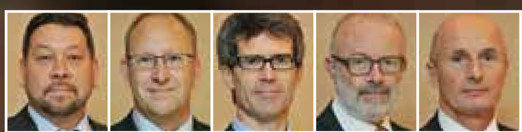
Global equities

Targeting worldwide growth



Joey Alcock | John Belgrove | Michael Bourke | Richard Greening | Donny Hay

Equities: Going global

The case for investing in global equities is compelling. The FTSE All-World Index improved by more than 20% in 2017 and thanks to upbeat global growth forecasts for this year the case for adding an international flavour to UK equity portfolios remains strong.

The FTSE, S&P 500 and Japan's Topix hit record highs in early January as investors are happy to stomach more risk, a result of lower bond returns and bullish outlooks from economists.

The price of oil hitting a four-year high of $70 a barrel and expectations of growing corporate earnings, especially in the US, are cited as reasons to maintain a bullish stance.

But it is not only about generating returns. Building a global portfolio of equities could also provide much needed diversification, especially at a time when the UK economy is not growing as quickly as it was once believed to be.

There are concerns. Some believe that valuations, especially in the UK and the US, are overheating. The S&P 500, for example, was trading at 26 times earnings at the time of writing.

The benefit of having a global investment strategy is that there are alternatives if you feel some markets are expensive. The main option today appears to be the emerging markets, which are coming back after a few difficult years resulting from a collapse in commodity prices.

Finding attractive markets is a tough task, especially in the developing world where the flow of corporate data is not on par with that in the developed world. This is changing with some companies improving their governance policies in a bid to be more shareholder-friendly.

Then there is political risk, especially with the frosty relations between North Korea and the US continuing to hang over the world.

To tackle such political and governance concerns perhaps the best approach could be to pick stocks based on fundamentals not geography.

This is a case of the right stock, not the right country.

With so much to debate we brought a group of owners, investors and advisers together to discuss the most effective global equity strategies. The conversation starts on page 4.

Mark Dunne
Editor, *portfolio institutional*

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Deputy fund manager, equities
M&G

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portfolio institutional

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PTL

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Senior partner
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Director, public markets investment advisory
Bfinance

Michael Bourke

"Passive is not as passive as it sounds. Whether you like it or not it's an active choice because of the composition of the index."

Michael Bourke, M&G

Richard, around 60% of the Islington Council Pension Fund's equity portfolio is invested overseas. What countries are you exposed to?

Richard Greening: Allianz and Newton are our primary equity managers. Their investments are mainly in Europe and the US, so we have taken out a £100m emerging market portfolio with Legal & General. That is passive, but we're looking to move to an active stance, which is more effective in the emerging markets.

Michael Bourke: The rise of passive should not necessarily be viewed as something negative. It forces everybody to raise their game. Though in the emerging markets there are particular difficulties in going overly passive. You're buying something that's increasingly dominated by a few large caps. Two or three stocks in the index have managed a 25% to 30% performance, which is fantastic, but when you look at the multiples on some of these names they are on 40, 50, 60, 100 times earnings. Plus, some of the tech names carry quite pronounced Chinese policy risk, which the passive investor may not be aware of. So passive is not as passive as it sounds. Whether you like it or not it's an active choice because of the composition of the index.

With regard to ETFs, in the emerging market space they move around the NAV. So any saving you make on the fee differential between active and passive is wiped out when buying an above NAV ETF. So there are various pitfalls.

What role do equities currently play in a pension portfolio?

Greening: A pretty important one, particularly global equities. We've all had the huge benefit of Brexit's effect on sterling. Relatively speaking, we are now in a much stronger funding position. We're approaching 90% having been in the doldrums of around 70% for many years. Pension funds were once much more invested in the UK stock market, but as time has gone on people have concluded that global equities is a larger and more profitable market. So there has been an incentive to move to global. There is also this bet against the pound, which combined with quantitative easing, is inflating asset prices.

Donny Hay: Global equities play a crucial role in terms of diversification away from the narrowness of the UK. The IMF's recent global growth forecast has increased to around 3.2% to 3.5% for 2016, 2017 and 2018. What's unusual at the moment is that synchronised growth across the world, particularly in emerging markets. Having the diversified exposure to that for a pension fund is important in terms of maximising returns, but also getting the diversification benefits. We come across lots of different countries, stocks and currencies.

John Belgrove: Equities play an important growth role in any long-term portfolio in any prevailing market condition. A low return outlook doesn't change that, but obviously it adds some challenges to meeting clients' objectives. Long-term investors typically are looking to invest globally to benefit from diversification and although it will be fun to choose which markets look attractive, predicting markets is hard and professionally it has a high failure rate. Therefore it can be a stretch for trustees to take this on.

Hay: So many valuations are at extremely high levels. If you look at the cyclically-adjusted price-earnings ratio it's about 30 times now. When you start getting over 22 times history tells us that in the following three years on average you should expect a downturn in prices of more than 20%. People are concerned but bull markets are born on pessimism and then they mature on scepticism and then they move into a phase of euphoria where things go badly wrong. People are nervous, but markets have a nasty habit of climbing a wall of worry and people have been sceptical about the rise in equity markets but it's continued partly because bond yields are so low. It's extrinsically linked to interest rates and what happens to the future direction of interest rates because we are in this synchronised world and if interest rates were to rise they would rise across the board, but as yet there's little sign of wage inflation, so the party continues.

Joey Alcock: It's that party continuing theme that is the real challenge. There's a sense that valuations are worrying but it keeps going, the low interest rate environment is still here even though we're starting to see cash rates creep up. It's still kind of perverse in terms of the lower rate environment allowing for this easy money, but if we start to see rates beginning to rise in a more pronounced manner that's probably up for debate whether or not the glide path to high or normalised rates is going to be a key element to determine a shock or an easier path to normalisation. If we do see that start to grip equity markets it feels like they are precarious in terms of where the valuations are and this is where passive investing is a concern.

There's a sense that passive is somehow safe. It's safe when you're benchmarked against a passive index. Frankly it's safe for people looking after their jobs because they can always say: "At least we didn't underperform the benchmark." In terms of actual returns to the consumers of these pension products ultimately you're doing them a disservice if you're allowing them to ride the full market cycle down. We've been getting interest from our clients with respect to equities that have downside protection capabilities with a strong ability to protect in down market environments.

Belgrove: Passive certainly isn't safe because equities aren't safe investments. I would caution not to overplay that active equity investment has some magic capital protection formula. Strongly rising rates would be one of the catalysts for a shock in equity markets and in those circumstances, just as all boats rise with the tide, they're all going to go down. Therefore it becomes more a global asset allocation decision, which moves us beyond equities and thinking about other assets that provide a more robust total fund structure.

Alcock: The actual allocation to equities is substantial in most pension funds and it's about what do we do when government bonds, the traditional area of protection, are so highly valued that the only way you can really see it protecting is if there was a significant compression going back to negative rates. That's the key challenge and that's why we temper our conversations with our clients around the ability of active management to protect them from the downside. They have to have equity exposure to make long-term returns and outperform inflation, but the real question is where do you get genuine defensive characteristics? We see our clients increasingly move towards alternative risk premia to get that genuine diversification away from the classic equity beta. We have to have the equities, but where do we get the protection from?

Bourke: Looking at the trends in developed markets over the last five years, it's been fascinating to watch the rise of valuations. We're very valuation sensitive and thinking deeply about how much one pays for an asset.

When you look across valuations of developed market equities it certainly standouts how expensive the US looks. You have to separate the strong thematic thing that has been going on underneath, so if you strip out the so-called FANG stocks maybe the US looks a bit less expensive. When you move to the emerging markets we are sitting there, scratching our heads saying: "Hold on, guys. We're extraordinarily cheap in a relative sense." We are no longer as cheap as we were in Q1 2016, but we're a long way off the valuations that you're seeing in developed market bonds or equities. Let's face it, some of these US glamour stocks are achieving fantastic growth rates, but there is some serious risk in the tech sector, it just seems to be that there is no price too high to get these things. But when you look at valuations, certainly on the value side of the screen, there's a lot of value in the emerging markets.

Alcock: We've seen a pick-up in demand for emerging markets, particularly Asia. Concerns have faded a little from a political perspective and potentially from an energy price perspective around the non-Asian areas. Nonetheless everyone's talking about Asia because of the attractive growth dynamics, the demographics and the perceived control of the North Korean risk or maybe there's nothing we can do about it, so why not just target Asia.

Hay: Emerging markets seem to be in a more synchronised economic growth cycle, which would hopefully point to a longer sustained period of good returns for equities. Do you see it that way?

Bourke: EM had a bad period between 2011 and 2015. It was essentially a bear market, a pretty torrid time to be an investor, especially when your developed market cousins were knocking it out of the park. It was a frustrating period, but in the last 18 months we have turned a corner. The EM is the comeback kid of the global equity markets. Valuations were seriously depressed in Q1 2016, but we've had this marked shift upwards in corporate fundamentals. EM management were perhaps slow to defend their margins when there was this top-line pressure. There are a lot of government-owned entities in there that maybe makes that reaction mechanism more sluggish. What we've seen in the last 18 months is that they cut capex, they cut spending, there's been a pick-up in margins and now we're starting to see top-line growth kick in. As a result you saw markets that had earnings picking up, good fundamentals and multiples at attractive levels.

Alcock: What about the perception of reduced political risks?

Bourke: When you look across Asia there's certainly a sense of political stability. I'm always a little wary of that. Let's face it whether it's the UK or China, political stability may belie the truth of what's going on beneath the surface, but certainly China's policy makers are in control of the ship. There has been a lot of policy action and shift in the last 12 to 18 months. China, if anything, is moving to a position whereby we're seeing a definite sense of policy makers being censored by the composition of growth. It's no longer about wanting 7%, 8%, 10% growth. The conversation has moved to the point where there are rising concerns about environmental issues. That's a good sign. In the EM opportunities always come because there are parts of those markets that come through a torrid period. Brazil is there now after a horrendous adjustment with the impeachment of the former president. We see a difficult political governance set-up there, but it has good corporate governance, some of the best in the emerging markets.

What effect has the stand-off between the United States and North Korea had on global equities?

Hay: Markets are poor at pricing tail-risks and North Korea is a tail-risk. They are much better at pricing interest rate risk, whether interest rates are going to rise faster or slower than people are expecting. They largely ignore the risks that they can't price.

Belgrove: Markets are not focused around tail-risks and maybe that means investors need to think about the degree of protection they have in their own portfolios. It's not going to come naturally from within the

Richard Greening

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Richard Greening, Islington Council Pension Fund

pricing mechanism. Everyone tends to start focusing on tail-risks when the event hits and then it's a bit late.

Bourke: In EM I'm always wary about pricing in too much for political risk because you can be worried about a country's political situation at the wrong time in the cycle. If you looked at Brazil last year you wouldn't have touched it, but it was the right time to get involved. It had touched the bottom, the impeachment was proceeding and there was a sense that the management ranks were being rotated. We've seen a lot of changes, whether it was a caretaker president or a new CEO of Petrobras. So it was the wrong time to suddenly get worried about the government. You start to get worried about political risk when everything looks rosy, but actually underneath the government was spending too much money in the wrong direction. When you start seeing those risks hit the front pages that tells you change is afoot and we've seen material change in Brazil over the last two years. Where you see central banking compromising in its function, the gross interference in the management of corporates, whatever that might be, that's where we start to have concerns. North Korea has been a problem for a number of years but arguably it's only increasing in the headlines now because of Mr Trump's erratic handling of it rather than the situation actually getting any worse. It's something we are aware of but not something that we watch more materially.

Belgrove: Focus on your market and make the right comments about how to manage the tail-risks. The job is, therefore, with the asset allocators to think about how am I going to proportion this for the tail-risks that may pop up and what am I going to allocate my portfolio to deal with that. The expert in the sub-

asset class isn't always going to get the downside risk right. That's the way it is, that's what investment is, financial markets are a beautiful, wonderful complex adaptive system. We can have astronomers that can tell us exactly what day and time a comet is going to pass the Earth in a hundred years' time, but we can't tell what's going to happen in markets next week and it helps to have an understanding of how that variability, notwithstanding the fundamental analysis, should drive long-term better outcomes.

Strategically we like emerging markets, have done for a long time, including during the difficult period earlier in this decade. We would advocate more of an active strategy because selection is particularly important in that environment, but all within proportion of a robust portfolio that's thinking about different scenarios that can hit it.

Hay: As an asset owner the large part of your returns are going to come from the strategic allocation that you make across global equities, emerging markets and different forms of credit and alternative risk premia. One's always looking for a bit of extrages and global equities has lent itself more to passive investment because it's been much harder for managers to outperform those more efficient markets, but emerging markets remain quite inefficient. In the last three years only a third of emerging market countries had positive returns, but two-thirds of stocks had positive returns across those markets. So the world's becoming a more global place where the countries themselves have less influence than where those stocks are actually trading and what they're doing across different markets. At the end of the day most of your returns are going to come from the actual asset class and, with the risks that we see with valuations, having a well diversified portfolio across a number of areas is the best protection you can have. My experience tells me it's time in the market not timing the market that will make you money. It is hard to know what the market's going to do next week. It's hard putting in protection strategies when you get a bit worried because it costs you money, it might cost you a 4% premium to put in an equity protection strategy. So a better way is to have a diversified portfolio across a number of asset classes and stick to your guns.

Bourke: One of the biggest tail-risks is paying too much for an asset. We are not cheerleaders for the emerging markets per se. There are dangers in paying too much for some of these large cap names that

have driven performance. When you look at the spread between growth earnings in EM and the price you're paying for that versus value names, it's at a record now. We are certainly pointing out the danger by saying that we're sensitive to how much we pay for these assets and we are bottom-up focused on the companies we own. We step away from saying the whole wider asset class is worth buying in its entirety. That would be a mistake. It's about being selective and choosing your assets carefully. Understand management, understand how they invest, understand the capital allocation record and then think about the right price to pay for that.

Belgrove: Do you think it helps investors to look at their investments less through a geographical lens and more through the lenses of value, momentum, quality and volatility?

Bourke: EM historically was very much a country selection approach. Going back to the Asian crisis, country risk was very prominent in investors' minds. We've moved a long way from that now. Arguably, with the rise of globalisation and financialisation where international investors cross into any country, nearly any asset you're seeing in emerging markets has become more integrated and therefore it's less about a country and much more about picking the right asset. Of course, we note how overvalued or undervalued the currency is but we don't sit there and choose country by country. We're not making any top down call regarding picking a country, we follow the bottom up process and we find that's where it leads us to.

What sectors are you looking at?

Bourke: Sector-wise, EM defers to DM in that it has a lot more government-owned entities and a lot more sectors. So technology now is 26% of the index, followed closely by financials. Beyond that telecoms are something we are looking at closely. Energy is something we've invested more in the past year or two. That's trading to a big discount to the fundamentals. Some people are becoming bearish about oil but we think oil demand is holding up quite well.

Belgrove: Do you think that there is a strong value theme coming through?

John Belgrove

"Astronomers can tell us exactly what day and time a comet is going to pass the Earth in a hundred years' time, but we can't tell what's going to happen in markets next week."

John Belgrove, Aon Hewitt

Bourke: We follow the ideas and generally that leads us to South Korea where we have tech, financials and energy. Financials in Korea have done well this year, they were depressed for a number of years but the turn in rates cycles starting to percolate through to Asia has helped financials. Samsung has been a fascinate case study, whereby you're seeing a serious shift in corporate governance, not denying some headlines regarding the owner, but underneath the managers have taken a proactive stance in paying out a lot more to investors. Korea used to have one of the lowest payout ratios globally and that's often an indication of poor corporate governance. The two are often aligned. There's been an inflection point in that over the last 18 months to two years. We foresee this continuing and it's something that other companies are starting to copy, so it's a very positive trend.

In a bid to revive the economy Japan is encouraging its companies to return more cash to shareholders. Has that put Japanese equities on people's radars?

Belgrove: Higher governance tends to lead to better outcomes in the long run, so these developments are welcome. We're quite favourable on Japan at the moment. Many things are driving that and governance is just one of the components. It's often said in emerging markets that corporate governance is weak and there is perhaps some evidence of that, but specialists in that area focus strongly on governance aspects. So high-quality emerging market managers are all over this even more so than the developed market counterparty, because it will drive better long-term outcomes. So better corporate structures and better decision-making will lead to better run companies. To an extent, that is happening. China is a fantastic case in point. Its thinking is rapidly accelerating around renewable energies, for example. I wouldn't necessarily associate emerging markets with bad governance, particularly in the hands of a skilful manager who will be focused on that task.

Greening: You have to look at the balance in terms of ESG. There are a lot of oil and mining companies in the emerging markets, which have had significant governance issues. For example, people were shot at one of Lonmin's sites in South Africa a few years ago. We exited although we're supposed to be passive and we also sold a particular mining company in Africa because it was about to start developing in a national park. The whole governance of the company just stank essentially. So there are real issues there and certainly with oil and mining companies there's a big focus amongst pension scheme members and the public on a big disinvestment campaign based on the Paris Climate Agreement and fears about stranded assets. The real role for us in terms of engaging with those companies is to get them thinking about where they place their capital because it's clear that the world is changing particularly led by China and now India to a certain extent where actually we are moving away from carbon in a real sense and so having a stake in the companies that are developing those new technologies makes an awful lot of sense environmentally and financially.

Alcock: We've certainly noticed a huge pick up in ESG-related emerging market searches. It's becoming more sophisticated. It's beyond: "We just want to exclude tobacco and want to exclude nuclear or gambling or alcohol." Investors want to see a genuine integration, a stock-by-stock basis of ESG through emerging markets and certainly in terms of the drivers of this it could be the underlying members just holding a divest campaign. I've seen some of those divest campaigns and slide shows, they're pretty compelling. I can understand why pension boards are feeling like they need to address these things to meet the concerns of their members. So the difference in where the drivers are coming from is reflected in the different approaches to what people want from ESG. Some will penalise a company for having poor ESG considerations, other managers might take the view: "Well, actually based on positive engagement going forward we see the potential for improvement on ESG at this particular company as a reason to buy in now, engage with the company and enjoy the gains because of that improved ESG focus." So it's this different rather than just sort of excluding bad it's also encouraging and rewarding the good and the potentially good as well.

If you divest out of a company it is difficult to engage. They're not going to talk to you if you're not an owner. If you are going to drive positive change from an engagement perspective that's an interesting balance to have to address.

Bourke: We have seen an increase in demand for mandates that incorporate ESG into the investment process. For us the G is a capital G. It's the centre of our investment process. It goes to the heart of how we think about investment and understanding how aligned management are with the minority shareholders. What has changed on that front in EM is corporate behaviour. It has improved, probably because they're getting more heat from investors, but there is also a pronounced shift by management policy makers. That depends on the country and sector you're looking at. China is the obvious one. This week I met the CEO of Lukoil, the largest private energy company in Russia. He's strongly ESG minded on how they're thinking about the assets and their relationship with investors. Sberbank is one that I find fascinating. It is essentially owned by Russia's central bank. We find that its behaviour to be one of the best in the EM, certainly amongst financials. Though it's not universal. There are certain other companies within the region that we would not invest in, but I would highlight Sberbank as being quite interesting in how they've changed and how they've increased in their focus and certainly in governance issues.

Greening: Islington is a member of the Local Authority Pension Fund Forum (LAPFF), which now constitutes about 70% of all of the local authority pension funds. Because we act together it is possible to get higher up the management tree in terms of influencing companies through AGMs and direct meetings. It doesn't always work but even if you don't win the vote or get a decision it has a long-term effect and it is the long-term we're focused on. That's where the G in governance becomes more significant because it's easy to say you're interested in governance but you're really, really focused on next quarter's results. Governance is something that has a long-term effect. If you're really focused on the long-term then it becomes far, far more important and integral to your approach.

Belgrove: There's another lens in the active-passive discussion. On the one hand you're in it for the long

Joey Alcock

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Joey Alcock, Bfinance

run, you're going to be an owner, you can influence. On the other hand, an active manager can be more selective and have that threat of removal. On balance the policy is likely to be more effective in a selective way than in a passive way, if that is the dominant feature. Of course, you can construct things as part of the policy that you're looking at in terms of a negative screening approach: "I don't want fossil fuels in my portfolio," but we suspect that renewable energy technology is going to come out of some of those same firms. So exclusion could restrict your opportunities.

Alcock: Developed market ESG data disclosure from companies is quite sound, but in emerging markets it's still a mixed bag. A lot of the work managers and advocates do is to get better disclosure from some of the companies around their ESG practices, but the passive guys tend to be reliant on some form of third-party ESG data in order to implement it into their modelling.

There's an interesting dynamic with respect to the inconsistency across ESG data provided by third parties. You often find they are on opposite sides of a particular ESG issue in a particular company and so we do tend to focus on managers in the emerging markets that have some capability of generating their own ESG data, their own scoring and their own analysis. Corporate meetings, direct engagements, there's a hugely valuable source of ESG data which active managers can funnel directly into their investment process. So if you really want oomph in your ESG approach, active in emerging markets appears to be a significantly more comfortable place for any ESG-focused investment.

Belgrove: The quality of non-financial data is markedly improving, but just to be a bit mischievous about it you do hear tales of corporates that have got cute to the investor interest and are paying lip service.

Alcock: One of the criticisms around MSCI is that it is overly focused on disclosure. You can put an investor relations team into your firm that says all the right things that MSCI or one of the others want to hear in terms of disclosure, but is that materially happening in the background from a headline management point of view? That's a key question and unfortunately the active managers still have that better access to the real, more genuine story.

Bourke: You said a word that resonates a lot with me, materiality. As an industry, we've moved a long way from the checklist approach to ESG to actively engaging by speaking to senior management. It's evolved and continues to evolve quite rapidly. China's now the largest supporter for the Paris Climate Change Accord, that's perhaps not something the investment community would have expected a year ago.

Alcock: One of the other revolutions is the breadth of ESG consideration. What we're starting to see with investors is the idea that if you do the governance right then the E and the S will follow. That is less and less a belief from our investors. They are looking for managers that address each of those areas in a sophisticated and detailed way because they do recognise that on the surface you can have attractive governance standards or practices but also fall over on the E and S and increasingly that story of if you get the G right everything else looks after itself is starting to weaken. That's a warning for managers to be careful what they say.

Bourke: When we look at Volkswagen and BP, the governance angle looked fine, it was cutting costs and corners that put them in a hugely risky environmental situation. ESG has moved a long way beyond thinking it's a moral issue; it's now about wanting companies to do the right thing because it could have serious financial investment implications.

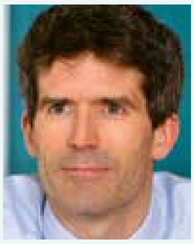
"My experience tells me it's time in the market not timing the market that will make you money."

Donny Hay, PTL

Donny Hay

Emerging markets warm to ESG outcomes

Michael Bourke, M&G



At a recent Camradata roundtable discussion, Michael Bourke, fund manager on the emerging markets team, spoke about why he is encouraged by improving ESG standards within emerging markets.

Environmental, social and governance (ESG) considerations are increasingly at the top of the agenda in emerging market investing. There is a greater focus on extracting ESG-focused outcomes with many new mandates being wholly driven by ESG responses. As investment managers, we need to be prepared for this.

Two changes have struck me over the past year or so. The first is, somewhat ironically, China's lead in global environmental initiatives especially in regard to COP (UN Climate Change) conferences since the US stepped down from the table. China is making great strides in steering its economy away from the traditional, high-pollution, manufacturing industries and towards consumer-led growth. This model would put sustainable, environmentally-friendly sectors such as healthcare, insurance and consumer technology at the forefront of growth. Although there are as yet no strict regulations governing how much information a company has to divulge about its ESG efforts, some Chinese companies are voluntarily disclosing their ESG data, a very positive step.

Second, corporate management is more responsive and sophisticated in responding to ESG questions and how the adoption of specific practices could lead to improved shareholder outcomes. For example, in Russia the perception of Russian political governance is very poor, but corporate governance in a number of instances is improving. Management are not willing to talk about these issues, but are actively steering their companies towards better outcomes, particularly around governance. In the oil sector, one of our holdings, LukOil is not only focused on meeting global environmental initiatives and standards, but also on maximising returns from its capital allocation decisions. In governance terms LukOil is, in our opinion, one of the best in the emerging markets in its sector.

A value stock can be a value trap if you have poor governance practices and as such, governance has always been at the heart of our emerging market investment process. While there are some firms with excellent governance standards and a commitment to shareholder value creation, there are many companies in the emerging market universe that are not run in the interests of all their shareholders. For instance, there are numerous companies with dominant shareholders, such as the state, who dictate how the company operates, often to the detriment of minority investors. Despite recent improvements, in China, for example, the majority of the stock market, from a market cap perspective, is made up of state-owned enterprises (SOEs) in which the government retains a majority stake and exercises effective control. The issue of state influence is important because SOEs can be run for social benefits, such as employment, or to control key industries, like banking and energy. It is not uncommon for governments to use state-owned banks as a policy tool to achieve their economic objectives. We find it harder to trust SOEs with our capital as they can prioritise the needs of the state over minority shareholders. Nonetheless, the direction of travel in China is encouraging.

Similarly, in South Korea, family-owned conglomerates, known as chaebol, dominate the market. These groups have been criticised for a lack of transparency and ignoring the rights of minority shareholders. We pay close attention to their capital allocation decisions and whether they respect the interests of minority investors. Encouragingly, there are signs chaebols are responding to calls for reform by adopting more shareholder-friendly measures and increasing their dividend payouts.

Overall, we believe there is a positive trend towards higher corporate governance standards across emerging markets. We are finding increasing numbers of well-run, shareholder-oriented companies, which in some instances have governance practices that are, in our opinion, as good as, if not better than, their developed market peers. As emerging market firms adopt global ambitions, management teams are becoming more professional and more international in their approach, benchmarking their businesses against global peers rather than just domestic rivals. In terms of personnel, greater diversity and experience among senior management teams undoubtedly helps them to operate in a global marketplace. We are optimistic that governance standards will continue to improve as firms embrace good capital discipline and focus on their investors and that improving standards will be adopted more broadly across environmental and social issues as well.

The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested. Wherever any indications of past performance is shown, please note that this is not a guide to future performance

Turning Japanese: Equities in the Land of the Rising Sun

Attractive valuations, improving governance and rising returns could make Japanese equities a good fit for cash-flow-hungry pension funds. *Mark Dunne* takes a look.

Japan is living up to its billing as the land of the rising dividend. Japanese companies handed ¥12trn (£87bn) to shareholders in 2016, compared to the ¥8trn they paid in dividends nine years earlier. Further growth is expected as the government increases pressure on boards to deploy the huge cash piles they have traditionally sat on.

The 30% pay-out ratio recorded in 2016 is largely thanks to reforms introduced by Prime Minister Shinzo Abe. After a debt-fuelled equity bubble popped in 1989 the country has struggled against low growth, deflation and a national debt stretching to 229% of GDP. Rising longevity and low birth rates have also hindered attempts to revive the economy.

Breaking the cultural practices that have kept some companies in their comfort zones, where they hoard cash and treat shareholders with indifference, has been one of Abe's core reforms. This has included setting return on equity targets and appointing more independent directors. The intention is to boost corporate earnings and investment as well as improve governance, which should whet the appetites of cash-flow-hungry investors.

"A greater focus on capital efficiency and shareholder value is helping to put Japanese corporates, and in turn, the broader economy on a sustainable growth path and rekindle lasting interest in Japanese equities among global investors," Jun Tano, who manages the Fidelity Institutional Japan fund, says.

Eric Lonergan, a macro fund manager at M&G Investments, believes that this translates into an implied real return of 7% in the medium term, based on the earnings yield. "Now that in the context of where global developed market assets are is, of course, a huge level of real return," he says.

Alongside dividends, companies have also used their cash to improve shareholder value through buy-backs. In February, tyremaker Bridgestone took advantage of a depressed share price by spending ¥150bn on buying around 6.5% of its shares, which were then cancelled. This is a growing trend. In 2016, company boards, under pressure to deploy their huge cash reserves, took advantage of attractive valuations by spending ¥5trn on such schemes, up from ¥4trn in 2007.

Another way directors are using strong balance sheets to improve shareholder value is to visit the M&A market. One example is Softbank's acquisition of Arm in 2016. "So rather than sit on that cash they are starting to put it to work in looking for higher growth, higher return investments or return it to shareholders," Helen Driver, a fund manager in Aviva Investors' Global Equities team, says.

Driver believes that governance reforms will continue to fuel dividend and buy-back growth. "This focus on returns for shareholders is very much an ongoing theme," she adds.

Making a more efficient use of this capital not only takes the form of dividends and buy-backs, but also investing in the future growth of the business or boosting wages to encourage consumer spending.

Return on equity among Japanese companies is expected to continue growing, which means it could be an investment suitable for pension funds. "Long-term it [Japan] makes sense," Cedric Le Berre, senior analyst at Union Bancaire Privée (UBP), says.

> **"The pendulum is swinging towards the shareholder and away from some of the traditional concerns that have dominated corporate governance."**
>
> Eric Lonergan, M&G Investments

NEW MARKET

Japan has traditionally been a "tricky case" for European investors, Le Berre explains. He says that there was a time when it was considered a beta play or a "risk-on cherry on top of the global equity cake".

This is no longer the case. A more structural case for investing in this market is emerging thanks to Abe's reforms. Increasing return on equity to boost returns to attract elephants, such as pension funds, to equities has been at the heart of the strategy. To achieve this companies have been encouraged to improve capital efficiency and deploy their excess rather than continue to lock it away in the bank.

"It [reform] is a complete game changer," Le Berre says. "It changes the profile of Japanese companies."

As a result of this change in mindset, dividends and share buy-backs have been rising. This has convinced GPIF, the government's ¥156.8trn (£1.04trn) pension fund, to increase its allocation to equities from below 10% to a target of 25%.

Abe's reforms have made UBP bullish on Japan and so it has taken a long-term position in the market. UBP is now overweight Japanese equities after being neutral last year. "The discount at which Japanese equities has always traded against those in the US should narrow," Le Berre says. "That is why we are positive about Japan for the future."

For some the market for companies trading in Tokyo is compelling. JP Morgan Asset Management global head of multi-asset strategy, John Bilton, is bullish.

"Japan has the best earnings momentum of any market just now and signs of improving corporate governance could add a further boost as the year unfolds," he said in June.

Tano adds that the investment case has improved since 2016. "Against a more benign global macro backdrop, a combination of improving earnings momentum, attractive valuations and favourable supply/

demand conditions is conducive to a sustained upturn in the Japanese market.

"Furthermore, from a historical perspective, Japan tends to outperform other global markets when US interest rates are rising," he says. "This reflects the relatively high weighting of Japanese stocks in economically sensitive sectors, which benefit from a strong or improving US economy, and the impact of a weaker yen on corporate earnings."

This is all the more attractive with stocks trading in Japan more favourably valued than their US peers at the moment. They traded on 16.4 times earnings at the beginning of October, compared to 22.4 times in the US. Valuations for Japanese equities might appear more favourable than their US counterparts, but investors need to ask if prices in Japan are lower for a reason.

"If I were to play devil's advocate, I would say that the risks to the downside in the US are lower than those in Japan," Aviva's Driver says. "Even prior to the election the US economy was in quite good health, so growth is on a more sustainable path."

Inflation and rate rises are drivers here. Despite this, Lonergan believes that Japan's equities are less risky than they have ever been, not only because of valuation, but shareholders now own the assets so they have property rights.

"The pendulum is swinging towards the shareholder and away from some of the traditional concerns that have dominated corporate governance," he adds.

AN AGE-OLD PROBLEM

Investors intending to increase their exposure to equities trading in Tokyo, and the excess cash on their balance sheets, need to tread carefully.

"While the Japanese market gets a strong tick in the box on the corporate governance front, I would counter that slightly with ongoing risks around the macro environment," Driver says. The economy has been dogged by almost three decades of deflation, is struggling with an ageing and declining population, a budget deficit and high public debt.

> **"This focus on returns for shareholders is very much an ongoing theme."**
>
> Helen Driver, Aviva Investors

"While there is no doubt that structural reforms and focus on corporate governance is positive and an attraction for investors, it does need to be taken in the context of these ongoing risks around the macro environment," Driver adds.

The country's demographic stats and predictions make alarming reading. In 1985 10% of Japan's population had celebrated their 65th birthday, but by 2015 the figure had risen to more than a quarter (26%). In 2060 it is estimated that 40% of the population will have reached the milestone, AMP Capital claims.

The high cost of providing pensions and medical care worsens with stats showing that Japanese families are shrinking. In 2014, one million children were born, 9,000 fewer than in 2013 and was a fourth decline in as many years, according to the ministry of health. This is fuelling fears that the population could fall by 30 million to 97 million in 2050.

Options that the government is exploring to ease the problem of low birth rates and rising longevity include boosting the number of women in the workplace through providing childcare. Pushing the retirement age back and reviewing immigration policy are also happening, as is introducing robots into the workforce, which you will discover if you check in to some hotels in the country.

GLOBAL REACH

Some, however, choose not to dwell on the country's economic and demographic woes. Looking at the bigger picture means that Fidelity's Tano sees the country as a "land of rich pickings".

"From a bottom-up investment perspective, Japan is home to some of the world's leading companies and brands, which command dominant market positions in global industries such as automobiles, robotics and electronics," Tano says. "Furthermore, many SMEs are major suppliers of parts, materials and equipment that are essential to the global competitiveness of large corporations."

Brands such as Sony, Toyota, Honda, Mitsubishi and Hitachi will appear on many investors' radars for the revenues they generate overseas, but politics could take the edge off their earning power. In early 2017, US President Donald Trump tore up the Trans-Pacific Partnership, a trading agreement that the US had with 12 countries, one of which was Japan. The trade agreement between the world's first and third largest economies will have to be renegotiated.

Le Berre expects the process to be "bumpy", but it could have a happy ending. "The only positive we see is the need for the US to have Japan and Taiwan as strong allies in the region," he says, pointing to China's financial might as a catalyst.

A meeting between Trump and Abe last year appears to have passed amicably. So perhaps Le Berre could yet be proved right. If a new agreement is struck it will be interesting to see what influence this has on boardrooms across Japan. Could it encourage them to buy more companies, in the vein of Softbank's Arm takeover?

"Undoubtedly with having cash sat on your balance sheet not doing a great deal from a shareholder-friendly perspective there comes a point where you put that to work and find return enhancing opportunities," Driver says. "Or if you can't find that, share buy-backs and dividends are set to continue to grow."

It appears that there are chapters in Japan's reform story that are yet to be written.

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Editor: Mark Dunne

Contact:
John Waterson
Phone: +44 (0)20 7822 8522
j.waterson@portfolio-institutional.co.uk

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Contact **John Waterson** to find out more:
Phone: +44 (0) 20 7822 8522
j.waterson@portfolio-institutional.co.uk

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