Market Insight: Japanese Equities

Tokio Marine Asset Management (London) Ltd.
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Another dynamism behind Abenomics: Improving corporate governance and shareholder returns

Akiyoshi Oba, President and CEO of Tokio Marine Asset Management, shares his views on new developments that should improve corporate governance and shareholder returns in Japan, and may in turn contribute to raising stock prices.

Mr Oba, one of the leading figures in the Japanese asset management industry, is a member of the 'Council of Experts Concerning the Japanese Version of the Stewardship Code' and is part of the team behind the 'Ito Review' of the 'Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors,' a project launched by the Japanese Ministry of Trade and Industry (METI) in 2013.

Four key changes

In our view, the Japanese stock market finally turned the corner after Prime Minister Abe took office. We have witnessed some positive changes and believe the outlook is compelling.

These changes should have an impact on how Japanese companies are run and on their return on equity (ROE), which has been notoriously low for a number of years. (Average ROE among Japanese companies is roughly 5 percent compared to over 15 percent in the United States.[1])

We've highlighted four initiatives that the Japanese government has taken to address the situation. These are:

1. Introduction of Japanese Stewardship Code
2. Reform of Government Pension Investment Fund (GPIF)
3. Further Improvement of Corporate Governance: 'Ito Review'

[1] Source: Bloomberg

4. Promotion of new JPX-Nikkei Index 400 (JPX400)

We believe that these topics will be very interesting for the market looking ahead.

1. Introduction of Japanese Stewardship Code

The code, inspired by a similar set of guidelines in the UK and completed in February, is part of the Abe administration's 'Revitalisation Strategy' to tackle deflation and encourage economic growth. It is designed to promote medium- to long-term sustainable corporate returns, transparency and corporate governance. It will encourage Japanese asset managers and asset owners, some of whom have tended to be somewhat silent in the past, to engage more with companies in which they hold equity on behalf of their clients.

By the end of May, 127 institutional investors had notified the Financial Services Agency (FSA), the agency overseeing implementation of the code, of their intention to accept the code. Among them was Tokio Marine Asset Management, further confirming our commitment to maximise medium-term investor return on behalf of our clients.

2. Reform of Government Pension Investment Fund (GPIF)

The GPIF is the world's largest pension fund, managing $1.26 trillion of funds, with $217 billion invested in domestic equities alone. It has also accepted the above mentioned Stewardship Code, meaning that asset managers working on their behalf will have to take a more active role in the governance of companies in which they hold equity.

The Abe government has recently urged the fund to diversify its portfolio from predominantly domestic bonds, which account for approximately 60% of its assets, to domestic stocks. This shift would take it closer to the investment models used by Western countries, which generally hold a higher proportion of their assets in equities.

Especially in the GPIF's case, diversifying its asset allocation should reduce risks associated with the change from a deflationary situation to an inflationary one. (Namely, keeping a high proportion of extremely low nominal yield bonds in an inflationary situation can be very high risk.)

3. Further Improvement of Corporate Governance: 'Ito Review'

Taking a lead from the 'Kay Review' of UK equity markets and long-term decision making, the Ministry of Technology, Trade and Industry launched a new project[2] in the summer of 2013 to deepen engagement between companies and investors. It aims to tackle a variety of issues, including factors that inhibit management from enhancing long-term value creation, overcoming short-termism in business and promoting investor engagement with companies.

The project team, chaired by Kunio Ito of Hitotsubashi University, is comprised of board members and top executives of leading companies (including Mr Oba himself) as well as long-term investors. Its ultimate purpose is to encourage Japanese corporations to deploy capital more efficiently, which accumulated as a cash pile during the deflationary period. The final report of its findings, which will be known as the 'Ito Review,' is due for release this summer and its recommendations will assist companies pursue long-term value creation and sustainable growth.

4. Promotion of new JPX-Nikkei Index 400 (JPX400)

This new index, introduced in January, is composed of companies which meet the requirements of global investment standards, such as efficient use of capital and investor-focused management perspectives. Prime Minister Abe had pushed for the creation of this new index in the hope that it will make Japanese shares more attractive to both domestic and foreign investors and to help reinvigorate the economy.

It is designed to encourage companies to improve shareholder return, as those which fail to do so will be forced out and replaced by companies that outperform them. This system of reward and punishment is already showing some early signs of success.

Japanese manufacturers Amada (TYO:6113) and Fujikura (TYO:5803), both listed on the Nikkei 225 but not included in the JPX400 Index, recently took action to boost returns to shareholders. (Amada more than tripled its dividend and said it would seek a payout ratio of 50 percent in future, while Fujikura announced a share buyback.) Their share price rose 30 percent and over 10 percent since its announcement respectively for their efforts. It is said that being listed on the JPX400 Index was their main motivation for these actions.

In fact, the JPX400 Index has outperformed both the Nikkei 225 and Topix since January, advancing around 3. 2 percent, compared with 1.2 and 2.7 percent gains for

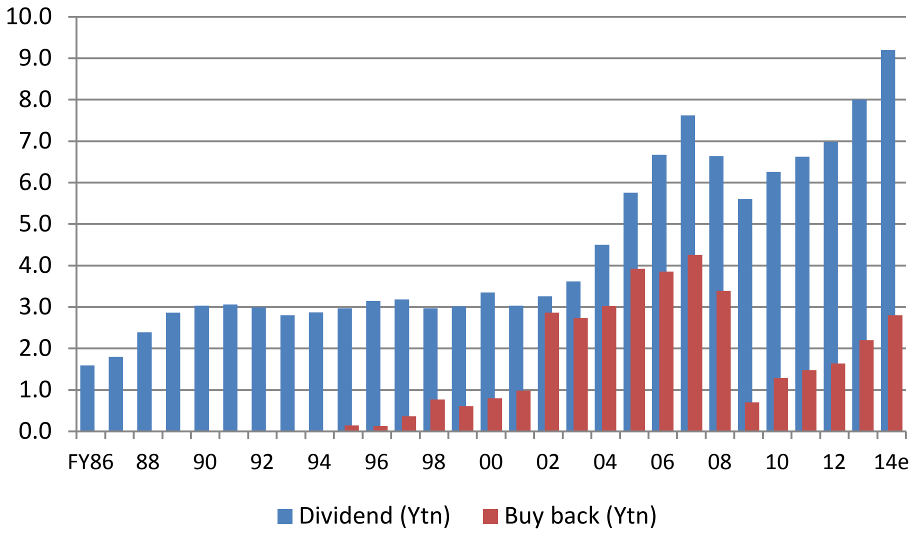
[2] Project entitled, 'Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors'

the Nikkei 225 and Topix respectively (as at 27 June 2014).

Looking ahead

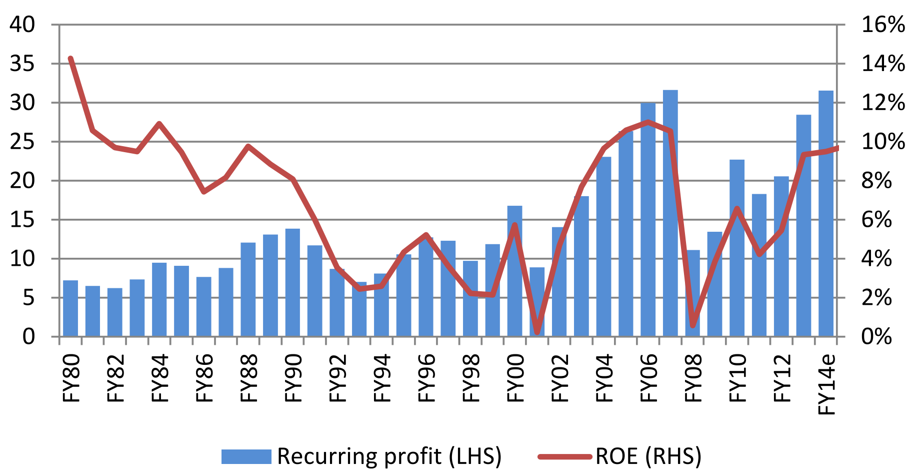
Although it is too early to judge its full impact, the initial signs are that the government's measures are having the desired effect. Japanese listed companies are stepping up share buybacks, with the buyback announced by companies and the expected buyback amount in total reportedly exceeding $27 billion this year, the longest run it has had since November 2008. Companies are also paying close to record-high returns (including dividends) to shareholders, as shown below.

Changes in management attitudes to ROE:



Source: TMA

As a result of all these changes, we expect more than 30% of public companies will break their earnings record.



Source: FactSet

This is not the case for all companies, however, as management attitudes vary across different businesses. For investors, switching from a top-down or beta investment strategy to a bottom-up, alpha-seeking strategy will be crucial to achieve competitive returns from the Japanese stock market.

Last year saw a peak in net cash inflow from foreign investors, especially cash inflow from macro oriented investors. Although this subsequently turned into a net outflow earlier this year, we are seeing cash inflows slowly starting to return. We believe that this indicates a return to a medium-term, bottom-up investment strategy by investors.

In our view, these developments offer attractive opportunities for Japanese equities.

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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