

# Lazard Japanese Equity

## The Case for Japan

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# Japan: Stable Source of Alpha

## **Japan's differentiated marketplace**

- We believe that the Japanese banking system is currently the healthiest in the world and is in an expansionary phase of its credit cycle
- Japanese banks are well capitalized and are investing in Western financial institutions
- 79% of Japanese stocks are trading below book value and the TOPIX is seeing lows not seen since the 1980s

## **Broad and diversified investment universe**

- Japan is the third-largest market and the second-deepest, as indicated by market cap and number of stocks
- Japan exceeds other major markets in depth and breadth, which have fewer stocks with larger market caps

## **Less efficient equity market**

- A stable source of alpha for active managers
- Timing entry is a fruitless exercise

Source: Lazard, Nomura Research

# Broad and Diversified Investment Universe

As with the U.S. market, the Japanese market is less concentrated towards large cap names. Concentrating on too few names minimizes full capture of benefits.

The top 10, 20, 50, and 100 companies in Japan make up a smaller percentage of total market capitalization than any market in the world outside of the U.S.

	Mkt Cap (USD MM)	# of Stock in MSCI	Top 10 (%)	Top 20 (%)	Top 50 (%)	Top 100 (%)
U.S.	11,943,896	591	17.94	29.01	46.84	61.27
<b>Japan</b>	<b>2449368</b>	<b>340</b>	<b>21.77</b>	<b>32.80</b>	<b>53.78</b>	<b>72.23</b>
United Kingdom	2,362,712	107	46.47	67.97	87.80	99.27
France	1,052,940	76	48.27	71.15	93.91	100.00
Canada	1,299,937	100	39.39	59.28	84.28	100.00
Germany	912,159	54	62.09	82.59	99.19	100.00
Switzerland	888,547	37	79.23	92.14	100.00	100.00
Australia	973,093	72	59.77	74.86	93.64	100.00
Spain	361,671	28	86.97	96.48	100.00	100.00

# Low Correlation to Developed Markets

As Japan's credit cycle has run counter to that of the West, it is not too surprising that risk/return metrics have diverged from the rest of the world. Considering that Japan remains one of the largest economies globally, correlation analysis reveals true diversification benefits for international investors.

## From January 1990 to December 2010

	The World Index	World ex-U.S.	World ex-Japan	EAFE	EAFE ex-Japan	U.S.	Japan	United Kingdom	France	Canada	Germany	Switzerland	Australia	Italy	Spain
The World Index	1.00														
World ex-U.S.	0.96	1.00													
World ex-Japan	0.96	0.87	1.00												
EAFE	0.95	1.00	0.86	1.00											
EAFE ex-Japan	0.93	0.92	0.94	0.92	1.00										
U.S.	0.90	0.74	0.95	0.73	0.80	1.00									
Japan	0.71	0.80	0.51	0.81	0.54	0.43	1.00								
United Kingdom	0.86	0.85	0.87	0.85	0.92	0.74	0.52	1.00							
France	0.85	0.85	0.87	0.84	0.93	0.73	0.47	0.80	1.00						
Canada	0.79	0.74	0.81	0.71	0.74	0.77	0.47	0.67	0.66	1.00					
Germany	0.81	0.80	0.85	0.79	0.90	0.72	0.40	0.74	0.87	0.64	1.00				
Switzerland	0.76	0.77	0.75	0.78	0.81	0.64	0.50	0.73	0.73	0.53	0.69	1.00			
Australia	0.76	0.75	0.76	0.74	0.77	0.66	0.50	0.70	0.66	0.73	0.64	0.56	1.00		
Italy	0.68	0.71	0.67	0.70	0.74	0.55	0.41	0.59	0.71	0.55	0.69	0.54	0.52	1.00	
Spain	0.79	0.80	0.78	0.80	0.84	0.66	0.50	0.73	0.80	0.58	0.76	0.66	0.64	0.71	1.00

- From 1990 to 2009 Japan showed the lowest correlation relative to the rest of world
- Getting exposure to Japan exclusively through a global mandate tends to provide less economic diversification benefits from an international standpoint
  - This makes sense when considering the fact that the largest company in Japan by market cap, Toyota, derives approximately 70 percent of its profits from North American auto sales

Source: Lazard, MSCI. The security mentioned is not necessarily held by Lazard for all client portfolios, and its mention should not be considered a recommendation or solicitation to purchase or sell this security. It should not be assumed that any investment in this security was, or will prove to be, profitable, or that the investment decisions we make in the future will be profitable or equal to the investment performance of security referenced herein. There is no assurance that any security referenced herein is currently held in the portfolio

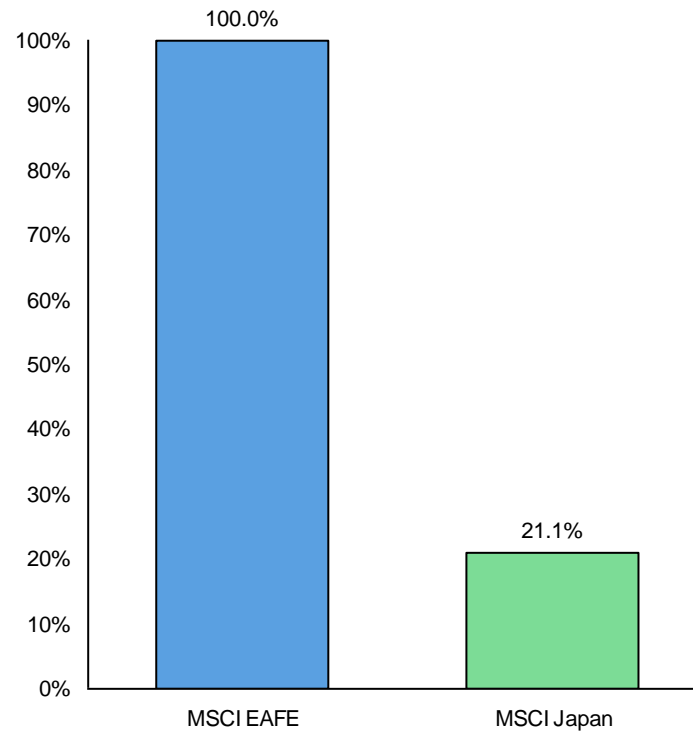
# Representation in EAFE Portfolios

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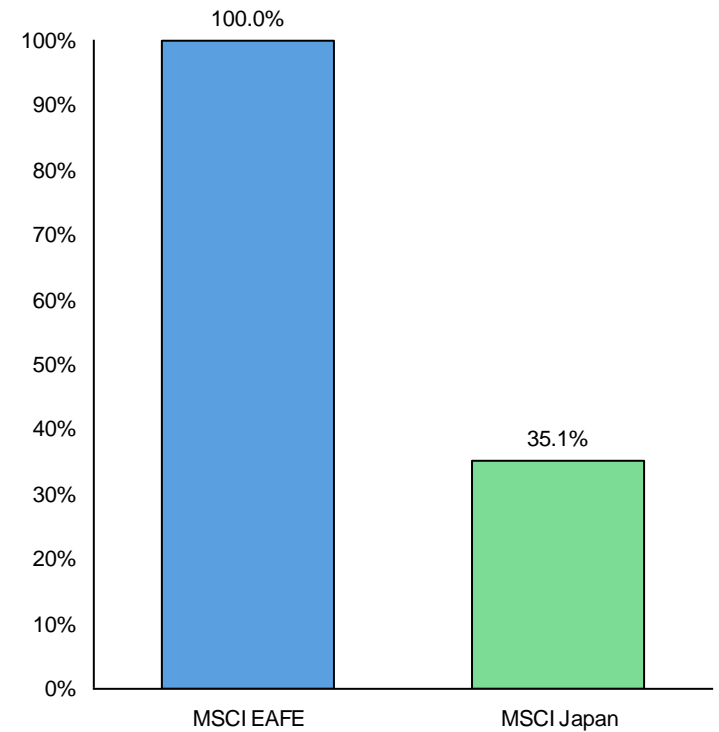
Do EAFE managers align resource allocation to reflect the depth and breadth of the Japanese market?

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**% of Market Cap**



**% of # of companies**



As of 31 December 2010  
Source: MSCI, Lazard

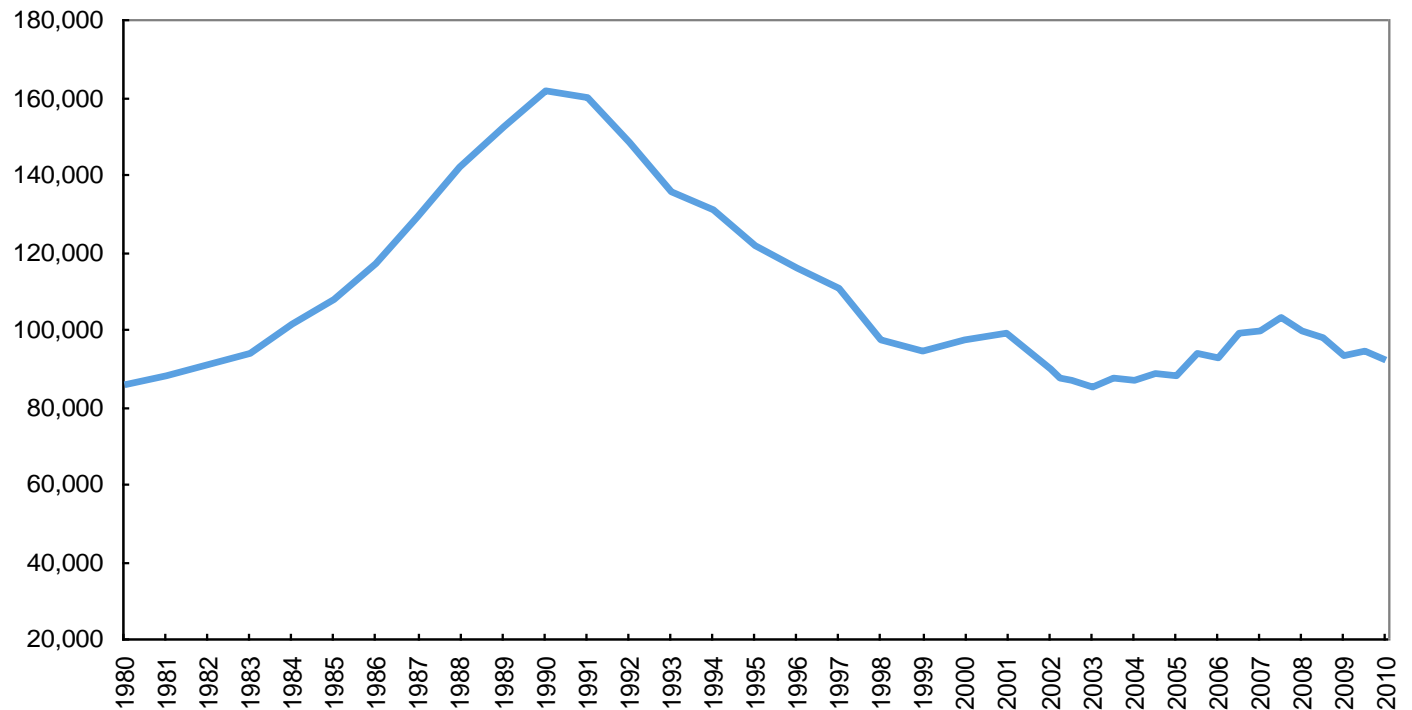
# An Inefficient Market

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Assuming a 10 percent annual increase in industry employment, and given Japan's market size, it would take at least five years before staff levels approach that of other major markets.

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## Total # of Employees in Japanese Security Firms



- After peaking in 1990, employment within the Japanese securities and asset management industry fell by some 50 percent
- The typical large Japanese securities company maintains formal coverage on roughly 25% of the companies within the TOPIX Index; 10% of all the listed companies

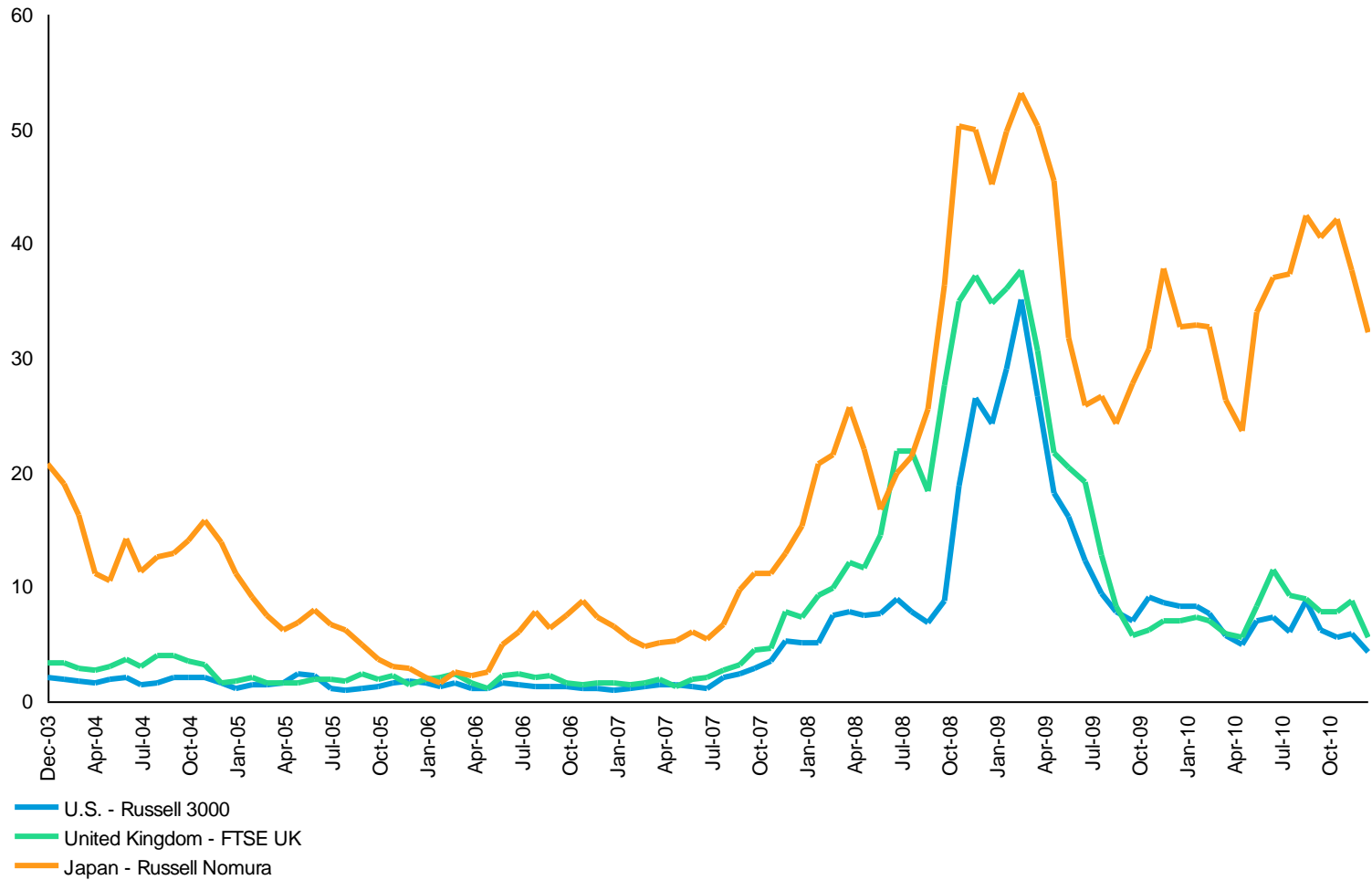
As of 31 December 2010

Source: Lazard, Japan Securities Dealers Association

# Valuation: Global P/BV Comparison

Approximately half of all listed companies in Japan are trading at a P/BV of less than 0.75x.

**% of # of Stocks: P/BV less than 0.75x**



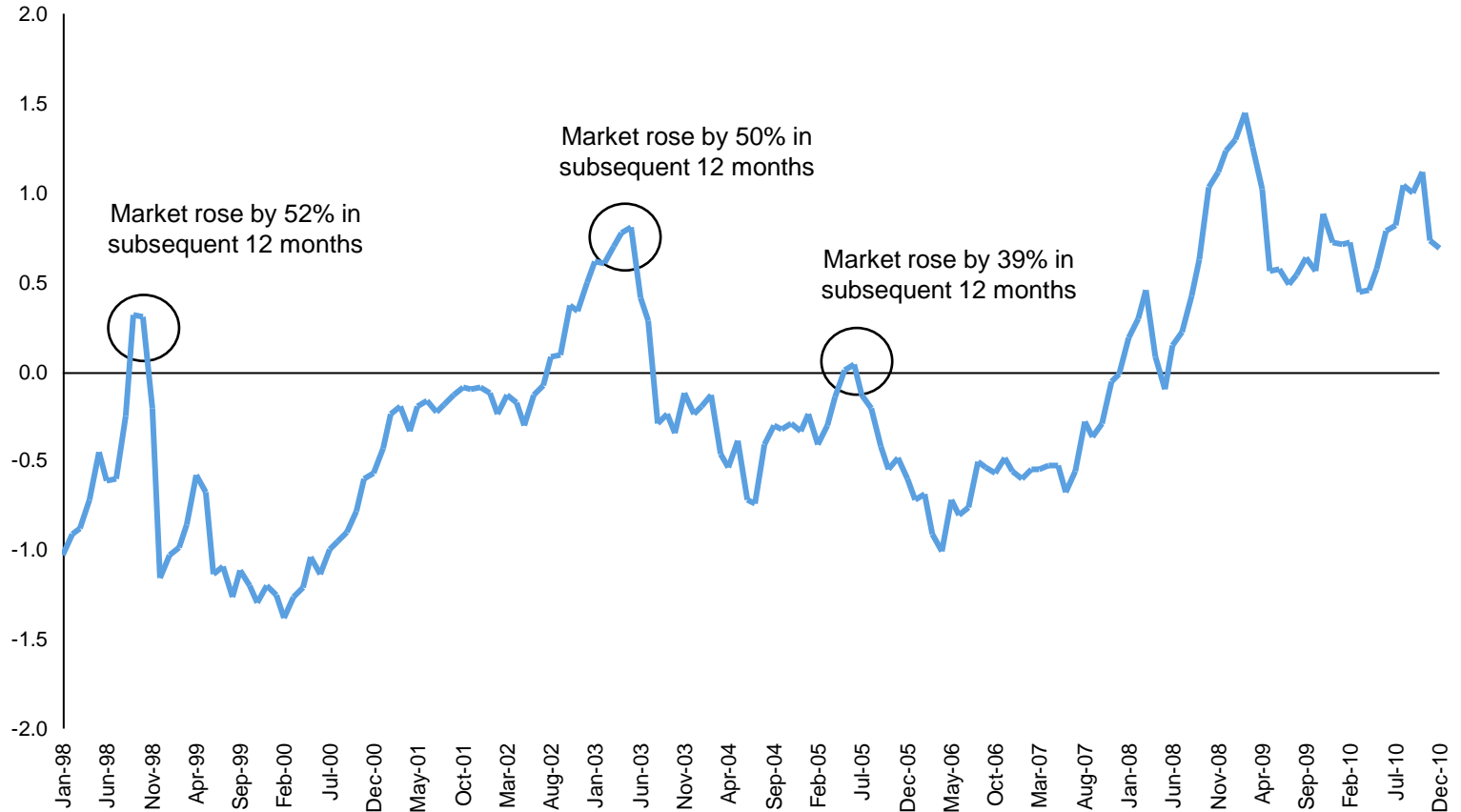
As of 31 December 2010  
Source: Lazard, Nomura Research

# Yield Pick Up

## Undervalued Against Japanese Government Bonds

Japanese dividend yields are at higher levels than 10 year JGBs. Previous peaks were matched with subsequent Japanese market rallies.

**Yield Differential: TOPIX Dividend Yield – 10 Yr JGB Yield**



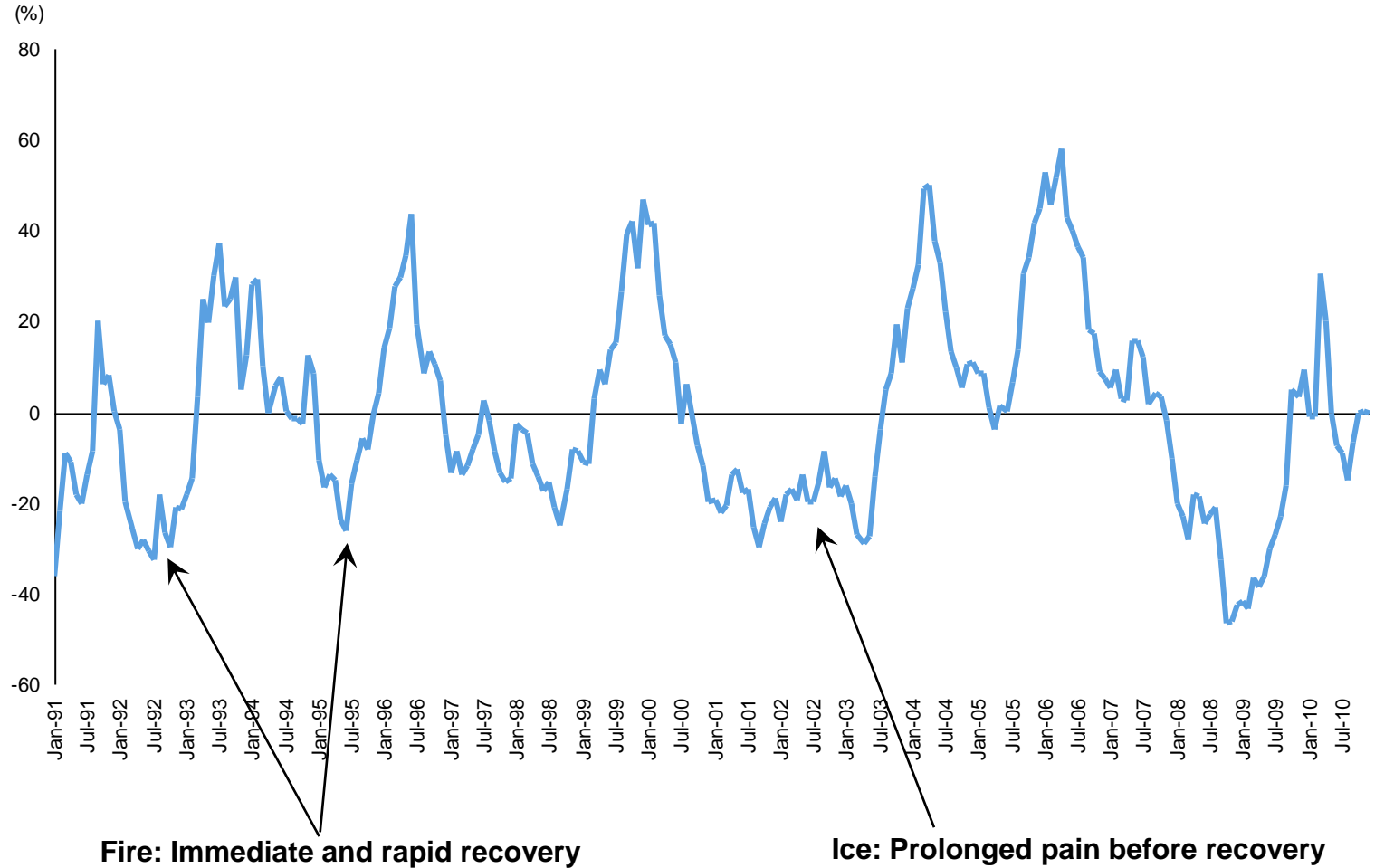
As of 31 December 2010



# Market Timing: Struggling between Fire and Ice

Historically, unlike most other markets, when Japanese shares move from bottom to top, they do so more quickly than when they fall from top to bottom. Timing an entry can be a fruitless exercise.

## MSCI Japan (Rolling YoY % Change)



As of 31 December 2010  
Source: Lazard, MSCI

# Common Misperceptions Regarding Japan

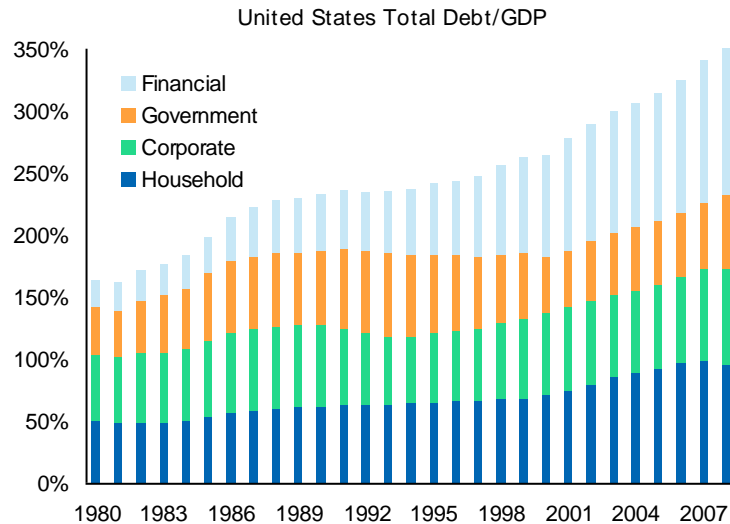
- Misperception **#1** – Japan’s debt levels are dangerous  
Reality: Private-sector Japan is under-levered and government debt is manageable
- Misperception **#2** – Japan has poor demographics  
Reality: Japan is now entering a positive Baby Boomer “echo” cycle
- Misperception **#3** – Japan often underperforms with low levels of profitability  
Reality: Topix Index price to book ratio (PBR) 1.1x, S&P 500 Index PBR 2.2x for similar levels of ROA

Opinions are as of 24 March 2010 and are subject to change.

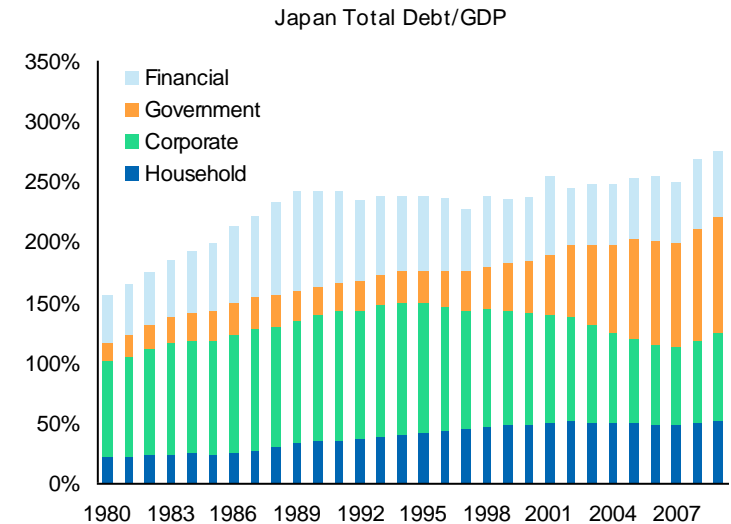
# Misperception #1

Japan's debt situation is significantly worse than that of other G7 nations

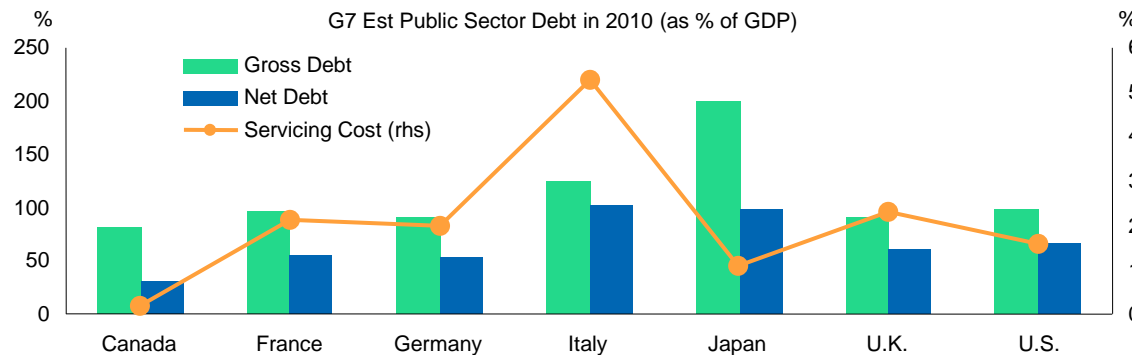
- While Japan's government debt has risen, total debt to GDP is lower than that of the United States
- Moreover, due to low interest rates, the cost of servicing that debt relative to GDP is also lower than that of the United States



As of December 31, 2008  
Source: U.S. Treasury, Merrill Lynch



As of December 31, 2009  
Source: Bank of Japan, Japan Banker's Association, Nomura



As of December 2009  
Source: OECD

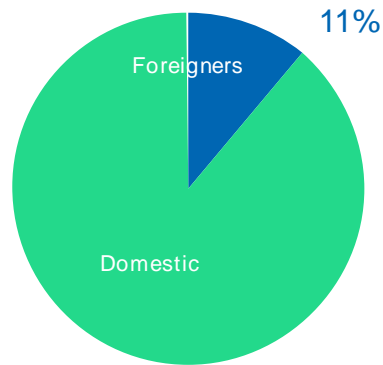
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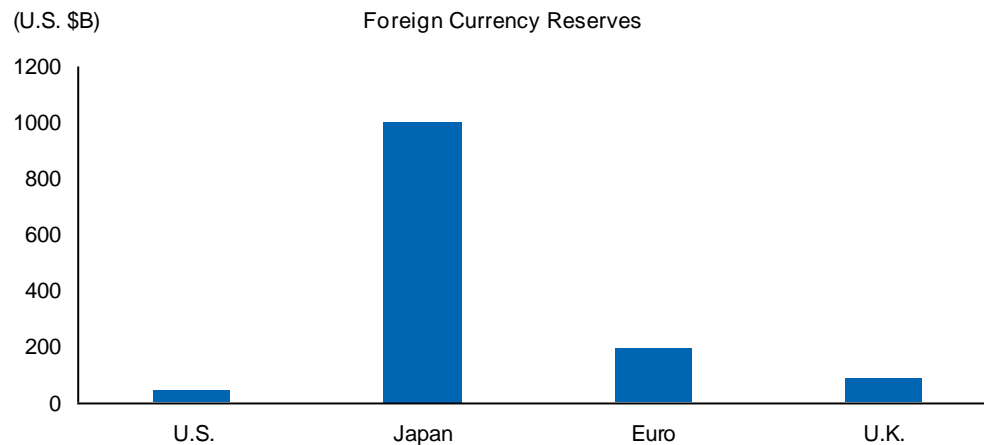
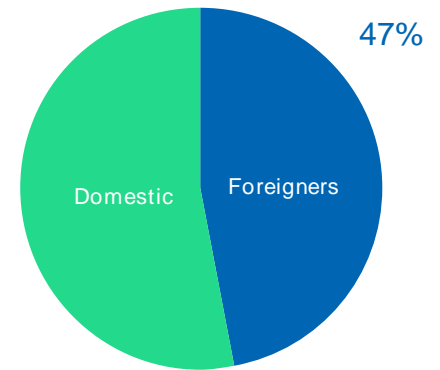
Bond market structure—or the ability to service debt—also differs greatly:

- Japan's debt held by the public is overwhelmingly owned by under-levered domestic financial institutions
- Conversely, the United States is heavily reliant on foreign countries to service its debt
- Additionally, Japan is a net creditor nation with large foreign currency reserves
- Finally, Japan is the largest foreign holder of U.S. Treasuries (\$770bn as of the end of February, 2010)

Japan % of Govt Debt Held by Foreigners



U.S. % of Govt Debt Held by Foreigners

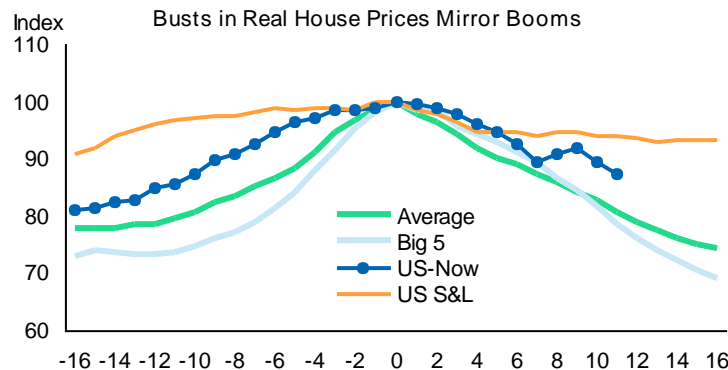
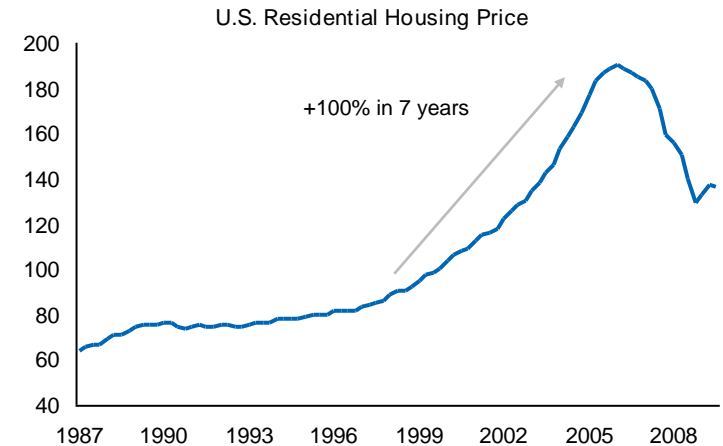
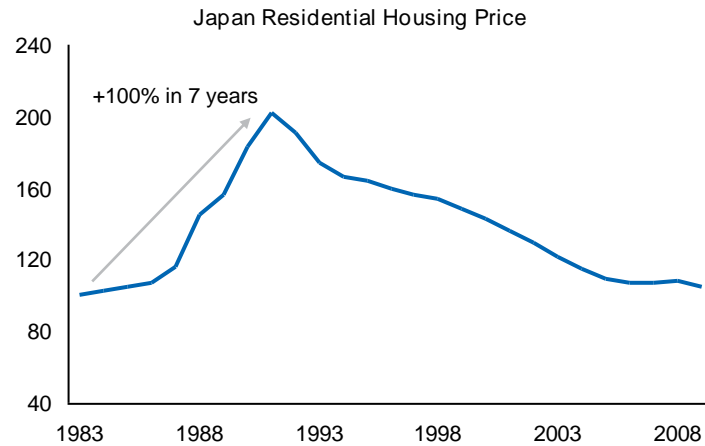


As of February 2010  
Source: Bank of Japan, U.S. Treasury, Morgan Stanley, OECD

# Misperception #1

Japan's debt situation is significantly worse than that of other G7 nations

- Japan's government debt has risen over the last two decades, as balance sheets and asset prices corrected following a real estate bubble
- Historically, corrections end when prices return to at least their pre-bubble levels. This would suggest that Japan's correction is mainly over, while a correction in the United States still has further to run



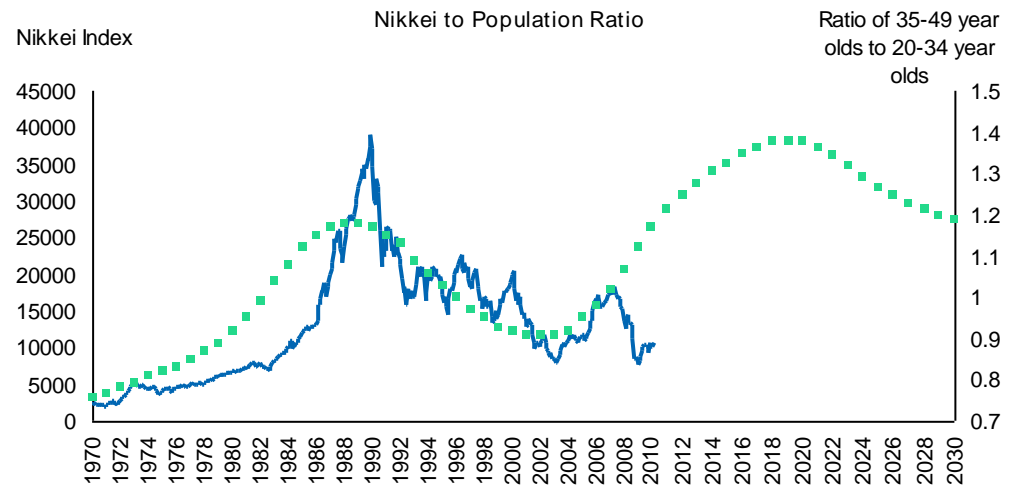
This chart is based on 24 house price boom and busts in OECD nations over the last 50 years.

# Misperception #2

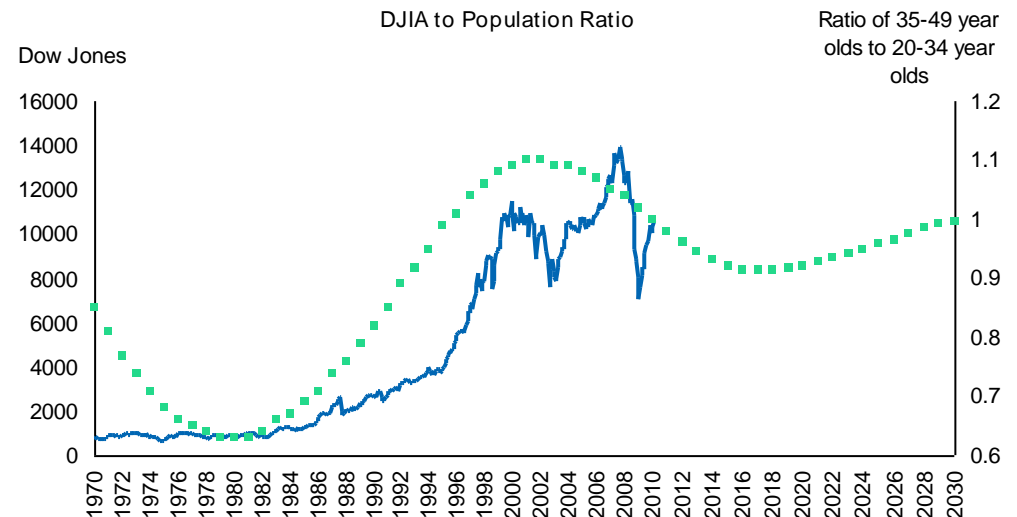
## Japan has poor demographics

- Baby Boomer demographics can be helpful in explaining longer-term economic and stock market trends
- Japan's Baby Boomer generation peaked in 1990, along with its stock market. The ratio of 35-49 year olds to 20-34 has recently bottomed, and is now rising as the Baby Boomer's children reach prime spending years
- U.S. Baby Boomer Demographics peaked in 2001, and, at least according to this ratio, look to bottom in 2018

- Ratio of 35-49 year olds to 20-34 year olds in Japan
- TOPIX Index PBR = 1.1x



- Ratio of 35-49 year olds to 20-34 year olds in the United States
- S&P 500 Index PBR = 2.2x



As of March 2010  
Source: United Nations

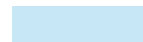
# Misperception #3

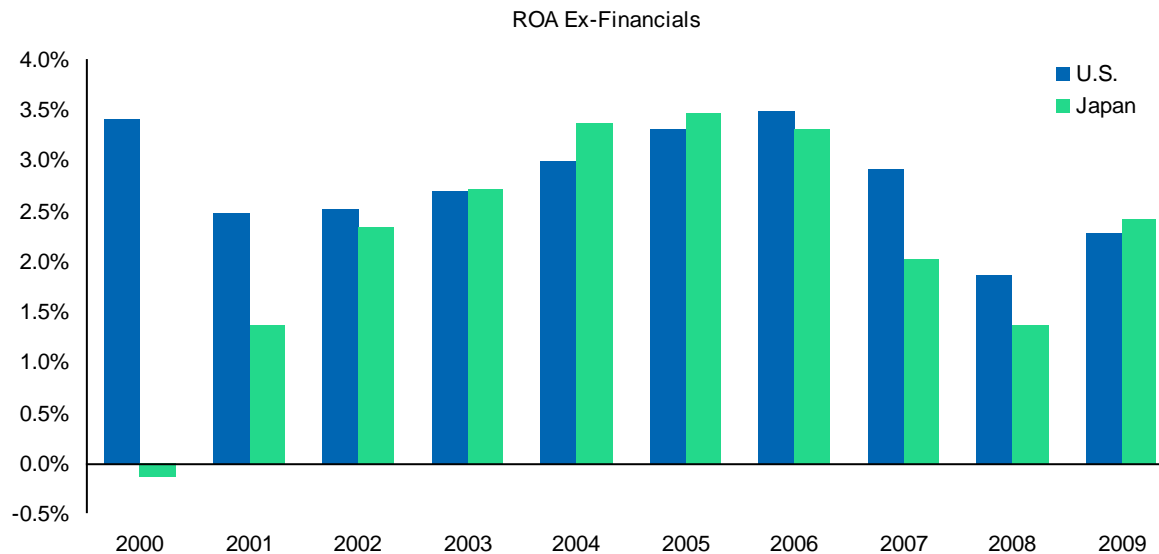
## Japan rarely out-performs, and has low levels of profitability

- Cumulatively, Japan has outperformed the United States in five out of the last 10 years
- Moreover, ROA is not materially different between the two countries. ROE has been much higher in the United States, primarily due to higher balance sheet leverage
- Given each country's respective credit and demographic cycle, it is much more likely that private sector leverage will (slowly) increase in Japan, and decrease in the United States

Cumulative Returns in U.S. \$ (%)

	1 Yr	2 Yr	3 Yr	4 Yr	5 Yr	6 Yr	7 Yr	8 Yr	9 Yr	10 Yr
Japan	16.17	-19.68	-27.22	-25.76	0.21	11.4	60.64	50.03	-1.2	-26.69
U.S.	32.65	-19.03	-21.23	-10.48	-0.86	4.6	40.14	6.67	-11.12	-15.15
	16.48	0.65	5.99	15.28	-1.07	-6.8	-20.5	-43.36	-9.92	11.54

 = U.S. outperforms Japan



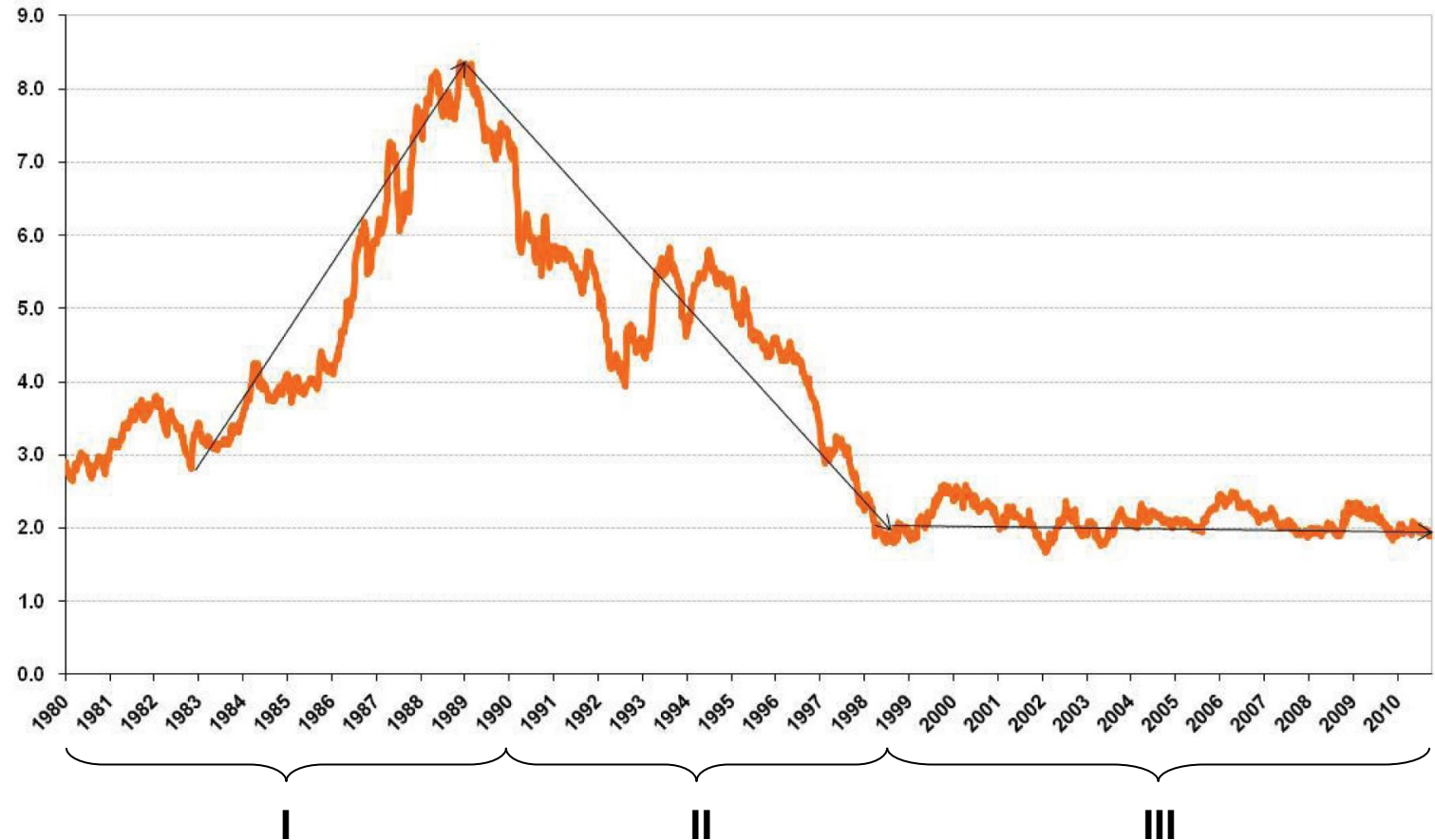
As of 31 December 2009  
 Past performance is not a reliable indicator of future results  
 Source: Merrill Lynch

# Japan Relative to the Rest of the World

- I Japan rallies relative to the rest of the world prior to the 1990's.
- II The 1990's are considered 'the lost decade' where Japan underperforms the rest of the world.
- III Over the last 12 years, Japan has performed in line with the rest of the world.

Contrary to common belief, as an investment market, Japan has performed in line with the rest of the world over the last decade or a true longer term horizon.

Japan relative to ROW



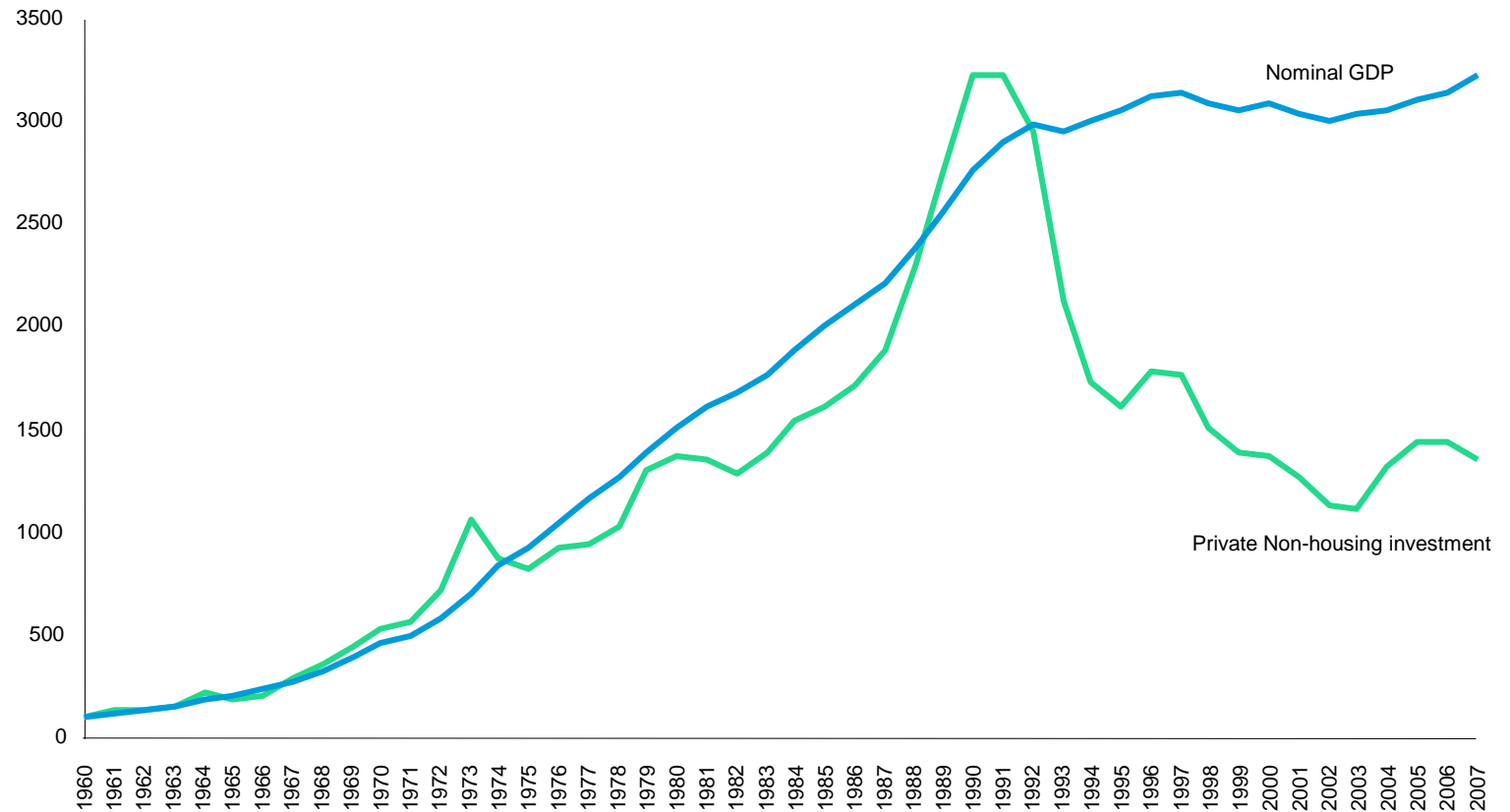
As of 31 December 2010.

Past performance is not a reliable indicator of future results.

Data used is a ratio of MSCI Japan and MSCI World in USD. Source: MSCI, Mizuho



# Japan's Capex Low Relative to GDP



As of 31 December 2010

Note: Indexing F1960 as 100

Source: Research institute of Construction and Economy, Morgan Stanley Research

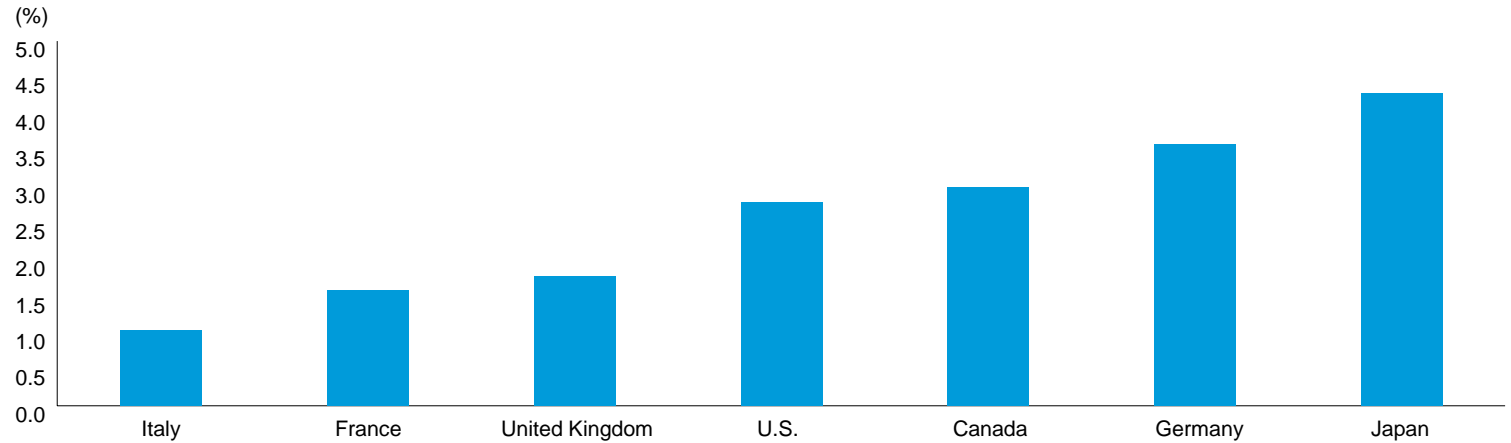
# Japan: GDP Growth and Equity Allocation

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Japan's economy has been outperforming the world.

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## 2010 Est Real GDP Growth

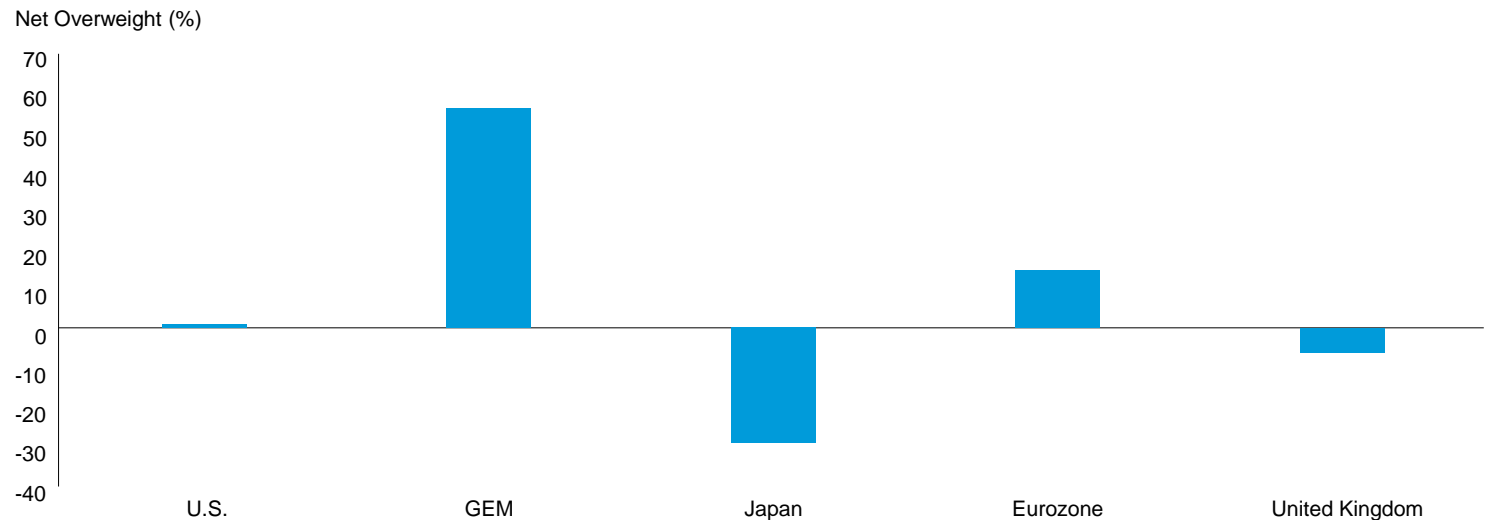


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Global Investors remain underweight Japan.

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## Global Equity Allocation



As of 31 December 2010  
Estimated data is not a promise or  
guarantee of future results and is  
subject to change.  
Source: Bloomberg

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## Lazard Japan Alternative Investment Series

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