2016 JAPAN EQUITY OUTLOOK
SURFING THE VALUE WAVE

A member of Prudential plc (UK)

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IMPROVING CORPORATE HEALTH OFFERS A SIGNIFICANT OPPORTUNITY IN JAPAN

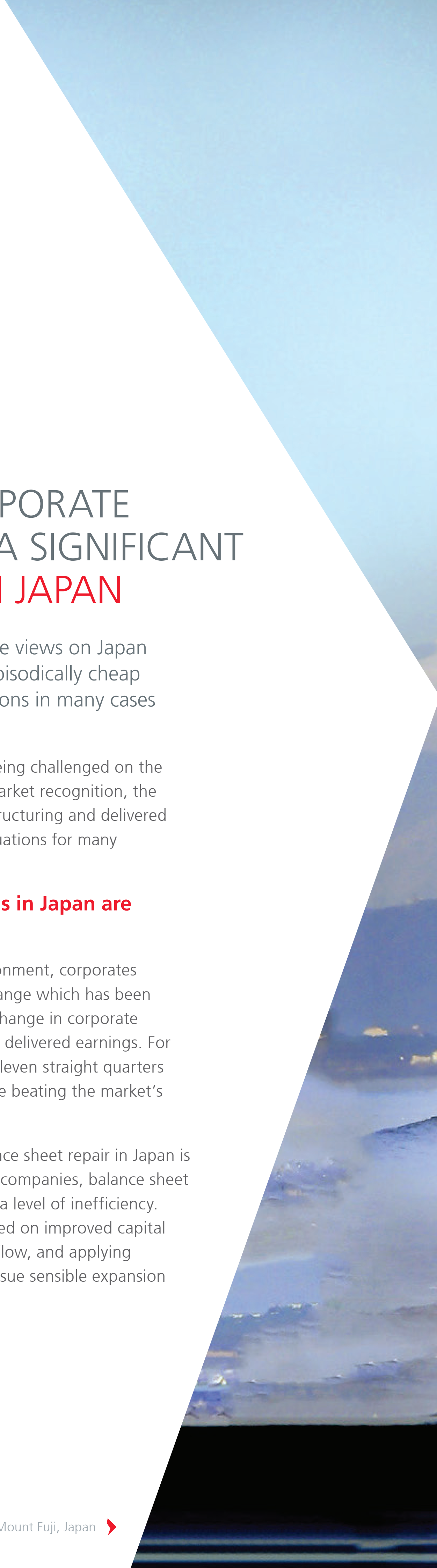
The market's entrenched negative views on Japan helped to drive share prices to episodically cheap levels some time ago and valuations in many cases remain supportive.

Nowadays, these negative views are being challenged on the back of meaningful change. Despite market recognition, the ongoing acceleration of corporate restructuring and delivered earnings have yet to be priced into valuations for many companies in Japan.

Improving trend fundamentals in Japan are underappreciated

In the midst of a difficult market environment, corporates in Japan have undergone structural change which has been accelerating since 2008. This positive change in corporate behaviour has also been supportive for delivered earnings. For example, since 2013 there have been eleven straight quarters of upwardly revised earnings, each time beating the market's expectations.

In aggregate, the long process of balance sheet repair in Japan is well and truly over. Arguably for many companies, balance sheet health is "too strong" which points to a level of inefficiency. In fact some companies are now focused on improved capital efficiency, generating significant cash flow, and applying renewed balance sheet strength to pursue sensible expansion strategies.



Surfing with the moon and Mount Fuji, Japan

Inflation expectations in Japan increase domestic investors' required returns

Since the introduction of Abe's reflationary policies, we have observed a shift in broad market expectations of mild deflation to expectations for inflation in Japan. A change in this economic imperative for domestic investors has increased their required returns amid even a mild inflationary environment. As a result, domestic investors are making use of significant cash savings (households) and also selling Japanese Government Bonds (institutions) in order to buy more equities.

Increased ownership of equities has sparked a rising focus on governance from domestic investors in order to "unlock value". Investor engagement with companies is causing the latter to focus on improving capital efficiency, increasing dividends as well as share buybacks to improve total returns.

Unlocking value in Japan

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

In addition, the introduction of the new Corporate Governance Code may encourage a move toward higher payout ratios that started in 2014. There is admittedly ample scope for payouts to improve. However this is an example of positive structural change we observe in corporate behaviour which is supportive for sustainability of returns.

Furthermore, over 100 domestic and foreign institutional investors have signed up to the Japan stewardship code. This represents investor commitment to active shareholder engagement and a pursuit of best practice in governance behaviour for companies.

Unlocking balance sheet cash is seen as a potential value driver: in 2014, total share buybacks were Japanese Yen 4.2 trillion, up 86% from 2013, and the trend has continued into 2015. In the past 12 months to 10 August 2015, companies have announced Japanese Yen 4.5 trillion in buybacks, a six-year high and equivalent to a 0.75% buyback yield for the TOPIX (Tokyo Stock Price Index).

Where are trend valuation signals taking us?

There are unexpected investment opportunities in Japan - if you are willing to avoid the herd, let cheap share prices take you to opportunities, confirm that value exists and be patient.

We have found, on a stock by stock basis, high conviction names with strong valuation signals across much of the market. There are names in major banks, insurance companies, consumer electronics and information technology, specialist materials and industrials, auto–related as well as domestic names.

Market overreaction to news flow can drive mispricing

The market obsesses over recent news flow on sector or global macroeconomic cycle forecasts. We let cheap share prices take us to opportunities.

The future is inherently uncertain, and we ensure that there is a significant margin of safety in the valuation for every investment. This helps to mitigate the downside risk in the stocks we invest in compared to other expensively valued stocks in the market.

We avoid expensively valued names that are loved by the market.

In aggregate we are finding either insufficient conviction or unattractive valuations in the more defensive stocks including consumer staples, pharmaceuticals, railways and utilities.

UP 86%

from 2013, total share buybacks, JPY 4.2 trillion, in 2014 – the trend has continued into 2015

JPY 4.5 TRILLION

in buybacks, in the past 12 months to 10 August 2015

0.75%

buyback yield for the TOPIX in the past 12 months to 10 August 2015, six-year high

What's in store for 2016?

The game plan for 2016 is the same one we've been successfully executing for over ten years.

There are no bold forecasts to be made. We will leave you with a quote from Warren Buffett, which reflects our sentiments on the subject of contrarian investing.

"Be fearful when others are greedy and greedy when others are fearful".

Daring to be different can sometimes be painful, but we think it offers the greatest rewards.

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