Investment Insights
Turning Japanese: The Case for Holding Japanese Equities

Morningstar Investment Management LLC
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At a time when we find most global stock markets as being overpriced, Japan has re-emerged as an attractive buy, in our view. We explain why we like this major developed international market.

Key Takeaways

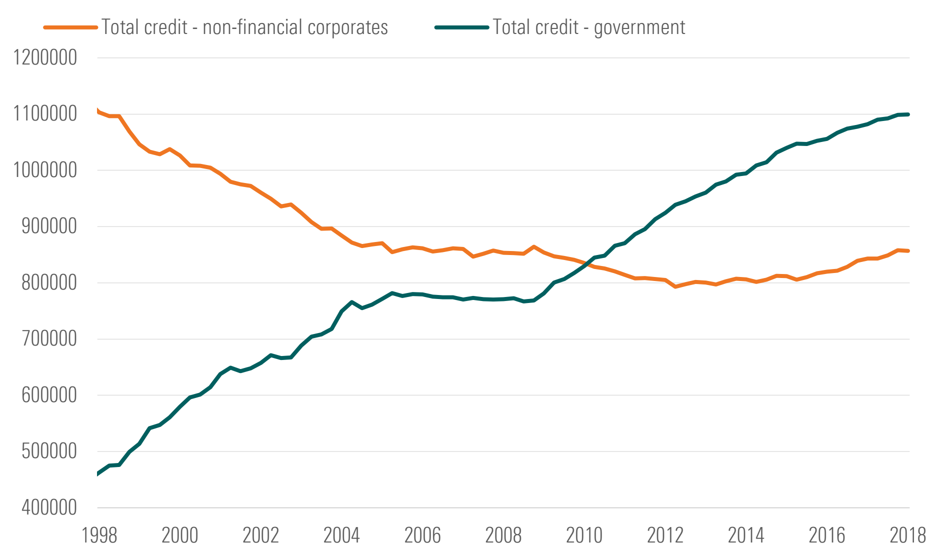
- Japan has endured a remarkable period of economic stagnation, but the future looks brighter to us.
- A legacy of poor corporate governance hampered Japanese equities, although this seems to be improving. As a result, dividends and buybacks continue to improve, albeit from a dismally low base.
- The fundamentals are improving. The deleveraging cycle appears to be halting, while corporate profitability in Japan is at 20-plus year highs. Amid the structural reforms, if the banks can find a way to lend more, we see opportunities for upside.
- The valuations are still cheap, especially among Japanese financials. Taken together, we like Japanese equities from current levels and assign a “Medium” conviction.

Returning From Lost

The lost decades in Japan have become one of the defining investment stories of our time. From its 1989 highs, the country endured a sustained period of weak economic growth with intermittent recessions and periods of deflation that resulted in stagnant economic growth. Asset price deflation accompanied these economic woes, and both equities and residential property remain below their 1989 highs. Thirty years later, Japan's weight in the MSCI EAFE Index now stands at less than half of what it was back in those heady days.

This has created a fascinating situation, with an extended period of stress and many false starts. In an attempt to end the ongoing trauma, promote growth and counteract the deleveraging in the private sector, the government of Japan increased leverage significantly to become one of the world's most indebted countries (with a debt-to-GDP ratio at over 200%). Only recently has corporate leverage finally returned, perhaps enabling the government to ease its own debt issuance.

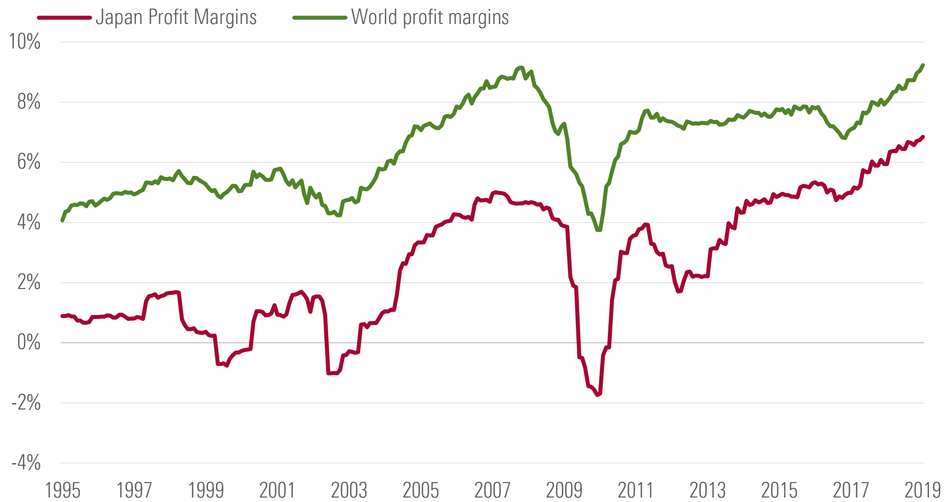
Exhibit 1 Japanese Leverage [in Billions of Yen] Has Transformed, But May Be Stabilizing



Source: FRED, Morningstar Investment Management. Data as of 01/01/2018.For illustrative purposes only.

The question is whether Japan is ready to turn the corner—both economically and in the markets. While the relationship between the two is often tenuous, Japanese equities remain relatively unloved and could be an attractive long-term position as well as offering potential diversification benefits. This is especially true if Japanese companies can sustain their profitability growth, which has turned the corner after a few poor decades.

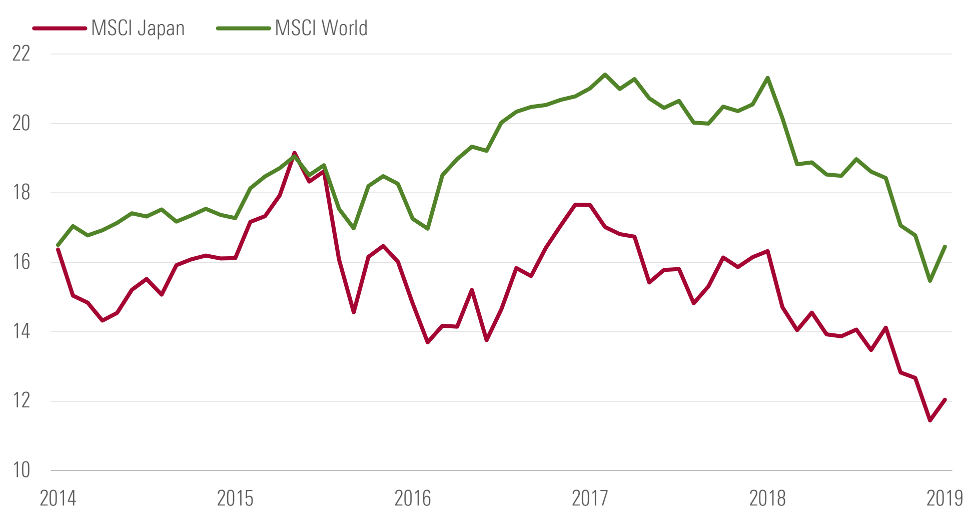
Exhibit 2 Profitability in Japan, Which Long Lagged Peers, Appears to Be Improving



Source: Morningstar Investment Management. Data as of 01/31/2019. For illustrative purposes only.

To assess the potential for improved profitability, one must acknowledge what went wrong and why. One of the most-cited problems was weak corporate governance, which resulted in poor dividend policies, obscure compensation schemes, a lack of appropriate risk-taking, a very low percentage of independent directors and high cross-shareholdings, making merger and acquisition activity problematic. Japanese companies also failed to target appropriate profitability metrics, leading to high cash holdings and a general perception that they don't always act in the best interests of shareholders. As such, investors have priced in a valuation discount relative to global peers.

Exhibit 3 The P/E Ratio [Left Axis] Has Trailed Peers, Especially Among Financials



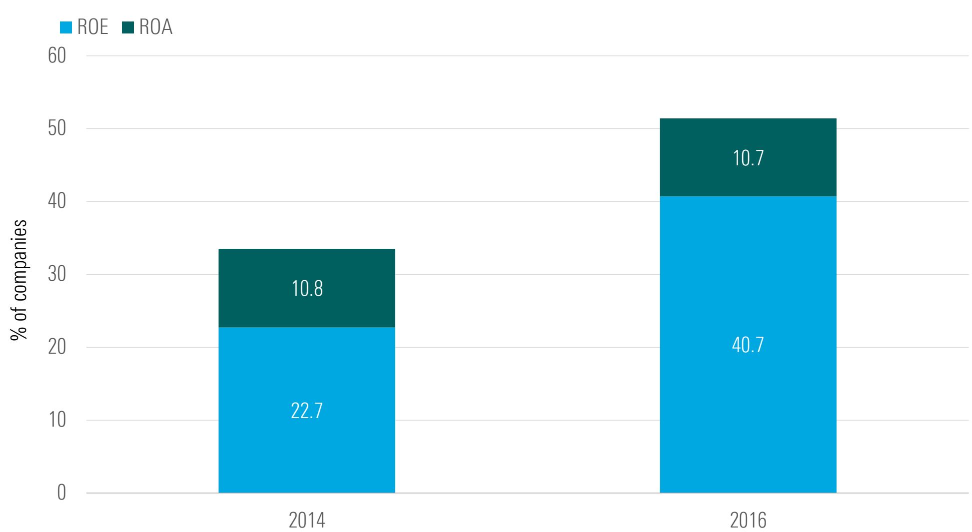
Source: Morningstar Investment Management. Data as of 01/01/2019. For illustrative purposes only. Individual index performance is provided as a reference only. Each index is unmanaged and is not available for direct investment.

So, what is going on and could we expect a change?
With so many underlying issues, investors have been yearning for a catalyst. Regarding profitability, in 2012, along came Abenomics and the so-called "Third Arrow," as Prime Minister Shinzo Abe tried to stimulate economic growth and address some of the profitability issues that have plagued Japanese companies. As a part of this response, Japan's Corporate Governance Code—aimed at reversing poor corporate governance practices—came into effect on June 1, 2015.

Skeptics were quick to question whether the government could influence the fundamental structure that had held back corporate Japan for so long. For example, in Japan very high corporate cash holdings were associated with a low percentage of independent directors, but it wasn't clear whether government regulation would meaningfully shift that cash into shareholders' pockets.

Now several years into Abenomics, we're able to see some clear positive developments. One of the most encouraging has been profitability targeting by corporate management, which has increased rather dramatically.

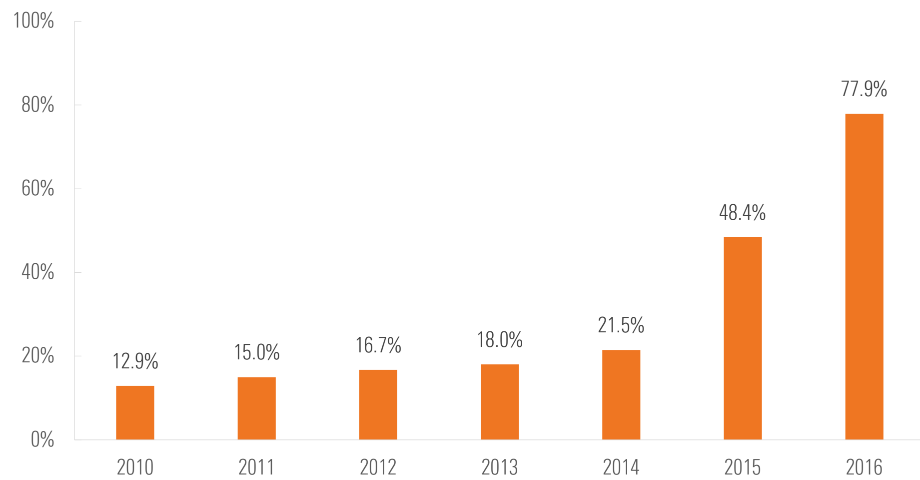
Exhibit 4 We're Encouraged by the Growing Percentage of Companies Citing Return on Equity (ROE) Targets



Source: Japan Investor Relations Association, cited in 2014 and 2016. "ROA" stands for return on assets. For illustrative purposes only.

As intended, independent directorship also increased significantly, with the Corporate Governance Code acting as an effective method for change. This was undoubtedly encouraging, but it is worthwhile remembering that it will only be helpful if it drives outcomes such as increased payouts to shareholders.

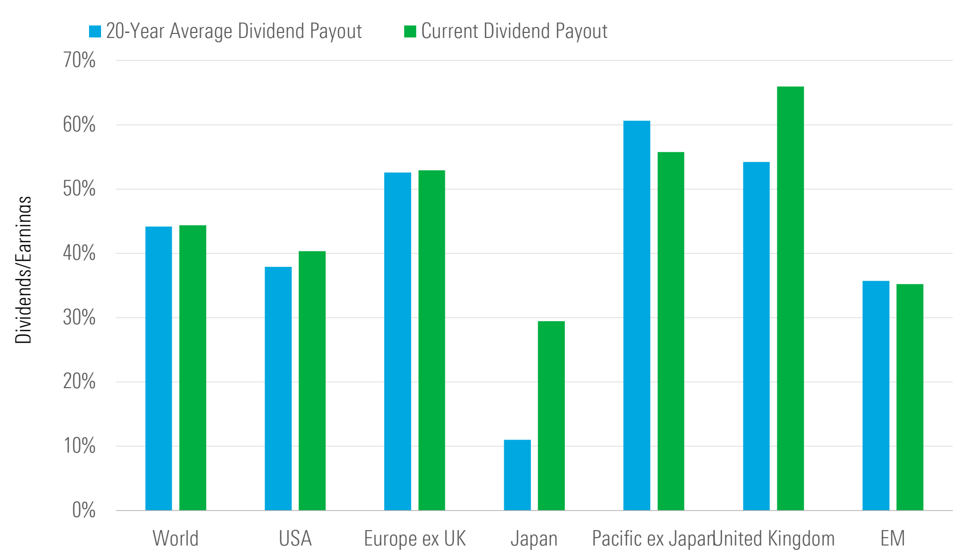
Exhibit 5 Corporate Governance—[%] of Companies With Two or More Independent Directors—Is Also Improving



Source: JPX Tokyo Stock Exchange.https://www.jpx.co.jp/english/news/1020/b5b4pj000001538o-att/20160617-2.pdf. Data as of 2016 and is the most recent available. For illustrative purposes only.

In respect to payouts, dividends in absolute terms have increased across the board and payout ratios have grown significantly. In addition, buybacks (which only became a legal practice in 1994) have grown in popularity, as the number of companies initiating their first buyback program continues to increase. We believe that these developments are likely to be structural and profoundly important for investors, although wouldn't be surprised if it is slow-moving progress.

Exhibit 6 Dividend Payout Ratios Have Increased Markedly, Now Closer to Those of Peers



Source: Morningstar Investment Management. Data as of 01/31/2019. For illustrative purposes only.

Are Japanese Financials the Key?

The last piece of the puzzle is valuations, which continue to trade at a discount to global peers. Much of this is driven by the large caps, especially financials, a segment we find appealing. Japan's deleveraging and deflation after excesses of the past have plagued financials, leaving the sector with a lot of upside potential.

We note that financials are largely a function of the economy, with a reasonable portion of its profitability attributable to lending (either via credit growth or net interest margins). Fundamentally, this may remain a constraint to price growth, although could offer upside if corporate deleveraging reverses.

However, quite a large part of the financials opportunity is sentiment. Valuation multiples among Japanese financials are some of the lowest we have seen and appear to be factoring in bleak times well into the future. Whilst it is not likely Japan is going to grow rapidly, we just don’t think the market appreciates many of the structural changes underfoot.

Of course, there are other influences which must be considered too. For starters, currency trends have played their part, with the Japanese yen enduring volatility. Industry concentration also remains low across the Japanese corporate landscape. We see evidence of consolidation in pockets, but mergers-and-acquisitions activity is not widespread.

Yet, regardless of how one views it, there are likely two key pillars that make Japanese financials a potentially enticing opportunity:

1. The fundamentals are reasonably sound. The deleveraging cycle appears to be halting, while corporate profitability in Japan is at 20-plus year highs. Amid the structural reforms, if the banks can find a way to lend more, we see opportunities for upside.
2. The valuations still look cheap. If investors realize the demons of the past are behind them, we may see a re-rating of these companies which could offer upside.

Assessing Our Conviction

With positive developments evident in Japan, we evaluate the market using our four pillars of conviction, which is our way of considering the holistic opportunity under a long-term, valuation-driven framework. In this regard, we want to address: the absolute and relative expected return, fundamental risk, and contrarian indicators. We find that Japanese equities look reasonably attractive, with valuations that look encouraging compared to other key markets. The financial sector also lines up well with other opportunities such as European telecommunications, providing reasonable forward-looking prospects and a profile that offers potential diversification benefits to investors. From a fundamental risk perspective, there is still some volatility in the cash flows and some concerns that profitability is at a cyclical high, tempering our enthusiasm somewhat.

Overall, we view Japanese equities as a “Medium” conviction opportunity, reflecting developments that continue to be both captivating and compelling.

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Indexes

The MSCI EAFE Index measures the performance of the large- and mid-cap segments of developed markets, excluding the US and Canada equity securities. It is free float-adjusted market-capitalization weighted.

The MSCI Japan Index measures the performance of the large- and mid-cap segments of Japan equity securities. It is free float-adjusted market-capitalization weighted.

The MSCI World Index measures the performance of the large- and mid-cap segments of world equity securities. It is free float-adjusted market-capitalization weighted.

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