The Association of Investment Companies

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"THE OUTLOOK IS BRIGHT": INVESTMENT COMPANY MANAGERS ON THE RECOVERY IN JAPAN

In the past few weeks Japan's **Topix** index has hit a **33-year high**, while **Warren Buffett** has visited Tokyo to stock up on his Japanese holdings. The **AIC Japan** sector has returned 4.7**%** in the year to date, compared to 1.9% for the average investment company[1].

The more optimistic mood has made a welcome change for investment company managers investing in Japan. The **Association of Investment Companies (AIC)** has gathered comments about the reasons for Japan's recent good performance, the outlook and risks, and where they are seeing the most exciting opportunities.

James Rosenwald, Chief Investment Officer of Nippon Active Value Fund, said: "There are various reasons that the Japanese stock market is performing well. Geopolitical alliances are shifting, with China and Russia versus the US, Japan, South Korea and Australia (the Quad). The Japanese government, through the Bank of Japan and the government pension fund, are the two largest investors in the equity market and are making changes to the tax code and the corporate governance codes which are extremely positive for shareholders.

"Japan has the cheapest stocks on a cash flow and income basis in the developed world, and its interest rates are the lowest in the world. Equities, through their dividends and share buybacks, provide the largest carry trade in the world. The example is Warren Buffett's borrowing in yen and investing in equities which offer a return on equity of more than 10%. The positive carry is positively amazing."

Thomas Patchett, Japan Investment Specialist at the Baillie Gifford Japan Trust, said: "Japan may have finally defeated three decades of deflation. We have never witnessed this rate of inflation – in pay or products – in the past 30 years of investing in Japan. If sustained, this could stimulate consumer spending and greater capital expenditure, and drive up the required return on financial assets, buttressing recent initiatives from the Tokyo Stock Exchange and the Financial Services Agency.

"Although these short-term trends are helpful, our enthusiasm remains underpinned by some of the longer-term structural growth opportunities, unique to Japan. One example is in earlier-stage disruptive internet businesses such as **Freee**, a cloud-based accountancy software provider that is addressing the IT infrastructure inadequacies of corporate Japan, laid bare by Covid. Other areas that we are excited about include global leaders in robotics and automation and leading consumer brands, that are set to capitalise on rising Asian consumer wealth."

Nicholas Price, Manager of Fidelity Japan Trust, said: "For some time now, global equity portfolios generally have been underweight the Japanese stock market. This reflects misplaced presumptions that date back to Japan's 'lost decades'. But that hasn't been Japan for some time. The Japanese economy has been riding a recovery since around 2012 that has been as steady as it is low-profile, while a structural improvement in operating profitability remains underappreciated. Finally, many Japanese stocks are undervalued due to a lack of sell-side coverage and limited disclosures, especially in the mid/small cap space – all of which creates a wealth of overlooked and differentiated opportunities for the trust.

"Identifying under-covered companies with idiosyncratic sources of growth represents a potential source of differentiated returns for the portfolio. A case in point is **Tsuburaya Fields**, a digital content and game machine company that was added to the portfolio last July."

Improving corporate governance

Taeko Setaishi, Manager of Atlantis Japan Growth Fund, said: "Japanese corporate governance has been improving steadily for decades, driven by occasional activist forays, the steady reduction in cross-holdings, the change in Japan's demographics from a country of workers to a nation of pensioners reliant on dividends, and incremental pressure from the stock exchange and government. The results can be seen in steadily increasing shareholder returns – the adoption of 8% as a minimum target return on equity, the acceptance of 30% as a baseline pay-out ratio, steadily increasing buybacks, an enhanced corporate governance code and some consolidation in overcrowded industries.

"Whilst we do anticipate that governance will continue to improve, we do not expect a sudden market-wide rush to return years of excess accumulated cash, rapid industry consolidation or activist victories."

Joe Bauernfreund, Manager of AVI Japan Opportunity, said: "The outlook is bright. There have been some very positive structural changes on the back of the corporate governance and stewardship code that mean that companies are now working far harder to deliver shareholder returns than they ever have been. To that extent, we would argue this time is different. The one fly in the ointment is capital flows. Japanese investors have not been big buyers of their stock market in recent years meaning that foreign flows have been a key part of the story. Should foreign flows reverse and domestic flows fail to pick up the slack, then the market could face some headwinds."

Masaki Taketsume, Manager of Schroder Japan Trust, said: "Japan is currently under the spotlight due to a request at the end of March by the Tokyo Stock Exchange to Japanese companies whose stock prices are traded below 1x price-to-book value. The request urged management to make strategies and plans to boost their stock prices by focusing more on the cost of capital and proper capital allocation. Many Japanese companies have responded by announcing dividend increases and share buybacks. Further interest has also been generated as a result of legendary investor, Warren Buffet visiting Japan in early April. Valuations have been cheap and we believe there are a number of increasingly positive factors bringing global investors' attention to Japan."

Finding the best opportunities

Richard Aston, Portfolio Manager of the CC Japan Income & Growth Trust, said: "The best opportunities for the medium to long term are those companies that have clearly defined growth strategies, good corporate governance and a demonstrated history of favourable shareholder returns. Examples include **DIP**, a digital recruitment services provider and **Shin-Etsu Chemical**, a market leading silicon wafer manufacturer. Companies with other characteristics may offer short-term reward but are unlikely to offer sustained returns.

"There are many companies in Japan that will remain challenged by the simple consideration that has put the majority of investors off, namely the declining population. However, there are many high-quality companies whose origins are in Japan but can now offer good long term growth potential from international growth, or in some cases from the domestic market as attitudes and behaviours change."

Nicholas Weindling, Portfolio Manager of the JPMorgan Japanese Investment Trust, said: "Investors are often surprised to learn that Japan remains behind most other advanced economies in many key growth themes, such as technology and e-commerce. Such growth-oriented companies are set to gather momentum over time and provide resilient, long-term sources of returns for investors.

"For example, the penetration of e-commerce within the Japanese retail market is just over 10% and remains much lower than in China, the UK, South Korea or the US. Yet this is an area primed for growth, with companies such as **Zozo**, Japan's number one online apparel retailer, and **Monotaro**, a top-ranked business-to-business e-commerce company, well placed to benefit. Similarly, Japan is only at the beginning of its journey towards digitalisation, leaving a strong growth runway for workplace solutions such as cloud computing."

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Notes to editors

1. Source: theaic.co.uk / Morningstar. Share price total return from 1 January to 26 May 2023.
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