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Market Update

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At the start of a new year it is refreshing to look forward to the year ahead with a renewed sense of optimism and perhaps dwell less on the challenges and difficulties of the year past. As Japanese fund managers, we are more than happy to consign the year 2009 to history as we leave a disappointing period for Japanese equities behind; a year which has seen Japan as one of the worst performing major markets.

The FTSE World Japan's return of 2.51% year to date leaves a lot to be desired when compared to the FTSE All World Developed Europe, which rose 33%, and the MSCI Emerging Markets index which is up 59% over the same period. The combination of a stronger yen/dollar weakness, a seemingly directionless and conflicted new government and the drag of record new stock issuance has held back the Japanese market despite a strong rebound in economic activity.

Still, our focus is to look to the future although, even with the ever optimistic, resilient and patient nature of an investor in Japan, we cannot deny that some investors are asking "why bother investing in Japan at all?" In answer to that question we contend that the Japanese market remains too important to ignore and is becoming increasingly attractive on many investment fronts. Indeed, we seek to highlight below that Japan offers opportunities for investors across many broad investment styles.

The Thematic Investor

Japan's economy and the market remain primarily export driven and to that end the investment themes in the short term are defined by the macro view. However, any thematic investor would be remiss in not addressing the most pressing issue of our time: the question of climate change and the need to lower carbon emissions through alternative energy sources and greater production efficiency. Japan's lead in many climate-change related technologies is perhaps not fully appreciated. From innovative materials to key

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components through to end products, Japan is carving out a commanding position in what may be the country's next export growth driver.

Japan's clear lead in the Auto market is well regarded and the country's automakers are investing heavily to retain that position with the next generation of automobiles. Toyota already dominates the market for hybrid vehicles whilst Nissan is aggressively launching its new electric vehicle (the Leaf). Japan's smaller auto assemblers are also making their presence felt in the move to next generation vehicles as Peugeot is in talks with Mitsubishi Motor on developing a closer relationship, whilst Suzuki is planning an alliance with VW to focus on hybrids.

Additionally, components and new materials will drive the success of hybrid and electric vehicles, and the close relationship between Japan's suppliers builds a strong technological barrier. Investment in battery cells is being conducted by Panasonic amongst others, whilst chemical companies are researching new related materials. Although small, Japanese companies probably hold around 80-90% of the market at present. Other key components such as motors, semiconductors or new lighting devices like LEDs are all being developed by Japanese players who already command high market shares in their respective fields.

The country is also a pioneer in alternative energy. It is arguable that the only feasible method by which we can reduce carbon emissions quickly, whilst still retaining adequate energy supply, is by moving substantially to nuclear energy. Given that Toshiba's recent purchase of Westinghouse now positions two of the three major global nuclear plant providers in the country, Japanese companies are likely to benefit from a shift towards nuclear energy. Turning to solar energy, Japan also has a strong position throughout the supply chain from manufacturing equipment makers, raw materials such as solar glass and polysilicon in addition to the finished panels themselves.

Japan's commitment to climate-related technologies is clearly evident in the recent OECD report on Japan, which lists the top 10 nations in terms of percentage of climate-related inventions between 1998 and 2003. Japan's share was 40.8%, well ahead of the US at second place on only a 12.8% share.

The Value Investor

There are undoubtedly many opportunities for value investors in Japan, particularly in small and medium company stocks. There exists a wealth of niche players, who have remained profitable throughout the downturn, have medium-term growth potential, trade on a discount to book value and have plenty of cash on their balance sheet. The improvement in many of the larger company share prices has lagged international peers substantially, as sentiment in Japan has remained poor. On a medium term basis, some excellent companies are simply far too cheap.

Mabuchi Motor, for example, is a company which has managed to stay in the black throughout the downturn via a flexible production system. The company has leading market shares in its core product area of small motors, with shares as high as 90% for items such as car mirror motors. The share price of its main competitor, Hong Kong-listed Johnson Electric, has risen around 132% over one year, whilst Mabuchi is up only 43%. Mabuchi trades at book value, compared to 1.6x for Johnson; it is more profitable and around 32% of its market cap is represented by net cash. The company has a growing, profitable business, is cheap in its own right and offers excellent value compared to its peers.

This is not an isolated case as numerous companies with strong business franchises remain on low valuation levels. Topix itself remains the cheapest major market on a book value basis, trading at 1.2x book compared with 2.3x for the S&P 500. The dividend yield of 1.68% is lower than the S&P's 2.06%; however, compared with bond yields of 1.32% and 3.67% respectively, dividends in Japan are attractive. Small-cap markets trade at even more depressed levels, with the Topix small index on a price to book value of 0.8x.

The Special Situations Investor

Japan appears to have been a perennial special situations market, particularly whilst the long awaited restructuring of corporate Japan has not yet materialised. We believe, however, there has been a gradual and important shift in the mentality of much of corporate Japan, as the growing appreciation of increasing global competition is forcing a greater desire for adequate returns on invested capital. The speed and depth of this current downturn in particular has seen a particularly swift response from Japanese companies to cut costs, which has been helped by a more flexible labour market via greater use of temporary workers.

There have been some notable moves by companies to focus on core operations and to a lesser degree we are witnessing cash-rich companies taking advantage of a stronger yen to conduct sensible M&A activities.

The Contrarian Investor

What is the definition of an optimist? A Japanese fund manager who irons five shirts on a Sunday. This joke is currently doing the rounds and I suspect it has been adapted over the years, and will continue to be adapted in the years to come, to fit whatever market is out of favour. I also suspect that when someone tells you this joke about a particular stock market, then this is probably the time to start looking at it as an investment. Indeed, the current lack of enthusiasm for Japan is potentially one of the more powerful reasons to consider its stock market right now. We are never fully comfortable when everyone in the room agrees with the wisdom of our point of view and right now Japan is clearly out of favour. We hear of numerous managers exiting the market altogether, whilst global investors seem to have little interest in Japan as an investable market.

Japan's recent press has generally been negative, with much attention given to the country's supposedly perilous fiscal situation. Needless to say sentiment is very low, investors are underweight and expectations

are rock bottom. At the very least this should lead those of a contrarian nature to take a second look at whether the pendulum has swung too far on Japan.

The Macro Investor

There are numerous economic headwinds that make a long-term investment call on Japan somewhat problematic. Demographics remain a concern for future growth, whilst presently the country is battling seemingly ingrained deflation. The primary concern is to increase growth and the driver of this growth is increasingly shifting towards emerging markets, particularly China.

China is now Japan's single largest export market, overtaking the US in during 2009. Indeed, the importance of the Asian region to Japan's exporters has been steadily growing since long before the recent fall in US and EU economic stability saw China emerge as Japan's top market. Admittedly, much of Japans' exports to China remain destined for other markets; however, the changing nature of China's manufacturing base and its emerging consumers are providing substantial opportunities for many leading Japan companies.

As China's manufacturers move up the value chain and increasingly automate their production systems, Japanese companies, which excel in this field, are there to provide high-end factory automation machinery. Companies such as Fanuc, Keyence, SMC and THK are highly profitable world leaders in this area and are seeing increasing sales in the region.

Japan is also expanding its retail presence throughout Asia via its convenience store formats, selling its cosmetic brands such as Shiseido and gaining market share in other consumer goods, such as baby nappies. The potential for a more motorised China presents a market considerably larger for auto companies than the current profit driver the US.

Summary

It's not unreasonable for investors to be cautious on Japan as a potential investment. Nevertheless, the region retains many world-class companies on low valuations and some of the longer-term positives have been overlooked whilst sentiment is generally negative.

As a large, liquid, diversified market we believe Japan offers an excellent hunting ground for the active stockpicker. Opportunities to invest in strong medium-term themes such as emerging market growth and green technology are numerous, and valuations are far from stretched compared with global peers.

After a disappointing 2009, we believe that Japan warrants greater attention from investors in 2010.

Stefan Bain, Director, Japanese Equities

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Notes to Editors

F&C Investments

- F&C Asset Management (F&C) is an independent London Stock Exchange listed asset management group with around 100,000 shareholders.
- F&C traces its origins to 1868 with the launch of Foreign & Colonial Investment Trust, the first ever publicly listed investment fund. Foreign & Colonial Investment Trust remains a client of F&C.
- F&C is an active fund manager with a multi-specialist investment model where individual teams have strong accountability for their products and processes. The group is also an active shareholder with a leading franchise in governance and sustainable investment.
- F&C manages £99.2 billion (€108.5 billion) of assets* for a diverse range of institutional, insurance and retail clients across all major asset classes – equities, bonds, cash and property – as well as alternative and specialist product classes. F&C invests globally and has been a longstanding investor in emerging markets.
- F&C has three pillars to its strategy: *Advisory & Solutions* – the servicing of strategic partners and the provision of investment solutions and overlays such as shareholder engagement programmes, Liability Driven Investments, Asset & Liability Management, Multi-Manager and Fiduciary Management; *Alpha Investing* – active fund management across a diverse range of asset classes and markets but with a focus on UK and European equities and fixed income and Emerging Markets; *Environmental, Social & Governance Investing* – building on its market leading presence in ethical investment with new products.
- F&C REIT Asset Management is the group's global property asset management business. It was formed in 2008 from the merger of F&C's property division and REIT Asset Management. F&C REIT operates from offices in London, Dublin, Munich, Mumbai and Stockholm.

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- F&C manages assets principally from three investment centres: London, Amsterdam and Edinburgh. The group has a global office network spanning a dozen countries: China (Hong Kong), France (Paris), Germany (Frankfurt & Munich), India (Mumbai), Ireland (Dublin), The Netherlands (Amsterdam), Portugal (Lisbon), Sweden (Stockholm), Switzerland (Geneva), UK (London, Edinburgh, Dorking) and the United States (Boston).
- In March 2009 F&C signed a Memorandum of Agreement with Hua Xia Bank, one of China's twelve nationwide joint stock commercial banks, to establish a joint venture fund management company in China in which F&C will have a 19.5% interest.

* As at 30 September 2009.