



Opalesque Round Table Series '10 JAPAN

Opalesque 2010 Roundtable Series Sponsor:



Editors' Note

Dear Reader,

Welcome to the Opalesque 2010 Japan Roundtable! Any financial prediction is only as good as the presence has been understood. In this Roundtable, you will discover a multitude of key aspects about Japan and Japanese hedge fund investors – who were the first institutions in Asia to support hedge funds. This wealth of information, compressed into 28 pages, is hard to beat:

- How comes that **big global brand name hedge funds are not trusted as much as in the past by conservative Japanese investors? That smaller funds have unique opportunities at the moment?**
- **Japanese institutions are well-known as huge holders of foreign bonds like US treasuries. Are they now reducing their bond exposures against hedge funds?**
- Investors say 2009 was a very positive year for the Japanese hedge fund industry. While the macro numbers are well known – the population decline, debt, and deflation etc. – **how comes that still many people are able to make money in Japan? 22 new hedge funds were launched last year alone?**
- Since 1945, Japan went through 14 business cycles. **Did you know these cycles can be easily modeled?**
- Did you know that Japanese firms have cut costs to the extreme so that **if in 2010 sales grow just by 3%, earnings for the top 300 companies can go up by 50% or more?**
- What **lessons from Japan's last twenty years** can be applied to the U.S. and Europe going forward?
- **How comes that probably until 2020 Japan will be able to afford its low interest environment?**
- What does the recent **technology upgrade by the Tokyo Stock Exchange** to their Arrowhead System at the start of this year mean for hedge funds and investors?
- **Why do hedge fund managers celebrate the introduction of IFRS** probably within the next three years?
- Did you know that **Japanese individual investors are more contrarian investors, while foreign investors are usually trend followers?**
- How is Japan coping with the rise of Asia and China? What are the opportunities for Japan in green technologies?
- The Democratic Party of Japan has taken control of Japan's Lower House with an historic election victory, a turning point in post-war Japan. **What does the "end of the Japan Inc." era – exemplified by letting the national flag carrier Japan Airlines go bust – mean** for the country? What opportunities do hedge fund managers see?
and much more!

The 2010 Opalesque Japan Roundtable was sponsored by NYSE Liffe and took place in their Tokyo office with:

- **Hidemichi Watanabe, Founder, CEO, WERU Asset Management**
- **Dr. Izumi Kazuhara, Chief Representative, NYSE Liffe**
- **John Inamine, Head of Alternative Investment Strategies, SPARX Asset Management**
- **Masahiro Koshiba, Founder, CEO, United Managers Japan**
- **Paul MacGregor, Director, NYSE Liffe**
- **Rory Kennedy, COO, Rogers Investment Advisors**
- **Toshihiro Hirao, Co-Founder, Asuka Asset Management**

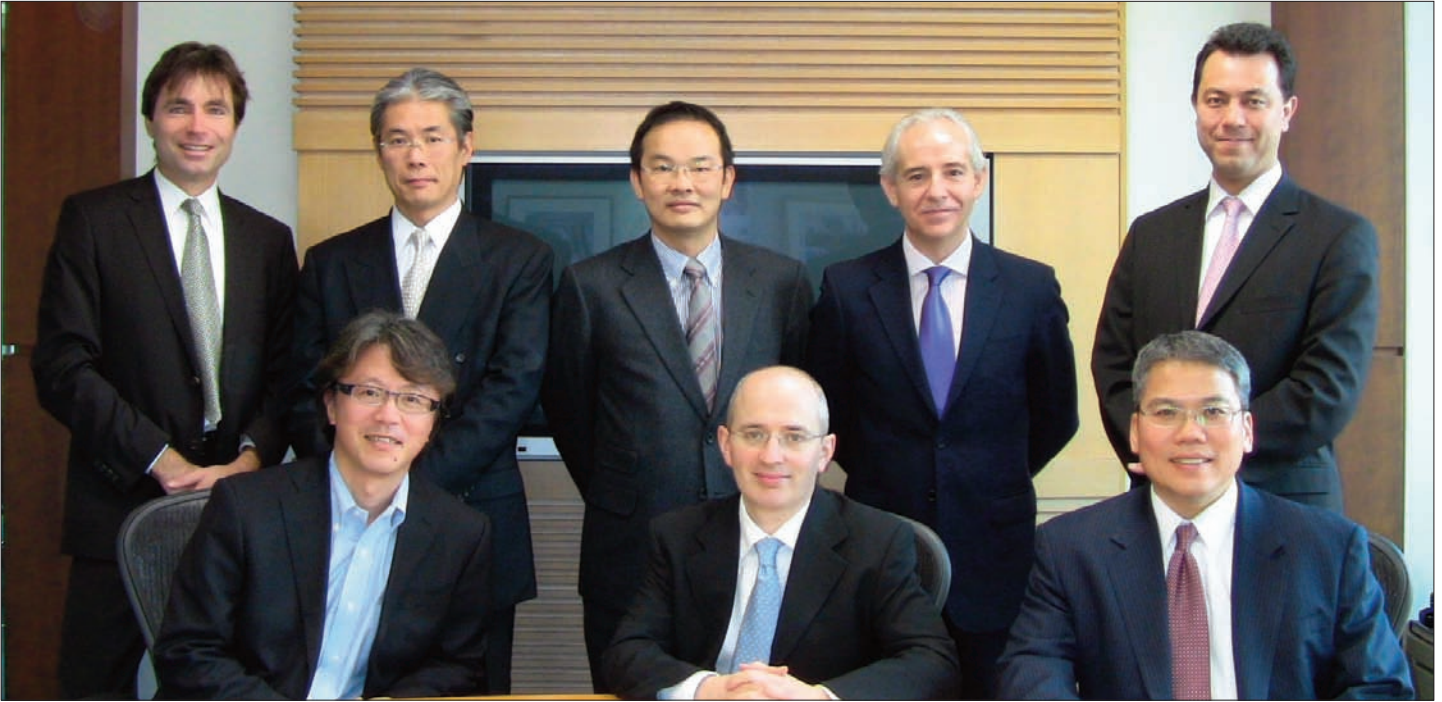
We also thank Rory Kennedy for helping us put the group together, and Customhouse Group and Taussig Capital as our 2010 Roundtable Series sponsors.

Matthias Knab
Director Opalesque Ltd.

Knab@opalesque.com

Cover Photo: Mount Fuji is one of Japan's "Three Holy Mountains". The volcano erupted last in 1707–08. Photo by Matthias Knab.

Participant Profiles



(LEFT TO RIGHT)

Matthias Knab, Hidemichi Watanabe, Masahiro Koshihara, Paul MacGregor, Dr. Izumi Kazuhara
Toshihiro Hirao, Rory Kennedy, John Inamine

Introduction

Rory Kennedy
Rogers Investment Advisors

My name is Rory Kennedy. I am COO for Rogers Investment Advisors, an emerging alternative investments advisory firm headquartered in Tokyo.

Rogers Investment Advisors was set up by our founder, Ed Rogers, almost four years ago. Our first product is a Japan focused fund of hedge funds called the “Wolver Hill Japan Multi Strategy Fund”, which has just established its three-year track record as of November 2009.

Since its inception, this fund of funds has outperformed the TOPIX index in Japan by over 50% and has outperformed the S&P 500 by more than 40% over the same period. Of particular note, we were up almost +6% in 2008, which would have put us in the top few percent of fund of funds worldwide. We think this outperformance has come from our “boots-on-the-ground” intensive due diligence process, which we think is one of the best in the world. It has allowed us to deliver uncorrelated, stable returns with low volatility which we believe is what investors need right now.

We have taken our local operational expertise and launched our 2nd fund in November 2009, called the “Wolver Hill Asia Emerging Manager Fund”. It is a private equity fund that looks to either seed promising new start-up Asian managers or to help grow emerging Asian managers who may already have a track record but need the business-side advice that we can bring to them.

Research has shown that most hedge funds fail through operational failures rather than for performance reasons and we aim to help these emerging Asian managers build better businesses, and then bring them to the attention of the wider world. The first investment by our PE fund has been into H3, an outstanding Sydney-based CTA manager with a 4 year track record of outperformance and over \$200m in AUM.

Toshihiro Hirao
Asuka Asset Management

My name is Toshi Hirao. I am one of the founding partners of Asuka Asset Management, which started operations in 2002. I also serve as the Chief Fund Manager of our Japanese equity long/short fund.

Asuka Asset Management runs four funds, one is the Japanese long/short fund, another is Opportunities Fund, which is a multi-strategy fund. The third fund is the Value Up Fund, which basically helps the management or owner of a company to increase the value of the firm, so that subsequently the stock price will go up too. That fund is more of a long-only fund.

Asuka also runs a CTA/managed futures fund, which mainly focuses on the Japanese commodity market.

In total, we hold over US \$500 million in our four funds. We started the company after a management buyout from Tudor Capital Japan. The three founding partners worked together for more than 25 years, having started at Salomon Brothers Prop Trading, then at Tudor and now at Asuka Asset Management.

Masahiro Koshiba
United Managers Japan

My name is Masahiro Koshiba, I am the Chief Executive of United Managers Japan. United Managers Japan is sort of the first hedge fund incubation platform in Japan. Over the last five years, we have launched about 11 funds, but unfortunately, over time, we also had to close some of them.

At this moment we are running three types of Japan long/short funds. Another fund is an energy fund of fund set up as a joint venture with Mitsui & Co. and The Norinchukin Trust and Banking. We also manage a Russia venture capital fund, which is the first fund investing in the Russian private equities space.

Recently, we started providing support for a long-only product that invests in Japanese equity as well. I have been in this business since 2000 – also on a personal level, I have been a fund manager for twenty years now.

I have recently launched a fund in November 2008, in the midst of the Financial crisis, is called “Kotoshiro”. Kotoshiro is a Japanese god who is associated with Ebisu, the god of good fortune. The most important and unique feature of the fund is tightly controlled daily volatility; it is controlled by adding and reducing positions on a real time basis. The rigid risk control means downside risk is very limited. The fund accumulates 1% - 2% on monthly basis, making 12%+ on a yearly basis. We call this approach the “winning by not losing” philosophy.

This long/short fund is seeking double alpha (i.e. alpha from both long and short sides), and most of the source of alpha comes from individual stock picks. The correlation between the fund and TOPIX is almost nil.

Hidemichi Watanabe
WERU Asset Management

My name is Hidemichi Watanabe. I am the co-founder and CEO of WERU Asset Management Co., Ltd., which would be probably the first hedge fund manager in the Japan credit space. The WERU Japan Credit Fund was launched in September 2008 to provide the stable and attractive absolute return for worldwide investors including fund of funds, pension sponsors, endowments, family offices, etc. When it comes to unique investment opportunities, I believe Japan credit is one of the new, differentiating and attractive places that investors should take into account.

The Sharpe ratio that the WERU Japan Credit Fund provides is over 5. The risk the fund has been taking since inception is only 2.5% p.a., and no monthly drawdown was recorded so far. The correlation between the WERU Fund and any other asset or strategy has been significantly low, which is important for investors. The WERU Japan Credit Fund can help improving the risk/return profile in clients' portfolios. With our strong and sophisticated credit risk management and multi-strategy approach within credit markets, WERU aims to offer a very efficient and unique opportunity for domestic and global investors.

We have seen a lot of structural and dynamic changes in Japan credit markets over the past years. Japan credit is now totally unique. At the same time, the Japanese corporate bond market is the 4th largest in the world. We provide access to attractive strategies within this new and unique market, which are different from those in the U.S. or Europe or ex-Japan Asia. Japan credit can be immensely valuable by adding a unique element of diversification to investors' portfolios.

The co-founder and CIO of the firm, Tomone Kawachi, is one of very few top credit managers in Japan. Risk management is our edge – we have integrated quantitative credit risk analysis into the qualitative approach. Tomone Kawachi has a long experience and excellent track record of investments in both low-grade and high-grade corporate bonds as well as credit derivatives.

WERU Asset Management was incorporated in March 2007 as a member of WERU Group, which is backed by the Waseda University Entrepreneurial Research Unit – one of the educational organizations at Graduate School of Waseda University in Tokyo. This is a wonderful platform for finance professionals as it brings together broad range of specialists from many different disciplines.

John Inamine
SPARX Asset Management

My name is John Inamine. I am the Head of Alternative Investment Strategies at SPARX Asset Management in Tokyo. SPARX was founded in 1989 and is one of the oldest independent asset management companies specializing in Japanese equities. We are known for our fundamental approach to stock-picking, through which we have run long-only funds since our inception and long/short strategies since 1997. In the early 2000s, we recognized that Asia would rise in

importance as an investment destination for global investors, and as a result, the SPARX Group also includes PMA in Hong Kong, which runs Asia ex-Japan hedge fund strategies, and Cosmo in Seoul, which runs long-only and long/short equity strategies in Korea. All together, the group has close to \$7 billion in assets under management.

I am responsible for our hedge fund strategies in Tokyo - our operations in Hong Kong and Seoul are run separately. I work very closely with our long/short investment team, particularly in the areas of portfolio construction and risk management, where over the past several years, we have developed a portfolio management framework that combines fundamental stock-picking with many of the risk management concepts that I learned and used for more than ten years as a trader of convertible bonds and other derivatives at Swiss Bank/O'Connor and Associates and Deutsche Bank.

At SPARX in Tokyo, we are looking to expand our hedge fund business beyond our historical focus on equities, and our first step in that direction was the launch of a global macro fund in August of last year. We are actively seeking to add other strategies, such as event-driven and credit. In addition, our next fund launch will be a green technology smart-grid fund, which will be run by our founder Shuhei Abe.

Dr. Izumi Kazuhara
NYSE Liffe

My name is Izumi Kazuhara. I am running the Tokyo office of NYSE Liffe, which is the global derivatives business of NYSE Euronext. I joined NYSE Liffe in April 2008, but this office itself was established 10 years ago by NYSE mainly for its IPO business.

I have a legal background originally and studied in Japan and Germany. I lived in Germany for 14 years was involved with the Frankfurt-based derivatives exchange Eurex for eight years before joining NYSE Liffe.

My task here at the NYSE Liffe Tokyo office is to promote our products in Japan, to maintain good relations with the regulator, exchanges, industry associations, investors, and also do research for our business development.

Our main customers in Japan are banks, who mainly trade our fixed income products. While banks are the main customers, also some hedge funds in the Asian region are using our products, depending on their strategy. If they run a fixed income strategy fund or managed future fund, they are most likely our customers.

Paul MacGregor
NYSE Liffe

My name is Paul MacGregor, I work alongside Izumi at NYSE Liffe, the Derivatives division of NYSE Euronext. A quick word about the NYSE Euronext group. Most people will know the New York Stock Exchange which in 2007 purchased the Europe-based Euronext exchange to become NYSE Euronext. And by that purchase they also acquired LIFFE, which stands for London International Financial Futures and Options Exchange, an international business offering derivative products on mainly short-term interest rates futures and options, long-term interest rate futures and options, equity options, index options, and commodity products as well.

I am responsible for the fixed-income division, which is the single largest business within NYSE Liffe. NYSE Liffe is a derivatives market and it accounts for over 25% of the revenue of the group, so a quite significant unit within the NYSE Euronext group, which for many people is still viewed as a pure stock market exchange.

So, actually, we are the most important business within the group and we are very determined to change this perception of NYSE Euronext as purely a stock market - it is very much an integrated stock and derivatives business.

In terms of my personal background, I have been running the fixed income team at NYSE Liffe now for the last two years. Prior to that, I was running the LIFFE CONNECT development program. LIFFE CONNECT is the trading platform, matching engine and serves as the distribution platform for our derivatives products.

I started coming to Tokyo around 10 years ago, when we started talking to the Tokyo Financial Exchange about using our matching engine for their technology. More recently, the Tokyo Stock Exchange has also launched our matching engine Tdex+ as part of their new options marketplace.

We also have product linkages with the main Japanese exchanges. For example, we offer our NYSE Liffe Euroyen in London, which then transfers back to the CFX at the close of business in London. We also have a similar arrangement with the Tokyo Stock Exchange for JGBs.

We are enjoying a robust growth in Euribor futures and options offerings and our business originating from Japan. Here, the banks and funds are now also trading the short-term interest rate products on NYSE Liffe to get some European exposure and not just Euro/Dollar exposure.

Matthias Knab

Going forward, what is the outlook for your funds and for your strategies? Obviously, at this point in time not everyone is convinced they will make money investing in Japan.

Masahiro Koshiba

There has been a lot of focus on Japan's declining and aging population. Probably in the next 10 years, China and also other countries will face the same issues.

However, it is the task for committed fund managers to look out for opportunities in every market environment, and also here, there are significant opportunities.

While you could argue that in the long-run an economy may shrink because of the aging issue and a declining population, if you look at the sectors and sub-sectors of a country, you will often find a consolidation and concentration trend.

In the case of airlines for example, if you look at it cycle by cycle, the number of seats and players within the industry is declining. It used to be three; ANA, JAL, and JAS. JAS got taken over by JAL and in the current cycle, JAL is actually a bust. In the electronics industry, the same happened when Sanyo was taken over by Panasonic.

In order to survive, companies merge, with probably the better company taking the market share of the disappearing company. Again, an excellent territory for long/short strategies, where clearly also on the short side money can be made.

The story is different in China or India at the moment. There, the sub-sectors are actually expanding. Once more, this is a unique investment scheme for Japan.

Rory Kennedy

I think it would be fair to say that the rest of the investor world has either been disinterested in Japan or been outright hostile towards investing in Japan over the last few years, as they have found it so hard to make money here. But to me that means that the hedge fund managers that do succeed in Japan are actually earning the high fees they charge, rather than camouflaging beta as alpha as so often happens in the rest of the world.

The negative macro numbers are well known – the population decline, debt, and deflation etc– yet many people still are able to make money in Japan. If you think of the concept of hedge fund investing, there were people trading rice futures hundreds of years ago here in Japan, long before the development of the markets in the rest of the world.

I follow closely the international media on their reporting of Japan, and over the last couple of years, 99% of all coverage has been negative.

But now, over the last two to three months I have noticed that about 20% of the stories are now

relatively positive. Europe and America are looking more and more risky with the spectre of sovereign default in Europe and continuing economic woes in the US hanging over investors. Chinese stock markets were down around 10% in January alone and that kind of volatility has to be hard to take if you are still licking your wounds from 2008.

I think it would be fair to say that the rest of the investor world has either been disinterested in Japan or been outright hostile towards investing in Japan over the last few years, as they have found it so hard to make money here. But to me that means that the hedge fund managers that do succeed in Japan are actually earning the high fees they charge, rather than camouflaging beta as alpha as so often happens in the rest of the world.

The negative macro numbers are well known – the population decline, debt, and deflation etc– yet many people still are able to make money in Japan.

We have talked with some of the smartest Pan-Asian hedge fund managers over the last quarter and they have indicated to us that they expect to put large percentages of their portfolios into Japan this year – a stark difference from previous years. At the same time, we tracked 22 new Japan-dedicated strategies launching last year, and we expect a lot more this year.

We think that the election of the new government marks a turning point in post-war Japan. Steps such as forcing open the “closed-shop” press clubs to new media, fostering a warmer relationship with China, inviting the general public to view the budget battles between bureaucrats and politicians, allowing the national flag carrier Japan airlines to go bust - all of these moves would have been unthinkable even 18 months ago. Change is clearly in the air in Japan, whether or not this gets recognized by overseas investors is a different story.

Rory Kennedy



We have talked with some of the smartest Pan-Asian hedge fund managers over the last quarter and they have indicated to us that they expect to put large percentages of their portfolios into Japan this year – a stark difference from previous years. At the same time, we tracked 22 new Japan-dedicated strategies launching last year, and we expect a lot more this year.

We think that the election of the new government marks a turning point in post-war Japan. Steps such as forcing open the “closed-shop” press clubs to new media, fostering a warmer relationship with China, inviting the general public to view the budget battles between bureaucrats and politicians, allowing the national flag carrier Japan airlines to go bust - all of these moves would have been unthinkable even 18 months ago. Change is clearly in the air in Japan, whether or not this gets recognized by overseas investors is a different story.

Another thing to remember is that Japan is a very cyclical market. The equity markets here are highly correlated to the OECD indicators and by that reckoning it is roughly every five years that the Japanese stock market gets a significant “bounce”. We are coming up to the five year term now so while every year people say “this could be Japan’s year”, with stock valuations as low as they are, even from a simple beta capture play- now is probably a good time to get back into Japan. But we are an alternative investment firm so we do not care whether the Japanese stock market goes up or not. We have been able to find excellent Japanese fund managers who are able to make money in any climate.

Toshihiro Hirao

Let me add to that from the viewpoint of the long/short strategy of Japanese equity. We had quite bad economic conditions after the Lehman shock, and many companies lost money for one or more years. But, if we look at those companies now, a lot of them drastically reduced their costs and are actually now starting to make good profits again. As you know, there are quite a number of Japanese firms that are very strong in technology and environment related goods and services.

So as an investor, you have the combination of strong companies within a growing sector.

However, at the same time some of the companies are still in quite bad situations – they are not able to make a profit and they keep losing money. So from a long/short perspective, the gap between good and bad companies is widening. This means there are opportunities to make money for savvy investors who don't have to revert to market beta.

A quick point about the Japanese stock market, which is quite a liquid market, easy to trade and accessible for everyone. We do expect to see more money coming in from overseas investors, and also some of the Japanese domestic pension money will be moving from a long-only into the long/short format or into alternative investments.

John Inamine

There are a number of reasons why investors should be involved in Japan. As Hirao-san said, Japanese companies have cut back on their costs so much that just a slight improvement on the revenue side will provide a turbo boost to earnings.

The Daiwa Institute of Research has a construct called the DIR 300 that consists of 300 of the top Japanese companies. Daiwa recently estimated that if the DIR 300 grows sales by 3%, earnings can go up by 50% or more.

There are a number of reasons why investors should be involved in Japan. As Hirao-san said, Japanese companies have cut back on their costs so much that just a slight improvement on the revenue side will provide a turbo boost to earnings.

The Daiwa Institute of Research has a construct called the DIR 300 that consists of 300 of the top Japanese companies. Daiwa recently estimated that if the DIR 300 grows sales by 3%, earnings can go up by 50% or more.

From a fundamental perspective, we believe that Japan has entered a phase when it will be easier to pick winners and losers, which means good opportunities for bottom-up long/short investors.

John Inamine



From a fundamental perspective, we believe that Japan has entered a phase when it will be easier to pick winners and losers, which means good opportunities for bottom-up long/short investors. More generally, if and when the Japan market recovers, it won't move in a straight line. There will be volatility and ups and downs. Long/short strategies in general can smooth returns and add alpha over time. Japanese long/short hedge fund managers over the years have displayed a high level of skill in preserving capital in bad markets and in making money in good times as well.

Hidemichi Watanabe

Addressing the Japanese credit space again for a moment, it has sometimes been mentioned that it would be a niche market. However, the Japanese corporate bond market counts for 7% within the Barclays Capital Global Aggregate Corporates Index. The U.S. has 44%, the UK stands a 9% and France at 7% as well. The Japanese credit market is smaller than the US, but large enough in size to be attractive to investors. In addition, the new issuance of corporate bonds has increased in

The Japanese corporate bond market counts for 7% within the Barclays Capital Global Aggregate Corporates Index. The U.S. has 44%, the UK stands a 9% and France at 7% as well. The Japanese credit market is smaller than the US, but large enough in size to be attractive to investors. In addition, the new issuance of corporate bonds has increased in Japan. The difficulties in obtaining funding changed the companies' way of thinking and strategies of how to obtain funding.

Hidemichi Watanabe



Japan. The difficulties in obtaining funding changed the companies' way of thinking and strategies of how to obtain funding. They are now forced to find new avenues for funding other than issuing equity or lending money from the banks. In fact, the issuance of new corporate bonds in Japan has dramatically increased and the potential for bond issuance is substantial.

Masahiro Koshiba

I agree, the Japanese equity market provides a very unique opportunity for investors.

I have been a fund manager since 1990. At that time the Nikkei was at 38,900, and now we are at around 10,000 after having hit the bottom of 7,000 in March 2009. That's down over 80% for the last 20 years.

During this period, the stock market obviously displayed a very high correlation to the Japanese economic business cycle. Since 1945, the economy went through 14 business cycles. We are now in the 14th cycle. With each economic downturn usually comes a stock market crash in the magnitude of 50% or higher. For example, in 1990/92 the Nikkei was down 63%, and in 1997/98 - 50%. From 2000 to 2003 down another 60%, and in 2009 down 63%.

But on the other hand, once you hit the bottom, if you take an average of the last 14 cycles, you will notice that the stock market will move well ahead of the business cycles and usually enjoys a solid run of about five months.

I have been a fund manager since 1990. At that time the Nikkei was at 38,900, and now we are at around 10,000 after having hit the bottom of 7,000 in March 2009. That's down over 80% for the last 20 years.

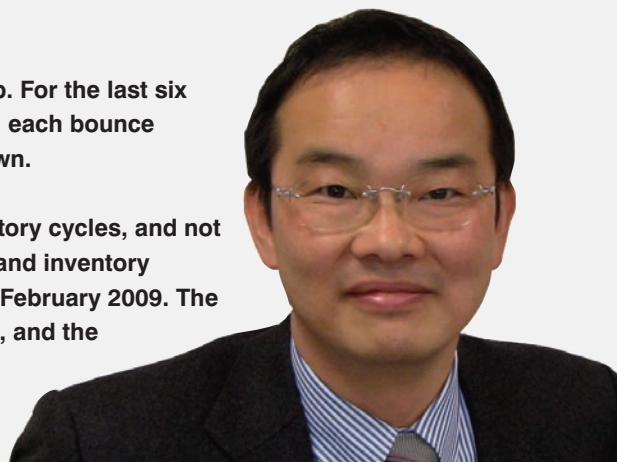
During this period, the stock market obviously displayed a very high correlation to the Japanese economic business cycle. Since 1945, the economy went through 14 business cycles. We are now in the 14th cycle. With each economic downturn usually comes a stock market crash in the magnitude of 50% or higher. For example, in 1990/92 the Nikkei was down 63%, and in 1997/98 - 50%. From 2000 to 2003 down another 60%, and in 2009 down 63%.

But on the other hand, once you hit the bottom, if you take an average of the last 14 cycles, you will notice that the stock market will move well ahead of the business cycles and usually enjoys a solid run of about five months.

If you catch that trend, you can get over 100% returns on the way up. For the last six years or even since 1990, you could have made 134% on average in each bounce back. And all this while the long-term trend was still be trending down.

The key is watching the business cycles, and here I mean the inventory cycles, and not the investment cycles. All you have to do is look at the production and inventory indexes. To give you a recent example, the product index bottomed February 2009. The average expansion period for last 14 cycles was actually 33 months, and the average reverse period is about 16 months.

Masahiro Koshiba



If you catch that trend, you can get over 100% returns on the way up. For the last six years or even since 1990, you could have made 134% on average in each bounce back. And all this while the long-term trend was still be trending down.

Again, if you are right on the timing, you can get very good returns. The key is watching the business cycles, and here I mean the inventory cycles, and not the investment cycles. All you have to do is look at the production and inventory indexes. To give you a recent example, the product index bottomed February 2009. The average expansion period for last 14 cycles was actually 33 months, and the average reverse period is about 16 months.

If we look at the current reversal period, the Japanese government already announced that in October 2007 the Japanese economy had reached a peak.

At UMJ, we launched a new product two years ago, actually just two months after the Lehman crisis, which I manage. I thought at that time if the peak was October 2007 and average length of a reversal or downturn is 16 months, probably the next bottom of the economy could be February 2009. Indeed, exactly at that time the production index actually hit its low on February last year.

But on the other hand, the final product sales of auto or electric goods were bad, but actually not as bad as those 70% to 80%. The shipment level was probably down more like 30% or 40%.

After the Lehman shock, at the height of the financial crisis, Japan's corporations started to cut down inventory – successfully, The peak of inventory was in December 2008 and has been coming down since then continuously. This kind of pattern always happens – since 1990 I have personally gone through four business cycles. Of course, there are some differences each time, but the pattern is always the same.

That means, if the economy hits the bottom around February or March 2009 and the average expansion period is 33 months, then one year has already passed and we may have another two years of a good business environment, in terms of the trend.

If the average return of the up-trend is 130%-140%, and we hit the bottom at 7,000, then the next peak could be around 16,000, or something of that order. But still, as the last peak was actually over 18,000, even if we may see a level of 16,000 in the next two years, the Japanese equity market would still be providing negative long-term returns.

However, from an absolute return perspective, if you get the cycles right during these phases of high volatility, you can get very unique returns.

Paul MacGregor

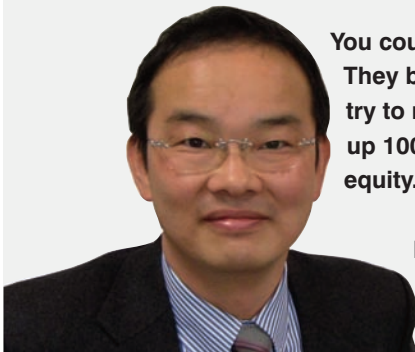
What are your views in respect of the actual innate liquidity within the Japanese stock markets and its ability to absorb some of these volatile shocks? In Europe after the Lehman crisis, a lot of risk capital was withdrawn from the market, and people did not want to get involved in choppy and volatile markets.

Obviously, Japan has been in very low-rates environments for nearly 10 years. What is the ability of the Japanese stock markets therefore in terms of general liquidity, is there much capital at risk, are people willing to invest to actually absorb some of these shocks?

Masahiro Koshiba

Actually, over 50% of the turnover is created by a receding investor base – sometimes up to 60% or 70%. In such phases, finance is provided by domestic investors like pension funds and individual investors. Since 1990, individual investors have become a marked force in the Japanese equity market and are always there. In November 2008 for example, they bought one trillion Yen in Japanese equities.

Since 1990, individual investors have become a marked force in the Japanese equity market and are always there. In November 2008 for example, they bought one trillion Yen in Japanese equities.



You could say that Japanese individual investors are kind of a contrarian type of investor. They bottom hunt and sell on the way up. Also the pension funds have their pattern. They try to manage their allocation to Japanese equities, and in times of increased volatility – like up 100%, down 50% or 60% etc. - they try to keep an average allocation for Japanese equity. This means that they are also contrarians.

Foreign investors, on the other hand, usually tend to be trend followers.

Masahiro Koshiba

You could say that Japanese individual investors are kind of a contrarian type of investor. They bottom hunt and sell on the way up. Also the pension funds have their pattern. They try to manage their allocation to Japanese equities, and in times of increased volatility – like up 100%, down 50% or 60% etc. – they try to keep an average allocation for Japanese equity. This means that they are also contrarians.

Foreign investors, on the other hand, usually tend to be trend followers. Once the economy hits the bottom, foreigners try to buy a lot of Japanese stock. On average, foreign investors buy Japanese equities in the order of four or five trillion Yen per year for the last 20 years. These activities are providing liquidity. One advantage of the Japanese stock market is that it is a very large and liquid market, probably next to the New York Stock Exchange or London.

If we look at the alternatives universe, the combined assets of Japan-based long/short strategies are still tiny. With the financial crisis, global hedge fund investors experienced that liquidity risk is always one of the biggest risks. In that sense, Japan is actually one of the safest areas in terms of liquidity risks.

Dr. Izumi Kazuhara

As hedge fund managers investing in Japanese markets, do you think you have all the right financial instruments to realize your strategies?

Masahiro Koshiba

Hedging small cap stocks can be a challenge. If you create some vehicles or instruments for us, that will be great.

John Inamine

I used to trade options a long time ago in Japan, and the one thing I always wanted to see was a liquid market for single stock options.

I think that would be a huge help in terms of structuring bets or hedging certain risks, including small cap exposure. In addition, if there were a more liquid and diversified market for Japan ETFs – for example ETFs for specific industries or market caps – it would be possible for us to be more creative in executing or hedging certain strategies.

Paul MacGregor

I believe that one of the things that in the past held back some of the Japanese exchanges was their technology, the inability of the technology to cope with growing bandwidth, algorithmic trading etc., which in the U.S. and Europe are well established trading styles. The recent moves by the Tokyo Stock Exchange to upgrade their technology by bringing in state of the art platforms will help grow that market. We have a very active options market in Amsterdam with a large retail participation, and I agree that there is a proper Japanese domestic market, including retail, for active options trading.

John Inamine

I agree. Going back to the outlook for our strategies, let me add that over the last couple of years you really had to be able to trade your exposures around. It was very tough for pure fundamental stock pickers.

That being said, we think that in recent months, things have started to change. We are definitely seeing our stock picks getting a lot more traction as the macroeconomic outlook becomes clearer and more positive. From a pure fundamental stock-picking standpoint, 2010 could be a really interesting year.

I also would like to point out that some of the statements and policies put forth by the Democratic Party of Japan since it came into power last year have encouraged changes that many Japan watchers have been waiting to see for a long time. This will result in an environment where the winners and losers can be more easily identified, which is very beneficial for equity long/short strategies.

For example, the Japan Airlines situation is fascinating from multiple perspectives. Here you have a classic “Japan Inc.” company that is finally being allowed to go bankrupt in a way that clearly affects not just creditors, but the work force and pension holders. And most interestingly, there was little protest about that happening. I believe the general public felt that it was about time for

JAL to face up to its problems and they welcomed the fact that the government had finally forced JAL to take that route.

Over the last couple of years you really had to be able to trade your exposures around. It was very tough for pure fundamental stock pickers.

That being said, we think that in recent months, things have started to change. We are definitely seeing our stock picks getting a lot more traction as the macroeconomic outlook becomes clearer and more positive. From a pure fundamental stock-picking standpoint, 2010 could be a really interesting year.

Some of the statements and policies put forth by the Democratic Party of Japan since it came into power last year have encouraged changes that many Japan watchers have been waiting to see for a long time. This will result in an environment where the winners and losers can be more easily identified, which is very beneficial for equity long/short strategies.

For example, the Japan Airlines situation is fascinating from multiple perspectives. Here you have a classic “Japan Inc.” company that is finally being allowed to go bankrupt in a way that clearly affects not just creditors, but the work force and pension holders. And most interestingly, there was little protest about that happening. I believe the general public felt that it was about time for JAL to face up to its problems and they welcomed the fact that the government had finally forced JAL to take that route.

The message is that there will be no return to the old convoy system, because the country will not support it any more. People are not willing to continue throwing money down into the money pit, even for a company like JAL, the flag carrier. As fundamental long/short investors, we think this is very exciting.

A lot of companies in Japan are very strong in what's now called green technologies, which includes alternative energies and a new smart-grid concept. A lot of companies are strategically looking at those sectors as an opportunity to evolve beyond what they have been doing - in a way that can be hugely dramatic.



For example, Panasonic announced early this year that they are essentially turning away from their roots as a domestic-focused consumer electronics company in order to reposition themselves as a global provider of green energy systems and other green technology solutions. Panasonic is a classic Japan Inc. company as well, and I am sure that there were traditionalists there who were bothered by that decision. But the firm had to confront the reality that it would no longer be able to compete against Asian competitors in the electronics sector without taking advantage of its edge in green technology.

John Inamine

The message is that there will be no return to the old convoy system, because the country will not support it any more. People are not willing to continue throwing money down into the money pit, even for a company like JAL, the flag carrier. As fundamental long/short investors, we think this is very exciting. Good companies that make the changes necessary to adapt to difficult economic conditions will win, while bad companies that stay bad will lose.

There is another area I want to address. A lot of companies in Japan are very strong in what's now called green technologies, which includes alternative energies and a new smart-grid concept. A lot of companies are strategically looking at those sectors as an opportunity to evolve beyond what they have been doing - in a way that can be hugely dramatic.

For example, Panasonic announced early this year that they are essentially turning away from their roots as a domestic-focused consumer electronics company in order to reposition themselves

as a global provider of green energy systems and other green technology solutions. Panasonic is a classic Japan Inc. company as well, and I am sure that there were traditionalists there who were bothered by that decision. But the firm had to confront the reality that it would no longer be able to compete against Asian competitors in the electronics sector without taking advantage of its edge in green technology.

Going forward, those companies that can make such changes and execute them in a reasonably quick fashion will be the winners. And those companies that won't change or have too much of a domestic focus – or simply cannot get out of businesses where they are facing overwhelming competition – will be the losers, and they won't be able to look to the government any more for support.

This is a long-term development and it will be interesting to observe the market from this perspective.

Hidemichi Watanabe

Over the history of the hedge fund industry, you can see that it was through a constant development of new ideas, new strategies, new instruments or new markets that alpha generation and diversification is achieved. Through the recent market turmoil, investors recognized that they need the new ideas and new strategies again, and in many cases, these have been implemented successfully. Even in Japan we have seen various unique approaches, and I believe the Japan credit strategy would be one of the most effective solutions among them.

There used to be very few or no credit managers from the hedge fund industry participating in the Japan credit markets. At the same time, there were significant structural changes in the Japan credit markets during the past several years. I found the time very propitious to design and provide unique credit strategies for investors. We are now confident that Japan credit provides attractive investment opportunities and it is one of the new solutions available for investors.

Matthias Knab

Can you address how the demand side is doing? Are investors coming back in to your funds - domestic or international?

Rory Kennedy

At our firm, I'm happy to say our firm's AUM has been increasing steadily but I don't think AUM across the wider Japanese hedge fund industry has shown much improvement yet. On the Japanese domestic investor front, many domestic investors got badly burnt from the financial crisis that hit global hedge funds.

They were disappointed by performance of course but they were really offended by the lockups that were put in place at so many of the global funds. It took a long time to encourage many Japanese domestic institutions to move into the hedge fund space and unfortunately a lot of them are going to be out for many years, as the career risk they took investing in hedge funds has not paid off in many cases.

One interesting difference to overseas investors is that while most western pension fund managers typically viewed hedge fund investments as a substitute for their equity portfolio, many Japanese domestic pension funds have regarded hedge funds as a substitute for their bond portfolios. Clearly the volatility of hedge fund investments has been nothing like holding JGBs. So we think that has been a bit of wake up call for many investors here.

If there is one clear result of the financial crisis though, it is that brand names will not be trusted as much as in the past by conservative Japanese investors. It is no longer sufficient to be a well known, global, billion dollar hedge fund - if you did not give them their money back when asked, you did not fulfill your side of the bargain. In addition, the more sophisticated investors here are reading the same research as in the West about smaller hedge funds typically performing better than their larger peers over the long-term. As a consequence, we are starting to see a move by pension funds in particular away from global brand names towards less well-known, but performing hedge funds. I believe this trend will continue in the future.

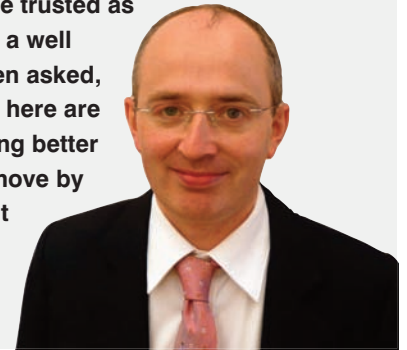
I'm happy to say our firm's AUM has been increasing steadily but I don't think AUM across the wider Japanese hedge fund industry has shown much improvement yet. On the Japanese domestic investor front, many domestic investors got badly burnt from the financial crisis that hit global hedge funds.

They were disappointed by performance of course but they were really offended by the lockups that were put in place at so many of the global funds. It took a long time to encourage many Japanese domestic institutions to move into the hedge fund space and unfortunately a lot of them are going to be out for many years, as the career risk they took investing in hedge funds has not paid off in many cases.

One interesting difference to overseas investors is that while most western pension fund managers typically viewed hedge fund investments as a substitute for their equity portfolio, many Japanese domestic pension funds have regarded hedge funds as a substitute for their bond portfolios. Clearly the volatility of hedge fund investments has been nothing like holding JGBs. So we think that has been a bit of wake up call for many investors here.

If there is one clear result of the financial crisis though, it is that brand names will not be trusted as much as in the past by conservative Japanese investors. It is no longer sufficient to be a well known, global, billion dollar hedge fund - if you did not give them their money back when asked, you did not fulfill your side of the bargain. In addition, the more sophisticated investors here are reading the same research as in the West about smaller hedge funds typically performing better than their larger peers over the long-term. As a consequence, we are starting to see a move by pension funds in particular away from global brand names towards less well-known, but performing hedge funds.

Rory Kennedy



Toshihiro Hirao

When we look at the asset mix of domestic investors, especially the pension money, they are currently they holding JGB, also some fixed-income and also long-only Japan equity. But as Koshihara mentioned if you look at the Japan equity returns over a longer time horizon, it is negative.

Of course, timing is quite important for pension money, but with Japanese equity return being negative and getting almost 0% interest on the fixed income side, they cannot make a good return anyway.

When we look at the asset mix of domestic investors, especially the pension money, they are currently they holding JGB, also some fixed-income and also long-only Japan equity.

With Japanese equity return being negative and getting almost 0% interest on the fixed income side, they cannot make a good return anyway.

From that starting position they are now starting to think about investing into the alternative or global equity market. What are the options? The Japanese market remains volatile, and the global equity markets, especially Asia or China, can also be extremely volatile. It is quite easy to go down 10% or even 30% and more. Therefore, we expect these investors to move to alternatives, especially long/short funds or other hedge fund products, as these will be outperforming in long-only strategies in the long run.

Toshihiro Hirao



From that starting position they are now starting to think about investing into the alternative or global equity market. What are the options? The Japanese market remains volatile, and the global

equity markets, especially Asia or China, can also be extremely volatile. It is quite easy to go down 10% or even 30% and more. Therefore, we expect these investors to move to alternatives, especially long/short funds or other hedge fund products, as these will be outperforming in long-only strategies in the long run.

Dr. Izumi Kazuhara

Japanese institutions are also well-known as huge holders of foreign bonds like US treasuries. Do you see them reducing their bond exposures against hedge funds?

Toshihiro Hirao

We discussed that Japanese institutional investors will be moving from long-only equity into the long/short format, and also fixed-income will be moving into alternatives due to the low interest rates. These changes are within the domestic Japanese Yen portfolios. Regarding foreign-denominated fixed income instruments, I do not believe that the institutions will be increasing their holdings.

Japanese institutional investors will be moving from long-only equity into the long/short format, and also fixed-income will be moving into alternatives due to the low interest rates. These changes are within the domestic Japanese Yen portfolios. Regarding foreign-denominated fixed income instruments, I do not believe that the institutions will be increasing their holdings.

Toshihiro Hirao



Rory Kennedy

In mid 2009, the top 50 performing Japanese pension funds were holding approximately 20% in cash, 28% in JGBs, 28% in general account assets like principal protection notes and only 9% in global bonds, so if they were reducing U.S. treasuries, they were doing it even before the financial crisis.

Interestingly, those top 50 performers had less than 2% of their assets in hedge funds in 2009. But like pension funds everywhere in the world, Japanese pensions have an asset/liability mismatch - which is exacerbated here as the Japanese have a longer average life span. Quite simply, Japanese pension funds will not produce enough returns to meet their future liabilities with their current asset mix. This would indicate that they will have to make greater allocations to alternatives in the near future.

In mid 2009, the top 50 performing Japanese pension funds were holding approximately 20% in cash, 28% in JGBs, 28% in general account assets like principal protection notes and only 9% in global bonds, so if they were reducing U.S. treasuries, they were doing it even before the financial crisis.

Interestingly, those top 50 performers had less than 2% of their assets in hedge funds in 2009. But like pension funds everywhere in the world, Japanese pensions have an asset/liability mismatch - which is exacerbated here as the Japanese have a longer average life span.

Rory Kennedy



Masahiro Koshiba

Most of the investment coming out of Japan into overseas fixed income is from banks. One of the problems of the Japanese financial systems is that there are too many savings. The trend is that the savings to loan ratio of Japanese banks keeps on declining. It is now probably less than 70%, so the balance of over 30% has to be invested into something, which to the most part is treasuries, of course.

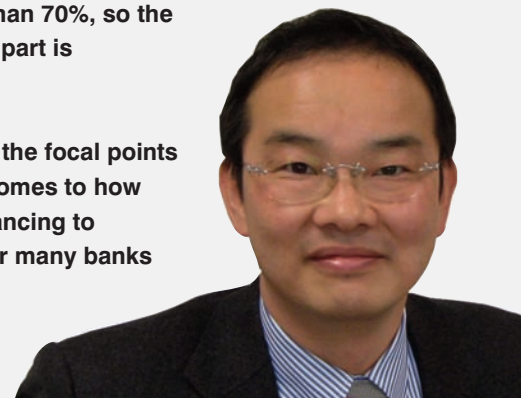
The banks are restricted by the capital requirement as it has been laid out in the Basel I or Basel II frameworks. The banks cannot take so much risk (in relation to their capital), so one of the focal

points within the Japanese banking system is the quality of net capital. When it comes to how banks invest, some of the large banks would probably need additional financing to increase their capital base, before taking on incremental risk. Therefore for many banks the investment universe is constrained to treasury bonds for fixed income products.

Most of the investment coming out of Japan into overseas fixed income is from banks. One of the problems of the Japanese financial systems is that there are too many savings. The trend is that the savings to loan ratio of Japanese banks keeps on declining. It is now probably less than 70%, so the balance of over 30% has to be invested into something, which to the most part is treasuries, of course.

The banks cannot take so much risk (in relation to their capital), so one of the focal points within the Japanese banking system is the quality of net capital. When it comes to how banks invest, some of the large banks would probably need additional financing to increase their capital base, before taking on incremental risk. Therefore for many banks the investment universe is constrained to treasury bonds for fixed income products.

Masahiro Koshiba



Paul MacGregor

In Europe and the U.S., the response to the financial crisis has been an enormous government debt issuance - by the U.S. and the U.K. in particular. The authorities have adopted this quantitative easing program, where they are issuing large amounts of government debt, and the actual Central Bank then repurchases that debt back.

Those programs are due to be wound down at the end of the first quarter this year. The European ECB has taken a slightly different strategy, and their support programs are due to be wound down as well at the end of the first quarter.

From the Japanese experience and point of view, looking at the fact that you have been in this zero rates environment for the last 10 years, do you have any comment or outlook what could happen to the other major economies as they wind these programs down?

Masahiro Koshiba

Correct, Japan has been struggling with this kind of issue for the last twenty years. As everyone here knows, the government debt level stands at 200% of GDP - almost 1,000 trillion Yen. The statistics provided by Bank of Japan says that government debt has actually increased by 50% within the last 10 years. What may be different to other economies is that Japan has on a net basis still a lot of financial assets. These assets are mostly held by individuals. Private households in Japan hold about 1,400 or 1,500 trillion Yen.

We mentioned that also Japanese banks have a lot of savings, and even if the government has increased the issuance of bonds, all this supply is consumed by domestic banks or investors so far. On a net basis, Japan does not need to rely on foreign investors. That is why probably we can keep a very low interest rate and maintain this large interest differential to other economies.

But there is a trend here that I have to point out. The pace of the increase of government debt, especially after the Democratic Party of Japan has come into power, is actually the same as the U.K. or U.S. And as Japan has already reached a debt level of 200% of GDP, this has already caused a downgrading of JGBs by some of the rating agencies.

While it is true that for the last 20 years Japanese investors consumed the new issuance of government debt, a comment I recently read says probably by 2020 the Japanese government debt level will meet household financial assets, and afterwards - or probably even before that date, Japan will have to raise assets from foreign investors. This of course will have implications on the interest rate. That is my concern on the long run. But I am a long/short fund manager, so I can take that problem from two sides.

The government debt level stands at 200% of GDP - almost 1,000 trillion Yen. The statistics provided by Bank of Japan says that government debt has actually increased by 50% within the last 10 years. What may be different to other economies is that Japan has on a net basis still a lot of financial assets. These assets are mostly held by individuals. Private households in Japan hold about 1,400 or 1,500 trillion Yen.

We mentioned that also Japanese banks have a lot of savings, and even if the government has increased the issuance of bonds, all this supply is consumed by domestic banks or investors so far. On a net basis, Japan does not need to rely on foreign investors. That is why probably we can keep a very low interest rate and maintain this large interest differential to other economies.

A comment I recently read says probably by 2020 the Japanese government debt level will meet household financial assets, and afterwards – or probably even before that date, Japan will have to raise assets from foreign investors.

Masahiro Koshiba

Hidemichi Watanabe

There are some risk scenarios for the increase of Yen's interest rates. One may be the Japanese governmental financial deficit as discussed. However I personally think that from the global economic perspective, this will not happen in the near future. Raising Yen interest rates can cause large gaps of benefits between the generations in Japan. This is the domestic issue and will be the point of the political argument in the near future, but I do not expect that the Yen's interest rates will dramatically increase in the next several years.

Another risk scenario would be that we need to be more seriously careful about relates to inflation, which is not currently expected. In fact, we have no evidence in the domestic economy that may hint to increasing the interest rates. The deflationary pressures exist, GDP growth struggled and the population will decrease for long term. However if some inflationary pressures come to the world economy and interest rates go up, it would spotlight the Japanese financial deficit.

With labor productivity not improved, wages not increased, inflation worsened, interest rates increased.....all this would have negative impacts on the economy, companies and individuals. Right now, people seem concerned only about the deflation. This biased attitude concerns me much more - inflation may be the more serious danger. Once inflation happens, the Japanese governmental financial deficit would put a lot of stress on the economy, and as a result because people may recognize even JGBs are a risky asset, the downward pressures toward the prices of both equities and bonds may increase under such scenario. From the viewpoint of long term investment, the investors would need to consider how to manage the interest rate risks if the inflation scenario becomes more likely.

Right now, people seem concerned only about the deflation. This biased attitude concerns me much more - inflation may be the more serious danger.

Hidemichi Watanabe

John Inamine

Japan at this point is sort of turned upside down relative to the rest of the world. That means things that are bad for the rest of the world actually may not be so bad for Japan. For example a bit of inflation would be a great thing for Japan. Also higher interest rates would have positive effects on the 1.4 quadrillion Yen in personal assets held by the Japanese people, half of which are just in cash or near cash.

The holders of these assets are generally members of the older generation, and as you know the

older generation anywhere does not want to spend principal unless it is absolutely necessary. Interest income, on the other hand, will be happily spent or passed on as gifts to children or grandchildren who will then either spend or invest the money themselves. In this way, higher interest rates could be a huge stimulus for consumption as well as investments in Japan.

As for concerns that Japan could not afford higher interest rates given the government's large funding requirements, the thing to remember is that the higher interest rates would apply just to newly issued JGBs, and not to bonds already outstanding. In addition, with 95% of JGBs owned by domestic investors, higher interest rates would simply move money from one pocket to another, while, as I have mentioned, potentially kick-starting consumption in Japan. And the best part for the government is that it would take a piece back through taxation of the interest income.

Japan at this point is sort of turned upside down relative to the rest of the world. That means things that are bad for the rest of the world actually may not be so bad for Japan. For example a bit of inflation would be a great thing for Japan. Also higher interest rates would have positive effects on the 1.4 quadrillion Yen in personal assets held by the Japanese people, half of which are just in cash or near cash.

The U.S. is in a different situation. The question here is whether the U.S. can finance the kind of borrowings that they have. If you assume that the U.S. can do that, then we can ask ourselves how the lessons from Japan's last twenty years can be applied. Here, one thing really stands out in my view, and that is the role that the banks played in the decline of the Japanese economy.

In the 90s, everyone knew that Japanese banks were sitting on a massive amount of bad debts, but the government as part of the convoy strategy for "Japan Inc." refused to let the banks go down. They also refused to push the banks to write off bad loans, because that would have forced debtor companies into bankruptcy and caused unemployment and other disruptions in the economy. This resulted in a situation where the banks were left sitting on a bunch of bad assets, and they knew it. As a result, they did the rational thing, which was to cut back on risk.

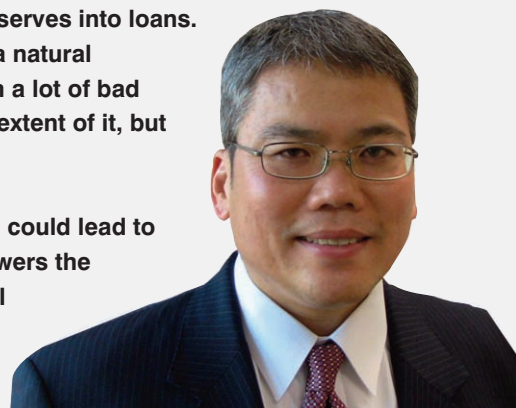
In the case of a bank, reducing risk really means cutting back on lending money. That is okay for a limited period, but once this becomes a long-term condition, the character of the bank as a lending institution changes, and it then becomes a real challenge to break out of that.

In the U.S. we can observe that the Fed's quantitative easing is not translating into strong money supply growth. The same thing happened in Japan when the BOJ tried quantitative easing between 2001 and 2006. The monetary base expanded dramatically, but the multiplier (the velocity of money) declined as well, so the net result was that there was little expansionary effect on money supply.

The reason for that was that the Japanese banks did not turn their excess reserves into loans. In the U.S. you are seeing that the banks are not lending as well. Again, it's a natural response because the U.S. has also allowed its banks to continue to run with a lot of bad assets hidden somewhere on their balance sheets. No one really knows the extent of it, but the banks know.

The problem is that if the U.S. does not watch out, this lack of credit creation could lead to the kind of deflation that we have seen in Japan because it systematically lowers the economy's growth potential. The wild card, of course, is whether the U.S. will face difficulties in financing its debt in the future.

John Inamine



Therefore, higher interest rates may not be a bad thing for Japan, at least over the near to mid-term.

The U.S. is in a different situation. The question here is whether the U.S. can finance the kind of

borrowings that they have. If you assume that the U.S. can do that, then we can ask ourselves how the lessons from Japan's last twenty years can be applied. Here, one thing really stands out in my view, and that is the role that the banks played in the decline of the Japanese economy.

In the 90s, everyone knew that Japanese banks were sitting on a massive amount of bad debts, but the government as part of the convoy strategy for "Japan Inc." refused to let the banks go down. They also refused to push the banks to write off bad loans, because that would have forced debtor companies into bankruptcy and caused unemployment and other disruptions in the economy. This resulted in a situation where the banks were left sitting on a bunch of bad assets, and they knew it. As a result, they did the rational thing, which was to cut back on risk.

In the case of a bank, reducing risk really means cutting back on lending money. That is okay for a limited period, but once this becomes a long-term condition, the character of the bank as a lending institution changes, and it then becomes a real challenge to break out of that. So instead of lending money and pursuing typical banking business, you could say that Japanese banks became hooked on investing in JGBs, because by doing so, they did not have to worry about additional capital charges or provisions for bad debt.

As a result, the actions and characteristics of the whole banking system changed, and banks now seem to have no choice but to keep a big chunk of their assets in JGBs.

In the U.S. we can observe that the Fed's quantitative easing is not translating into strong money supply growth. The same thing happened in Japan when the BOJ tried quantitative easing between 2001 and 2006. The monetary base expanded dramatically, but the multiplier (the velocity of money) declined as well, so the net result was that there was little expansionary effect on money supply.

The reason for that was that the Japanese banks did not turn their excess reserves into loans. In the U.S. you are seeing that the banks are not lending as well. Again, it's a natural response because the U.S. has also allowed its banks to continue to run with a lot of bad assets hidden somewhere on their balance sheets. No one really knows the extent of it, but the banks know. From their perspective, again, they are exhibiting a rational response by cutting back on taking risks via loans.

The problem is that if the U.S. does not watch out, this lack of credit creation could lead to the kind of deflation that we have seen in Japan because it systematically lowers the economy's growth potential. The wild card, of course, is whether the U.S. will face difficulties in financing its debt in the future. If it does, then we start to talk about rising interest rates, a pounding of the dollar in forex markets, and inflation. That would be a different outcome to Japan's, and the world is watching to see which path the U.S. will be taking.

Rory Kennedy

A lot of the chatter in global media recently has been about the parallels between the U.S and the Japanese financial crisis of the late '90s.

But unlike Japan, the U.S. seems to be tending towards an inflationary mode. There is also the legitimate concern about how long will the Chinese and Japanese continue to finance American debt? In Japan, as John mentioned, approximately 95% of JGB debt is domestically financed. If the debt is all within Japan and all in Yen, bought by captive Japanese institutions who are fully backed or partly owned by the Japanese government, I don't think JGB issuance is going to be a major problem for the next few years with trillions of dollars in domestic savings supporting it all, although clearly, the long-term will be a concern if the cost of servicing the debt grows.

The fastest and the best way to reduce that scary 200% debt to GDP number is for Japan to grow its way out of it. The economy has to be stimulated, and if the current Yen-Dollar rate stays where it is - 90 to 95 - that is probably okay for exporters who will lead the charge when the global economy comes back.

But domestic consumption stagnation remains a major problem. A great way to increase

consumption would be to allow greater tax free transference of money from the older to the younger generation and not just for property purchases as is allowed at present. As John highlighted, the older generation is protecting their principal but the principal is not gaining anything, it is not earning any material return. To release the trillions of dollars money held by the proverbial “Mrs. Watanabes” in their bank accounts, you have to give them incentives to do so.

Masahiro Koshiba

Let's compare some of the housing data between Japan and Europe. During the Japanese property bubble from 1977 to 1991, during those 14 years property prices went up 80% and then burst, right? In the U.S. between 1995 and 2006 (that is before the Lehman shock) average house prices went up 58% and then crashed. In the case of the U.K., this statistic says that average house prices went up 201% between 1996 and 2007. Ireland was up 207%, France 123%, Spain 113%. Let's look now at the leverage of the banks. At the peak of the Japanese banks' leverage, the savings to loan ratio was actually less than 100%. The bad news is that some statistics say that the savings to loan ratio of European banks was in the order of 150% or 160%.

You had asked us what can we conclude from the Japanese experience for some other Western economies. Well, if you look at some of these metrics, the situation in Europe could end up being a much tougher challenge or experience that Japan went through over the past twenty years.

Paul MacGregor

We have to have in mind that a place like London has always been a magnet for very, very wealthy people, and that they will typically overpay for property. There is a continuous influx of “Nouveau Riche” who move into a fancy London area like the West End continually driving up prices.

Let's compare some of the housing data between Japan and Europe. During the Japanese property bubble from 1977 to 1991, during those 14 years property prices went up 80% and then burst, right? In the U.S. between 1995 and 2006 (that is before the Lehman shock) average house prices went up 58% and then crashed. In the case of the U.K., this statistic says that average house prices went up 201% between 1996 and 2007. Ireland was up 207%, France 123%, Spain 113%. Let's look now at the leverage of the banks. At the peak of the Japanese banks' leverage, the savings to loan ratio was actually less than 100%. The bad news is that some statistics say that the savings to loan ratio of European banks was in the order of 150% or 160%.



You had asked us what can we conclude from the Japanese experience for some other Western economies. Well, if you look at some of these metrics, the situation in Europe could end up being a much tougher challenge or experience that Japan went through over the past twenty years.

Masahiro Koshiba

But also other attractive parts by the coast in Cornwall, the West Country, or North of England had witnessed huge property increases, and those places have not recovered yet since the crash. However London has bounced back immediately, while not quite to the peak levels, but it is getting back towards there.

It's a bubble, there is no other way to describe it. The only thing I can offer is that the U.K. is a small country with a genuine shortage of land, which is very much a fundamental factor compared to the U.S. or France.

Matthias Knab

Let's go back to Japan – what else is happening in the country? What is new from the regulatory front? Over the last years, there were big initiatives from the government to develop an encompassing financial regulatory framework, the FIEL regulations. How is FIEL doing?

Rory Kennedy

While the FIEL legislation had a significant impact on the broader domestic landscape, it was not a game-changing event for the hedge fund industry. It was more a tidying up of a variety of existing laws and grey areas within the regulatory framework.

I believe the Japanese regulators were quite proud of the minimal structural impact that the global crisis had on the financial industry in Japan.

On the regulatory side, it was very encouraging for the industry that short selling in Japan was never halted even during the depths of the 2008 turmoil. The regulators added a sensible requirement that restricts naked shorting and added some additional reporting requirements that can be handled easily by any organized hedge fund. Prohibiting short selling is a disruptive measure that unduly restricts market forces and price discovery. Research has now shown that the banning of short selling did not help support the markets in the US at the time and I'm glad the regulators here resisted populist calls for a ban from some bureaucrats and politicians.

From a broader regulatory perspective, Japan has suffered over the past 5 years from a sort of regulatory arbitrage between the different Asian jurisdictions. Many people set up their offices in Singapore or Hong Kong, because it was perceived to be easier, faster and with less oversight, i.e. possible interference. However, over the past few months, I think that arbitrage window has narrowed. Singapore in particular; their exempt fund manager regime was considered to be the most welcoming for opening up hedge funds. But that's no longer the case: the regulators there are clearly tightening up and are likely to make it more difficult to open up and run hedge fund management firms there.

While the FIEL legislation had a significant impact on the broader domestic landscape, it was not a game-changing event for the hedge fund industry. It was more a tidying up of a variety of existing laws and grey areas within the regulatory framework.

I believe the Japanese regulators were quite proud of the minimal structural impact that the global crisis had on the financial industry in Japan.

On the regulatory side, it was very encouraging for the industry that short selling in Japan was never halted even during the depths of the 2008 turmoil.

From a broader regulatory perspective, Japan has suffered over the past 5 years from a sort of regulatory arbitrage between the different Asian jurisdictions. Many people set up their offices in Singapore or Hong Kong, because it was perceived to be easier, faster and with less oversight, i.e. possible interference. However, over the past few months, I think that arbitrage window has narrowed. Singapore in particular; their exempt fund manager regime was considered to be the most welcoming for opening up hedge funds. But that's no longer the case: the regulators there are clearly tightening up and are likely to make it more difficult to open up and run hedge fund management firms there.



Rory Kennedy

Matthias Knab

Do you see actually more hedge funds in Japan over the past one year?

Rory Kennedy

As I had mentioned earlier, we have tracked 22 new Japan-dedicated hedge funds over the last year.

Like the rest of Asia, the vast majority of new hedge funds are still fundamental equity long/short funds. However, we are seeing more non-vanilla Japan funds setting up such as event-driven, statistical arbitrage and several credit funds like Watanabe san's WERU fund.

An important factor in attracting more funds will be the recent technology upgrade by the Tokyo Stock Exchange to their Arrowhead System at the start of this year. Arrowhead reduces exchange latency to about 10 milliseconds, which is on par with NYSE and slightly less than the London Stock Exchange.

As a result, we hear that market participants which rely on execution speed like high frequency trading firms and many of the global giant hedge funds are already on the ground ramping up their presence in Japan to take advantage of these advances in technology.

Generally, 2009 was a very positive year for the Japanese hedge fund industry, even though from a macro perspective, the overall situation of Japan has not improved that much. From the perspective of an alternatives investor, Japan is now offering a solid variety of strategies, run by seasoned professionals within a stable legal and regulatory framework.

Like the rest of Asia, the vast majority of new hedge funds are still fundamental equity long/short funds. However, we are seeing more non-vanilla Japan funds setting up such as event-driven, statistical arbitrage and several credit funds like Watanabe san's WERU fund.

An important factor in attracting more funds will be the recent technology upgrade by the Tokyo Stock Exchange to their Arrowhead System at the start of this year. Arrowhead reduces exchange latency to about 10 milliseconds, which is on par with NYSE and slightly less than the London Stock Exchange.

As a result, we hear that market participants which rely on execution speed like high frequency trading firms and many of the global giant hedge funds are already on the ground ramping up their presence in Japan to take advantage of these advances in technology.

Generally, 2009 was a very positive year for the Japanese hedge fund industry, even though from a macro perspective, the overall situation of Japan has not improved that much.

Rory Kennedy



Dr. Izumi Kazuhara

Rory, thank you for highlighting the importance of exchange technologies. As Paul mentioned at the beginning, NYSE Euronext is very much involved in this development, especially in Japan.

When it comes to financial instruments, many people know that the rice future was the first exchange-traded derivative in the world, and the Japanese are very proud about that. But what most people, even Japanese, don't know is that the rice contracts traded in Osaka at that time was not just a commodity future, but also a financial future, because at that time the official state economy was counted in rice; the samurais for example were paid by rice.

Coming back into the present, as an exchange we do see that our Japanese clients are now investing more and also extend their business beyond the cash market into derivatives trading.

Paul MacGregor

Correct. Against trends last year where all exchange traded volumes were down as a loss of risk capital from the marketplace, NYSE Liffe managed to grow by a small amount, by 1%. And we are starting to see a lot of business coming out of the Japanese market, trading quite complex options strategies like delta neutral strategies, complex ladders, butterflies etc. using the full functionality of the platform. That is very encouraging for the long-term development of the Japanese market.



Against trends last year where all exchange traded volumes were down as a loss of risk capital from the marketplace, NYSE Liffe managed to grow by a small amount, by 1%. And we are starting to see a lot of business coming out of the Japanese market, trading quite complex options strategies like delta neutral strategies, complex ladders, butterflies etc. using the full functionality of the platform. That is very encouraging for the long-term development of the Japanese market.

Paul MacGregor

Masahiro Koshiba

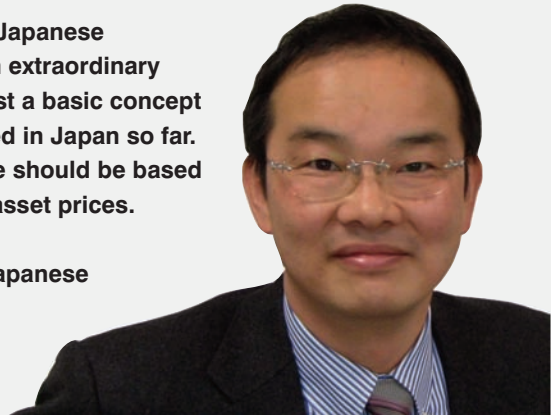
There is another major development that we haven't covered yet. Behind the scenes, in Japan and also in the rest of the world, many people are working on the introduction of new IFRS accounting rules.

Introducing IFRS into Japan means that probably in the next three years, Japanese corporations will have to follow the global accounting standard. This is an extraordinary opportunity for good fundamental research. For example, if you look at just a basic concept like income, the IFRS definition is totally different from what has been used in Japan so far. In Japan, income is based on operating profit, while IFRS says the income should be based on total profit, not only from operating income, but also from changes of asset prices.

Introducing IFRS into Japan means that probably in the next three years, Japanese corporations will have to follow the global accounting standard. This is an extraordinary opportunity for good fundamental research. For example, if you look at just a basic concept like income, the IFRS definition is totally different from what has been used in Japan so far. In Japan, income is based on operating profit, while IFRS says the income should be based on total profit, not only from operating income, but also from changes of asset prices.

This has huge consequences and creates many opportunities, because Japanese corporations still have cross shareholding schemes.

Masahiro Koshiba



This has huge consequences and creates many opportunities, because Japanese corporations still have cross shareholding schemes. I assume that a lot of corporations will realize that they will not be able to continue holding certain cross-ownerships or assets and will therefore starting to dispose large equity holdings. This will create volatility in the market, and also significant income for the firms.

Particularly the Japanese banks have a lot of cross ownership holding all kinds of shares, and because of capital constraints they as well will not be able to keep some of their assets at the current level.

Dr. Izumi Kazuhara

Rory, you spoke about the regulatory arbitrage and that the gap is narrowing between Japan and other Asian jurisdiction. You yourself are based in Japan, what is your personal experience about the advantages or disadvantage of running a hedge fund or fund of funds in Japan? It's not just the great Japanese food, I guess?

Rory Kennedy

The food here is great though. I gather Tokyo has more than twice as many Michelin-starred restaurants than any other city in the world.

As to why be based in Tokyo? Well we think its better to be nearer our portfolio managers. More research has come out showing that the performance of managers who are based in the region of their investment is higher than managers who trade that market from further away.

More research has come out showing that the performance of managers who are based in the region of their investment is higher than managers who trade that market from further away.

But intriguingly, the AUM of those managers located further away from their target market is higher. In other words, if you are closer to the main investor hubs, you have more assets, but if you are closer to what you invest in, you have better returns.

Rory Kennedy



But intriguingly, the AUM of those managers located further away from their target market is higher. In other words, if you are closer to the main investor hubs, you have more assets, but if you are closer to what you invest in, you have better returns.

From a personal point-of-view, I've lived in Tokyo for over 11 years and it's a great place to live. It is clean, safe, cosmopolitan and everything runs on time, which having lived in London, I can really appreciate. Of course, I would prefer the personal tax rates were much lower, but then you can't have everything. In running a business, the loyalty and work ethic of staff here is exemplary, and staff turnover tends to be much lower than in most other Asian countries.

Matthias Knab

Are there any other relevant developments from Japan we should mention?

John Inamine

Yes, let me come back to the SPARX Smart-Grid Fund that we are currently working on, as this showcases not only green technologies, but also a new paradigm by which a fund management company can actually add value to companies in which it invests.

Ever since the energy crisis in the 70s, Japan has been at the forefront in the drive to move away from an over-reliance on fossil fuels and has become one of the most efficient users of crude oil in the world, in terms of consumption per unit of GDP.

Along the way, Japanese companies have built up a significant edge in the expertise and technology needed to build Smart-Grids that can manage the flow of energy produced by a network of power generation facilities, including fossil fuel and nuclear plants, wind farms, and homes with solar energy panels, and moreover, have the energy ready for use on demand by electric vehicles and by smart appliances and equipment.

Let me come back to the SPARX Smart-Grid Fund that we are currently working on, as this showcases not only green technologies, but also a new paradigm by which a fund management company can actually add value to companies in which it invests.

Ever since the energy crisis in the 70s, Japan has been at the forefront in the drive to move away from an over-reliance on fossil fuels and has become one of the most efficient users of crude oil in the world, in terms of consumption per unit of GDP.

Along the way, Japanese companies have built up a significant edge in the expertise and technology needed to build Smart-Grids that can manage the flow of energy produced by a network of power generation facilities, including fossil fuel and nuclear plants, wind farms, and homes with solar energy panels, and moreover, have the energy ready for use on demand by electric vehicles and by smart appliances and equipment.

We believe that Smart-Grid technologies represent a can't-miss growth area in Japan

This is a slightly different twist compared to most green technology funds, as SPARX will not only manage the fund, but will also be actively involved in the gestation, deployment and distribution/export of Smart-Grid technologies and know-how.

John Inamine



We believe that Smart-Grid technologies represent a can't-miss growth area in Japan, because structurally, the world needs alternative sources of energy, and governments everywhere are prioritizing investments in green technology infrastructure—which ultimately means Smart-Grids.

This Smart-Grid Fund that we are setting up will invest in Japanese companies that can help build and service Smart-Grids and we will assist these companies in building up business partnerships with leading Japanese corporations to achieve global penetration for their Smart-Grid technologies. There have been examples in the past of Japanese companies—especially domestic-oriented ones—that have had good technologies but simply did not have the capability or resources to exploit overseas opportunities. SPARX will help such companies to bridge this gap. This is a slightly different twist compared to most green technology funds, as SPARX will not only manage the fund, but will also be actively involved in the gestation, deployment and distribution/export of Smart-Grid technologies and know-how.

Matthias Knab

In your perspective, how is Japan coping with the rise of Asia and China?

Dr. Izumi Kazuhara

Geopolitically, Japan has a very unique position and could be a bridge between Asia and North America especially between China and the United States. Political and economic systems as well as legal frameworks have Western standards, at the same time it has close economic and cultural relations to the Asian region.

Rory Kennedy

Many investors have looked at Asia for growth, of course, but I would say that Japan, unlike Europe and America, has not viewed the rise of India, China and the rest of Asia as an economic threat but as an opportunity. Japan is a nation led by exporters and it now has this enormous expanding market on its doorstep to the extent that China has now replaced America as Japan's biggest trading partner. And if you look beyond China, I believe that Japan is now one of the largest investors in India as well.

The Asian growth story is massively benefiting many Japanese companies but this is not yet being really reflected in the prices of Japanese firms. As such, we feel that Japan offers an excellent opportunity for investors to participate in the growth of Asia without the enormous volatility of the Asia Ex-Japan markets.



Many investors have looked at Asia for growth, of course, but I would say that Japan, unlike Europe and America, has not viewed the rise of India, China and the rest of Asia as an economic threat but as an opportunity.

The Asian growth story is massively benefiting many Japanese companies but this is not yet being really reflected in the prices of Japanese firms. As such, we feel that Japan offers an excellent opportunity for investors to participate in the growth of Asia without the enormous volatility of the Asia Ex-Japan markets.

Rory Kennedy

ANOTHER STERLING OPPORTUNITY.

SHORT AND MEDIUM GILT FUTURES ARE NOW AVAILABLE FROM NYSE LIFFE.

NYSE LIFFE NOW OFFERS EVEN MORE EXPOSURE ALONG THE U.K. GOVERNMENT BOND YIELD CURVE WITH OUR SHORT AND MEDIUM GILT FUTURES CONTRACTS. THESE CONTRACTS JOIN OUR ESTABLISHED LONG GILT FUTURES TO FORM A COMPREHENSIVE RANGE OF PRODUCTS WHICH CAN BE USED TO BETTER MANAGE INTEREST RATE RISK.

SUPPORTED BY MARKET MAKERS, OUR NEW SHORT AND MEDIUM GILT FUTURES ALLOW YOU TO GAIN ADDITIONAL EXPOSURE TO SHORTER-DATED U.K. GOVERNMENT BONDS AND STERLING INTEREST RATES, OFFERING ENHANCED OPPORTUNITIES TO MANAGE PORTFOLIO DURATION.

OUR GILTS PRODUCT SUITE IS JUST ONE MORE WAY NYSE LIFFE COLLABORATES WITH OUR CUSTOMERS TO MEET THE CHANGING NEEDS OF THE EXCHANGING WORLD.



FIND OUT MORE:
FIXED INCOME DERIVATIVES

+44 (0)20 7379 2222

bonds@liffe.com

nyx.com/bondderivatives

QV CODES	SHORT GILT	MEDIUM GILT	LONG GILT
BLOOMBERG	WBA<CMDTY>CT<GO>	WXA<CMDTY>CT<GO>	G A<CMDTY>CT<GO>
REUTERS	0#G:	0#H:	0#FLG:

NYSE Liffe is the brand name of the derivatives business of NYSE Euronext, comprising the derivatives markets in Amsterdam, Brussels, Lisbon, London and Paris; and the futures markets in the U.S. This notice is for information only and does not constitute an offer, solicitation or recommendation to acquire or dispose of any investment or to engage in any other transaction. Those wishing either to trade in any products available at NYSE Liffe or to offer and sell them to others should consider both their legal and regulatory position in the relevant jurisdiction and the risks associated with such products before doing so. Potential users of the Gilt Contracts made available on The London International Financial Futures and Options Exchange should familiarise themselves with the relevant Contract Terms and Administrative Procedures. Potential users should consider the risks of holding a position into the Notice Period of a Gilt Contract wherein they are potential buyers or sellers in the delivery process. In particular, they should familiarise themselves with the use of Price Factors and the EDSP price formation process as these are both constituents of the formula for the calculation of the invoicing amount.

accurate

professional reporting service

No wonder that each week, Opalesque publications are **read by more than 600,000 industry professionals in over 160 countries**. Opalesque is the only daily hedge fund publisher which is actually read by the elite managers themselves



Opalesque Islamic Finance Briefing delivers a quick and complete overview on growth, opportunities, products and approaches to Islamic Finance.

Opalesque Futures Intelligence, a new bi-weekly research publication, covers the managed futures community, including commodity trading advisers, fund managers, brokerages and investors in managed futures pools, meeting needs which currently are not served by other publications.

Opalesque Islamic Finance Intelligence offers extensive research, analysis and commentary aimed at providing clarity and transparency on the various aspects of Shariah compliant investments. This new, free monthly publication offers priceless intelligence and arrives at a time when Islamic finance is facing uncharted territory.

Alternative Market Briefing is a daily newsletter on the global hedge fund industry, highly praised for its completeness and timely delivery of the most important daily news for professionals dealing with hedge funds.

A SQUARE is the first web publication, globally, that is dedicated exclusively to alternative investments with "research that reveals" approach, fast facts and investment oriented analysis.

Technical Research Briefing delivers a global perspective / overview on all major markets, including equity indices, fixed Income, currencies, and commodities.

Sovereign Wealth Funds Briefing offers a quick and complete overview on the actions and issues relating to Sovereign Wealth Funds, who rank now amongst the most important and observed participants in the international capital markets.

Commodities Briefing is a free, daily publication covering the global commodity-related news and research in 26 detailed categories.

The daily **Real Estate Briefings** offer a quick and complete oversight on real estate, important news related to that sector as well as commentaries and research in 28 detailed categories.

The **Opalesque Roundtable Series** unites some of the leading hedge fund managers and their investors from specific global hedge fund centers, sharing unique insights on the specific idiosyncrasies and developments as well as issues and advantages of their jurisdiction.

OPALESQUE

www.opalesque.com