Schroders TalkingPoint

Investing in Japan – a long-term game

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June 2013

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Prime Minister Shinzo Abe has been whetting investors' appetite for Japan, and the country has finally started to emerge from an exceptionally difficult period. His economic policies, dubbed 'Abenomics', have arguably started to have some impact and the Japanese equity market has expanded at an astonishing rate, returning 50.8% from 30 November 2012 to 30 April 2013*.

Recent market turmoil

The recent set back which the market has experienced since late May, in fact, seems to be a reasonable correction after such a long winning streak. Admittedly the size of some daily moves, coupled with high intra-day volatility, appears slightly disturbing, but some of this has been generated by moves in bond and currency markets. If we carefully look at the equity market, valuations do not look particularly stretched, and the outlook for corporate profits has improved.

In our opinion, investing in Japan remains attractive as the market is eventually driven by fundamentals – not short-term momentum. Therefore, such a market environment often provides opportunities for long-term investors like Schroders.

The basics of valuation discipline

Valuation discipline is a critical part of long-term investment. While it is uncomfortable for any fund manager to see his/her portfolio holdings underperforming, at such times of market boom and panic, the basics of valuation discipline are vital. This is the essence of successful long-term investment and what we believe will generate return for investors.

> "…holding long-term positions based on attractive valuations, supported by our fundamental research, can add significant value over the longer term."

For example, there are a number of risks which must be weighed up carefully. Over March, the growing risk in the JGB (Japanese government bond) market was a concern. Prior to Mr Kuroda's aggressive monetary easing policy, all JGB yields had sharply declined, including long-dated bonds with twenty or thirty year maturities. Given the improving economic conditions and potential outcome of monetary easing, this was an uncomfortable situation for a number of investors.

Let's take the example of a life insurance company which we held during the period. Its share price fell on concerns about the negative impact of declining long-term interest rates on its embedded value. The multiple of this 'embedded value' to market capitalisation is a standard valuation measure for life insurance companies and is sensitive to long-term interest rates. As a result, the stock prices of life insurance companies tend to be volatile in response to movement in the JGB market.

Even during such movement in the market, we took a contrarian approach and held the position. This was based on the company's earnings prospects in the life insurance business, which was improving. The danger to the bond market started to materialise in April and May, which in turn pushed life insurance stocks higher. It was too early to say whether this could have a successful outcome or not, but we believe that despite signs of short-term volatility, holding long-term positions based on attractive valuations, supported by our fundamental research, can add significant value over the longer term.

* Source: Bloomberg

Earnings recovery for exporters

Another interesting case study which we have recently witnessed is the behaviour of exporters. After a consistently weaker trend in the yen, the Japanese yen/USD rate also became very volatile in recent weeks. Based on fundamental views and valuations, yen weakness since the start of the year has corrected the previous overvaluation of the yen which stemmed from the global financial crisis in 2008 strength. At any yen/dollar rate around the current level, exporters can certainly recover their earnings power, yet the stock prices of exporters still seem to be significantly over-reacting to short-term movements in the currency.

Our view on earnings recovery for exporters are not dependent solely on further yen weakness, but are supported by economic recovery in the US. Therefore, such market volatility again provides good buying opportunities for a long-term investor.

So, our strategy remains a very bottom up one, driven by individual companies' earnings, growth prospects and valuation. We do not think politics has much influence although, of course, we must be aware of the impact that a change in macro factors can have on a company's earnings outlook. Fundamental views and valuation discipline should be the golden rules for long-term investors, especially in cases like life insurance companies or exporters, where spikes in market volatility provide long-term investment opportunities.

The Japanese market remains on the track

The sharp sell-off in the long-term JGB market also impacted the Japanese stockmarket and is now said to be one of the triggers for the recent market correction. We believe the recent market turmoil is mainly driven by short-term money, not by long-term investors looking at fundamentals, economic developments and corporate earnings. The bond market is beginning to adopt higher inflationary expectations, which will inevitably lead to higher yields. However, it must still adjust to the announcement of sustained bond purchases by the Bank of Japan (BoJ).

Despite the recent spike in volatility created by these competing factors, absolute yields remain at historically low levels. It would, therefore, be incorrect to view the recent market activity as any kind of verdict on the policies of the government and the BoJ. In fact, actual economic data continues to improve and encouraging news on the labour market, inflation and industrial production came through at the end of May. We believe that the gradual cyclical recovery, which was arguably in place well before Mr Abe's election, continues to head in the right direction. In addition, we continue to believe that official policy will push the recovery further in the medium term.

Overall, Japan looks to be well-placed to benefit from the gradual improvements in the global economy. We believe that Mr Abe's growth strategies, needed for the current short-term stimulus from monetary and fiscal policies to be translated into higher long-term trend growth, will provide further support to long-term equity investors.