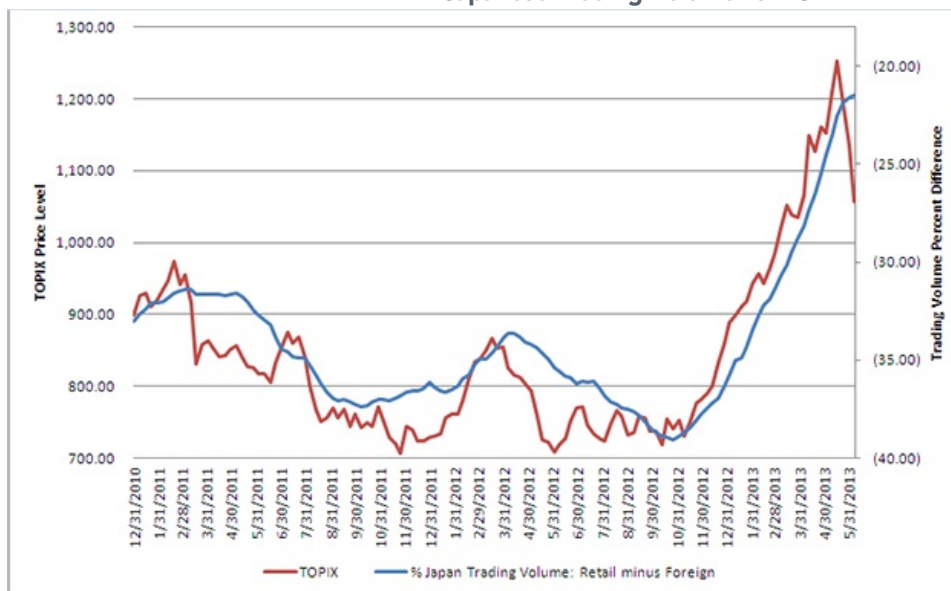


WILL JAPAN'S DAY TRADERS BECOME LONG TERM INVESTORS?

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One of the central tenets of Shinzo Abe's new economic policy centers around asset price reflation—from equity markets to real estate. Deflation has been a major structural impediment, as Japan's citizens curtail their consumption and keep large cash balances in savings accounts. An oft-cited statistic puts the total Japanese household balance sheet size at over \$15 trillion, with over \$9 trillion just in bank deposits.¹ The Japanese equity markets have been in a nearly 25-year bear market since their highs in 1989, when the [Tokyo Stock Price Index \(TOPIX\)](#) hit 2,881—so it is not much of a surprise that Japanese households are skittish and shy away from being long-term investors in the equity markets. But there are winds of change, and the Abe government is looking to motivate Japanese citizens to become long-term equity market participants. Trading volume from Japanese retail accounts has certainly moved up significantly. Yet J.P. Morgan's Jesper Koll has stated in numerous research reports that foreigners have been the only net buyers in this equity market rally, while Japanese locals have not increased their equity exposure. Much of Japan's retail trading volume is day-trading activity and, I believe, related to new margin rules that were implemented in 2013. Will Japanese day traders become long-term focused? I am encouraged by new incentive programs for tax-free savings accounts that could become a focus for 2014. I just learned about them recently and do not see them being widely discussed. **A Look at Japan Trading Volumes** In the chart below, I graph the TOPIX and the trading volume difference between retail (domestic) and foreign investors. I first saw this chart in a research note from John Davi at Morgan Stanley and thought it showed an interesting relationship between the equity markets and retail trading activity.

Japanese Trading Volume vs. TOPIX



Source: Bloomberg; data from 12/31/10 to 06/07/13. "% Japan Trading Volume: Retail minus Foreign" is the 26-week moving average of percent retail trading volume minus percent foreign trading volume. Past performance is not indicative of future results. You cannot invest directly in an index.

• Japanese Retail Investor

Participation in Trading Activity Increased – The percentage of trading volume difference between retail and foreign investors has decreased as retail participation increased since late 2012. • **Retail Investors Have Experienced Gains** – As the retail participation rate has increased relative to the foreign rate, the TOPIX has increased by over 26% year-to-date through 06/18/13. • **New Margin Rules:** One factor explaining the pickup in retail trading activity relates to new

margin rules that went into effect on January 1, 2013. The Financial Services Agency eliminated a three-day waiting period on rolling collateral over into new margin trades.² Other margin changes that took effect include allowing gains from trades to be added to collateral before settlement dates so that borrowers can take on more leverage. This pickup in margin-related trading activity may be one factor leading to more volatility in the markets on both the up and the down side. • **Margin Trading Dominates This Retail Trading Activity:** One explanation for the spike in retail trading activity is that margin trades often account for over half of the retail trading volume and that the margin-related percentage of retail volume increased following the new margin rules. According to data provided by the Tokyo Stock Exchange, margin transactions accounted for over 65% of individual transactions as of June 7, 2013, compared to fewer than 57% at the end of last year. **But will Japan's retail day traders become more long-term investors? One catalyst pending for 2014 is a new tax incentive program to encourage equity market investments. Japan ISA: Tax-Free Investment Accounts to Be Introduced in 2014** In a discussion with Morgan Stanley's Japan equity research sales team, I just learned about a new investment savings account (ISA) that Japan is looking to introduce in 2014. This investment account creates a tax incentive to encourage more participation in the equity markets. The below description of the Japan ISA was provided by Nikko Asset Management:³ • "Any dividend income and capital gains from listed shares and mutual funds held in the account will be allowed to grow completely free of any tax during the tax-free period. • "The tax-free period will be five years for each investment, or until the end of the fifth calendar year after the investment is made. For example, the tax-free period for all investments made during 2014 will end on December 31, 2018. • "Up to ¥1 million per year, with an overall upper limit of ¥5 million, can be invested in the account. • "Japan residents (or owners of a permanent residence in Japan) aged 20 or above on the 1st Jan of the year of account opening are eligible to open a single account, anytime during the 10-year period from 2014 to 2023." The SoftBank Investment Group (SBI) also focused on the Japan ISA as part of its initiatives for expanding equity market activities. The SBI Group noted in its investor presentation:⁴ • "SBI SECURITIES started accepting preliminary applications for opening an account from Mar. 29, 2013. • "Morningstar Japan launched a NISA portal website on May 20."⁵ While the total dollar figures being discussed here are not large—¥1 million per year and ¥5 million total correspond to approximately \$10,000 a year and \$50,000 total, respectively—the symbolic value of these investment accounts could help change the psychology of Japanese local investors. Japan needs to turn the retail day traders—who are trading in margin accounts—into more long-term investors, because they certainly have large asset bases. I look forward to seeing how these accounts might impact Japanese retail behavior over time. **Strong Initial Interest** According to a Nikkei story, Nomura Securities and Daiwa Securities have received applications for approximately 400,000 and 300,000 accounts, respectively. It has been reported that approximately 1.5 million investors in total have already applied for a tax-free investment account, even though the accounts cannot officially be opened until October. Nomura eventually expects the number of accounts to grow to 10 million. Nikkei further reports, the FSA (Financial Services Agency) aims for ¥25 trillion (US\$250bn) of household savings to flow into ISA accounts by 2020. Rarely do you see a government try to encourage investment at these levels and with these types of tax incentives. **Conclusion** There is no way predict the future of the TOPIX, but I do think current signs are encouraging for a long-term move higher. Increased retail investor participation and their potential allocation out of cash into the financial markets could be a major catalyst if Japan can provide the proper incentives to change the equity market culture. I believe this Japan ISA account is the right type of incentive program, whereas margin boosts that increase day-trading activity are less helpful. ¹Source: Bank of Japan, as of 12/31/12 ²Source: Kana Nishizawa & Satoshi Kawano, "Japan Margin Trade Doubles Amid Rally, Looser Regulation," Bloomberg, Feb 13, 2013. ³This material was prepared solely for the purpose of Nikko AM to communicate information on the Japan ISA. The information in this document has been prepared from what is considered reliable information, but the accuracy and integrity of the information are not guaranteed by Nikko AM. This information may be subject to change in the future, depending on changes to laws or the regulatory system. 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