Time to look to the East?

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In the first in a regular bulletin for Russell OpenWorld® investors, Russell's European head of Capital Markets Research, Dr John Velis, discusses the opportunities presented by the current historically low valuations in the Japanese Equity markets.

Of all the major developed-country market indexes, Japan has turned in the worst performance since the outbreak of the credit crisis last summer. Ever since the "lost decade" of the 1990's, non-Japanese investors have usually looked askance at the Land of the Rising Sun, and this market continues to be associated with poor corporate governance, sclerotic market mechanisms, and the heavy hand of increasingly ineffective governments. In fact these stereotypical views on Japan are less valid than before; in a structural sense, Japan has come a long way in the past decade.

Table 1. Russell Global Index performance, selected regions

Index	since Jun-07	YTD
Russell Global UK	-32.6%	-31.0%
Russell Global Developed Europe x UK	-42.5%	-38.7%
Russell Global US	-34.4%	-33.2%
Russell Global Japan	-50.4%	-41.0%

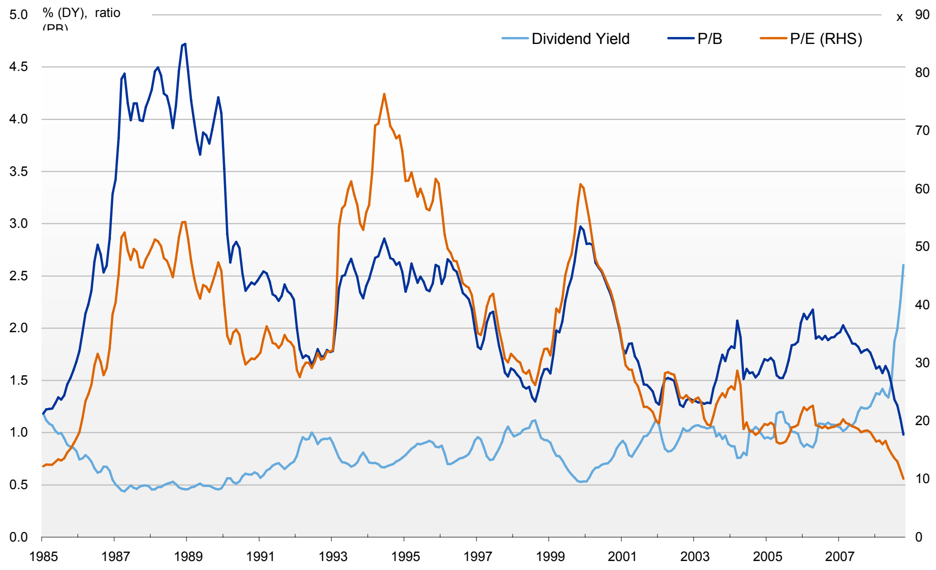
NOTES: Russell Global Indexes, Total Return, Local Currencies
Source: FactSet as of 31-Oct-08

Nevertheless, the present economic and financial cycle has not been kind to Japan, as table 1 above demonstrates. Large cap companies in Japan are heavily geared to foreign economic demand, and the market tends to move in line with foreign inflows into the domestic market; the fact that global investors do not favour equities in general has certainly held Japan back.

However, we currently view Japan to be offering historically attractive value. In our most recent market outlook, in which we argue for a positive stance on global equities (and this for the first time in the four quarters since we have been publishing explicit market views), the only region within the asset class that we favour an above benchmark exposure is Japan.

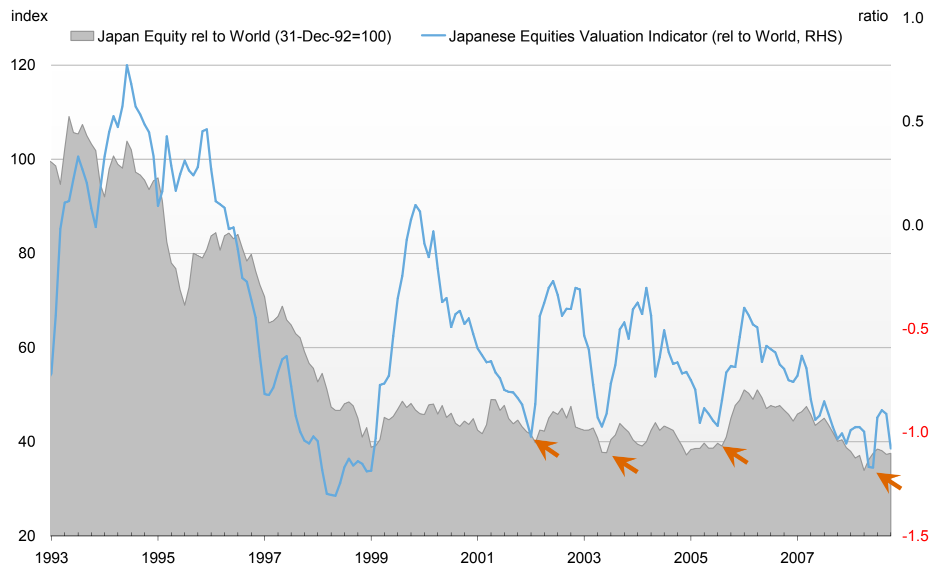
Valuations in this market are at historic lows. Traditional measures, like Price to Earnings and Price to Book ratios are at historic lows, and dividend yield (the inverse of which is a measure of value) is at a historic high (see figure 1). Furthermore, our in-house proprietary valuation indicator, which is a combination of over half a dozen traditional valuation multiples in Japan relative to the same multiples for the global market, all adjusted for historical behaviour, is at levels that typically correspond to subsequent Japanese outperformance relative to the rest of the world. This is shown in figure 2. There is indeed value in Japan!

Figure 1. Japanese Equities, various valuation indicators



NOTE; Factset Indexes, data as of 31-Oct-08
SOURCE: Factset

Figure 2. Japanese Equity Price and Japanese Composite Valuation Indicator, relative to world



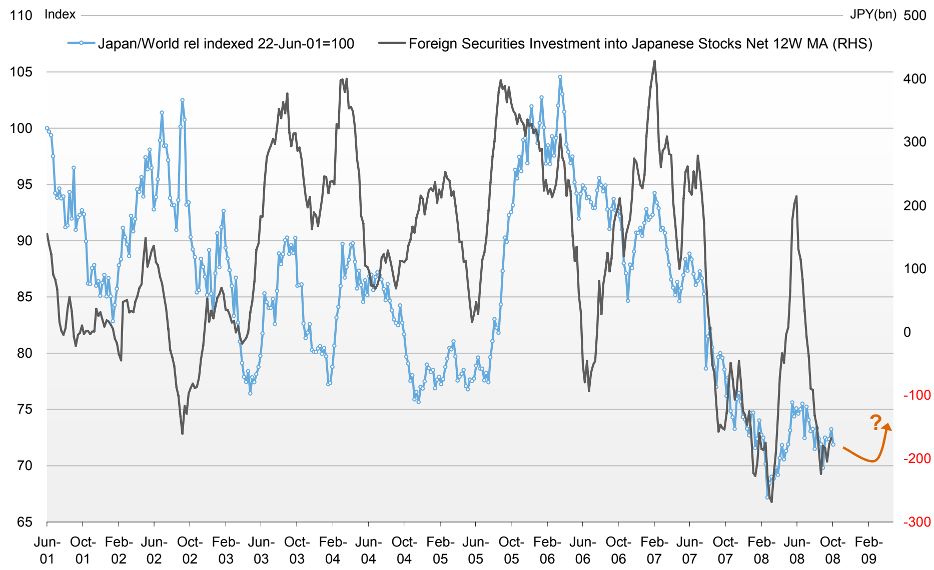
NOTES: Japanese Valuation Indicator (composite of PSales, P/B, PCFlow, EV to EBITDA, Div Yield, G-D P/E, all relative to World, Z-score adjustments) lower=cheaper. Price index comparison using MSCI Japan index (JPY) and MSCI World index (USD).
SOURCE: Russell Calculations, FactSet, Bloomberg as of 31-Oct-08

Russell's senior portfolio manager for Japanese Equities, Ross McFarlane, a nearly 20-year veteran of the Japanese market supports this view:

"As a cyclical market, Japan is currently being affected by the global economic slowdown, which is clearly seen in the sharp earnings falls being experienced by even the best managed companies like Toyota. However, many value investors have identified Japan as currently offering an incredible opportunity. The market Price to Earnings Ratio (PER) is at historically low levels (although the 'E' is subject to revision), and the Price to Book Ratio (PBR) for the market – the most reliable indicator in previous downturns - is at levels last seen nearly forty years ago. In addition, the market dividend yield is now close to 3%, compared to long bond yields of 1.5%."

In addition, shorter-term technical indicators are suggesting that the time might be ripe for a long Japanese exposure. One of our favourites looks at foreign (i.e. non-Japanese) purchases of Japanese equities. When investors from abroad enter the Tokyo market, it tends to rise quite sharply. At present this indicator shows that investors have been "out" of the Japanese market in great numbers. We also point out that this indicator has pretty reliable mean-reverting behaviour. If we are right that global equities are due to rebound somewhat in late 2008 and early 2009, then Japan is a place that could stand to benefit from an onrush of foreign buy, propelling the market higher.

Figure 3. Foreign purchases of Japanese Equities



NOTE: 12-Week Moving Average
SOURCE: Bloomberg, Factset, Data as of 24-Oct-08

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