Japan 2.0 – The Case for Japanese Equities Part II

GLOBAL MACROECONOMIC RESEARCH SERIES
FEBRUARY 2024

GLOBAL MACROECONOMIC INVESTMENT COMMITTEE
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Key takeaways

- Economic Shift: Japan is experiencing positive economic dynamics and undergoing market reforms that, taken together, could benefit investors.
- Retirement Savings Reforms: The Japanese government is aiming to transform household savings into wealth-generating investments, drawing parallels to the financial reforms in the United States during the 1970s.
- Stock Market Reforms: The Tokyo Stock Exchange has restructured its market sectors and enforced governance standards with the intent of improving corporate performance and boosting investor returns.
- Mergers and Acquisitions: New guidelines have been released to encourage consolidation among companies, aiming to enhance corporate value and shareholder interests.
- Venture Capital Reforms: The Financial Services Agency has issued guidelines to support start-up formation and financing, increasing transparency and institutional investor access to emerging companies.

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Introduction

Part one of this series ("Japan 2.0: A New Paradigm?") discussed the history of the Japanese economy. It summarized the evolution of Japan's economic boom of the 1980s through the decades of weak economic growth and low inflation from the 1990s to the present. It also pointed out that Japan appears to be benefiting from post-pandemic dynamics, a de-risking of global supply chains, a return of wage gains, and a weaker, more competitive currency. The key observation was that, from a macroeconomic perspective, Japan may have finally escaped the disinflationary undertow of the past three decades, and Japan may be facing more tailwinds than headwinds.

In this paper, we focus on equity market reforms in Japan designed to boost shareholder returns, activism, raise stock market valuations, promote mergers and acquisitions ("M&A"), and unlock trillions of household savings held in cash. Many of these changes have their roots in former Prime Minister Abe's reform agenda that began in 2012. Abe was seeking to combat the high debt and low economic growth of the prior three decades. Now, the coordinated efforts from the government, the Financial Services Authority, and the Japan Exchange Group's Tokyo Stock Exchange ("TSE") could unlock shareholder value and boost investor returns.

Retirement savings reform

In 2023, the government in Japan announced that it was planning a fundamental transformation of the asset management sector. The goal was to convert Japan's massive stock of savings into wealth-generating investment via an initiative called "wealth management nation."[1] The scope of reforms to Japan's retirement savings industry, known as NISA,[2] has been compared to the sweeping financial reforms in the United States during the 1970s.[3] The Japanese government hopes to make more productive use of an estimated fourteen trillion dollars of household savings that are sitting in NISA cash deposits.[3] Much like the inception of the 401(k) industry in the United States, the reform of the retirement savings industry will focus on doubling income from investment, improving tax incentives for retirement investment, facilitating job mobility via portability of retirement savings, and improving investor services (see Figure 1).[4]

The government plan is being coordinated at several points in the financial and pension sectors. The plan has three main goals. First and foremost is to double the current asset-based income for investors in Japanese companies. For public and private pensions, as well as defined contribution plans, this would not just be a tax incentive for more contributions.[5] The second goal should help form the corporate basis for better investment returns – that is corporate governance reforms. These reforms include support for more shareholder activism, investor awareness, and legal changes supporting mergers and acquisitions as well as buyouts.[5] Finally, the plan will look to overhaul the asset management sector with increased competition, transparency, and better access to stock-related reports and documentation for improved investment capacity.[5]

[1] Source: Nomura Research Institute, "Japan's Asset Management Business 2023/2024, December 2023.

[2] Established in 2014 and based on the United Kingdom's Individual Savings Accounts ("ISAs"), the Nippon Individual Savings Accounts ("NISAs") are tax incentivized individual savings accounts.

[3] Source: GMO, D. Edwards et al., "The Four 4s Behind the Compelling Opportunity in Japan's Equities," December 2023.

[4] Source: Financial Service Authority of Japan, "Overview of Promoting Japan as Asset Management Nation," December 2023.

[5] Source: Ibid.

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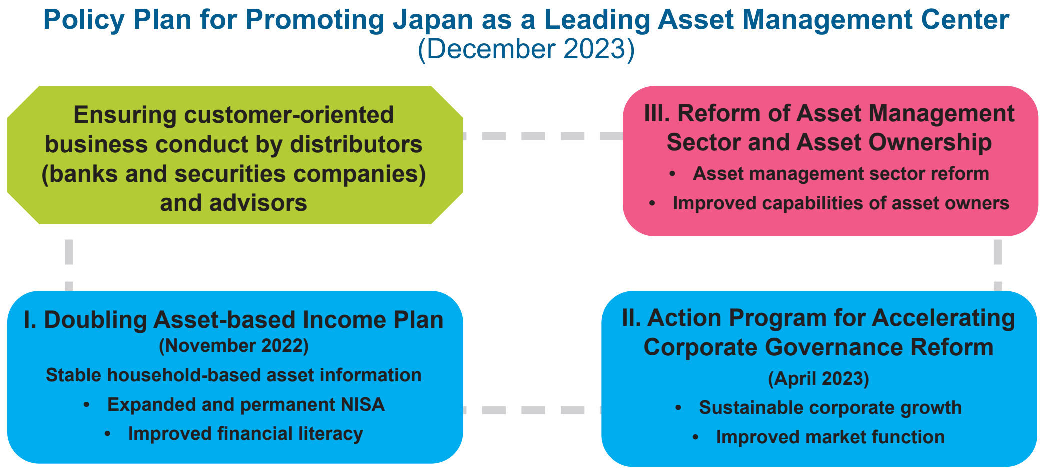

FIGURE 1
Illustration of Retirement Savings Reforms

Source: Financial Service Authority of Japan, "Overview of Promoting Japan as Asset Management Nation," December 2023.

Starting in January 2024, the maximum yearly contribution for individual savings accounts was doubled and income earned on these savings became permanently tax free.[6] The asset structure will also be more focused on growth and long-term investments instead of capital preservation.[7]

Defined benefit plans (i.e., pensions) will have new rules to ensure the review of selected investment and asset management providers to target the best results for beneficiaries. Defined contribution plans will have to improve transparency, providing investment menu and investment policy details to beneficiaries. The Ministry of Health, Welfare, and Labor will also require standardized disclosure of investment information to beneficiaries for all defined benefit and defined contribution plans.[8]

The Bank of Japan estimates that about half of Japan's household savings, which is estimated to be over 2 quadrillion yen (approximately $13.5 Trillion USD) is held in non-productive investments like cash.[9] Compared to listed companies in the US, Japanese companies hold an average cash balance three times greater, averaging twenty percent of their market capitalization in cash.[10] As transparency improves from listed companies, asset managers, and retirement plans, Japan's government hopes to stimulate a flow of cash to more productive use.[11] Greater shareholder awareness and activism elsewhere has historically tended to result in higher investment returns.[12]

Stock market reforms

Since the late 1990s the Tokyo Stock Exchange ("TSE") has incrementally increased its governance and reporting requirements for listed companies.[13] These reforms include rules for independent audits and standardization of corporate governance reports.[13] For example, in 2015, the TSE established the "Corporate Governance Code" and updated it in 2018 and 2021. At the start of 2022, the TSE restructured the five sector categories of the 2,000+ listed companies on the Nikkei into three distinct sectors. The Prime Market sector

6 Source: Financial Service Authority of Japan, "Overview of Promoting Japan as Asset Management Nation," December 2023. The original NISA waived twenty percent capital gains tax for five to ten years depending on structure.

7 Source: Reuters, B. Riley et al., "What is Japan's NISA Tax Free Investment Scheme?", November 29, 2023.

8 Source: Financial Service Authority of Japan, "Overview of Promoting Japan as Asset Management Nation," December 2023

9 Source: Reuters, B. Riley et al., "What is Japan's NISA Tax Free Investment Scheme?", November 29, 2023. and GMO. Yen:USD estimate as of February 5, 2024.

10 Source: Bridgewater, "Will Corporate Reforms Be Another Support for Japanese Equities?", January 23, 2024.

11 Source: Nomura Research Institute, Capital Group and GMO.

12 Source: Bridgewater, "Will Corporate Reforms Be Another Support for Japanese Equities?", January 23, 2024. Bridgewater found that since 2010 companies with shareholder activism and governance reforms outperformed by 40% globally.

13 Source: Tokyo Stock Exchange, "White Paper on Corporate Governance," March 2023.

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was designated for the largest, best run, and most liquid companies. This sector would function as the "blue chip" stocks. Prime Market companies have "a market capitalization large enough to be a target for many institutional investors" and have "a higher level of corporate governance."[14] The Growth Market sector was designated for smaller cap companies with the potential for long-term growth. Finally, the Standard Market sector includes everything else. The TSE is particularly focused on enhancing and enforcing governance reforms in the Prime Market listed companies.[14]

The TSE's rules for continued listing for Prime Market companies include full enforcement of governance code requirements. These governance rules include electronic shareholder voting, nomination of women to leadership and boards, receptivity to shareholder proposals, report standardization and production in English, and other initiatives related to the government's goals of doubling investment income for investors in Japanese listed companies. In December 2023, the TSE established a Council of Experts to continue to monitor initiatives to restructure and upgrade management and return on capital for listed Japanese companies.[15]

	Prime Market	Standard Market	Growth Market
Liquidity (Continued Listing)	Basic Liquidity for Institutional Investors	Basic, Smooth Trading for Public Investors	Minimum Liquidity for Public Investors
Number of Companies	1,839	1,824	466
Tradable Market Cap	JPY 10 B	JPY 1 B	JPY 0.5 B
Trading Value	JPY 20 M (daily)	10 units (monthly)	10 units (monthly)
Governance	Constructive Dialogue Between Companies & Investors	Governance for Sustainable Growth	Appropriate for Growth Stage Companies
Governance Code Level	Revised Code Fully Applied	Revised Code Fully Applied	Basic Principles
Tradable Share Ratio	35%	25%	25%
Share Holder Dialogue/ Activism	65% Institutional (outside) Shareholders		High Growth Business Plan
Business Performance & Financial Status	Stable & Excellent Revenue/ Financial Base	Stable Revenue Foundation & Financial Status	Business Plans for high growth for Public Investors
Total Profit	JPY 2.5 B (2 years- IPO Minimum)	JPY 0.1 B (IPO Minimum)	JPY 0.5 B
Sales	JPY 10 B & Market Cap JPY 100 B		
Shareholder Equity IPO	JPY 2.5 B (2 years- IPO Minimum)	Positive	
Shareholder Equity	JPY 5 B (IPO Minimum)		

FIGURE 2
The Tokyo Stock Exchange's New Taxonomy

Source: Japan Stock Exchange "Improvements Market Structure," April 4, 2022. Since restructuring has begun some designations for companies may have shifted.

14 Source: Tokyo Stock Exchange, "White Paper on Corporate Governance," March 2023.

15 Source: TSE website announcing creation of Council of Experts, December 2023.

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Sorting companies by board structure, market cap, revenue, and liquidity was a helpful first step, but the TSE wanted to go further. At the end of 2023, nearly 40% of the stocks listed on the TSE were trading with a price to book value below 1 compared to only 5% for the S&P 500 index.[16] Further, as was noted earlier, Japanese companies held a tremendous amount of cash on their balance sheets.

In early 2023, the TSE rules required that companies with a price-to-book ratio under one to boost value via dividends and share buybacks in order to continue listing.[17] The TSE's "Action to Implement Management That is Conscious of Cost of Capital and Stock Price" required that every company submit an action plan for value creation and stock price appreciation.[18] So far, 78% of the Prime Market companies with low valuation have submitted plans to boost share price and return capital to investors.[18] Companies trading at higher valuations have been slow to submit plans for increasing shareholder value. Most companies in the Standard Market and Growth Market have not yet submitted their plans.

To boost compliance to the new guidance on share price and cost of capital management, the TSE is planning on releasing a list of companies who have submitted plans.[19] Early indications about compliance to the governance rules is encouraging, in that preliminary analysis indicated that Japanese companies that submitted plans to boost shareholder returns outperformed the broader market in 2023 (see Figure 3).[20] For example, a record number of Japanese companies announced share buybacks, helping to boost earnings per share while reducing their cash reserves.[21]

16 Source: Capital Group, "Japan: Will Reforms Unlock Stock Valuations?" September 5, 2023; and Tokyo Stock Exchange. As of year-end, 145 Prime Market companies traded below book value of 0.5 and another 591 traded between 0.5 and 1.0 of book value.

17 Source: The Japan Times, K. Nagata, "TSE Finally Ramps Up Market Reform One Year After Questionable Restructuring," April 18, 2023.

18 Source: Tokyo Stock Exchange, "Action to Implement Management that is conscious of Cost of Capital and Stock Price," January 2024.

19 Source: Tokyo Stock Exchange, January 2024.

20 Source: Bridgewater, "Will Corporate Reforms Be Another Support for Japanese Equities?", January 23, 2024. Data from Goldman Sachs.

21 Source: Nikkei Asia, "Japan Stocks' 28% Jump in 2023 Fueled by Reform, Buffet, and M&A," December 30, 2023.

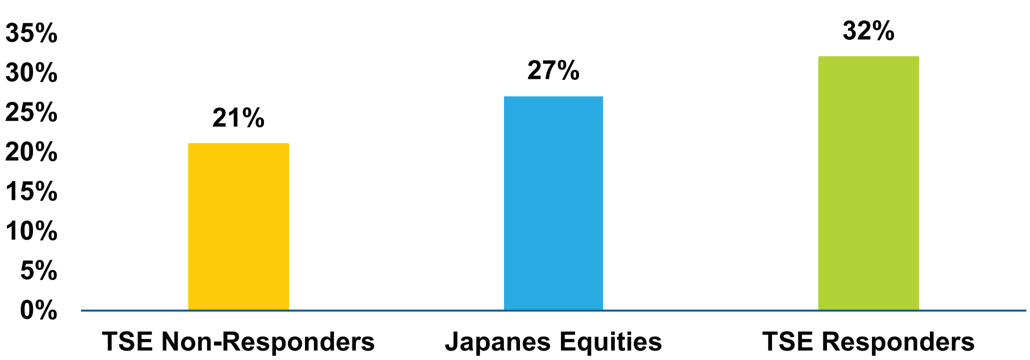

FIGURE 3

TSE Corporate Governance Responders Outperform in 2023

Source: Bridgewater, "Will Corporate Reforms Be Another Support for Japanese Equities?", January 23, 2024. Data from Goldman Sachs.

Mergers and acquisitions

Additionally, in August 2023, the Japanese government released new guidelines to promote more mergers and acquisitions among companies.[22] The Ministry of Economy, Transportation and Industry ("METI") is playing an active role in the Kishida government's goals to transform Japan into an asset management nation via new "Guidelines for Corporate Takeovers: Enhancing Corporate Value and Securing Shareholders' Interests."[23] In a corporate landscape that is more fragmented than the US (with market cap more widely distributed and not concentrated in several big players),

22 Source: Neuberger Berman, "Japan: Unlocking Hidden Value Through Engagement," 2023.

23 Source: METI, "Guidelines for Corporate Takeovers: Exchange Corporate Value and Securing Shareholder Interests," August 31, 2023. Rules for buyouts and takeovers are still quite new with the first METI rules published in 2005. In 2007, the first METI rules for MBOs were published.

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the regulations are intended to spur consolidation and improve profitability. While the TSE has focused on improving management awareness of the cost of capital and share prices, the METI new guidance describes rules for the management of listed companies' response to takeover bids either by outside companies or activist shareholders.[24]

The METI guidelines focus on three key principles that harmonize with the new TSE rules for management to increase their share price and book-value ratio. The first principle for corporate takeovers is that management (i.e., directors) should evaluate a welcome or unwelcome takeover bid "on the basis of whether it will secure an enhanced corporate value and shareholders' common interests."[24] The second principle for evaluating a corporate takeover bid is likewise based on shareholder interests. Management should approach offers from the perspective of shareholder rationale.[24] This aligns with the TSE goal of shareholder engagement and dialogue outlined in their new corporate governance rules described above. Transparency is the third METI corporate takeover principle. METI requires that all relevant information regarding the value, share price, and terms of the takeover proposal should be made available to shareholders proactively.[25]

[24] Source: METI, "Guidelines for Corporate Takeovers: Exchange Corporate Value and Securing Shareholder Interests," August 31, 2023.

[25] Source: "Guidelines for Corporate Takeovers: Exchange Corporate Value and Securing Shareholder Interests," August 31, 2023.

Venture capital reforms

The Financial Services Agency ("FSA") has also issued new guidelines to promote the formation and financing of start-ups.[26] The FSA's working group on capital market regulations has focused on improving transparency regarding private equity's role in financing of start-up ventures with an eye to increasing institutional investors' access to emerging companies.[26] New guidance aligns company share allocations among management, investors, and employees prior to public offering. [26] The FSA reforms will improve the quality and number of companies that could eventually list as public equities.

[26] Source: Financial Services Agency, "Report of Working Group on Capital Market Regulations & Asset Management Task Force on the Financial Systems Council," December 2023.

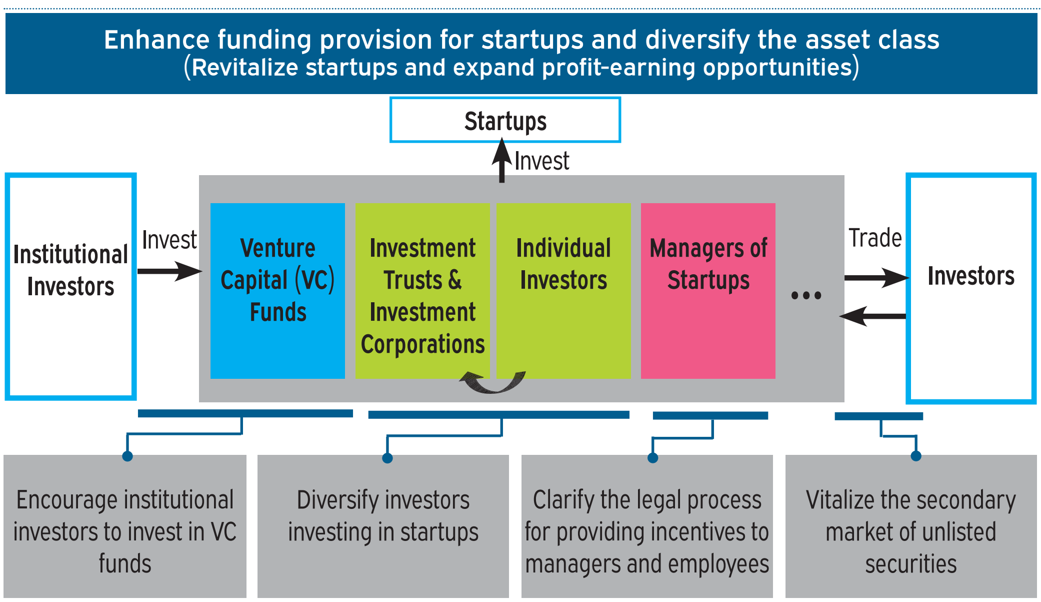

FIGURE 4
Venture Capital Reforms

Source: Financial Services Agency, "Report of Working Group on Capital Market Regulations & Asset Management Task Force on the Financial Systems Council," December 2023.

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Turning the corner?

Japanese equity markets returned 20.8% in 2023 (in USD), as investors appeared to become optimistic about the regulatory reforms taking place (see Figure 5). For for the calendar year, Japanese equities outperformed the broader EAFE index for the first time since 2020.

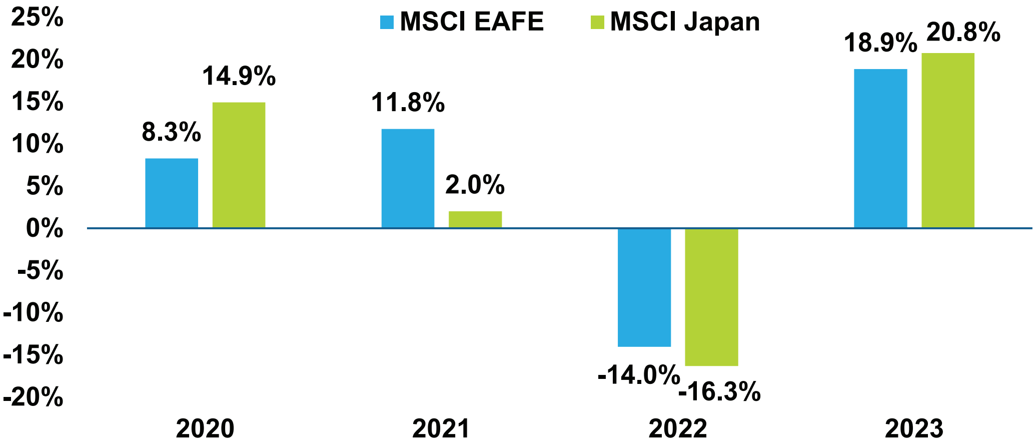

FIGURE 5

MSCI Japan and EAFE Index Calendar Year Performance Capital Reforms

Source: MSCI as of December 2023.

Exposure to Japanese equities

Many institutional investors in the US have exposure to Japanese stocks through regional indices such as the MSCI EAFE index or the MSCI All Country World index. Japan is the largest country weight (22.5%) in the MSCI EAFE index, followed by the United Kingdom (14.75%).[27] The MSCI Japan index measures the performance of the large and mid-cap segments of the Japanese market. At 225 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

Relative to the MSCI EAFE index, the MSCI Japan index has a smaller average market cap and has larger allocations in the industrials, consumer discretionary, and IT sectors.[28] At the end of 2023, industrials, utilities, oil and gas, banks, machinery, construction, and materials stocks tended to trade well below their book value.[29] Conversely, technology, communications, and retail companies tended to trade at higher valuations.[30]

One reason investors might choose to allocate to Japan is for diversification benefits. Japanese equities have exhibited a lower correlation to US equities than have European or emerging market stocks for most of the past 30+ years (see Figure 6). Arguably, this could be due to larger relative differences in sector composition, revenue source, or monetary policy. However, if Japan is becoming more closely aligned with the US as a trading partner, and if its monetary policy is likewise becoming more closely aligned with that of the US and Europe as its inflation rate normalizes, some of the diversification benefits of Japanese exposure could diminish.

[27] Source: MSCI EAFE Index (USD) FactSheet as of December 2023.

[28] Source: MSCI as of December 2023.

[29] Source: Tokyo Stock Exchange, "Action to Implement Management that is conscious of Cost of Capital and Stock Price," January 2024. 145 Prime Market companies traded below book value of 0.5 and another 591 traded between 0.5 and 1.0 book value.

[30] Source: Tokyo Stock Exchange, "Action to Implement Management that is conscious of Cost of Capital and Stock Price," January 2024.

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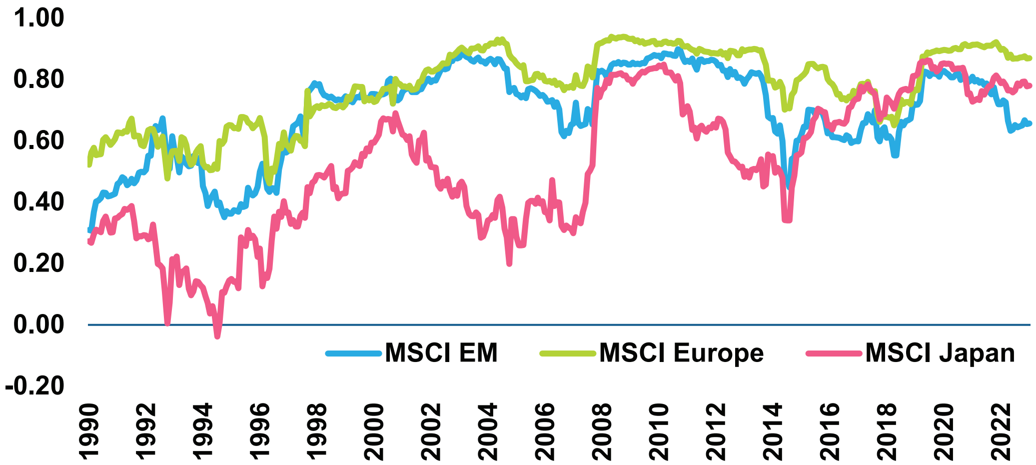

FIGURE 6
Rolling 3-Year Correlation with US Equities

Source: MSCI and Russell, Russell 3000 is used as a proxy for US equities. Data is for the period January 1988 through December 2023.

Betting against Japan by being underweight Japanese equities versus an EAFE or ACWI benchmark has been a popular position among US investment managers for decades. Most active investment managers appear to still be underweight Japan in their portfolios. For example, as of September 30 , 2023, of the 238 actively managed EAFE strategies in the eVestment database, 83% were underweight Japan, and by a sizeable average of 7.6%.[31] Anecdotally, investment managers continue to have diverging views on Japan, depending on their style and opportunity set. Many investment managers acknowledge the current positive conditions in Japan but may not necessarily believe the changes are material, enduring, or exceptional relative to peers.

[31] Source: Data as of September 30, 2023, pulled from eVestment alliance on December 11, 2023.

Conclusions

Japan has overcome many of the challenges of low growth and inflation that plagued its economy for decades. It is now implementing reforms to boost shareholder returns, corporate governance, and innovation. These include reforms related to retirement savings, the stock market, M&A, and venture capital.

The government has implemented a plan to transform Japan into a “wealth management nation” by mobilizing household savings into productive investments, improving tax incentives, facilitating job mobility, and enhancing investor services. The Tokyo Stock Exchange has restructured its market segments, enforced higher governance standards, and required companies to increase their share price and book-value ratio through dividends and buybacks. The Ministry of Economy, Transportation and Industry issued new guidelines to promote more mergers and acquisitions among companies, based on the principles of enhancing corporate value, securing shareholders’ interests, and improving transparency. Finally, the Financial Services Agency issued new guidelines to improve the formation and financing of start-ups, by increasing transparency, aligning share allocations, and facilitating access to emerging companies.

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Japan's favorable economic conditions, improving corporate governance, and attractive valuations are worth following, and some may argue that these factors make the Japanese equity market a compelling opportunity set. The coordinated regulatory reforms are aligned to improve shareholder returns. While most US investment managers have been underweight Japanese equities, perhaps the tide of reforms will cause investors to re-think their allocations to Japan.

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