BIG IN JAPAN

The 2020 Olympic Games were, as expected, a marvelous spectacle. New heroes emerged as the world witnessed the feats that the human body could achieve. What was not expected when the games were awarded to Tokyo back in 2013, was that they would be staged a year later than planned due to Covid.

It is interesting that the delayed Olympics were held in Japan, a quite traditional country that is often seen as being behind schedule when it comes to modernization. Nowhere is this more evident than in the country's corporate practices, which have been deemed to be far behind the more shareholder-friendly standards applied in the West.

But this is changing. The government is pushing Japanese companies to improve their reporting, consider climate risk and embrace the digital world. Such a move will be welcomed by international investors, many of whom have been left frustrated at trying to persuade Japanese companies to invest the vast sums of capital they hold to become more competitive. The current mergers and acquisitions boom in the country shows that this message is finally hitting home.

This change is needed. Although home to global giants such as Sony, Toyota and Honda, Japan has endured three decades of stagnation and has an increasingly aging population. It has also lost its position to China as the world's second largest economy and so Japanese companies need to improve their competitiveness on the world stage.

We spoke to Asset Management One to find out how the country is shredding its traditional image to become more investor friendly.

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RE-VISITING JAPAN AS A LAND OF GOLD

750 years ago, in 1271, a young Venetian merchant set sail for Asia, travelling extensively across the continent. He later went on to write the renowned book, The Travels of Marco Polo, in which he described Zipangu as the land of gold.

In this well-known tale, Zipangu is believed to be the origin of Japan. In the Japanese language, the country is called "Nihon" or "Nippon", which literally means "the land of the rising sun".

So, is Japan a land of gold or the land of the rising sun? Will the sun rise and shine again as it did in the 1970s and 80s? Most investors seem to disagree. They have been attracted to the US markets where many technology-driven companies list their shares. They are also looking to China, which has overtaken Japan as the world's second largest economy after the US.

Current day Japan is a low growth, if any, mature economy with a rapidly ageing and decreasing population. An old school industrialised nation with boring conglomerates that engage in cyclical businesses, lacking cutting-edge innovation and thought-provoking initiatives. The nation is heavily indebted and financed by 0% coupons and its central bank. The government seems to lack a clear strategy and is often criticized for being slow to react.

Not to be cynical here, but this is a stereotypical image that global investors associate with Japan these days. Unfortunately, there is a degree of undeniable truth in this view.

However, Japan is going through transformations which are often missed, even by observant investors. Although less conspicuous compared to its rival China, Japan tends to move in one direction with strong commitment once the course is clearly set. Therefore, identifying such changes and investing in relevant opportunity sets early could yield attractive investment returns.

Transformation underway

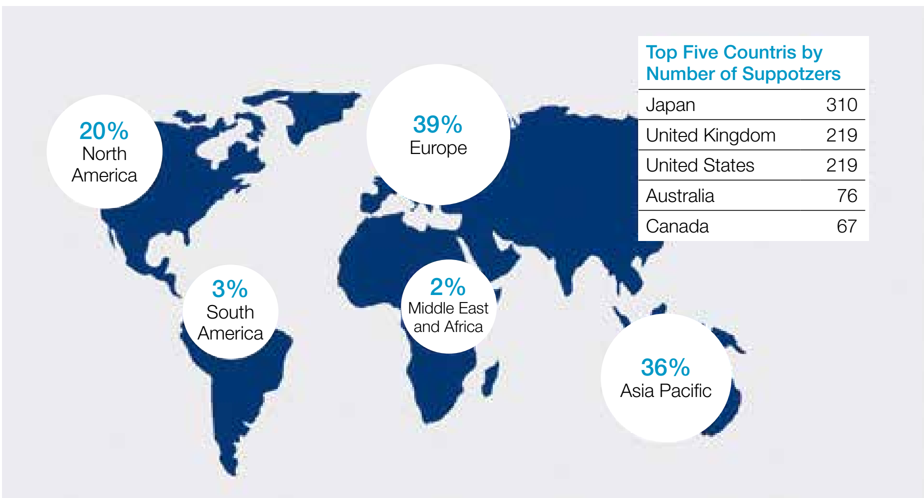
There are several areas of transformation that Japanese companies and society are currently going through. These are corporate governance, activism, mergers and acquisitions, enhanced disclosure, climate change and digital transformation.

The notoriously poor corporate governance of Japanese companies is a story of the past. This can be attributed to government initiatives to improve corporate management's mind-set towards profitability and shareholders through the introduction and regular revisions of Japan's corporate governance and stewardship code. Although somewhat conservative, many companies nowadays provide a clear strategy and profitability objectives in their guidance. Moreover, they have also conducted record levels of share buybacks during the past few years. Return-on-equity is expected to bounce back to achieve the 8% target prescribed in the Ito Report published in 2014. Companies are buying back more than ¥4trn ($40bn) worth of shares every year and, together with dividends, total shareholder return has climbed above 50% in the past few years.

Activism, which society had previously been critical of, is gradually gaining traction in Japan. The discord between Sony and Third Point, run by US billionaire Daniel Loeb, is an apt example. In 2020, 24 listed companies received activists' proposals, a substantial increase from just two companies in 2015, according to IR Japan. Corporate Japan's move to improve profitability is also evident in the growing number of mergers and acquisitions initiated by Japanese companies. More than 3,500 transactions have been completed per annum in the past three years.

Corporate disclosure in English is an area that is a work in progress, and adaptation has been particularly slow with only 30% of listed companies notifying investors of their annual general meeting in 2020, according to the Tokyo Stock Exchange. However, this was an increase of 7% in 12 months, with large-cap companies leading the way. A surprising fact is that, in terms of Task Force on Climate-related

Geographic distribution of TCFD supporters



Source: Task Force on Climate-related Financial Disclosures 2020 Status Report

Financial Disclosures (TCFD), Japan has a top ranking in terms of its number of supporters. It ranks number two in the level of companies taking action on science-based tests and is third in terms of the number of RE100 members. With the revised corporate governance code implemented this year, which encourages companies to provide TCFD or an equivalent level of disclosure on climate change actions, and with Sustainable Finance Disclosure Regulation and taxonomy coming into effect in Europe, one would expect that Japanese companies are preparing to improve their disclosures in these areas.

In addition, reforming the TOPIX is underway, with an aim to enhance the attractiveness of the index along with the re-classification of listing markets. The proposed change is prompting 664 companies, a quarter of its 2,190 constituents, to increase their free float by January 2025 or face exclusion from the index.

Digitalisation is another area that has taken off in Japan in the wake of the pandemic. With the government finally promoting change and, in many respects, forcing companies to adopt to a new reality, this transformation has accelerated significantly during the past 18 months. Companies such as M3, GMO GlobalSign and NRI are leading the digital transformation of Japan.

Our approach

The Japan Growth Equity Strategy, managed by Japanese equity market veteran with over 27 years investment experience, Seiichiro Iwamoto (an employee of Asset Management One), is unique in its approach. The team use a proprietary "Growth Categories Framework" to map all the growth opportunities throughout society and classify them into a matrix. They then populate each category with relevant companies identified through bottom-up research. This holistic approach provides Iwamoto a breadth of investment opportunities without focusing on particular sectors or themes. This approach is available through Asset Management One International's Luxembourg domiciled UCITS fund, AMO Japan Growth Equity Portfolio.

Playing the China story through Japan

Given the recent tensions between China and the US, the amplified protectionism around the world and Beijing's crackdown on Chinese tech giants, property, education and gaming industries, coupled with its growing influence over Hong Kong, is it safe to invest in Chinese stocks? With growing regulatory scrutiny and political risks, the attractiveness of investing directly in Chinese companies is eroding quickly, and no longer compensates investors for the associated risks.

A compelling proposition is to play China through Japan. Despite Beijing's push for the "buy made in China" campaign, expertise in the production of certain materials, such as components and machinery relevant for the development of the Chinese manufacturing sector, remains in Japan, therefore offering attractive exposure to growth stories in China.

Re-visit Japan to uncover gold

Japan may not be positioned at the top of a global investor's list of attractive opportunities, however nor should it be at the bottom. Japan is experiencing numerous transformations and has lower risks as a developed market when compared to emerging markets. Many investors have become sceptical about Japan and have been reducing their exposure to the country over the past few years. This move has made it deeply undervalued and left it with many untouched opportunities.

It has become a neglected land of gold, where many hidden gems are waiting to be discovered.

Asset Management One International, a leading asset manager headquartered in Japan, with deep roots in the development of industrial Japan, can assist you in constructing your portfolio's exposure in Japan.