COMMENTARY

March 13, 2015

Dear clients and colleagues,

Last week, we attended the Daiwa Investment Conference in Tokyo, which is the largest of its kind in Japan. Over 400 companies and 700 investors participated, a record high. We attend this conference every year and found the overall sentiment to be more positive than in recent visits. In March of 2013, Japanese companies expressed concern regarding Abenomics. Last year, businesses felt that the government policies were better than nothing. This year, we saw widespread acknowledgment of the success of both monetary and fiscal policies (the first two arrows of Abenomics). Businesses appear confident in the growth strategies (the third arrow) as well. Some key reforms aim to decrease corporate taxation, allow greater income disparity, reduce healthcare costs, and encourage further private participation in public infrastructure.

The most popular topic at this year's conference was the 2020 Tokyo Olympics. Reforms generally require time, but the Olympics will serve as a power source, putting pressure on deadlines and accelerating reforms. Japan appears well on the way to 2020; we are already seeing a boom in infrastructure and inbound tourism.

In 2014, the government set a target of 20 million inbound tourists per year by 2020. It also launched several new initiatives such as improving infrastructure, easing visa requirements, issuing more hotel building permits, and promoting MICE events (Meetings, Incentives, Conferences, and Exhibitions). As a result, Japan logged a record 13.41 million international visitors in 2014, double the figures from 2011. A weak yen and fading fear of nuclear radiation exposure have certainly helped. Since early 2013, the yen has weakened approximately 40% against the US dollar.

Tourists from China, Taiwan, and Korea flood luxury boutiques in Ginza. The number of Chinese visitors increased by 80% yoy in 2014. The fact that Japan accounts for only 2% of the Chinese outbound travel market suggests further growth potential. The new environment in Ginza is that Mandarin-speaking workers are everywhere.

Foreign interest in Japan is being reflected in the stock market as well. Foreign investors account for roughly 60% of trading value and 30% of ownership. We have noticed improving transparency and better corporate governance.

- Japanese companies are more open to foreign leadership. Recently, Takeda Pharmaceutical named a French national as its CEO. Toyota has stated that its European chief is to become one of six Executive Vice Presidents, the highest position to be held by a non-Japanese.

- "Corporate Governance Codes" for companies and "Stewardship Codes" for investors have been introduced.

- The proportion of independent directors within the Tokyo Stock Exchange (TSE) has increased to 60% from 30% in 2010.

- The TSE has implemented listing rules, requiring a minimum of two outside independent directors and explanations for cross-shareholdings.

Following our meetings at the Daiwa Conference, we feel that Japanese companies have become more investor-friendly. The “JPX-Nikkei 400 index” was frequently mentioned. The index was introduced last year in an effort to promote improved corporate management, and it combines quantitative (ROE, liquidity, market cap) and qualitative (independent directors, English earnings reports, etc.) indicators. Many of the companies we met emphasized a focus on improving ROE and shareholder return. One particular company has set out to become a JPX-400 member by 2016.

By coincidence, nearly half of our holdings in Japan are JPX-400 members. Low liquidity and a small market cap are less of a concern for us. We select niche leaders in growing industries with higher operating margins and less debt than peers. Some of the JPX-400 members do not meet such criteria.

We remain optimistic about the Japanese economy and its stock market.

The economic recovery is on the right track. Since Abenomics began in late 2012, real GDP is up 1.6%. Corporate profits are increasing as well. Private sector capital investment forecasts are showing double-digit growth. Unemployment has reached its lowest level since December 1997 and the ratio of jobs to applicants is up in every region. Real gross income (excluding the impact of the consumption tax hike) has increased since June of 2014.

The stock market will benefit, not only from economic drivers but also structural changes (pension fund injection and individual participation). Japan’s $1.2 trillion public pension fund has increased its allocation for domestic and international stocks to 50% of the total from 24%. Equities are only 9.4% of household assets. Individual trading values are rising, so too are the number of brokerage accounts (up 8 million in 2014). A new tax-free savings account (called the NISA) offers tax exemption on capital gains up to 1 million yen.

The Japanese population, although aging, has significant wealth. Net financial assets of household heads aged 60 and up are roughly JPY22 million. The wage increases that started last year should help create a virtuous cycle of reflation.

Our outlook is simple. Buy Japan.

Have a great weekend.

The Global Alpha team