Investment Review

Overview

After their striking performance in 1999, Japanese smaller companies were an area of bitter disappointment in 2000. The Nikkei OTC Average Index fell by 50.9% and the JASDAQ Index by 50.1%. Having greatly outperformed both indices in 1999, the NAV of the Company dropped by 72.9%, and ended year 2000 weaker than both benchmarks.

After reaching all-time highs by the end of March, the Japanese market started a decline in April which remained the trend for the rest of the year.

First, the emergence of problems at Hikari Tsushin raised questions about an entire group of stocks which had been branded “New Japan” plays. Next, we saw the building up of fears about the health of the US economy, which resulted in a sharp drop in NASDAQ. This dulled investor appetite for growth stocks in other overseas markets as well, including Japan.

In the last quarter of the year approximately 90% of the stocks held in the Company either announced upward revisions to their earnings forecasts, or came out with results exceeding expectations. Yet this trend went totally un-noticed as the market preoccupied itself with the direction of the Japanese and US economies, and other macro issues.

It was not only the sell-off in growth stocks held in the portfolio which caused substantial pain. In the second and third quarters matters were made worse when the market started to buy the type of old economy, so-called ‘value’ issues, in which the Company is underweight. Investors perceived these issues to be undervalued laggards in an economy which might finally be showing signs of life. As an illustration of the type of low quality issue targeted by the market, 47 of the 50 most indebted companies in Japan were outperformers over the three months from April to the end of June.

Outlook

Over the final quarter of the year it became clear that Japan’s economic recovery was weaker than the Japanese authorities had insisted, confirming our belief that the market had over-reacted in its excitement about cyclical and economic sensitive stocks such as shipbuilders, textiles and steelmakers. Considerable restructuring will be necessary to bring competitiveness in these areas in-line with flexible, low-cost overseas producers. Regardless of the pace of reform at the companies , these efforts are certain to produce a drag on economic expansion and on the share prices of the companies concerned.

On the contrary, the outlook for many new businesses operating in new sectors remains very good. The sizes of, for example, the Japanese internet advertising economy and the e-commerce market are only a fraction of those in the US, implying higher sustainable growth rates for good companies that operate in these areas. Similarly, the outsourcing of personnel training, software development and medical services are also new, and growing, industries. Non-bank finance is another industry still in its infancy in Japan.

Portfolio Strategy

Early in the year, the Company’s positions in technology and internet issues were reduced significantly with the belief that market volatility would remain and that, subsequently, investors might question the rationale behind paying such high premia for growth. In some cases it became clear that increasing competition had diminished the growth prospects for some companies, making their share prices seem rather expensive as a result. This was behind our decision to sell stocks such as MTI and Inter Q. Although our decision could have been implemented earlier and more aggressively, it was, in general, correct. In a continuation of this theme, since the end of the year the position in Yahoo Japan has been eliminated completely. Finally, the gearing was cut to zero, and for much of the second half of the year the portfolio ran a cash position in excess of 10%.

We seek to invest in companies which are small today, but which we believe have the management quality capable of turning them into large ones in the future. Examples of companies which rank amongst the Company’s top ten holdings are Trend Micro (anti-virus software), Eneserve (power generation), Otsuka Kagu (furniture retail) and Net One Systems (major Cisco distributor).

Although many growth stocks fell out of favour last year, we see no reason to abandon them. Their earnings are growing steadily, and in some cases rapidly. They have good management and most look set to exceed their earnings estimate for the approaching March 2001 earnings season. The trading game behind last year’s bounce in low quality, low-priced shares does not tempt us in any way and we intend to concentrate on finding good companies which are well priced relative to the growth rate expected from them. Recent examples of companies purchased for the Company, where share prices have imploded and where investors appear to expect nothing in terms of future profit growth include Goodwill (personnel supply) and TOW (advertising campaigns).

As an example of the value-for-earnings approach inherent in the Company, the current forecast growth rate in profits for our holdings in the fiscal year to March 2002 is estimated at 42%, with a price to earnings ratio of 26x.

JF Asset Management Limited
Investment Manager
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