

Japan Strategist Roundtable: Jesper Koll—What Is Different This Time?

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When I spoke with Jesper Koll from J.P. Morgan Securities, one particular theme appeared in our conversation: Prime minister Shinzo Abe is an important catalyst—but not necessarily the primary factor—for what is different this time in Japan. **Let's start with Koll's discussion of one of the largest Japanese companies, Hitachi. Koll:** Hitachi Corporation¹ is Japan's largest employer: 162 divisions, only five profitable divisions at any point. The rest are losing money or breaking even. This is a company that is the real thing with a stature like GE or Siemens. It has new management that can spell ROE/ROA, and they put it on page 2 of their investor relations presentation. Their new president was in line to be the CEO of Keidanren, Japan's major business lobby. He wanted to raise Hitachi pay because profits were up 50%. But he also knew one day when profits go down he would have to cut pay, so he wanted to introduce the concept of pay for performance. The Keidanren said—in so many words—“No way. You are the devil incarnate.” He then refused to become its president. He may not have fully implemented this pay for performance yet, but this is an example that showcases the changing mindset of corporate Japan.

Question: Why has Hitachi really focused on ROE recently? Is it being encouraged by the new JPX-400 index that has a bias toward ROE, like everyone discusses? **Koll:** I have been in Japan for 30 years. What has changed, what is different this time? The savings/investment balance has turned to deficit. One can debate the current account, but on a flow basis the marginal buyer has been foreigners over the last five years. In the debt markets, from Bank of Japan (BOJ) flow of funds, a few years ago foreigners owned 5% of Japanese government bonds (JGBs); now it is 8%. Foreigners were also the provider of the marginal capital in equity and also in real estate. What does that have to do with Hitachi and ROE? If the marginal buyer is a global saver or investment fund, global savers will demand global prices and standards. Will ROE go to parity of the U.S. like 15%? It is a bit more complicated. But because of scarcity of capital and Japan now a debtor country, that is a big stick on companies to focus on global standards. **Question: What does this deficit mean for the currency?** **Koll:** As investors, we ask what the implications are and where the adjustment is going to come from. The yen being a structurally weak currency is the right bet to make. **Question: Can Japan continue to have declining gross Domestic Product (GDP) and increased profit? How much profits come from overseas operations?** **Koll:** I have been trying for nine months to discern exactly how much profits come from global operations. If one takes out banks, real estate and construction, on any factor model one might find 75% to 80% of the earnings of Japanese companies are being generated abroad. The profit margin differential even at 103-105 yen is very significant for global businesses. Just look at how corporate Japan behaves. Clearly they have been investing overseas. I don't see an onshoring drive. In 2012, 80% of capital expenditures went outside. Domestic component picked

up recently but is still less than 30%. Domestic businesses will see margin expansion because of industry consolidation. There is a capital shortage, but now also we have a labor shortage. Five years ago, Japan universities produced 78,000 engineers, but now it is only 41,000. This is not because Japanese kids are lazy. There are just no kids. Even companies like Toyota² are having trouble recruiting with the best brand. Imagine other smaller companies. **Question: Do you think Abe's third arrow is off track?** Koll: Let me give you an analogy. What sports are Japanese good at? Synchronized swimming. There are a bunch of pretty legs moving around. We don't know what is going on, but somehow it is pleasant to watch. And women's marathons; Japanese are good at things where one is in it for the long run. This is the third arrow of structural reform. It is a marathon pace of structural reform versus a sprinter pace. **Question: Are there any of Abe's growth strategies that people are missing?** Koll: The most tangible benefit is in the health care segment. Take stem cell research. If you are an entrepreneur in stem cell research, you are doing it in Japan. This is not an ethics argument, but you can do anything you want in this area here. On biosciences, research is happening here. The patent cliff for large pharmaceuticals rolled off. The Ministry of Finance wants to cut health care costs, and generic drug penetration, at present, is less than 20%. That will be ramped up. We want to thank Jesper Koll for his always insightful commentary and note that this is just the start of the conversation with him. For more insights from Mr. Koll and some of the other strategists and economists we spoke with in Japan, please see our full roundtable [here](#). ¹Hitachi Corporation Holdings: WisdomTree Japan Hedged Dividend Growth Index – 1.41%; WisdomTree Japan Dividend Index – 1.23%; WisdomTree Japan Hedged Tech, Media and Telecom – 6.47%, as of 9/18/2014. ²Toyota Motor Corp holdings: WisdomTree Japan Hedged Capital Goods Index – 9.54%; WisdomTree Japan Hedged Dividend Growth Index – 4.04%; WisdomTree Japan Dividend Index – 5.19%, as of 9/18/2014.

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