

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

The Japan Equity Fund: An Overview

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SECTOR – GENERAL INVESTING

TWST: Would you begin by telling us about the Japan Equity Fund and your investment philosophy?

Mr. Small: The Japan Equity Fund was first listed on the New York Stock Exchange in mid-1992. At that time, we used quantitative analysis and a program-trading model developed by Dr. Harry Markowitz. In 2001 we switched the investment process of the fund to more of an active style, and our institutional portfolio managers took over the day-to-day operations of the fund. We manage the Japan Equity Fund very similarly to the way we manage our institutional and pension accounts, in that we primarily use a value approach, which is not really surprising in the Japanese market. We strive to beat our benchmark through active management, which is comprised of about 30% quantitative and 70% qualitative analyses done by our research people and portfolio managers. One of the main reasons that we use a value approach in Japan obviously is due to the maturity of the market. That philosophy has been our flag bearer since our firm, Daiwa SB Investments, was founded more than 35 years ago. We transferred that strategy, which has been very successful in the domestic Japanese market, to this particular fund in order to provide U.S. investors with access to that style of management.

TWST: What is your benchmark and how have you done compared to it?

Mr. Small: The benchmark for the Japan Equity Fund is the TOPIX, or the Tokyo Stock Price Index. The reason we use this as our benchmark is that we feel it is a much broader representation of the Japanese market than either the MSCI Japan or even the Nikkei. Over the past few years, we've had a couple of good years and a couple of down years. One of the issues with working in the closed-end fund arena is that our performance, meaning the net asset value performance of the fund versus the TOPIX, is not really correlated to the performance of the fund's shares here in the U.S. With that said, on an NAV basis, we are up

about 65 basis points on the index year-to-date. As of the end of September, the fund was up 7.25% and the TOPIX was up 6.61%. In 2007 and 2008, we underperformed a bit; while in 2005 and 2006, we exceeded our target and outperformed by about 0.4% and 2.5%, respectively.

TWST: Generally speaking, why do you think you have that kind of variation from the benchmark?

Mr. Small: To be honest with you, I don't know. I'm not the fund manager. I'll tell you that right up front. What I do know is that we have chosen not to really take any large sector bets.

TWST: Japan has been a tough market for a pretty long time now. What's your view on Japan's prospects, particularly in light of the change in government?

Mr. Small: I think that is the key factor right now. Similar to what happened here in the U.S., everybody was clamoring for change, change, change during the election process. Nobody really took a deeper look at it and said, "Okay, what is this change going to do? How is it going to affect the market?" Our short-term view is actually pretty positive in Japan. We think that it has lagged some of its developed market counterparts around the world, and that it's poised for a short-term recovery with short-term meaning somewhere up to the first quarter, maybe early second quarter of next year. After that we are a little less confident because we think that a lot of the shakeout of the newly implemented DPJ government policies, and some of the positive effects of all of the fiscal stimuli and ultra-easy monetary policies over the last couple of months are going to dissipate a bit. We think there is some value now, but we're not so sure come March or April of next year. Although we don't think the market is going to decline significantly at that point compared to what we expect to happen over the next few months, it should slow down a little and move sideways for awhile.

TWST: Is your fund more of a macro bet on Japanese companies and the Japanese economy?

Mr. Small: Not necessarily. The way that our firm operates, and again this applies to the Japan Equity Fund as well as our institutional Japanese equity products, is that we have an investment policy committee that meets on a monthly basis. At those meetings, broader macro issues are discussed, and we come up with a firmwide top-down strategy for the asset class. Once that's been accomplished and we'll set broad sector weightings at that meeting we come up with forecasts on various macro indicators. Our portfolio managers, with the help of our analysts, take it from the other side and go very bottom-up, very stock specific, staying within or around the guidelines as dictated by this firmwide strategy. We say that as a rule, 30% of our excess return is derived from this top-down strategy, with the remaining 70% coming from bottom-up analysis. In practice, however, it's really more like 90% bottom-up. So we use our investment policy, we use macro factors as the theme, but the real value and the real excess returns that we've been providing have come from the stock selection or bottom-up side.

TWST: From picking winners out of a theme?

Mr. Small: We hope. One of the benefits we have as a Japanese company is that our majority shareholders, **Daiwa Securities Group** and **Sumitomo Mitsui Financial Group**, are two of the largest financial institutions in Japan, so we have access to a lot of senior people within a lot of the companies that we're investing in, and that's certainly one of the advantages that I like to point out when I'm speaking with people. Also as we manage a sizable portion of the Japanese pension market, we are often approached by the companies we invest in directly. That is not to say that we get any sort of inside information, but I think we just know better what to do with the information that we're getting.

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TWST: Let's talk about various sectors within the Japanese economy. What are some of the ones you are excited about?

Mr. Small: I could tell you up until maybe two, three months ago the portfolio was very defensively biased. We've changed that and not a fundamental change but really a broadening of our scope to take a more cyclical look at the Japanese market. Right now we're overweight materials, industrials and consumer discretionary. We're neutral in financials, and financials really are the only defensive bias to the portfolio at this point. But we've taken no really large bets in that sector. We're underweight utilities, specifically energy. Energy stocks are not a very well-developed sector in Japan, at least from a performance standpoint, also health care and consumer staples. We're taking a look at how these

new DPJ policies will affect the market. I don't know how familiar you are with them, but the DPJ's campaign manifesto or what got them elected into office was more of a populist approach: social security, child-care reforms, those sorts of things.

TWST: Privatizing the postal system?

Mr. Small: That's something that's under consideration and has been a very market-unfriendly sort of initiative. With that said, at this point it's all conjecture: This is what the manifesto is, this is what the plan is, but what actually will shake out remains to be seen. So while we understand and recognize the potential impact of these new policies, one of them again being the privatization of the Japan post, we have still somewhat taken the perspective that not all of these initiatives may come to pass. Japan is still in a recessionary environment and we don't expect it to emerge over the next few months. So we're kind of up-hedging our bets there. We think that a lot of the potential implications of these DPJ policies have been priced into the market already, which is another reason why we think there is some value there. So if they are already priced in as a collective and not all of them come to pass, we think there could be some inefficiency

and there could be some room to maneuver. We're taking more of a cyclical approach, as though everything vis-a-vis the recovery is proceeding according to plan, but yet we remain cautious with regards to the new government.

TWST: Given the context of some market unfriendly policies, what sectors may benefit in an upcycle, if you are becoming more cyclical?

Mr. Small: I think that health-related stocks, not specifically health care, in which we are underweight, but drug-makers are fairly

popular these days. A lot of consumer stocks also. We think that with the more populist strategy of the DPJ, there will be more money flowing into the domestic side and demand is going to pick up a little bit. And that will, we hope at least, translate into the homebuilding and into construction side. Although at the same time, because a lot of the money that the DPJ is using to fund these strategies is coming from infrastructure projects, which is really all that's gone on in Japan over the past 60 years, we're talking a little bit of a hedge, where you have stocks within the same sector, some stand to benefit, others do not. One of the other sectors that we think is going to benefit if everything does come to pass is green technology or eco-friendly companies, which is another one of the DPJ's policies. They put out a mandate a few months ago to decrease CO2

Highlights

Michael Small manages the Japan Equity Fund in the same way the institutional and pension accounts are managed, using primarily a value approach due to the maturity of the Japanese market. A few months ago the portfolio was very defensively biased but he has since been taking a more cyclical look at the Japanese market and he is currently overweight materials, industrials and consumer discretionary. Financials are the only defensive bias to the portfolio and he is underweight utilities, specifically energy. Companies include: Mitsubishi UFJ (MTU); Honda Motor (HMC) Toyota Motor (TM); Sony (SNE).

emissions by 25% by 2020. So that, too, is another big initiative there. We're looking at those names, and we do feel somewhat positive about them. One of the main problems of having this fairly broad benchmark is that a lot of the stocks that we're currently holding are sizably underweight due to their large percentage makeup of the index. We have stocks that we may not have as high conviction about and have underweighted, but they still represent a fairly sizable portion.

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TWST: How many individual holdings do you have?

Mr. Small: Last check, it was 102 as of the end of October. The top 10 holdings make up about 25% of that.

TWST: What are some of the top individual holdings?

Mr. Small: Our biggest holding right now, as of October end, is **Mitsubishi UFJ** (NYSE: MTU). We have a little over 4% in that particular stock, and we view it as a core bank stock. We think that its capital adequacy ratios are currently better than its peers. And while it doesn't stand to benefit, it should at least to survive the tighter requirements that everybody has been talking about. Basically, we think it's the

1-Year Daily Chart of Mitsubishi UFJ



Chart provided by www.BigCharts.com

top bank in Japan, with the exception of **Sumitomo Mitsui**, which, as one of our parent companies, we're not allowed to hold in the portfolio. So we've actually increased our weighting in **MUFG**, that's one of the reasons behind it. Another stock, actually numbers two and three on our list, are **Honda** (NYSE: HMC) and **Toyota** (NYSE: TM) very, very familiar names. **Toyota** represents a little over 3% of the fund's holdings while **Honda** is around 3.25%. **Toyota** is actually underweight versus the benchmark by almost 100 basis points, so even though it's a large holding this is kind of speaking to the point I mentioned earlier even though it's a large holding and makes up a fairly sizable percentage of the portfolio, it's actually not our top pick in the space. We think that **Honda**, which has industry-leading electric vehicles versus **Toyota's** hybrid vehicle technology, will be better able to compete going forward. We also think that **Toyota** has gotten a little bit too big for its britches, and it will be hard for management to maneuver the company as it's trying to recover some sort of corporate profits. The one thing we do like

about **Toyota** is that its price-to-book ratio is very reasonable, actually below one, which is another theme of the Japanese market right now. From a valuation standpoint, we think the market is fairly priced right now. We think that p/e is not really a good indicator of the market's valuation at this point, and we're looking more at p/b, which is very cheap compared to the U.S. The Japanese market's p/b is approximately half that of the U.S., as well as Europe and the U.K. So if we're looking

at p/b right now, most of the companies in our top 10 have p/b's sub-1. One other company that we're looking at right now, again not really a surprise, is **Sony** (NYSE: SNE). **Sony** is actually our fourth largest holding in the portfolio. We think that the company is poised for a recovery in share price at least. With their PlayStation 3 game consoles, especially with the upcoming holiday season and after the company has slashed the prices on the models, they've become more competitive from a pricing standpoint. We think that there is going to be some demand. As bad as the economies have been, somebody somewhere always finds money to get their kids presents. So we think that that is doing fairly well. In addition, we like the advancements and the improvements that they've made in their television business and LCDs, which is again another theme right now as looking at it from a broader perspective LCD technology we think is really going to take off, if it hasn't arguably already. And any of the components-makers, any of the liquid crystal display manufacturers themselves, any of the lithium-ion battery-makers, everything that's

1-Year Daily Chart of Honda



Chart provided by www.BigCharts.com

going into the end products themselves, will also stand to benefit. **Sony**, as I've said already, is also trading well below one times on a price-to-book basis, and we think that it's got some real upside, if for no other reason than the brand name value. **Sony** is one of the stocks that we think is really going to outperform in the longer term, whereas the market itself maybe a little bit stagnant beginning early next year.

TWST: Many of the companies you mentioned are export oriented, global names. How important is the world macro economy to your portfolio?

Mr. Small: Ultimately important. The Japanese market is widely viewed as kind of a cyclical play on the global economy: As the world goes, so does Japan. The reason that we think Japan is poised for a quicker recovery, if not a longer one, is its proximity to China. Without argument, and very few people will argue with me on this, China is the single fastest-growing economy in the world.

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At some point in the next few years, it will surpass Japan as the second largest in the world as a percentage of GDP. Not that other countries around the world will not stand to benefit from the growth in China, but Japan's proximity kind of puts it in a better position in terms of being able to capture a lot of the demand coming out. The one thing that has been a bit of a knock lately though is I'm

1-Year Daily Chart of Toyota



Chart provided by www.BigCharts.com

sure you're going to ask me on this is the appreciation of the yen. We don't view the appreciation of the yen as being as bad as the subsequent depreciation of the U.S. dollar. One of the main issues is that a lot of the companies in Japan had to take into account a yen trading at around 95 to 100 per dollar in their recent forecasts; they have since downgraded that or upgraded depending on how you look at it to the 85 to 90 range. So that obviously has had some paper effects on the forecasts of management and their forward-looking statements. The other thing that we think is a real problem now with the weakened dollar vis-a-vis the yen is the emergence of dollar carry trades. You may know that yen carry trades were all the rage several years ago; now we're seeing dollar carry trades, in which people are borrowing USD at low interest rates and investing that money abroad, and they used to do that with the yen. I think the BOJ just recently left rates at 0.1%, and the U.S.'s are not much higher. But obviously it's a more stable currency, so people are switching over to dollar carry trades, which also have had a bit of a negative effect on the yen. But you're right, with Japan an export-related economy, a stronger yen is certainly not helping anybody.

TWST: Do you do any actual currency hedging in the portfolio?

Mr. Small: We do not. As a matter of principle, whether it's within the fund or any of our institutional accounts, we don't engage in any sort of hedging, whether it be currency, futures or otherwise.

TWST: So that's a "buyer-beware" aspect in other words?

Mr. Small: In this particular case, yes and no. With our institutional accounts, most of the cash management side is handled by our clients' custodians. They do everything; we take care of the actual investments. As far as the Japan Equity Fund is concerned, we are investing yen in the Japanese market directly. So any sort of conversion, any sort of FX, any sort of hedge for that matter would be done in the U.S. on a different side of the business. And really the genesis of that policy came from the fact that Japanese institutions don't really engage in currency hedging it's considered a bet against your own currency or your home country to do something like that, which I don't know how much you know about Japanese culture is just something that's not done. As a matter of policy, the firm does not engage in currency hedging. However, in certain cases our institutional clients have asked us to at least consider that while working with their custodians. As a matter of principle, we take the yen, we invest in the market, we return in yen. Whatever happens once it leaves Japan is the investors' business "investor beware," as you said.

1-Year Daily Chart of Sony



Chart provided by www.BigCharts.com

TWST: Let's talk about some of the risks that you see for anyone participating in Japan in the next year to 18 months. What do you think are some of the concerns that investors ought to be aware of?

Mr. Small: I think we need to wait to see a shakeout of what's going to happen with the DPJ. We think that they are fairly obstinate in their pursuit of their campaign manifesto. I think that that's butting up against the impressions and the expectations of the rest of the world. I'm

sure you've been reading about President Obama's visit to Japan, which got a lot of press over there because he met with the Japanese for about 10 hours and spent three days in Beijing, so that was a big problem. Seeing the way that the DPJ policies are going to shake out, I think, is probably our biggest risk factor at the moment. Another one that I would mention would be the mini credit bubbles that these dollar carry trades that we talked about earlier are creating. Obviously there have been a lot

Japanese banking industry in general is as healthy as it can be given the current conditions. The problems of the past and you say it was a "lost decade," in reality it was probably a lost 20 years I think that transparency among and within the banks has gotten a lot better. In addition to the NPLs, I know that cross shareholdings among banks and between banks was another big issue. What I can tell you is that as foreign money has gone into the market and by "has" I'm not saying within the last six

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of boom and busts over the last 10 years, and there is now some concern that we are seeing another bubble develop, prompted by the ultra-easy monetary policy of the Fed and other central banks for that matter. Obviously everybody was throwing water on the flames, and now that we're taking a look at it, we realize there may have been some alcohol mixed in with that water. So that is another problem: How and more importantly when the global economy is going to emerge from these ultra-easy monetary policies, which should have some sort of effect. Whether it will be positive or negative, we are not a 100% sure yet, but what that effect will be on the Japanese markets is really more of an uncertainty at this point than a bad feeling.

TWST: Regarding the famous "lost decade" of the Japanese economy, a lot of the finger-pointing has been toward the banks and their inability to clean up their balance sheets to recognize non-performing loans. Is that issue behind Japan in your view?

Mr. Small: From a nonperforming loan standpoint, yes, I would say it is behind us. What I can tell you is that the market crash in and of itself and the whole subprime mess did not affect Japanese banks nearly to the degree that it affected their counterparts around the world. However, the recession that followed hit Japanese banks harder than any

months, I'm talking within the last five years as foreign money has gone into the market there has come with it this cry of, "You need to Westernize, you need to become more transparent, you need to think a little bit more about corporate governance and shareholder value." I think to a certain extent, Japanese banks were moving in that direction. Then came the crash and then came the recession, and I think they've had to scramble a little bit. But in general, Japanese banks are much healthier than those in the U.S. or even Europe for now.

TWST: You would attribute some of that to market discipline?

Mr. Small: Well, possibly. I think it's got more to do with really the culture of the business community there. And the fact that these companies, which traditionally have almost overlooked shareholder value they didn't pay high dividends, they kept most of their cash in the coffers for a rainy day I think as much as we knock them, they were actually rewarded for that over the past year, and they were in a better position because they were doing things their own way. So while we kind of knock Japan because the stock markets haven't done all that well, in reality the business mood right there is much better than it is probably anywhere else. So from our standpoint, looking at it as an insider from

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of their counterparts. A lot of banks are issuing new stock to generate cash. I think **Mitsubishi UFJ** just announced the other day that they would undertake the largest-ever equity financing or new share issuance in Japan, about 11.5 trillion yen worth of new stock. Most of the Japanese banks didn't take much in the way of government money, so they weren't beholden. At the same time, this has created the need for them to go ahead and issue new shares to generate some capital. The reason behind that is that with these new capital adequacy requirements everyone is discussing, the banks have to find some other way to meet the new requirements without taking money from the government. I think the

Tokyo, we think that there is a lot of potential. Unfortunately, just as Japan is dependent on exports and the outside world to help boost its economy, at this point because the market has been so stagnant, and because, I don't know how familiar you are, but the Japanese culture is to save, save, save, save 50% of household assets are in bank deposits right now. Because of that, not only does the economy need the outside world to help give it a boost, but the stock market needs foreign investors to come in and give it a boost as well. At last check, probably the end or middle of October, foreign investors accounted for roughly 50% of all daily trading volume on the TSE, which is a sizable increase from where

it was even two or three or four years ago. So there are a number of factors. Obviously, Japan is an island, and it does rely on the outside world from both a demand and economic standpoint, as well as from a stock market standpoint and everything in between.

TWST: As you say, so much of that is cultural. And for all of their great strides exporting to the rest of the world, they still remain in many respects a very closed, insular society.

Mr. Small: They do, they are. I of all people, as an American working for a Japanese company, can attest to that.

TWST: But am I hearing from you that the DPJ, the new party in power, seems to hold some promise of possibly opening up a little?

Mr. Small: I think if it's done the right way, yes. I think if it's done with the market, with really the global markets taken into consideration, it is a good thing. I feel pretty strongly about that actually, but again it's how it's gone about.

TWST: The devil's in the details?

Mr. Small: Well, as an example, they are talking about issuing a \$350 subsidy per child. Knowing the Japanese culture as I do, what are they going to do with that \$350? It certainly is not going to be to put back into the economy. It's going to be used and I think

TWST: You mean buying a new PlayStation? What do you mean by "used?"

Mr. Small: No, I think it's going to be used for daily expenses. I think it's going to be used for that rather than for the children themselves. But that's a very, very small example. In my own personal opinion, nothing official on that, but I think if it's done in the right way, they are giving the education credit, they are talking about free schooling or free high school, free university for children there, I think is a much more or a much better way to use that same incentive money than giving the cash directly to the parents and saying, "Okay, save this for a rainy day," which they may do. Their culture is such that they would take that \$350, put it under the mattress and forget about it. At the same time, you got to look at it as though, "What are the classical reasons for subsidies and

those sorts of programs?" It's to generate or to invigorate domestic demand, and that's very, very anti what the Japanese culture is all about. You give somebody \$500 in Japan, they are not going to go and buy a new washing machine or a new TV, or anything like that. They are going to save that money. But what happened now is that that's kind of creating some sort of almost a culture clash, as that the money is needed to be used now. So people are dipping into their savings but not using those savings for anything that might reinvigorate the domestic economy. They are using it for bills and whatever else have you, simply based on the problems that they've had there, the problems that we've all had there. So I think the DPJ ultimately is positive, but it all depends on how it's going to shake out.

TWST: Is there anything else you'd like to add?

Mr. Small: No, just that we always like to represent that we do think that there are some opportunities, and the benefit of a closed-end fund and benefits of working with a Japanese manager and theoretically, in our situation in practice, the insight of a local really gets you moving in the right direction.

TWST: Thank you. (SGD)

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