Investment Review

Market Review

JF Japan OTC Fund Inc. achieved a return of 15.6% over the first half of 2002 versus the Nikkei OTC Average Index return of 16.6% in USD terms, partly helped by the 9.5% appreciation of the yen. However, month-to-month performance has fluctuated considerably.

Economic data over the last six months suggests that a nascent global recovery is intact, but extremely fragile. On the positive side, general consensus has been reached that industrial production in Japan has bottomed as of the fourth quarter of 2001. The combination of stabilizing order trends and corporate restructuring has led most Japanese firms to forecast extremely positive earnings growth for the new fiscal year. Official forecasts show profits rebounding between 30%-40% in the coming year.

Contrasting with this positive news, however, has been the downgrading of Japan's sovereign debt, the lack of action on the part of Japanese authorities to restructure the government or stimulate domestic economic growth, the vacillation on government policy, as well as the continued downgrade of expectations for the US economy and equity market. These mixed signals have increased volatility as equity investors have fluctuated back and forth between the temptation to buy on dips and to flee to the safety of cash or treasuries. On the whole this increase in market risk has resulted in a continued investment bias for the perceived safety of value stocks. This trend was particularly noticeable during the January/February period when our growth-focused portfolio lost considerable relative performance against the value-biased index. Foreign investors have been especially reluctant to participate in the brief and short-lived market rallies we have seen this year. It seems clear that global portfolios have been shedding some of their overweight position in US equities as expectations for growth in the US have diminished over the last six months. This action has not translated into a rebalance of their Japan holdings to neutral, however, as uncertain outlook has directed funds to the safety of cash and treasuries.

Investment Review (continued)

Market Outlook and Portfolio Strategy

Accounting related scandals, poor earnings, and an unsteady recovery in the US will keep global equity markets volatile in the near term. Although economic data in Japan suggests that a mild recovery is on the way, investors are sceptical about the prospects for continued improvement if the US economy continues to weaken. As US assets are sold off by global investors, decreased demand for dollars will continue to put upward pressure on the yen and exacerbate the difficulties of Japan's exporters. Although we believe that Japanese equities valuations have fallen to reasonable levels in both absolute and relative terms, it is likely that the pervasively negative sentiment toward equities as an investment vehicle will dampen upside potential in the short term. Taking a longer view, this presents investors with an unprecedented opportunity to buy good quality names at significant discounts based on the gap between sentiment and the underlying fundamentals.

Given the current market volatility and growing uncertainty about the breadth and strength of the US economic recovery, the portfolio is positioned conservatively with a concentration in low-priced, domestic shares. We are staying away from export and yen-sensitive names so as to minimise the potential downside impact from a slowing of growth expectations in the US and Europe. We are also avoiding high beta stocks since these names will be more prone to suffer large price swings based on the daily shifts in market sentiment. We believe that for the next few months performance will be improved by focusing on steady, albeit less-exciting companies, which offer a high degree of clarity on earnings.

JF Asset Management Limited
Investment Manager
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