Japan: three reasons for a positive outlook

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In recent weeks we further raised our allocations to Japanese stocks, with near-term catalysts including: increased strength in bottom-up corporate earnings; evidence of ongoing corporate reform driving better shareholder returns; firm economic expectations; receding political risks, with Prime Minister Abe having secured a strong victory at the recent snap elections; and high operational leverage of Japan Inc to synchronous global economic improvements.

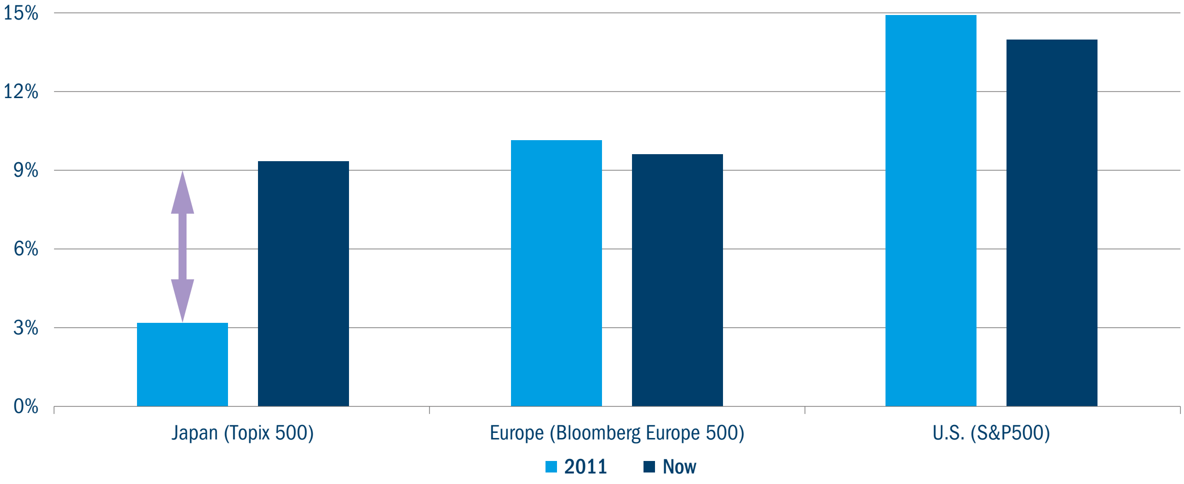
Looking further ahead, we see three key trends that we believe will be positive for Japanese equities in 2018 and coming years.

1) Corporate governance reform

Topics of discussion with Japanese corporate management have shifted materially over the last decade towards long-term corporate strategy, principal-agency relationships, etc. This positive development has derived from the introduction of corporate governance reform two years ago, and has gradually helped increase the return on equity (ROE) for Japanese companies. We believe that better corporate governance will continue to help unleash the value that has been hidden within Japanese equities.

Two of the major objectives of the corporate governance incentives are: 1) to eliminate conflicts of interest that exist between management and shareholders, and; 2) to ensure that a company's assets are used effectively in the best interests of stakeholders. There is a positive correlation between the level of improved corporate governance and ROE in Japanese companies. Figure 1 indicates that the average ROE of Japanese companies was substantially lower than in the US and Europe in 2011, but the gap had narrowed noticeably by 2017.

Figure 1: Return on equity



Source: Bloomberg, 9/30/2017.

Japan's Financial Services Agency proposed a 'Stewardship Code', which endeavours to promote sustainable growth in the corporate sector in addition to achieving fair investment returns for clients and beneficiaries. We are thus witnessing Japanese companies significantly raising dividends and initiating share buybacks. With total cash sitting on corporate Japan's balance sheet amounting to a record high of more than ¥250 trillion ($2.3 trillion), it is likely that Japanese companies will continue to raise dividends, increase mergers and acquisitions (M&A), and complete further share repurchases to mitigate the drag of excessive cash balances on ROE.

Returning excess cash to shareholders or putting cash to work for investments is a reasonable management decision since cash balances earn a zero – or sometimes negative – return, after inflation. We believe that investors will reward companies that generate sustainable free cash flow, earn returns significantly above their cost of capital and regularly conduct shareholder-friendly capital management (such as increasing dividends, buying back shares, and pursuing accretive M&As).

Additionally, Japan's Government Pension Investment Fund (GPIF), the world's largest public pension fund with assets under management of approximately $1.2 trillion,[1] has been starting to focus on Environmental, Social & Governance (ESG) oriented investments. Given the size of the fund and its influence in the investment community, GPIF's stance towards ESG will force Japanese companies to be increasingly aware of improving corporate governance as well as their social/environment behaviours. Corporate governance reform is not a single-year event, but an irreversible structural move, which should continue to be welcomed by equity investors.

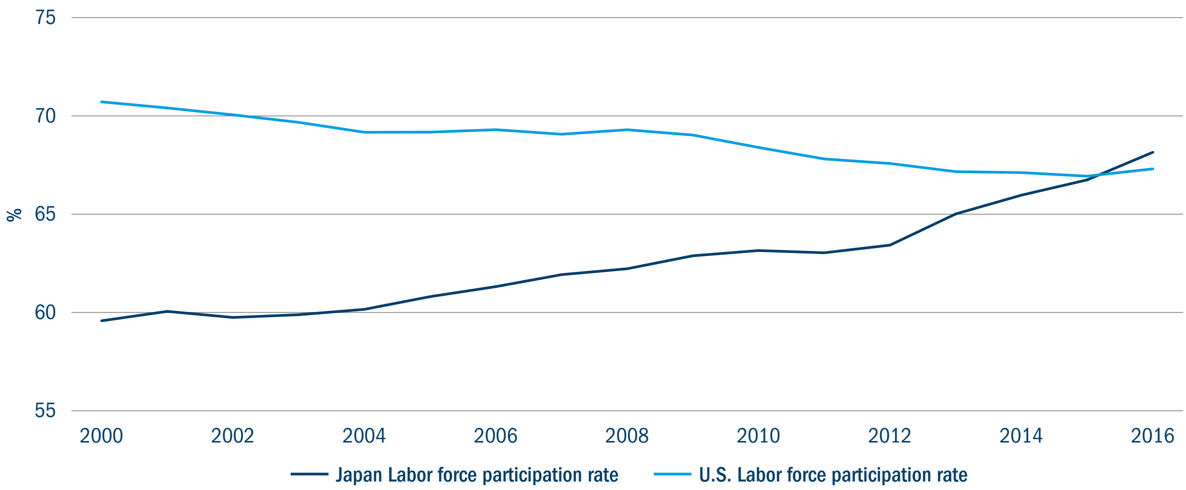
[1] Pensions and Investments/Willis Towers Watson, 31/12/2016.

2) Improving productivity: labour market reform

Productivity is a far more critical concept for the Japanese economy and its corporate sector than simply high growth. Abe drove labour reforms forward with a goal of encouraging women and retired workers to return to work, increasing the rate of labour force participation.

The government's various efforts are starting to bear fruit: some 1.5 million Japanese women have been added to the workforce over the last four years and the female labour participation rate (Figure 2) has risen to 68% – up eight percentage points in the last 15 years, having caught up with the US, according to OECD data. Also, the total number of employed has increased by more than 2.4 million over the last four years.

Figure 2: OECD female labour force participation rate (ages 15-64)



Source: OECD.

Deregulation of Japan's labour structure is underway with the goal of increasing salaries and providing better career opportunities for non-fulltime workers. As part of Abe's structural reforms, the government introduced the concept of 'equal pay for equal work', called 'Hatarakikata-Kaikaku' with the aim of improving labour productivity. According to McKinsey's report titled "The Future of Japan: Reigniting Productivity and Growth", if Japan succeeds in doubling its rate of productivity, it could boost GDP growth to about 3% and increase GDP by up to 30% by 2025. Note that the Japanese government's goal is to increase GDP to ¥600 trillion (currently ¥546 trillion), or to $5.5 trillion, by 2020.[2]

[2] Japan Revitalization Strategy, 2016.

3) Can companies maintain their competitiveness?

A belief among some is that Japanese companies are simply not competitive. This argument stems primarily from two assumptions: 1) that Japanese companies are not producing value-added products/services, and; 2) that Japanese companies are not pricing products/services appropriately (i.e. selling value-add at significant discounts).

With regard to the first point, the Atlas of Economic Complexity Index[3] measures the extent of critical knowledge incorporated in an economy, implying the relative uniqueness of the products that are marketed to overseas trading. On this measure, Japan has been rated as the world's most complex economy every single year since the start of this data collection in 1995, which suggests that Japanese companies have continued to bring value-added products to market.

On pricing, there is huge room for improvement. The 'irrational behaviour' of excessive price discounts among Japanese companies was to some extent exacerbated by deflation, which plagued Japan for more than a decade, and also by excessively competitive market dynamics (too many competitors in the same industry). Although inflation has not reached the 2% level targeted by the Bank of Japan yet, at least we can say that Japan was able to defeat deflation.

Also, data compiled by Nomura shows increasing M&A activity from 2010 to 2016, indicating industry consolidation has been taking place gradually but surely. Demographics come into play here as well. Given the ageing society, an increasing number of small business owners are starting to think about retirement.

Japan's small/medium enterprises account for about 99% of its total number of companies, employ 70% of the workforce, and have seen the average age of their presidents climb each year.[4] These businesses will continue to come up for sale, fuelling industry consolidation, and eventually increasing pricing power.

It can be said that Japan's elevated economic complexity over decades has been supported by high levels of patents and R&D. We believe that through its continued investments in future technologies, Japan should be able to maintain its leading technological edge across such industries as robotics, automation, games, specialty materials, and precision equipment.

We are witnessing many technologies and inventions emerging in Japan, supported by its research-oriented corporate culture. There are multiple ways for Japanese companies to enhance their competitive advantage and increase operating productivity. McKinsey's "Future of Japan" report claims that simply by adopting global best practices, deploying next-generation technologies, and organising for discipline and performance, Japanese companies can achieve at least 50% of their productivity goal by applying practices that are already in use elsewhere around the world.

[3] Center for International Development at Harvard University, www.atlas.cid.harvard.edu.
[4] Japan Ministry of Economy, Trade and Industry.

Summary

We believe there are various opportunities in the Japanese equity market that favour an active approach that allows concentrated investments in high-conviction areas. While it is encouraging that further improvement in ROE for Japanese companies as a whole is expected, identifying businesses with a high probability of expected outperformance is far more important. Companies that benefit from the structural tailwind provided by automation, robotics, data storage, advanced new materials, and outsourcing, should outperform irrespective of any near-term changes in the macro/political environment.

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