

THE SUBSTANTIAL INVESTOR™

STRATEGIES FOR CONSISTENTLY COMPOUNDING CAPITAL™

FLASH REPORT NO. 2 MARCH 2006
EDITOR: RICHARD MASINO

Published by Private Investor Research, LLC.
© 2006 All Rights Reserved.

The Best of All Worlds

- ❖ Unlimited growth potential
- ❖ 100% principal protection
- ❖ Buying a dollar's worth of assets for 92.4 cents

The idea

Japan has been in bull mode for the last three years, and it still may have some more legs. This is a market that I want to participate in. However, I don't want the risks associated with a market that has already made a big move and isn't particularly cheap. I have found a way to eliminate those risks and therefore, this is my favorite way to play Japan.

The details

Another publicly traded structure product will be entering the Tax-Deferred Model Portfolio. The manufacturer of the product is Merrill Lynch & Co. Inc., and the security is called Nikkei 225® Market Index Target-Term Securities®.

CONTINUED ON NEXT PAGE

Members please note: I am delivering my main idea intended for the April newsletter issue in this report. Rather than sitting on this information for several weeks to meet some arbitrary date on the calendar, I am providing it to you now. I would hate to see a price rise from current levels while the idea sits on my desk.

Therefore, the April issue will contain the Model Portfolios, a summary of positions, and some additional content that I am beginning to work on.

The process of pre-releasing ideas will only be necessary on those that are new and particularly time sensitive. Special feature ideas such as hedge funds, investment partnerships, managed accounts, and the like do not possess time-sensitive characteristics.

Ticker symbol: NKS

Maturity date: June 5, 2009

Current market price: \$9.95

Liquidity: While thinly traded, you can add or decrease your position at any time. Use limit orders (not market orders).

Type of security: Senior Unsecured Debt Securities of Merrill Lynch.

Interest: None. The returns or Supplemental Redemption Amount are linked to the Index.

Initial starting value: \$15,130.50. This was the closing value of the Nikkei on the pricing date of December 1, 2005.

Participation rate: 109.5% -- We have leveraged upside! This means that we participate in 109.5% of the upside, if there is any, between the ending value and the initial starting value.

Sample calculation: Let's use the current Nikkei price as the ending value as if the Notes were going to mature today for this hypothetical example:

$$\$10 \times \frac{(\text{Ending Value} - \text{Starting Value})}{(\text{Starting Value})} \times \text{Participation Rate}$$

$$\$10 \times \frac{(16,115.63 - 15,130.50)}{(15,130.50)} \times 109.5\% = \$0.7129$$

$$\$10 + \$0.71 = \$10.71$$

Principal protection: At maturity, Merrill Lynch will pay at least \$10 for each Note. So if you pay \$10 or less for the Notes, you have a 100% principal protection guarantee from Merrill.

Prospectus: I have attached a link to the prospectus for your convenience and review.
<http://www.sec.gov/Archives/edgar/data/65100/000119312505239177/d424b3.htm>

The silver lining

I want to bring your attention back to the sample calculation above. The current market price of the Notes is \$9.95. But if the Notes were to mature today, they would be valued at \$10.71. That means that they can be purchased at a 7.6% discount to the Net Asset Value (NAV). Said alternatively, a dollar's worth of assets can be bought for 92.4 cents.

It appears to me that we have a very attractive combination here. If the Nikkei were to rise to 20,000 or 25,000 or any level over the initial starting value, we'd have a leveraged benefit because we have a 109.5% participation rate. Yet there is the safety of a principal guarantee,

and the assets can be purchased at a nice discount. For a kicker, there is no asset management fee, which is a savings of another 50 basis points (bps) versus an index fund tracking the same market. Double or triple that for an actively managed fund.

Why anyone would choose to invest in Japan via a mutual fund or Exchange Traded Fund (ETF) with the risk of unlimited downside, simply escapes me. I suppose the biggest reason is how many advisors are interested in suggesting a product manufactured by a competitor.

The critics

Now remember, for the reasons I mentioned in last month's issue on the foreign currency structured product, I would not acquire these in a taxable account because of the tax implications. You'll definitely want to read the prospectus (link provided above).

Additionally, we will not be receiving any dividends because this is a debt instrument. But that does not concern me. Here's why. The Nikkei has a very low dividend yield of about 1% annually. If you offset the savings from the lack of a management fee, let's say 50 bps, that would mean we're only missing out on ½% per year. Since the Notes mature in about 38 months, we're not even talking about 2% in aggregate. That's roughly a quarter of the discount to NAV that the Notes can be purchased at.

Lastly, as these are unsecured debt instruments of Merrill Lynch, a default is theoretically possible. I believe it's a remote possibility, though, as this firm is among the largest financial institutions in the world and carries an A+ S&P credit rating.

Why Japan?

The Nikkei reached nearly 39,000 in December, 1989 and Japan has been battling deflation ever since. After numerous head fakes, the index bottomed in April of 2003 at a touch over 7,600. Looking ahead, Japan still faces major issues:

Poor demographics – there is an expression, “demographics is destiny.” And the demographics don't look good for Japan. According to *ChinaDaily*, Japan's fertility rate sank to slightly under 1.29 in 2004. Yamaguchi Kazuo, a visiting Fellow at the Research Institute of Economy, Trade and Industry (RIETI), estimates that based on current trends, Japan's population could decline to 40 million by 2100. That's a massive 2/3 reduction in population.

The most obvious implications of a declining population are a shortage of labor, an aging population, and a shrinking economy. Then you have a smaller workforce trying to support the health care and pension costs of an increasingly large and elderly population. Not to mention who will be left to pay off the huge deficits (see item 2).

Massive deficits - if you think the US has big deficits, just take a look at Japan. Combined borrowing by central and local governments totals nearly 800 trillion yen. This is the equivalent of approximately \$6.8 trillion -- about 180% of Japan's GDP.

So why bother investing in Japan? Well let's not get scared off too quickly by demographics. While demographics may be destiny, the effects take time to develop. And as for the deficits, there's a bigger story out there.

CONTINUED ON NEXT PAGE

The bigger story

After nearly 15 years, Japan appears to be on the road to an economic recovery and beating deflation.

Gross Domestic Product (GDP) has been consistently improving:

<u>Year</u>	<u>% Growth in GDP</u>
2002	0.1%
2003	1.8%
2004	2.3%
2005	2.8%

Source: Economic & Social Research Institute, Cabinet Office Policy Research Institute & Ministry of Finance.

The Consumer Price Index (excluding fresh food), registered a 0.5% increase in January, marking its third consecutive monthly increase.

Real estate appears to have bottomed, the banking system has made significant progress in addressing bad loans, and corporate profits have been strong.

Recent and expected reforms in corporate law and regulations regarding mergers & acquisitions and reductions in taxation of investment income have all been favorable.

On March 9th the Bank of Japan (BOJ) summarized the current environment as one of steady recovery. It is benefiting from increased exports, domestic private demand, and business fixed investment.

The Bank announced a new framework for the conduct of monetary policy by issuing a medium-to-long-term price stability target of 0 – 2%. It's also ending the quantitative easing policy it had enacted in March, 2001. This policy was designed to encourage commercial bank lending, which in turn would stimulate economic growth and activity.

Importantly, the BOJ did say that short-term interest rates would remain at zero percent and that there would be no abrupt change.

A touch of skepticism

The Nikkei rallied over 400 points on the BOJ news. I must say, that while I enjoyed being a part of the rally, I am somewhat skeptical as the recovery still appears to be fragile.

Unrelated to the statements by the BOJ, I am uneasy that Prime Minister Junichiro Koizumi has said he will step down in September of this year. Prior to his arrival, Japan had gone through seven prime ministers since the bursting of the bubble in 1989. He has been a bold leader and has been at the helm during this turnaround.

Lastly, like the rest of Asia, Japan has a dependency on exports, and by extension, worldwide growth (especially in the US and China).

CONTINUED ON NEXT PAGE

Question – Hey Masino, why are you voicing skepticism and issuing a buy at the same time?

Answer – Because I'm not selling anything to anyone, so I can be completely honest. I tend to be skeptical about almost everything because doing so helps prevent me from getting separated from my money. It does not insulate me, but it helps me. It keeps me from taking positions that are too large and potentially damaging. It drives me to find ideas with downside protection. It keeps my hand close to the rip cord if I have to exit a position rather than cling to hope. Skepticism is the cousin of rigor and the enemy of complacency. The key to healthy skepticism is not to permit it to morph into paralysis or eternal pessimism.

Summary

If things break right, there could be some serious pin action in Japan, and I want to be involved. At the moment (though this may change at any time), I have no personal investment in these specific Notes. I already have a rather hefty piece of my tax-deferred accounts allocated to Japan through similar vehicles. However, I like the entry point and risk/reward scenario of this particular idea. I will add a 5% position of NKS to the TSI Tax-Deferred Model Portfolio.

Remember if the idea appeals to you, larger positions will need to be built over time as the shares are thinly traded.

Good compounding,

Rich

At the time of publication, Mr. Masino and/or account(s) that he manages for his family had no position in NKS.

All content is provided for informational purposes only and should not be used for or considered a solicitation of an offer to sell, buy or subscribe for securities, investment partnerships or other financial instruments. Nothing contained herein should be considered individual investment, tax or legal advice or an endorsement or recommendation of any firm, financial advisor, individual or investment. Any investment or strategy communicated herein can result in a complete loss of money. It is your money and you are solely responsible for it. Information provided is believed to be reliable but its accurateness and/or completeness is not guaranteed. Information is of the date referenced and publisher is under no obligation (nor does it plan) to update information. Information may change without notice. Publisher, its affiliates, principals and employees may have long or short positions in public or private securities or investments mentioned. Securities or investments mentioned may not be suitable for all investors. Subscribers are bound by the Terms of Use to which they agreed upon subscribing to *The Substantial Investor*. Readers who are not subscribers are responsible for reviewing the Terms of Use, which are available at www.thesubstantialinvestor.com, before implementing any of the ideas or strategies contained herein.

PUBLISHED BY PRIVATE INVESTOR RESEARCH, LLC
373 Nesconset Hwy., #329
Hauppauge, New York, 11788

PHONE: 631.348.2007
FAX: 631.584.3192
EMAIL: service@thesubstantialinvestor.com

© COPYRIGHT 2006 PRIVATE INVESTOR RESEARCH, LLC. ALL RIGHTS RESERVED.

Reproducing or sharing any part of this document or granting third parties access to password protected parts of website is strictly prohibited without written permission from publisher. Copyright infringement may be punishable by prison and/or substantial monetary fines.