Japan – A "two-way" investment star?

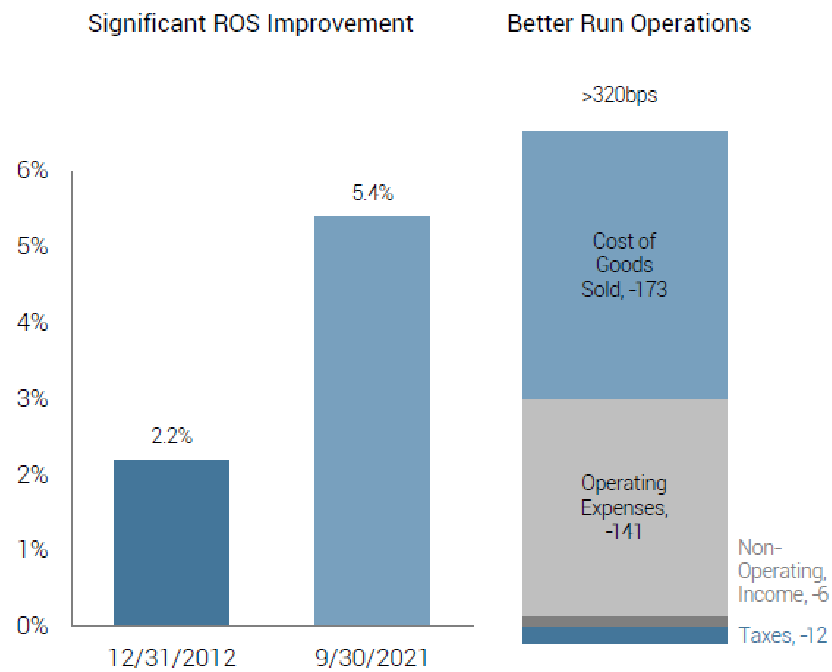
In his speech on 22 September 2022 to the New York Stock Exchange, Japanese Prime Minister Kishida spoke of his country's famous "two-way" baseball star Shohei Ohtani, comparing Ohtani's ability to both hit and pitch with Kishida-san's vision of both growth and sustainability in Japan.

Kishida-san began by describing the influence of his stay in Queens, NY during his formative years. He stressed his belief in the American form of capitalism, noting "I am the only post-World War Two Japanese prime minister with a financial background" (Kishida-san worked as a banker in foreign exchange and corporate restructuring). The clear message to the assembled audience and the broader financial world was that the Prime Minister is one of them and that the market friendly shift in Japan initiated under his predecessor Shinzo Abe is here to stay.

The Structural Improvements To Date

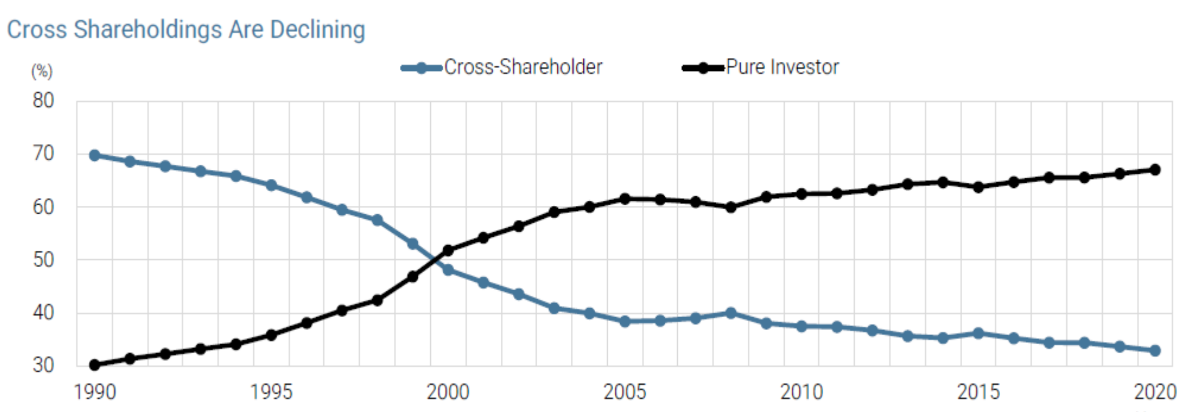
The first key topic in the speech was the major positive changes in the behavior of Japanese companies:

- **Increasing profitability** – For too long, Japanese corporates had the twin problems of depressed profitability (due to unnecessarily high cost levels) and excess cash held on balance sheets. This led to structurally poor Return On Equity (ROE) across Japanese corporates. While we might tone down Kishida-san's statement that "ROE ratios have soared", we believe that corporate Japan has undergone the hard work of structurally improving profitability by cutting costs and embracing digital transformation. The chart below shows just how much Return on Sales (ROS) has improved over the last decade, through more efficient operations. We have also seen increasingly efficient capital allocation practices, with cash being returned to shareholders through dividends and buybacks. Progress can be attributed to the combination of the government's mandated 8% ROE target on the one hand and the pressure from activist investors including Dalton on the other. However, there remains room for significant further improvement.



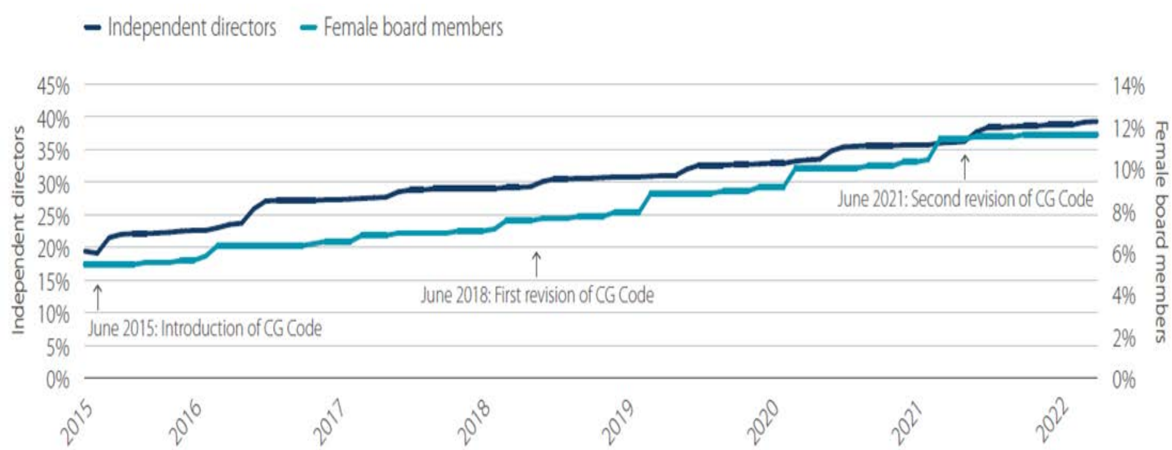
Source: Worldscope, GMO

- **Structural reforms** – An additional burden on the stock market has been the inefficient structures of Japanese firms, with cross holdings between firms and the retention of unprofitable non-core businesses. However, there have been structural changes, driven by the government's corporate governance reforms and the new Tokyo stock exchange rules on liquidity and float. The chart below shows the thirty-year trend of cross shareholdings reducing, with ownership moving to investors who are primarily interested in shareholder return.



Source: Nomura. As of 2020. Cross-shareholder includes government, corporates, financial institutions, and investors holding > 10% total shares outstanding

- **Independent oversight** – Almost all Japanese companies now have independent outside directors – a major shift from 2014, when late Prime Minister Shinzo Abe began his reforms. Accompanying this positive trend has been the significant increase of female participation on Japanese boards. The chart below shows this marked change, with independent directors rapidly approaching 50% of all Japanese board members. Kishida-san made it clear that he expects Japanese companies to continue to increase the representation of women and foreigners in top management and throughout organizations. Embracing diversity of thought and having more voices focused on rewarding and protecting minority shareholders are to be applauded.



Source: Nikko AM, QUICK

The Growth Opportunities To Come

Kishida-san believes that the key challenges facing Japan (an unstable energy supply, climate change, poor demographics, etc.) are in fact the country's key opportunities for growth. He expanded on the "two-way" opportunity of sustainability focused growth as follows.

- **Invest in people** – Labor market reform in Japan is necessary and overdue. The shift from the historic job-for-life "salary man" system to a meritocracy with performance-based pay is under way but needs continued encouragement from the government. The potential opportunity is for significantly increased wages (fueling consumption growth) and productivity. Kishida-san paid special attention to the efforts needed to ensure the continued growth of female participation in the workforce.

- **Invest in innovation** – The Japanese government has formulated national strategies to target growth in AI, quantum, biotech, digital, and decarbonization. Kishida-san placed particular emphasis on the role of startups and the need to make further changes to the tax treatment of incentivization structures to align interests and drive ambitious growth.

- **Invest in green transformation** – Japan is aiming for carbon neutrality by 2050, which Kishida-san believes will mean over $1 trillion worth of investment into green transformation – a "booster rocket to Japan's economy". While large, this figure is dwarfed by the approximately $40 trillion required for carbon neutrality across Asia by 2050. Kishida-san sees corporate Japan as a key beneficiary from the required spending on major power generation and infrastructure projects. Additionally, Kishida-san once again hinted at the prospect of restarting and expanding Japan's nuclear capability. The country's huge and largely mothballed nuclear power capacity represent a critical advantage versus rival countries, especially in the current environment of spiraling energy prices.

- **Asset-Income Doubling Plan** – Japanese citizens have around $14trn in personal financial assets, with just 10% currently invested in stocks. Clearly a structural increase in stock market investment would be a huge boost to what is currently, on most metrics, the cheapest developed stock market in the world. Kishida-san plans to continue to provide tax incentives to encourage this shift.

- **Build a nation that grows together with the rest of the world** – Kishida-san's Japan will be a "trading and investment nation open to the world" and will maintain its intertwined economy with the US. From October 11, 2022, Japan will relax border control measures and resume visa-free travel for many countries. This has the potential to be a major lift to the country, given the depressed level of the Yen (the weakest in 50 years in real terms).

Dalton's Thoughts

Dalton viewed Kishida-san's speech as highly positive for investors in Japan. While we understand the deeply skeptical attitude held by many investors towards the potential for real change in Japan, we feel that the speech should be seen as a clear signal of intent from the Japanese government. Dalton Senior Portfolio Manager Gifford Combs was interviewed by TV Tokyo (one of the major Tokyo television stations) following Kishida-san's speech. When challenged on whether Kishida-san's speech really contained any new policy content, Mr. Combs responded that [for Japan's Prime Minister] "to come to the floor of the NYSE and say it in a 40-minute English speech makes a big difference to foreign investors. [Kishida-san] has put a stake in the ground and said 'this is what we are going to do. Hold me accountable.'"

Gifford was particularly excited by the potential for further labor market reforms, noting "the idea of doing away with seniority-based pay and moving to more of a merit-based system – this is something that we have been telling our companies that we want them to do for a long time". Dalton believes strongly that aligning the interests of company employees, management teams and shareholders should continue the trend of improving profitability and capital allocation in the country. With valuations and the Japan Yen at depressed levels, we believe Japan is a compelling long-term opportunity.

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