Making up for lost time

Why Japan has risen like a phoenix to deliver eye-catching returns for investors...

Update
28 February 2024

Analysts:
Jo Groves
Jo@keplerpartners.com

If I had a pound for every article referencing the lost decades in Japan, I'd probably be reclining on a superyacht in Antibes rather than labouring away under the grey skies of London. That said, it's hardly surprising that investors have eschewed Japan after three decades of stagnant economic growth and disappointing returns. But the tide has turned with the TOPIX (the all-share benchmark index for Japanese equities) rewarding investors with total returns of more than 20% last year. It's also started 2024 with a bang, adding a further 6% in the year-to-date (as at 26/02/2024).

Japan has long been dogged by a general perception of being the slightly staid and conservative uncle to the dynamic tech kids on the other side of the Pacific. There's undoubtedly some truth in differing cultural attitudes but the numbers reveal a different story entirely. According to Yardeni, the annual forecast earnings growth for the MSCI Japan Index was 11% in 2023, far higher than the 2% growth for the MSCI US Index and 4% for the S&P 500.

But, as we know, investing is about looking forward, not in the rear-view mirror, so what does Japan have to offer investors? Let's get the obvious selling points out of the way first: Japan is the third-largest global economy and a leading exporter to Asia and beyond, with a stock market jam-packed with global powerhouses such as Panasonic, Toyota, Sony and Nintendo. The government is also investing billions to re-establish Japan as a leading semiconductor manufacturing base in Asia. Put another way, Japan could be a potential proxy play on China without the associated geopolitical risks.

On the flip side, Japan is undoubtedly a laggard on the corporate governance front, with legacy issues including cross-shareholdings and a lack of diversity on boards. The fear of failure and 'shame culture' endemic in Japanese society have also hampered entrepreneurship, together with risk-aversion to raising debt to fund growth. This has led to a historic hoarding of cash, with Schroders reporting that an estimated 50% of Japanese companies are in a net cash position.

However, a suite of corporate reforms could provide the catalyst to unlocking the latent value in Japanese equities. My colleague wrote in a recent note: "In our view, this is a genuine cultural revolution underway, akin to something like the Thatcherite reforms in the 1980s, which have the potential to completely change how Japan is viewed by overseas investors."

One such initiative has been introduced by the Tokyo Stock Exchange (TSE), which is requiring listed companies to improve their capital efficiency, either by re-investing surplus cash or returning it to shareholders. Indeed, companies trading on a price-to-book ratio of less than one (in layman's terms, when net assets exceed market cap) face an ultimatum of being delisted from the TSE as early as 2026. This has prompted a record high in share buybacks and the adoption of more generous dividend policies.

Despite the recent upturn, Japanese equity valuations remain some way below their counterparts, with the MSCI Japan trading on a forward price-earnings ratio of 15, compared to 18 and 20 for the MSCI World and US indices respectively (as at 31/01/2024). Large-caps have also fuelled the lion's share of the rally in Japanese equities, leaving Japanese small-caps trading on subdued valuations.

A relative lack of analyst coverage may also create opportunities to uncover pockets of value: on average, there are 25 analysts covering S&P 500 companies, compared to just 13 for Japanese stocks, according to S&P Global. Although that may be about to change with investor interest piqued by Warren Buffet upping Berkshire Hathaway's stake in five Japanese companies last year.

Investors looking to increase their exposure to Japan may want to consider a broad-based Japanese fund rather than investing in individual companies. Japan is a sector which benefits from active management, with 'boots on the ground' specialists who can get under the bonnet of company boards and apply pressure where needed: as my colleague David recently **noted**, some fund managers hold upwards of 1,000 company meetings a year. Added to this, many UK trading platforms offer a limited number of Japanese equities, and often only via American Depository Receipts (ADRs) which carry additional exchange rate risk.

Schroder Japan (SJG) is one such example of active management, with manager Masaki Taketsume drawing on the resources of a dedicated 12-strong team of equity analysts in Tokyo, including three small-cap specialists. This helps to narrow down the potential universe of 3,000 companies and the collective team makes around 2,500 contacts with Japanese companies every year. Masaki has extensive experience of almost 30 years investing in Japanese equities and builds strong relationships with the management teams of portfolio companies.

The trust has the flexibility to invest in the best ideas across the market cap and sector spectrum, and, unlike many of its peers, typically has a value rather than growth tilt. Masaki targets high quality, undervalued companies with the potential for a turnaround, or where the long-term growth prospects are not reflected in the current valuation.

This approach has paid off, with SJG delivering a top-quartile five-year net asset total return of 47%, comfortably in excess of the 37% for the AIC Japan sector (as at 23/02/2024). It's also outperformed over the last year, with a one-year NAV return of 21% compared to 13% for the sector. Its current discount of c. 9% (as at 23/02/2024) may also provide a further kicker to returns if the discount narrows.

Alternatively, **AVI Japan Opportunity Trust (AJOT)** focuses exclusively on over-capitalised small-cap Japanese equities and takes an activist approach to encourage management to improve capital efficiency and address broader operational and strategic issues.

In the last five years, it has launched 10 public (and many private) campaigns, submitted over a hundred letters to boards and held almost 500 meetings. These aim to raise awareness of issues weighing on company valuations and encourage other shareholders to apply pressure on management teams.

The team identifies companies with cash-rich balance sheets and holds a fairly concentrated portfolio of around 15 to 25 core holdings, with a minimum initial position of 2% to enable close monitoring. AJOT has delivered the highest five-year returns in the (albeit small) AIC Japan Smaller Companies sector, with a NAV total return of 35% (as at 23/02/2024).

Looking ahead, one possible cloud on the horizon is the weakness of the Yen, with the 25% fall against the US dollar and the pound over the last five years eroding returns for overseas investors. That said, corporate reforms and the shift from a deflationary to inflationary environment should support the longer-term outlook for Japanese equities, or in the words of the famous Japanese proverb, "Fall seven times and stand up eight".

Disclaimer

Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that if you are a private investor independent financial advice should be taken before making any investment or financial decision.

Kepler Partners is not authorised to make recommendations to retail clients. This report has been issued by Kepler Partners LLP, is based on factual information only, is solely for information purposes only and any views contained in it must not be construed as investment or tax advice or a recommendation to buy, sell or take any action in relation to any investment.

The information provided on this website is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. In particular, this website is exclusively for non-US Persons. Persons who access this information are required to inform themselves and to comply with any such restrictions.

The information contained in this website is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules. A copy of the firm's Conflict of Interest policy is available on request.

PLEASE SEE ALSO OUR TERMS AND CONDITIONS

Kepler Partners LLP is authorised and regulated by the Financial Conduct Authority (FRN 480590), registered in England and Wales at 70 Conduit Street, London W1S 2GF with registered number OC334771.