The Many Facets of Japanese Investing

Disruptive Forces in Investing **May 16, 2023**

Anu Rajakumar: Japan is an intriguing nation and economy. As the third largest in the world, Japan is rife with opportunity, though is an outlier in the way it operates. With a new governor of the Bank of Japan just stepping into his role, we continue to see a dovish stance in the nation's accommodative monetary policy. But in this volatile world we've lived in since the start of the decade, what lies ahead for Japan and its impact on the global economy, and how can investors uncover opportunities amid this unique backdrop? My name is Anu Rajakumar and joining me from Tokyo is portfolio manager for Japan Equity, Kei Okamura to reveal some of the many aspects of the Japanese economy and what makes it different from other areas of the investment spectrum across the globe. Kei, thank you for joining me today.

Kei Okamura: Thanks, Anu. It's a pleasure to be here.

Anu: So, Kei, just to get us started, tell us a little bit about the current investment landscape in Japan against the backdrop that we have around the world, really of market volatility.

Kei: Sure. so let me start with the backdrop. So, in the 1990s to 2000s, Japan experienced stagnant growth, disinflation shrinking demographic. And from there, in the 2010s, the late Prime Minister Shinzo Abe launched Abenomics growth strategy in the three arrows of fiscal stimulus, accommodative monetary policy and short-term reforms.

Now, this third arrow was comprised of corporate governance reforms to improve quality of corporate boardrooms, to make them stronger and to focus on company's sustainable growth of corporate value. And just when we were starting to see all of these efforts sort of come to fruition in 2020, the pandemic hit. And, as you know, Japanese equities like many other markets and many other asset classes were hit quite hard, especially in March of that year. But Japan's economic recovery from that point was somewhat slower than other regions. There's a couple reasons for that. Japan had one of the most strict border controls and supply chain disruptions kept on affecting the manufacturers in this country. And as you know, Japan is a net importer of many commodities. So there was an added element that we saw in this market where rising input costs were affecting margins. And this was a result of the conflict that we had in Ukraine and Russia.

So, if you look back this past year or so, Japanese equities have been recovering, but actually, if you look at it compared to other markets, it's actually done quite all right. And in particular, small to midcap market have actually outperformed its large cap peers and also small caps in other regions like the US and Europe. Now, why is that? First, consumer spending in this market has remained relatively okay, thanks to the government's support measures, and second is inflation. We've seen consumer prices pick up here as well, but unlike the US where wages have been a principal driver. In Japan, wage growth hasn't picked up nearly as much. So that has kept CPI relatively in check. So the Bank of Japan hasn't moved nearly as aggressive as a US Federal Reserve or the ECB, and it's maintained most of its ultra-loose monetary policies. That's why we think the more domestic economy sensitive, smid cap stocks have done okay. And with that backdrop, our strategy continues to look for attractively valued high quality companies with good long-term growth potential; that are run by progressive management who are willing to be engaged by shareholders like us, and really looking to grow the company over the long term to unlock value. And these are the companies that we call, “hidden gems”. And not many people know this, but roughly one fifth of this market has zero sell side analysts covering companies. So there's actually quite a few of these gems in this market waiting to be discovered by investors like us.

Anu: Perfect. Well, thank you very much, Kei. I really appreciate that background. It sounds like you mentioned your progressive management, a lot of hidden gems that you and your team are looking for. It sounds like Japan really is becoming a nation of shareholders. Tell us what goes into your investment process that really allows these companies to become hidden gems.

Kei: Sure. So we’re long-term, bottom-up investors. Our average holding period is somewhere around five to seven years and for companies that we really like, we'll hold them for more than a decade. And first and foremost, I think our focus is on business fundamentals, so the types of companies that we hold are those with attractive growth prospects that have very strong moats. And this can be, say, scale, brand, technology. That's all leading to pricing power that can maintain good profitability. And from there, we'll look at balance sheet strength and cash flow generation because at the end of the day, we want to be invested in companies that can reinvest through good times and perhaps not so good times, like the ones that we've s-seen in the past several years. Another unique aspect of our strategy is that we focus on corporate governance and sustainability. So the types of companies that we're invested in are run by progressive management that I mentioned earlier that are looking to grow the business for long-term profits as opposed to short term gains and really trying to help protect minority shareholder rights for instance. And so we take a very close look at who's sitting on the board, and we look at their track record. And we also take a look at how companies has been, addressing material environment and social issues because many of these factors can have a substantial impact on corporate value, especially over the long-term horizon that we're invested in these companies.

And then there's of course valuations, which is crucial. We rigorously monitor, valuations because we want to make sure that we're buying these, good companies at attractive multiples, and, you know, taking profits, when we feel that the stock has run ahead of its fundamentals. And once we've analyzed the company on all these points that I've just mentioned, we'll put to work our scoring model and score the companies on fundamentals, governance, sustainability, valuations, and the higher the score, the higher the weight it'll be in our portfolio. And the key point here is that we, the investment team, does this work, as opposed to like a separate research team or another sort of group, because we do think that at the end of the day, all these factors really will help, make or break the company over the mid to long term. And last but not least, another key aspect of our work is engagement. For all of our core holdings, we'll engage senior management on all the topics that I mentioned earlier.

And what we mean by that is we'll come prepared within each of these meetings with a 60 to 70-page presentation deck where we'll do a line by line of all the key issues that are afflicting valuation. So this could be on topics like capital management, corporate governance, sustainability issues. And we'll walk through management why we think as investors, these are issues that need to be addressed, how they should tackle these topics, and how they should disclose on them. And we do this because many of these companies that were invested in this smid-cap range or not the likes of say Toyota or Sony or Nintendo. These are very small companies with limited resources that need our support. So we also often get asked, you know, "With all this engagement that you do and some of them, you know, include sustainability topics, are you ESG investors?" And our answer is, not really because we consider sustainability topics as part of our investment process. But, for example, we don't invest in poor quality companies to become say ESG darlings.

We engage on these topics on sustainability, but also capital management, corporate governance, because we think that all of them will be creative to shareholder value over the mid to long term, and that's why we call these companies basically hidden gems. once we're invested in these companies, they're sort of like uncut stones at first, but we'll utilize all of our analysis and engagement tools to polish these stones and to make them glittering gems, over the mid- to long term.

Anu: Terrific. Thank you very much. Now, you mentioned your comments. One element that you focus on is corporate governance, and I have learned in recent news that the Tokyo Stock Exchange is pushing over 3,000 companies to improve their capital management restructures. So, would love it if you could give a little bit of an overview about this initiative from the Tokyo Stock Exchange, the TSE, and secondly, what does that mean for investors and shareholders?

Kei: Sure. No, it's actually been really, really interesting and, it's really made this market quite exciting, especially over the next several months. Before I answer your question on that point specifically, I'll just give you a bit of a background. So the interesting part about Japan's corporate governance reforms is that, unlike the rest of the world, reforms here have been led by the government and basically regulators. And the rest of the world has been probably more hybrid approach or led by the private sector. Now, the reason why the reforms in Japan with regards to corporate governance has been led by the government really came about from the Abenomics and the late Prime Minister who launched the double codes of corporate governance in stewardship for companies' investors. So that essentially, corporate boardrooms will be more effective and that there will be higher board of independence and more diversity in the boardroom in terms of gender and skillsets that you'll have more dynamic discussions about long-term growth and strategy.

And what you're referring to with respect to Tokyo Stock Exchange's latest initiative is sort of like the next step in that evolution of Japan's reforms and its targeting specifically the issue of capital management. So, what's interesting about Japanese companies, and particularly smid-cap firms, is that over the past decade or so, their return on invested capital, so ROIC, has been improving on the back of higher profitability. And its ROIC is actually now higher than some of their developed market peers, like say the US even. But when you actually look at it from a return on equity, so ROE, perspective, Japanese companies still lag. And this has to do with the excess cash that companies have amassed over the last decades. So you see, when the bubble burst in the early 1990s, banks stopped lending to companies and many of these firms had to fend for themselves. So they decided to be basically become banks on their own right and relied less on external funding. So much so that some of these companies have cash that exceeds their own market cap. And we actually have a company like that in our portfolio today. And that bodes well for balance sheet strength, but the flip side is that it weighs heavily on return on equity and pushes down valuations. And that's why roughly half of the 1,800 companies listed on Tokyo Stock Exchange coveted, prime-market section are trading below one times price to book, which is a financial market anomaly that is quite unique to this market. So the TSE took note of this, and in its most recent efforts to revitalize the market and decided to do something about this. And in March, the board sent a guideline to over 3,000 companies listed on the Tokyo Stock Exchange prime and the next tier standard markets to address this low capital efficiency issue and to get companies to make public, what plans they have to raise ROE and ROIC sustainably over the cost of capital. And responses from Japanese companies has been surprising in a positive way. Many of these companies have announced sizable share buybacks. Some of them have announced higher dividends. Some have begun to unwind cross-shareholdings that they hold with suppliers and group companies. And all of these we think will be quite positive to reduce the asset size, and that in turn would help to raise ROE. And in terms of say, share buybacks, we actually saw the highest level of share repurchases in 16 years in the year leading up to March.

But we think this is just the tip of the iceberg, and what's really going to be exciting, and interesting, is what's to follow because the more, progressive management-run companies won't just stop at unleashing the excess capital on its balance sheet, the companies we're engaging in are, proactive looking at more fundamental ways to revamp its capital management strategy, while also making sure that they'll continue to reinvest in their business for mid to long term growth. And at the end of the day, you know, a share buyback will help to raise share price, but that's only going to be for the near term. If the company wants to see a fundamental rerating of their valuations over the mid to long term, it needs to demonstrate their investors like us, a realistic and achievable mid- to long-term growth strategy while also making sure that capital efficiency is well controlled.

And that's why we think that the TSE's latest initiative will also make this a very interesting market, for active investing, but also make engagements with companies, more exciting. And I think we're going to see a lot of great results going forward.

Anu: Sure. It sounds like the initiative is well aligned with the efforts that your team has already been making. And so moving on then to engagement, which you just mentioned, we're in the depths of proxy season at the moment, and so I'd love to get your take on how Japanese companies manage the engagement process, similarly or perhaps differently than say, companies in North America or in EMEA. What are some of your thoughts there?

Kei: Sure. So, proxy voting is a crucial part of our engagement process, and we think it's actually one of the more effective tools that we have to get our views across the companies. If we look back 10 years ago, I would say [that] proxy voting was somewhat of like a tick-the-box exercise and AGMs, were sort of like, I wouldn't say a non-event, but it certainly wasn't what it is today. You know, a lot of the corporate directors will all come to the meeting, bow, give an update, get reelected, and then it's like Sayonara, [laughs] and see you next year. Some meetings would be done in 15, 20 minutes. Today, the story is much different. You alluded to earlier about shareholder rights, this is crucial today in Japan, we're seeing more investors both more active and passive, attending these AGMs sitting next to us. They're closely scrutinizing the directors, their independence profile, their qualifications, the overall board composition, the business performance. And Japanese companies are improving their corporate governance, but it still has a long way to go, to be on par with, say, US and European companies. So, let me give you an interesting statistic. US corporate boardrooms are required to be majority independent, but in Japan, only 12% of the coveted TSE prime market has majority board independence. So that means over 80% of the companies don't. And that has to do with Japan's unique company law. And this is why the Abenomics reform is focused on raising board independence to begin with to get more independent oversight of management. So it wasn't only until a few years ago that the guideline was amended to increase board independence from two independent directors to one-third representation on the board.

But there's still quite a few companies that can't meet this because they keep on appointing affiliated, external directors with say, you know, business relationships with the companies which calls into question, the independence, of each of these members. So that's why we're continuing to see higher opposition rates at these AGMs. And this has been one of the key reasons why some of these companies have been taking action on capital management and board effectiveness to sort of appease very frustrated shareholders. And now, the focus is shifting increasingly to board diversity. And this encompasses, of course, gender. You know, this is very important. But also diversity skillset as well, because the majority of companies in Japan are actually, they're not majority independent. They're actually majority internal represented boards. So what you get is an overrepresentation of operational skills of people that have spent their entire lives at the firm, but they don't have much management know-how. So we need more corporate boardrooms with say ex-CEOs, ex-CFOs of leading companies that can really help to drive some of the deep discussions that we hope corporate boards will have about managing their capital efficiency, but also their long-term growth.

Anu: That's terrific. No, I'm so curious, Kei, to hear a little bit about maybe an example of one of your engagements. Because I'm sure you have many different examples to share. And just similarly, what the reception has been like from these companies and their own managements when you go in to try and have these conversations, is it a conversation that is welcomed? Do you receive pushback? You know, obviously, you're a long-term shareholder, you said, you know, five to seven plus years. What is that reception like? And again, if you can give an example or two, I'm sure our listeners would really appreciate that.

Kei: Sure. we do sometimes receive pushback, but actually, I think we have that, quite well controlled because in our, initial due diligence process we always meet senior management ahead of our initiation of the company. So in that process, we always go through several key questions to try to understand whether management is willing to be engaged by shareholders like us. And that helps us to sort of avoid the so-called value traps if you will. And then, when we show up to these engagement meetings, a lot of companies are caught by surprise, and they understand that we're really there to help them. And that helps to win trust and builds a very strong relationship with these companies.

In terms of a case study, we actually have a company called Okinawa Cellular. And the issue with Okinawa Cellular is that this is a mobile telecommunications company. This company owns 50% of the market share of the Okinawa Islands which is located in the south of Japan. And, as you can imagine, a cellular company generates a lot of cash. It has to do with the fact that once it distributes the handsets, the monthly cellphone charges, which continues to keep going up, but is very, very cash flow generative. Unfortunately, the company hasn't been so good at managing its inflow of cash and how that sits on the balance sheet. And in this company's case, it's a listed subsidiary of Japan's second biggest telecommunications conglomerate called KDDI. And what it does is once it has all this cash on its balance sheet, it loans it out to its parents with an added interest rate. So we've been engaged in the company for many, many years, asking the company to be more transparent in its capital management to address this loans that it makes the parent, which quite frankly should be utilized to reinvest in its business or be paid out to shareholders. Because if you take a look at this company's, fundamentals, it's got great profitability, but its return on equities that had actually been declining because of this buildup of cash on its balance sheet. So, we had been seeing some progress on this front and announced this first ever share buyback in 2020. That was great. We still never got that sort of midterm plan in the strategy. And so, we escalated. And what we mean by that is, we wanted to give the company a bit of a nudge in the right direction.

So to do that, we utilized NB Votes. So what we did was we voted against the CEO, and this is all on the Neuberger Berman website, so please have a look if you're interested. We voted against the CEO for the lack of transparency of on its capital management plan. We also engaged the parent company, KDDI, and we also even worked with the global equity team on this front as well, which was great. Because it tells the firm that we're interested on this topic as a firm. And thankfully, the company finally listened. And in October last year, it announced its first ever midterm plan, and this consisted of a target to raise EPS by a certain amount in order to achieve that goal. It'll grow its business organically, but also committed to buying back shares from the market, and also set a target on that as well over the next three years. All this has had a big impact on the company's share price. But in addition to that, the company most recently decided to draw down on its loans made to its parent, and to fund a share repurchase from that as well. And that has been really, really great progress on the company in terms of alleviating that weight on its balance sheet and to improve its return on equity and consequently its valuations.

And we feel that the company has been more attentive to our response. The president has been meeting with us more regularly and I think overall we've had a very good response; and in return provided the company how to address not just capital management, but to also strengthen corporate governance and also address some of the sustainability topics that the company needs to address of the mid to long term. So I think this is a really good engagement case study for us.

Anu: Yeah, I think that engagement study really kind of nails it on the head that the value that we as active investors can bring to the table. As you said, you made some remarks earlier where you said, we are here to help *them* and what you're looking for is, you know, financially material issues that are core to their business. So I think that's a great example. And for our listeners, you know, NB Votes is a terrific program that we've been doing for several years here where we publicly pre-disclose voting intentions for a number of companies around the world. Now, Kei, we would be remiss not to discuss the recent shift in the Bank of Japan's policy. A few months ago we had my Multi-Asset colleague, Fumi Kato, on to discuss this topic. Now, the stance has changed a few times since Fumi was on the show, and there's also been a change of guard with Ueda, the new governor of the Bank of Japan. Would love for you to comment a little bit and share if you think there are any key impacts of the policy shift for Japanese assets, both in the short term and the long term.

Kei: Yeah, absolutely. So Mr. Ueda took on the role just very recently as BOJ governor. And so, he will be now the chief of Japan Central Bank. And there's actually quite a few unique parts to this.

First of all, Mr. Ueda is the first, academic background, Central Bank governor in the history of the Bank of Japan. Historically, the Bank of Japan's governor has been an ex-bureaucrat of the Ministry of Finance or an administrative official of the Bank of Japan itself. And why is this important? Because Mr. Ueda is not only just an academic, he was actually educated by Stan Fischer of MIT, who, as you may know, was also the professor for Ben Bernanke, Mario Draghi, and several other central bank governors who have done a phenomenal job at trying to bring stability to financial markets, control inflation, et cetera. And so from that standpoint, this is actually quite a marked departure from the Bank of Japan's history.

In the most recent monetary policy meeting, and this was Mr. Ueda’s first, one of the things that he said was he's going to spend at least a year to examine closely how the BOJ has taken action on its monetary policy and its efficacy. And also, he made it a point that, at least for his time being, he will continue to maintain accommodative monetary policy, which we think is actually quite crucial in a market like Japan.

And one of the key figures that the bank released, was its outlook for future inflation, which continues to remain below the 2% target that this BOJ considers as necessary to consider that inflation is now sort of on an upward trajectory, sustainably. And this actually is closely aligned with our long-held view that, the disinflationary pressure in Japan is quite entrenched. And so, this is not a wage-driven inflation that we're seeing in Japan right now. It's fairly driven by the commodity prices and rising input costs, as a result of geopolitical interest. So it's going to take some time to get to that point.

So what that would entail is, the Bank of Japan will likely maintain its accommodative policy. Obviously make adjustments so, you know, one of the first things that the bank will consider adjusting is a yield curve control. And I believe, you know, Kato San, alluded to this in his discussions; after which it'll be a reexamining at the negative interest rate then it'll be the zero-interest rate. Then it'll be putting the foot to the pedal on interest rates. So we have a long ways to go for the Bank of Japan to tighten, in your near as close to tightening that we've been seeing in the Fed and the ECB.

Anu: Great. Yeah, it's a fascinating divergence that we're seeing between these Central Banks. Thank you for sharing your views there. Now, Kei as we begin to wrap up I would just like to ask you to share, maybe two or three things that you think our listeners should absolutely walk away with when it comes to investing in Japan.

Kei: Sure. You know, a lot of people sort of forget the fact that Japan is the world's third biggest economy. It's also the world's second most liquid market, in terms of equities, with the over 3,500 companies listed in this market. And what that means is that there is really a plethora of investment opportunities in Japan, and a lot of hidden gems. The beauty of these companies is that they're actually riding on the same sort of amazing growth themes or disruptive technologies that are valued at astronomical multiples in the US and Europe. But in Japan, they're at rock bottom valuations simply because they're not discovered, and they've been overlooked. And this is where we think we see a lot of opportunities. And a lot of these companies are now really willing to listen to shareholders like us, because they don't have the know-how themselves internally to address many of these issues like capital management, corporate governance, sustainability. So they look to investors like us to help them, and in turn, we could help navigate these companies in the direction that we think will be accretive to long-term corporate value. I've been having discussions with many, many people investing in Japan, and they all say, you know, we've been hearing about the reforms in Japan, but we've just never seen them come to fruition. And actually now, Japan is finally looking to take off I think. The reforms that we're seeing is finally translating to capital management, and this has always been the missing piece of the puzzle. And this is finally starting to come through. And we think that this is actually going to potentially make for a very interesting next couple of years where all the reforms that we've been long talking about is going to start to move the needle for the market. So, please stay tuned for this.

Anu: That's excellent, Kei. Thank you very much. And that absolutely aligns with Neuberger Berman Asset Allocation Committee's view on Japan as being constructive as well. So thank you for sharing all those thoughts.

Kei, before I can let you go, I have to ask you one bonus question which I know our listeners look forward to every time. Now, you began your career as a reporter for Reuters and Bloomberg, so I'd love to hear a little bit about how you got your start in reporting and what are some great lessons that you learned while being a reporter that you think have served you well as you've transitioned to being a portfolio manager?

Kei: Okay, [laughs] all right, yes. In my previous life, I was a correspondent for the two news agencies that you mentioned. When I was a student, I was fascinated in journalism and wanted to become a journalist. So I started my career, actually in New York, making documentaries. And then I moved over to financial journalism. And that had to do with the fact that I spent all my life abroad as a child. And, you know, one day, my mother approached me and said, "What have you done for Japan, lately?" And I was like, I was living in New York at the time, and I was like, "Not a whole lot." So I decided maybe it's time for me to go back Japan and do something for Japan.

And I thought, you know, well, I won't become a journalist, so why don't I become a financial journalist and maybe I could help companies invest in some of the great companies in Japan. And that is what drove me to coming back Japan and joining these news agencies and becoming a reporter. From there, I was very lucky to get to know someone in the buy side who he himself was actually a journalist, many years ago. And one day he asked if I wanted to join his team as an investment analyst. And now that I could possibly stand on the side of being an investor, yeah, it's a no-brainer. I'll take the opportunity.

And from there, I've been an analyst, a portfolio manager. I also had a stint at engagement and ESG integration. And that also is connected to my thesis, which is that, you know, I want to be helping companies be sustainable and be investible for the mid to long term. And to your question about, "what are some key takeaways?", one is about being a truth seeker. I think if you want to be a good long-term investor, as you know, you really need to know what you're investing in. And some of these will involve a lot of hard work, going through years of public filings, looking at the track record of the directors who are running the company. It's almost like being an investigative journalist. So that part, I think, I actually am doing quite all right in, and that helps in my efforts to sort of lead the integration of ESG and engagement and addressing capital management and, of course, corporate governance issues for many of the companies that we hold.

Anu: Well, wonderful. Thank you so much for sharing. I think I can speak on behalf of Mothers everywhere to say that I'm sure she's very proud of what you've done. You and your team have been terrific stewards for Japanese equities for a long time, and we appreciate the work that you do. And moreover, just been lovely to hear from you today. As you said, this is a really exciting time for Japanese equities, and a lot of hidden gems that investors should certainly be paying attention to. Kei, appreciate your perspective and we look forward to having you on the show again soon. Thank you for being here.

Kei: Thank you very much Anu. It's been a lot of fun and it's been a true pleasure.

Anu: And to our listeners, if you've enjoyed what you've heard today on Disruptive Forces, you can subscribe to the show via Apple Podcasts, Google Podcast, or Spotify, or you can visit our website, www.nb.com/disruptiveforces, where you'll find previous episodes as well as more information about our firm and offerings.