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Opinion

Investors in Japan need pinpoint accuracy

Those who do not understand the changes taking place risk being left behind

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Japan was one of the standout performers of 2017, ending the year up by nearly a fifth. This surprised many investors, some of whom have avoided the country for years, thinking it something of a basket case.

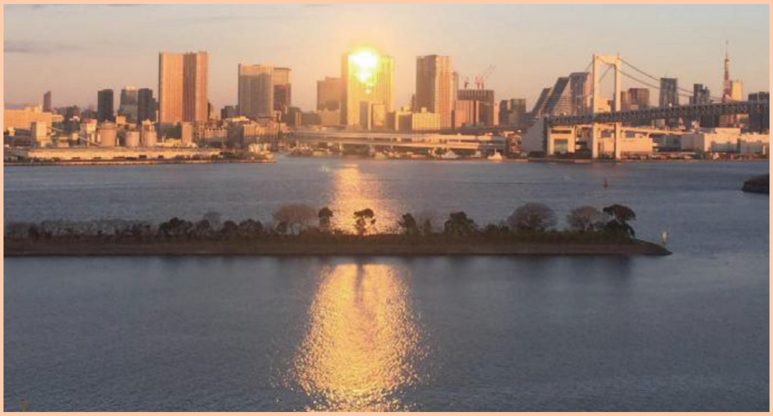
Today, though, particularly in the light of global market volatility, many wonder whether this impressive run was a one-off or sustainable in the medium to long term.

Commentators often focus on the known and longstanding challenges facing Japan's society and economy, in particular its ageing population, absent growth, deflation and ballooning public debt.

While these have been important factors, the dynamics of the market have evolved because of emerging forces.

Corporate Japan is far less homogeneous in character than it was in the 1990s and 2000s. After the market crash, companies stuck together, extensive crossholdings were common and nearly all boats rose or fell on the same macroeconomic tides, particularly the fortunes of the yen. In more recent times, conditions have emerged that have enabled more companies to reinvigorate themselves.

Investors who do not understand and embrace this change risk being left behind, though this may be through no fault of their own: many of the available routes to Japanese exposure reflect an outdated perspective of the market.



Tokyo Bay: making money in Japan is a question of picking the right funds © Stockimo/Alamy

Broad market indices such as the popular Topix, which has 2,000 constituents and is the reference for more than $400bn of investment, are designed to provide investors with diversified exposure to Japan's companies and industries.

They capture a large proportion of the listed market but while this attribute was previously a strength, it does not reflect the variety of modern corporate Japan.

One of Prime Minister Shinzo Abe's early priorities was to impose governance standards on company boards and institutional investors, seeking to establish shareholder-friendly behaviours and international standards, with the objective of making companies more competitive.

Adoption of these reforms has been mixed. Some outward-looking and ambitious companies recognised the benefits of buying into Abe's vision of corporate competition contributing to a strong Japan at home and abroad.

Others were resistant, with many managements preserving the generations-old stance that businesses exist primarily to serve customers, the community and support employees, in that order, with the interests of shareholders often incidental.

Corporate profitability in Japan remains, for now, firmly at the bottom of the ranking of developed countries, although the past decade has seen encouraging signs of life, with return on equity rising from 5 per cent in 2011 to an estimate of more than 8 per cent in 2018.

The picture for the overall market, however, does not acknowledge the increasing number of companies able to generate higher returns.

The proportion of companies with return on equity of more than 10 per cent has risen from 19 per cent in 2009, to an estimated 41 per cent in 2018, while an impressive 17 per cent of companies are achieving return on equity of greater than 15 per cent.

Unlike the old days, when one could happily just buy the market, today's investors in Japan should be more selective, funnelling investment towards better-run, more profitable companies that prioritise shareholder returns, and avoiding those that do not.

One way to capture this new dynamic has been developed by Mitsubishi UFJ Trust and Banking, the Japanese financial group.

The iSTOXX MUTB Japan Quality 150 Index targets companies consistently achieving the highest profitability, achieved through superior return on equity. Well-managed businesses that are capable of converting a high proportion of profit into cash flow, and those that use cash flow to keep debt low, are also favoured.

A portfolio based on the MUTB index during 2017 achieved a return-on-equity ratio more than 40 per cent higher than one based on the Topix, with this index outperforming the Topix by almost 4 per cent.

Japan's economy still has the same problems as it did decades ago, and many of its companies do, too — but new opportunities are emerging. Investors waiting for meaningful inflation to return, a prospect that may take many years to materialise, are focusing too much on the past and risk overlooking the ambitious and shareholder-friendly Japanese companies building the country's future.

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