Market Insight: Japanese Equities

Tokio Marine Asset Management (London) Ltd
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Hiroyasu Sato: It's time to focus on Japanese company fundamentals again

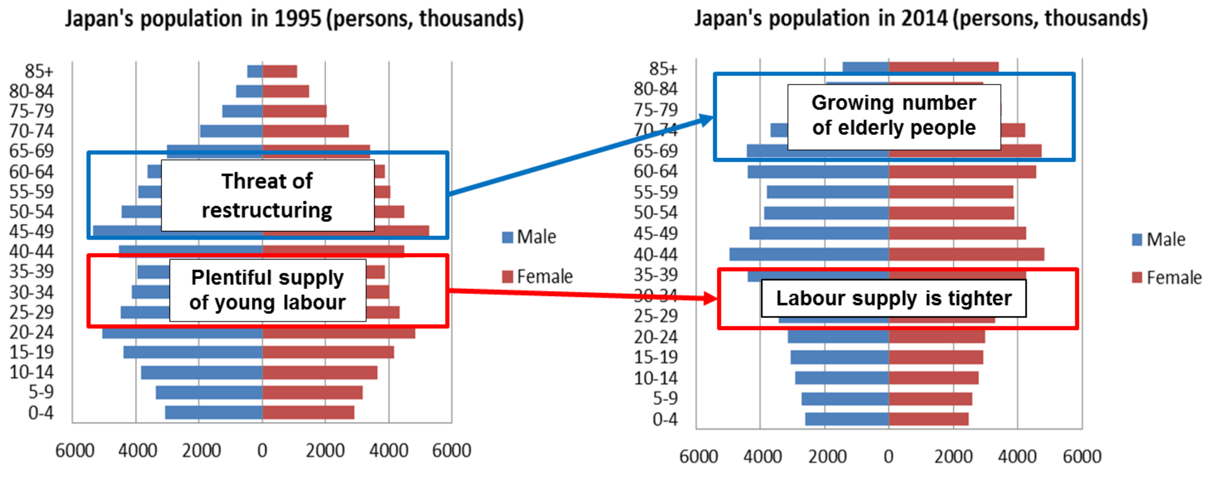
Hiroyasu Sato, Chief Portfolio Manager of the Tokio Marine Japanese Equity Focus Strategy, believes that it's now time to concentrate on how some companies are benefitting from structural changes rather than just focusing on headline macro policy.

Abenomics has garnered much interest in Japan and Japanese equities from overseas investors in the last couple of years. While many made quick gains from the BoJ-inspired rally in 2013 – Japanese equities gained nearly 55% and were one of the best performing asset classes that year – the structural changes taking place behind the scenes even before Abe took office are often neglected. These changes are taking place both on a societal and corporate level, and understanding them could be key to making the best investment decisions.

Japan has been stuck in a 20-year deflationary spiral but this is slowly changing. In fact, we believe the shift back towards inflation had begun before 2012. In our view, Abenomics simply provided a timely boost to the underlying changes that have been taking place over the last two decades, as outlined below.

Changing demographics

Japanese society is ageing rapidly and the first baby boomer generation is now enjoying their current 'retiree' status, the majority of who receive generous company and state pensions. At the same time, wage hikes from a tighter labour market due to the lack of young workers are slowly reversing the downward deflationary pressure from 20 years ago, a time when corporate restructuring left many fearing for their jobs and there was a plentiful supply of young labour. Both these factors are helping to support Japan's return to inflation.



Source: OECD

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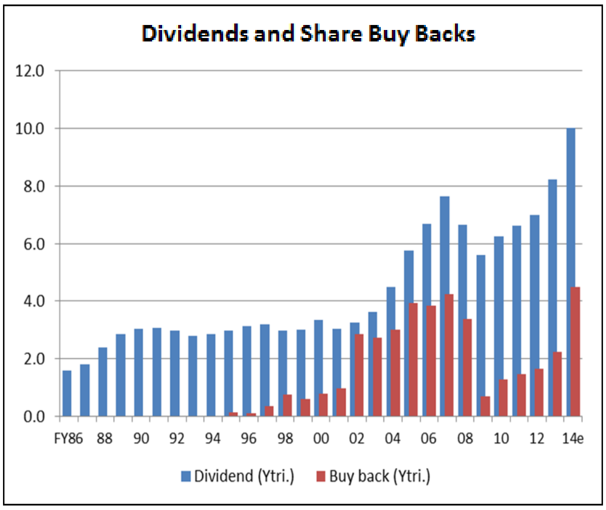
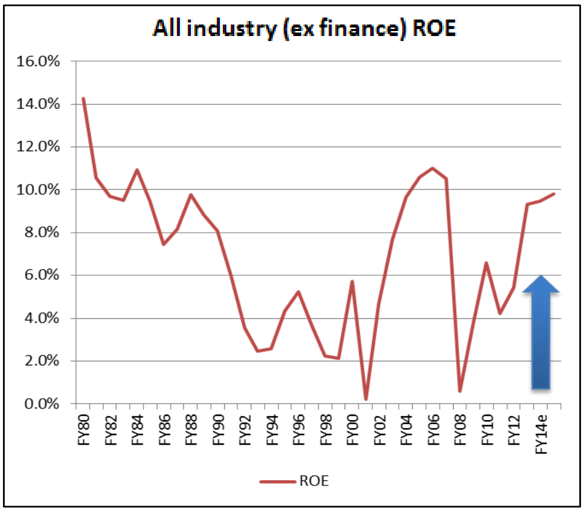
Shift in corporate mindset

The knock-on effect of a return to inflation is that companies are having to change their business mentality. While hoarding cash and cutting costs may have worked during the deflationary era, they apply less now. Companies are being encouraged to deploy accumulated cash and they are doing so – as shown by record dividends and share buy-backs. Of course, the Abe government has been supporting this change by backing the implementation of an ROE-linked index (JPX-Nikkei 400) and the Japanese version of the Stewardship Code last year and the Corporate Governance Code proposed for 2015.



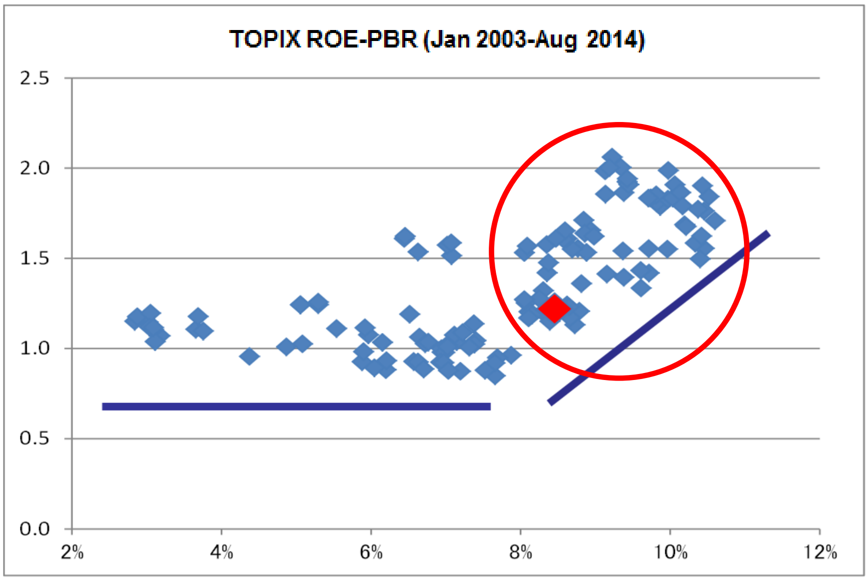
Source: Bloomberg



Based on Russell/Nomura Large Cap Index (ex Financials)

Return to fundamentals

This 'new normal' where ROE is greater than 8% – it's expected to be 9.8% in 2015[1] – is in our view leading to the 'normalisation' of the stock market, where fundamentals such as earnings growth, are reflected rationally.



Source: Bloomberg

As a local manager, we are beginning to see first-hand a growing dispersion between 'winner' and 'loser' companies. Coupled with the lessening impact of the Abe government/BoJ's macro policy, we believe that focusing on company specific performance will be the key to making the best possible returns in Japan in 2015.

Focusing on 'winners'

Making use of our on-the-ground bottom-up fundamental research and high-touch corporate contact, we are able to quickly identify and capture inflection points, such as changes in a company's strategy or restructuring, which have the potential to lead to earnings growth. In fact, we have identified two themes which we expect will strengthen the growth drivers of certain companies.

New breed of exporters: When one thinks of Japanese exporters, carmakers such as Toyota or Honda, or electronics giants such as Sony and Panasonic, usually spring to mind. However, we have been closely following companies that have traditionally been domestic-oriented but are now transforming themselves into a new breed of exporters. These companies are making inroads into the lucrative Asian market, where incomes have been steadily rising.

[1] Average ROE for Russell/Nomura Large Caps excluding financials

Company consolidation: In the past, many large Japanese companies competed with each other in overseas markets but now most have scaled back sales operations abroad. For example, only a few Japanese companies remain in the consumer electronics industry in Europe today. These companies now have to compete with cheaper and more competitive makers such as Samsung and LG, forcing them to streamline operations and become more efficient.

Japan is still attractive

In our view, Japan still has plenty to offer in terms of attractive investment opportunities. As discussed above, there are some companies that can take advantage of Japan's structural changes and transform themselves, regardless of the overall macroeconomic picture. Our key messages to investors would be:

1. Don't just rely on headline macro events

- Impact of Abe government/BoJ's macro policy will lessen as investors become more accustomed to interventions.

2. Look more closely at company specific performance

- Dispersion between winning and losing companies will widen further as the stock market begins to 'normalise.'

3. Focus on 'winners'

- Select thoroughly researched stocks based on strong company fundamentals, such as high earnings growth potential.

● Tokio Marine Asset Management is a Japan/Asia equity specialist with 30 years' market experience and approx. $54bn AUM. The Focus strategy is a concentrated portfolio of 20-40 high conviction stocks using the best investment ideas of today.

If you have any queries regarding the above or should you wish to discuss Japanese equities with us, please do not hesitate to contact Business Development at Tokio Marine Asset Management (London) Ltd.

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