
TIME TO REENGAGE WITH JAPAN

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I recently had the opportunity to interview Jesper Koll, a Senior Advisor to WisdomTree, on opportunities in Japan's equity market for our "Behind the Markets" podcast.

Koll believes Japan will be a source of surprise for both economic strength and corporate performance.

Positioning Japan in Portfolios

Koll sees investors as underweight in Japan today as they were at the time of the Fukushima nuclear reactor disaster. This relative positioning makes Japan interesting by itself, but we do see [Abenomics](#) showing positive domestic strength. The industrial sector and exporters have certainly been hit by trade fears, but there is outperformance in some of the small and medium-sized companies within the local economy from a profit perspective.

Delivering Growth, but [Valuation](#) Multiples Shrinking

Japan has been delivering healthy earnings growth, but valuations have fallen, making Japan even more of a [value](#) play. What can unlock this value?

Koll sees signs of corporate activists getting more involved, with 70 different proposals to Japanese companies at the latest June board meetings.

There is increasingly more focus on capital stewardship in the form of more [dividends](#) and [buybacks](#) at a time when corporate activism is trying to change businesses' operational focus to shed non-core assets.

Japan [Payout Ratios](#) Rising and [Return on Equity \(ROE\)](#) Increasing

Koll has observed twice as many buybacks as this point last year, and dividends already growing at double-digit rates this year. He sees the Japanese pension program, the Government Pension Investment Fund, putting pressure on Japanese companies to deliver meaningful value to investors.

ROE has increased from 3% over the last 15 years, on average, all the way up to 10% for broad market Japan indexes, with a majority of companies having a target of 14%.

Hitachi as an Example of Newfound Operational Focus

Multinational conglomerate Hitachi¹ has engaged private equity firm KKR & Co. Inc. to help them restructure their business. This would have been taboo in Japan even five years ago, but now they are going to change their operational focus to be more globally competitive.

Koll's Bet

Koll believes Japanese companies have a war chest of cash to deploy around the world, and he foresees one of the mega banks in the market likely to buy a major U.S. bank sometime soon.

The Japanese banks are stuck, however, because the Bank of Japan (BoJ) has capped long-term bonds at 10 [basis points](#), limiting their financing opportunities domestically. Japanese banks are now also the largest creditor to non-China Asia. Their portfolios are growing aggressively in Asia, but they desire more of a U.S. presence.

BoJ Policy and Government Debt

Despite Japan's [debt to gross domestic product \(GDP\) ratio](#) having grown from over 100% of GDP to 300% of GDP, [interest expense](#) has fallen and is now only 1% of GDP. The government is getting this debt essentially for free. And despite this "unholy" monetary experiment where the Bank of Japan is financing this debt and capping long-term bond [yields](#), Koll sees no distortions. He sees no signs of an asset [bubble](#), [inflation](#) or a collapse in the exchange rate. He believes this program (or bold experiment) may be a precursor of what is to come globally in the future.

Is the BoJ Buying Equity Exchange-Traded Funds (ETFs) a Problem?

Koll sees one of the greatest hesitations that global investors have toward investing in Japan as the Bank of Japan's ETF purchases, which now account for 5% of total ownership of the equity market. There are even fears that the BoJ may eventually have to wind down and sell these ETFs.

But Koll has a proposal for potential buyers. Who has the money to buy? The older generation in Japan, meaning people over age 65. Their biggest concern is an inheritance tax that is 60% of assets. Koll said jokingly that if they can make ETFs exempt from the estate tax, the BoJ could sell their ETFs to individuals in 24 hours as that would eliminate the tax concerns.

Where Is the Yen Headed?

Koll and I discussed the [risk on/risk off](#) funding dynamics that make the yen the preferred trading vehicle of global speculators. But as Koll looks out five years ahead, he sees the yen as a weaker currency driven by capital outflows, with corporate Japan making more acquisitions like the bank discussion above.

Koll makes a compelling case that Japan is an unloved market, ripe for catch-up with other global markets, that gets compounded higher with improving corporate governance. Koll particularly likes small and medium-sized companies that could have performances less synchronized with the rest of the global markets.

Please listen to the full conversation below.

Unless otherwise noted, data source is Bloomberg, as of 7/12/19.

For more investing insights, check out our [Economic & Market Outlook](#)

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DEFINITIONS

Abenomics : Series of policies enacted after the election of Japanese Prime Minister Shinzo Abe on December 16, 2012 aimed at stimulating Japan's economic growth.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Dividend : A portion of corporate profits paid out to shareholders.

Buyback : When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

Payout ratio : The percentage of earnings paid to shareholders in dividends. Calculated as yearly dividends per share over earnings per share.

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

Basis point : 1/100th of 1 percent.

Debt to gross domestic product (GDP) : the debt-to-GDP ratio is the ratio between a country's government debt and its gross domestic product (GDP).

Interest Expense : The cost incurred by an entity for borrowed funds.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Bubble : when market participants drive stock prices above their "fair value" in relation to some system of stock valuation.

Inflation : Characterized by rising price levels.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.