

## Market Insight: Japanese Equities

Tokio Marine Asset Management (London) Limited  
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### Which to favour: large cap or small cap investment in Japan?



*An improving economy and trade war worries should favour domestic-oriented small caps but it's large caps which have come out on top so far this year.*

After an impressive showing last year, small cap stocks in Japan have lagged their large cap counterparts so far this year. This is perhaps not surprising considering their strong relative outperformance for the past several years had led to valuations becoming somewhat stretched. At the same time, however, this may seem counterintuitive given their more domestic-oriented business focus should benefit from an improving economy at home and provide greater protection from the ongoing trade dispute between the US and China.

So, what are the factors which could explain this paradox?

One major factor cited for the disparity in performance this year has been continued yen weakness. Despite a period earlier this year when the yen-dollar rate appreciated sharply, the currency has ranged at a healthy level for the more export-driven large cap stocks in Japan to make profit. In addition to this, Trump's protectionist stance has had the effect of bringing Japan and its Asian neighbours, particularly China, closer together in terms of cooperation and trade.

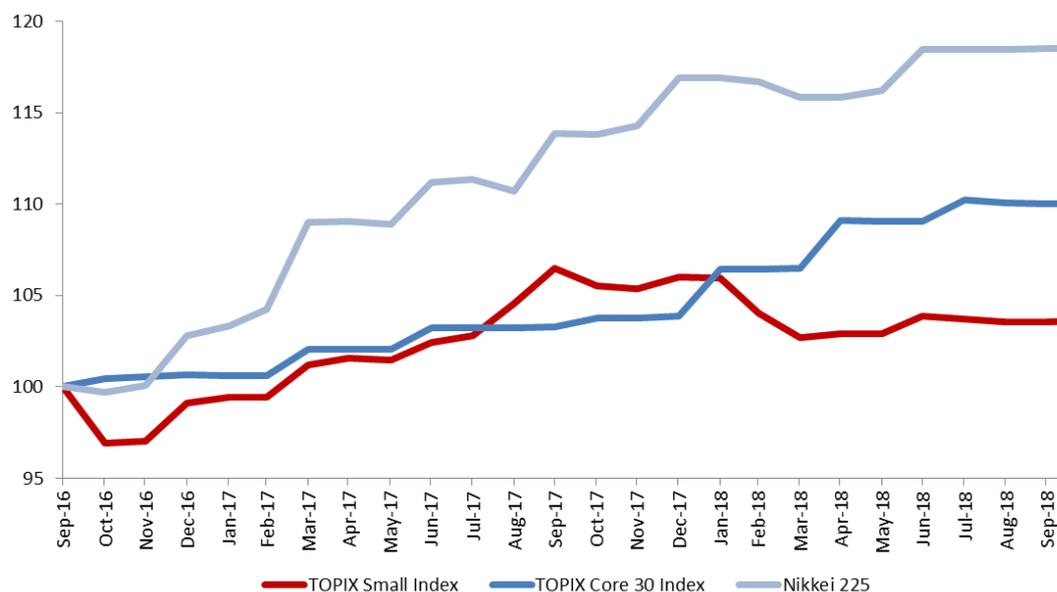
A second aspect to consider is rising cost pressure domestically. With the population greying rapidly and unemployment at historical lows, wage hikes for part-time workers especially are accelerating. The cost of services such as logistics is also on the rise. In a well-publicised move last year, Japan's largest delivery company, Yamato Logistics, raised its parcel delivery rates for the first time in over two decades.

This upward cost pressure presents a headache for corporates. Fearful of margins being eroded, they have embarked on a series of cost cutting measures. While this may be limited in scope due to scale for small caps, these measures have been quite effective for larger companies. A good example this year would be Toyota, which posted record results in May despite uncertain market conditions for auto makers.

These factors, along with a stronger global economy, have helped large caps to improve their margins steadily at a greater rate than small caps over the past 12 months.

### Relative Change in 12-Month Trailing Operating Profit Margin

(30/09/2016 = 100)



Source: Bloomberg, compiled by TMAM

Finally, not all small cap companies are totally immune from external events either. Some belong to a vertically integrated 'keiretsu' or business group, and as a lower ranked member of the group, may be susceptible to pricing pressure from a strong parent company should trading conditions worsen.

Small manufacturers may also have production quotas determined by these owner companies which are below their full capacity. Others may have undiversifiable foreign exposure as downstream suppliers who have invested in localised operations over the past 20 years.

Of course, that is not to say that there are no attractive opportunities in the small cap space in Japan. As is often mentioned, research coverage by sell-side analysts can be sparse, which can present greater chances to find mispriced companies. And while large caps have

on the whole managed to improve profitability through cost reduction, there is a limit to how far this can go.

That is why we believe that taking an active approach, whether it be for large cap or for small cap stocks, particularly in the current market environment is as important as ever in Japan. Tokio Marine Asset Management is a Japanese equity specialist with over 30 years' market experience and approx. \$60bn AUM (as of September-end 2018). As a Tokyo-based investment manager, we feel ideally placed to pick winning stocks and help successfully navigate our clients through this ever-changing investment landscape.

For more information about uncovering investment opportunities in Japanese Equity, please contact Business Development, Tokio Marine Asset Management (London) Limited authorised and regulated by the Financial Conduct Authority (FRN 487699).

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