

# Strategy commentary



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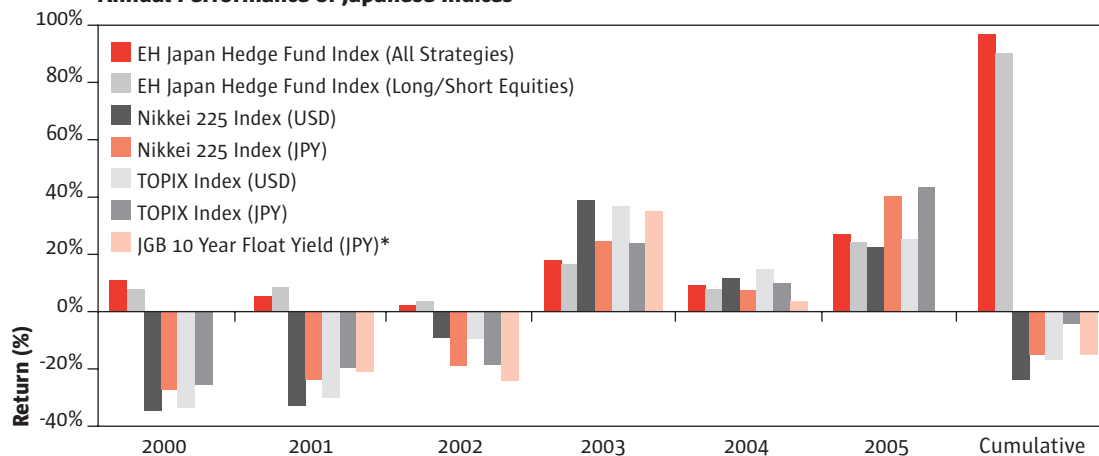
## Long/Short Japan

Japan's securities markets are among the largest and most liquid in the world. Equities of large and mid cap companies may be borrowed and sold short. Index options, currency hedging and other hedging instruments are readily available. Japanese markets afford good opportunities for hedge fund managers utilizing sophisticated trading and investment strategies. Like other market centric hedge fund strategies, however, Japan-focused hedge funds have delivered widely dispersed performance which can be expected to persist. Quality manager selection is important over the long term, although in the up +40% stock market of 2005 (Nikkei 225 in yen), most hedge funds fared well. Beta alone provides acceptable results in rising markets, but in down markets, the ability to preserve capital and generate alpha on both the long and the short sides is critical.

The overall economy has shown sustained growth. Economists estimate that Japan's economy grew 2.5% in 2005 and 2.7% in 2004. Japan is the world's second largest economy, yet it has struggled with significant deflation. Interest rates on the 10-year government bond were less than 1% in 2003. December 2005 was the first month of rising prices in two years. Unemployment has been declining and stood at 4.6% at the end of November. The economy is benefiting from trade with China, India and other burgeoning Asian economies. Capital expenditures are growing as industrial firms invest in plant and equipment. The consumer sector is also improving as increased corporate profitability drives higher wages and discretionary income.

Nevertheless, there are some concerns. After re-election, Prime Minister Junichiro Koizumi has focused on fiscal policy reform, moving toward a balanced budget and pushing through the

Annual Performance of Japanese Indices



Sources: Nikkei 225 Indices, Topix Indices, and JGB Index data from Bloomberg; EurekaHedge Japan Indices data from EurekaHedge and is qualified by disclosure available from EurekaHedge. The information is provided on an "as is" basis. Neither Bloomberg, EurekaHedge, or their affiliates provide any express or implied warranty or representations as to originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for any purpose. \*Data as of January 11, 2006.

privatization of the postal system. Tax measures include two rounds of probable income tax hikes, higher prices for state-provided medical services and higher cigarette taxes. The draft budget 2006/07 (April-March) has a 4.3% tax increase and an overall 3% spending cut. Planned JGB issuance is the lowest in five years at 30 trillion yen to cover 38% of total spending. If the Bank of Japan reduces liquidity and interest rates rise, both fiscal policy and interest rates may restrain growth. On the other hand, some think rising rates would benefit Japanese financials and also result in a higher yen. Another consideration is high energy prices over which Japan has virtually no control. Whether the economy continues expansion in the face of these conditions is an open question. Additional uncertainty arises from the end of Koizumi's term in office in September 2006.

The stock market has risen for the past three calendar years from below 8,000 in 2003. Today at over 16,000 it still has a long way to go in reaching its peak of nearly 40,000. The Nikkei 225 today reflects a 2006 P/E of 27 based on 14% assumed earnings growth. Nevertheless, both undervalued long and overvalued short opportunities are being uncovered by astute investment managers. In recent years Japanese companies have cut costs, improved operating margins and positioned themselves for earnings growth.

The outlook for Japanese equities remains bullish, and they continue to present an attractive investment opportunity. However, the possibility of a pullback considering dramatic 2005 gains and uncertainties of the economic environment is significant; therefore, monitoring of positions is advised in combination with a long/short investment program.

Hedge funds have demonstrated their abilities in Japan through recent market cycles. Japanese hedge funds have generally dampened volatility, afforded capital preservation and exhibited significantly higher, more consistent and positive returns versus long only market indices. Correlation characteristics with long indices have been moderate (in the 0.6 range). However, there is considerable dispersion of performance of Japanese hedge funds including losses. Many successful managers tend to combine both qualitative and quantitative investment methodologies, in effect, melding both art and science into the process.

Long/short equity is the primary strategy of hedge fund managers investing in Japan. However, the event-driven hedge fund category has at least three strategies with success in Japan: distressed security investing, activist investing, and merger-related trading and arbitrage. M&A volume in Japan was third in the world in 2005 behind the US and the UK. In contrast to the US, another successful strategy in Japan was convertible arbitrage (specifically volatility trading) where the rising stock market caused dramatic increases in the optionality value of convertible bonds.

We are bullish on Japan as an investment venue with the caveat that a temporary pullback is possible after the equity run up in 2005. Over the last market cycle, hedge funds demonstrated their potential for return generation, mitigation of downside risk, and capital preservation. Moreover, a variety of hedge fund strategies have been successfully executed in Japan. As 2006 gets underway, we are observing capital inflows to Japanese hedge funds and increased geographic weighting. In 2006, Japanese hedge funds should provide a vehicle for exposure to the growth opportunity in Japan in a risk-managed manner.