FINDING DIAMONDS: THE QUIET REVOLUTION IN JAPAN ROLLS ON

Shintaro Harada
Japan High Conviction Fund Manager,
Nomura Asset Management

In markets, as in life, narratives can be misleading, and the prevailing story about Japan and its companies is a point in case. The country is saddled with huge debts and, as its detractors point out, its demographics are poor. Growth has been tepid, if not anaemic, for years and its equity market is highly cyclical and dependent on a weak currency. These arguments are well-known: Japan remains one of the most unloved and inexpensive markets in the world – offering a rare hunting ground for value investors.

However, if you look beyond these well-trodden tropes, you will see a brighter picture than many might imagine. The Nikkei 225 Index, a broad measure of Japanese stock performance, has been one of the quiet achievers of late, recently hitting a 26-year high even as the US dollar, a major, albeit diminishing tailwind to Japanese earnings, has stuttered. Not only that, but it has far outpaced the FTSE 100, 250 and All-Shares indices over the past year and was only a stone's throw behind the growth-orientated, and richly-valued, Dow Jones. So, what is going on and can this continue?

Although there are many high quality, well-run companies in Japan, a major game changer has been 'Abenomics', the current Prime Minister's program for economic stimulation. Boldly aimed at escaping 20 years of deflation, the initiative has three prongs: accommodative monetary policy from the central bank; fiscal stimulus; and structural reform. The first two are not too dissimilar from policies adopted in the US and Europe, but it is the last measure that is the key to unlocking the potential of Japanese corporates.

Prime Minister Abe continues to promote a pro-business environment by reducing government restrictions, recalibrating the tax code, reforming the labour markets and, crucially, through enhancing corporate governance. On this note, the introduction of the Stewardship Code and Corporate Governance Code – which encourages institutional investors to engage with companies directly – is another important step; more than ever before, conversations are being had around shareholder returns, and firms are increasingly receptive.

Indeed, such initiatives are starting to bear fruit as companies are encouraged to improve efficiency, productivity and returns on equity (ROE). Historically, Japanese companies have produced approximately half the ROE of western markets, but they are catching up. According to a study by the Nikkei, the ROE on the Tokyo Stock Exchange, excluding the financial sector, is soon expected to surpass 10% for the first time ever.

That puts it close to European markets, although still lagging the US which enjoys an average ROE of 14% among its blue chips. Moreover, the trend should continue: net profit at publicly traded companies is expected to jump 27% year-on-year for 2018. Years of stagnant growth, crippling deflation and poor demographics have seen the country's companies evolve and they no longer need impressive headline growth to grow their profits. Furthermore, the country is leading the world in key areas like healthcare, biotech and robotics. Japan is not simply a market for value investors.

These shifts make the Japanese market ideal for stock picking – especially since, unlike Europe and the US, Japanese markets are inefficient, with analyst coverage well below that of most developed markets – over 50% of TOPIX companies are covered by one or two analysts, and often none. That's a good environment for a bottom-up, high conviction strategy.

At Nomura we look for companies where returns are steady and growing and where poor coverage means that re-ratings are likely. We do not have a sector or thematic bias, and so we are not constrained by global themes or fads, resulting in a consistency of performance through different market environments.

With a portfolio of around 30 best-in-class names, and an investment horizon of around five years, our returns have been strong: Nomura's Japan High Conviction Fund has comfortably beaten its TOPIX benchmark every year for the past five years and has a 3-year annualised return of 8.70% (as at 29th March, 2018), outperforming the TOPIX by 3.12% annualised, net of fees.

As the quiet revolution rolls on, investors may want to enlist a Japanese stock picker after all.