Investment Insights

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Japanese Equities: Progress Underway, but Challenges Remain

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Highlights

- While capital discipline, corporate governance, and buyback trends all bode well for Japanese equities, we do not see enough momentum relative to global peers to meaningfully boost exposure in client portfolios.
- Structural issues affecting employment and innovation, the nature of the equity market, as well as the upcoming consumption tax increase and ongoing global trade war, remain headwinds.
- Bessemer portfolios have benefited from limited exposure to Japanese equities in recent years. While always evaluating potential catalysts that could change our view, we maintain an underweight positioning.

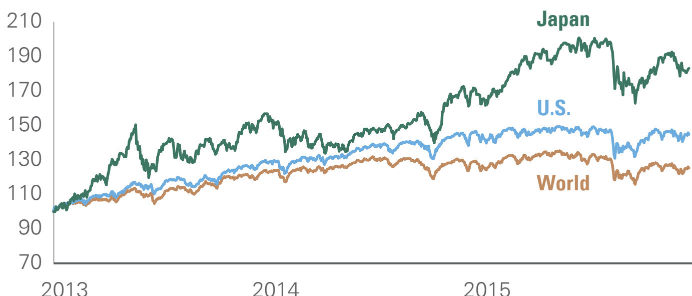
Bessemer always seeks to maximize risk-adjusted returns by combining bottom-up security analysis with top-down macroeconomic research, the latter including country and regional exposure. To that end, we recently traveled to Japan, meeting with more than a dozen policymakers, strategists, companies, and economists to deepen our understanding of what might make us want to increase our Japanese equity allocation.

For historical context, Bessemer portfolios established an overweight allocation to Japan versus global equity benchmarks in 2013, after Shinzo Abe was elected prime minister. After his victory, Japanese equities had a period of strong outperformance, with returns beating those of most global peers. These gains followed a sharp weakening in the yen (helping exporters) and came alongside hopes for a number of policy changes (dubbed "Abenomics") that were meant to lift Japan out of decades of economic stagnation.

After outperforming, particularly in 2013 and 2015 on the back of Abe's initiatives, Japanese equities began to lag global markets again. We reduced our exposure in 2016 and have remained underweight the region since. From the start of that year, Japanese equities have risen 11% while the S&P 500 is up 41% and the MSCI World Index has increased by 27% (Exhibit 1).

Exhibit 1: Japan, U.S., and Global Equity Market Performance, 2013–2015 and 2016–2019, Indexed to 100

Key Takeaway: Japanese equities outperformed peers after Prime Minister Abe was elected in 2012, but have more recently lagged.



Data as of August 28, 2019. Japan, U.S., and World equity markets are represented by Nikkei 225, S&P 500, and MSCI World, respectively.

Source: Bloomberg

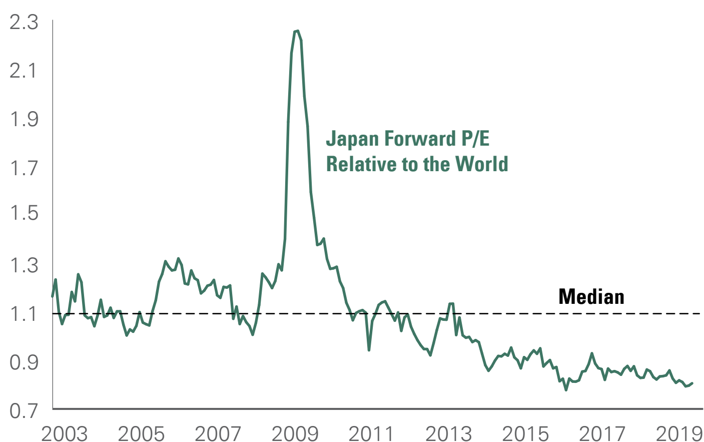
Our recent underweight to Japanese equities has contributed to the relative outperformance of Bessemer portfolios.

One thing we know today about Japanese equities (which make up roughly 7% of the MSCI All-Country World Index) is that they are attractively valued, both versus history and versus global peers (Exhibit 2). The forward price-to-earnings (P/E) ratio of the Japan MSCI Index has fallen from 14x to 12x, near the low end of its five-year range, and below the MSCI World Index forward P/E of 16x.

Valuations, however, are just one piece of the puzzle — usually not sufficient in and of themselves to merit an investment. The rest of this *Investment Insights* considers what possible catalysts or trends could add to those valuations to help Japanese stocks post strong absolute and relative returns compared to global peers. For now, our conclusion is not particularly upbeat: While positive changes are underway in Japan on many fronts, and there are certainly select outstanding firms within the country, we do not see sufficient evidence today to consider an increase to our Japanese equity exposure anytime soon.

Exhibit 2: Japanese Equity Valuations Relative to the World

Key Takeaway: Japanese equity valuations appear relatively cheap versus both history and global markets.



Data as of July 20, 2019. Japan and World represented by MSCI Japan Index and MSCI World Index, respectively.

Source: IBES, J.P. Morgan

Japanese equities have historically lagged global peers with regard to profit growth, returns on capital, and shareholder alignment. While the profitability and return on capital of many Japanese companies have increased through efficiency gains, capital discipline, and corporate reform, improvement has been modest, and momentum for a meaningful increase in earnings and returns is limited by the difficulty of quickly implementing structural change.

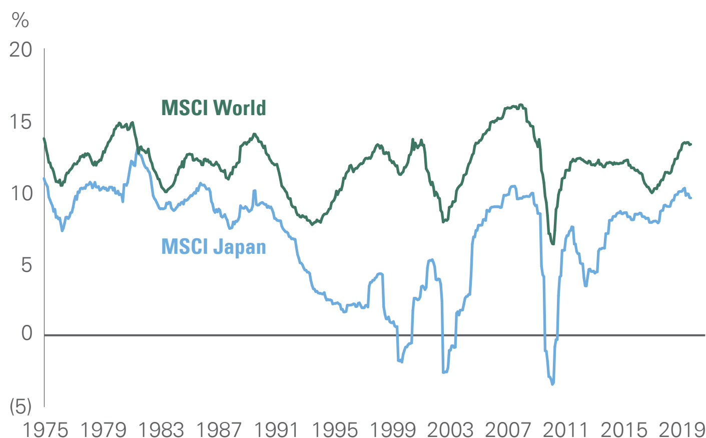
Japanese culture is a key element underlying the country's ability to effect rapid change. The Japanese tradition tends to be rooted in stability, structure, and hierarchy, as well as deliberate and careful decision-making. In the U.S., generally speaking, risk-taking is admired, and mistakes are forgiven, often seen as a tradeoff for speed. But in Japan, where errors have historically been less easily overlooked and can have lasting impacts on one's reputation, individuals and companies often move more cautiously, taking their time to ensure precision and accuracy and also gain consensus support.

A slower pace of decision-making combined with more moderate risk-taking has translated into a Japanese tradition of gradual, cautious change, especially when compared to America's fast-paced culture. These slow, deliberate movements can be seen in how quickly companies improve fundamentals or enact corporate reform. Elements of stability and hierarchy are evident in a work culture based on lifetime employment. Risk aversion and cautiousness manifest in views toward entrepreneurship and the equity market. Below, we explore several of these topics in more detail:

Company returns: Investors have been encouraged by recent improvements in company fundamentals, especially returns. Notably, return on equity (ROE) is now averaging 10%, a dramatic increase from the 3%–4% seen in 2010, but still trailing the rest of the world's average of 12% (Exhibit 3). This ROE improvement has been driven by several factors including higher gross and operating margins, a lower tax burden, expense reduction, and increased share buybacks and dividend payout ratios. In particular, margin gains have been a key factor and have been attributed to cost rationalization, reductions in interest and non-interest expense — in part as companies have been able to control selling, general,

Exhibit 3: Japan MSCI Returns on Equity versus MSCI World

Key Takeaway: Japanese returns on equity have seen dramatic improvement over the past decade, though they still trail global peers.



Source: Morgan Stanley Research, RIMES

and administrative costs. Still, when evaluating Japanese companies, our portfolio managers have struggled to find companies with promising growth and return profiles at attractive valuations that offer a better value proposition when compared to opportunities elsewhere in the world.

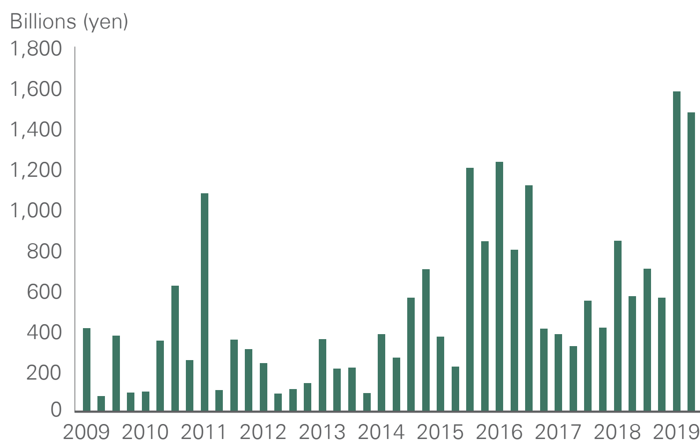
Corporate governance: Profitability has also been enhanced by better capital discipline, which has been driven in part by improved corporate governance, though momentum for reforms has been sluggish. Japan has seen a number of initiatives since Prime Minister Abe's push in 2013. The 2014 Stewardship Code and 2015 Corporate Governance Code both encouraged firms to adopt better capital policies and improve balance sheet management. There is some evidence that corporate governance has been gaining traction. For example, most listed Japanese companies now have at least two independent directors on their boards. However, during our trip, we heard several comments suggesting that companies have been primarily focused on corporate reform marketing proposals in order to boost their share price, while underneath there is still internal resistance to real change. As investors, we are looking for signs of further improvement in terms of corporate restructuring, overhauled takeover provisions, the unwinding of cross-shareholdings (that is, when a publicly traded corporation holds shares in another listed firm), and increased independence and diversity of company management teams and boards.

Share buybacks: One area of corporate reform where we have seen positive steps is an improvement in balance sheet efficiency and a rising trend toward share buybacks. As companies have become more focused on capital policy, especially shareholder return policy, share repurchases have increased dramatically. Shareholder returns in terms of dividends and share repurchases are now at record levels. Buybacks for Japanese companies are up over 100% this year (Exhibit 4). However, we are wary of how much further and more materially buybacks can boost returns and equity prices without being accompanied by meaningful steps in corporate governance.

Employment: While the Japanese economy has seen a tight labor market given the demographic trend of an aging population combined with limited immigration and foreign workers, the rigid employment system has negative impacts on the flexibility and productivity of the workforce. Corporate culture is still generally focused on stable employment (often for life), and restrictive labor regulations make it difficult for firms to fire employees or decrease wages. This employment structure may be stifling Japanese animal spirits, which

Exhibit 4: Nikkei Buyback Volume

Key Takeaway: Japanese buybacks have increased recently and are on track to double from 2018 to 2019.



Data is quarterly and as of June 30, 2019.

Source: Bloomberg, J.P. Morgan

combined with an aging workforce, could be dampening productivity. When analyzing investment opportunities, our portfolio managers often have a critical eye toward the existing employment structure, believing that dollars currently allocated to heavy payroll operating expenses might be better put toward other opportunities that generate greater shareholder returns.

Innovation: Japanese public and private sectors have been surprisingly late to adopt modern technologies. Taking a step back and remembering the Japan of the 1980s with the newest gadgets and gizmos from Sony Corp. or Panasonic Corp., one might wonder how Japan has fallen behind in innovation and technology. Some experts we met with pointed to Japan's strength in process and supply chains, and its expertise with single machines that enabled it to be a leader in hardware but at the same time made the transition to software much more challenging. Indeed, the hierarchical corporate structure does seem to be at odds with the flat structure of many software companies elsewhere in the world. Still others also pointed to a risk-averse culture and an education system that is too focused on memorization rather than creativity and innovation. Finally, it is important to note that the banking system and lack of venture capital funding have put the Japanese entrepreneur at a disadvantage compared with some peers overseas. It is very difficult to take out a cash flow-based loan as requirements are incredibly rigid and usually require land collateral. Further, a general lack of venture capital funding for growth companies in new technologies has resulted in relatively few IPOs of high-growth, high-return companies.

Still, it is important to mention that Japan has been and remains a leader in automation and robotics. As the world's predominant robot manufacturer, Japan has one of the highest levels of global sales and a very high robot density in manufacturing. The government embraces automation as a key pillar of economic revitalization given Japan's demographic headwinds, recognizing that automation can help propel productivity gains and circumvent labor shortages.

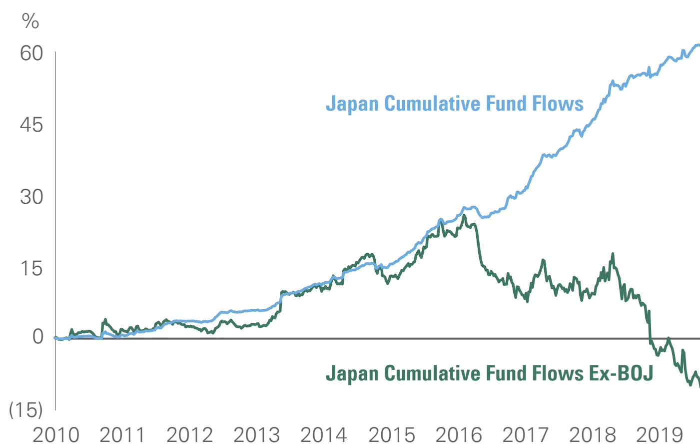
Market structure: One area of concern for foreign investors, in particular, is the nature of the country's equity market. Japanese equities can be swayed more by macro factors, which may move prices in a chaotic way, rather than by company fundamentals, which are not always reflected in stock prices. Historically, Japan's deflationary spiral and multiple recessions have contributed to market volatility. In general, those we met with characterized the market as highly speculative and prone to quick moves. Interestingly, many Japanese, especially the elderly, are reluctant to buy equities. Some see stocks as a risky investment while others do not view equity investing as a clean business, perhaps given that insider trading was made illegal as recently as 1988, and enforcement has been relatively lax compared to international standards. Further complicating Japan's market structure is the Bank of Japan's (BOJ) ETF purchase program.

BOJ asset purchases: The BOJ's exchange-traded fund (ETF) buying program is a key area of unease for investors given its impact on the equity market. As of September 2019, the BOJ owned over 29 trillion yen (roughly $270 billion) of stocks and ETFs, an amount that represents roughly 5% of the total market cap in Japan and over 75% of the nation's ETF market. These stocks were purchased through its ETF buying program, a quantitative easing-linked equity program that it has been running since late 2010. The program was originally designed as an emergency measure to combat deflation, but it has been scaled up progressively over time as part of the BOJ's ongoing policy easing. Over the past three years, the BOJ has been buying roughly six trillion yen worth of ETFs annually. During our trip, we met with an economist who helped design and implement the original program. Interestingly, he suggested surprise that the program was still in place so many years later.

The BOJ's interference in the equity market has been a factor driving the net pullback of foreign investors from Japanese equities recently. Foreign investors have withdrawn over 13 trillion yen from local stocks since the start of 2018. Last year saw the largest annual outflow from Japanese equities since 1984 (Exhibit 5). While it could be argued that the BOJ has a floor under the market as it often steps in and accelerates ETF purchases to support prices after meaningful market declines, these actions make fundamental security selection less predictable; the market is reacting to external forces rather

Exhibit 5: Cumulative Fund Flows in Japan

Key Takeaway: Excluding Bank of Japan (BOJ) ETF purchases, investors have been net sellers of Japanese equities in recent years.



Data represents Japanese cumulative fund flows as a % of AUM as of July 31, 2019.
Source: Flows & Liquidity, J.P. Morgan

than reflecting company performance. Many believe the BOJ's actions have distorted equity prices, hurt the market's ability to allocate capital efficiently, and have pushed out "good money."

Because the ETF program is biased toward several market-weighted indices, the BOJ has ended up with large ownership positions in several of Japan's major companies. The BOJ is a top-three shareholder in the majority of companies in the Nikkei 225 Index through its ETF holdings, and it is estimated the BOJ owns more than 10% of about 30 Japanese companies. For example, the BOJ now holds roughly 20% of Fast Retailing Company, the owner of Uniqlo, which presents a potential overhang issue that could affect the company's attractiveness for a foreign investor.

Further, the prices of some small-cap stocks included in the indices the BOJ has been buying may have increased as a result of these actions, and consequently, their shares could be considered overvalued. Some investors are also concerned that market liquidity will decrease with fewer free-floating shares in the market. Finally, it is unclear what the BOJ's ETF exit plan is and whether it can sell its ETFs without crashing the market — that is, if it even exits at all. In fact, there is some thought that the BOJ may actually increase its ETF purchasing program as it is one of the only tools available for further stimulus given Japan's already low-interest rates and heavy debt load.

Short-Term Outlook Challenged

In the near term, Japanese equities face several headwinds, including an upcoming consumption tax increase and growing global trade tensions.

Consumption tax: Japan's government plans to increase its consumption tax from 8% to 10% this October. This tax increase could have a negative effect on the economy as it has the potential to dampen domestic demand, at least tactically. It also could fuel consumer fears about further taxes; after all, the government already raised the VAT tax in 1997 and 2014 (in both cases, tax increases were accompanied by a pre-hike acceleration in consumption demand paired with a subsequent swing back the other way).

Historically, Japan's equity market has underperformed following consumption tax hikes, and the economy has fallen into recession. Japan's TOPIX underperformed the S&P 500 by roughly 10% in the six months after the past two VAT tax increases. This time, the government is attempting to mitigate the effect of the tax increase on the economy; it has pledged that more than half of the tax revenue will be directed toward welfare benefits. But even as local policymakers assured us "this time is different," it remains unclear whether their measures will be enough to offset the impact of the tax on consumer sentiment and behavior.

Trade tensions: Increasing global trade frictions with the U.S.-China trade war and heightened Japan-South Korea tensions are a key risk factor for Japan. Its economy is vulnerable to a slowdown in global trade as manufacturing is a relatively large percentage of GDP and because the country plays a pivotal role in many global supply chains that form the backbone of modern international trade. Specifically, manufacturing represents roughly 20% of Japan's GDP compared to 12% for the United States. Because Japan's economy relies heavily on exports, trade disruptions that impact

global supply chains can be particularly painful. Japanese manufacturers supply critical electronic parts and devices for smartphones and laptops, items that have been recent targets of U.S. tariffs.

As the U.S.-China trade war has intensified and China's economy has slowed, Japan has seen a decrease in exports to China, its biggest trading partner. Unlike other low-cost Asian countries, Japan is not positioned to benefit much from the resulting shift in manufacturing from China to other Asian markets as it does not have comparable low-cost workers and production capabilities. Rather, Japanese manufacturers have outsourced a significant part of production to lower-cost Asian countries, including China. Moreover, uncertainty regarding trade may dampen Japanese corporate activity as companies delay or reduce planned expenditures. While Japan has benefited to a degree from Chinese tourists and consumers who have opted to visit Japan over the U.S. or purchase Japanese consumer goods instead of American ones, these gains have been limited by its own recent trade strains with the U.S.

Indeed, the U.S. remains at odds over trade with Japan, its fourth-largest trading partner. The nearly $70 billion bilateral goods trade deficit with Japan and the idea that the imbalance is related to nontariff barriers (e.g., discriminatory regulatory treatment or disadvantaged U.S. sales) in the Japanese market have been key sources of tension. With a renewed focus on trade deficits, the U.S. withdrew from the Trans-Pacific Partnership early in Trump's presidency. The U.S. trade deficit in autos has been especially in focus. Currently, the U.S. places a 2.5% tariff on Japanese passenger cars and has been contemplating placing additional tariffs of up to 25% on auto exporters globally. Increased auto tariffs would clearly harm Japan's auto industry, which exported over $40 billion worth of cars to the U.S. last year. As of this writing, the two countries continue to negotiate a bilateral trade pact with the aim of increasing Japanese purchases of U.S. agriculture products and resolving U.S. auto tariffs.

Meanwhile, increased tensions between Japan and South Korea, one of Japan's most active trading partners, also appear to be weighing on Japanese markets as the dispute is only further disrupting global supply chains. The standoff between the two ramped up lately when Tokyo placed export controls on three chemicals used in semiconductors to South Korea, and both countries removed each other from their respective list of trusted trading partners. Because Japan produces almost all of the world's supply of these three chemicals, and semiconductors have long been South Korea's most exported item (over 20% of its exports), this dispute has the potential to have a significant impact on both economies in addition to global technology supply chains. Further complicating the situation is that these trade tensions are tied to national security concerns and also rooted in deep emotions given the long and complicated history of grievances between the two countries. Many contacts that we met with in Japan believed the situation was more likely to escalate before it improves.

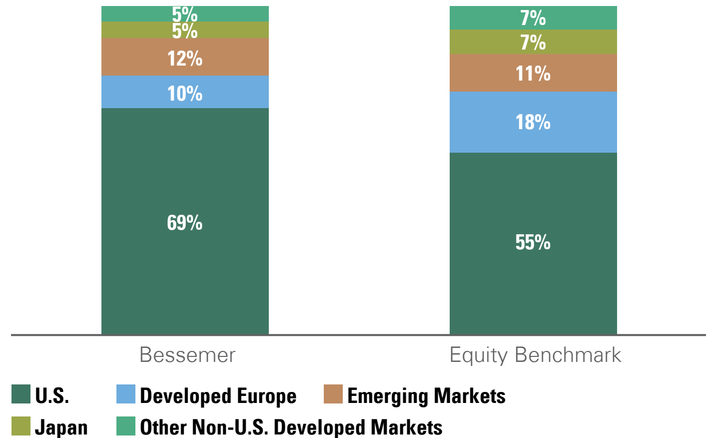
Finally, there is a risk of Japanese yen appreciation in response to escalating trade tensions and Fed policy. In theory, lower rates in the U.S. without a change in Japanese policy should exert downward pressure on the U.S. dollar and push the yen higher. Japanese equities have historically had an inverse relationship with the yen as a stronger yen disadvantages Japanese exporters selling goods to American consumers. A weaker yen, on the other hand, means imports from Japan are cheaper in the U.S. while the cost of U.S. exports is greater. The BOJ's current options for preventing yen appreciation through additional easing are now more limited than they were in the past. Additionally, Japan's currency movements may have to take into account the increased scrutiny from the current U.S. administration on currency intervention as a tool in trade wars. Japan remains on the U.S. currency monitoring list given its large trade and current account surpluses with the U.S.

Portfolio Positioning

Overall, we left Japan thinking that any sustained period of Japanese equity outperformance is more likely to be triggered by an outside catalyst (for example, a stronger global economy or a much stronger dollar that allows for a weaker yen) rather than driven by Japan's domestic economy or slow, incremental changes within Japanese company culture and activities. For now, we are reassured that our Japanese equity underweight is not a threat to portfolio performance. As a percentage of an overall Balanced Growth 70/30 portfolio, Japanese equities are 5%, about 30% below a benchmark weight (Exhibit 6).

Exhibit 6: Bessemer Balanced Growth 70/30 Regional Equity Weights

Key Takeaway: Bessemer portfolios remain underweight Japanese equities relative to the benchmark.



Refects positioning based on current weights as of July 31, 2019. The weights may not sum to 100% due to rounding. "70/30" represents the intended risk profile of this model portfolio's neutral allocation. Regional weights include equities held in the Multi-Asset Opportunities mandate; "Other Non-U.S." includes Canada, Israel, and Asia Pacific ex-Japan. The Equity Benchmark represents the MSCI All Country World IMI.

Source: Factset, MSCI.

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