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Performance: YTD April 30: '96 116.9%; '97 28.1%; '98 36.4%; '99 39.4%; '00 180.9%; '01 -50.5%; '02 18.7%; '03 28.8%; '04 166.7%; '05 28.2%; '06 153.3%; '07 8.8%; '08 -25.2%; '09 -50.3%; '10 162.3%

Junior Gold and Natural Resource Sector Report

April 24, 2011

Japan Smaller Capitalization Fund (JOF-NYSE)

INITIAL REPORT



Weekly chart, High \$18.80, Low \$5.38, Last trade \$8.43

Why Buy Japan Now?

Japan has suffered a series of significant disasters -- earthquakes, aftershocks, tsunamis and now a major nuclear accident. The Japanese stock market went down dramatically in the wake of these unfortunate events, but we have avoided making any Japanese investment or trade for nearly 20 years, largely reflecting our concerns over Japan's demographic and structural issues. But we suspect that now may be the time to consider the opportunities being presented in Japan.

Why would anyone want to invest there? Virtually every great buying opportunity starts with that question. But it certainly takes more than just lack of interest to create a true contrarian opportunity. We want to see sentiment and valuations at an extreme, and total apathy and even disgust from the retail investing public.

After two decades of severe under-performance and headline-grabbing disasters, negative sentiment against the Japanese market is understandable. Aside from the unfathomable human suffering being experienced in Japan, there have been enormous and prolonged economic setbacks.

In December 1989 the Nikkei was at about 39,000. The ensuing bear market reached a 27-year low of 7,055 in March 2009. Similarly, the average residential real estate price in Japan slumped to less than 10% of its 1989 peak valuation. In the commercial sector, by 2004 choice properties in Tokyo's financial districts had relentlessly declined to values of less than 1% of their peak. Only in 2007 had property prices started some modest price gains, but the 2008 global crisis struck and most prices soon retested or hit even lower lows, seemingly caught up in what can only be described as a deflationary spiral.

While real estate tends to be much less liquid than stocks, and therefore will see price declines of a more prolonged and relentless nature, publicly listed securities react more efficiently and may be a better measure of the dynamics of public sentiment and fair value.

Currently the average Japanese stock is selling for less than 14 times its annual profit. That's cheap, and Japanese accounting methods also tend to understate earnings. An even better indicator is found in book values (assets minus liabilities). Stocks around the world (including the U.S., Europe and China) are selling for approximately two times book value. In Japan, they sell for less than book value. By this measure, U.S. stocks are twice as expensive as Japanese stocks.

One needs to understand that Japan is largely mercantilist in nature. The country avoids importing foreign-manufactured products at all costs, even when cheaper, or of better quality. There are three major exceptions, in general, to that trade bias: raw materials, petroleum and luxury goods.

History shows that Japan is adept at rebounding from catastrophe. World War II and the 1995 Kobe earthquake are notable examples. Japan was largely rebuilt by allied occupational forces after World War II, and even today the U.S. has a large naval presence in Japan. Japan's post-war coming-out party was the 1964 Summer Olympics in Tokyo. It was from that period on that the country became a major exporter of technology, cars, automotive parts, consumer electronics, commercial ships and pharmaceuticals.

When Tokyo enters a bull market enormous gains are possible. If you invested \$10,000 in the Nikkei 225 in 1970 this would have turned into more than \$600,000 two decades later. In comparison the S&P 500 over this period would have turned \$10,000 into about \$76,000.

What will turn Japan's market around? For starters, enormous rebuilding will be required over the next few years. Devastated areas account for 7% of Japan's economy and a substantial portion of its land mass. A lot of businesses will receive substantial contracts as a result of the catastrophe.

Sendai, the biggest port in northeast Japan and a major exporter of auto parts, machinery and marine products, was virtually wiped off the map. Half a dozen oil refineries in the same area, representing a third of the nation's entire refining capacity, are shut down. Roads, bridges, railways and other major infrastructure have been destroyed. And the Japanese economy - already limping along for most of the past two decades - has the world's highest public debt relative to GDP (225%) and a rapidly aging population.

In order to rebuild the country, the Japanese government will first throw money at domestic companies such as Komatsu and Sumitomo Heavy, but those companies cannot be invested in directly by North American investors. We need to seek out those companies that will benefit from the massive reconstruction and trade in the U.S. markets in American Depository Receipt (ADR) form, or through an Exchange Traded Fund (ETF).

The first such Japanese company that comes to mind is Kubota (KUB). Kubota is first and foremost known for manufacturing industrial, farm and construction machinery and equipment. To that extent, Kubota's American competitors would be Deere (DE) and Caterpillar (CAT). Kubota is also engaged in the design and construction of water and environmental systems, which will be in great demand in Japan. Kubota also fabricates materials, pipes and electrical equipment for infrastructure projects.

Kubota is expected to grow earnings by 13% in fiscal 2012 (March YE). With a shortage of machinery likely to occur because of increasing demand, Kubota is going to see earnings grow by at least 20% in fiscal 2012 to at least \$3.10 per share.

Another Japanese company that will benefit from the rebuild in Japan that is also traded in ADR form is Kyocera (KYO), a diversified electronics company. In its consumer products division, Kyocera produces a wide variety of products such as wireless phones, kitchen utensils and stationery. Its larger business-to-business segment focuses on industrial and commercial products such as information and telecommunications equipment medical and dental devices, ceramics, electronics and semiconductor components, LED lighting, automotive components, lenses, cutting tools and chemicals. In addition, Kyocera produces solar power-generation systems for commercial and residential use. Kyocera clearly has a full array of products that will be necessary for the reconstruction of Japan.

Kyocera, like Kubota, will experience better than the expected 6% earnings growth that analysts currently expect for 2012. The stock sells at a discount to the market multiple, which for a company of Kyocera's size and quality is not enough. Kyocera has an excellent balance sheet with nearly \$5.3 billion of net cash and short-term investments as of the end of its 2010 fiscal year. That is nearly a third of the company's market capitalization.

A third Japanese ADR is Hitachi (HIT), which is primarily a consumer electronics company. Many homes and buildings will be built or repaired in Japan requiring home appliances and electronics. Hitachi also produces a large line of commercial and industrial products. In this business segment, Hitachi offers information technology solutions; electronic devices; industrial chemicals and materials; cabling; public and urban transportation systems, logistics and instrumentation; medical, health care and life sciences machinery; and environmental, power and industrial systems and equipment. Hitachi is uniquely positioned to benefit from both the commercial and residential rebuilding which will take place.

Analysts expect Hitachi's earnings to decline in 2012. This is hard to believe given the massive stimulus expected. Furthermore, as is the case with Kyocera, Hitachi sells at a discount to the market multiple.

We can also go with a more diversified fund strategy. Two exchange-traded funds provide diversified exposure to the broader Japanese markets. The most actively traded Japanese ETF is the iShares MSCI Japan (EWJ), which focuses on large-capitalization Japanese stocks. The iShares family of funds also offers an ETF, which directly correlates to the Tokyo Stock Price Index, or TOPIX: the iShares S&P TOPIX 150 (ITF). The iShares TOPIX 150 is far less actively traded and so has less liquidity than the iShares MSCI Japan.

Of more interest to our more aggressive nature in the ETF category is the closed-ended Japan Smaller-Capitalization Fund (see our featured chart). It is a non-diversified, closed-end management investment company seeking long-term capital appreciation primarily through investments in smaller capitalization Japanese equity securities traded on the Tokyo, Osaka and Nagoya Stock Exchanges, JASDAQ, Mothers, Hercules, Centrex, and other indices, or markets determined by Nomura Asset Management U.S.A. to be appropriate indices or markets for smaller capitalization companies in Japan.

Any massive effort to rebuild Japan, especially with governmental stimulus, will be focused not just on the large companies mentioned earlier but also on smaller and regional companies. The Japan Smaller-Cap Fund enables investors to benefit from the spreading of reconstruction money across the entire country and economy. Currently this closed-ended fund trades at a small discount to net asset value.

The Japanese market and its related stocks and funds are oversold and opportunities are presenting themselves. The situation in Japan, especially as it relates to the reactors of the Fukushima Daiichi nuclear power plant, remains tenuous. A further deterioration of the condition at that facility could lead to further market weakness. The road to recovery will be long and protracted.

Conclusion

Our strategy as opportunistic stock pickers is to identify some target stocks or funds now. The beginning of the reconstruction process is likely to correspond to the start of an uptrend for many Japanese companies.

Although China's economy has now eclipsed Japan's in size, Japan is still Asia's most advanced economic power, with world-leading technologies and an unmatched infrastructure.

The cost of doing business in Japan has decreased dramatically in recent years, as well. Land prices, office rents and labor costs have come way down. So have taxes and tariffs. And the government has instituted serious banking reforms.

The nation sits on a mountain of personal financial assets - more than \$100,000 for every man, woman and child. After a decade of negative stock market returns, most of this capital is sitting in low-yielding bank deposits. Even a small fraction of these assets returning to the equity market could give it a serious jolt.

The healing there will take time, of course. But just as the U.S. stock market rebounded from the recent financial crisis quicker than almost anyone expected, things in Japan may look dramatically different in six to 12 months from now. Right now very few people believe that. Negative sentiment and low valuations are the defining characteristics of contrarian investing.

Japan Smaller Capitalization Fund, Inc.

Statistics

Net Assets	\$195,080,59
	3
Net Asset Value per Share	\$9.18
Closing NYSE Market Price	\$9.11
Percentage Change in Net Asset Value per Share*	(2.9%)
Percentage Change in NYSE Market Price*	1.6%

*From January 1, 2011 to March 31, 2011. Includes reinvestment of any income dividends and capital gain distributions. Changes in currency rates have influenced the Fund's performance. PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.

Market Index**

	Yen	U.S. \$
Benchmark Index ****	1.6%	(0.3%)
TOPIX	(3.3%)	(5.2%)
Nikkei Average	(4.6%)	(6.5%)

**From January 1, 2011 to March 31, 2011. The TOPIX consists of all companies listed on the Tokyo Stock Exchange (the "TSE"). The Nikkei Average Index ("Nikkei Average") is a price-weighted index of 225 leading stocks on the TSE.

Average Annual Total Return***

	Return
One Year Ending 3/31/11	4.4%
Three Years Ending 3/31/11	1.1%
Five Years Ending 3/31/11	(7.4%)
Ten Years Ending 3/31/11	4.2%
Since Inception (3/15/90 to 3/31/11)	1.0%

Reflects the percentage change in net asset value per share and includes reinvestment of any income dividends and capital gain distributions. Changes in currency rates have influenced the Fund's performance. PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. *Since inception to 8/31/04; Nikkei JASDAQ Average Index. 9/1/04 onwards, Russell/Nomura Index.

Industry Diversification

	<u>% of Net Assets</u>		<u>% of Net Assets</u>
Services	13.1	Iron and Steel	4.1
Miscellaneous Manufacturing	10.7	Transportation	3.6
Information and Software	10.2	Telecommunications	3.3
Chemicals and Pharmaceuticals	9.1	Food Manufacturing	3.3
Electronics	8.6	Textiles and Apparel	1.0
Retail	7.7	Wholesale	0.5
Automotive Equipment and Parts	6.4	Restaurants	0.4
Banks and Finance	6.4		
Machinery and Machine Tools	5.4		
Real Estate and Warehouse	4.5		

Ten Largest Equity Holdings by Market Value

	<u>Market Value</u>	<u>% of Net Assets</u>
Otsuka Corporation	\$6,554,582	3.4
Itochu Techno-Solutions Corporation	4,431,663	2.3
Hitachi Chemical Company, Ltd.	3,924,861	2.0
Park24 Co., Ltd.	3,151,351	1.6
Rohto Pharmaceutical Co., Ltd.	2,992,787	1.5
Fuji Machine Mfg. Co., Ltd.	2,965,475	1.5
Nihon Kohden Corporation	2,857,689	1.5
Neturen Co., Ltd.	2,769,258	1.4
Hanwa Co., Ltd.	2,592,207	1.3
Daicel Chemical Industries, Ltd.	2,578,481	1.3

The industry diversification and ten largest equity holdings by market value reflect the Fund's investments on the date indicated and may not be representative of the Fund's current or future holdings

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