JAPANESE EQUITY

Time to revisit Japan?

A great deal has changed over the last year as far as Japan is concerned, and Keith Donaldson believes that now is the time for significant inflows from European investors

The four most dangerous words in the history of stock market investing are 'this time it's different'. So I'll preface what I'm going to say by looking back 12 months.

In October 2007 we gave a presentation in London to a large group of private banking clients entitled 'Why you shouldn't invest in Japan'. It was a deliberately provocative title, but reflected what we saw as the only rational position at the time. It was also a message the audience was only too happy to hear. Despite being the world's second-largest stockmarket, international investors have been underweight Japan for many years. Too many false dawns have bred a healthy scepticism about stories of a Japanese revival.

A year on and what has changed? Well, a lot. So much so in fact that we believe there are compelling reasons why European investors should now be considering a significant asset allocation to Japan.

Here are five:

1. VALUATIONS ARE AT HISTORIC LOWS

We all know that Japan is home to many world-class businesses that have global leadership in their respective industries. But they haven't always been great investments. Even when valuations were very low back in 2003 and 1998, Japan was beset by cross-shareholdings and a lack of commitment to shareholder value. Today Japan's price/book ratio is just 1.2 times, the lowest level for 40 years, while many of the problems that dogged Japan in recent years have been eradicated.

Keith Donaldson

"WHEN THE GLOBAL ECONOMY SHOWS THE FIRST SIGNS OF RECOVERY FROM ITS CURRENT SLOWDOWN, WE EXPECT THE JAPANESE STOCKMARKET TO RISE"

Corporate profitability has been rising over the last five years, profit margins are at record highs, companies have been buying back their own shares and many firms have a dominant global market share in their respective industries. As a manufacturing-led economy, Japan is geared into the global economic cycle. So when the global economy shows the first signs of recovery from its current slowdown, we expect the Japanese stockmarket to rise. When that will happen we don't know, but the potential upside is significant and the downside risk looks minimal.

2. A WEAKENING YEN AND LOWER COMMODITY PRICES WILL BOOST EXPORTS

Japan's manufacturing-dominated economy has suffered from the dual effect of a strong yen, which has made its exports less competitive, and high commodity prices, which have raised input costs and squeezed profit margins. Since July 2008, the US dollar has been strengthening relative to the yen, while commodity prices have fallen back from their highs. Both are good news for Japanese companies.

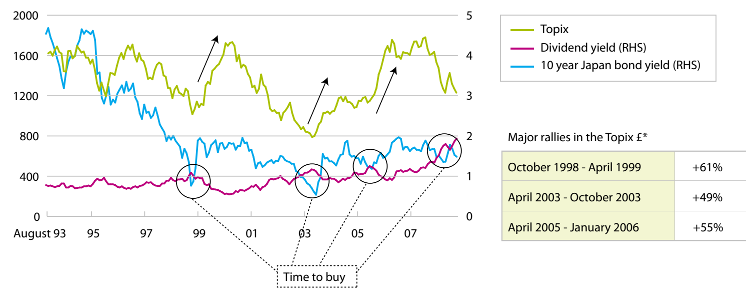
3. DIVIDEND YIELD IS HIGHER THAN THE BOND YIELD

With a new focus on shareholder value, Japanese companies have been increasing their dividend payout ratios. So much so that the dividend yield on equities is now higher than the yield on bonds, which makes equities attractive to domestic investors. This is a real buying signal. As the chart below illustrates, whenever this has happened in the past, it has marked the start of a major stockmarket rally.

4. JAPANESE COMPANIES ARE STRONGER THAN THEIR WESTERN COUNTERPARTS

While Japan remains a cyclical economy, it has been much less exposed to some of the excesses

Topix, dividend yield and 10-year Japanese government bond yield



Source: Datastream

market still has many inefficiencies, including domestic buyers who are highly thematic, and significant 'herding' of analysts, who overvalue the consensus and underestimate the extent by which things can change.

Positive change is coming from the growing number of companies that are focusing on delivering shareholder value, while M&A activity and private equity are beginning to exploit inefficiencies.

that have dominated Western economies. Banking exposure to global sub-prime-related losses has been relatively small, while Japanese financial institutions are not dealing with the aftermath of private consumption growth supported by deflating property.

Instead, Japanese companies have strong cashflows, are relatively lightly geared, and have been taking advantage of the fall in global equity and asset prices to buy cheap overseas assets. For example, non-life insurer Tokyo Marine bought US insurer Philadelphia for nearly $5bn in July, and Mitsubishi UFJ is making Union Bank of California its wholly owned subsidiary at a cost of $3.5bn.

The big reforms that were needed in Japan, such as restructuring the banking system and privatising the post office, have been made, and Japanese companies are in a much stronger position than in the 1990s, and even ahead of the last rally in 2003. The performance of Japan relative to other major regions in 2008 illustrates that it has offered protection to investors on the downside.

"BANKING EXPOSURE TO GLOBAL SUB-PRIME-RELATED LOSSES HAS BEEN RELATIVELY SMALL"

But it also underpins our confidence in its potential to rise significantly when global leading indicators start to pick up.

5. AN IDEAL ENVIRONMENT FOR STOCKPICKERS

Home to over 3,000 listed companies, Japan offers a large and diverse range of investment opportunities, and offers excellent opportunities for stockpickers. The

SUMMARY

Japan is looking exceptional value, both historically and relative to other global investment opportunities. There looks to be little downside risk and significant upside opportunity. When this will be realised we don't know. But when the rise comes, we expect it to be large and swift. So how should investors take advantage of this opportunity?

Martin Currie offers two actively managed Japanese equity funds that are available through our Luxembourg-domiciled Sicav, and as segregated accounts:

Martin Currie GF Japan Fund is our core Japanese equity fund of 60–80 stocks. It aims to outperform the Japanese market by 2 per cent p.a. with a controlled level of risk. The fund is 'A' rated by Standard & Poor's and 'AA' rated by OBSR.

2. Martin Currie GF Japan Mid-Cap Fund invests in a portfolio of 45–65 primarily mid-cap Japanese companies. It aims to outperform its benchmark by 3 per cent p.a. with a controlled level of risk.

Martin Currie is a specialist investment management business. From its headquarters in Edinburgh, the company manages US$18 billion in active equity portfolios for clients around the world, including retail and private banks, family offices, foundations, pension funds and government agencies. Its pooled funds include a Luxembourg domiciled SICAV, a UK OEIC, and a successful range of hedge funds. Martin Currie is a private company, owned and managed by its full-time employees. This helps it to attract and retain investment talent, while providing the stability and flexibility to make decisions for the long-term benefit of clients.