FLASH

Japan at a crossroads

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For professional investors only

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- BOJ, GPIF policy changes to accelerate long-term structural improvement in Japan's corporate sector
- Greater focus on RoE to prompt companies to use cash
- Delay in sales tax hike should encourage spending by indviduals and investment by companies

Japanese shares have held near a six-year high after Prime Minister Shinzo Abe called a snap general election and delayed a sales tax hike. The market has rallied significantly in the past two weeks after the Bank of Japan expanded its monetary stimulus programme and the GPIF public pension fund announced a bigger-than-expected reallocation of funds from bonds to domestic stocks. Sam Perry, senior investment manager of Japanese equities, explains how the latest policy developments will accelerate efforts to improve the corporate governance of Japanese firms and spur them to spend the cash they have accumulated over the past two decades.

We think the latest policy moves, especially those of the BOJ and GPIF will help speed up structural changes that have begun to take root in corporate Japan over the last couple of years.

For more than two decades, Japanese firms have been paying down debt and hoarding cash, a process that was intrinsically deflationary.

But over the past several years, their cash hoarding has stopped and there is growing evidence that some of them have started to put their cash piles to work.[1] Net cash levels among Japanese companies are starting to decline gradually after peaking at 30 per cent of gross domestic product in 2012.

One of the drivers for this change in behaviour is the renewed push led by Abe to improve return on equity (RoE) in Japan. The RoE among Japanese companies in the TOPIX index stands at 8.4 per cent, only just over half that of firms in the S&P 500 index.

RoE, which measures the ratio of net income to shareholders' equity, is affected by three elements – profit margin, asset turnover and financial leverage.[2] While margins have improved and asset turnover remains strong, corporate Japan's very low or non-existent leverage helps explain much of the RoE gap.

RoE and culture change

Efforts to address this problem are accelerating, especially after the launch earlier this year of an innovative stock index that seeks to use market forces to raise the standard of corporate governance.

In existence since January, the JPX-Nikkei index 400 selects companies that score highly on governance, using fundamental inclusion criteria such as cumulative operating profits and RoE.

This index has been endorsed by some of Japan's most influential institutions.

Both the BOJ and the GPIF have got behind the index. The central bank announced that exchange-traded funds that track the JPX-Nikkei 400 would form part of its vastly expanded ETF purchase programme.

The GPIF has also adopted it as a benchmark for some of its domestic equity portfolios. We expect similar moves by other public and private pension funds as domestic investors place a higher premium on RoE.

We expect to see a growing number of companies respond positively to such changes: the promise of a place in Japan's premier equity benchmark is sure to encourage them to spend cash and improve efficiency.

[1] See "Embrace changes at Japan Inc", Pictet Asset Management, August 2014
[2] DuPont analysis that states that RoE equals profit margin * asset turnover * financial leverage

Metal processing company Amada, left out of the new index at launch, pledged to pay out all of its net profits of the fiscal year 2013 back to shareholders – by giving half of them in dividends and using the other half to buy back stock. The 68-year-old firm now targets RoE of 7 per cent, almost double the current level.

Fujikura, a manufacturer of wires and cables also excluded from the JPX-Nikkei, plans to spend JPY5 billion buying back 3 per cent of its shares. Kazuhito Iijima, the firm's finance manager, said: "We have too many shares outstanding. We want to move towards debt financing."

Adding further momentum to this trend is influential proxy advisory firm Institutional Shareholder Services, which plans to include scrutiny of firms' RoE in its voting guidelines for Japan next year.

Together, such efforts promise to bring an end to Japan's poor record on corporate governance. No longer will Japanese executives, for so long cushioned by a cosy web of cross shareholdings, be able to put their interests above those of the shareholders they are supposed to serve.

In this new era, they have to put cash to work, improve corporate governance and maximise value for shareholders.

GPIF equity flows

There are other ways in which the GPIF will prove to be an agent of change in corporate Japan.

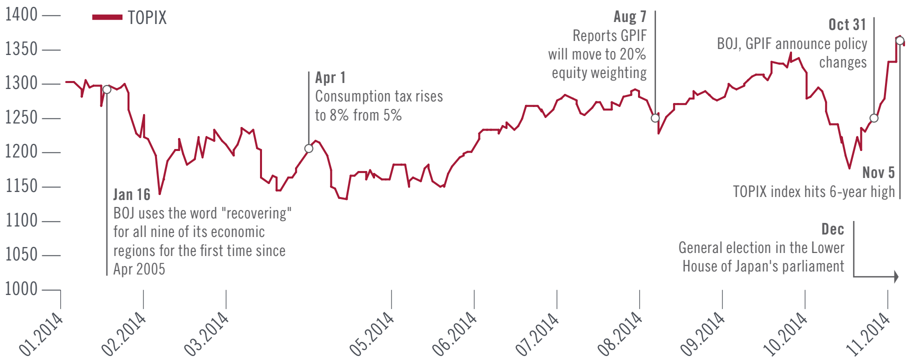
The JPY130 trillion (USD1.1 trillion) fund's new asset allocation strategy is likely to become an enduring source of demand for Japanese equities.

The fund's decision to increase its allocation to domestic equities to 25 per cent (plus or minus 9 per cent) from a current central target of 12 per cent (plus or minus 6 per cent) suggests it will need to buy an additional JPY10 trillion of Japanese stocks. To hit its upper target limit, purchases would need to rise to JPY21 trillion – about double its current holdings[3].

While no timeframe has been set for the portfolio rebalance, we can put these numbers in perspective: during the TOPIX rally of 2013, when the index gained 51 per cent, the overwhelming incremental demand was from foreign investors, who bought JPY16 trillion of Japanese equities through the year.

We expect other public pension funds[4] which collectively manage assets of around JPY30 trillion and still have a very light weighting towards domestic equities are also likely to follow the GPIF's lead.

FIGURE 1 - JAPANESE SHARES AND KEY 2014 EVENTS



Source: Thomson Reuters Datastream, Pictet Asset Management

[3] All figures reported end of June 2014, GPIF Investment Results for the First Quarter of Fiscal 2014 (revised)

[4] Federation of National Public Service Personnel Mutual Aid Associations, Pension Fund, Association for Local Government Officials, and Promotion and Mutual Aid Corporation for Private Schools of Japan

JAPANESE EQUITY INVESTING AT PICTET ASSET MANAGEMENT

- **Pictet-Japan Equity Selection** is a concentrated long-only fund that typically holds just 50 to 60 stocks
- **Pictet-Japanese Equities Opportunities** can take both long and short positions; it also has greater exposure to small-cap stocks
- Both strategies invest on a company-by-company basis – a rewarding approach in an asset class in which 58 per cent of stocks are covered by just two or fewer sell-side analysts

Staying focused on cash

Those bearish on Japanese stocks may argue that such moves count for nothing if the economy remains weak. Indeed, the economy unexpectedly shrank 1.6 per cent in the third quarter on an annualised basis, hit by the negative economic impact of the sales tax hike to 8 per cent in April.

However, there are signs that suggest growth might soon pick up.

Consumer spending has been holding up outside of big-ticket items such as TVs. Another encouraging sign is a tightening labour market. While wage increases for permanent employees are emerging only gradually, amongst temporary workers, whose wage rates are typically more sensitive to demand, wage inflation has picked up strongly since last year, reaching an annual growth rate of 3.5 per cent.[5]

This, along with the BOJ's expanded QE programme, should help Japan reach its underlying inflation target of 2 per cent, which should in turn encourage domestic investors rotate into risk assets such as equities away from government bonds.

The delay in the second sales tax hike until April 2017 is also positive, in our view, as it should encourage spending by individuals and investment by companies.

The upcoming general election may also clear political uncertainty. Polls show Abe's ruling coalition is likely to win a majority in the face of a fragmented opposition. A fresh four-year mandate would give the prime minister the backing he needs to implement the remainder of his structural reform agenda.

But whatever Abe manages to do, investors should remain focused on the cash.

As rising inflation turns cash from a defensive asset to a wasting asset, companies will begin to normalise their balance sheets and invest their vast cash piles. We will then naturally see an increase in the RoEs of corporate Japan and with it, a closing of the valuation gap that exists between Japan's stock market and that of its international peers.

[5] SMBC Nikko Securities/Recruit Holdings, January

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