

# Japan Equity Fund Positioned for Sustainable Growth This Year



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The Japan Equity Fund (JEQ) is a diversified, closed-end fund listed on the New York Stock Exchange and its portfolio is comprised of companies that are traded on the First or Second Section of the Tokyo Stock Exchange, or are listed on the over-the-counter market in Japan. Managed by Daiwa SB Investments Ltd. since its inception in July of

1992, the main goal of the fund has been to outperform its counterparts in the Tokyo Price Index (the TOPIX) over the long term. Performance is calculated on a total return basis, which includes appreciation in stock prices as well as the payout of dividends to those invested in the fund.

### **Portfolio Approach**

One of the fund's strongest aspects is that its managers do not look to "time the market" by making an unrealistic attempt to predict price activity in the benchmark Japanese

indices, currency exchange rates relative to the US Dollar, or in the Japanese economy as a whole. Instead, the fund is designed to improve on the performance of the underlying benchmark indices and to keep a maximum amount of capital invested at all times. Essentially, this means that hedging strategies are not implemented, as this would limit the ability of the fund to maximize total returns and remain at or near a full level of investment.

The fund's management team selects investments for the Fund using an "active" analysis of various factors that will influence the value of each security over the lifetime of each position. Traditionally, a quantitative valuation approach is followed by a judgmental analysis that is used as a basis for each "buy" position, and only then will investments be established. This two-tier approach helps to eliminate stock choices that carry an unnecessary amount of risk and enables the management team to select stocks which are undervalued at their current prices. To date, the Fund has made three transferable rights offerings, which were all fully-subscribed and created proceeds of more than \$72 million.

Transparency and accuracy are both hallmarks of the managerial plan, as the Fund publishes reports to its stockholders semi-annually

◀ and will distribute earnings press releases on a quarterly basis. This is released in lieu of an annual prospectus as this provides a more up to date description of the fund's performance. Another positive is that the Fund has the ability to repurchase shares in the open market, although the Board of Advisors has not undertaken this action since the Fund's inception.

### Dividend Distribution

In terms of dividend payments, it is the intention of the Fund to distribute its taxable income and capital gains at least once each year. One of the most attractive aspects of its dividend payment system is the Dividend Reinvestment and Cash Purchase Plan that is made available to shareholders. With this plan, dividends and capital gains on additional shares are automatically reinvested so that long term shareholders can achieve additional appreciation without actively managing their position sizes. The additional cash investments are carried out on a semi-annual basis (conducted in February and August) as the additional shares are purchased in the open market. Investors can register for the program by calling the American Stock Transfer & Trust Company at (866) 669-9904 or (718) 921-8124.

### Asset Allocation

Looking at the specifics of the portfolio's component stocks, we can see that cyclical companies are favored over more defensive investments, which is reflective of the Fund manager's wider economic outlook: "We have a bullish view on both the global and Japanese economies, and we are positive on cyclical sectors, such as industrials, materials, and financials. We are currently underweight defensive



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sectors such as consumer staples and health care," says Naoto Nagai, Senior Portfolio Manager at Daiwa SB Investments Ltd. and lead manager for the Japan Equity Fund. Primary choices within the Industrial sector include trading companies with significant commodity exposure (specifically in coal, copper and oil)

as these companies continue to post attractive valuations relative to historical averages. The latest run-up in commodity prices is viewed as supportive for these companies as an improved global economy continues to drive demand for these materials.

Another focus of the fund comes with an overweight exposure to financials. Most of the major banks in this sector saw aggressive sell-offs as the European debt crisis started making its way into the headlines and valuations remain at attractive levels months later, with price-to-book ratios still seen in the 0.8-0.9 region. Supportive policy measures from global central banks suggests that the worst of the declines in banking stocks have

reached completion, and with many of these stocks offering dividend yields near 4%, it is easy to see why this sector provides some of the best opportunities for gains in 2012. In terms of actual price targets, managers at the Fund see the potential for significant upside: "We expect the TOPIX index to rally by another 15 to 20 percent from current levels, which means that our price target could reach as high as the 950 to 1000 level for the index. We also believe that cyclical stocks, financials and exporters will outperform the benchmark TOPIX index," says Nagai.

### Supportive Central Bank Policies

During the sell-off in equities that was driven by negative debt headlines out of Europe, the Fund began accumulating stocks in cyclical sectors, and reducing positions in domestic defensive stocks, such as those in consumer staples and health care. Since then, Central banks have adopted an easing stance in monetary policy that is expected to generate positive market performance going forward. Another factor that should be emphasized is the recent action taken by the Bank of Japan (BOJ), which surprised markets and showed that the BOJ has become willing to commit to a more accommodative monetary policy. The reaction of the markets was a reversal in last year's strength in the Japanese Yen against the US Dollar and other major currencies.

During the Bank of Japan's policy meeting on February 14th, 2012, the Bank expanded its asset purchase program and altered its inflation targets for the year. "We believe this changed the direction of the Yen rate and we believe



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that the rally in the Yen is finished. Currency depreciation will be the main theme this year and beyond," says Nagai. "This means that export manufacturers in Japan will be better-off and will continue to post gains in sales." The actions taken by global central banks should be viewed as a major positive for the

fund, as it remains overweight in electronics and auto manufacturers (such as Honda and Isuzu) which are primarily driven by exports. The portfolio is clearly positioned for a sustained depreciation in the value of the Yen and given that this is now a central policy at the Bank of Japan, any additional downside in the currency appears limited.

### Capturing the Commodity Rally

The fact that this year's rally in commodity prices is due largely to the geopolitical risk situation in the Middle East, suggests that the rise in oil prices could be temporary. But with the collective accommodative monetary policy actions from the European Central Bank, the Bank of Japan and the US Federal Reserve, economic activity across the globe is widely forecasted to see continued strength. "With the accommodative stance in central banks, we see more upside than downside in commodity prices, as demand is likely to remain elevated in this economic environment," Nagai explains.

To capitalize on this expected strength in commodity prices, the Japan Equity Fund focuses on trading companies, as there are examples of companies actively investing in commodity-related projects in Australia, South America and, to some extent, in North America. These programs are expected to start generating profits next year, and this activity forms the basis for their selection within the fund. "In the next 6 months, we expect industrials (such as machinery and trading companies), financials and materials to outperform the rest of the market and provide the best opportunities for investment within the fund," Nagai says.

## ◀ **Asia as the Engine of Global Growth**

Economic growth in Asia is currently the fastest in the world and financial stability in these countries is now validating these trends, with trade surpluses being generated in many Asian countries. The regional economy has shown consistent improvement since the Asian Financial Crisis: "At the moment, the financial situation in Asian countries is very sound. Our fund looks to capture this high level of growth with stable economic activity. This is our focal point for investment in Asia," explains Nagai.

The Fund's primary focus is on names that have benefited from the Asian growth story, with some select choices coming from within the factory automation space. Higher income levels in Asian countries will likely continue to generate demand

for automation. As a measure of diversification, the Fund does own some consumer staple companies but remains underweight within this sector. Some exposure, however, is viewed as necessary in order to capture the higher consumption levels expected in Asian countries going forward. Another area of focus is on companies that will be able to benefit from the reconstruction activity expected in Japan following last year's earthquake/tsunami, which has been delayed due to slow government budget activities. These selections include construction and cement companies, as well as companies that can provide energy-saving technology. These themes help round-out the strategy of the Fund's stock selection process.

### **Conclusion**

With all of these factors in mind,

it remains clear that the Japan Equity Fund will enable investors to capitalize on the latest developments in the Asian markets while at the same time avoiding the volatility that is generally seen in funds with heavy exposure to emerging economies. The Fund's managerial team is committed to producing long term growth while at the same time allowing investors to stay informed of the performance and strategy that is being implemented by the team of Fund portfolio managers. All of these positives set the Japan Equity Fund apart from its counterparts and provide a clear choice for long term investors looking for stability-based diversification in the Asian growth market. ■

*At the time of publication, the author holds no position, long or short, in the Japan Equity Fund.*