Standard Life
Investments

Japanese Equities

4th Quarter 2009

Global Outlook Q4

STANDARD LIFE INVESTMENTS

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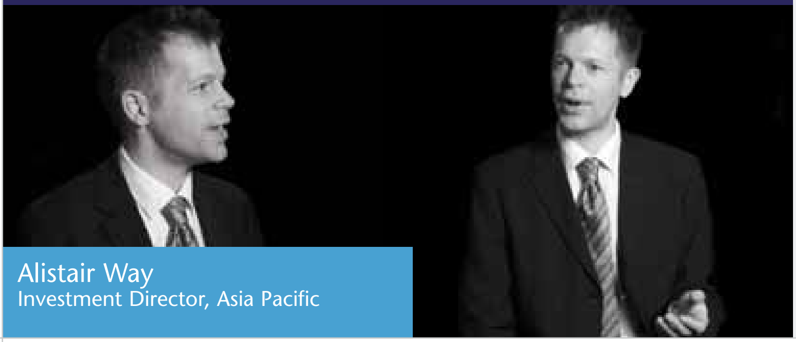
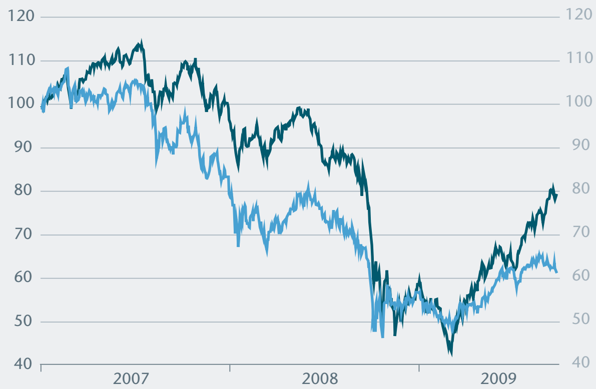
Japanese Equities
Crisis into opportunity

Those firms that are quickest to adapt to the post-recession environment are likely to emerge stronger and more profitable than their rivals.



Alistair Way
Investment Director, Asia Pacific

Chart 1
Valuation gap set to narrow



Share price performance for (04/01/07=100):
MSCI World small cap index — TOPIX small cap index

Source: Bloomberg

Technology firms bet on change

As the economic downturn heightens competitive pressure on the world's technology firms, some of Japan's industry heavyweights are determined not to get caught standing still. They are launching into bold restructuring programmes and the relative strength of their balance sheets means they are well placed to deliver. Two examples we have researched are Fujitsu and Omron, which have already taken a number of concrete steps to focus and improve their business. Fujitsu recently sold its hard disk drive business to Toshiba and outsourced its semi-conductor business to Taiwan Semiconductor Manufacturing Co. Electronic device maker Omron has shut factories and is consolidating its design and manufacturing departments.

These restructuring programmes may appear unremarkable given the depth of the recession, but Japanese technology firms have a history of failing to deliver on promised reforms. This time we believe the outcome will be different. In the case of Fujitsu, the reforms include a complete reorientation of the business from technology generalist to IT services firm. By disposing of its non-core business and focusing on cash-generative, asset-light IT business it is positioned to emerge from the downturn stronger. Omron's restructuring plans are equally ambitious; it has closed two factories and pulled out of the large LCD-backlight business. More importantly, our meetings with company management have revealed a determination previously lacking in its rationalisation initiatives.

In our view, the reforms designed to free up cashflow and improve margins, such as those being implemented by Fujitsu and Omron, will be key if Japanese technology firms are to outperform their peers. For those companies that are slow to adapt to the new market conditions the consequences could be severe. The Japanese economy is expected to lag a recovery elsewhere and the only help on offer may be self-help.

Mechanisation of Asian agriculture

The global economic downturn has had far-reaching consequences. One of the business areas that has been particularly badly affected is agricultural machinery. The traditionally cyclical industry has had to deal with a collapse in demand as farmers have chosen to tighten their belts rather than replace existing farming equipment. Despite the recent struggles, our analysis suggests that the sector is likely to see a major rebound in the coming months. Much of this will come from a short-term market correction but the improvement will be sustained by a growing commitment by governments across Asia to mechanise their agricultural industry.

This is positive news for Japanese machinery firm Kubota, which generates a third of its sales from Asia. The firm has a clear competitive advantage over its rivals based on its product range and its reputation for product quality and durability. It also has an extensive sales network within the region and a track record of improving its market share. The attractive fundamentals of the firm are likely to be augmented by the huge government subsidies that are being implemented across Asia. China, India, Thailand and Vietnam are all investing in order to improve rural incomes and the mechanisation of agriculture is regarded as a strategic priority in the region. With a 60% share of China's combined harvester market and an 80% share of Thailand's tractor sales, Kubota appears set to benefit from this positive trend. Our research suggests that the benefits will extend into the medium term as Asian agricultural production remains some way behind more developed nations. For instance, the productivity of rice farming in Thailand is approximately one third the level of Japan.

Our strategy within Japanese equities

The transportation sector has suffered particularly severely in Japan as the global recession combined with a swine flu outbreak and removal of domestic motorway toll charges. However, despite the pain experienced by both the land and air transportation industries, we are increasingly optimistic on the outlook as passenger numbers have shown signs of stabilising. We are particularly upbeat on Japan's rail operators with JR East, JR West and JR Central all expected to benefit from an improving environment. Another area where we are looking for improvement is the Japanese small cap market. There has been a long-standing valuation gap between Japan's listed smaller companies and their global counterparts (see chart) but that is likely to narrow as firms such as Hamakyorex (transport) and Shinko Plantech (engineering) rally.

Oct 09

House View

This page sets out our House View as it applies to a UK based balanced fund. Details of how the House View applies to other UK-based funds and funds based in other parts of the world can be obtained from your Standard Life Investments representative.

	Positive	Negative	Our View
US Equities	• The recession is ending in response to major policy measures, such as fiscal packages and quantitative easing • Valuations are attractive, especially as more companies return to profitability	• Squeeze on corporate margins is forcing major cuts in employment and investment • Continued uncertainty about extent of downturn in the housing sector	Market supported by favourable long-term valuations and easier monetary and fiscal policy despite credit concerns STAY HEAVY
European Ex-UK Equities	• Management responding to pressures on margins through cost cutting and more M&A activity • Parts of the region did not experience as large a credit boom as other countries	• Exports remain under pressure due to euro appreciation and sharp slowdown in global trade • Continued concerns about efficacy of policy response in Europe	The region remains vulnerable to the strength of the euro currency impacting on company margins STAY LIGHT
UK Equities	• More aggressive monetary and fiscal support than in many other countries • Valuations such as dividend yields provide underpinning for the market	• Oil and resource companies vulnerable to sharp falls in commodity prices • Concerns remain about extent of consumer and housing bad debts as unemployment rises	Despite concerns about the valuation of a number of cyclical sectors, the market is supported by favourable valuations STAY HEAVY
Japanese Equities	• Japan's financial sector is in a stronger position than in some other countries • Increasing dividends plus share buybacks are helpful for investors	• Companies facing much weaker export demand from the US and Europe • Domestic data suggests economy is suffering a severe recession	Growing concerns about the impact of deflation on profit margins while the policy response is more limited than elsewhere STAY VERY LIGHT
Pacific Basin Ex-Japan Equities	• Infrastructure spending remains a primary driver of many economies • Some governments have taken strong action to support domestic activity	• Earnings at risk from the length of the slowdown in OECD demand • Concerns growing about eventual policy tightening in China to cap inflation risks	Long term valuations remain a concern but governments are taking strong action to support domestic activity STAY LIGHT
Global Emerging Market Equities	• Strong commodity demand is supporting some economies • Current account surpluses protect some countries from credit concerns	• Certain economies still require significant support from international bodies • Some central banks are becoming concerned about inflation risks	Some economies are supported by strong China trade links but others remain vulnerable to capital constraints STAY LIGHT
International Bonds			
US	• Quantitative easing by the US authorities should cap Treasury yields	• Vulnerable to increased supply as the fiscal position deteriorates rapidly	STAY HEAVY within international bonds as Treasuries benefit from quantitative easing
Euro-zone	• Slow response by the monetary authorities to the financial and economic crisis	• Extent of likely debt issuance from easier fiscal policy	STAY HEAVY within international bonds on expectations of further ECB quantitative easing
Japan	• Return of deflation and the lack of policy levers to stimulate economic growth	• Valuations starting to look stretched	MOVED TO VERY LIGHT within international bonds on a comparison of international bond yields
UK Bonds			Within UK bonds:
Gilts	• Interest rates are close to zero, anchoring short-dated gilt yields while the authorities are continuing quantitative easing to affect longer dated yields • Defensive characteristics increasingly recognised	• Continued concerns about the extent of the rise in the public sector deficit • Uncertainty about an exit strategy from quantitative easing is worrying some investors	Stay Heavy in conventional gilts Stay Neutral in index-linked debt
Corporate	• Strong retail and institutional investor demand for extra yield	• Downturn in corporate cash flows will lead to higher corporate bond defaults	Stay Very Heavy corporate bonds Corporate bond valuations remain attractive although individual issues require careful examination
Property			
UK	• Property income yields relative to gilt yields have risen to highs last seen in the 1930s. Evidence of price improvement in 'prime' assets as newly raised capital is invested.	• Rental values are falling in line with a weak economic recovery, especially continuing pressures on the retail sector	We favour well located properties with tenants of good financial strength, plus a sector bias towards core London markets, where future supply is limited, and dominant retail locations MOVED TO NEUTRAL
Global	• Lack of overbuilding in this cycle should support growth in rents as economies emerge from recession. • Infrastructure investment underpins opportunities in emerging markets.	• Credit conditions remain very mixed with commercial bank holdings of property overhanging some markets	We prefer selective high yielding logistics markets in Asia & Central Europe, and office locations with low future supply such as Paris and Sydney.
Cash	• Cash is an attractive alternative when corporate earnings and dividends are under pressure	• Cash yields close to zero are encouraging more investors to seek higher-yielding assets	Official interest rates in major economies are expected to remain low well into 2010 STAY VERY LIGHT

The terms, Very Heavy, Heavy, Light, Very Light and Neutral express Standard Life Investments' view of a balanced portfolio against a given benchmark.