‘I am sticking with my conviction that small and mid cap stocks are the longer-term winners’

Hideo Shiozumi, manager of the £250.7m Legg Mason Japan Equity fund, speaks about the strengthening economy and which sectors he believes will be the first to benefit from this growth

Q: Livedoor proved to be a bit of a trapdoor for Japanese stocks at the start of the year. Has this correction affected your portfolio structure at all?

Hideo Shiozumi: Not at all. We always will invest in small to mid cap growth stocks. Even with the market falling most heavily in the small caps arena, and greater strength being shown among large cap cyclicals and international blue chips, this does not mean I will change my investment philosophy. I am sticking with my conviction that small and mid cap stocks are the longer-term winners, using this market weakness to add to existing holdings and buy new stocks.

The market has fallen so much that share prices overall have gone down quite a bit. I am not simply picking any stock just because it is cheap; I have been buying similar companies to the ones I already own, particularly in the service and real estate industries. Two new names in the real estate sectors are Risa Partners and Zecs, which look to be good companies.

Q: What are the drivers behind these sectors, and what makes them so attractive?

HS: First property prices have gone up for the first time in 16 years. Initially property prices only went up in Tokyo but now they are rising in places such as Osaka and spreading to local areas. Transactions in property markets have become more active and many companies in this sector are showing signs of strong profits growth.

Also, banks and other lenders have started to increase, although they are keeping a close eye on mortgage lending as they do not want to make the same sort of mistakes that they made in the 1990s.

Q: It must be quite cheap to borrow still in Japan, both for consumers and corporates. But with the end of the zero interest rate policy, will future rises have a significantly detrimental impact on the consumer or the housing market?

HS: It might affect Reits, but property companies are fine and will not be affected. As land prices are rising, most of these companies which have bought residential properties have been able to refurbish them and sell these for much higher prices within a year.

These companies have benefited from this capital growth and higher rental income, and these profits will not be hurt by higher interest rates. In any case it should not rise significantly. We only anticipate an average of up to 0.5 per cent maximum after the summer.

Q: So you are still confident in Japanese spending power?

HS: Yes. Higher interest rates mean the economy is recovering, and a recovering economy will mean greater wage growth, which keeps spending momentum. I still back the consumer story still in Japan.

As the economy grows we are seeing strong spending on goods and imports, as well as capital spending. Income is improving and now for the first time in many years we are seeing a shortage of labour, which is a sharp turnaround. Once there was over-employment, now there is a lack of it.

4.2m

Number of smaller companies in Japan – the investment universe for the fund

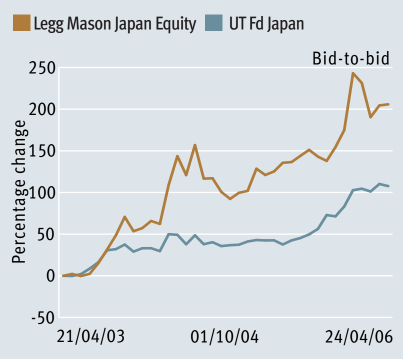
Q: What impact does this have on companies and their profits?

HS: With greater demand for services and goods, companies such as banks and some of the big companies are having to increase their employee counts by up to 30 per cent.

During the downturn a lot of these put job freezes on, but the economy has picked up and a more demanding consumer means these companies have to unfreeze jobs and meet demand. In terms of the CPI charts for Japan, you can see that for the first time in 13 years, demand has outstripped supply. Companies are busy hiring employees.

Also, many companies are aware that the baby boomers are retiring next year and so they are already starting to hire replacement workers. The government itself is trying to encourage companies to hire people over the age of 60. All these factors point to a strong consumer, a wealthy consumer which is keeping company profits looking healthy.

Legg Mason Japan Equity v sector



Source: Standard & Poor's

CV

HIDEO SHIOZUMI

2001 Moved business to Tokyo as Shiozumi Asset Management,

1990 Shiozumi Investment, founder

1983 Shiozumi & Company, founder

1971 Robert Fleming, portfolio manager and director

Q: You mention the imminent retirement of the baby boomer population – does this mean there will be significant problems for the stock market and for companies having to meet pension liabilities next year?

HS: The problem is not as exacerbated as in other developed economies. And actually one of the biggest forces for consumer spending is from the elderly. They are getting a huge lump sum on retirement and they are buying all sorts of goods and services.

I have been tapping into this growing market with companies such as employee benefit administration company Benefit One, which enables employees to build up points during their working life so they can get huge discounts off leisure resorts and golf clubs when they retire.

Q: You say that it is not just the consumer but also the companies that are contributing to a high rate of spending-related gross domestic product. Can you elaborate?

HS: Corporates have become very cash rich and capital expenditure is strong. In 2003 companies had suffered from three excesses: debt, capacity and employees. Since then, they have successfully restructured their debts, reduced their employees and have paid off debt and become cash rich. But now this restructuring seems to be maturing, as employment levels are starting to rise again.

Capital expenditure has been increasing for seven straight quarters but companies are only investing 60 per cent on average of cash flow into new plant and equipment. During the tech boom they were investing up to 130 per cent of cash flow so there is still room for capital expenditure to grow.

Q: Some of the larger cap Japan managers have been looking at dividend payments from large companies, as they remind us continually that the blue chips have the highest levels of cash and have the interests of the shareholders more at heart. Would you agree?

HS: Of course. Large companies are cash rich, but this is because of restructuring mainly, whereas smaller companies have much stronger balance sheets. Large caps have had to cut costs while small caps were already increasing their staff numbers and their profits through bottom-line growth, finding niche opportunities in service industries.

For example, one of my largest holdings is Telewave, which helps small companies establish their IT and customise their web administration. Their clients are small companies with less than 20 employees.

Now there are about 4.2m small companies in Japan, of which Telewave's client base is about 0.5 per cent, so if Telewave can get hold of even get 1 per cent of the market, it will be well away.

Q: So 4.2m smaller companies sounds like a recipe for disaster. There must be a lot of dross out there – how do you avoid it?

HS: It is all down to the process. I will never show interest in the Livedoors of this world as I look hard at the management. Do they have an established track record and a solid business model? The companies I buy will have had top management which has had experience working for large companies before setting up on their own. For example, Telewave's management is very experienced. You have look carefully at new companies, and even if their young are very clever, if they have little experience, I will always avoid them.

The reason there are so many companies in this areas of the market is that the old way of seniority and lifetime employment has broken down since 2000. With restructuring and job cuts, people started to think seriously about setting up on their own, and seeing new opportunities in new growth areas of the economy. Also the IT revolution – some three or four years behind the US – has meant companies have only just started to conduct business, advertise or recruit over the internet.

Q: You cannot escape the fact that small caps by nature are more volatile than large caps, and your fund does have a higher volatility than its peers in the IMA Japan sector.

HS: Yes, there will always be inherent short-term volatility. But the economy is strong, companies are profitable and the drivers are set for longer-term growth.

In August last year, investors started buying large caps because they could see the restructuring story of that time and they thought this would lead to stronger profits growth and dividend payouts. But the market is sitting on around 22 times earnings, and so are these large caps, so this story will be over by this summer and where will the high growth come from after that?

I do not know what will change market sentiment, but the strengthening of the yen will be a big factor in this and interest rates will also have an impact on these large caps.

So we will continue to focus on companies will strong profits growth. You cannot look at short-term performance – we are not traders or market followers.

I have more than 35 years' experience in this market and while running the Bermuda-domiciled Shiozumi Japan Opportunities fund, which the UK-authorised Legg Mason Japan Equity fund mirrors, we have had just two years' underperformance against the market since 1990.