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Japan heralds the dawn of a new empire

Serious money As Akihito hands a nation in the middle of economic reform to his son, **Mark Atherton** assesses the opportunities for investors

Japan's stock market has been a slumbering giant for much of the three decades since Emperor Akihito, 85, ascended the Chrysanthemum throne of Japan in 1989. The Nikkei 225 index hit a high of 38,916 in December of that year but it has not come close to reaching that level since. After falling to 7,054 in March 2009, the index rebounded above 24,000 last year, assisted by the prime minister Shinzo Abe's programme of economic and structural reforms. Now some pundits are hoping that, after Akihito abdicates on Tuesday in favour of his son, Crown Prince Naruhito, 59, and more progress is made with Abe's reforms, the market will make fresh advances. But others, scarred by decades of false dawns in Japan, are cynical. We consider the chances of a new Japan emerging from the shackles of the old.

What has changed?

Twenty years ago more than half of the shares in Japan's corporations were owned by other corporations through what are known as cross shareholdings.

This "keiretsu" structure of interlocking business relationships led to bad economic decision-making.

Jesper Koll, the head of Japan at Wisdom Tree, a fund manager, says: "In finance, the cross shareholdings kept 'zombie' companies alive for much longer than their economic worth warranted. In management it enforced a closed fortress corporate culture of rule followers and yes-man salarymen. Today corporate Japan has liberated itself from the group-ownership straitjacket and has turned from a membership-only closed club to an open-for-business culture."

As an example of what is possible, the AVI Japan Opportunity investment trust has successfully lobbied the management of Tokyo Broadcasting System (TBS), one of the stocks it holds, to sell a chunk of the investments that made up more than 50 per cent of the assets on its balance sheet. Joe Bauernfreund, the manager of the trust, says: "These investments have no strategic benefit to TBS and add unnecessary risk to shareholders. This is further evidence that the Japanese system of cross-shareholding relationships is beginning to unwind."

Other reforms

In 2015 a corporate governance code was introduced in Japan, with the aim of pushing institutional investors to become more active shareholders. Japanese companies are slowly starting to embrace the idea behind the code.

Junichi Takayama of Nikko Asset Management says that payouts to shareholders in the form of dividends and share buybacks are thought to have doubled over the past five years. The amount of cross shareholding has declined every year for seven years, there has been an increase in the percentage of company boards with outside directors and there has been a rise in the percentage of companies with nomination or remuneration committees.

Bauernfreund says: "Over the past quarter, eight of the 29 companies in our portfolio took measures to improve shareholder value, five announced share buybacks, one had only its second dividend rise since 1998, one reduced a portion of its cross holdings and one decided to cancel its strict anti-takeover provisions, also known as poison pills."

One area where Japanese companies are making big improvements is in return on equity (a key measure of how efficiently a company is generating income). Michael Stanes of Heartwood Investment Management says that in the year to March 2019 the return for Japan's largest companies is expected to exceed 10 per cent — a record high.

Japanese companies have traditionally held large amounts of cash on their

The experts' picks

Anthony Stern of Stifel, a stockbroker, selects **Fidelity Japan** investment trust and **Baillie Gifford Shin Nippon** trust. "The Fidelity trust has good performance, yet it stands at a discount of 11 per cent to its net asset value. The Baillie Gifford trust is the best performer in its sector over three and five years.

Mick Gilligan of Killik & Co likes the **Schroder Japan Growth** investment trust. "It is run by an investment house that has a long track record in Japan, a distinct value style and it outperforms long-term."

Sam Lees of Fundexpert, a fund research website, likes **M&G Japan Smaller Companies** and **Baillie Gifford Japanese Smaller Companies**. "The M&G fund has more in services and basic material sectors, while Baillie Gifford prefers healthcare, technology, media and telecoms."

balance sheets, which is regarded as an inefficient use of capital. Bauernfreund says: "Only one or two companies use the archaic argument that the cash is off limits for a 'rainy day'." One of the key players driving the changes is the Japanese government's pension investment fund, the largest pension investor in the world. Thomas McMahon of Kepler Partners, an investment trust specialist, says: "The government is effectively becoming a major shareholder in Japanese companies, allowing it to practise what it is preaching and agitate for the improvements to corporate governance that it has made part of its policy."

The working population

Demographics has been seen as Japan's Achilles' heel. The number of people aged 15 to 65 has fallen about half a per cent a year for two years.

Koll points out that employment has been rising at about 1.5 per cent. He says: "This is because the drag from falling population numbers has been more than offset by a rise in the number of people participating in employment and economic life."

He says that as the supply of labour shrinks, companies are offering better terms of employment and higher wages. "They are creating net full-time jobs — a reversal of what we saw during the previous 20 years, when Japan Inc was a net destroyer of full-time jobs, and part-time jobs were the only jobs created. About two years ago this started to change and in 2017 more than half of all jobs created were full-time."

He adds: "The importance of the change in job creation cannot be emphasised enough. Household formation and marriage rates are rising again. In Japan the younger generation are poised to be better off than their parents."

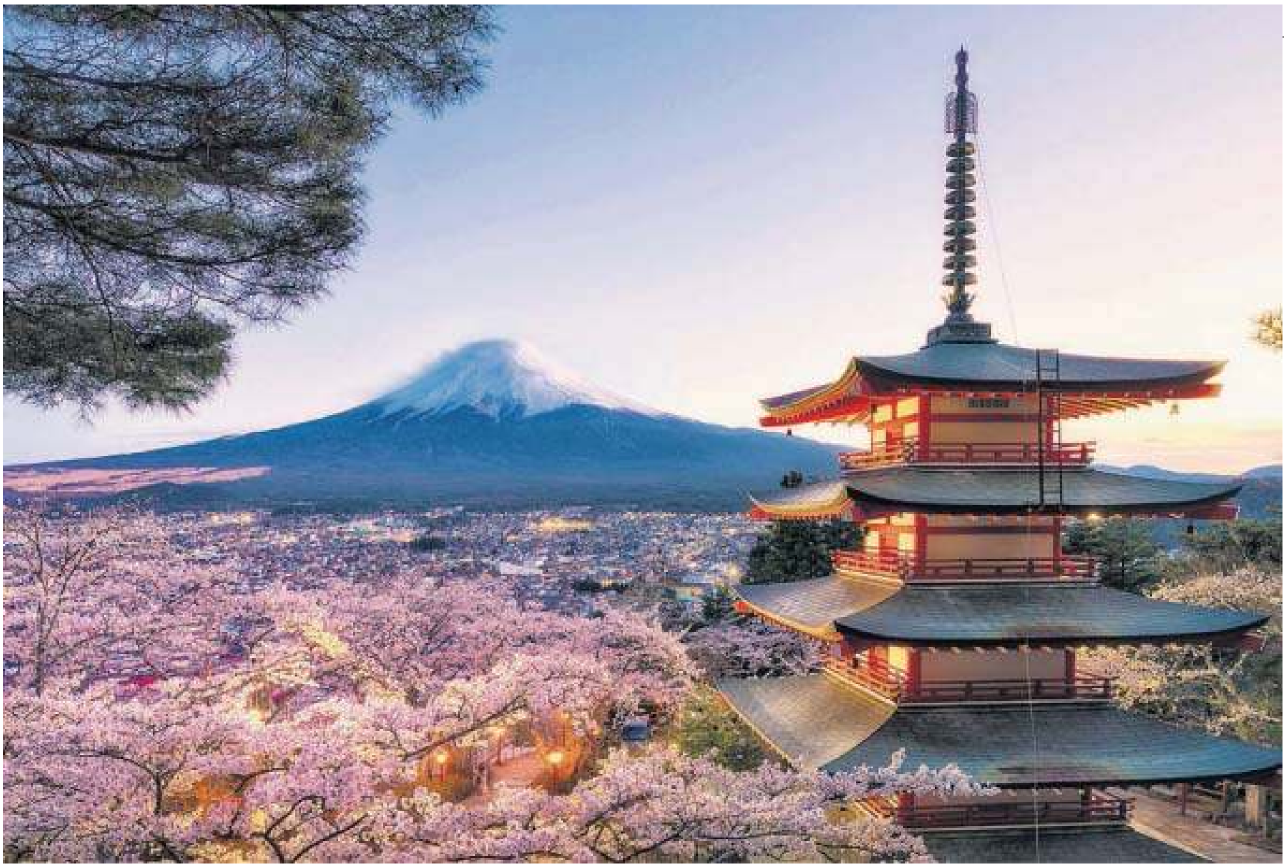
The outlook today

Koll recognises that Japan continues to confront serious problems. GDP fell 1.2 per cent in the three months to September 2018, dragged down by lower public investment and weak consumer demand. Stanes adds that Japan could be hit by the fallout from the continuing trade dispute between the US and China, while a consumption tax rise planned for this year threatens to take more money out of consumers' pockets.

Brian Dennehy of Fundexpert, a research website, says that there is good news for investors. Japanese stocks look cheap compared with those of other global markets, he says, adding: "Japan is the world's third largest economy but is massively under-researched. There are great opportunities for investors, especially in smaller companies. Tourism is booming and Japan is hosting the Rugby World Cup this year and the 2020 Olympics."

The drive for reform continues, fuelled, Koll believes, by fear of being left behind by its arch-rival China. He says: "The rise of China has focused Japanese minds like nothing else."

Japan's stock market will be closed for the ten-day holiday, starting today, to mark the coronation of the new emperor.



Pundits are hoping Japan's programme of economic and structural reforms will continue after Akihito abdicates