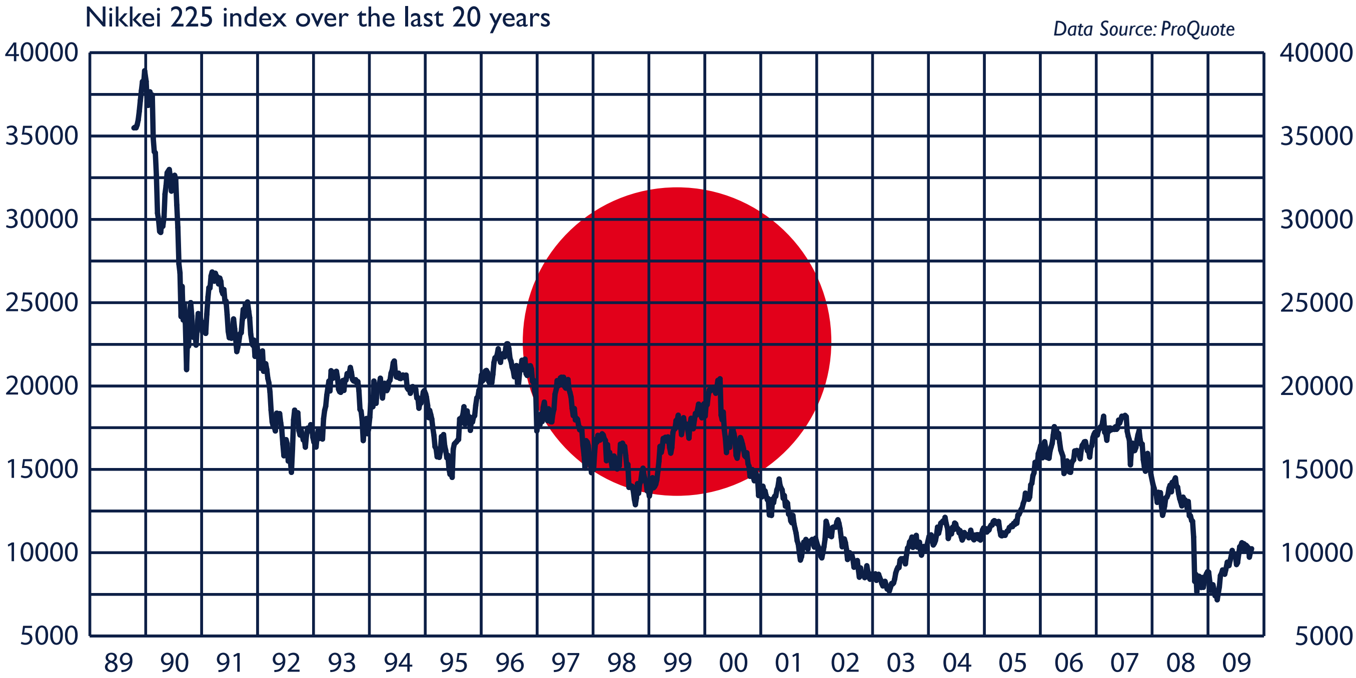
GIBRALTAR ASSET MANAGEMENT

STOCKBROKERS & INVESTMENT MANAGERS

Japan



Land of the Rising Market

There has been so much said about the BRIC countries (Brazil, Russia, India and China) in recent years, in particular China, that most investors will have some exposure to at least the "Beast of the East" in one way or another. However, diversification should not stop at China. One of the world's most important economic powers, Japan is also one of the key global stock markets, with Japanese manufacturers being world leaders in several major industries.

Japan's prolonged economic downturn, which has lasted 20 years, has made it largely unpopular with investors. However there are signs that things could be about to change with export data perking up amidst a resurgent Chinese economy. In fact there are several reasons why we are looking at gaining exposure to the Japanese stock market right now:

1. Low Valuation

With a low price to book value, the Nikkei is by far the cheapest of the world's largest stock market indices.

2. Sound Banking System

Unlike Western banks who leveraged their way into state ownership and protection, Japanese banks have much stronger balance sheets with less exposure to US housing-related debt. With Western banks having only written off half of their toxic debts, this bodes ill for future economic growth.

3. Liquidity

Japanese household debt as a percentage of GDP is substantially less than the levels witnessed by the UK and the US. That means there's plenty of cash around making Japan the largest liquidity pool in the world.

4. Overseas Opportunities

The credit crunch has caused only shrapnel wounds to Japan. Japan is obviously part of the world economy, but it is not involved in the deleveraging credit crunch. That happened in the decade post 1989 (the "lost decade") when it had mountains of unmanageable debt which had to be worked out. The response from the UK & US authorities has been swift but the pain will nevertheless be drawn out. Prior to 1989 Japanese financial institutions had been expanding globally but then had to withdraw to their core domestic markets. The same is happening with UK & US banks, creating a vacuum – which we think Japan will fill. Japanese companies (many of them cash-rich from the manufacturing and industrial sectors) have amongst the highest profitability, lowest leverage and strongest capitalisation in the developed world which gives them the balance sheet strength to take advantage of globally depressed asset prices.

5. Importance of Diversification

With the UK representing no more than 5% of global GDP, diversifying overseas has become both necessary and easy with the advent of Exchange Traded Funds. Going forward UK-only investors will grow poorer relative to the rest of the world which has higher GDP growth – especially since Western currencies seem likely to suffer long-term devaluation against Asian ones.

6. Government Change

During the recent Japanese election held in August, the Democratic Party of Japan (DPJ) won a landslide victory gaining 306 out of 480 seats and thereby ousting the Liberal Democratic Party, which had ruled almost uninterrupted since 1955. This is generally perceived to be good news for the economy, with the main policy shift expected to be towards a more consumer-friendly "economic revival through higher living standards" stance. With such a landslide result the DPJ has been given a huge mandate for change. The result has also changed investor's views of Japan: the idea that Japan is unwilling and unable to change from a bureaucracy-driven policy process. If the DPJ gets it right, there will be an awful lot of people dusting off the "How to invest in Japan manual". There are indeed previous examples where the promise of reform spurred international investors to overweight Japan. This proved to be the catalyst for a sustained rally.

7. Asian Emergence

Much of Asia has a trade surplus, low debt and huge foreign exchange reserves. In fact all the creditor nations are in Asia, the five biggest being China, Japan, South Korea, Taiwan and Singapore. The emergence of the rest of Asia and the likelihood that business investment – a key drag on the Japanese economy for years – will pick up in response to this, will prove a real boost to the economy.

8. Green Credentials

The country's high-tech economy is also likely to profit from the global shift towards greener technology – indeed, Prime Minister Hatoyama's announcement at the weekend of an ambitious target for reducing greenhouse gases should help put Japan in the forefront of this.

Where to Invest

It is predicted that many of the initial policy directives by the DPJ could help small businesses by stimulating domestic consumption. The new government will want to show it is dedicated to raising the standard of living of ordinary Japanese. This will in part be achieved by aiding smaller companies who received far less support than big firms during the previous government's rule. A further boost to this sector of the economy is reflected by the fact that many smaller cap companies are still run by men in their 70s or 80s. A consolidation is due and that will underpin share prices.

What to Buy

The iShares MSCI Japan SmallCap ETF (ISJP) is a low cost tracker fund that aims to track small-cap Japanese firms, defined as being those companies whose total market capitalisation lies between the 85th and 99th percentile of the country's total market capitalisation. Traded on the London Stock Exchange during normal market hours, the ETF offers investors a low-cost method of gaining exposure to over 700 companies with a total expense ratio of just 0.59%.

Conclusion

Given the additional attractions of the smaller companies sector, we are advising clients to invest up to 5% of their equity allocation in the iShares MSCI Japan SmallCap ETF.

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