FUND ANALYSIS

Clearer signs emerging of durable revival in Japan

The notoriously sluggish Japanese market has suffered numerous false dawns in recent years. But the latest upswing in sentiment looks well-founded, writes Cherry Reynard

For many years the Japanese market has been prone to frustrate rather than enrich. However, investors were finally rewarded for their patience in 2017 as Japanese companies outpaced their rivals. The spoils were not evenly shared, however: there was a notable gap between the winners and the losers. For 2018 investors may need to pick a team, either sticking with the racier growth companies or rotating into those unloved companies left behind last year.

Japan's new-found strength has several drivers. The economic backdrop has materially improved – GDP growth is rising and there are even signs of organic inflation. New corporate governance rules have encouraged companies to sharpen up their acts, bring in independent directors, pay dividends and tackle the cronyism that had held back shareholder returns. Then there is the buoyancy of the wider region. Japan has proved a natural beneficiary of China's increasing demand for manufacturing automation, for example.

The average fund in the Investment Association's Japan sector was up 17.9 per cent over the past year, the strongest performance of any developed market sector. Over the past six months, in particular, the Nikkei 225 index has outpaced the S&P 500 and (less impressively) the FTSE 100 index.

WIDE VARIATION IN PERFORMANCE

Fund	Total return (%) over: 3 mths	6 mths	1 year	3 years
First State Japan Focus	24.60	39.92		
Legg Mason IF Japan Equity	19.31	36.07	164.56	333.40
Fidelity Japan Smaller Companies	18.27	32.60	92.47	168.04
Fidelity Institutional Japan	17.25	29.48	70.96	126.29
RWC Nissay Japan Focus	17.58	27.40		
Neptune Japan Opportunities	15.84	26.91	27.31	103.58
Lindsell Train Japanese Equity	7.77	26.77	111.03	161.12
Baillie Gifford Japanese	14.69	26.56	89.69	172.89
Barclays Global Access Japan	16.94	26.33	49.78	144.98
JPM Japan	14.29	24.80	89.09	165.50
IA Japan sector	*10.72*	*17.93*	*68.23*	*113.01*
TSE TOPIX 100 index	*8.08*	*13.02*	*61.34*	*103.91*
MSCI Japan index	*8.31*	*13.25*	*60.31*	*103.97*

Notes: Table shows top-performing funds in the Investment Association's Japan sector, ranked by one-year returns. **Source:** FE Analytics, as at 1 January 2017

However, this broad strength masks considerable disparities in underlying returns. The top-performing fund, the First State Japan Focus fund, was up 39.9 per cent for the calendar year. In contrast, the bottom fund in the sector, the Principal GIF Japanese Equity fund, rose by just 10 per cent.

In many ways, the performance of companies in Japan mirrored that of firms in other developed markets. The strongest funds have been determinedly growth-focused. Their portfolios have incorporated themes such as robotics, semiconductors, service companies and internet disruptors.

The weakest funds have tended to have a value or dividend skew. Respected managers with solid, long-term track records such as Stephen Harker and Neil Edwards, at the Man GLG Japan Core Alpha fund, for example, had a tough year. These funds tended to have higher weightings in sectors such as financials and automotives, and in some industrial names.

Market leadership has been dominated by some clear themes. Praveen Kumar, manager of Baillie Gifford Shin Nippon trust, highlights three strong themes. The first is companies benefiting from a drive towards factory automation in China, the US and even Japan itself. These include robotics companies, a particular strength in Japan. The second theme is domestic services. Japan remains in thrall to its ageing population, and companies that provide services to this group saw strong growth during the year. The third theme is online disruption, where upstart companies shook up sleepy incumbents.

> **"The valuation of the Japanese market is quite reasonable at a time when other markets are pretty expensive"**
> Tom Stevenson

In contrast, there were notable weak spots. Jonathan Dobson, manager of the CC Japan Alpha Fund, says: 'The real laggards were the banking and auto sectors. They were very dull and underperformed the index. 2017 was truly a tale of light and dark for the Japanese market.'

Looking forwards into 2018, many asset allocators are broadly optimistic about the market as a whole. Tom Stevenson, investment director at Fidelity Personal Investing, says: 'The valuation of the Japanese market is quite reasonable at a time when other markets are pretty expensive. Earnings growth is also quite a lot stronger in Japan than it is elsewhere, largely thanks to slowing wage growth.

'The structural reforms put in place by [Japan's prime minister] Shinzo Abe were slow to get going, but they are now beginning to come through. There has also been a real change in the corporate landscape in Japan. Inefficiencies such as cross-shareholdings and a lack of independent directors have largely been addressed, with companies moving to a more western style of corporate governance.' Moreover, he sees some support for the equity market coming from domestic pension funds, which have finally started to buy shares in place of bonds and cash.

Turning point

There has been a subtle change in attitude on the part of global asset allocators. For many years, Japan was considered to be a market in structural decline. However, Abe has finally shown that this time it could be different in Japan. There may be a sustained rise in inflation and economic growth, plus enduring improvement in corporate governance.

Joe Bauernfreund, portfolio manager of the British Empire Trust, increased the trust's exposure to Japan from 9.1 per cent at the end of 2016 to more than 16 per cent by the end of 2017. He says: 'Much has been written about Japan and the amount of value on offer there. This value has been stored up in corporate Japan's overcapitalised balance sheets and kept locked away in a labyrinth of cross shareholdings, inert boards and bank alliances.

'Cynics argue that this will never change and that this moment is no different from other periods when there was hope for a wave of change in corporate mentality. Our view is that things are changing, and the evidence suggests these changes are bearing fruit.'

The puzzle for investors is identifying which part of the Japan market will prove more fruitful in 2018. For Kumar at Baillie Gifford, the demographic problem is here to stay, and despite the government taking steps to introduce limited immigration, labour shortages will remain a challenge. He says: 'In sectors such as information technology the problem is particularly extreme, with up to eight jobs available per person. Meanwhile, there is considerable construction work required for the Olympics in 2020, while the number of elderly people requiring care is only going to increase.'

Dobson is also sure these factors are here to stay, but he is less certain on the prospects for companies geared to manufacturing automation. He says the wider trend depends on Chinese spending, which could slow. Kumar, in contrast, believes the automation theme has further to run, given the low levels of automation in many factories to date.

> **"Evidence suggests [economic] changes are bearing fruit"**
> Joe Bauernfreund

Meanwhile, internet stocks are likely to power on. Kumar points to companies such as online brokerage SBI Holdings and Yume No Machi (the Japanese equivalent of Just Eat) which continue to see structural growth. He says that while valuations may be higher, earnings justify the higher rating. Stevenson adds: 'This type of technology company is quite pricey in the US and China. In Japan, investors are getting this technology leadership without the premium paid elsewhere.'

Usual suspects

The car manufacturers and financials have their supporters. They still form a relatively large part of the Nikkei, and some argue they look far cheaper than their racier growth peers. However, Dobson sees little prospect of exciting growth for either sector. He says: 'I can't see any reason for banks to outperform the market. They form a big sector and people who care about the index may want to hold them. However, there is no loan growth and the population is declining, so there is unlikely to be significant demand in future.'

Meanwhile, the car industry is in flux, with disruptors such as Tesla creating real change. Dobson says: 'Across the world car companies trade on around 10 times earnings. They show similar profit margins, and unless the yen were to weaken, it is difficult to envisage a lot of traction for the sector.'

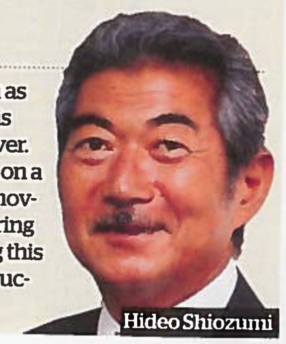
Historically, when investors have confidently declared that 'this time it is different' in Japan, they have found themselves nursing losses. Undoubtedly, it remains a difficult and idiosyncratic place to invest. That said, at a time when global stock markets are expensive and technology firms even more so, Japan seems to offer some strong growth opportunities at lower prices. Maybe this time it really will be different.

FUND IN FOCUS

LEGG MASON JAPAN EQUITY

The Legg Mason Japan Equity fund generally finds itself at the top or the very bottom of the IA Japan sector as its unique high-growth, high-conviction style moves in and out of fashion. However, over the long term – which is how manager Hideo Shiozumi likes to look at things – its results are impressive. It is first-quartile over one, three and five years, outpacing the wider sector by more than 200 per cent since 2012.

Shiozumi has 45 years' experience in the Japanese market. He looks for small and medium-sized companies operating in profitable niches. Among his current top 10 holdings are mergers and acquisitions broker Nihon M&A, manufacturing outsourcing group Outsourcing Inc and more familiar names such as Nintendo. The fund is generally low-turnover. Shiozumi is focused on a deregulated Japan moving from manufacturing to services, believing this to be an enduring structural shift.


Hideo Shiozumi