THERE IS GOLD IN THE TOKYO STOCK EXCHANGE'S OBSCURE MEMOS

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"With this year as the first year of my 'asset income doubling plan,' we will promote, boldly and fundamentally, the shift from savings to investments."

– Japanese Prime Minister Fumio Kishida, February 2023

Nothing will put you into a deep nap quite like a PowerPoint deck entitled, "Summary of Discussion on Measures to Improve the Effectiveness of the Market Restructuring."

It's dry and boring, but there is some gold inside the 12-pager that can be tackled over a cup of coffee. In my view, what is inside it and other similar Tokyo Stock Exchange (TSE) memos is the primary bull case for Japanese equities.

Firstly, the TSE reminds us that the government is expanding the Nippon Individual Savings Account (NISA) program.

Individuals who participate are exempt from a 20% tax on capital gains and dividends. Starting in 2024, the maximum contribution will be tripled from ¥400,000 to ¥1,200,000. To put that in "IRA terms," it would be like if we had a program in the U.S. that had a set-aside maxed out at $2,739 and then they expanded the maximum contribution to $8,219. This may be one of the initiatives Kishida had in mind when speaking of a "bold" promotion of the investing society.

We get more meat and potatoes later in the memo in the part that addresses the *price-to-book thing*. The TSE explains:

> *Considering that the purpose of this market restructuring is to contribute to the improvement of corporate value of listed companies, it will be meaningless unless we address the fact that about half of all listed companies have a price-to-book ratio below 1. Whether or not we can take any steps forward to improve financial indicators such as PBR is a point of discussion at the council.*

There is one way we can interpret the TSE's dislike of sub-1 price-to-books. It would be very easy to host a ton of symposiums, invite bigwigs, talk about it over dinner and then watch as the status quo persists. That is a possibility to be appreciated.

However, consult the TSE's March memo, entitled "Action to Implement Management that Is Conscious of Cost of Capital and Stock Price." It followed up:

> *While share buybacks and dividend increases are considered effective means of improving profitability, if shown as such by the company's analysis of whether the balance sheet effectively contributes to value creation, TSE is not necessarily expecting companies to use only these or solve issues with a one-off response. Efforts are expected on a fundamental level to attain profitability in excess of cost of capital on a sustained basis and achieve sustainable growth.*

In order to fall within the TSE's guidelines, companies need to put together an "Analysis of Current Situation," whereby management has to analyze the company's cost of capital and profitability at board meetings. They are then tasked with developing "policies, targets, planning periods and specific initiatives for improvement." Finally, the price-to-book thing is expanded out to include other metrics. In this document that the companies are mandated to compile, they need to explicitly discuss either the stock price, the market cap, or price-to-book and price-earnings ratios. Also, they need to put all of that in specific context. One or more of these four measures must be addressed:

- Weighted average cost of capital (WACC)
- Cost of equity
- Return on invested capital (ROIC)

- Return on equity (ROE)

Then, the TSE "expects companies (to)…engage in dialogue with investors including overseas investors based on this disclosure."

To give an idea on where the country stands on some of the above metrics, the MSCI Japan Index trades for 15 times forward earnings, while the WisdomTree Japan Hedged Equity Fund (DXJ) is priced at a 12.1 times forward multiple. Broad Japan exposures only rarely trade at a premium to the U.S., and that is the case now; the S&P 500's forward P/E is 20.6.

Time will tell if the TSE's push will be taken to heart, but there is plenty of upside if Corporate Japan can get its act together. Currently, MSCI Japan's ROE is only 8.7%, while DXJ's 11.3% is better but well below the 17.8% being posted by the S&P 500. A closing of the profitability gap is necessary if the TSE's push can be measured a success.

All fundamental metrics as of 8/31/23.

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DEFINITIONS

Price-to-book ratio : Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Weighted average cost of capital (WACC) : The average rate that a business pays to finance its assets. It is calculated by averaging the rate of all of the company's sources of capital (both debt and equity), weighted by the proportion of each component.

Cost Of Equity : Represents the amount of compensation investors demand to invest in the future profits of company.

Return on Invested Capital (ROIC) : Measures the efficiency of invested capital and how it relates to generated returns.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

MSCI Japan Index : A market cap-weighted subset of the MSCI EAFE Index that measures the performance of the Japanese equity market.

Forward multiple : A valuation ratio that reflects a company's value on the basis of an estimated financial metric, i.e. forecasted earnings performance.

Forward P/E ratio : Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.