INSIGHTS

# INVESTING IN JAPAN: FOCUS ON WHAT MATTERS MOST

MARCH 2014

## LOOK THROUGH MARKET VOLATILITY

Macroeconomic concerns have dominated the conversation on Japanese equities since the start of the year. Topping the list of market concerns is the economic impact of the impending consumption tax increase. Other current obsessions of market prognosticators include Japan's current account deficit and government debt. In our view, these concerns are not new. We believe market prices have already discounted these issues.

## EXPLOIT MARKET OVERREACTIONS BY FOCUSING ON FUNDAMENTALS

Our investment strategy is not based on analysing market themes. Instead we exploit market overreactions to macro comforts or concerns with disciplined, bottom-up stock picking. When stock prices overshoot, that is an opportunity to buy more shares in companies we like from a fundamental perspective. In order to outperform the market a contrarian approach is required.

## WILL THE CONSUMPTION TAX CREATE AN ECONOMIC HEADWIND? WE THINK NOT

On 1 April 2014, Japan will increase its Value-Added Tax from 5% to 8%. This forms part of the reform policies that aim to broaden the tax base and cover the increasing social security expenses.

We believe market concerns about the consumption tax are overdone. Some investors draw a parallel to 1997. Then an increase in the consumption tax was accompanied by an economic downturn. While this year's sales tax hike may cause some short term impact on the headline numbers, the economic environment is vastly changed today. Back then, against the backdrop of the Asian Financial Crisis, the Japanese financial sector was insolvent and corporate Japan's ability to withstand shocks was low. That is not the case now.

> Corporate Japan looks different today from any point in the last decade.

We believe corporate Japan is in a position of strength as the result of meaningful restructuring and deleveraging efforts. This time, with a tightening labour market and both the financial and corporate sectors possessing strong balance sheets, the economic impact of the tax increase should be limited.

Furthermore the government has put in place measures to mitigate its economic impact. In December 2013 the government formalised a 5.5 trillion yen economic stimulus package to help offset the shorter term effects that the consumption tax rate increase may have on the economy. Additionally, the government will lower the effective corporate tax rate by 2.4% in April 2014 from 38.0% to 35.6%, with potential for further reductions later. This tax cut is anticipated to assist with improving corporate profitability, which may translate to higher employee wages amid a tightening labour market.

For equity investors, the consumption tax increase should come as no surprise. It is well known by the market and its impact, if any, is priced in.

## WHAT IF THE CURRENT ACCOUNT DEFICIT PERSISTS?

Another area of investor concern is Japan's current account balance, which is a measure of a country's foreign trade. Japan, long a net exporter, saw its monthly current account move into deficit during 2013. This change may have been driven by Yen depreciation and the nuclear power shutdown as fuel import costs grew quickly. Increased consumption ahead of the 2014 sales tax increase may have had an impact.

Moves in the current account balance do not affect the way we assess undervalued companies. Although a weaker Yen makes Japanese exports more competitive in international markets, export volumes have remained basically stable, possibly because export contracts with longer durations take time to adjust to relative price changes. In the medium to long term, contract renewals at more attractive prices might encourage higher export volumes. This suggests that the full benefits of a weaker Yen for Japanese exporters may not have come through yet.

## GOVERNMENT DEBT IS MOSTLY DOMESTIC IN NATURE

95% of government debt is domestically owned.

Many investors are attuned to the high level of government debt in Japan. This story is very well known and it is more than priced into the market. Importantly, the bulk of Japanese central government debt is held by domestic institutions. Around 95% of government debt is domestically owned. Being "indebted to itself" makes a default by Japan much less likely compared to countries whose debts are held by foreign investors.

Nonetheless the Japanese government realises it has a window of opportunity to address its fiscal position. The current government has shown a willingness to do so through fiscal policy measures like the upcoming consumption tax increase. Budgetary and fiscal policy changes, combined with the monetary action already underway, could spur progress toward fiscal sustainability. As a significant net creditor, unlike many European countries, Japan has leeway to adjust to a sustainable path. In fact, Japan has significant levels of private savings and is the world's largest net creditor.

## FOCUS ON WHAT MATTERS MOST

We believe that starting valuations are critical when investing in equities. We analyse company valuations independent of the macroeconomic themes that the broader market perceives to be important at a point in time.

"Flavour of the month" comforts and concerns, such as those highlighted in this article, can drive prices to extremes of both greed and fear. We find the greatest opportunities where such extreme valuation anomalies exist. For example, when market sentiment negatively affects the share price for any company we identify as an investment candidate, we may see this as an opportunity to buy more of the stock at a discount.

In this way, we have in place an investment process than can "look through" such short term volatility to take advantage of mispriced opportunities. As patient investors, we believe the market will eventually come to appreciate the companies we have identified as undervalued today.

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