Is Japan on the road to recovery?

Good companies can thrive regardless

A falling population, enormous government debt, low to no growth, persistent deflation; this is not most people's idea of the recipe for attractive investment returns. While they disagree on the impact of government efforts to kick-start the economy, the investment managers of investment companies specialising in Japan believe many Japanese companies can thrive regardless.

Figure 1: Large Cap. Japanese Investment Companies

	(Disc.) Premium (%)	Market Cap £m	Div. Yield (%)	Ongoing Charge (%)
Aberdeen Japan	(7.7)	75	0.9	1.38
Baillie Gifford Japan	0.7	327	-	0.89
JPMorgan Japanese	(10.3)	479	0.9	0.78
Schroder Japan Growth	(9.1)	194	1.2	1.37

Source: QuotedData website based on data from Morningstar

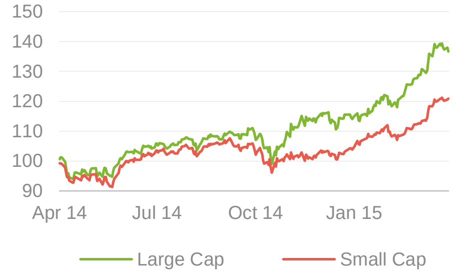
Figure 2: Small Cap. Japanese Investment Companies

	(Disc) Premium (%)	Market Cap £m	Div. Yield (%)	Ongoing Charge (%)
Atlantis Japan Growth	(8.6)	57	-	1.97
B. Gifford Shin Nippon	(4.2)	142	-	1.24
Fidelity Jap. Values	(12.5))	96	-	1.80
JPMorgan Japan Small	(9.9)	118	-	1.59
Prospect Japan	(16.0)	96	-	2.27

Source: QuotedData website based on data from Morningstar

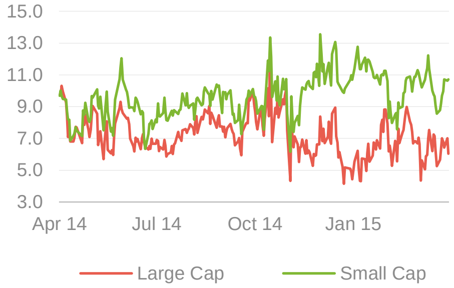
Sector average NAV perf.

Time period 1/04/2014 to 31/03/2015



Sector average discount

Time period 1/04/2014 to 31/03/2015



More information about the funds mentioned in this report is available on our website. If you are reading this online, just click on the name of the fund in the table on the left to go straight to the relevant webpage.

Individual Fund Performance

Below is a table showing all the London listed closed-end funds dedicated to Japan. This data is taken from the QuotedData website which is updated daily using a feed from Morningstar. These figures are as at end March 2015.

Figure 3: Japanese funds investing in larger companies. NAV performance, figures over 1 year are annualised

Heading	3 months	1 year	3 years	5 years	10 years
Aberdeen Japan	18.4	47.2	n/a	n/a	n/a
Baillie Gifford Japan	20.2	36.5	26.2	16.1	9.8
JPMorgan Japanese	21.1	35.7	19.7	10.5	4.6
Schroder Japan	16.6	33.0	16.6	10.6	6.4
Investment Company sector avg.	19.1	38.1	20.8	12.4	6.9
IA sector average	n/a	24.5	12.2	6.7	n/a

Source: QuotedData website based on data from Morningstar

Figure 4: Japanese funds investing in smaller companies. NAV performance, figures over 1 year are annualised

Heading	3 months	1 year	3 years	5 years	10 years
Atlantis Japan	14.8	23.7	17.8	12.4	3.3
Baillie Gifford Shin Nippon	20.4	31.9	27.4	19.7	8.3
Fidelity Japanese Values	17.3	23.9	14.3	8.5	2.1
JPMorgan Japan Smaller Co.s	16.0	30.9	19.3	8.8	1.1
Prospect Japan	6.2	-9.5	8.2	9.9	-3.5
Investment Company sector avg.	14.9	20.2	17.4	11.9	2.3
IA sector average	n/a	25.4	17.6	11.8	n/a

Source: QuotedData website based on data from Morningstar

A bit about the sector

Japan is the world's third largest economy but, with a collective market capitalisation of just £1.5bn, the Japanese investment company sector doesn't reflect that. The problem has been that investors lost faith with the country after decades of disappointing performance; just how disappointing is reflected in the 10 year numbers in figures 3 and 4 above. However the election of Shinzo Abe late in 2012 changed all that. The stock market has been marching upwards since then and has been particularly strong over the past year as is reflected in the performance numbers above. The excitement was high enough that, in October 2013, Aberdeen relaunched its Asia including Japan fund as pure play on the Japanese market. Shareholders in this fund were rewarded with impressive NAV growth last year but, so far in 2015, Aberdeen Japan has been lagging its peer group.

Baillie Gifford Japan is now the only fund in the sector trading at a premium. It has been trading around asset value for two years now and has been taking advantage of this by issuing shares to meet demand – adding about £40m to its market cap. This is fund is one of the largest in the sector. These funds have the lowest ongoing expense ratios (see figures 1 and 2) as fixed running costs are spread over a wider pool of assets.

Japanese investment companies outperform equivalent open-ended funds

Generally the investment companies investing in Japan outperform their open-ended competitors as you can see in figures 3 and 4 above. For the large cap. funds, that outperformance is decisive with all the funds outperforming the average open-ended fund. Were it not for Prospect Japan, the smaller companies funds would have done even better though these funds came under some pressure last year as, globally, investors took money out of that area of the market. We think the reason is that the managers of the investment companies are free to take a long-term view.

Investor sentiment driven by success or failure of "Abenomics"

Investors already holding Japanese funds will be counting their gains and wondering whether they should cash in their investment. Those who dismissed the Japan recovery story will be wondering if they have missed the boat. Though we argue below that there are plenty of companies that can grow regardless of the economic environment, investor sentiment will likely depend on the success of "Abenomics", a set of economic policies implemented by Shinzo Abe after his election. The measures include using quantitative easing to lower long-term borrowing costs for companies, weakening the yen (to make Japanese exports more competitive in world markets), discouraging the hoarding of cash, increasing government spending and targeting inflation of 2%. One recent idea, which we like and could have a long-term positive effect on the stock market, is to divert government pension funds into a new index of stocks selected for their corporate governance, profitability and return on equity as much for their size.

Is "Abenomics" working?

Short answer – the jury is out. For a while things seemed to be going in the right direction but one problem with the plan was that it was exacerbating an existing problem of excessive government debt. To shore up its revenues, the government increased consumption taxes (akin to VAT) from 5% to 8% in the middle of 2014. This had a big negative effect on consumer spending however and the economy shrank. Though, by the fourth quarter of the year, growth was back, at an annualised rate of 2.2%. Another consumption tax hike was planned for 2015 (to 10%) but Shinzo Abe called a snap election late in 2014 to get a mandate for delaying this and succeeded. He and his coalition partners managed to retain a comfortable majority in parliament.

Ordinary Japanese people want pay rises but cheaper fuel costs do mean they have more money in their pockets.

For Japanese consumers, the problem has been that there has been some inflation but wages have not been rising. The government acknowledges the problem and has been urging companies to award pay rises. Much will depend on the success of this measure. The other potentially significant event of the past few months has been the collapse in oil prices. Japan is a big net importer of oil and oil related products. Its reliance on fuel imports was compounded by the closure of nuclear generating capacity after the Fukishima leak. The falling oil price could be a significant benefit to Japan but it also makes the 2% inflation target harder to achieve.

What do managers think?

Stock market performance is not all about the economy however. Japan has a number of dynamic and innovative companies. We asked some of the leading managers of investment companies focused on Japan about their views on Japan's economy and asked them if they could suggest an example of a stock that could generate growth regardless of the success of Abenomics.

Nicholas Weindling, manager of JPMorgan Japanese Investment Trust, told us…

“Concrete signs of progress”

“A transformation is slowly and steadily taking place in the Japanese corporate sector and investors continue to have high expectations for the third arrow of Abenomics. Whilst regulatory and structural reform to improve the country’s industrial competitiveness still has some way to go, we are certainly beginning to see concrete signs of progress vis-à-vis clear signs of improving corporate governance, healthy earnings growth being delivered by Japanese corporations and an environment of relatively stable political leadership led by Prime Minister Abe underpinned by a commitment to reinvigorating Japan’s economic growth prospects.

JPMorgan Japanese Investment Trust is currently focused on stock specific secular growth themes, including Japan’s ageing population, the increasing use of the internet, factory automation, driverless cars and Japan brand. We’re also focused on signs of improving shareholder returns.

We do not believe a failure of Abenomics would be detrimental to the fund’s performance, as the portfolio does not currently take macro bets. However this would change if, in the unlikely event, a failure of Abenomics derailed Japan’s on-going gradual economic recovery and triggered a market sell-off.

Stock pick - Keyence

Keyence is a growing high-tech company that develops sensors and measuring instruments used for factory automation and other products. Keyence surprised investors in October 2014 by more than tripling its dividend forecast, from JPY60/share to JPY200/share. A more upbeat stance on dividend payments was unexpected because the company has in the past been known for its shareholder unfriendliness, with its founder a firm believer in the “cash is king” mantra, letting cash pile up on the company’s balance sheet. While its pay-out ratio remains relatively low at around 10%, we expect further progress from Keyence on this front, as well as from other cash-rich companies with high growth potential.”

Sarah Whitley, manager of Baillie Gifford, Japan told us….

“We think the Abenomics is a useful back drop to Japan's economy. It will take time to work but the Yen has weakened making Japanese companies more profitable in the export market. His regulatory and legislative reforms will take longer to make an impact and no one can doubt the government's commitment to Quantitative Easing. However over and above all this we at Baillie Gifford are stock pickers at heart so it is really only company prospects and long term potential that matters to us. A company like Rakuten which is a leading ecommerce firm in Japan should thrive despite macro considerations.”

Stock pick - Rakuten

Kwok Chern-Yeh, manager of Aberdeen Japan Trust, told us….

“Abenomics has worked but only in part. It hasn’t been fully realised, with “third arrow” reforms still missing their mark. Whether it will work over the long term remains to be seen. Nevertheless, a re-elected Abe, armed with a fresh mandate, has pledged boldness, even though he has yet to address structural shortcomings. On monetary policy, the Bank of Japan has its work cut out for it, with the falling oil price making its inflation target harder to attain. Further stimulus may be expected in the face of weak demand and anaemic consumer purchasing power. Meanwhile, the benefits of a weak yen and cheap energy have filtered through to only some consumers and companies and as such, the positives may be over-stated. Exporters could also be vulnerable to a deceleration in China and a sputtering US recovery.

Stock picks – Toyota, Japan Tobacco and Unicharm

Some examples of our key holdings include carmaker Toyota, Japan Tobacco and diaper-maker Unicharm. These companies are those that have successfully adapted to Japan's decades-long malaise and should have the necessary wherewithal to navigate any adverse conditions that crop up. As bottom-up investors, we are focused on seeking out world class, nimble, well-funded and forward looking companies. They are usually the conservatively-run industry leaders that have quality management, backed by robust balance sheets and good cash flow."

Shinji Higaki, manager of Fidelity Japanese Values, told us….

No quick fix

"Of the three arrows of Abenomics, the first two – bold monetary policy and flexible fiscal spending – hit the target and supported the market rally in 2013 and 2014. The third arrow of reform in various economic areas is proceeding, but it will inevitably take time to reap the benefits of reforms. Those who expected a dramatic overnight transformation in Japan might have been disappointed at this slow pace of changes, but we believe that Abenomics is working. What's different this time is that Abenomics appears to have unified a wide range of interest in civil and corporate Japan, and that Abe has a better chance of implementing his economic measures than his predecessors against the backdrop of a relatively high cabinet approval ratio among the electorate.

Abe's careful reform of government finances brought with it a rise in consumption sales tax from 5% to 8% last April, and as a result, the economy slipped back into a temporary recession in the latter half of 2014. However, a postponement of a second increase in the consumption tax (from 8% to 10%) proves to be growth-positive. Employment conditions are becoming increasingly tight, nominal wages are rising steadily and spending by seniors, who hold the bulk of the country's financial assets, is robust. The Bank of Japan's move to expand its quantitative easing programme has reaffirmed its commitment to achieving sustainable inflation. In terms of corporate Japan, profits are rising faster now than anywhere else in the world, and this has given companies the ability to focus less on sheer survival and more on shareholder returns. Moreover, an introduction of the stewardship code and the corporate governance code forces companies to rethink their capital efficiency. As corporate earnings continue to grow and companies become more focused on capital efficiency, we expect to see further improvements in shareholder value and ROE.

Stock pick – M3

Japanese Values Plc. invests in companies that can achieve long-term organic growth irrespective of macro-economic conditions. Such companies are often benefiting from a broad shift towards internet-based commercial and consumer services remains intact. This is reflected in the large overweight positions in the services and information & communication sectors. The largest single stock position in the portfolio as of the end of January 2015 was M3, which operates medical portal sites dedicated to health care professionals in Japan, US, South Korea and Europe. Strong earnings growth is driven by overseas expansion, particularly in China. It also provides large-scale clinical trial services for pharmaceutical companies, which are expected to give additional impetus to M3's mid-to-long term growth. M3 has consistently added value over time since the position was initiated in 2007."

Andrew Rose, manager of Schroder Japan Growth, told us….

"Abenomics hasn't delivered growth and has not really been of broad benefit to Japan yet. Under Abe's watch both real GDP and real incomes have been flat lines. The re-firing of the first two arrows of the programme (aggressive monetary policy and more flexible fiscal policy) is an implicit recognition that more needs to be done. This begs the question: will it be more successful this time around? This remains to be seen, but lower oil prices and a tight labour market increase the chances of success."

John MacDougall, manager of Baillie Gifford Shin Nippon, made the following comments in the fund's results statement published on 13 March….

"The great opportunities for the small but expanding cohort of Japan's entrepreneurs working to change business practices and offerings for the better have been noted in recent Managers' reports. A lingering concern was that the majority of these innovators were focused on the internet and digital sectors. However, there are now encouraging signs that positive entrepreneurial developments are spreading to other parts of the economy.

In the past year we have met with hungry, young business founders with big ambitions in sectors such as robotics and biotechnology. Several appear to have made globally relevant technological advances in their fields of expertise. This contrasts with some of the attractive smaller internet businesses in Japan that are capable of growing rapidly in the domestic market, but generally lack the ability to expand overseas. The start-up community remains vibrant, while increased efforts to make the Japanese stockmarket a more attractive place to invest are encouraging. The recent broadening out into new sectors of the range of businesses that meet Shin Nippon's investment criteria is a welcome and healthy development for the long term."

Summary

The managers don't agree on how successful Abenomics has been (that is what makes a market!) but we feel there is no quick fix for the Japanese economy and it will take time to get things moving again. The good news to take from these comments is that the managers see a wide range of companies that are capable of growth regardless of the success of this initiative. This should reassure long-term investors in the country.

QuotedData

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123a Kings Road, London SW3 4PL
0203 691 9430
www.quoteddata.com
Registered in England & Wales number 07981621,
135a Munster Road, London SW6 6DD

Edward Marten
(em@martenandco.com)

James Carthew
(jc@martenandco.com)

Matthew Read
(mr@martenandco.com)