

Uncovering Japan's hidden gems

- Japanese companies are used to dealing with a tough backdrop and their natural caution served them well in 2020
- The Japanese market thrived amid widespread volatility last year, rising 16%¹
- Japanese companies reflect many of the most important growth themes in the post-Covid environment

In the rush to capitalize on China's rapid growth, investors have often neglected Asia's other dominant economy – Japan. Japanese companies are not only beneficiaries of Chinese growth but are plugged in to other key growth themes in the global economy – digitization, robotics, electric cars, a rising middle class – yet they remain only lightly explored by investors.

Japanese companies are used to dealing with a tough backdrop. While Japan's economic backdrop has improved in recent years through the 'Abenomics' program led by then-Prime Minister Shinzo Abe, Japanese businesses have had to fight through a deflationary environment for years. They tend to be cautiously run with strong balance sheets and prudent management as a result. This made them resilient in 2020 and meant that the Japanese market thrived amid widespread volatility, rising 16% over the year.

The depth of the markets has also been a real advantage in this climate. Active managers could pick from pharmaceutical or manufacturing giants, right down to small cap components makers, or specialist chemical groups. There have also been many ways to invest in significant global themes through the Japanese market: health and technology innovation, for example. Japanese companies have played their role in the fightback against Covid-19. An R&D-focused drug maker that specializes in niche but difficult-to-treat conditions has been involved in Covid drug trials.

Japanese companies have become a benchmark for quality, proving adept at using technology to improve quality at lower cost. This has made them the manufacturer of choice across the world, but particularly in China. One of the top coatings groups in China is currently benefiting from the widespread home improvement trend, but also looks set to benefit from infrastructure development across the region.

Environmental sustainability is also well-represented among Japanese companies. One company, a leading maker of energy-saving chips, can cut carbon dioxide emissions of household electronics by as much as 30%. Another company makes components for electric cars, while another makes energy-saving headlamps for cars, which lower energy usage by 40% compared to conventional headlights.

Finding value

We find Japanese markets packed with opportunities for active investors, yet this opportunity is often poorly understood. Half of the market has no sell-side coverage, which means information isn't widely available. Foreign investors have been net sellers of Japanese markets since 2015. The value in Japanese markets is often overlooked by global investors.

How do we find that value? To our mind, it is important to be local. Japanese corporate culture has its idiosyncrasies and being able to talk to companies in Japanese, while understanding the etiquette and dynamics is vitally important in making a judgement on a business. That said, many Japanese companies are global in their outlook, part of global supply chains and competing with international peers. As such, a local presence with a global platform drives the best results.

¹ Nikkei 225 Index, January 1, 2020 – December 31, 2020

Equally, it is important to engage with companies to improve governance and release value. Governance has long been a sticking point for Japanese companies. Japanese companies have historically been prone to excessive caution. They have sat on huge cash balances, resisted value-adding merger and acquisition activity, and lack dynamism. There have been moves in recent years to improve governance and there are signs that companies are achieving a better balance. We actively engage with companies to try and improve their governance record.

Among our recent engagements was one where the management team had started to neglect customer engagement. We pushed the business to restructure and to focus more on profitability. This has been reflected in an improving share price. These engagements are vitally important in helping ensure that the value in a company is realized in the share price.

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The future

We believe Japan should prove a good place to invest for the coming economic recovery. Sectors such as technology, autos and those linked to China growth are already seeing improving demand. Japanese corporates are busy, exports have rebounded and we see growing earnings across a range of cyclical sectors. At the same time, the new Prime Minister, Yoshihide Suga, has promised a continuation of Japan's economic reforms and is driving areas such as digitization.

Japan is an exciting market for active investors. Investors can take exposure to many important global themes at a fraction of the price they would pay in the US market. It is time for investors to cast aside some of their historic views on the Japanese market and discover the value to be found there.

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