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JAPANESE CORPORATES: NEGLECTED OPPORTUNITIES

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Global equity markets are currently facing uncertainty on growth, interest rates, trade and political issues, however, despite these concerns we can still find some compelling investment stories, one of which is Japanese equities.

In common with many developed countries, Japan faces many challenges, most notably it is a mature economy with a rapidly aging population and a growing debt problem. Consequently, the attraction of Japan is not its economic growth profile – it is at the corporate level that Japan's potential can be found.

Japan has a wealth of strongly-positioned companies in the technology sphere and elsewhere; many are household names but others are not. Examples of the best known include Toyota, one of the world's largest car makers, a leader in hybrid technology; Fanuc, a world leading robotics company and Shimano, the premium bicycle components maker with a global market share in bicycle components of around 70%. In addition to these household names, the Japanese market also contains many world-leading companies that have bright futures but are often overlooked by overseas investors. This neglect results from the fact that Japanese companies, even global leaders, have a history of producing disappointing returns. Too often companies have been run not only for the benefit shareholders but also for a range of stakeholders including management, employees and other related entities. Returns on Equity (RoE), a key measure of shareholder returns, have struggled to hit 10% at the peak of the earnings cycle, against figures of 20% or more for other developed markets.

The good news for investors is that this situation is changing, with returns rising as corporates bend to ongoing pressure from investors (and the Abe government) to lift their returns. Shareholders want improved dividends and higher share prices whilst the authorities want a more efficient corporate sector to support the wider economy. This trend received a major boost with the introduction of the RoE-focused Nikkei 400 index in 2014. Only those companies with above average returns can gain entry to this index and inclusion has become something of a badge of honour and a strong incentive for change.

We believe that the increased focus on returns is likely to be a long-term theme in the Japanese market and it is something from which Nomura's Japan High Conviction Fund is well placed to benefit. The Japan High Conviction strategy offers a concentrated, unconstrained portfolio that focuses on high quality growth companies whose strong returns are (crucially) sustainable.

Identifying companies with sustainably strong earnings is the key. It involves fully understanding companies and their operations, knowing where the company sits within its industry - its competitive position, sources of growth and financial soundness. Above all, assessing the quality of management is essential, the priority being to identify business leaders who see the company's full potential and look to maximise shareholder returns. It is precisely these factors that the team's disciplined investment process is built to examine.

Nomura's in-house research[1] has confirmed what many investors intuitively believe; that even highly concentrated funds are not significantly more risky than diversified funds but offer the chance of significantly better than average investment returns. This strategy therefore typically holds 25-40 stocks in order to maximise the impact of the team's proven stock-picking ability. It is managed by Chief Portfolio Manager Shintaro Harada and has delivered top quartile performance since its launch over five years ago. Moreover, it is encouraging to note that this strong performance has not been interrupted by recent bouts of market volatility.

[1]Source: 'Stock Count and the Balance of Risk' by Nomura Asset Management U.K. Ltd.

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