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Industry Voices

Commentary: Time to actively look for opportunity in Japan

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By Katie Koch

The U.S. has received a lot of attention for another healthy equity run this year. But which market outperformed the U.S.? Japan.

Japanese equities have outperformed U.S. equities in U.S. dollar terms so far this year; the TOPIX returned 18%, while the S&P 500 returned 15.9% (total returns in U.S. dollars as of Oct. 16). Looking ahead, we believe Prime Minister Shinzo Abe's re-election will continue this positive momentum, focusing on continued economic and corporate reform aimed at boosting Japan's growth.

With this in mind, we believe investors should take a closer look at Japanese equities and consider the value of being active in this growing market.

Upbeat outlook

First, on the back of improving global demand, we believe corporate earnings growth will be about 15% in local currency for fiscal year 2017 (ending March 31, 2018), and about 10% the following fiscal year. Over the long term, earnings growth should be driven by an improvement in domestic consumption and exports, particularly those rooted in secular trends such as electrification and automation in automobiles, factory automation and medical electronics.

Investors should also look at the improving fundamentals in Japan. Since the asset bubble burst in the late 1980s, Japanese company fundamentals have recovered — as evidenced by high cash levels, low debt levels, improving profit margins and a rising return on equity. More than 50% of the companies in Japan have a net cash position and have started to invest this cash through capital expenditure and M&A, and return it to shareholders. We believe investors in Japan will continue to see rising cash returns and exceed other markets where corporate balance sheets are more leveraged.

In addition to solid fundamentals, corporate governance reforms are resulting in more shareholder-friendly actions. Mr. Abe's government introduced a corporate governance code as a set of rules that corporations are expected to follow or provide an explanation of why they didn't. This has resulted in more independent directors on company boards.

Be active

With all this positive data, how can investors tap into this growth trend?

In our opinion, Japan's indexes do not effectively capture the growth areas on the horizon. The Nikkei 225 is a price-weighted index, a design that is not very fundamental in nature, and the TOPIX is a product of more than 2,000 stocks, so the secular growth stocks typically get lower weights despite having high return potential.

Instead, investors should be active in Japan. It will allow them to be more focused within the diverse market and identify differentiated, high-growth areas in Japan to generate excess returns.

Two stable, long-term growth areas include the electrification of automobiles and industrial automation.

Japan has been famous for its car manufacturers, which form a big part of the index. But we are less bullish on them, because we feel the auto volume growth will be slow over the next few years. However, cars are becoming more sophisticated and will eventually be driverless. Electronic features in cars that were optional are increasingly becoming standard. The proportion of cost of electronic components in a car is expected to rise to 50% by 2050 from 22% in 2000. We prefer companies having exposure to these segments, as we expect the growth in these areas to be faster than the overall auto market growth.

At the same time, we also expect industrial automation to accelerate over the coming years because of aging populations in developed countries and the need for productivity improvement, and rising wages globally. Robot penetration in China, the world's primary manufacturer, is just three per 1,000 manufacturing employees, a level equivalent to Japan 30 years ago. As a result, the demand for industrial robots is expected to grow at an annual rate of around 14% until 2020. We are bullish on Japanese companies that manufacture sophisticated, high-quality components for industrial robots.

As corporate earnings continue to grow, strong fundamentals hold and corporate governance increasingly favors shareholders, we think portfolios will benefit from Japanese exposure. It's a deeper story than the traditional indexes are telling, but as investors take a closer look and recognize long-term growth areas, Japan appears to be on the cusp of a new growth wave.

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Index definitions
The **TOPIX** is a market capitalization-weighted index of Japanese stocks.

The **S&P 500** is a market capitalization-weighted index of American stocks.

The **Nikkei 225** is a price-weighted index of Japanese stocks.

It is not possible to invest directly in an unmanaged index.

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