FIS GROUP

February 2015

MARKET INSIGHTS ALERT

The Big Structural Upside in Japanese Equities

Small Caps Are Especially Attractive

Author
Adam Choppin
Manager Research

CIO & CEO
Tina Byles Williams

SYNOPSIS

Since late 2012, coinciding with the election of reformist Prime Minister Shinzo Abe, Japanese equity markets have surged nearly 70% (in local currency) in the past two years. Yet 'Abenomics', as the set of ambitious and bold fiscal and monetary policies pursued by the Abe Administration have been dubbed, have thus far failed to move the appetites of Japanese household savings. But there is reason to believe that Japan is on the precipice of reordering its domestic savings structure as soon as this year, with potentially significant implications for its equity markets.

MACRO CATALYSTS…

Abenomics, including its much discussed "three arrows" and ambitious goals of breaking Japan's 15 year deflationary cycle and 25 year economic funk have been much discussed and analyzed elsewhere. In particular the potential implications for corporate earnings and stock prices from ending deflation, improving corporate governance and depreciating the yen, among other major changes in Japan's macro-economic outlook, are probably well-understood and perhaps priced into the Japanese market already. In that regard, lower oil prices is merely just another wonderful gift for the Japanese economy. These aforementioned factors guide what might be labeled as 'discretionary demand' for equities. This includes investors (Japanese and global) with geographically agnostic mandates, including hedge funds, or other more nimble investors.

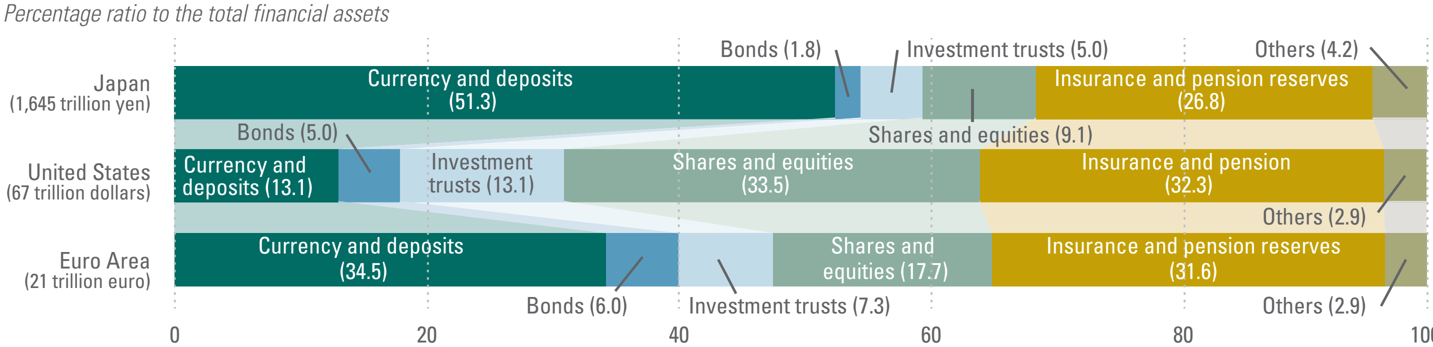
Japanese equities have also received a substantial boost from a new 'structural demand', particularly from the Japanese central bank and government pension funds. On October 31, the Bank of Japan (BoJ) and the Japanese Government Pension Investment Fund (GPIF) together announced that they would each substantially increase their asset purchases of Japanese equities. The BoJ said it would triple its purchases of exchange-traded funds (ETFs) to 3 trillion yen annually ($24.8 billion), while the GPIF, which has about $1.3 trillion AUM and is the world's largest employee pension fund in the world, announced that it would double its total equity allocation from 24% to 50% (12% to 25% in Japanese equities). Together this portended future inflows of about $195 billion in new 'structural demand' for Japanese equities over the coming year. Understandably, markets reacted strongly, with the Topix soaring 4.3% on very heavy volume in just one day. Perhaps without coincidence, $195 billion is nearly equivalent to 4.3% of the market cap of the Tokyo Stock Exchange ($4.5 trillion). Meanwhile, EPFR data indicates that through the first 11 months of 2014 (i.e. capturing the big boost to markets from the BOJ/GPIF announcements at the end of October) fund flows into Japanese equities totaled a mere $12bn.[1] Thus, it seems that most of the buying at the end of October was not driven by retail, but institutional or other discretionary buyers who efficiently priced in the BoJ and GPIF announcements into market prices. This leaves open the possibility that Japanese retail investors may still shift their own structural demand for Japanese equities.

…MICRO DRIVERS

Presently, Japanese household savings are substantially more conservatively allocated than their American or European peers with an amazing 53.1% of savings held in cash (see CHART 1).

CHART 1 Financial assets held by households

Percentage ratio to the total financial assets



*"Others" is the residual which is the remaining after deducting "Currency and deposits", "Bonds", "Investment trusts", "Shares and equities" and "Insurance and pension reserves" from total financial assets.

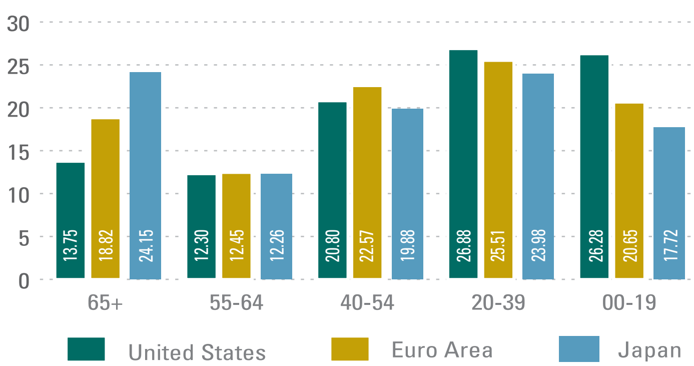
Source: Flow of Funds, Research and Statistics Department, Bank of Japan, 26 September 2014.

[1] *EPFR data generally captures only registered fund flows and certain other publicly available information. As such it is generally regarded to capture mostly fund flows from retail or other smaller investors, not large institutions. EPFR Chartbook. EPFR Global. 28 November 2014.EPFR fund flow data notably excludes separately managed account data and is sourced exclusively from registered fund data, IMF data, and other publicly available sources.*

But this difference is not proportional to the difference in age distribution between these markets (see CHART 2), thus reflecting a structural bias unique to Japan vis a vis its developed peers. For example, the percentage of the population age 65 or older is 24% in Japan, 19% in Europe, and 14% in the U.S. However, the average allocation to cash in the U.S. and Europe was 13% and 34%, respectively, versus 53% in Japan. This allocation percentage has been consistently high over the past 25 years, ranging from a low of 44% in 1989 to a high of 54.5% in 2009.[2] The variance in the allocation to cash has come almost entirely in line with equity market performance, further indicating no meaningful allocation changes from Japanese savers during this time, even during the bull markets of 1999-01 or 2004-07. Thus it would probably take an environment that is substantially different from the past 25 years to nudge Japanese savers into a more aggressive investment posture. Yet, that is arguably exactly the environment Japan presently finds itself with the overwhelming re-election of Shinzo Abe's coalition in the December elections.

CHART 2 Population distribution by age

Percent



Source: OECD.StatExtracts.

If Japanese household savings were to rise from their current levels to mere European area levels of equity exposure, that would be an additional $1.1 trillion to flow into equity markets. Should Japanese households return to their peak exposure to equities in 1989 (23.4%), that would top up the market by an estimated $1.5 trillion. If only half of this were to flow into Japanese equities (a very conservative estimate given the currency weakness and general tendencies of national savers to keep most of their assets at home), that would be equal to about 16.7% of the present Japanese stock market. Moreover, as past trends indicate, any allocative change in savers' accounts will almost certainly come at the expense of cash and savings account deposits and not bonds or other risk assets. Thus, this would be a gain in the markets net of any other asset class (except perhaps the value of the currency if a significant percentage of new equity purchases are in unhedged foreign shares).

So far, however, Japanese retail investors have been slow to change the allocations of their savings. The recent introduction of Nippon Individual Savings Accounts, or Nisas, modeled on the ISA program in Britain, has been slow to gain traction in the Japanese market. But in an ageing society such as Japan, this should not be a surprise. Older investors may be prone to a more deliberate decision-making process and also less inclined towards incurring undue risk in a portfolio that is shorter-term in nature. However, the Abe Administration is reportedly planning on launching a "junior Nisa" where parents and grandparents can set up an account for children who are 20 or below with an annual limit of Y800,000 (about USD $6,600).[3] Many observers expect this to be a much more substantial catalyst to the retail market. According to Takashi Hibino, chief executive of Daiwa Securities Group, "of all the measures out there, the junior Nisa will have the biggest impact in terms of scale. This will allow the Nisa system to become permanent." [4]

Meanwhile, a set of younger, longer-term investors may be undeterred by the relatively lower liquidity or higher volatility and attracted by the favorable valuations offered by smaller cap Japanese companies with their net cash position and improving earnings environment (see TABLE 1). Meanwhile for foreign investors, the consensus trade of long Japanese equities and short the yen appears to remain the most sensible route through at least the first half of 2015. But as broad allocative shifts of household savers is a slow process, there is a strong case for the structural upside to Japanese equities, small caps in particular, over the next 12-24 months, regardless of one's views on the major macro-economic issues of Japan which are not the direct subject of this paper. The high potential of a major shift in the 'structural demand' for Japanese equities, warrants a re-evaluation of longer-term investors' allocations to a market that has long been regarded in Western investment circles as a value trap.

TABLE 1 net cash position and improving earnings environment

	Net Cash (% of Market Cap)	Avg P/E ex Net Cash (x)	EPS growth 2014/15 (%)	Median Price/ Book (x)	Div growth (%)
Topix 500	-13.6	21.8	7.4	1.3	16.7
Topix Small	6.4	15.6	4.9	1.0	11.7
S&P 500	-21.0	22.9	15.1	3.1	16.9
US Small Cap -Russell 2000	-20.2	16.7	6.5	2.0	6.1
Stoxx 600	-26.2	21.7	8.0	2.2	4.0
Asia ex Japan 500 largest	-20.4	22.4	6.6	2.4	27.1
MSCI EM	-36.6	21.1	5.2	2.6	18.4

Source: FactSet

[2] *Flow of Funds, BoJ Time-Series Data Search, Bank of Japan. Retrieved on 29 December 2014.*
[3] *NISA. Retire Japan. http://www.retirejapan.info/nisa.html*
[4] *Retail investors snub 'Abenomics' savings. Financial Times. 18 December 2014.*