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Japan Market Pulse

Japanese equities: The 'bargains' that go begging

Stacks of idle cash driving away international investors

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TOKYO -- Various metrics tell us that Japanese stocks are undervalued against global peers, but international bargain hunters have shied away from them, pointing to their hoards of cash not being put to use.

Though the Nikkei Stock Average notched its best gain in about three months Monday, trading volume on the Tokyo Stock Exchange's first section fell below 2 trillion yen ($18.3 billion), considered the threshold for an active market.

"The short selling manifest up until the end of last week unwound itself," said Satoshi Kashihara at Nomura Securities. But beyond that round of repurchasing, the market went silent.

"Maybe international long-term investors are pruning Japanese equities," said a trader at another Japanese brokerage. The numbers strongly support that hunch. In each of the six weeks through the end of August, foreign investors have sold more domestic stocks than they bought.

And during that span, "we have received large-volume sale orders from value stock funds located overseas," said the same trader.

Investment funds specializing in global value stocks have been cutting their allocations of Japanese equities. Honda Motor and Nomura Holdings, for example, disappeared from the top 10 companies owned in the past year by Oakmark International, the U.S. vehicle managed by Harris Associates.

Even though Japanese equities account for more than 20% of global market value outside of the U.S., Oakmark's ratio of Japanese stocks is now a mere 6%.

Japanese stocks have always been known to be notable bargains -- at least on paper. About 40% of TSE first section components have price-to-book values that fall below the liquidation multiple of 1. And more than 200 Japanese corporations enjoy ready liquidity equivalent to 30% of their market capitalization.

On top of that, geopolitical risks have caused some price correction, so what is keeping the bargain-hunters at bay?

Dalton Investments, a U.S. asset manager, recognizes only half of cash on hand when determining the corporate value of Japanese companies, which are seen to be lacking in corporate governance, said co-founder James Rosenwald.

Cash equivalents are piling up around the globe, but Dalton trusts U.S. companies to at least make effective use of those funds eventually. But the investment house strongly suspects Japanese corporations of stockpiling cash indefinitely. There is also the risk of those firms squandering that money, meaning Dalton has no choice but to price in only half their cash, said Rosenwald.

When Ryohei Yanagi, chief financial officer at Japanese drugmaker Eisai, asked 40 international investors what they thought of Japanese cash holdings, a majority said they value the liquidity at half their worth or less.

Lowering the appraisal of the cash on hand raises the price-to-book value. "Foreigners are not seeing Japanese equities as bargains in terms of 'face value,'" said Yanagi.

David Herro, partner at Harris Associates, said there is no reason to place funds in what he considers low-quality Japanese stocks when there are better investment opportunities in Europe. The number of funds specializing in Japanese stocks is dwindling, and more diversified global portfolios now reign supreme. And those megafunds are icing out companies that do not compete at the international level in earning power and corporate governance.