REFORM

Russell Investments

Structural changes in Japan:

Spotlight on key themes creating investment opportunities

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Structural changes in Japan

Here we've put the spotlight on the changes in Japan that are coming to the fore and having real impact. We highlight the key aspects of the instrumental political, regulatory and investor-led reform taking place, as well as the impact of the changing demographic picture.

We outline:

- the shift and improvements we have seen in Japanese corporate governance over recent years
- the changing demographics seeing contrasting challenges and needs for both the elderly and the young
- how these are carving out multiple opportunities for investors within this space.

Makiko Hakozaki,

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Corporate governance

Japan is changing – for real this time

Over the last 20 years there has been lots of talk about the supposed 'changes' happening in Japan. For the most part, this has been all talk, and there hasn't been much evidence of Japanese businesses actually walking the walk.

As such, many who invested in Japan off the back of these inflated headlines have been badly bruised. Some stalwart critics have even gone as far to claim that Japan will never change. However, we believe that the emerging developments coming out of Japan are positively affecting the fundamentals. In our view, the outlook for investors is optimistic – for real this time.

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Three key developments

Below we discuss the top three developments that we believe have been critical to securing corporate governance reform in Japan.

1) Abe's policies

Japan's Prime minister Shinzo Abe, elected in 2012, has been on a mission to resolve his country's macroeconomic problems. A three-pronged approach (pillars), his policies – more commonly known 'Abenomics' – aim to deliver:

- Monetary policy
- Fiscal policy
- Structural reforms

His third pillar has homed in on tackling some of Japan's long-standing concerns within corporate governance – a first in Japanese government history. His administration has actively encouraged corporates to diversify management, increase spending/investment and to unwind their cross-shareholdings i.e. Japanese companies holding shares in other Japanese companies, as a part of their business relationship.

It's not just Abe's third pillar that has bought about change, however. Some changes have been decades in the making but have only recently become more meaningful; while others are the result of shareholders speaking up.

2) 'Corporate Japan': Stewardship and Governance Codes

Abe's vision for the new 'Corporate Japan' has also encouraged the government's Financial Services Agency (FSA) and regulatory bodies to toughen up.

Modelled after the existing UK Stewardship Code, Japan's Stewardship (JS) Code was established by FSA in 2014. The JS Code is closely aligned with UNPRI's second principle on active ownership and the incorporation of ESG issues into ownership policies and practices. In 2015, the Tokyo Stock Exchange, with support from the FSA, issued the Japanese Corporate Governance Code, which established fundamental principles for effective corporate governance in listed companies in Japan.

These are seen as powerful positive forces in reshaping corporate behaviour. The former aims to improve the dialogue between institutional investors and the companies in which they invest, to promote long-term shareholder value. But in order for it to be successful, it ultimately requires companies to embrace certain principles. This was where the Corporate Governance (CG) Code came in. The CG Code is designed to elevate the broad governance culture among Japanese companies and encourage them to target sustainable growth in corporate and shareholder value. The introduction of CG Code is expected to accelerate changes across the corporate sector by positively redefining board structures – supporting a firmer focus on shareholder value creation.

As a result of these codes it has become very difficult for companies to maintain their sloppy governance practices. Indeed, we have started to see market dynamics shift in response to these codes (see development 3).

Companies are being forced to adhere to global standards by their overseas shareholders and this is bringing about credible change.

3) Market dynamics: Foreign investment, global standards and vocal shareholders

While the Japanese share market still isn't transparent enough for us to segment it with definite numbers of percentages, we recognise how its shape has drastically changed since the 1990s.

Today, we believe that is can largely be divided into three equal parts:

- One-part passive, domestic investors
- One-part foreign investment
- One-part domestic cross-shareholdings

Proof that fundamental and attractive change is occurring in Japan can be evidenced by the fact that the number of foreign investors in Japan has significantly grown over recent years. Meanwhile (and fortunately) cross-shareholdings are moving in the opposite direction and are declining. This reduction is no doubt thanks to the Abe and Codes we saw in points 1 and 2; but it is also because of the increase we have seen in foreign investment.

Overseas investors are speaking up

After years of stark contrasts between Japanese companies and their global counterparts, foreign investors have now fostered a new and bold culture of speaking up and calling out. Companies are being forced to adhere to global standards by their foreign shareholders and this is bringing about credible change. And for most foreign investors, cross-shareholdings are a complete no-no, while dividends, buy-backs and independent management get a big thumbs up.

Indeed, Japan has numerous companies who operate globally such as Panasonic, Sony and Toyota, for example. Take Toyota for instance – whose board used to be comprised entirely of Toyota staff. Toyota took many by surprise when they appointed their first ever third-party board member in 2013. Today they have three formally-appointed external directors sitting on their board, including 1 female. They are now thought of as an early adopter and leader of corporate governance – in 2018, they reduced advisor and counsellor positions (jobs considered 'honorary' for ex-management members) down from 61 to 9.

Figure 1: 'Old Toyota' versus 'Reformed Toyota'

	OLD TOYOTA	REFORMED TOYOTA
Board members	All Toyota employees	• First external member elected in 2013 • Three external members elected in 2019 (including one female)
Adviser/Counsellor positions	61	9

Source: Russell Investments

Three reasons why these reforms matter to investors:

More benefits for shareholders such as dividend pay, increased share buy-backs and huge improvements management structures and governance practices.

Increased focus on profitability. Corporate Governance is not the only reason for this – fundamentals such profit margins and returns are displaying real growth. This will pave the way for the next phase of improvements which should see an increase in financial efficiencies, such as better use of capital by improving balance sheet management.

Poorly-managed companies have been severely penalised and have now changed for the better. There is now less tolerance for issues such as accounting or quality management fraud (take recent cases for example, such as Tokyo Steel, Suruga Bank and others. And we are confident this will continue to have a domino effect.

Shareholders are more vocal, and this has seen more companies listen and respond to requests.

Shifting demographics

Does 'value' still represent value in Japan?

The 'value factor' is one of Japan's oldest and most successful investment stories. It was made popular thanks to Japan's history of company bail-outs by banks, the government or even peers (if you were a part of the Zaibatsu group – a collection of conglomerates who controlled a large portion of the Japanese economy). Downside protection was commonly assumed.

However, the Global Financial Crisis (GFC) in 2008 was the key catalyst of change for this investment opportunity, fundamentally changing the backdrop as a result. Value stocks continued to perform well up to 2011. Until, for the first time, companies began to go bankrupt, such as the infamous Elipda in 2012 or Takata in 2017.

Lessons learned from the GFC combined with endeavors to reform corporate governance saw increased fiduciary responsibility, tighter regulation and rules around bail-outs. Assumptions about downside protection were no longer. The rules of the game had changed, and this saw the value opportunity deteriorate. Indeed, Japan has been the worst performing market globally for value stocks over the last decade.

There are, of course, value investors who did well all through these time periods, particularly those with the skill to avoid real value traps and a unique stock picking ability. However, we believe that that typical sweet spot of value investment in Japan has changed over the years.

Value is no longer the outstanding investment story of Japan. Instead, we think that a new investment opportunity can be found around the theme of aging.

Why active in Japanese equities?

1. Shift in Japanese corporate culture and an increase in overseas investors has improved return on equity, as cash is being mobilised

2. Small and mid-cap stocks are **under researched** relative to large and mega-cap stocks, providing better alpha opportunities for investors

3. Dynamic and Defensive stocks in the TOPIX are **negatively correlated**

A 'super-aging' society

Japan has the highest proportion of older adults (65 and above) in the world.[1] And it's causing a serious bottle neck for the country and a lot of pressure on the young workforce. This is one of the main reasons why some investors might feel uncomfortable investing in Japan today.

However, we think that aging– is actually a catalyst for change in the country and thus, an investment opportunity. Our view is twofold:

- Aging is giving way to more efficiencies in corporate Japan. Policies to help cope with Japan's super-aging population are the key to this.
- The issues resulting from aging have reached boiling point. The country is on the cusp of change. It has to change. This change will bring about growth and opportunity to those who are already invested.

Policies to support the workforce

Over more recent years, Abe has begun working on a series of reforms intended to boost opportunities for the young workforce and reduce the costs associated with supporting the elderly:

- In 2018 Abe vowed to raise the retirement age from 65 and allow people to defer their pension beyond 70. Not only does this support the existing workforce (which is declining as more and more retire), but it also means less years of a pension.
- More nursery spaces and improved day care facilities have been made available to encourage younger parents back to work and specifically, to help increase the number of women in work.
- Rules for immigrant workers have also been relaxed, in the hope that they will help to fill the much-needed workforce of the elderly caregivers
- Minimum wage is on the way to being standardised
- Young people being encouraged to move out of overcrowded cities through housing incentives for property in the countryside, where living costs are cheaper, and standards are better.

The wheel is always turning though, and more new, innovative ideas around how to tackle the age demographics are coming out of Japan. Sociologists, for example, have called for more targeted investment into select areas outside of Tokyo – which is overcrowded and heavily populated with very elderly retirees. At the moment, the government invests equally across Japan.

The cusp of change

Labour shortage

Another key concern is the critical labour shortage gripping many industries, as a result of more and more employees retiring. Japan's economy is growing, and more job opportunities are opening up, but the number of able workers is declining. Without these jobs being filled, there is a risk that Japan's growth will stagnate.

[1] "Japan: Super-Aging Society Preparing for the Future", Naoko Muramatsu and Hiroko Akiyama. The Gerontologist, Volume 51, Issue 4, August 2011, Pages 425–432

In an effort to help, the government amended their labour laws (which came into effect in April 2019) to improve working conditions by reducing hours, revising wage laws and annual leave rules. The hope is that employees less able to work long hours or more labour-intensive jobs (such as the elderly, parents/carers or disabled) will remain, enter or return to the work place. This is starting to become a major headwind for the traditional retail industry, who are struggling to keep up with the rate of change.

Productivity

An indirect consequence of all the above has also left Japan facing a crucial and systemic problem: poor productivity levels – for example, the output of one worker in Germany equates to three in Japan for the retail industry (as seen in the chart below).[2]

This is also due, in part, to the workforce's traditional values and lack of vigor to change and adapt to new technologies. Culturally, Japan is notorious for being slow to change – never wanting to be the first or the last – and the aggregate workforce is no different. As a result, many archaic processes have been retained with businesses working without the internet, using fax machines and even cassette tapes – juxtaposing Japan's reputation of being at the forefront of technology and the digital era.

This is not sustainable. Japan's future prosperity depends on businesses adopting more efficient working practices so that they can continue to compete in the world economy. And thanks to Abe's corporate governance reforms around family ownership and cross-shareholdings referred to earlier, more investment into business and new ideas are seeing meaningful changes. We believe that we are only on the cusp of change in this regard, and more is to come. This will likely see further improvements to corporate fundamentals, increasingly the opportunity for investors.

Employment practices

Businesses are also being pressured to improve their employment practices. For example, many younger employees have higher expectations and demands of their employers, including better pay and benefits. They, and Abe, are calling for businesses to modernise and align their approach with global peers to attract a new, younger workforce. This too is forcing businesses to change for the better, making them more competitive and attractive as investments in the long run. Plus, it is also is likely to see an uptick in workforce productivity.

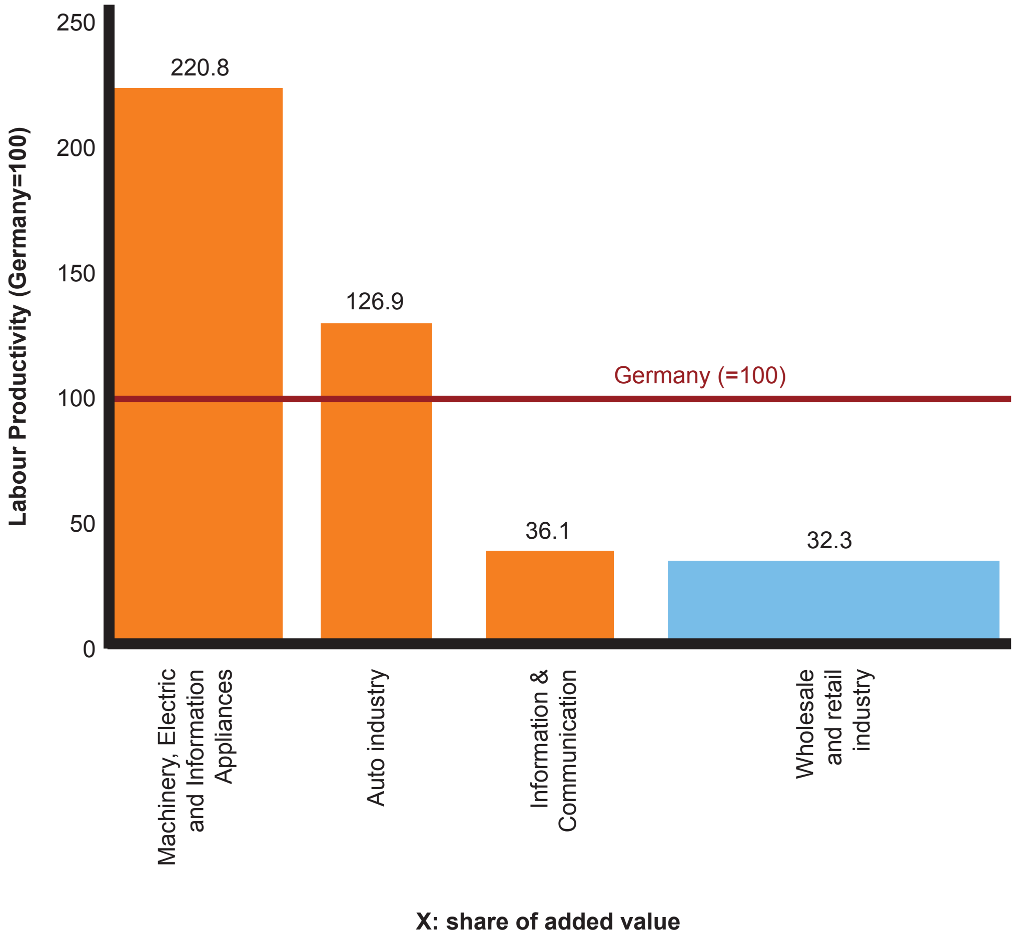
Shifting demographics: It's now or never

Japan's aging population combined with Abe's reforms and new globally aligned standards feels as if we are on the precipice of change. Indeed, the degree of change appears to be underestimated by many investors and market players.

For much of Japan, it's now or never. We believe that together, these changes are going to turbo-charge development in Japan, contributing hugely to why we think it is a timely and attractive investment opportunity at the moment.

[2] The Japan Productivity Centre, https://www.jpc-net.jp/eng/

Figure 2: Japan's labour productivity versus Germany / Per hour productivity comparison with Germany (year 2015)



Source: Japan Productivity Centre, 2019. https://www.mof.go.jp/pri/research/conference/fy2017/inv2017_01.pdf

Why Japan? Why now?

Japan is reforming itself from communist to capitalist – imposing new rules to legitimise companies and help the country move more in line with global peers. How well and how early Japanese companies adopt these new rules is key to their survival. Ongoing pressures to improve corporate governance and help Japan cope with society's 'super-aging' keeps the reforms developing at a rapid rate – leaving behind those who can't keep up.

Although, it is important to remember that Japanese equity has a history of not being well-researched and indeed, not being a well-trusted market. Years of false dawns have bruised investors; still today, we see frequent episodes of fake news driving activity in the market, some good and some bad. However, we believe that with local knowledge, on-the-ground expertise and unique insight, investors can rid themselves of bad memories and access the wealth of new and growing alpha opportunities now available in Japan.

So, in short, the answer to why Japan, and why now is this: We believe that Japan is well and truly on the path to reform. And the interesting secular changes happening as a result are paving the way for some unrivalled investment opportunities.

About Russell Investments

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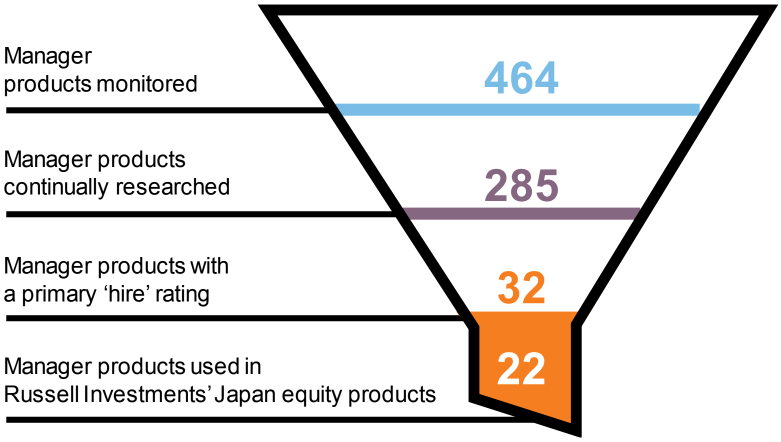
How Russell Investments invests

Japanese equities manager research funnel



Source: Russell Investments. Data as at 31 March 2019.

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Call Russell Investments at **44 (0)20 7024 6000** or visit **russellinvestments.com**

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