

2016 JAPAN EQUITY OUTLOOK

IMPROVING CORPORATE HEALTH OFFERS A SIGNIFICANT OPPORTUNITY IN JAPAN



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Q1. Why do you choose to be a contrarian value investor?

For those investors who choose to focus on the ever changing daily macroeconomic news flow, it becomes a challenge to identify what is really important in forming their investment decisions.

Too often we observe significant weight being applied to almost irrelevant information in decision making.

We argue it is almost impossible to consistently forecast the effects of short term news flow on markets. Forecasting is inherently biased, underestimates uncertainty and gives false confidence in the ability to “time the market”.

Instead we choose to let share prices lead us to the most attractive opportunities, and be patient.

The market has recently shown a strong preference for more defensive stocks. This may be a response to rising volatility.

These kinds of stocks appear to offer comfort to investors due to a perception of certainty around the delivery of short term earnings. Examples of these names can be commonly found in Consumer Staples; Pharmaceuticals; Railways; and Utilities.

The main problem with this investment thesis is that many investors were willing to handsomely over pay for this comfort from perceived earnings certainty. This is something we avoid at all costs.

Overpaying for shorter term certainty can give way to longer term underperformance. A herd-like focus on shorter term macroeconomic news flow often serves to harm investors’ longer term returns.

On the other hand, the market’s narrow focus on themes can leave behind a long tail of unloved, out of favour and very cheap names for contrarian investors seeking out value to exploit. These opportunities are best identified on a stock by stock basis.

Start by focusing on the extremes of valuation and there are plenty of opportunities to exploit. Starting valuations help to determine the likely upside potential for investment. The more mispriced, the higher the upside potential may be.

The detailed work confirming that value exists is vital. We focus on value relative to long-term sustainable earnings. This detailed analysis also gives us a good understanding of what is happening more broadly in corporate Japan.

We find many investment opportunities across the market in Japan – because we are willing to avoid the herd, let cheap share prices take us to opportunities, confirm that value exists and be patient.

Q2. What factors might be supportive for the longer term market performance in Japan?

Corporate Japan looks very different when compared to any other point in the last decade.

The long process of balance sheet repair is over; many companies are starting to focus on improved capital efficiency; generating significant cash flow; and applying renewed balance sheet strength to pursue sensible expansion strategies.

Japanese companies are getting better at focusing on and continuing to improve their core businesses compared to the value destroying diversification of the past. They are also increasingly using their renewed strength for sensible overseas expansion. ▶

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Despite some market recognition, the ongoing acceleration of corporate restructuring and delivered earnings have yet to be priced into valuations for many companies in Japan.

Encouragingly for shareholders, more companies are returning value in the form of dividends and buybacks. There is large scope for improvement but this change in corporate attitudes is setting a new tone for the Japanese corporate landscape, and shows all the signs of a renewed competitive edge.

Improving shareholder oriented behaviour from Japanese companies; as well as improving capital efficiency and the positive use of cash makes a strong case for a sustainability of returns and the longer term outlook for Japanese equities.



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