Investment Review

Small cap stocks led equity markets in Japan during the first half of 2001. The benchmark Nikkei OTC Average Index bottomed in the first week of January and showed steady upward momentum through May with a year-to-date peak level of 1,453, up 17%. More than half of these gains were shed in June, however, as global markets suffered renewed volatility. Japanese equities share many of the concerns of their global counterparts - among them, the slower pace of global growth, the cyclical downturn in technology, and tenuous consumer confidence. However, some Japan-specific factors have also contributed to the volatile returns thus far this year.

First, much of the optimism that took root after the market sell-off last year was attributable to the emergence of Mr. Koizumi as a long-shot candidate for Prime Minister. Unlike the generic party leaders who also joined in the race, Mr. Koizumi was successful in taking his aggressive reform message to the people. This message not only delivered him to the sought after post, but also helped him to achieve the highest approval ratings in history for a Japanese Prime Minister. While this clearly contributed to the market's health in the early months of the year, skepticism about what can actually be accomplished by this anti-establishment administration is growing. At the same time worries about the financial system and the handling of bad debts at Japan's leading financial institutions continue to hold sway in investors' minds.

Second, officials at the Bank of Japan have reiterated their pledge to do their part in reviving the economy. This pledge takes the form of a commitment to fight deflation with a renewal of the "zero interest" policy. While this would usually be considered a positive for the economy and equity markets, banks are unwilling to increase lending and potential new money is not finding its way into the economy. In the past two months it has been made clear by these same BoJ officials that positive action on the part of politicians to restructure the economy is a prerequisite to more aggressive quantitative easing and money creation. Against this backdrop investors' initial optimism has faded with growing doubts about the establishment's willingness and ability to change its spots.

Under these circumstances the core positions in the Company have remained in place. We believe that the proper stance is still a recession-resistant portfolio concentrated in retail and services. While the retail portion of this stance may seem counter-intuitive, we have found that legal barriers and political interests have conspired to preserve fragmented markets in which only the weak economic environment has succeeded in driving consolidation. For this reason clear winners and losers are emerging. Performance of the Company has kept pace with the Benchmark Nikkei OTC in the first half despite having lost considerable ground in very difficult June trading.

Investment Review (continued)

Market Outlook

Uncertainty is the key word for the balance of the summer. The much-hoped-for self-sustaining economic recovery has not materialised and the data seems to get worse by the hour. The outlook seems especially bleak for technology companies where market expectations have remained unrealistically high. While analysts and companies are currently revising down estimates, it is still likely that the market will be hit by negative surprises in interim previews. A key problem we note in our company visits, but do not hear discussed in broker research and media reports, is the vast increase in production capacity for everything from semiconductors to optical fiber, even as demand has declined sharply with slower economic growth and inventory adjustments. This suggests that many technology firms could see record losses this year, and that a return to stronger order trends will not necessarily result in a return to commensurate levels of profitability.

On-going corporate restructuring will keep unemployment high and put pressure on consumption. Lack of final demand domestically and slowing economies around the globe will exacerbate the existing output gap and fuel deflationary pressures. Despite this generally grim economic outlook, we believe some positive arguments for Japanese equities can be made. We note that the broader market is at or near historical lows despite the fact that many companies have undertaken significant restructuring programs. Corporate profits have improved considerably over the past couple of years even though revenue growth has been less impressive. New accounting standards are resulting in an increased level of disclosure and clearly improved corporate governance. Declining levels of cross-shareholdings are breaking the cozy arrangements between management and their banks and other vendors. With the dissolution of these protective relationships M&A activity is on the rise.

Clearly the big question is the extent to which the new administration will pursue structural reform after elections in late July. Significant upside for equity markets will require a conscientious and aggressive response to the looming financial crisis as well as significant effort to restructure government participation in the economy. Whether this hoped-for action is taken or not, the economy has considerable pain to go through before a self-sustaining recovery can be achieved. If the proactive choice is taken, however, investors may be coaxed into taking a long-term view on the market. If the government disappoints with "business as usual", investors will continue with their current negative to neutral weightings in Japan and search to increase exposure in other more forward-looking markets. While we acknowledge the sincerity and broad-based support of this reform-minded administration we are also wary of the lethargy and inertia that comes from the vested interests within government. Now is the best chance Japan has seen in over a decade to make significant changes to the economy. We hope for the best, but will wait to make aggressive bets on success until concrete signs of reform start to appear following the July elections.

Portfolio Strategy

We believe that regardless of the path chosen by government leaders, the economy will struggle into the foreseeable future. Although economic activity remains subdued, the Company is kept fully invested as 1) at current levels a great deal of negativity is already priced into shares; and 2) we feel confident that our core holdings are not only surviving the difficult economy, but are also taking market share from the competition. Companies such as Otsuka Kagu (8186), Eneserve (6519), and Arrk (7873) — all top holdings in the Company — have credible track records in a difficult economy. At the top end of valuations we see primarily technology companies which still trade on relatively high PERs. The Company is underweight in this area, even though some technology companies have not disappointed and demand continues to be strong, because it is difficult to see what might push valuations higher in the current difficult environment. The core of the Company remains mid-priced service and retail stocks like Otsuka Kagu (8186), Goodwill (4723), and Eneserve (6519), leaders in their respective market segments.

The Company has also avoided the "cheapest" stocks in the market which have so far out-performed this year. Most of these companies operate in Japan's old-economy sectors and suffer from bloated balance sheets and falling prices. Although the ephemeral revival of positive GDP in Japan over the last year sparked renewed interest in these value plays, a return to negative growth and deflation will weigh heavily on these already asset-heavy companies. We are mindful, however, that within these tired sectors of Japan also lay the greatest potential turnaround opportunities. We are therefore spending considerable time looking for restructuring plays amongst the rubble.

Given the uncertainty of global markets and the many changes taking place in Japan, we believe that a cautious stance for the Company is warranted despite the technically oversold nature of the OTC market. We will be watching events closely over the coming quarter in the hope that positive developments will emerge to justify a more aggressive stance.

JF Asset Management Limited
Investment Manager
7 September 2001