Abenomics: A roadmap to corporate reform

How Abenomics reforms could bring about significant corporate sector improvements that rekindle sustained interest in Japanese equities

2013 was a great year for Japanese equities. Investors returned to the world’s third-largest economy on a wave of euphoria surrounding Prime Minister Shinzo Abe’s bold ambition to drag Japan out of a deflationary stagnation that dates back to 1990. The first two arrows of Abenomics - aggressive monetary stimulus and flexible fiscal support - were highly successful in building initial enthusiasm around Japan’s economic outlook, triggering a sharp rally in the Japanese stock market.

However, enthusiasm has given way to scepticism in 2014, and investor unease was exacerbated by a worse-than-expected fall in quarterly GDP after the increase in consumption tax in April 2014. Japan’s stock market has been a relative laggard year-to-date amid mounting concerns over whether Abe can deliver on his all-important third arrow of structural reform.

Recent developments suggest investors may be being too pessimistic. The government has put Japanese companies at the front and centre of its structural reform efforts. The revised Japan Revitalisation Strategy (June 2014) and the Ito Review (August 2014) emphasise the importance of corporate sector reforms – in particular, greater capital efficiency alongside improvements in stewardship and corporate governance. Progress on these reforms could rekindle interest in Japanese equities among global investors. For instance, if returns on equity (ROE) were to move up to the levels seen in the US, Japan’s equity market has the scope to potentially double in value.

From a vicious to a virtuous circle

Aging population, Budget deficit | Uncertainty, gloomy sentiment | Abenomics | Raised growth & inflation expectations, improved sentiment
---|---|---|---
Wage compression | Low growth | Wage increases, higher bonuses driven by performance | Growth strategy
Yen appreciation | Deflation | Yen depreciation | Inflation
Growing budget deficit

Source: Fidelity Worldwide Investment

In essence, Abenomics is fundamentally an attempt to change expectations – the way consumers, investors, and company managements think about the future path of the economy. The aim is to move Japan away from a general psyche of deflation and diminishing wealth towards an expectation for rising prices and sustained growth. The charts above show the vicious circle (on the left) that Japan has been in and the virtuous circle that “Abenomics” is attempting to establish (on the right).

Capital efficiency and the Ito Review

A strange paradox afflicts Japan. It is home to some of the most innovative companies in the world, yet corporate profitability has been persistently low, which is reflected in low ROEs. The Ito Review calls on companies to target ROEs

---

1 World Economic Forum’s Global Competitiveness Report 2013 ranks Japan third globally in “innovation and sophistication factors”.

---
above their cost of equity. Higher ROEs above the cost of equity would support higher wages, increased capital and R&D investments, growth in pension assets, higher tax revenues and more inbound investment.

Higher ROEs should mean there are greater resources available for growth. However, in case the sustainable growth rate is lower than ROE, as is often the case, the difference (excess cash) should ideally be returned to shareholders rather than hoarded on balance sheets. Indeed, we can expect many companies to boost dividends and buybacks as a way of mechanically increasing ROEs.

Japanese payout ratios have typically lagged European payout ratios

Source: DataStream, 01.01.1973-01.08.2014

The Japan Stewardship and Corporate Governance codes

Japan’s Stewardship Code (published in February 2014) and the Corporate Governance code (to be implemented prior to the 2015 AGM season) can be 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. Using a principles-based approach, referred to as ‘comply or explain’ the code urges participants to review their activities against the aim and spirit of the code. The concept is new in Japan where regulation has tended to be rules rather than principles-based.

Encouragingly, the number of signatories has been much greater than anticipated (160 institutional investors as at 8th September), greatly exceeding the 70 institutions that adopted the UK Stewardship Code in its first year. But in order for it to be successful, it ultimately requires companies to embrace certain principles. This is where the Corporate Governance Code comes in. This is designed to elevate the broad governance culture among Japanese companies, and encourage them to target sustainable growth in corporate and shareholder value. While it is also a ‘comply or explain’ regime, signing up to the code will effectively make it ‘compulsory’ for listed companies to appoint independent directors by the middle of next year, due to the ignominious task they would face of explaining why they had not. In 2013, nearly 600 of the 1400 largest listed Japanese firms had no independent directors. It is hoped that the introduction of independent directors can also internationalise the board make-up. One key contributor to the strength of European corporate governance and shareholder returns in the past 20 years, against a backdrop of lagging economic growth, has been the strong internationalisation of boards.

---

2 Source: Economist Intelligence Unit, May 2014.
There are incremental signs of change from leading Japanese companies such as Canon, Toyota and Toray. The introduction of the Code is expected to accelerate these changes across the corporate sector by positively redefining board structures – supporting a firmer focus on shareholder value creation.

**Pension Fund Reforms and ROE benchmarks**

The GPIF – the world’s largest pension fund and public sector investor with ¥128.6 trillion (US$1.26 trillion) in assets – has historically been a risk-averse investor. However, it has recently begun to tilt more firepower to equities, with a current allocation to Japanese equities of around 16%. In August, it scrapped the investment cap on domestic shares and is expected to introduce a new 20% target. Equally significant was the fact that the GPIF embraced and signed up to the Stewardship code – ensuring other pension funds quickly followed suit. Indeed, the likelihood is that corporate pension funds will respond similarly to expectations of growth and inflation in the economy and also become less risk averse.

Japanese companies will no longer be able to ignore low ROEs, since they risk disinvestment and voting opposition from pension funds adopting new ROE-aware benchmarks. Japanese households have been as equally defensive in their investing and risk-taking as companies and pension funds. With pension funds moving into equities, combined with an outlook of improving ROEs, better stewardship and corporate governance, it is hoped that a significant chunk of the country’s US$8 trillion of bank deposits can find its way into the stock market.

**Bringing it all together: A hugely ambitious reform programme**

<table>
<thead>
<tr>
<th>Companies</th>
<th>Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Strategic Special Zones (Mar 2014, Cabinet)</td>
<td>TPP (Cabinet)</td>
</tr>
<tr>
<td>Revision of Companies Act and Corporate Governance Code (2015,TSE, FSA)</td>
<td>Industrial Competitiveness Enhancement Act (Jan 2014, METI)</td>
</tr>
<tr>
<td>JPX Nikkei 400 (Jan 2014, JPX)</td>
<td>Specified Business Restructuring Plan (Jan 2014, METI)</td>
</tr>
<tr>
<td>Japan Stewardship Code (Feb 2014, FSA)</td>
<td>GPIF Reform (MHLW)</td>
</tr>
</tbody>
</table>

Source: Fidelity Worldwide Investment

**Labour Market Reforms and Wages**

Japan has one of the most inflexible labour markets in the developed world – characterised by long hours yet relatively low productivity, low immigration and low female participation rates. Giving Japanese firms the right to sack workers would be unpopular, but it would be an important reform for labour markets. For political and cultural reasons, increasing immigration remains a relatively contentious issue, but foreign workers are being considered for special economic zones. A key thrust of Abe’s labour reform is to increase female participation in the workforce, which is among the lowest in the OECD. Abe’s goal is that by 2020, 30% of managers in companies should be women in all business areas. The early signs are positive; Abe’s cabinet office estimates that over half a million women have entered the workplace since the policy was first announced.

One of the most critical measures and enablers of the progress of Abenomics is wages. Due to a combination of inflexible labour markets and Yen appreciation, the Japanese economy has seen wage compression rather than unemployment over the last 20 years, meaning an entire generation of Japanese have experienced no lasting increase in wages. Encouragingly, there have been recent signs of nominal wage growth in the economy, although the picture has been mixed and inconclusive so far. In July 2014, average monthly wages rose by 2.6%, the first increase of over 2% for a decade. However, in real terms, wages are not yet keeping up with inflation. Realistically however, there is a lag between inflation picking up
and a wage response being accepted in the real economy, particularly given the calendar incidence of wage cycles. Real wages remain a critical factor to monitor and could yet respond positively.

Building a ‘Buy and Hold Case’ for Japanese Equities

Abenomics has only just begun given the extent of what is left to achieve of its ambitious reform agenda. The size and commitment to reform are unprecedented. Moreover, it’s very rare for the Japanese government, the Bank of Japan and the corporate sector all to be pointing in the same direction. More than ever before, there is a broad-based commitment to reform in order to exit deflation and move towards sustainable growth.

Given the current levels of investor scepticism – heightened by the temporary hit to GDP from the recent consumption tax – Japanese equity valuations remain close to historic lows. We may be at an inflection point for Japan in terms of the Abenomics journey, as we move into a structural reform phase where progress will be incremental but cumulatively powerful. In this scenario, there is significant potential upside, but limited downside at current valuations from taking a ‘buy and hold’ approach to Japanese equities.

Japanese equity valuations remain close to historic lows

Conclusion

For the last 25 years, Japan has been a market reserved for nimble value investors. With the focus of corporate reforms on raising capital efficiency, profitability and shareholder value within a positive growth and inflation environment, the market can reward a fundamental earnings-focused approach. Such an approach can help to differentiate those high-quality companies that are most serious about improving ROEs and sustaining total shareholder returns from the lower-quality, lower-profitability companies who will fail to attract a premium from investors.

Over the next decade it could be costly for global investors to ignore Japan given the combination of low valuations, reform commitment and the attractive earnings outlook. The country has a strong tendency for consensus politics which has been a hindrance – however incremental progress can precipitate tipping points and, when Japan does move, it can do so in a surprisingly rapid consensual wave. We could well be on the cusp of such a tipping point in corporate behaviour that underpins a sustained rerating of Japanese shares.

Source: DataStream, as at August 2014
Important Information

This document is provided for information purposes only. Fidelity only gives information about its products and services. Investment involves risks. Any person considering an investment should seek independent advice on the suitability or otherwise of a particular investment. Fidelity is not authorised to raise, distribute or manage mutual funds or the relevant products in, or to provide securities investment management or advisory services to persons resident in, the mainland China.

FIL Limited and its subsidiaries are commonly referred to as Fidelity or Fidelity Worldwide Investment. Fidelity, Fidelity Worldwide Investment, the Fidelity Worldwide Investment logo and F symbol are trademarks of FIL Limited.

CM20141020C