SMS Capital Management, LLC

www.smscap.com

Phoenix Tower • 3200 Southwest Freeway, Suite 3300 • Houston, Texas 77027-7526
Phone 713-402-6116 • Fax 713-840-6005 • Email info@smscap.com

Japan…Bull Market or False Hope?

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By Steven M. Sheldon, CFA

Like jaded "Houston Texans" football fans heading for the doors early at yet another doomed game, investors used to getting burned by failed Japanese bull markets may be ready to lock in profits and run for the hills. However, taking money off the table, while tempting, may prove premature this time around.

Heading East

While the U.S. stock market has been stuck in a sustained trading range for most of the last two years, Japan's market continues to log fresh 4 ½ year highs.

Stock Market Returns

Index	Year-to-date Return*
Dow Jones Avg.	-0.9%
S&P 500	1.19%
Nikkei Avg. (Japan)	23.0%

*As of 11/11/05

Although the Japanese stock market up about 90% since it bottomed in November, 2003, the market is still at 1986 levels and half of what it was when the 1980's bubble peaked in December, 1989. That's right; twenty years have gone by without the market making a sustainable advance.

From the chart below, you can see that since 1990 Japan's stock market has been anything but a nice steady climb upward.

About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.

About the Author

Steven Sheldon has more than twelve years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the CFA Institute and the Houston Society of Financial Analysts (HSFA).

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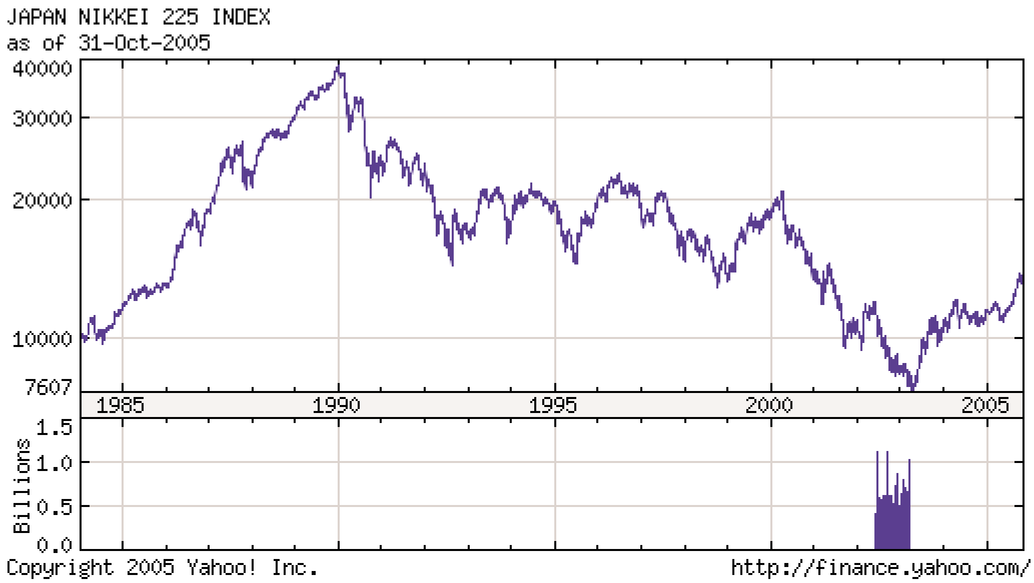
Japanese Stock Market
(1985-2005)



During this two-decade malaise, investors were tortured by periods marked by solid gains followed by hefty losses. Just by looking at the chart, you can clearly see seven such periods (not including the current bull market) of rising prices followed by falling prices.

Is it Different This Time?

You can understand why Japanese investors are a skeptical bunch when the talk turns to whether or not this latest bull market "has legs", which explains why foreign purchasers rather than Japanese households have largely fueled this latest bull market.

Deflation, spotty economic growth, a troubled banking sector, and a bloated government are just a few of the factors that contributed to the shaky Japanese economy (and the disastrous stock market). However, clear signs of change may mean better times are ahead.

For starters, after nearly fifteen years of inconsistent expansion, Japan's economy appears to be on solid footing. For the third quarter of 2005, Japan's GDP expanded at an annual pace of 1.7 percent, representing the fourth straight quarter of positive growth.

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On the political front, things seem to be heading the right direction as well. In September, Prime Minister Junichiro Koizumi and the ruling Liberal Democratic Party won re-election on a platform of economic reforms aimed at streamlining the government.

Deflation may also be coming to an end. In 2001, the Bank of Japan pushed interest rates to near zero percent by increasing the amount of money in the banking system in an effort to get prices rising and stir up the economy. The central bank is committed to maintaining the expansionary policy until core consumer prices, which have risen only one month since April 1998, end their decline. That may occur soon as the bank is forecasting a 0.1 percent gain for the fiscal year ending March 31st .

A weakening yen will also help. During 2005, the yen has weakened against the dollar making Japanese exported goods more attractive in the global marketplace.

If the stars continue to align for the Japanese economy, the bull market that started in 2003 may continue for several more years ratcheting up another 40-50% of positive returns. Of course, there will be corrections along the way, but the trend is up.

Riding the Wave

For those desiring to bet on a sustained Japanese recovery, there are several ways to participate. Almost all international and global mutual funds will have Japan exposure, but to varying degrees. Read the prospectus and annual report to see how much. The EAFE benchmark index for international developed countries has about 20% exposure to Japan. If a fund has more exposure than that, the managers are more bullish on Japan.

For those that want more concentrated Japan exposure, there are several mutual funds and Exchange-Traded-Funds (ETFs) that invest solely in Japanese companies. The Fidelity Japan Fund and EWJ is the IShares – Japan ETF are two examples of funds focused on Japan. The market has been hot this year so investors desiring to gain exposure should stagger purchases and wait for pullbacks.