Matthews Asia

Matthews Asia Perspective
Japan's New Growth Drivers

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Over the past two decades, Japan's economy has moved from an industrial base to one centered around knowledge and services. Growth is now driven by a combination of innovation, improving efficiency and developing compelling brands that can help companies protect and grow market share. On December 31, 2018, the Matthews Japan Strategy celebrates its 20-year anniversary. We recently sat down with Matthews Asia Portfolio Manager Taizo Ishida to discuss the evolution of Japan's equity market and the opportunities that lie ahead for investors with a long-term view.

Some investors prefer to index their Japan exposure because it's a developed market. Yet Japan has proven a fertile source of alpha for many active managers. Why should investors consider including Japan within their active risk budget?

Part of the opportunity set for active managers is that indices tracking Japan's equity markets tend to be full of older, more industrial companies, which we believe have less attractive growth potential. The equity universe in Japan is quite large, so looking beyond the largest index constituents can be a natural way to generate alpha. If we include small caps, there are more than 3,700 stocks in Japan. For the Matthews Japan Strategy, we run a high-conviction portfolio that typically ranges from 50 to 70 holdings, seeking to identify the cream of the crop. We strive to build a portfolio that has a higher return on equity than the broader market, higher revenue growth and a significant weight in smaller companies with higher growth potential. Indices naturally tend to be backward-looking, showing you a picture of what Japan used to be. The Matthews Japan Strategy seeks to capture a picture of what Japan is going to be, which is very different from its industrial past.

Japan has low GDP growth and very little inflation. How can companies create long-term earnings growth in this macro environment?

Japan's growth story is about individual companies rather than its overall economy. Growth leaders tend to be companies that have found new products and services to sell, or those that have uncovered new ways to reach customers. Following the dot-com bust in the late 1990s, a fresh generation of IPOs came to market. At the time, the web was little more than individual pages connected by hyperlinks, waiting for search engines and an entire ecosystem of service providers to emerge. Today, the shift to mobile is creating yet another generation of companies finding new ways to reach customers. As bottom-up investors, we start by considering the growth potential of attractive individual companies. We're generally looking for companies with a high level of cash flow, pricing power within their markets, solid corporate governance and a strong track record of allocating capital. Companies with these characteristics have the potential to create earnings growth through innovation and creativity.

How has investing in Japan changed over the past 20 years?

Twenty years ago, it was difficult to find attractively priced companies with sustainable growth prospects and solid earnings, but today we have a good assortment of growth companies to choose from. Looking back to 1998, the average price-to-earnings (P/E) ratio in Japan was remarkably high, making stocks very expensive at that time. Because earnings were so small in comparison to stock prices, there essentially was no "E" in the P/E ratio. Companies weren't doing a good job of capturing profits or rewarding their shareholders. Today, the average P/E for the Japanese equity market is closer to 12X to 15X earnings, much more in line with global averages. Earnings have improved and valuations are much more attractive. We've also seen improvements in corporate governance and a broadening of innovation.

What has been the catalyst for these improvements in corporate governance?

A positive regulatory framework has helped a lot. Prime Minister Shinzo Abe's administration codified many of the best practices that global shareholders have come to expect in terms of corporate governance and treatment of minority shareholders. For example, foreign investors have long encouraged Japanese companies to get cash off their balance sheets, pay out dividends and improve their profit margins. Abe incorporated these global norms into more formal regulatory guidance for companies, which in my mind has been a significant achievement for his administration.

Where are Japanese companies finding customers?

On Japan's domestic front, there's been low overall economic growth. Some parts of the economy, however, are growing nicely, including health care and internet services. So there is considerable growth within Japan's own borders. Among Japanese companies that are global conglomerates, many have done a good job of creating brands that have gained traction worldwide, so companies are also finding growth outside their borders. On the business-to-business side, for example, Japanese robotics experts are helping Chinese manufacturers automate warehouses in response to rising labor costs in China. On the consumer side, high-end Japanese baby products, including baby bottles with uniquely designed rubber openings that make it easier for babies to drink, have been a hit across Asia. With 15 million babies born annually in China and 25 million in India,[1] Asia is a growth market for baby products. As companies grow, many have the potential to expand their reach, within Asia as well as globally.

What are some risks that investors should consider before investing in Japan's equity market?

All equities contain risk, so we believe it's important for investors to have a long-term time horizon, typically five years or longer, before considering Japanese equities. Japan's political structure has been fairly stable during Abe's current tenure as prime minister, which began in 2012. But there is always the risk that changes in political landscape could cause a short-term disruption in Japan's market. In terms of the financial health of individual companies participating in Japan's public market, we generally don't see a significant number of companies in Japan that are overleveraged or taking unnecessary financial risks. If anything, many companies tend to be underleveraged and could put their balance sheets to better work for shareholders.

Japanese equities have performed well in recent years. What are the drivers of future performance?

As in the past, future growth will likely come from individual companies that are continually innovating and finding new ways to serve customers. On the domestic front, labor shortages in Japan and the demographic challenges of an aging population with a low birth rate mean that there is more room for automation and creating better efficiencies in existing businesses. No one wants to work late hours in a restaurant anymore, for example, so those types of functions are increasingly being automated. Rising wages and household incomes across the emerging parts of Asia, such as China and India, also mean that there will be a much larger middle class in Asia that Japanese companies can sell to in their own backyard. While the U.S.–China trade dispute has created a recent hiccup in globalization, we expect the larger forces driving globalization to continue, allowing Japanese companies to market their goods and services on a global stage. For investors who are looking to capture global growth, an allocation to Japan through an actively managed strategy can play an important role within a diversified portfolio.

1 Source: UNICEF.org

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