Investment Review

Market Review

This reporting period started with excitement and hope as Mr. Koizumi emerged as a popular Prime Minister. His talks of aggressive action to clean up banks, privatization initiatives, and a comprehensive reform of public works were exactly the right triggers to entice foreign investors back to the Japanese market. This initial enthusiasm was short-lived, however, as Mr. Koizumi's proposals lacked detail and action. After peaking in May, all major indices gave back their gains by mid-July and went further south. As the economic situation at home and abroad worsened, Japanese equities suffered further. A crushing blow to worldwide markets came with the tragic terrorist attacks in the US on 11 September. Investors rushed to the safety of cash and treasuries, and avoided equities. Governments and regulators have since moved swiftly to restore order and stability to the markets. Post-September, tech stocks led a liquidity-driven market rally and global markets recovered to pre-incident levels by year-end.

The Portfolio performed roughly in-line with the OTC universe during the year, with the NAV declining 23.0% in US dollar terms and 11.5% in yen terms, yen weakness against the US dollar accounting for the balance. The Nikkei OTC Average index declined 20.2%, whilst the market-weighted OTC (JASDAQ) index declined 24.1%. The difference between the two reveals a positive performance bias for lower capitalization shares in 2001.

Portfolio Activities

Given the weakening economic situation in Japan and concerns about financial distress in the banking system and the corporate sector, the Portfolio remained in a conservative, net-cash stance over the review period. Investments continue to focus on the growth of the service economy. Otsuka Kagu, Japan's largest furniture retailer, remains a core holding despite unsatisfactory performance in 2001, as our frequent company visits confirm that the company manages to grow market share rapidly and improve profitability. HIS, a leading discount travel agency, was added as a core position in the wake of the September incident when negative sentiment brought the stock price down by 50% to very reasonable valuations. As expected, the travel sector recovered considerably since the attacks. Other core holdings include Plenus, a boxed lunch restaurant, Arrk, the world's foremost prototype modeler, and Photonics, a leader in the field of nano-level measurement devices.

The investment manager kept the core "growth" holdings, even when the market biased towards economic sensitive and value stocks. We believe that balance sheet "value" in Japan is often illusory and is unlikely to be unlocked and realized by investors. In the current environment safety is to be found only among the top players in each sector which possess the strength to survive an extended domestic recession. A strong balance sheet alone is insufficient - aggressive management, a focus on profitability and a robust business model are essential for survival. Unfortunately these small latter companies are typically punished most when foreign capital leaves.

Market View and Investment Strategy

Japan's economic outlook remains bleak. Deflationary pressures are keeping all but the most competitive companies from achieving sales growth. Deteriorating profits, record levels of bankruptcy and tightened credit are combining to force companies to lay off workers. Growing unemployment and gloomy prospects for wages will bring forth lackluster consumption. The Bank of Japan reacted to these concerns with a return to the 'zero interest rate policy' to achieve a target of 'zero deflation', a move which would weaken the yen ultimately. Neighboring Asian countries have already criticized the weak-yen policy on the grounds that Japan is exporting the burden of structural over-capacity rather than pursuing meaningful fiscal and structural reform.

We expect a low interest rate environment to spur economic growth, and abundant liquidity to fuel the equity markets. It is difficult to imagine, however, that this liquidity will sustain the recent strength in tech, as capital expenditure on tech-related equipment is being pared back. Whilst broad market themes such as "high-tech" or "value" may enjoy short-lived rallies, it will be company specific fundamentals that drive sustainable share price moves. We continue to pay company visits and are encouraged to find many undervalued small and mid-cap companies which have managed to flourish and exceed expectations even in these difficult economic circumstances. Many of these companies have been overlooked by investors and remain on attractive valuations. We continue to count on company visits to discover undervalued quality companies and invest in these promising growth stocks with a medium-term view.

JF Asset Management Limited
Investment Manager
27 March 2002