Evolving global investment trends in Japanese equities

A quantitative analysis of capital flows and qualitative study of investor sentiment

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Introduction

In Q3 and Q4 2019, IHS Markit undertook an in-depth study of the Japanese equity market with the goal of understanding investment trends and the drivers of historic, current, and future market performance.

The result is a two-pronged study that combines capital flows analyses and direct feedback from prominent investors in the market. This study presents a clear view of the historical context of global investment in the Japanese market, present conditions and sentiment, and actionable insights for issuers to best engage global investors and facilitate investments in their respective companies.

IHS Markit's Analytics team reviewed long-term and near-term capital flows and institutional investment trends in the Japanese equity markets. The analysis incorporated ten years of active institution- and fund-level equity investments in the Japanese market to isolate trends and granular takeaways concerning company size, sector, and shareholder return strategy. Moreover, this study looks at the key global investment centers and specific funds driving this activity.

IHS Markit's Perception Research team conducted 30 telephone interviews with institutional investors across North America, EMEA, and APAC, who represent a collective $352B in EAUM with $75B in Japanese equities. The topics included areas of perceived opportunity and risk when investing in Japan, as well as actionable feedback on how Japanese issuers can best engage global institutional asset managers. All participants were promised anonymity in exchange for their candid feedback.

Key findings

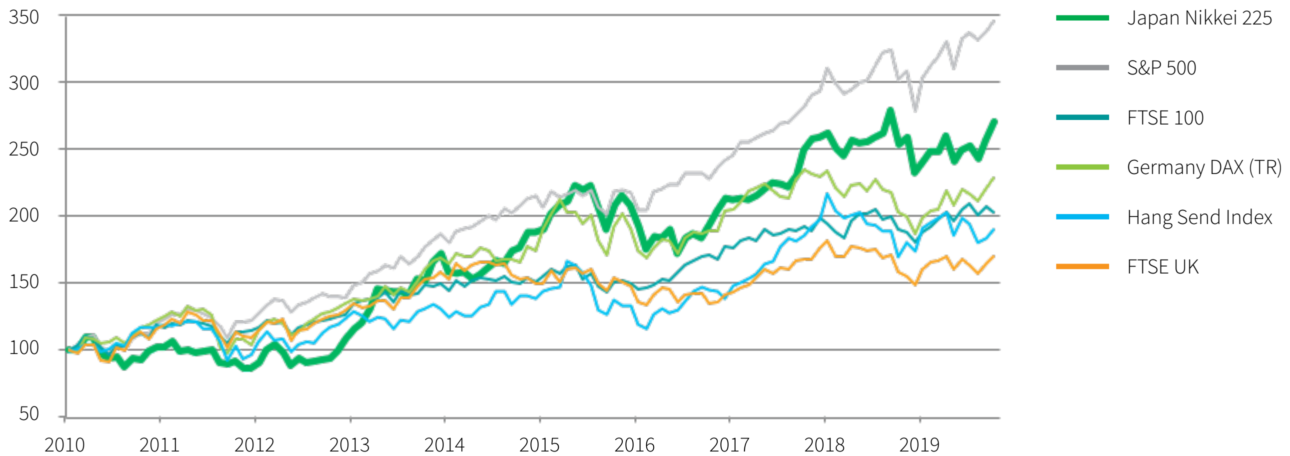
- The introduction of Abenomics led to an aggressive inflow of active global investment, resulting in multi-year outperformance by the Nikkei
- Between 2010 and 2018, approximately $400B in active global capital entered the Japanese equity market, with North American, British and European asset managers exhibiting the greatest interest in the market
- However, more recently, the Nikkei has experienced four straight quarters of net active capital outflows
- Feedback reveals that investors are primarily concerned by the macroeconomic environment, FX risk, and corporate governance
- Amidst this period of capital flux, IHS Markit observes a clear trend in Japanese Large-cap issuers that have outperformed the Nikkei and their respective ability to attract foreign capital
- From a sector perspective, foreign investors have been most attracted to the Consumer Goods, Industrial, Technology, and Healthcare sectors
- Large-cap Japanese equities account for 67% of the total foreign capital investment in Japanese equities
- Trends show that a higher dividend yield has not necessarily attracted more foreign capital. However, companies with greater buybacks have seen greater foreign investment interest.
- Meanwhile, relative undervaluation and the potential for stock picking are top investors' key motivations for investing in Japan
- Improvements to shareholder return strategies and a growing focus on corporate governance are also drivers of bullish investor sentiment
- Looking ahead, attracting global capital will hinge on Japanese companies' communication practices, engagement on corporate governance, and capital deployment
- IHS Markit recommends increasing focus on a data-driven outreach strategy to target global metros exhibiting buying interest and purchasing power for Japanese equities, as well as understanding drivers of investment decision-making in order to tailor the equity story messaging

Part I: Setting the stage–

Abenomics attracts global investment

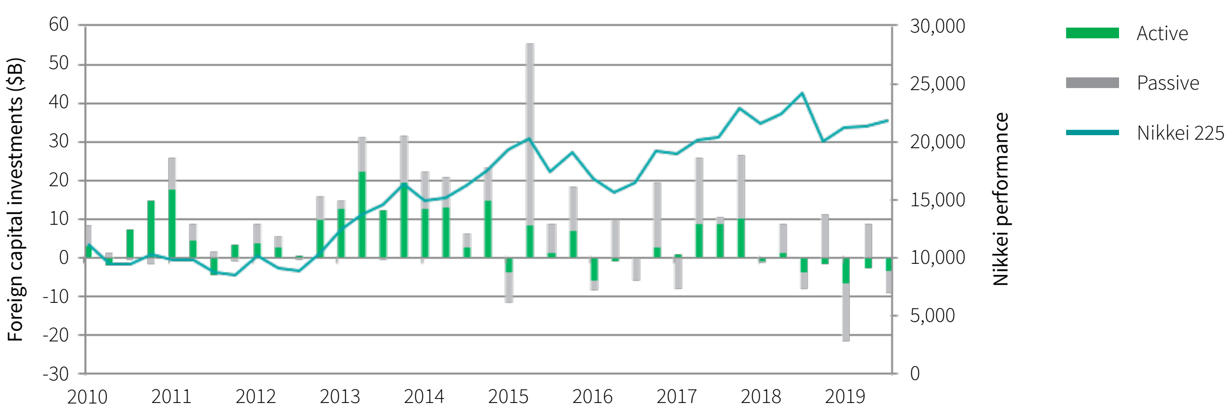
The impact of foreign investment on the Nikkei

Index performance of Nikkei and other major indices: 2010 to 2019



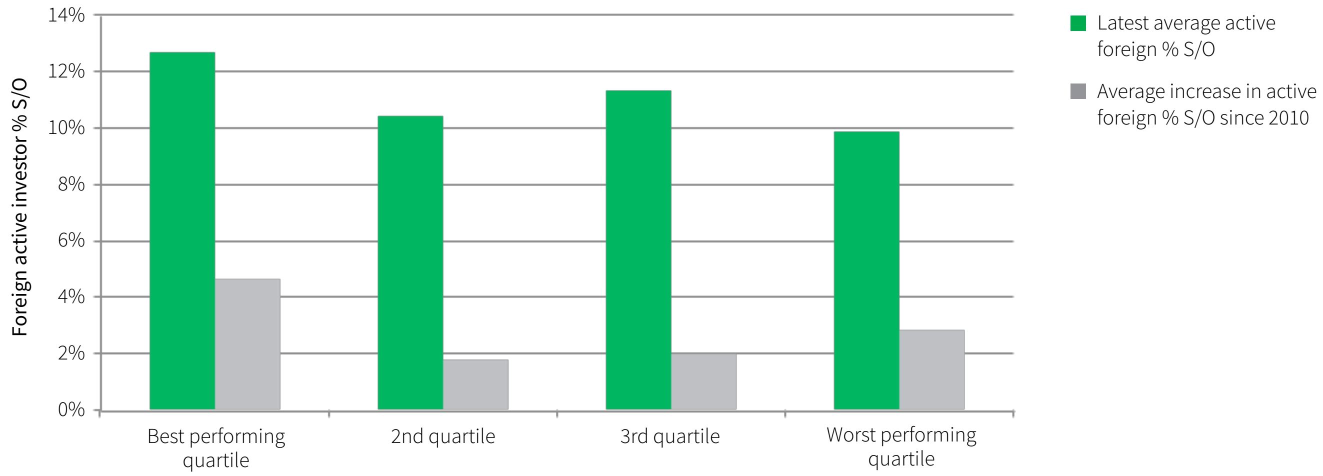
Reviewing Japanese equity market performance on a ten-year basis, the Nikkei initially relatively underperformed versus major global indices and this was the case until Prime Minister Abe's election and the administration's introduction of 'Abenomics'. These policies led to a sharp outperformance by the Japanese index and positive momentum through 2015. From late 2012 through the end of 2019, the Nikkei outperformed all major indices, aside from the S&P 500.

Foreign capital influence on index performance: 2010 to 2019



The Abenomics-linked outperformance in the Nikkei was supported by a sharp period of foreign institutional capital inflows into the Japanese market. Since the initiation of Abenomics, the Nikkei has benefited from net foreign capital flows during 74% of calendar quarters and this has driven a net ~$400B into the Japanese equity market.

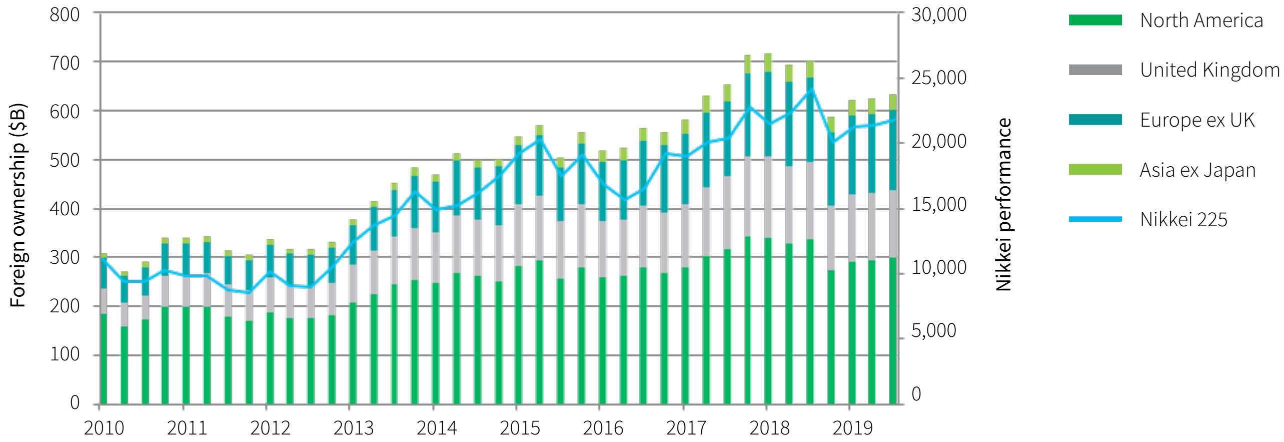
Foreign active institutional investment and share price performance



On a stock specific basis, IHS Markit observes a clear connection between Japanese Large-cap issuers that have outperformed the Nikkei and their respective ability to attract foreign capital. On a ten-year basis, the best performing companies in the top quartile have the highest average foreign active ownership at around 13% of their shares outstanding. This group also shows the highest increase in foreign active ownership over ten years.

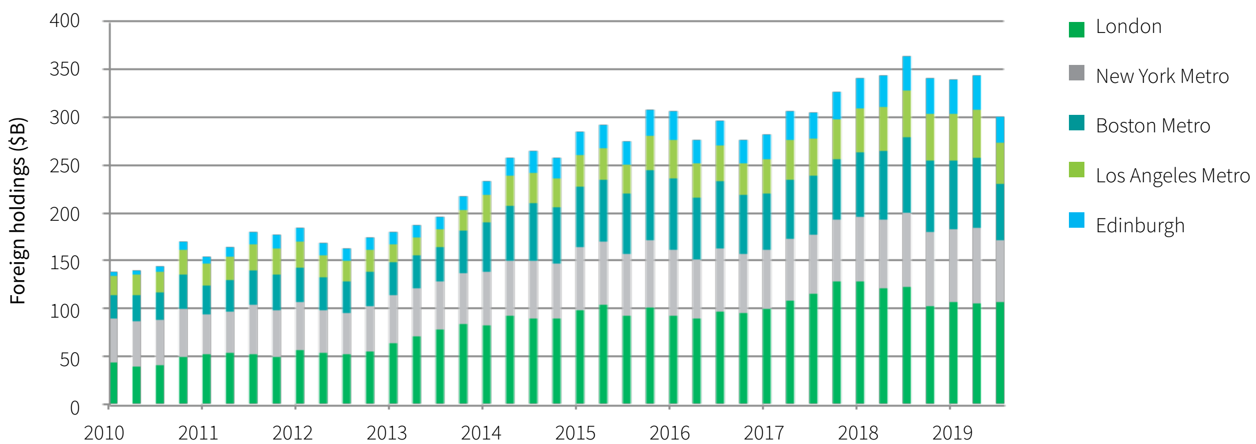
Global asset managers pushing into the market

Foreign ownership by region and index performance of Nikkei: 2010 to 2019



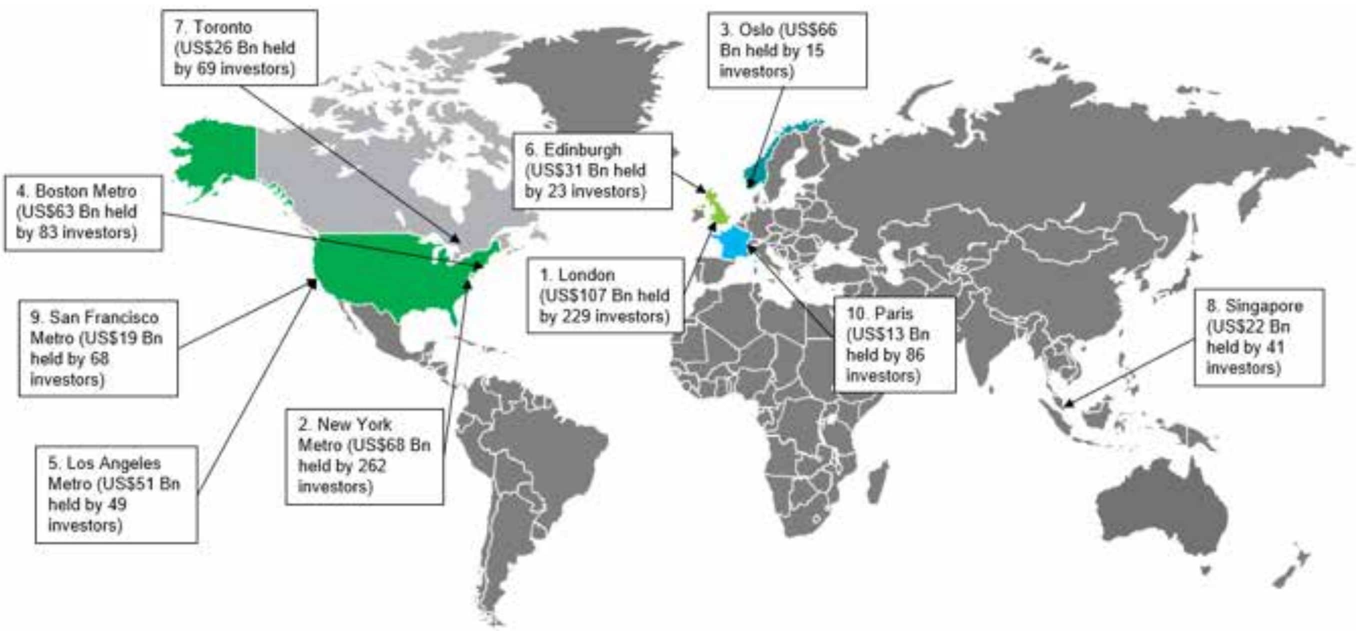
As illustrated in the above chart, the Japanese equity market was stimulated by pools of active foreign capital. Active foreign portfolios have more than doubled their exposure to the Japanese market over the 8-year period since 2010; from $300B to $700B in absolute terms. This activity has been led by investors in North America, the United Kingdom and continental Europe, with a much smaller amount coming from Asian portfolios outside Japan.

Top 5 global metros holding Japanese equities: 2010 to 2019



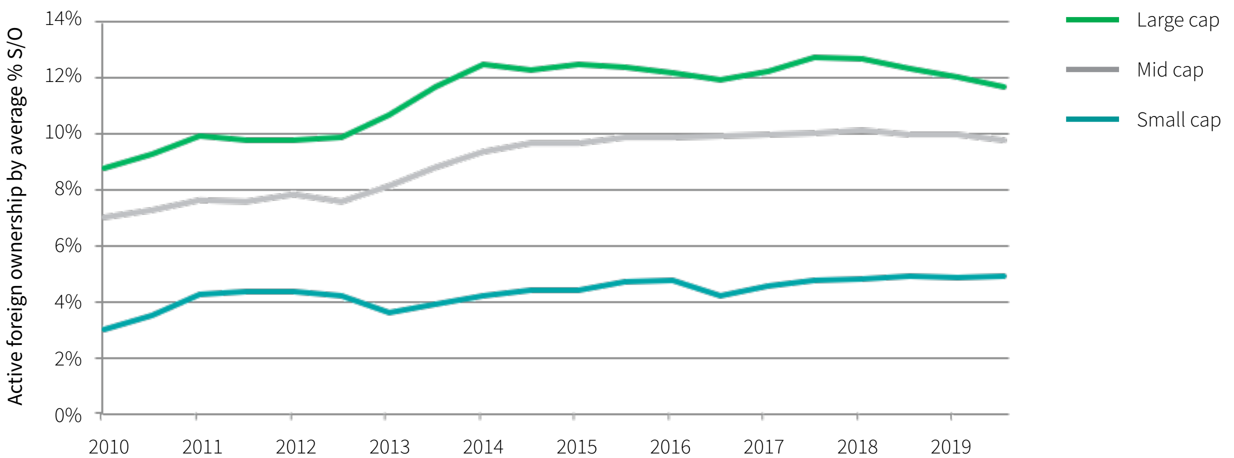
Narrowing our focus, London-based investors have been a lead supporter of Japanese equities, with 18% of foreign active investment held in the city. The New York metro area is the second key capital center and, together with Boston, the two areas represent close to 22% of foreign Japanese ownership, led by fund managers such as Fidelity Management & Research Company, TIAA-CREF, First Eagle Investment Management, and MFS Investment Management.

Outside of these areas, the IHS Markit Advisory team sees an increasing ownership in Japanese equities over the past five years in Los Angeles (Capital Group), Toronto (CPP), Edinburgh (Baillie Gifford), Singapore (Effissimo, GIC), and Paris. These cities have growing importance for companies who wish to visit investors out of the more common routes.



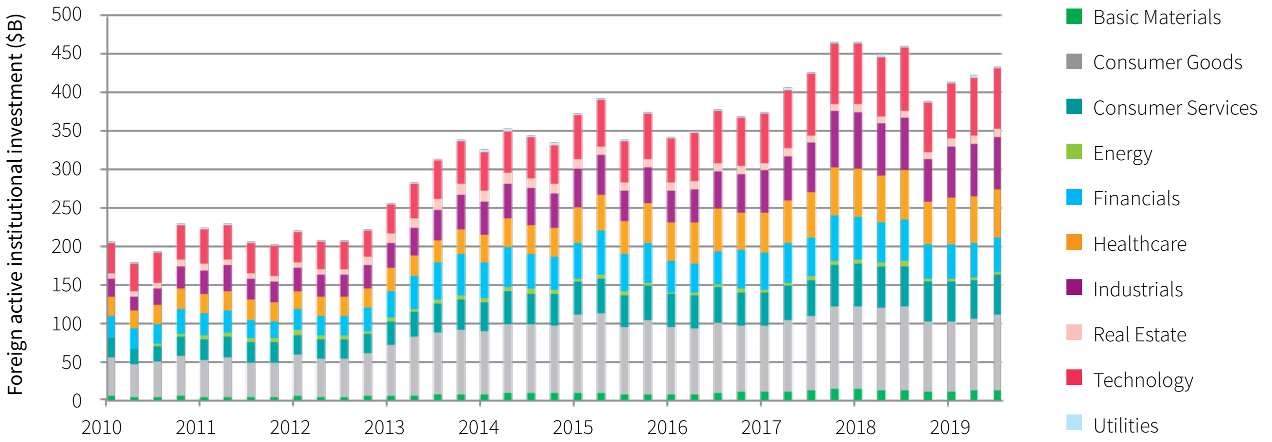
Japanese equities receiving global interest

Foreign active institutional investment by market cap: 2010 to 2019



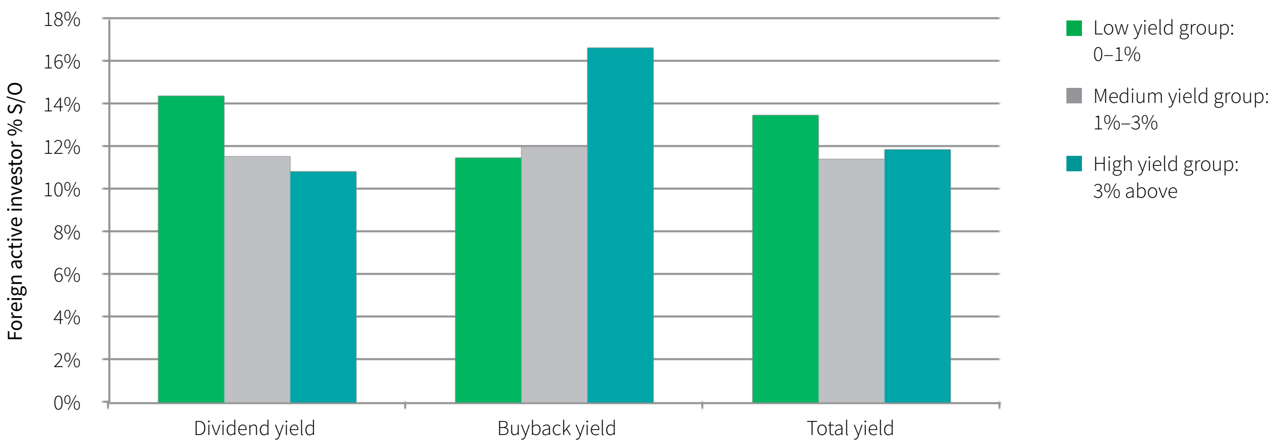
There is a correlation between foreign investment interest and market cap, as foreign active investors have been most active in buying well researched Large-cap Japanese issuers. Specifically, these Large-cap Japanese equities account for 67% of the total foreign capital investment in Japanese equities. From a historical perspective, Large-cap equities saw the sharpest inflows from global investors at the onset of Abenomics, while interest in mid-cap and small-cap names has risen at a far more gradual rate. Interestingly, direct investor feedback indicates that some investors are more predisposed to looking for mispriced opportunities amongst smaller-cap companies that have less coverage and visibility.

Foreign active institutional investment by sector: 2010 to 2019



From a sector perspective, foreign investors have been most attracted to the Consumer Goods, Industrial, Technology, and Healthcare sectors, as these industries have close ties to the overall Japanese economy and include two-thirds of large cap companies in the Nikkei.

Foreign active institutional investment by shareholder return strategy



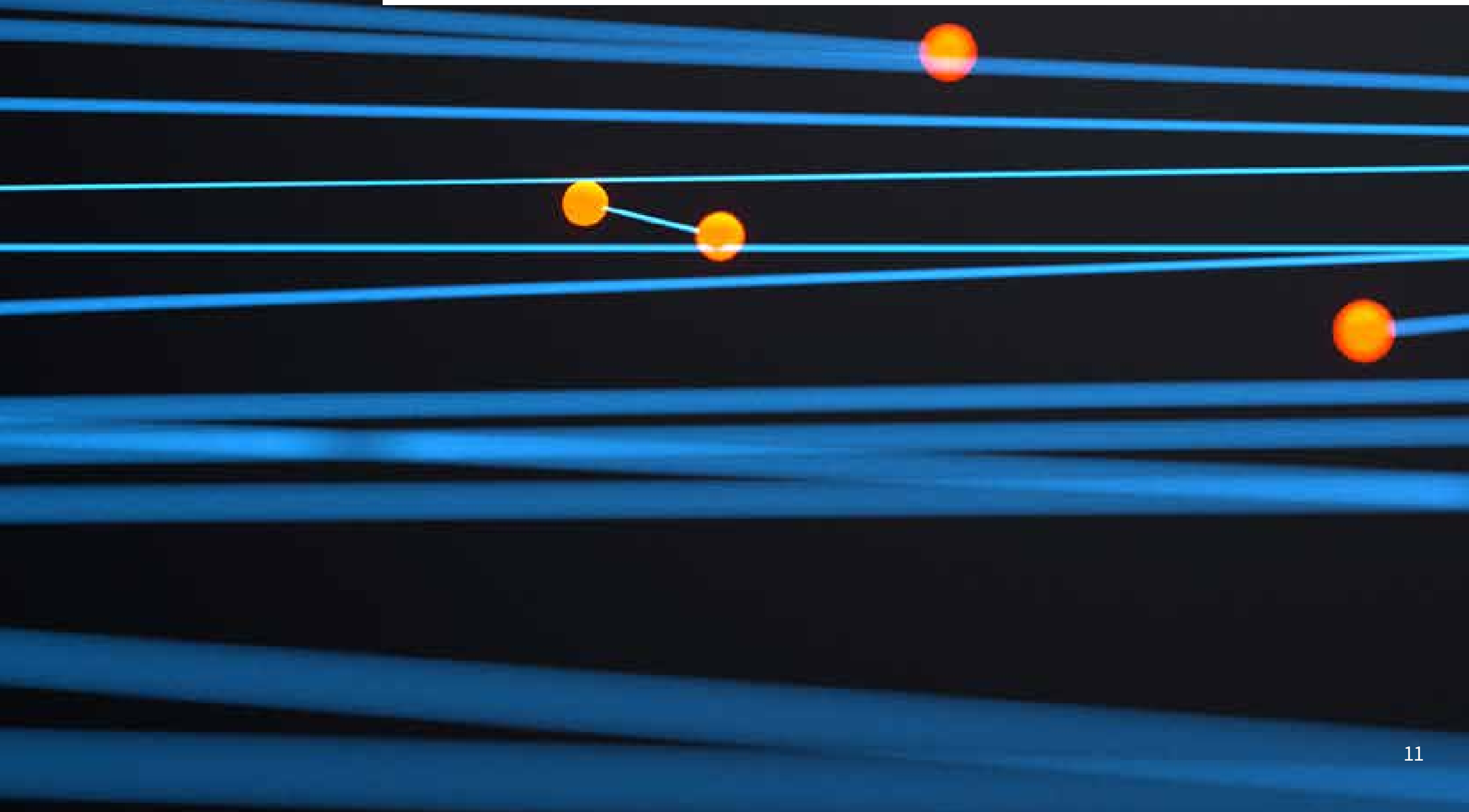
Lastly, the IHS Markit Analytics team analyzed shareholder return strategies to determine whether certain company strategies acted as a point of attraction or blocker for global fund managers. The trends show that a higher dividend yield has not necessarily attracted more foreign capital. Although, companies with greater buybacks have seen greater foreign investment interest. On a net basis, the trends do not show direct correlation. One interesting point to note is that a large portion of high-dividend yield issuers are Financials companies, which are currently out of favor as evidenced by near-term capital flows. Direct feedback from investors indicates that shareholder returns are of upmost importance to foreign institutional investors given the historical issues with large cash accumulations on corporate balance sheets in Japan.

Part II: The current perspective –

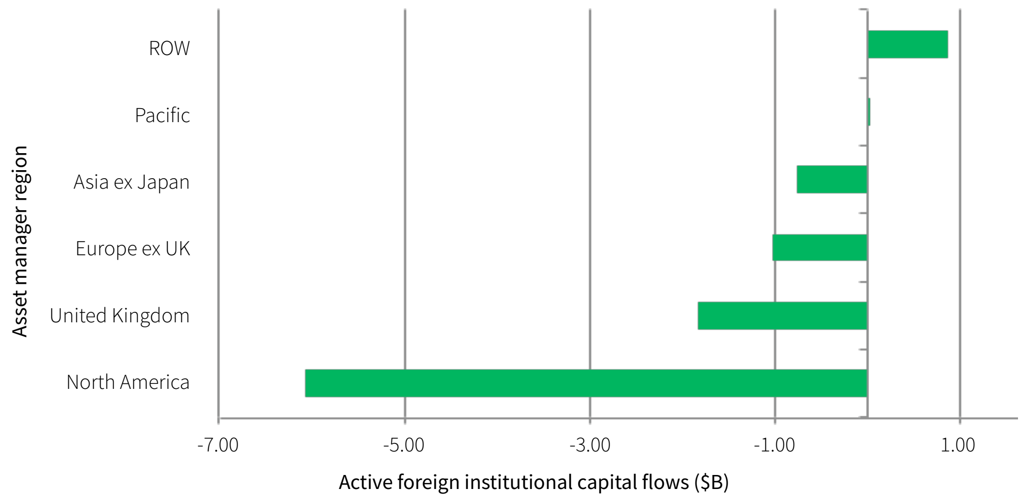
Outflows from Japanese equities

Near-term selling in 2019

On a net basis, reviewing portfolio activity through 9/30/19, foreign asset managers pulled $8.7B out of the Japanese equity market during 2019. However, despite this net outflow, there are pockets of interest from certain asset managers looking to opportunistically move into the market on weakness. This section will review 2019 trends, and the institutions driving capital both in and out of the market.

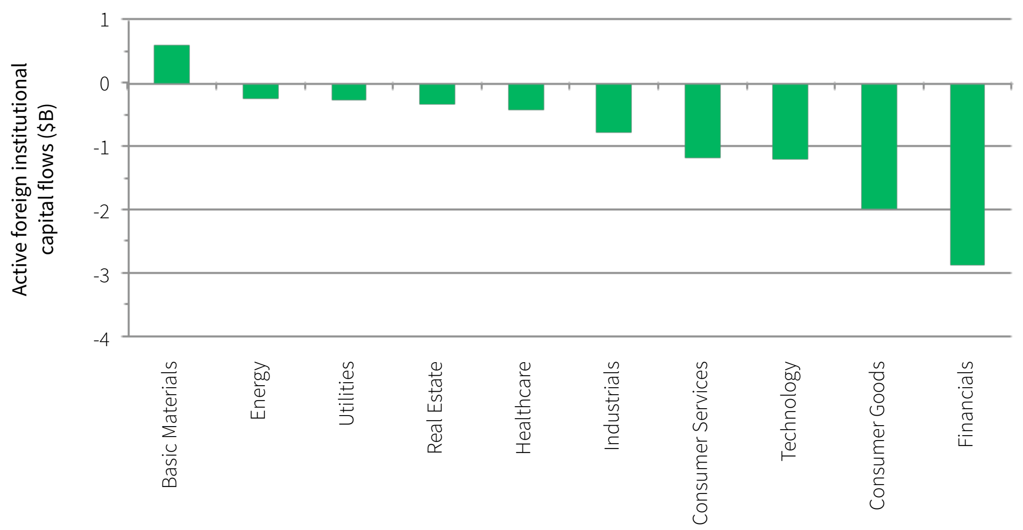


Active foreign institutional activity in Japanese equities by region: 2019 YTD



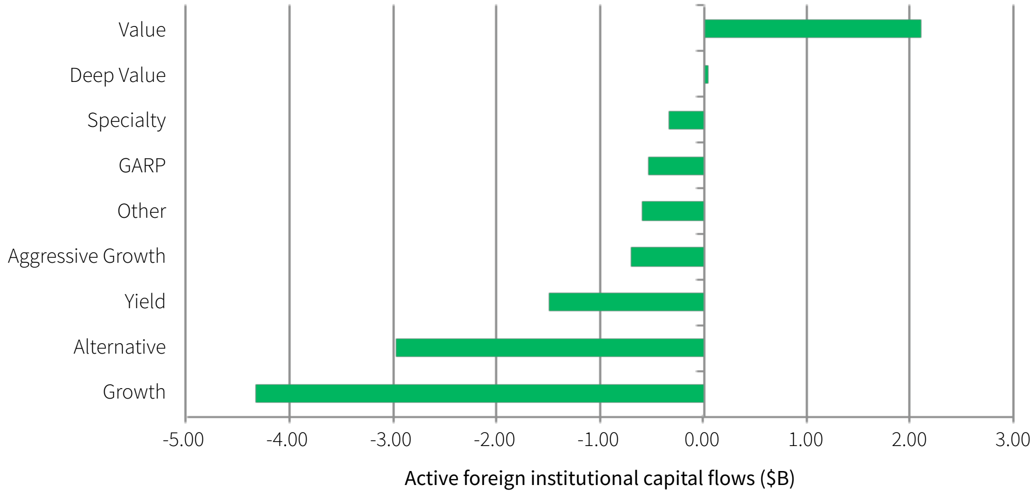
During 2019, the majority of global regions displayed net selling in Japanese equities. This activity was led by North America and followed by the United Kingdom and Europe. The ROW (Rest of World) group was the only region to show net buying, and this was led by one asset manager, Templeton Global Advisors (based in Nassau, Bahamas), which made a significant investment into Japanese equities (+$918.2M) during the year.

Active foreign institutional activity in Japanese equities by industry: 2019 YTD



In a similar pattern to regional flows, Basic Materials is the lone sector showing net buying over the three-quarter period, while the Financial, Consumer Goods, Technology, and Consumer Services sectors have seen the most selling activity.

Active foreign institutional activity in Japanese equities by investor style: 2019 YTD



Breaking down capital flows on a style basis begins to show areas for IR opportunity, as a pocket of Value-oriented investors moved over $2.1B in active capital into the market during 2019, while growth and alternative (hedge fund) investors led selling, notably followed by yield-biased investors.

Top foreign active mutual fund buyers: 12/31/18 - 9/30/19

Fund name	Institution name	Style	Value ($M)	Value change ($M)
Dodge & Cox Funds - International Stock Fund	Dodge & Cox	Deep Value	5,627.99	881.30
American Funds EuroPacific Growth Fund	Capital World Investors (U.S.)	Growth	22,252.91	830.14
American Funds Capital World Growth and Income Fund	Capital Research Global Investors (U.S.)	Yield	4,048.58	698.89
American Funds - American Balanced Fund	Capital World Investors (U.S.)	Value	933.51	505.43
American Funds Capital Income Builder Fund	Capital Research Global Investors (U.S.)	Yield	1,664.43	438.29
American Funds SMALLCAP World Fund	Capital World Investors (U.S.)	Growth	2,233.49	433.18
Bridge Builder International Equity Fund	WCM Investment Management	Growth	1,835.14	379.55
Templeton Growth Fund, Inc.	Templeton Global Advisors, LTD	Value	1,073.25	358.95
American Funds Growth Fund of America Fund	Capital World Investors (U.S.)	GARP	1,692.45	332.15
American Funds New Perspective Fund	Capital World Investors (U.S.)	Value	4,870.67	279.69

A firm-level analysis shows a clear trend indicating net buying by value-oriented institutions. Interestingly, a fund-based analysis exhibits that the stylistic interest is more nuanced. Digging into the key funds driving this specific buying activity, Dodge & Cox and the Capital Group (Capital World Investors, Capital Research Global Investors) stand out for their opportunistic rotations into the Japanese equity markets. As exhibited in the above table, the styles driving these strategies vary from deep value to yield to growth.

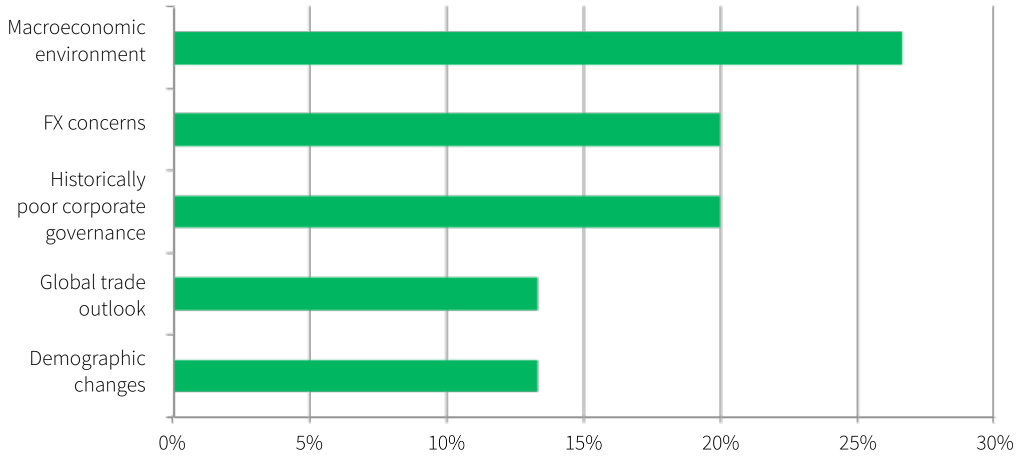
Top foreign active mutual fund sellers: 12/31/18 - 9/30/19

Fund name	Institution name	Style	Value ($M)	Value change ($M)
BlackRock Global Allocation Fund	BlackRock Advisors, LLC	Value	1,508.15	-1,051.18
Matthews Japan Fund	Matthews International Capital Management	Deep value	2,288.13	-985.10
Pictet TR - Diversified Alpha	Pictet Asset Management S.A.	Aggressive growth	37.32	-871.75
Matthews Asia Dividend Fund	Matthews International Capital Management	Yield	1,308.15	-623.99
Oakmark International Fund	Harris Associates, L.P.	Value	1,383.18	-563.25
Vanguard Health Care Fund	Wellington Management Company, LLP	Specialty	3,661.89	-546.37
UniGlobal Vorsorge	Union Investment Privatfonds GmbH	Value	496.71	-383.22
JPMorgan International Advantage Fund	J.P. Morgan Asset Management (UK), LTD	Value	622.47	-376.05
Harbor International Fund	Marathon Asset Management, LLP	Value	1,608.72	-375.80
Goldman Sachs Funds - Global CORE Equity Portfolio	Goldman Sachs Asset Management, L.P. (U.S.)	Deep value	284.13	-375.08

In a similar vein, the lead fund sellers during the period represent a diversified group of global fund managers, aggressively moving out of Japanese equities. Notably, the BlackRock Global Allocation fund was responsible for over $1B in selling activity, as well as the regionally focused Matthews Fund family, which reduced its Japan exposure by a net $1.5B.

Key concerns detracting from investor interest

Greatest risks with investing in Japan



When asked about their concerns with investing in Japan, the most common risk mentioned relates to the wider macroeconomic environment. Investors are wary of slowing global growth, changes to the value of the yen, and the continuing potential for global trade tensions. Participants are acutely aware of Japan's record of consistently low economic growth and worry that a decelerating global economy, especially in China, will exacerbate any weakness.

The importance of export industries to Japan means many respondents are anxious about the potential for movements in the value of the yen because of how this can affect the competitiveness of exports and the affordability of imports. The value of the yen is particularly important for non-Japanese investors who value their holdings in their respective domestic currencies.

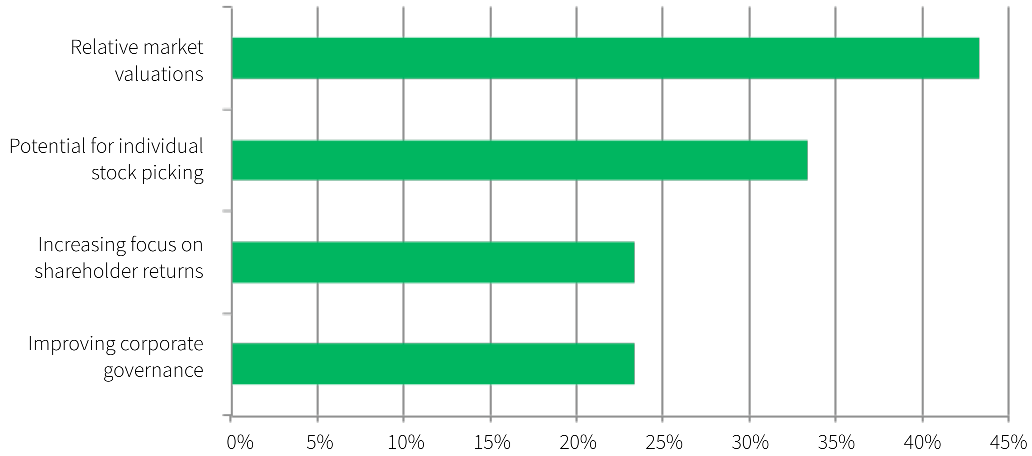
Global trade dynamics are also front of mind for many respondents. With trade tensions developing between some of the world's largest economies including the US, EU, China, South Korea, and Japan itself, the potential for a greater reversion to mercantilist policies and the negative impact this would have on international trade flows weighs on the market's view of Japanese assets.

Despite improvements being made, respondents remain cautious on Japanese corporate governance practices. Uncertainty remains in participants' minds as to whether management teams in Japan are well aligned with the long-term interests of shareholders. Experiences of previous corporate mismanagement have not yet been forgotten for many and the risk of further principle-agent problems continues to impact sentiment.

The changing demographic landscape in Japan also presents a risk to investing. The shrinking and ageing population presents a significant challenge to Japan's public finances. The combination of sluggish GDP growth, minimal inflation, and high government debt creates a situation where difficult choices, such as further tax increases or spending cuts, will have to continue to be made. While the high proportion of domestic ownership of the public debt provides some mitigation, it does not completely remove the possibility of a future Japanese debt crisis if policy decisions cease to reflect the fiscal reality.

Points of attraction for global investors

Most attractive aspect of investing in Japan



Despite investors' concerns, there remains interest in the Japanese market and many participants interviewed point to areas of attraction.

Investor feedback mirrors some of the trends seen in the correlation between the Nikkei's performance and capital inflows. Investors are most commonly attracted to Japan because of the general level of valuations in the market. Compared to international, and particularly Western peers, many Japanese companies are viewed as trading at a significant discount. Beginning in 2016, the Nikkei dropped to trade at a discount to the S&P 500 on a forward P/E basis and during 2019, this discount averaged roughly 10%.

Many interviewees reference the fact that the Japanese market is less well covered and researched relative to other developed markets and therefore, there is a greater potential for assets to become mispriced. One investor even says that some Japanese companies seemingly present an arbitrage opportunity because of the valuation differential between themselves and firms listed elsewhere. With regard to levels of research coverage, the S&P 500 on average has 24.8 analysts covering each company, while Japanese Large-caps, on average, have 13.2 analysts covering each company.

Given the historical underperformance of the Japanese equity market compared to global peers (S&P 500 has a total return of 346.5% since 2010, while Nikkei has a total return of 271% since 2010) participants believe this increases the potential for upside outperformance for individual stocks. Numerous respondents explain that they see specific businesses that have excellent fundamentals in terms of the strength of their market position or the quality of their intellectual property for example, which go underappreciated by many market participants as a result of both low coverage and historical underperformance as a developed market.

The liquidity of the Japanese stock market is also often discussed. Beyond the mega cap names that are well-known and well-traded, the depth of the market quickly decreases. For example, the 3-month average daily trading volume (ADTV) for Large-caps is $85.8M, $18.2M for mid-caps, and $1.4M for small-caps. Many interviewees see smaller cap stocks, which are less well covered and understood, as providing a greater opportunity to generate outsized returns.

While not citing Abenomics directly, investors acknowledge and appreciate the importance of shareholder returns and corporate governance. Positive developments and greater company focus on these two areas, driven by the government's reforms, has helped to shape better investor sentiment.

There is a belief that many Japanese companies have long failed to maximize the value of their balance sheets by accumulating excessive levels of cash, making acquisitions without tangible synergy benefits for shareholders, and failing to divest underperforming businesses. However, there is a belief that this is starting to change with greater emphasis being attached to delivering returns to shareholders.

Market participants view positively the progress made in reforming corporate governance practices. Corporate Japan is widely seen as improving its historic tendencies of running inefficient balance sheets, overseeing poor capital allocation, and maintaining cross-shareholdings. Respondents value the efforts being made to better align the long-term interests of management and shareholders.

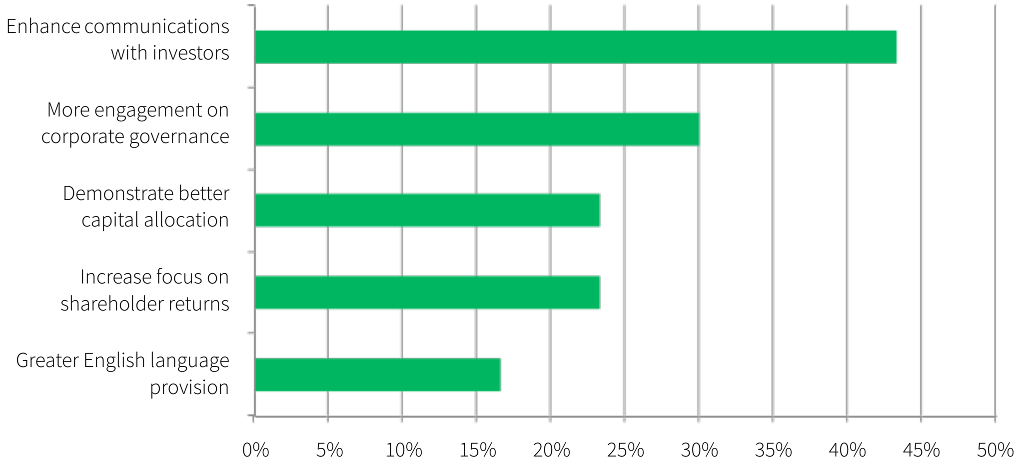
Part III: The path forward –

Regaining active global investment interest

In conclusion, below are recommendations for Japanese issuers to attract greater global investment interest. Garnered directly from participant feedback and leveraging IHS Markit's expertise and experience partnering with global issuers on their IR strategies, the suggestions cover the importance of positioning the investment story and targeting the right pools of capital.

Positioning your investment story

Ways to attract global capital



Interviewees believe that Japanese businesses could better attract global capital if they communicated and engaged with investors more. Participants highlight the importance of having quality IR functions that are active in reaching out and ultimately act upon feedback from shareholders. Recommended communication best practices include helping investors fully appreciate the value of the information disclosed and ensuring that market participants understand what differentiates each individual business.

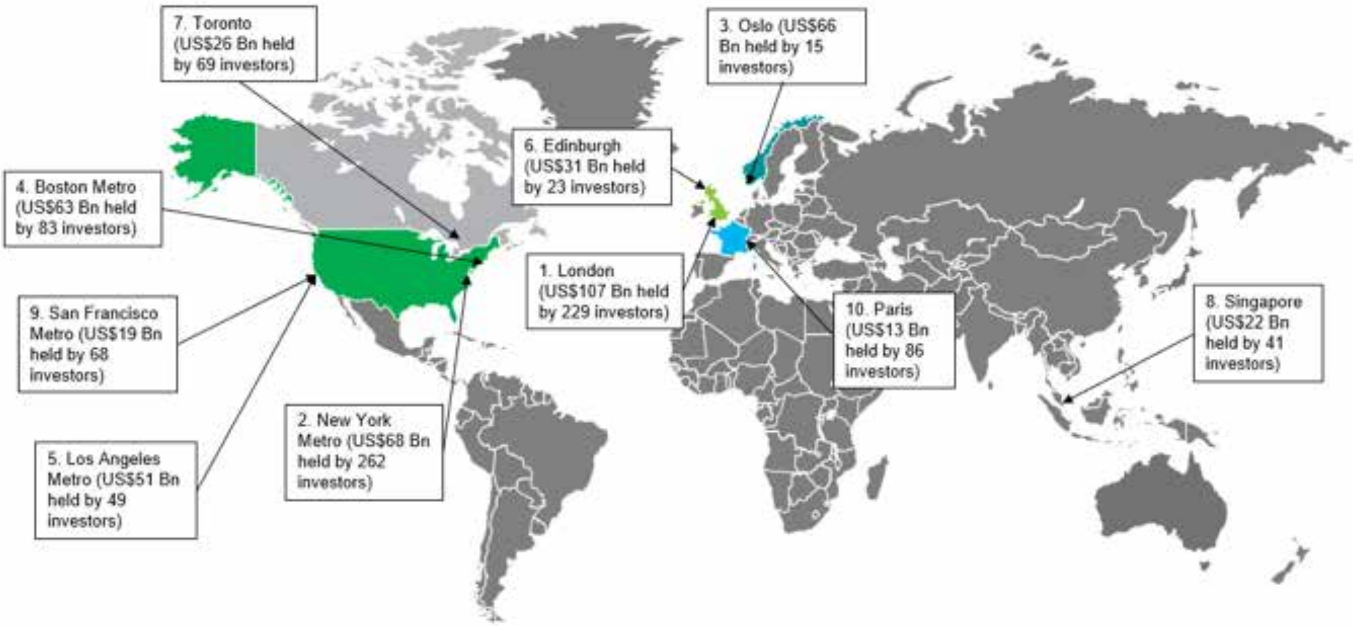
International investors are more likely to be attracted to firms that can demonstrate strong and improving corporate governance regimes. Following the principles laid out in Japan's Corporate Governance Code, with particular importance given to unwinding cross holdings and diversifying Boards, will help entice global investors by showing that management teams are running companies primarily for the benefit of shareholders.

Japanese corporations are encouraged to only allocate capital to value accretive projects, and when no such opportunities are available, any excess cash should be paid out to shareholders rather than being left to linger on the balance sheet. Compared to Western peers, management teams in Japan are generally perceived to be less conscious of their costs of capital. While interest rates in Japan have been negative for several years, this is not the case in the rest of the world. Global investors compare Japanese companies to their international peers when making investment decisions and thus will apply a positive cost of capital to all of the firms they cover.

The investment community urges companies in Japan to place a higher priority on delivering returns for shareholders. Again, Western peers are used as a comparison and the emphasis given, particularly by US firms, to rewarding shareholders is viewed as the standard that Japanese businesses need to aspire to. Corporations need to focus on maximizing, rather than only satisfising, the level of return they deliver.

Many global investors value access to information in English. Providing translated materials, like investor presentations, press releases, and financial reports, can hugely benefit the global following that a Japanese company attracts.

Targeting relevant pools of capital



When crafting an annual investor engagement program, the IHS Markit Investor Targeting team advises focusing on the following key goals: (1) Undergoing strategic data-driven identification of global investors who are compatible with your investment story (2) Ensuring efficient use of IR and leadership time (3) Taking proactive steps to drive higher meeting ROI (4) Empowering your team with unbiased data and advisory to optimize all sell-side hosted events for your company's benefit. Moreover, IR teams are well served to think about their investor engagement program as long-term, with each annual period focused on proper planning, execution and then measurement of results to best prepare for the next fiscal year.

Best-in-class IR programs harness all data available to make the most efficient decisions on time allocation for engaging potential shareholders. At its most basic sense, it is a simple equation of opportunity cost (holdings or potential holdings/hour vs. the cost of that period for IR or leadership). Notably, the key data point missing from this equation focuses on active decision making. Why, if the investor screens very well for compatibility with your investment story, are they not a shareholder already? For Japanese investor relations teams, gathering this feedback through direct and third-party perception outreach is essential in order to synthesize sentiment and drive IR actions on access, messaging, transparency, and events to better facilitate understanding and drive potential investment.

As evidenced by participant feedback, Japanese IR teams face headwinds in separating their investment story from global macroeconomic conditions and country trends, whilst also having to compensate for a relative shortfall of global research and marketing for their companies. For success, IHS Markit recommends that Japanese IR teams need to effectively differentiate their investment story as a compelling source of value creation regardless of macro and sector themes. Concurrently, from a targeting perspective, teams must understand in real-time the shifting mandates and levels of interest for global asset managers in order to plan marketing trips to key regions and also invite select global investors to company IR events. Lastly, regulatory trends such as the European MiFID II and Japan's foreign exchange law are adding extra hurdles for IR teams to overcome as the legacy rules of corporate access and investment ability are changing both locally and globally. In this environment, the importance of investor relations has never been greater and teams that are properly resourced and given a strategic seat at the leadership table will have a clear competitive advantage over their peers.

About IHS Markit

IHS Markit (NYSE: INFO) is a world leader in critical information, analytics and expertise to forge solutions for the major industries and markets that drive economies worldwide. The company delivers next-generation information, analytics and solutions to customers in business, finance and government, improving their operational efficiency and providing deep insights that lead to well-informed, confident decisions. IHS Markit has more than 50,000 business and government customers, including 80 percent of the Fortune Global 500 and the world's leading financial institutions. Headquartered in London, IHS Markit is committed to sustainable, profitable growth.

CUSTOMER CARE

NORTH AND SOUTH AMERICA
T +1 800 447 2273
+1 303 858 6187 (Outside US/Canada)

EUROPE, MIDDLE EAST AND AFRICA
T +44 1344 328 300

ASIA PACIFIC
T +604 291 3600

E CustomerCare@ihsmarkit.com

ihsmarkit.com

456928537-0220-YM