Why We Expect Japan to Regain Favor with Investors

December 18, 2014

by Robert Sharpe

of Heartland Advisors

Executive Summary

- Japan recently surprised investors by raising its quantitative easing (QE) like program by $250 billion. As occurred in the U.S., a substantial portion of this new liquidity may flow into stocks, supporting valuations.
- Additional inflows into equities are set to come from Japanese pension funds after a re-allocation toward greater exposure to domestic and foreign stocks.
- Global investors often bemoan low levels of return on equity. Now, more Japanese companies appear likely to put excess cash to work, which should boost return on equity.

For a long time, many analysts have called Japan inexpensive—but not particularly attractive. The consensus view has been that Japanese stocks are cheap. This sentiment is in part due to global investors deducing that they have better options elsewhere and having experienced relatively low return on equity in these investments. As a result, Japan has traded at a discount compared to other markets.

Stock market dynamics in Japan are changing. We think global investors are going to take increasing note, and more money will flow into Japan—in turn supporting equity prices. Here's why.

First, the Bank of Japan recently announced an increase in its QE-like program that increases the monetary base. The boost is from an annual rate of 50 trillion yen (about $450 billion) to 80 trillion yen (over $700 billion). That's an additional $250 billion of liquidity looking for a home. In the U.S., the path of least resistance for proceeds received by sellers of bonds has found its way into "more risky" assets, such as equities. The Japanese are employing the same game plan as the U.S. with the assumption that these funds will also find their way into equities. Furthermore, when the Bank of Japan announced the increase in October, investors were genuinely surprised. The message is getting clearer and clearer: Japan is serious about meeting its 2% annual inflation goal.

Second, the managers of the largest pension fund for state employees in the world, the Government Pension Investment Fund (GPIF) in Japan, announced in October a major reallocation of assets—toward equities. The right-hand column of the table shows the value of funds set to flow into the Japanese stock market ($87 billion domestic equities) when the GPIF moves to the new target allocation.

In addition, we expect corporate and other public pension funds—which have a reputation for following the GPIF's lead—will also increase their allocations to Japanese equities. The current proportion is very low, compared to what we'd consider normal in the U.S., with only about 10-11% of corporate pension assets held in equities.

When the planned GPIF allocation increases are combined with other Japanese pension funds, we see the potential increase of nearly $280 billion in net equity exposure (both domestic and international) to reach the new target allocations—equivalent to 10% of the value of the TOPIX Index. Some of that increase will likely flow to stocks outside Japan, but a large portion should remain internal. Market inflows of that scale should impact average stock prices. While it's true that market participants have anticipated some of these moves (if not the specific details until the recent announcement), there's a difference between anticipating the fund flows and the actual influx of funds.

The increased allocation to pension funds comes among other reforms intended to make equity ownership more attractive. For example, the Nikkei 400 Index was launched early this year. This index, designed to be a prestigious subset of the main Nikkei, requires constituent firms to adopt certain shareholder friendly policies such as greater transparency and improved corporate governance. In addition, firms must achieve certain levels of return on equity.

Return on equity, then, brings us back to where we started this exploration—one of the reasons global investors have shunned Japan. But what many observers fail to mention is the fact that equity returns are, for many companies, diluted by large cash holdings on the balance sheet. Because so many firms got burned by imploding banks in the 1990s, Japanese companies tend to hold much more cash than, say, their American counterparts. That may be changing, with Nikkei 400 membership as one impetus, and a mergers and acquisitions landscape likely, in our view, to pick up.

Ultimately, we expect return on equity for the average Japanese public company to rise from current levels—at the same time share prices are supported by more money flowing into equity markets. We think global investors won't be able to ignore Japan for much longer, because the combination of its current cheapness and strong prospects—particularly given the multi-faceted catalysts for recognition we've laid out here—are just too attractive to ignore.

With regard to our own exposure, we remain invested slightly below the Japanese allocation in the Heartland International Value Fund's benchmark, the Russell Global® ex-U.S. Small Cap Value Index (33% for the Index vs. 29% for the Fund, as of 9/30/2014). While we aren't overweight Japan, it does remain our largest single country exposure. We remain optimistic about Japan as a whole and, in particular, the prospects of the specific companies we've chosen for investment. To help generate alpha gained on individual security holdings, we are also maintaining a dollar-yen hedge because we see the yen as likely to continue falling versus the dollar as these market reforms play out.

Addendum

The following charts provide further insight into just how cheap Japan seems to be versus the U.S. and Europe markets.

The first chart shows the continuing downward trend in Japanese price-to-equity levels relative to the U.S. and Europe. Then, what we see in the second chart adds insult to injury. It shows a greater price-to-book multiple discount than return on equity discount for Japan versus the rest of the world for the last six months—implying the market suspects earnings will fall short in Japan. This data suggests just how out of favor Japan remains—and, in our view, why the opportunity is significant given the catalysts we've discussed here.

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HLF4543/0115