Japan: Our Outlook

William W. Priest, CEO, Co-CIO & Portfolio Manager
David Pearl, Executive Vice President, Co-CIO & Portfolio Manager

Overview

We are shocked and saddened by the massive human toll and destruction caused by the tragic events in Japan over the last week. Japan, the third largest economy in the world, was rocked on March 11 by a huge earthquake (the 5th worst in recorded history) and a related tsunami that has caused untold damage, including a nuclear power plant incident with potentially catastrophic consequences at the time of this writing. While the full extent of the human toll and economic destruction continues to play out, Japan's capital markets have been extraordinarily volatile. We have seen contagion effects spilling over into other markets globally as supply chains are questioned and aggregate global GDP measures are affected.

In this note, we want to share with you a brief perspective from a portfolio standpoint regarding what these events could mean in a broader global context as well as specifically within our strategies. When these events began, Epoch's global and international strategies held a low exposure to the Japanese equity market reflecting our belief that the long-term factors of poor demographics and sovereign debt issues overwhelmed most individual company prospects with the exception of a handful of Japan's world-class group of exporters.

Clearly, the disruption within Japan will be immense. At this moment, we are not in a position to reach any concrete conclusions as we have yet to see the full effects of the earthquake on the country's nuclear energy facilities. Given Japan's importance in the global economy, however, the impact can only be negative for shorter-term growth in a world where developed economies in particular remain fragile following the global financial crisis. The timing, from a recovery perspective, could not have been less helpful given this year's events in the Middle East and the subsequent rise in oil prices. In addition, in response to rising inflationary pressures from soaring energy and food prices and pressures related to currency pegs to the U.S. dollar, developing markets generally have been tightening both monetary and fiscal policies in the past several months. Countries pegging their currency to the U.S. dollar are effectively adopting U.S. monetary policy which is incredibly loose by historical standards. What may be right for the U.S. is clearly not right for China today.

Coincident with this tragedy, we had one analyst in Japan the week prior to the earthquake and two analysts present the week of the incident visiting companies and attending research conferences. Fortunately, all returned safely. Their conclusions were that a secular recovery of the Japanese economy was less evident than a cyclical bounce in activity. In part, this view reflects a slowing economy in emerging Asia – an important export market for Japan. These countries have a significant inflation problem and governments are tightening monetary and fiscal policies in response. In addition, we continue to be skeptical about the vigor of the U.S. recovery while Europe remains stressed by both demographic and sovereign debt problems. We did note that despite a stronger yen, Japanese companies have coped better than expected with their growth challenges. Nevertheless, while Japanese companies have successfully cut costs, profit comparisons are likely to become much tougher going forward. Most important, we continue to be concerned that the country's severe structural issues - falling population, shrinking labor force and rising government debt to GDP (the highest in the world) - have no evident solution. In fact, the reconstruction needs will only add to the debt burden facing the country.

In summary, although it is too early to determine precisely what the full effect of this terrible tragedy will be, it is possible to conclude that there will be significant repercussions for the local Japanese economy as well as short-term dislocations within the global economy. We believe our portfolios are well positioned given our focus on investing in companies with strong market positions and excess cash flows and we are monitoring events closely.

Below are brief updates on each of our strategies. We will be available to expand on these comments at our next client webcast on April 13, 2011.

Global equity shareholder yield

Eric sappenfield, portfolio manager & senior analyst

The Global Equity Shareholder Yield portfolio has no direct exposure to the Japanese equity market. Following the sharp sell-off, we re-screened the market to find two new companies passing our screens. Both companies are in the domestic household products sector of the economy and have sold off sharply given the obvious impact on the population. We will evaluate each company in the way we do every company in the portfolio - assurance of sustainable free cash flows, strong balance sheets, and managements committed to shareholder returns via cash dividends, share buy backs and/or debt reduction. This disciplined process has been the key to our past success and we believe future success.

Global choice/global absolute return

bill priest, CEO, co-cio & portfolio manager

We have no direct exposure to the Japanese equity market in these strategies. As they are global strategies, however, there are consequences for our holdings in other markets and sectors. We are evaluating these implications to determine if we need to exit positions or adjust weightings. For example, we do hold certain technology stocks and we are looking at the implications for materials and equipment sourcing. In addition, we are looking to determine whether price action in the Japanese equity market has created anomalies that offer significant investment opportunities relative to our opportunity set.

International small cap

Emily baker, portfolio manager & senior analyst
Eric citerne, portfolio manager & senior analyst

The portfolio was significantly underweight Japan prior to the earthquake given our concerns regarding the long-term structural challenges to their economy. The sharp contraction of equity market values has created valuation opportunities within Japanese small caps. We anticipate that damage to infrastructure, power cuts, parts shortages, etc. will harm domestic manufacturing, leading to a decline in Q1 GDP. However the economy may then recover, in part because the Japanese government will introduce a stimulus package. History shows us that the Japanese economy shrank 2% after the 1995 Kobe earthquake, but then recovered. We have checked with our holdings and have found no major shut downs in production or services at this time. The majority of our Japan exposure is focused on companies benefiting from aging demographics (health care needs) or from growth in China (emerging consumer, infrastructure) and less on Japanese industrial demand. Our second largest Japan name, JGC Corp, a construction engineer for oil, gas and nuclear plants may actually benefit from the efforts to rebuild.

The uncertainty in global growth following a pullback in Japan's potential output, as well as the situation in the Middle East is leading to a fall in oil prices in the near term, which has had a negative impact on our oil services exposure and some of our industrial names. However, we note that the shutdown of Japan's nuclear facilities could have a positive impact on oil and natural gas in the medium term. Should the Japanese authorities decide that the entire nuclear fleet needs to be retrofitted to handle higher-magnitude earthquakes, or be shutdown for some other political considerations, it would have a long-term impact on the demand for hydrocarbons. We have some exposure to the Japanese consumer through our luxury goods theme, but this is minimal as our companies within this segment have less than 10% of their sales in Japan. We continue to carefully monitor the situation and are taking advantage of the indiscriminate selling by adding to many of our holdings and also adding new positions primarily in the defensive consumer staples sector. Hence, our underweight position in Japan compared to non-U.S. small cap equity averages will be reduced relative to its weight before the crisis.

Global small cap

Eric citerne, portfolio manager & senior analyst
Janet navon, portfolio manager & director of research

Going into the recent market declines, we were significantly underweight Japan for structural reasons. As outlined above, our long-term views on the country have not changed, but we believe some holdings have been sold indiscriminately without taking account of the strength of their fundamentals or the broad geographical scope of their activities. As a result, we are increasing some of our positions and will add one or two new positions. Our desire is to increase the weight of positions with significant activities outside of Japan and take advantage of opportunities created by the market's volatility. Following our actions, our underweight in Japan relative to popular benchmarks will remain but to a much lesser degree.

U.S. equity

David pearl, executive vice president, co-cio & portfolio manager

As investors in U.S. companies that are global in nature, there is some exposure to the Japanese economy in our U.S. portfolios. We are closely monitoring the impact on our current holdings with exposure to Japan and view the portfolio exposures as small and manageable at this time. We have used the sell off in global markets as an opportunity to increase position size in

U.S. companies already owned in the portfolios that became mispriced and/or to take new positions in companies that were on our monitor list (previously identified companies where we have already done the fundamental analysis but were waiting for a more opportune entry price). While there will be near-term disruptions in the global supply chain from the tragedy in Japan, we are long-term investors with a forward view of the markets. The economic uncertainty stemming from not only the Japanese earthquake, but also the political turmoil in the Middle East and debt refunding challenges in Europe has increased price volatility. In this volatile environment, investing in companies that create shareholder value in part from return of capital provides more reliable total returns.