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streetbeat

By Kathryn M. Welling

The Golden Fleece?

Dryships' Debut Shows Speculation, Liquidity Trumping Experience

"It was surreal. When someone asked why he was doing the deal, here-now, he actually said, basically, 'Because Americans are the dumbest investors around, and there's lots of liquidity in this market.'"

The man sputtering on the other end of my phone line several weeks back is no innocent abroad in the wilds of Wall Street. Not with more than 40 year's experience in buying and selling institutional securities under his belt. And not with the sort of rare and enviable track record he has to his credit, one based on consistently *preserving*, as well as increasing, other people's capital. Turns out that this consummate pro had just gotten back from a "roadshow" lunch for a **Cantor Fitzgerald** deal. A luncheon he'd attended, quite frankly, because his sardonic sense of humor has, if anything, only been sharpened by his years of toil in the Street. He had expected, he admitted, to be provided "a little mid-day comic relief."

Instead, he'd gotten acid indigestion and yet another "in your face" demonstration of how utterly the institutional investment world has changed over the last decade or so—not to mention a little real-time immersion in the rising sea of speculative sap flowing around anything even remotely connected to the energy sector. He shouldn't have been so taken aback, he later reflected. For he knew darn well that the marine transportation group, linked at the hip, as it is, with surging Far Eastern demand for energy and basic commodities, has been one of the stock markets' few truly bright spots for more than a year. He knows well, too, that institutional memory in the investment world, other than in a few "relics" like himself, these days has a lifespan rivaling that of a fruit fly. Still, he'd thought, the red herring was so outrageous, the deal's timing so brazenly on the heels, practically, of its principal's last disastrous (for the public) foray into the public markets, that sparks would just have to fly when this fellow dared show his face in New York. Where the audience was sure to include more than a few investment pros whose very own institutions had been stiffed in his last deal, floated barely seven years earlier.

"I was treated to a spectacle, all right," he recounted. "The spectacle of a room full of portfolio managers being led like lambs to slaughter. No one even asked what happened to the $175 million this fellow raised in junk bond financing for something called **Alpha Shipping Plc**, back in 1998. Granted, these were mostly equities guys, and everyone's a specialist in his own little area these days, but *someone* besides me *has* to remember how this guy hung some of the biggest institutions in the Street out to dry. How he defaulted within a year of selling that package of 10-year 9.5% senior unsecured notes through **Citicorp" Securities,** with **Credit Suisse First Boston and SBC Warburg Dillon Read** as co-managers.

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Kathryn M. Welling
Editor and Publisher

Jean M. Galvin
Business Manager and Webmaster

Karin-Marie Fitzpatrick
Editorial Assistant

Alexander Isley Inc.
Graphic Design

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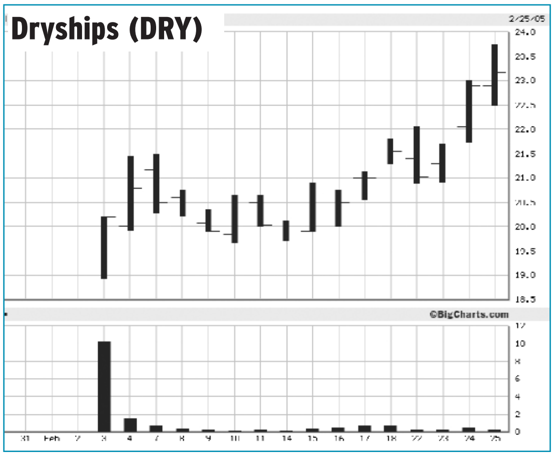
The gentleman in question is one **George Economou**, a MIT-educated scion of a prominent Greek shipping family. The 51-year-old has been actively involved in the shipping trade in both New York and Athens for more than 25 years. Mr. Economou is chairman and chief executive of **Dryships Inc.**, the company subject to the latest underwriting; he had styled himself general manager of the failed Alpha Shipping.

On the available evidence, "Gorgeous George" Economou, (as a long-term professional observer of the shipping scene swears Economou is familiarly known in industry circles, in part for his "louche mane of blonde hair" and in part for a reputation for *really* knowing how to party) is one persuasive wheeler-dealer.



Case in point No. 1: No fewer than 20 of the 26 Alpha Shipping vessels on which he raised the $175 million in *10-year* junk financing were then already more than 20 years old—and described *at the time* as "elderly" by the authoritative *Lloyd's List*.

Point No. 2: Though the shipping and junk markets cratered—and Alpha's bonds were downgraded—within months of that February 1998 deal, and although Alpha defaulted within a year on interest due to U.S. institutional investors, Economou negotiated a sweet restructuring deal via a quick "scheme of arrangement" in the Isle of Man courts and a related pre-packaged Chapter 11 in the Southern District of New York. Bottom line: He convinced UBS/Credit Suisse (which had scooped up three-quarters of the junk issue at distress prices) to settle for 37 cents on the dollar. Sure, he had to scrap and sell a few ships, but by July '99, *LLoyd's List* was headlining that Economou had regained control of his fleet.

No. 3: The success of Dryships' recent IPO, in which this latest Economou venture raised some $270 million through the sale of 15 million shares (roughly a 50% stake) to U.S. investors at $18—despite a 194-page prospectus (not counting amendments and exhibits) that is eloquent testimony to the well-intentioned futility of the full-disclosure standards enshrined as "investor-protection" in the U.S. securities laws. (While it's true, as Judge Learned Hand wrote, that sunshine is the 'best disinfectant," it's also true that there are none so blind as those who will not see.)

The candid if legalistic disclosures in the document run the gamut from the mildly spicy (both Mr. Economou's wife, and his ex-wife, through separate Liberian corporations, called (respectively) Advice Investments and Magic Management, are listed with him as principal shareholders in Dryships), to the familial: Among the first vessels Dryships planned to buy with the offering proceed were six owned by companies controlled by Economou's sister. Likewise, both Cardiff Marine, the affiliated Liberian-registered shipping management company that will actually handle Dryships' operations, and Drybulk, S.A., its Liberian-registered broker for charters and ship trading, are strictly family affairs. Economou owns 70% of each through something called the Entrepreneurial Spirit Foundation, a Liechtenstein entity he controls. (This same foundation acquired 70% of Dryships, pre-offering, in exchange for transferring effective ownership of its initial six-ship fleet to the IPO company). Meanwhile, the other 30% of both Cardiff and Drybulk are held by his sister's Prestige Finance S.A., yet another Liberian entity.

The prospectus for Dryships (a company Economou formed, perhaps for variety's sake, in the Marshall Islands) is rife, in other words, with convoluted related party transactions.

Not that it isn't up-front about them. Take the fact that Dryships has only two employees, its CEO and a CFO, and so will conduct virtually all of its operations through Cardiff, which Economou created back in 1991. It's right there, under risk factors, on page 12. And all that a prospective shareholder had to do was flip to the top of the next page to learn, "you will have no recourse against Cardiff." A little farther down that same page, furthermore, some fairly standard boilerplate verbiage about Economou's stakes in both Cardiff and Dryships creating potential conflicts of interest is capped with an unusually blunt warning that blood is thicker than water: *"Cardiff may give preferential treatment to vessels that are beneficially owned by related parties because Mr. Economou and members of his family may receive greater economic benefits."*

By then, however, even a mildly attentive reader should have been getting the idea. As early as page 3, the document revealed that, immediately prior to the public offering, Dryships planned to dividend $69 million, or substantially all of its retained earnings and cash on hand (save $7 million), to the private Economou-family interests that controlled it.

Stacked up against that sort of candor, it's perhaps an unseemly quibble to note that the little matter of Alpha Shipping's junk bond default, and the lead roles that both Mr. Economou and **Dryships CFO Christopher Thomas**, played in it, are relegated to the disclosure document's 67th page, where they're dispatched in a brief paragraph.

And my telephone informant, the sort who long ago cultivated a habit of inquiring, before he'd even open a red herring, about which firms had turned down the deal, wasn't really terribly surprised that this "detail" had escaped his luncheon companions' ken. "The shipping space has been hot for quite a while now, Dryships isn't the first of these deals to come to market, nor will it be the last. It would be wonderful if people learned, but they don't. The market has changed, it's all about demand. Everybody needs merchandise. The brokers will make good money this year, if they can keep these deals coming at a pretty good rate. Because the liquidity is out there. Especially in the hedge funds, most of which hold nothing long enough to concern themselves with anything as old-fashioned as fundamental investment value. They care only whether they can use the positive carry and highly leveraged money to trade vehicles like this—and show some performance."

On that score, so far, DRYS has yet to disappoint, as the chart over yonder shows, climbing from its $18 offering price to a high of 23.75, before closing last Friday at 23.16, up .26 on the day. To be sure, "Gorgeous George" has been visibly doing his part, even participating in the "opening bell" photo op at the Nasdaq market site on Feb. 7. So even the most skeptical of observers I've encountered expect the stock "to take time" to develop into a great short. Although I found little doubt that it will.

"Korean shipbuilders have record orders for drybulk carriers—and no one knows how many the Chinese, who are developing even greater shipbuilding capacity, have on tap," marvels the portfolio pro who phoned after DRYS' roadshow. "Yes, freight rates are way up, but this is a very cyclical industry—always has been, and always will be."

Another shipping analyst, one who took the time to delve into the numbers in the prospectus, came away "stunned that Economou made so little" on DRYS' vessels while day rates soared over the last couple of years; increasing their "time charter equivalents" (a standard industry measure) only by a factor of four, while the relevant index soared better than six-fold. That performance leakage, and the lack of any indication in the prospectus that the valuations of DRYS' ships have been independently certified, signal "something isn't right," he warned.

But it took a call to a senior shipping industry observer in London, a man oddly enough rather sympathetic to Mr. Economou, to get to the nub of what "isn't right" about the Dryships deal.

"It isn't that, in any other business, Economou would be dismissed as a disgraced junk bond salesman trying to float a bag of old ships—though that is true. The bigger issue is what does it say about the market that, given his track record, he's succeeded in floating Dryships?

"You very well *could* interpret Economou's deals as much as criticisms of the extreme naivete of the professional investing—and banking—communities, as of Economou himself," this Brit suggests. "No debate, he's an opportunist. But I venture that he's been as much *talked into* doing the deals as he's talked *others* into doing them. It takes two to tango, and the investment banks who brought these deals, I promise you, got their fees. They did their figures and decided these things were good enough to shove down the throats of their professional investor clients."

Clients, it must be said, for whom this fellow in London feels little pity. "The rule is *caveat emptor*. If you spent even 15 minutes doing research before buying a tanker or bulk ship, you'd realize there is no guessing where these markets are going to go. Yet here's DRYS, a deal clearly priced on current earnings in an extremely volatile market. This, in a business where the only *real profits,* historically have come *not* from operations, but from timely asset sales! It doesn't take a rocket scientist to see that it is the private Economou family companies, again, that are making money in the deal—by locking in profits on ships. So it is the public investors who can go swing with the markets."

Such a deal...

acuteobservation

An unorthodox check on valuations can be found by looking at the number of IPOs being conducted in Japan. Corporate managers are likely to issue less equity when it is expensive to them (i.e. cheap to investors). Conversely, they will be very willing to supply shares to investors when such shares are deemed to be cheap from the corporate perspective (expensive from the investor's viewpoint). At over 150 per month we are witnessing equity issuance on a scale not seen since the bubble years of the late 1980s!

From our perspective, the evidence suggests that Japan simply isn't cheap enough to account for the cyclical downturn. So we can find little reason for investors ignoring the slowdown in activity that appears to be ongoing. The chances of a reality check are increasing by the day. Bottom up orientated investors may not realise that a slowdown is at hand until it shows up in their portfolios, but...this day is coming ever closer. Short Japan.

As the other side of the trade, I offer up a long Korea position.

Korea is a cyclical economy much like Japan...The Korean economy is looking quite a mess. Exports have been dropping off the edge of a cliff, industrial production is slowing sharply. The consumer, in the wake of a credit card bust, is barely breathing...But perhaps above and beyond all else Korea is cheap. The 12 m forward P/E is just 8x, the average since the mid 1980s is 12.5x. The trailing P/E is also 8x. ... On a Price to Book basis Korea is trading at 1.4x, higher than the short historical average of 1.2x since the mid 1990s, but it is amongst the cheapest of the global emerging markets on this basis.

On our trend earnings P/E measure, Korea is trading on just below 15x, compared to an average of closer to 17x, and a massive discount relative to Japan's 40x!

James Montier
"A tale of two basket cases"
Dresdner Kleinwort Wasserstein Global Strategy Unit
Feb. 15, 2005
james.montier@drkw.com

listeningin

The Civilized China Play

Long-Time Japan Watcher Finds Value In Firms Serving Home Market

Way back in 1989, **Sid Klein** *was telling my old* Barron's *colleague, Peter DuBois, that the Tokyo market was heading for a major crack-up. And boy, was it. Well, since 2000, Sid, who publishes the* **Japan Asia Investments** *letter from Montreal, has been telling anyone who'll listen that what he calls Japanese domestic demand-oriented value stocks are going to erupt to the upside. And while the Nikkei took it on the chin, again, with the Nasdaq and S&P, until '03, his Japanese value stocks did, by and large, hold their ground. This year, they've come out of the gate strong again. So I checked in with Sid recently to see what he's thinking.*
KMW

You're still a bull on Japanese stocks, I take it, but only selectively here, Sid?
That's right. First of all, I have my own proprietary indicators for what I call "value," which is why, as a group, the stocks I've recommended–and which bottomed in 2000–haven't revisited those levels. I focus on companies that primarily do business within Japan or with the rest of Asia. What I've identified as " domestic demand-oriented value stocks." These are stocks trading at totally washed-out valuations. Meanwhile, money is more and more flowing into Japanese investments. The pot of money is getting bigger and bigger, especially the part controlled by hedge funds. And the reason is clear: When the Nikkei goes from 11,000 to 14,000, these are the sorts of issues that will soar by 70%-100%. Very high outperformance.

Really? I don't suppose you know exactly when the Nikkei will accomplish that feat–
No, but–

Or when domestic demand will be resurrected from the dead in Japan? It's been pretty much given up for dead, you know.
Oh, that's crazy. There is so much pent-up demand in Japan, that's been built up over the last decade–it's not just a recent thing. And major changes are occurring in Japan that are making this recent rally look to me like just a first move in the economy, at least in terms of the very big picture.

For instance?
Something I wrote about in my letter way back in 2003. They're making tax changes that would allow people who are 65 and up to make gifts to people who are 20 and over at a tax rate of 20%. In other words, make it so that people no longer have to wait for people to pass away. They call it "inheritances while alive." Now, there is something like $11.5 to $12 trillion U.S. dollars of savings in Japan–and about $5 trillion of that is in the hands of people in the highest tax bracket. So, if only 5% of that comes out as inter-generational gifts over time, that would amount to a transfer of $250 billion to people much more likely to circulate it through the economy and the financial markets. Now, this is something that's just warming up, but you've got to pick your sectors with that knowledge.

And those are sectors that serve Japan and export China?
Well, I'm looking more first for a major percent move in certain stocks because of the valuation play coupled with expectations of future growth. That's where the initial big move is; that's why the swings off of the January lows were so strong. All last year, I had been writing in my letter to expect big corrections into November-December. And we had very big bottoms and big retracements in Japanese stocks right before yearend. But the way they've turning up this year only convinces me further that we're talking about the best market in the world.

You're starting to sound like a broker. Besides, it won't be long now until the March 31 end of Japan's fiscal year. Which, for U.S. investors, often feels more like Halloween.
Well, that's all wrong, the cyclical lows in the Japanese market tend to occur at the very end of the calendar year, as they did in 2004,because a lot of trading there is driven by U.S. and British tax considerations. The thing is that the proper analysis of cycles in Japan's markets requires something like a 20-year study, which is something I've done, but not something that a lot of other analysts have bothered with.

I don't know, there's something about the way Japanese banks have all too often driven investors to hari-kari with March surprises–
Oh sure, in any given sector which an investor may happen to own, there can be trading extremes in the first 15 days in March that then in the reverse direction. But whether that extreme is to the downside or the upside really depends on the sector and the stock. And it surely doesn't mean that you can count on Japanese stocks all bottoming into March 31.

Isn't it premature to call for a "bottoming" in Japan? Western investors really poured back into Tokyo last year. And there even have been

signs of the speculative sap rising *in Japanese investors*, like the surging small-cap "MOTHERS" [market of the high-growth and emerging stocks], and trading volume.
I'm buying stocks that are the exact opposite of speculative. That is another area of the market that will correct. The hedge funds putting money into those things is trying to–incorrectly–hedge the leverage and risk they perceive in the North American markets. As for the domestic Japanese money that will be burnt in the MOTHERS, it'll just be a small factor–and those investors will soon enough join the rest of the crowd in chasing the Japanese value stocks higher.

So they'll get religion after getting singed?
I don't think investing in MOTHERS is reflective of the average Japanese investors. More and more, they're looking at companies whose dividends yields are as much as or even more than the 10-year bond rate. So I see the Japanese public actually becoming a further factor supporting the market for domestic value stocks. One of the ways they will do that will be through growing sales of mutual funds. That's why brokerage firms have been an early focus for me. As far as China goes, Japanese companies are setting up factories in China. But one of the things that created such great, cheap valuations in Japanese companies is the *perception* that all business is going to move to China. So many Japanese companies are trading at very low P/Es because their *perceived* future growth rates are really flat, conjuring expectations of earnings declines and fears of assets being marginalized. But you know how markets are. They go to an extreme. So you try to buy stocks when they are at ordinary valuations that can give you 50%-100% moves, as they go to an extreme.

> **"The future is Asia. The doorway to it goes through Japan. In fact, the most risk-averse and yet most highly leveraged way to invest in Asia's future is through Japanese domestic demand-oriented value stocks ."**

What are you calling an "ordinary" valuation in Japan these days?
That depends on the company and the industry. You have to look at it on a case-by-case basis.

Well, do the domestic value stocks you like tend to congregate in a particular section of the Japanese market?
No, my theme is not married to a sector or size, or to whether it's large-cap, mid-cap, or small-cap. My own approach to value involves fundamental and technical analysis.

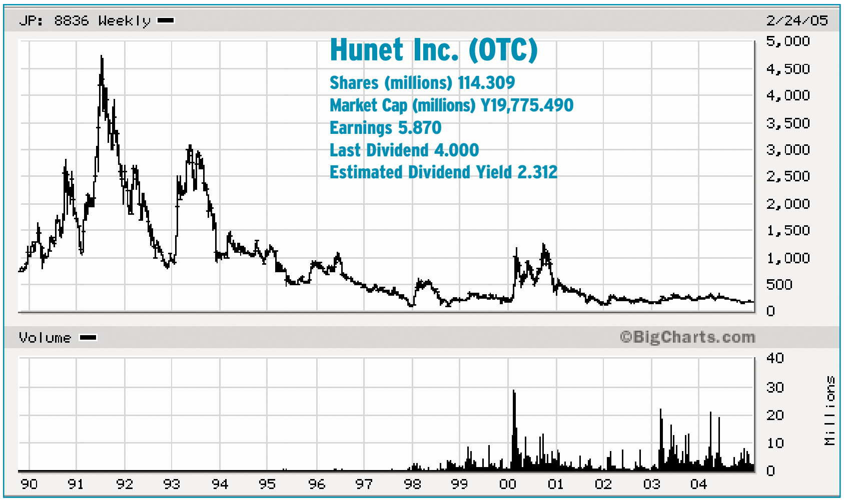
Before we go down that road, let me ask again: You're really certain Japan has finally shaken off its deflationary funk?
Yes, a couple of years ago, I put out a chart indicating that key deflation indicators had already turned positive, it was just a hard story to accept, because they were still in negative territory. Japan was still in deflation but the indicators I charted were telling you that it was coming out of deflation. But now I see evidence that Japan has completely emerged from deflation. Meanwhile, rest of Asia is facing *in*flation. And that is another reason that risk-averse yet high-return-oriented investors are looking toward Japan as a sophisticated way to invest in Asia. Japan represents about 60% of Asia's GDP and market cap. Its legal and banking systems are well-developed. So why do people even bother to come up with fancy stories about China and Korea and whatever else?

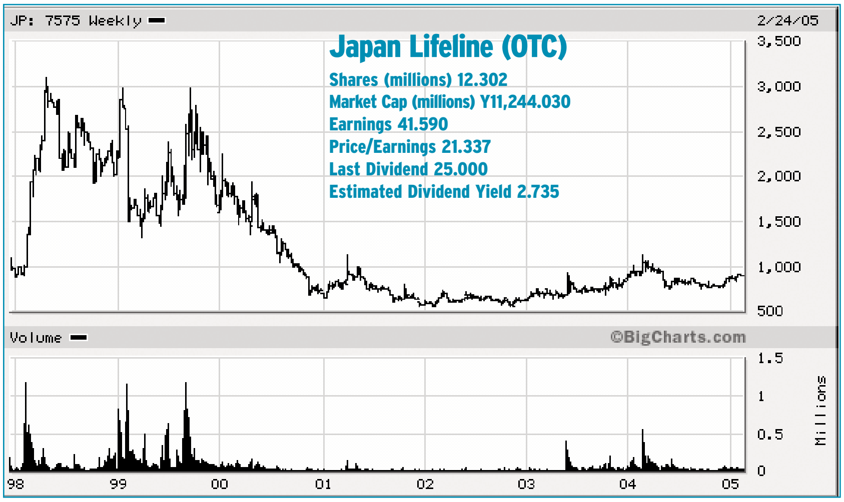
Maybe for the same reason that they don't recognize that "risk-averse yet high-return-oriented investors" is an oxymoron? Still, the Nikkei *is* up some 4,000 points from its low. That doesn't exactly look like neglect.
Yes, you can look at the Nikkei and say it has rallied 4,000 points from the low. But the reality is that 7,600 was never a real number anyway; there was almost no trading there. The Nikkei was theoretically undervalued from 9,000; that's where I drew its support. And it actually didn't even get there for long, though that was the right neighborhood. It did trade at 10,200, though, as recently as 2004.

So you're implying it's only "really" up around 1,500 points, instead of 4,000? That's still a pretty good move. Especially compared with the U.S. market lately.
What I've been writing for better than a year is that after last December's lows, we'd see a rally that will carry through the first half. So, by July 1, you'll have a lot of these Japanese value stocks up 50%-100%. But then, I expect a general correction in the second half, especially because I anticipate a lot of pressure–selling–coming out of New York. So it may be that you'll want to get out of these stocks that you've done very well in around then, even though, from an extremely long-term perspective, they will still be trading at only fractions of their ultimate highs. It's just a question of whether people are intermediate-term or very long-term investors in the Japan. But there are big potential gains to be found in Japanese value stocks, and now, in my opinion, is time to get started in them. The move has already begun.

In part, I guess, because you see little excitement here?
Correct. What is going on is a major secular transition. Even if the Japanese market pauses at 14,000, in another year, I'd expect to see the Nikkei at 18,000. Then at 24,000 and then it's going to go back through 36,000. The future is Asia. The doorway to it goes through Japan. And in fact, the most risk-averse and yet most highly leveraged way for you to possibly invest in Asia's future is through the sort of Japanese domestic demand-oriented value stocks that I have identified. Remember, the Nikkei
/Dow ratio was at 14 in the beginning of 1990. It's recently been around 1.06 and in January, it got down to 1.02. It dipped just below 1, very briefly, about a year ago. Well, you have to go back to the Korean War to find another time that ratio has been so low. That's a relationship that tells us a lot. It also explains why I see a lot of strategic opportunities for investors willing to increase their portfolio exposure to Japan.

A lot has changed in the markets—and the world—since the Korean War.
Granted, there are more ways today, for investors to try to balance there portfolios; synthetic ways to create various exposures through things like iShares and other ETFs and financial futures and all the rest. Nevertheless, as investments, none of those alternatives can even approximate the performance of appropriate stock selection. That's been shown repeatedly to be the case since 2000.





You're saying "the right stocks" have beaten the returns achieved in no-decision instruments like ETFs. But isn't that the catch–finding those "right stocks?"

Not really. You have had lower risk and higher returns, if you've had a basket of 15 of my stocks since the year 2000.

Any 15 of them? Or a basket chosen retrospectively?

I have identified 300 domestic demand-oriented stocks that I am talking about.

How have you gone about finding these gems?

I scour through all the research I can find. Monitor all the wire services. I'm an information junkie, Nikkei News, Japan Handbook, even research by brokerage firms.

You don't find it a handicap to be doing it mostly from Montreal?

No, while I do visit Japan, the reality is that it has probably helped me a great deal to be mostly observing the Japanese markets from afar. It's probably made it it a little easier to keep some emotional distance from the market. Besides, there's absolutely no information service on Japanese stocks that I don't have access to from here. It's just a question of tuning into that market and understanding something about it. You don't have to live in Tokyo for that. Remember, too, that I don't try to gather my own fundamental research on Japanese companies. I rely on analysts there to do that.

Besides, you don't speak Japanese, right?

No, but there are information services that offer me absolutely everything in English. Research, statistics, in real time. Besides, because I know what I am looking for, in terms of fundamentals and valuations and technicals, I can skip through a whole lot that is out there and just concentrate on what is meaningful to investment results.

And what is that, exactly, in the Japanese market?

Well, in terms of the fundamentals, what I want to see is an extremely low valuation and a strong balance sheet–positive cash flow, an improving earnings growth trend, recent positive capital spending, high real dividend yields.

Earnings growth? I thought you liked value stocks?

I like to see a trend towards earnings growth but because I'm a value player, I'll be a bit patient. I like to buy stocks when their earnings have just started to turn up and I like to find ones whose products and services are consistent with my big picture outlook that places Japan at the center of Asia's future growth. I mentioned that I want either positive cash flow or positive cap-ex because, while I want to find companies with certain solid balance sheet relationships, I am not particularly inspired by companies that are just sitting there with their money. Back in 2000, I was looking for companies where I could see that their negative growth trends were stalling out, even though their valuations were extremely negative. But things have improved in Japan, clearly. So now we are looking for positive growth trends and earnings that are at least starting to turn up off the bottom. And if those earnings are being generated by products and services in areas where we can see sustained growth in demand, so much the better.

So you actually pay attention to such old-fashioned indicators as price-to-book, P/E and price-to-cash flow?

Sure, but there are actually some relationships between balance sheet and income statement items that I have come up with myself that have worked even better since 2000.

Do tell.

Well, they're really proprietary. But they are essentially just indicators of valuation. Ones that tend to focus more on the relationship between things like price and book value, than on just their levels. It's the *relationship* between them that my proprietary indicators of valuation track. But don't get the idea it's rocket science. What I basically look for are things like a favorable P/E versus the historical data and or versus growth projections, for instance. Or price to cash flow versus its history.

Let me take a wild guess: You like to buy them when they look cheaper in terms of those comparisons.

Sure.

But you also pay attention to what sort of squiggles these stocks have been tracing out on charts?

I find that very helpful. Before I buy, I like to look at the stocks' charts–again, in relation to other indicators. I pay attention to things like resistance levels as they relate to the discounted fundamentals in these stocks. I like to see things like trend reversals, moving averages and trading volume confirming the quantitative conclusions I've come to about a stock's fundamentals. It gives me a measure of confidence when a stock's performance, relative to its industry or market, is turning up. It's all pretty standard blocking and tackling, when you come down to it. Then again, I'm following a universe of 300 stocks, out of which I basically look at 20 carefully every month. So, when I construct portfolio recommendations, they generally include 15-20 of these domestic demand-oriented value stocks. These tend to be established companies in the Japanese and Asian markets, but not the ones, often, that are household names in the West.

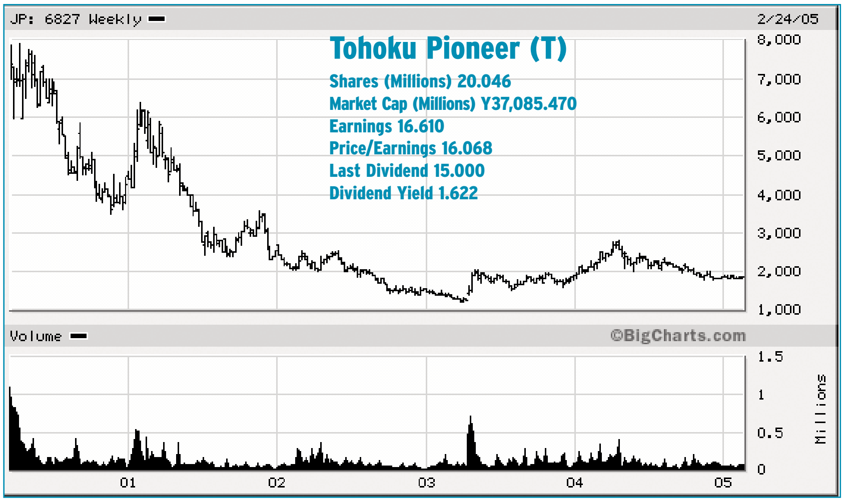
Why not?

Among other reasons, because I try to avoid companies that might still be exposed to the unwinding of cross-holdings. These stocks tend to have inordinately high risk-adjusted return potential–in no small part owing to their extremely low valuations. I mean, many of these issues have sustained 90% price declines over the last decade. Could their share prices fall further? I suppose it's possible. But I like the risk/reward. Especially because, as I said, these companies are well-situated to benefit from strong regional demand in Asia.

Still, if growth slows in the U.S., as you expect, that's bound to put a damper on Asia's.

I'm not so sure that impact on Japanese stocks would be all that bad. Ever since 2000, what had long been a very distinct inverse relationship between Japanese stocks and U.S. equities has reasserted itself in these domestic value stocks. Besides, Westerners are underweighted in these stocks, so they don't represent any sort of potential selling overhang in them. The reality is that right when the U.S. indices were topping, between January and March of 2000, when the Nasdaq hit 5000, the Japanese domestic demand-oriented value stocks were bottoming. There is an inverse relationship between Japanese domestic stocks and U.S. market over the longer term. Particularly on a risk-adjusted basis, this is the best investment theme in the entire world.

You're not much given to hyperbole, are you?



Well, in stocks, not considering, say, gold and silver and such. I've been saying the same thing for five years; I'm not going to downplay it now.

Okay, what industries do these Japanese value stocks tend to operate in? Finance, perchance?

I don't look at financial stocks, I don't own any banks, I don't recommend any–

No? Why not.

I don't look at the bank stocks. But when I talk about value stocks that are cheap and a leveraged way of playing the Nikkei, people tend to jump to the conclusion that I mean the bank stocks. But if you're trying to put together balanced portfolios, you don't look at just one sector. Besides, most of the Japanese financials don't meet my value criteria, even in many of the stocks do look like they've finally turned, and there's no denying that there's a lot of leverage in them, that's true.

What's more appealing?

First, while I focus on stocks that tend to be smaller caps, they're mostly still very active and some can trade in very high volumes at times. But I also will look at a few that just need to be accumulated, because Japanese stocks will surprise you and trade outrageous volumes as they move up. I've seen ones that traded maybe 2,000 shares a day when no one cared actually trade over 600,000 shares a day when they got hot. Even a relatively small company like **Hunet Inc.** (JP:8836) has over 114 million shares out. On a bad day, it will trade 300,000 shares and it will easily give you a million shares on a good one.

Is Hunet a good example of the sort of stock you are keen on here?

One of the smaller ones, yes. Hunet is in the real estate business and also makes and sells liquid crystal displays, but mostly it's a brokerage company. It also designs condos and custom-made houses, which puts it in the forefront of the "new Japan" I see coming out of the major tax overhaul. I think it will create a multi-hundred-billion-dollar movement into financial and hard assets. Another is **Japan Lifeline**, (JP:7575). It may appear to be less than liquid now, because it may trade only 5,000-10,000 shares a day while it is moving up from very depressed levels, but I am looking for stocks that should at least double. At just over 900, it's already begun a nice move over the last year from the mid-700s, but I'm expecting it to hit maybe 1,400 within a year and, longer term, go much higher than that.

What is Japan Lifeline, an insurance company?

No, they're basically a trading company for pacemakers and a lot of other medical devices. This company is very cheap on valuation. If it gets more aggressively involved in what is going to be an expanding medical market in Japan, it could have huge potential, but even just as a trading company, but even as a trading company, from this level, the stock should produce a very good return.

The term "trading company" covers a lot of sins in Japan. Does this company actually make pacemakers?

No, they're strictly wholesalers, buying and selling things like pacemakers, heart valves, catheters, and artificial organs.

Tell me about another company.

Tohoku Pioneer, (JP:6827) They make speakers and car stereos.

Is it an offshoot of Pioneer Electronics?

Yes, of some sort. What I like here is that there is this perception that the production of all these sorts of electronics products is rapidly being shifted to China. I think that perception is running ahead of the reality–and causing such an enormous undervalution of stocks like Tohoku Pioneer that the upside potential is pretty big, if the company just manages to turn in reasonably dynamic returns. Any indication that this company can show some sexy earnings growth again, could really produce explosive upside over the next two or three years. But even over the next year there's a lot of potential to the upside. This is a stock that has retreated to the low 1,800s after rallying to 2,800 last April.

Have they been having trouble competing with Chinese imports–or are they outsourcing production to China themselves?

All those kinds of concerns are really already in the stock price. Whatever downsizing they had to do to make themselves competitive, we've already seen reflected in the valuation at this level. that reflected in valuations because we're looking at. It has dropped to a low P/E, by Japanese standards, trades relatively cheaply versus its book value and also relative to sales. This is a company that's very liquid, and will respond very quickly when they see a pick-up in demand.

And it pays a dividend?

Yes. Tohoku Pioneer pays a good dividend–at least in the sense that it's a better yield than you can get on a 10-year bond in Japan, 1.55%. Japan Lifeline's is 2.8%. These companies also have cash, so if opportunities arise, they can take advantage of them.

Are you eyeing any stocks I might have heard of?

One that's a bit more recognizable is **Shinko Securities** (JP:8606). It's obviously a play on the market and also very cheap. They're associated with the Mizuho Financial Group, which is among the world's largest. Shinko was the first securities firm in Japan that I'm aware of to aggressively–years ago when there was nothing but darkness in Japan–pay commissions to get brokers to sell mutual funds. They're very adept at using the strengths of the Mizuho network, so it's a way of playing the financial sector in Japan, without buying a bank. Back last April, it rallied as to just under 460, but it's only around 340 now. This stock touched 100 back in 1998, only to shoot as high as 600 in 2003. Again, it's a nice way to play for beta on the Nikkei. If the index goes from 1100 to 1400, this could easily double. Of course, I can't argue that it's as cheap as the others, but financials are different animals. Frankly, I prefer stocks that will give you a cushion if something really crazy happens and the Nikkei tanks a quick 1,000 points. A financial stock isn't likely to give you time to react and sell into a rebound, unlike my real domestic value stocks, if only because the Nikkei *is* banks and techs. But Shinko has the right fundamentals and technicals, and the right partners, and I'm only sacrificing a little on valuation to get some exposure to the leverage in the financials.

Thanks, Sid.

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