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Japan: Past 25-year Performance is Not Indicative of Future Returns

Recent History: A Risk-Averse Generation

Global investors and even Japanese citizens are woefully although understandably under allocated to Japanese stocks. Why? For most of our “investment” lifetimes, the island nation has been a place to avoid, with equities (Nikkei 225) still unable to fully recover from the Japanese bubble that popped 25-years ago. From the 1989 top to the 2009 bottom, Japanese stocks lost 83% of their value. Even despite recent gains, a $1 million Japanese equity investment made in 1989 would be worth $500,000 today compared to $6 million if invested in U.S. stocks (S&P 500). And that pain wasn’t merely limited to a bad investment made during a narrow window in late 1989. The same investment into Japanese stocks made 6 years later (the typical length of a normal business cycle) would still be down 1% compared to a 350% gain here stateside. Is there any wonder why investors love U.S. stocks and seemingly despise the third largest economy on earth?

Adding insult to injury, the Japanese investment carnage wasn’t limited to stocks. The popping of the bubble brought down all types of assets from their dizzying heights. Even real estate plummeted, as property in Tokyo’s Ginza district priced as high as $139,000 per square foot had nowhere to go but down—way down. The plunge in asset prices wreaked havoc on the economy and real wages fell over 13%. Deflation ensued and signaled the standard way of life for nearly 20 years (from 1995 to 2013). This further damaged the economy, serving as a major structural impediment to capitalism as citizens curtailed their consumption assuming goods would be even cheaper next year. And if no one consumes, GDP falls. Japanese GDP fell 18% over the 22-year period (1995-2007)—an unprecedented number among developed nations. Government bond yields soon dropped in sympathy and reached historical lows of 75 basis points. But even at such a low level, assets kept in cash had a decent real return after accounting for deflation (negative inflation). Considering the devastating drop in asset prices all around, risk-averse investors were more than happy to earn a safe, positive real return. Simply put, fearful citizens love cash. Cash was not only king, it was hoarded—for a generation. But this is finally starting to change.

The Impetus for Change: Abenomics

In late 2012, after two “lost decades” Shinzo Abe was elected prime minister on a platform of aggressive economic policies. Now known as Abenomics, the policy entails “three arrows” (fiscal stimulus, long-term structural reforms, and aggressive monetary policy) in an attempt to stimulate economic growth by ending the secular period of deflation. Sound familiar? It should. Since 2008, both Europe and the United States have embarked on similarly aggressive monetary policy. Recently the European Central Bank (ECB) launched its own version of Quantitative Easing (QE), mimicking the U.S. Federal Reserve’s string of policy now known as QE1, QE2, and QE3.

Although QE cannot directly stimulate growth, it has a profound ability to affect three primary levers (interest rates, currencies, and inflation expectations) which can indirectly stimulate the economy. Under QE, real interest rates remain lower for longer thereby allowing market participants to borrow cheaply, repair balance sheets, and promote investment to help generate growth. After Abe’s 2012 election, Japan’s already low 0.75% interest rate moved even lower to 0.40%.

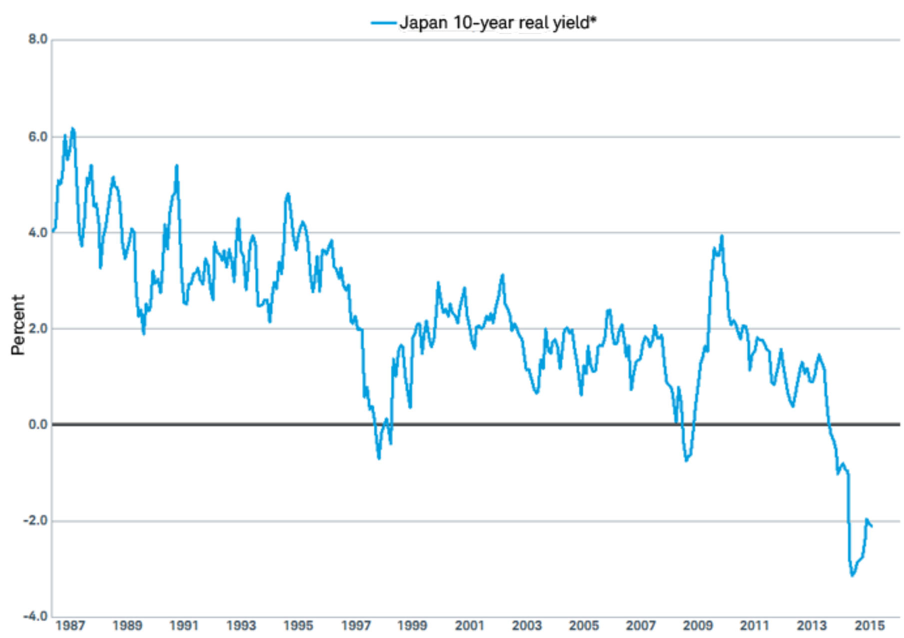
QE can also weaken a country’s currency not only by increasing the “supply” but also by altering the market’s “demand” characteristics. “Printing money” increases the amount of Yen in circulation leading to lower prices—expressed through the foreign currency exchange rate. By driving down yields, investors are subsequently forced to look beyond their own borders in the search for yield and income. Repositioning portfolios overseas in effect creates a mass financial exodus (out of the Japanese region and thus out of the Yen), dramatically reducing the demand for the currency. Taken together, these factors have served to substantially weaken the currency. Similar to the recent experience with the Euro, Abenomics has helped push the Yen down 38% which in turn helps Japanese exporters, their employees, and ultimately the economy.

Finally, QE can help break the vicious downward spiral of deflation (i.e., economic weakness creating deflationary expectations that delay consumer consumption which in turn leads to further economic weakness). Recent inflation data (running near 2%) suggests that the decades-long deflationary mindset may have started to recede. A perfect case in point is Tokyo-based ketchup maker Kagome, Japan's most popular brand of ketchup, which is hiking its prices for the first time in over 25 years.

Abenomics has thus far been embraced by investors, driving the Japanese stock market up over 120% since the election. But with such gains in the rear-view mirror, investors need to now ask themselves whether the Japanese investment premise is still a good one—and for good reason. With U.S. stocks trading at valuation levels not seen outside the Tech/Dotcom bubble, now may be a good time to look overseas in search of markets that still offer value. Our conclusions will sound familiar to long-time readers since we're employing the same tools that led us to overweight U.S. equities in 2011 as well as Europe in 2014—both of which were profitable. Looking ahead, we believe Japanese stocks will reward investors, and that the nation's 25-year past performance is not indicative of its future.

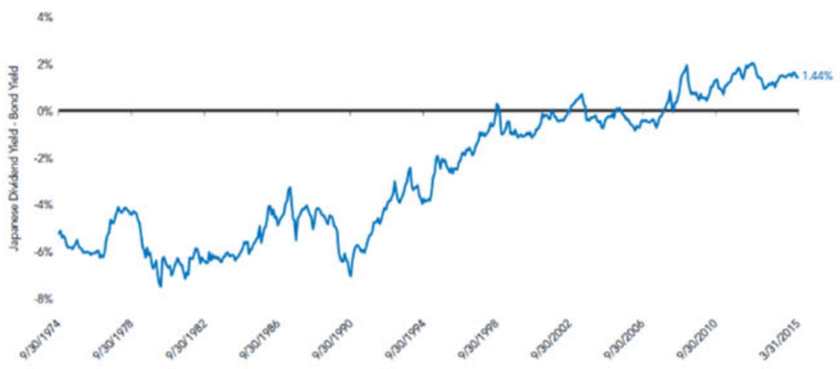
Japanese Stocks - Traditional Measures of Value:

More attractive than cash and bonds. One of the best ways to get risk averse investors out of the safety of cash is to make the cost of owning cash as painful as possible. Japan's low interest rates were acceptable in a deflationary period, but with inflation now at 2%, hoarding cash no longer generates positive real returns. Even an investment in 10-year Japanese Government Bonds (JGBs) with a 0.50% yield is now a losing proposition. As any investor will attest, losing money is a great motivator, and this change in dynamic may encourage Japanese investors to seek out other uses for their cash as well as their bonds.



One area that should benefit from the reallocation is Japanese stocks. For the income investor, stocks are more attractive than other alternatives since they now offer a higher yield. Today's investor can generate a larger income stream by diverting their cash/bonds into a basket of dividend paying stocks—and the spread between the two is approaching a 40-year high. In an era of negative real yields on fixed income instruments, income investors are forced into equities as there are no alternative options. Japanese stocks (similar to what has occurred in both the U.S. and European markets) should continue to rise as the exodus out of bonds and into stocks continues.

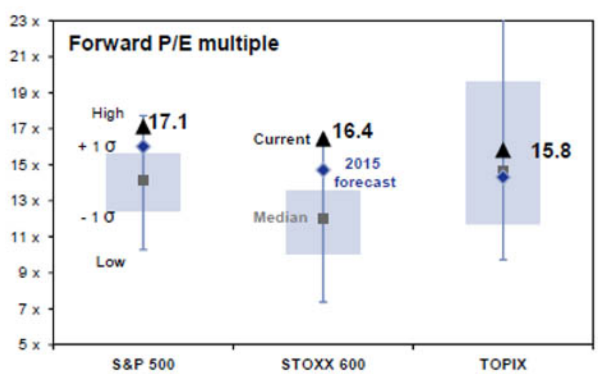
JAPANESE EQUITIES PROVIDE INCOME BUFFER



Sources: WisdomTree, Bloomberg, as of 3/31/15. The line chart above uses the MSCI Japan Index for the dividend yield and the nine-year Japanese government bond for bond yield; they are used due to historical data availability, starting 9/30/74. Past performance is not indicative

More attractive than global stocks (price). Not only are Japanese equities attractive to the income investor, they're equally attractive to the growth investor. Unlike other markets that are expensive versus their own history, price multiples on Japanese stocks (the market cap-weighted Topix Index is preferred over the price-weighted Nikkei 225 Index) are roughly in-line with its 10-year median. Japanese stocks are not only attractive to their own history, but to other stock markets as well. With a Price/Earnings multiple around 15.8x, the Topix Index trades at a steep discount to other global benchmarks including both the U.S. and Europe.

S&P 500 and STOXX 600 appear expensive relative to history
as of April 30, 2015



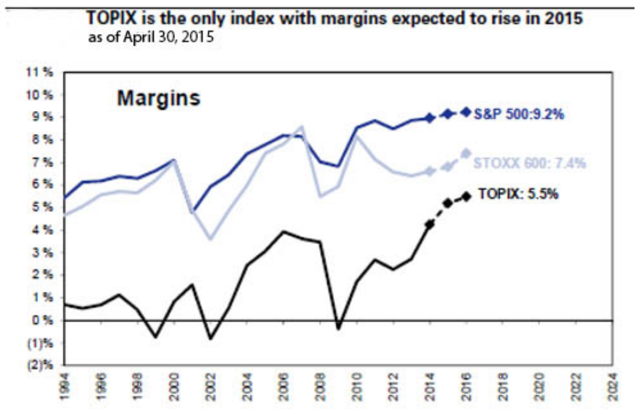
Source: MSCI, FactSet, I/B/E/S, and Goldman Sachs Global Investment Research.

More attractive than global stocks (growth). Despite a strong rally since the start of Abenomics, Japan's market has actually become cheaper due to strong earnings growth as the 'E' in the P/E ratio outpaces the 'P'. And this trend looks to continue. According to Goldman Sachs, earnings momentum will remain strong as they forecast 22% earnings per share (EPS) growth in 2015 and a total of 46% through 2018—each figure far greater than the growth projected in the U.S. and Europe. One key reason for this strong growth is the weaker yen. Corporate profits benefit as foreign sales are increased when translated back into a weaker yen, boosting the bottom line for export-oriented Japanese companies.

If these projected rates of growth prove true (and P/E's remain relatively constant), Japanese equities are poised to outperform U.S. stocks. The additional tailwind? If *growth* proves true and the *price* multiples of the two countries converge, then Japanese outperformance will be that much greater.

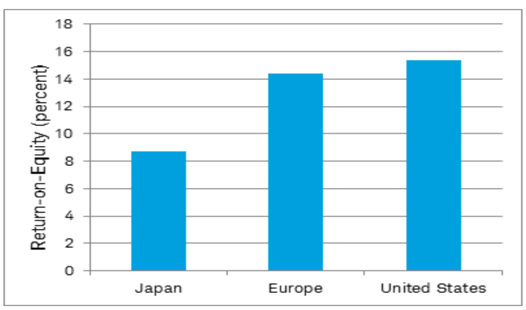
From Ketchup to Catch-Up - Price and Productivity

While the aforementioned Kagome Ketchup example highlights the possible end of deflation, we also hold the belief that Japanese stocks and corporations can catch up to that of the West. After recently posting strong returns, Japanese stocks have yet to surpass their 2007 highs—in fact, it will take another 17% gain for stocks to catch up to other Developed Markets in reaching a new post-crisis high (we'll save any speculation about surpassing Japan's 1989 all-time highs for another day).



Source: Compustat and Goldman Sachs Global Investment Research.
Pricing in this report as of April 30, 2015, unless otherwise indicated.

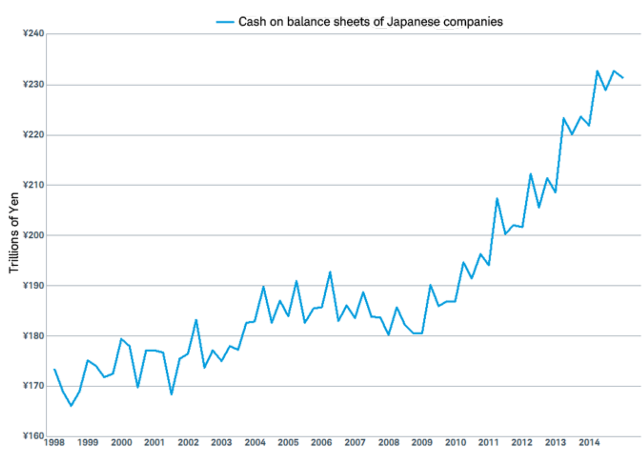
Double-digit price gains will most likely be driven by strong earnings gains. Contrary to common wisdom, corporate earnings can grow by 10% per year even if GDP remains sluggish. How is that? Earnings are a reflection not only of revenues but of profit margins as well—and this is an area where Japanese equities can greatly improve and catch up to the West. Goldman Sachs forecasts Japanese margins will increase by 1 full percentage point to 5.2% compared with flat margins in other regions. Better margins will improve Return on Equity (ROE) which is another measure of good corporate management. But why now? Why is 2015 different from 1995, or 2005 for that matter? To quote Charles Schwab, "*we may be at a tipping point where companies are starting to make profits and shareholder interests a higher priority*."



Source: Charles Schwab & Co. Inc., Bloomberg, as of 12/31/2014.

Transformational Measures Part I: A New Index

Japan's history includes corporate management that sometimes favored social goals over financial goals. As a result, sub-par corporate profitability (often 50-75% lower than the margins and returns of similar companies in other parts of the world) has been the order of the day. Today, after generations of risk-averse corporate mismanagement, the Japanese investment landscape is littered with companies delivering low returns—in part due to their high cash balances. While many companies around the globe understandably began to preserve cash in the wake of the 2008 credit crisis, Japanese companies win this race hands down. According to WisdomTree, in 2014 Japanese corporations held cash equal to 40% of GDP compared to only 11% in the United States. Japan's



corporations have continued to maintain a strong affinity for holding too much cash, limiting the profit-making ability of the corporation. But this too is changing.

Right now, there is a transformational and revolutionary shift in the management of Japanese corporations—but again, why now? For one, like Japanese citizens, corporate managers are concerned about the negative real return on cash. But more importantly, during the last decade or so, a new generation of corporate managers has begun to ascend to positions of executive power. This new generation not only has direct work experience overseas but is also not bound by the mistakes (and fears) of their predecessors. As a result, more and more companies are managing their corporate assets with an eye towards shareholders. New energy and a new way of thinking are prevalent, but as always a catalyst was needed. Fortunately, there is one. Recently the Nikkei created a new index named the JPX Nikkei 400 where the underlying companies are selected not on size (Topix) or on price (Nikkei 225), but rather on shareholder return metrics such as Return on Equity (ROE). ROE is calculated by dividing net income by shareholder equity, so it can be boosted by either improving profits or by reducing equity through share buybacks using excess cash. Almost instantly, the psychology of corporate management began to change. Holding massive amounts of cash is no longer rewarded. Rather, using the Balance Sheet to generate a return for shareholders is now *de rigueur* because inclusion in the new index is considered prestigious—the social goal is now also a financial goal. According to Tocqueville Asset Management, when a Japanese machinery company (Amada) was denied admission to the JPX Nikkei 400, management responded by not only increasing the dividend payout ratio to 50% but also announcing a large share repurchase to boost return on equity. The stock responded by gaining nearly 20% overnight. In the aggregate, share buybacks during 2014 nearly doubled from the previous year, and many believe the trend toward returning cash to shareholders will continue. This renewed focus on corporate profitability bodes well for continued earnings expansion.

And further research from Tocqueville suggests that the process of catching-up to the west (removing cash, increasing margins, etc.) could potentially reduce the price multiple on the Nikkei to an astonishingly low 5x.

Transformational Measures Part II: New Investors

After 25-years, the supply and demand dynamic for Japanese stocks is changing with the "demand" side poised to increase due to a number of different factors (remember with all else being equal, if the demand for a product increases then the price should increase as well). We believe Japanese citizens are looking to increase their stake in equities not only in search of higher yields, but also to invest in an asset that can earn a positive real (after inflation) return. A reallocation out of negative real return cash could be a powerful force to drive stock prices higher given that, according to WisdomTree, Japanese citizens are among the least allocated to their equity markets of any region in the world. Just like the country's companies, Japanese households also own too much cash. Case in point, Japanese citizens have a similar amount of cash on the sideline as do the households in the U.S. and Europe despite the fact that their economy is only one-third of the size!

Japanese pensions are also looking to add equity exposure. The world's largest government pension, the Government Pension Investment Plan (GPIF) with over $1 trillion, is taking the lead. In late October 2014, the GPIF announced it would double its equity allocation (from 24% of assets to 50%). The reallocation into stocks will not only add a source of demand, but the GPIF allocation to Japanese equities will target the new Nikkei 400 smart index which will further catalyze the goal of higher margins, higher ROE and larger dividends to shareholders.

GPIF SHIFTS ASSET ALLOCATION TARGETS TOWARD REFLATIONARY POSTURE

	Asset Allocation	
	Old	New
JGBs	60%	35%
Japanese Stocks	12%	25%
Foreign Bonds	11%	15%
Foreign Stocks	12%	25%

Source: "Adoption of New Policy Asset Mix," Government Pension Investment Fund, Japan, 10/31/14. Within the Old Asset Allocation there was a 5% target allocation toward short-term assets which was eliminated from the new target allocation.

But perhaps more importantly, because of GPIF's stature within the country, the new investment policy will likely motivate other pension plans and insurance companies to follow suit—further driving demand for Japanese stocks. According to Schwab, the $65 billion pension plan for public-sector employees (known as KKR) has already announced a tripling of equity targets to match the GPIF allocation.

Finally, the Bank of Japan (BOJ) QE program is not limited to buying government bonds (unlike the Federal Reserve) but rather also has the authority to buy REITs and stocks via exchange-traded funds (ETFs). With the Japanese government printing money and buying stocks, the phrase "don't fight the fed" takes on a whole new meaning.

Conclusion

Japanese stocks have great growth prospects but more importantly, catalysts abound. Not only has inflation made stocks attractive from a yield standpoint compared to fixed income, but after 25-years of depressed valuations and a renewed focus on profitability, Japanese stocks are also attractive versus other global stocks. When combined with additional tailwinds such as an under-allocated global community and the backing of the most stimulative and coordinated government effort that exists in the world today, Japanese stocks look poised to continue growing. In short, the sun may be rising on a new era.

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