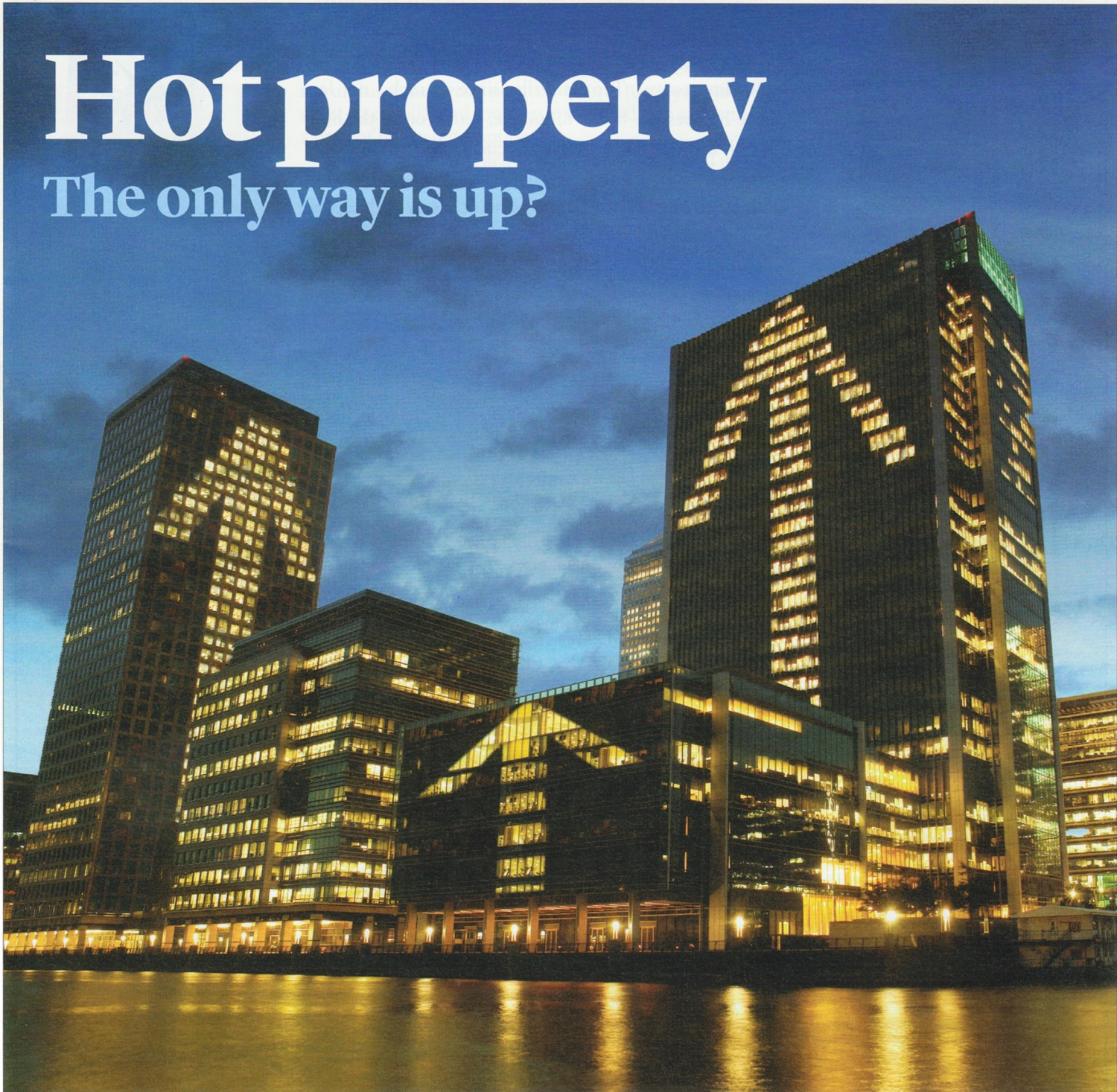


First for Investment Strategists/15 May 2013/£3.95

Hot property

The only way is up?



Patrick Collinson

Dunedin Smaller Companies investment trust manager

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Investment committee

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Holly Mackay

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A yen for Abe's Japan reforms?

“ Although there has been a very strong rally in Japanese markets it could have much further to go. Whether the stimulus and the weakening yen will lead to a sustainable economic recovery remains to be seen. There are many structural and demographic issues that make me suspect that this will be difficult to achieve. However, markets are not the same as economies.

I cannot see the currency weakening much further, so would be wary about hedging the currency risk. Investors who did so over the past few months will have done very well, but this could be a lot riskier going forward. Japanese companies' prospects, particularly those of exporters, have suddenly improved dramatically with the weakening of the yen. Many of these companies struggle to break even at ¥80 to the dollar. At ¥100 to the dollar they are much more profitable.

The authorities will be wary of the yen weakening much further as this could actually hurt the economy, particularly as Japan imports nearly all its energy. However, should the yen stabilise around the current level, this bodes very well for the Japanese market.

“ Japan's demographics are the worst in the developed world. Just last year the number of baby nappies sold was surpassed, for the first time, by the number of adult nappies sold. Caring for the elderly will be hugely expensive for Japan. Already Japan's tax revenues are only about a half of its government's annual spending. At practically zero interest rates they can manage. However, as the currency is decimated, government bonds will be too, interest rates will rise, borrowing will go to the stars (it is already at Mars) and the country will move from deflation to super- and maybe even hyper-inflation.

Thus, bonds will be sold and equities will be bought left right and centre. The problem for foreign investors is how to benefit when the currency debases, negating skyrocketing share prices. Our answer is the DXJ ETF from WisdomTree. The fund employs an investment approach designed to track the performance of the WisdomTree Japan Hedged Equity Index. The index and the fund are designed to provide exposure to equity securities in Japan, while hedging exposure to fluctuations between the value of the dollar and the yen.

On the assumption that sterling will be debased not materially faster than the dollar, the DXJ will allow us to benefit from the inflation that is likely to occur for years or decades in Japan.

“ At our asset allocation meetings, Japan polarises our team into two camps; those above 35 and those below. Those pro-Japan point to Abe's reforms as the catalyst to finally bringing their economy out of the doldrums and argue that from a historic valuation perspective the market provides good value. The anti-Japan camp point to poor demographics, a horrendous debt-to-GDP ratio and an element of witnessing potential reforms in the past only to see them fail, most recently under the Koizumi government in the early part of the last decade.

Both arguments have merit and one cannot deny the recent performance returned by the Japanese market. However, the strategy undertaken could be considered high risk, with markets potentially reacting quite savagely to any perceived lack of progress. Therefore for our real return mandates we have maintained a zero direct weight to Japan, although we maintain our overweight position to South East Asia, which would benefit indirectly from a Japanese resurgence. Within our higher-risk relative return mandates we have taken a modest weight to Japan through the Lindsell Train Japanese Equity fund.



Mike Deverell,
investment
manager,
Equilibrium Asset
Management



Jonathan Davis,
managing
director, Jonathan
Davis Wealth
Management



James Calder,
head of research,
City Asset
Management



**Adam Lewis, committee chairman
and associate editor, Fund Strategy**

Welcome to the third Fund Strategy Investment Committee. This month we are joined by Hermes' chief economist, Neil Williams.

Oh, Japan, Japan, Japan. Ever since I entered financial journalism back in 2001 it has been the one country that despite consistently being forecast to do well by a section of experts at the start of every calendar year, has consistently failed to deliver. In fact every time you hear the expression, "another false dawn" you cannot help but think of Japan's economic and stockmarket prospects.

So it will be no great surprise, despite the impressive gains posted by the Japanese stockmarket this year, with stocks enjoying their best run since the 2003-06 rally, if many investors remain wary.

But there is a lot of positive chatter in the market that Prime Minister Shinzo Abe's reforms finally show that the political will is there to support a sustained economic recovery. Indeed, some fund industry heavyweights are backing the story, with Neptune's Robin Geffen taking an overweight in the region.

On the back of Abe's promises to stimulate the economy and the Bank of Japan's aggressive moves to lift the country's growth rate, just last week the yen passed a psychological threshold, falling through the 100-yen barrier against the dollar for the first time since April 2009. This increases the hope that the exporters in the world's third-largest economy are heading for further booms.

So the question I pose to you this month, the one of many investors' lips, is this: Is the recovery in Japan real or just another false dawn?

Our expert panellists give their views on whether Japan's strong rise and Shinzo's Abe's radical economic reforms are the precursor to real recovery or just another false dawn



THE INDEPENDENT VIEW

Neil Williams, chief economist, global government & inflation bonds, Hermes Fund Managers

The trade-weighted yen may have weakened 23 per cent in a year but hopes that Abe will once and for all be able to accelerate growth and erase deflation look optimistic – against weak external demand, risk aversion, and liquidity injections in the US and elsewhere.

Abe's most radical measure – to double the Bank of Japan's 16 per cent share of Japanese Government Bonds to nearer the US Fed's share of treasuries – has forced global bond yields back toward historic lows. But it is difficult seeing meaningful economic and fiscal improvement ahead of the consumption tax rise from 2014 (from 5 to 8 per cent, then to 10 per cent in October 2015).

What the tax will do is bump up inflation. Elevation of the BoJ's plus 1 per cent year-on-year CPI "goal" to a plus 2 per cent target implies government influence on BoJ policy. But the MoF's grip has never been loose, including MoF oversight of the BoJ's monthly policy-setting meetings and direction of foreign exchange intervention. Yet getting the yen down far enough for Abe's 3 per cent year-on-year full-year nominal growth (last achieved in 1991) may be a struggle. PPP suggests fair value no higher than ¥109. Elimination of the trade surplus helps but; the ballooning of Japan's deficit with China is partly offset by a bloating of its surplus with the US; carry-trades look limited till rates lift elsewhere and overseas assets keep the current account in surplus.

Japan's day in the economic sun will come but with wages and land prices still falling, energy imports more expensive, a tax hike coming and G7 growth sluggish, there is scope for another false dawn.



Ryan Hughes, portfolio manager, Skandia, part of Old Mutual Wealth

“This time it's different” is a phrase that should generally make investors run for the hills but this time for Japan I think it might just be sufficiently different to make the cynics take a fresh look.

Japan has entered a period of change with a fresh government emboldened by a mandate to deliver real market reform and a new governor of the Bank of Japan with a clear remit to deliver growth and inflation back into the economy. The “different” element is that the government is rapidly backing up its bold words with even bolder actions. The huge stimulus plan is a massive statement of intent that demonstrates they are prepared to do pretty much whatever it takes to get inflation back into the economy.

Looking at the economic data, there are positive signs that also indicate that the economy is evolving. The manufacturing Purchasing Managers Index is up sharply while the services PMI is up even more, indicating expansion. Critically, consumer confidence appears to be on the up, as indicated by increasing consumption which is going to be vital in generating growth in the economy.



Tim Cockerill, head of collectives research, Rowan Dartington

“Abe's overwhelming majority should enable him to make major policy decisions more easily than other prime ministers have been able to do in the past. He kick-started his reforms by announcing an inflation target of 2 per cent followed by a huge quantitative easing programme. Japan has, of course, had QE in the past and its level of debt to GDP is already high, at over 200 per cent, but his new round of QE is larger than anything before.

Abe has two further “arrows” to fire to stimulate Japan's economy – spending on new public works and reforms to encourage the private sector to invest. If his first arrow, QE, and the inflation target create inflation, after two decades of deflation, consumers will spend and if companies see increasing profitability, investment will be encouraged and equities will come back into favour with Japanese investors who currently hold only a small percentage.

In the meantime, the market has become excited about the prospect of real change and risen strongly. There is still value in Japan and if the next two arrows are aimed well, the market is most likely to respond positively. If they then have the desired effect – and this will take time to become clear – the risk to investors will be on the upside.



Lee Robertson, chief executive, Investment Quorum

“Shinzo Abe, an extremely experienced politician, has swept into power for the second time and has already made his presence felt with what has been termed “Abenomics”. This is a bold strategy to “shock and succeed” against a backdrop of historic continued failure to stimulate the Japanese economy. The policy includes flooding the market with liquidity, weakening the yen and lastly aiming to get inflation up to two per cent.

A real change of sentiment appears to be beginning to take hold in Japan which initially surprised many market watchers who had long despaired of any real change of direction or momentum. Since the election, the Topix Index currently stands more than 60 per cent off the lows established in November 2012.

If earnings upgrades continue, if structural reforms stay the course and the Japanese exporters really do benefit from the lower yen, leading to greater competitiveness and employment numbers, we see this as a real opportunity, albeit with some risks attached.

Funds we consider useful in this space would be Jupiter Japan Income, GLG Japan Core Alpha and CF Morant Wright Japan. They have proven their worth in uncertain times and should benefit from the current upsurge in investor sentiment.