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The Case for Japanese Equities: Some Macro Thoughts

When a market has produced investment returns well above expected long-term averages, it is natural to wonder whether future results will be more pedestrian due to natural mean regression or whether the momentum will continue. To be sure, our focus is always on evaluating individual securities on a case-by-case basis. But occasionally, it is prudent to step back and look at the larger economic and financial picture. There is no doubt that the Japanese stock market has been red hot of late, generating returns among the best of any developed market over the past year. And this has been true even with the headwind of a depreciating yen. Given this result, should investors still be enthusiastic about investing in Japan? We think the answer is "Yes!" In this note, we shall outline our view. Our reasoning depends upon low valuations, cheap currency, investor positioning, government incentives and changing corporate behavior. We think the combination provides a powerful basis for a multi-year re-rating of Japanese equities.

Valuation. All investing begins with an effort to purchase securities at a price that is favorable relative to a reasonable estimate of value. In Japan, the market today is close to fairly valued, with a price-to-earnings ratio on the broad TOPIX index of 14.4 times forward earnings and a price-to-book value ratio of 1.5 times.[1] These figures are cheaper than many other developed markets, not to mention the much-elevated technology-heavy US market.

Japanese shares are cheaper than US stocks not because the companies themselves have underperformed on a fundamental basis. In fact, leaving aside the big American tech companies, Japanese corporate performance has generally been much better than that in the US, measured by a blend of real sales and earnings growth over the past several years. The difference in share price performance is entirely due to the valuation expansion in the US stock market, where price-to-earnings ratios have climbed sharply, and to depreciation of the yen.

Investors have not yet caught up with the better fundamental performance in Japan, or, if they have, they remain skeptical that it can continue. After all, over a period of several decades, Japanese corporates demonstrated very low returns on capital coupled with a disdainful attitude toward minority shareholders. Although returns on capital in Japan are now nearly equivalent with other developed markets, investors appear to be worried that the bad old days might return.

Smaller capitalization companies in Japan represent a real trove of value. The market indices, dominated by large cap companies, do not give a good representation of the cheapness of the small and mid cap universe in Japan. And that's where we do most of our hunting. There are still hundreds of publicly traded companies in Japan selling for less than book value and for very low multiples of "enterprise value" (the sum of equity market value plus debt less excess cash) to operating earnings. Such low multiples are attractive to private equity firms looking to structure leveraged buyouts.

Currency. It's no secret that the Japanese yen is undervalued by any reasonable estimate. The Boston-based investment firm GMO estimates that the Japanese currency is standing on a discount of forty percent to fair value—more than two standard deviations away from its average over the past fifty years. There are a variety of explanations offered but the easiest way to think about it is that Japan is now the only OECD country still experiencing negative real interest rates, making Japanese bonds unattractive relative to debt denominated in euros or US dollars. Pundits have been forecasting a recovery for the yen for a long time. Our fundamental view is that predicting currency movements is a mug's game and therefore not one we choose to play. Consequently, although the numeraire of NAVF is in British pounds sterling, virtually all of the fund's assets are in yen and are unhedged.[2]

[1] Source: I/B/E/S and Factset estimates.
[2] The Fund periodically converts some yen into pounds sterling to cover administrative expenses. For an investor, the Fund represents pure yen exposure.

Since the inception of the Fund, yen depreciation has cost us about thirty percent measured in pounds. Currency movements play out over many years and very long cycles. It is probable that the yen will, over time, eventually recover to a more normal valuation against the developed market currencies such as the pound, the euro and the dollar. While it is difficult to know how fast and when such appreciation might happen, a reasonable estimate might be that a change in fortune for the currency might offer an additional four or five percent per annum tailwind to the real return from owning Japanese stocks going forward.

How will this happen? Most probably the yen will begin to appreciate when the Japanese central bank decides to stop artificially repressing yields—today sitting at about one percent in nominal terms and, as mentioned, negative in real terms. Given that the latest readings of Japanese inflation at 1.6% are now only slightly lower than inflation in America, it makes sense that Japanese and US interest rates should begin to converge. This should encourage Japanese corporates and institutional investors to repatriate funds from abroad, for fear of being caught on the wrong side of an appreciating currency.

Second-guessing the Bank of Japan's actions is a favorite activity of macroeconomists around the world—it's another game we choose not to play. Nevertheless, whilst mindful of our limitations as economists and forecasters, the odds of yen appreciation going forward seem favorable.

Investor Positioning. Most investors around the world exhibit a strong home-market bias. That is, investors located in the US tend to hold most of their assets in US investments, while those in Frankfurt or Paris favor European-domiciled shares. Japanese investors, by contrast, exhibit the opposite behavior. Individual investors in Japan hold more than three times more in foreign stocks than they do in domestic shares—a substantial outlier from global investor behavior. Some of this is undoubtedly due to currency effects, as mentioned above, while a large part of it is probably the result of conditioning—a thirty-year bear market for Japanese stocks would tire even the most optimistic bull and cause an investor to look elsewhere.

In an effort to stimulate share ownership, the Japanese government in January re-launched the personal tax-free savings program ("NISA") modeled after the very successful British ISA plan.[3] While it is obviously early days, there have already been positive flows into NISA-approved Japanese mutual funds. A shift by Japanese investors out of low-yielding deposits into equities, coupled with an appreciating currency, could drive a substantial revaluation of the stock market. In turn, this would attract the attention of global institutional investors who have long lamented the low level of equity ownership by domestic investors. The combination could generate the sort of lollapalooza effect that would send stocks much higher.

Government Incentives. Japan's current prime minister, Fumio Kishida, has spoken repeatedly of his desire to reform the Japanese economy and make it more dynamic. In part, his policies are a continuation of his predecessor's reforms[4]; but they also go further. There are three main policy areas that should have a positive impact on corporate performance and share prices: labor market reforms, the "Asset Management Nation" policy, and financial market reforms.

Japan has an aging and stagnant labor force due to its demographic transition and lack of immigration. To combat this, the government wants to improve labor productivity as a whole by changing existing practices and increasing labor market participation by women. These changes include making it easier for participants to switch firms and altering rigid compensation structures based on seniority to ones based on merit. Together, these reforms represent a major upheaval in societal norms where the assumption has long been that school-leavers or college graduates would take a job and stay with that employer for

[3] "Individual Savings Accounts" in Britain allow persons to invest twenty thousand pounds per annum in shares or deposits and those investments compound tax-free. Japan's program is similar, though the annual contributions are much lower, unfortunately.

[4] Shinzo Abe, who served as prime minister from 2012 to 2020, instituted a series of economic and financial reforms collectively referred to as "Abenomics."

life. Making pension pots mobile through programs such as NISA will help improve mobility in the labor market. Although these changes will take time to work through, already there is an obvious upward trend in the number of individuals looking to switch jobs.

Wage and salary practice in Japan have long been based strictly on seniority as opposed to merit. At NAVF, we have consistently encouraged managements to institute both merit-based pay as well as substantial equity ownership through stock options. Both of these practices are consistent with current government recommendations. The wheels of compensation change "grind exceeding small;" but at least they do seem to be grinding and we do observe improvements in this area. We will continue to lobby our portfolio companies to make these changes as the benefits are clear.

The "Asset Management Nation" initiative is two pronged: First, it aims to free up the estimated 14 trillion yen that individuals hold in low-yielding savings accounts and redeploy a substantial amount into shares, and second, to force institutional investors to behave like true fiduciaries and put pressure on companies to increase returns. The concept here is to unlock the animal spirits of investors and get them to focus on generating share price returns over time. This is not unlike what happened in the US beginning in the 1970s with the changing regulations and tax incentives around pensions and savings.[5]

Institutional investors in Japan, accustomed to rubber stamping corporate behavior, have begun to exercise their authority by voting against management recommendations more often. Japan's corporate boards have traditionally been allies of management, exercising little authority, and largely unresponsive to demands from outside shareholders. This is beginning to change as increasing numbers of outsiders join boards and investors express their displeasure with poor performance by voting against board members' reappointment. A substantial majority of listed companies now have boards that have at least one-third independent directors. In turn, this has helped to end the tradition of entrenchment as represented by the number of "poison pill" anti-takeover measures—a number that has fallen by more than fifty percent in the last ten years. These are big and important changes in a culture that is built around consensus.

Financial market reforms have been driven by both government regulators and the Tokyo Stock Exchange. The Ministry of Economy, Trade and Industry ("METI") is encouraging consolidation of Japan's fragmented industrial economy through both mergers and takeovers. Its "Fair M & A Guidelines" policy prompts corporations to consider mergers or takeovers by requiring boards to review and actively consider bids. One of the main reasons that Japan has not had an active market for corporate control is that companies were able to avoid takeovers or mergers by simply ignoring communications from outsiders with impunity. This has now changed, though in our view it does not yet go far enough. Most importantly, Japan does not yet have anything similar to the "Revlon doctrine," which requires corporate boards to act as strict fiduciaries on behalf of all shareholders and to seek the highest possible price for a company in a merger or takeover.[6]

Although METI's guidelines have yet to be implemented fully, it is clear that they are already having the desired effect of encouraging consolidation and merger activity. Smart managers quickly realize that the easiest way to boost margins and profitability is to do the micro-economically obvious thing and buy one's competitor. Japan hardly needs an economy that numbers its auto companies in double digits let alone scores of pump manufacturers.

[5] The most important of these was the passage of the Employee Retirement Income Security Act ("ERISA") which mandated strict fiduciary duty for institutions managing pension assets. This caused US institutional investors to put a premium on enhanced share price performance. Japan is trying to accomplish something similar through light regulation and recommendation rather than strict legislation.

[6] The Revlon doctrine stems from an attempted hostile takeover in the United States in 1986 of the Revlon cosmetics company and the efforts of Revlon's board to prevent it. The lawsuits that followed created a substantial body of US case law that defines how corporate boards in America must behave. It is so entrenched in US corporate life that lawyers and investment bankers regularly advise corporate boards when they have entered "Revlon Land," meaning that the company is construed to be up for sale.

Japan is one of the very few countries that can boast of hundreds of publicly traded companies trading at less than book value. The Tokyo Stock Exchange wants to change that by requiring companies to outline a program to improve share prices and drive valuations above book. Companies can do this by shedding excess capital, thus improving reported profitability, by paying higher dividends, thus increasing attractiveness to investors, and by repurchasing shares to drive up reported earnings. Some forward-thinking managements, including some of our portfolio companies, have chosen to do all three! Not every listed company has embraced these ideals, and the Stock Exchange recently issued a list that details all the companies not yet in compliance. (Compliance only means a company has thought about doing something and formulated a strategy; surprisingly, some managements haven't managed to make it that far.)

Interestingly, in the past several weeks, the authorities in Korea have outlined a similar plan to raise valuations in that country. It seems likely, given their history of reciprocal intimidation and admiration between the two nations, that these plans might create a powerful symbiosis to drive valuations higher in both countries.[7] Stay tuned.

Changing Corporate Behavior. Not all Japanese managements have a laser-like focus on improving profitability, and not all boards care about driving shareholder returns higher. There is still a lot of poor corporate governance, lazy balance sheets, willfully ignorant management practice and lousy returns to be had in the Japanese stock market. But there is enough change afoot that it represents a notable development to which one should pay attention.

Managements scarred by the long bear market and the years of low or no growth are beginning to understand that husbanding cash on a balance sheet is not the recipe for success. Some have begun to realize that changes to incentives can have a powerful stimulus effect and drive corporate performance.[8] Nowhere is this more evident than in the activity by global private equity firms, most of which have established large presences in Tokyo. Companies have started to adopt best practices because they realize that the government and regulators want them to do better, and they know that if they do not deliver, there is now a real chance that another management will come along and wrest control of the company and make the appropriate changes.

The opportunity to take companies private at low valuations and restructure them out of the glare of public disclosure is substantial in Japan. The mix of low interest rates and ample capital from banks should make for a field day for the private equity world. To date, there have been relatively few deals announced, at least in comparison to the opportunity. But that is beginning to change. Last year set a record for the largest number of announced takeover bids since the beginning of Abenomics. That trend is only likely to keep going up. NAVF has been involved in three privatizations to date. In the most recent one, the Fund will invest a small amount in the new private company, effectively acquiring a highly-levered stub position in the equity. Our goal is to have many similar investments in the years ahead, and we will continue to cajole managements into building shareholder value either by remaining public and doing the right things, or by going private and having a private equity firm make those decisions for them.

In summary, we believe that there is still a wonderful opportunity in the Japanese market. There are many companies selling at low valuations. There is significant pressure in Japanese society to improve valuation levels from multiple sources, both public and private. And importantly, people have begun to "get the message" that higher valuations and better returns can have a wonderful effect on individual companies, the broader economy and society as a whole. Moreover, because these changes take time to play out, one can look forward to years of decent results. The good times aren't over—they are just getting started.

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[7] This is more of a dream rather than a prediction. -Ed.

[8] 'Show me the incentives and I'll show you the outcomes." — Charles T. Munger