to a fresh, forward-looking shift in the structure of its economy.

## Unique Opportunity for Active Managers

There are a number of characteristics about Japan that are attractive to investors, three of which we will explore in greater detail: Japan's broad and diversified investment universe, its less efficient equity market, and its differentiated marketplace.

## Broad and Diversified Investment Universe

As illustrated in Exhibit 1, the top 10, 20, 50, and 100 companies (by market capitalization) in Japan make up a smaller percentage of total market capitalization than any market in



## Exhibit 1: Percentage of Market Capitalization of the Top Companies in Developed Markets

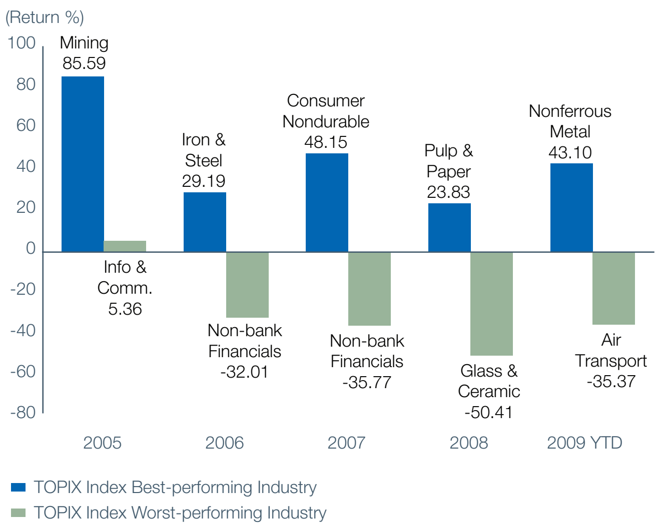
| | Mkt Cap (USD MM) | # of Stock in MSCI | Top 10(%) | Top 20(%) | Top 50(%) | Top 100(%) |
|---|---|---|---|---|---|---|
| United States | 8,584,892 | 601 | 19.10 | 30.96 | 49.05 | 63.39 |
| **Japan** | **1,995,432** | **347** | **21.08** | **31.75** | **52.01** | **70.14** |
| United Kingdom | 1,738,245 | 105 | 49.67 | 70.03 | 89.25 | 99.63 |
| France | 857,033 | 76 | 53.37 | 73.38 | 94.82 | 100.00 |
| Canada | 830,339 | 98 | 42.64 | 64.26 | 88.00 | 100.00 |
| Germany | 642,787 | 49 | 63.89 | 85.87 | 100.00 | 100.00 |
| Switzerland | 614,507 | 36 | 83.17 | 93.41 | 100.00 | 100.00 |
| Australia | 610,357 | 73 | 57.80 | 75.51 | 93.65 | 100.00 |
| Spain | 371,683 | 30 | 85.98 | 95.54 | 100.00 | 100.00 |
| Italy | 292,444 | 37 | 74.77 | 91.63 | 100.00 | 100.00 |

As of June 30, 2009

Source: MSCI, Lazard Asset Management

the world outside of the United States. This is important for two reasons: First, the size of the opportunity set is big, meaning that there are more places to add value through fundamental analysis. Second, the number of mid- and small-cap companies and the diversity of industries are substantially greater than other markets, which leads to dispersion between winning and losing companies over time, again creating opportunities for active managers. For example, the Japanese autos sector is up over 40% thus far into 2009; however, within the sector, a number of companies are up by more than 120%, but there are 10 companies that are actually down for the year. Similarly, 12 Japanese banks are up by more than 10%, despite a 14% decline in the banking sector overall.

## Exhibit 2: Best- and Worst-performing Japanese Sectors by Year




As of October 19, 2009

Source: Bloomberg

## Is Japan an efficient market?

A massive decline in employment in Japan's investment industry has occurred since the 1989 bubble. The total number of workers has dropped by approximately 70% and is only one-tenth the size of the U.S. market. Japan's largest broker covers only 400 out of over 3,000 listed Japanese stocks, meaning approximately 90% of the companies in Japan are not regularly researched.[1] Japan is also, on average, approximately 60% more volatile than other developed markets. We believe all of these factors leave room for active managers to exploit inefficiencies in the Japanese market.

## Opportunities Offered By Dispersion

Exhibit 2 shows the extent of dispersion within the Japanese market: There has been a consistent pattern of 60% to 80% spreads between the best- and worst-performing sectors. Similarly, dispersion occurs within each sector, even when the group as a whole has had a very strong or very poor year. For example, in 2007, the best-performing company in the consumer nondurable sector was up 117%, while the worst-performing company in the same sector was down 80%. As noted previously, this high level of dispersion offers alpha opportunities for investors.

## The Trouble with Timing Japan

One challenge that investors have long faced in Japan is timing their entry and exit into its equity market. We believe this is a much more difficult exercise than generating alpha from Japan's internal inefficiencies. Exhibit 3 demonstrates that, when Japan recovers, it tends to rally only for a short period of time. On average (over the past 20 years), rallies have lasted only 18 months. Therefore, unless an investor has been spot-on in timing both the trough and the peak of each market cycle, it has been very difficult to create value by timing market entries and exits in Japan. We believe this represents a significant source of frustration for investors in the Japanese market over the years, as it is essentially impossible to time it effectively.

## Low Correlation to Developed Markets

Japan has a low correlation to other developed markets. The correlation between the United States and Europe is quite high, while Japan has had a low correlation to both of these markets for many years. We believe this low correlation will continue, as Japan is at a completely different stage in its credit cycle and is currently experiencing positive structural effects related to greater integration with Asia.

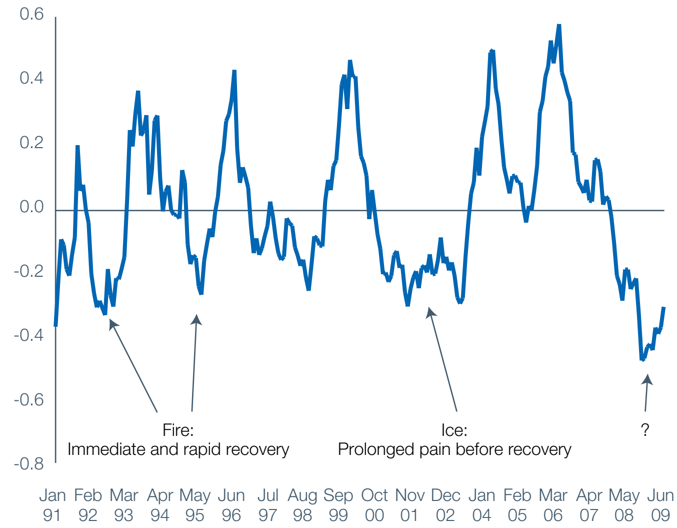
## Identifying Future Winners and Losers

The examples below illustrate a few of the more interesting dynamics in the Japanese market. Both the opportunity set and potential pitfalls become more granular when examined in detail, and contrast with the general tendency to lump all of Japan into a single buy or sell decision.

### Alpha-generating Opportunities:

- **Green technology** – Japan has leading green technologies in many areas, including next-generation batteries, engines, solar power, and the devices that these products will run on. Japan also boasts the lowest per capita energy consumption of any developed country. One good example of a company in this space is Rinnai, the world's largest maker of flow-through hot water heaters. The company's product is experiencing brisk demand, even during the slower economic environment.
- **Game software** – While demand for expensive PCs, flat panel televisions, and mobile phones fell during the recent slowdown, game software prices are low enough that sales held up even in the weakest period at the end of 2008. Japan heavily dominates this counter-cyclical industry globally. Game developer and publisher Capcom is a good example in this space.

### **Exhibit 3:** MSCI Japan Index Rolling 12-month Price Returns (in JPY)



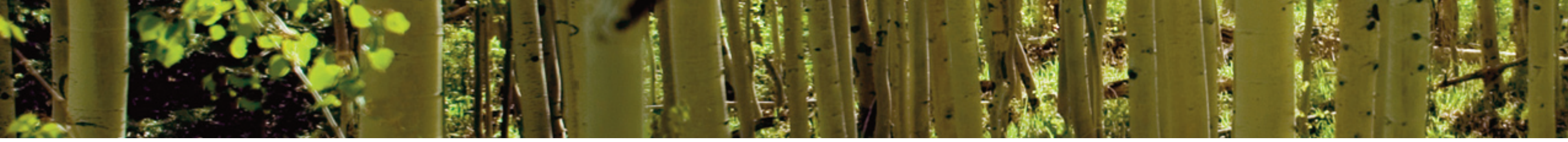

As of June 30, 2009

Source: MSCI, Bloomberg, Lazard Asset Management

- **Netbooks** – We believe that the diffusion of netbook PCs into the developing world will soar due to their attractive price point and efficiency. Japan has a number of core technologies for these devices, including touch panel displays produced by Nissha Printing.
- **Telecoms** – A robust fiber optic network will be necessary to facilitate the recent developments in cloud computing. Japan currently has the world's largest FTTH (fiber to the home) network. NTT is currently the largest provider of these services.
- **Health care** – The demographic trends in Japan necessitate higher health care spending. While there are a myriad of opportunities in this space, one good example is Miraca Holdings, Japan's largest medical testing lab, as recent deregulation has allowed labs to provide cheap and effective testing worldwide.

### Longer-term Risks:

- **Durable goods** – We expect traditional, mass assemblers of goods to perform poorly. Of note is the autos sector, as these companies' overwhelming focus on North America has left them with a production-demand mismatch. They have produced too many large cars, and not enough small, efficient cars for the tastes of China and India.
- **Basic industries** – These companies are likely to be hampered by a high-cost operating base and a lack of scale. Nippon Steel, a high-cost producer of rolled steel, is an example in this space.



- **Diversified conglomerates** – A lack of focus on core competencies may hurt companies in this space. Japanese conglomerates like Hitachi, where no division accounts for more than 15% of its total revenues, are likely to continue to struggle to deliver consistent profits.
- **Traditional retail platforms** – New formats and distribution channels, such as aggressive discounters and shopping malls, have undermined profits of traditional department stores.

## Conclusions

Japan is in the midst of a period of economic and political transition. This transition presents both risks and opportunities. While trying to time the absolute best entry point into the Japanese market is very difficult, internal market inefficiencies make it possible for active managers to generate positive alpha consistently. As the country's political transition proceeds, and Asia continues its path to a larger role in the global economy, we believe that positive investment opportunities should expand.

### NOTES

1. As of June 30, 2009. Source: Japan Securities Dealers Association, Lazard Asset Management.

### IMPORTANT INFORMATION

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