THE DRIVE YOU DEMAND

A FRESH LOOK AT JAPANESE EQUITIES

White Paper

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties
as defined by the relevant laws

Union Bancaire Privée, UBP SA | Asset Management

UNION BANCAIRE PRIVÉE

Making the case for Japanese equities

Markets have a way of defying even the most confident of predictions. Conditions can appear ideal for sparking a recovery and supporting growth, and yet the expected investment performance somehow fails to materialise.

Japanese markets have a bit of a reputation for causing disappointment. Investors wonder why this global success story, the world's third-largest economy, has not consistently fed its way through to investment valuations. A thriving export-led economy like Japan's should be able to sustain index performance over time. However, it has been tough over the last few decades to make a convincing investment case for that country, given the weakness of its domestic demand, its ongoing deflation, and its economy's vulnerability to global downturns.

That is, until December 2012 and the election of Prime Minister Abe, when things began to change. By the standards of Japanese politics, Abe is a true radical, as demonstrated by the fact that his ideas have a name: "Abenomics". The recipe is a powerful combination of a more accommodative monetary policy, some old-fashioned fiscal stimulus, and then serious structural change in the Japanese corporate sector. Shaking things up in this way was recognition that continuing stagnation would fundamentally undermine the Japanese economy and threaten its long-term survival.

Of course, such wholesale change takes time to take full effect but it is now clear that progress is tangible and the opportunity to profit from it is real. Although 2018 was a challenging year, we strongly believe that attractive valuations and supportive domestic conditions are once again making a compelling case for Japanese stocks. Understanding the market takes time, but investment managers who do will have the chance to capitalise on some attractive valuations and specific company circumstances.

1. Favourable macro and political environment

The Bank of Japan remains committed to its accommodative policy

The Japanese yen seems set to remain rather weak as the Bank of Japan stays committed to supporting the economy. Governor Kuroda, re-appointed in April 2018 for a five-year term, will ease monetary policy still further if he thinks it necessary, and the central bank's reactive policies suggest interest rate differentials will keep the yen low in 2019. Japanese yen investors should see a trajectory similar to that of their continental European counterparts: the 8% to 10% VAT hike scheduled in October 2019 should mean that domestic policy will continue to favour a weak yen, boosting the exports needed for an economy that is still under repair.

Attractive valuations

The valuations of Japanese equities are near their 2008 lows despite domestic corporate earnings outpacing US earnings. Although Japan also has a large and vibrant technology sector, its equities have not kept pace with their US counterparts. In fact, despite earnings growing 63% since end-2013 versus 31% for US equities, Japan investors today pay 25% less in P/E terms, with multiples having fallen to 13.3 times. This is a level not seen since the lows of the 2008 global financial crisis.

Government support remains active too

Prime Minister Shinzo Abe is a political winner. His Liberal Democratic Party (LDP) enjoys a strong mandate empowering him to implement pro-growth structural reforms with little opposition. With the LDP controlling a majority in both houses of parliament, political stability should enable the government to complete its transformation of the economy and society.

Japan is on track to record the longest period of economic growth in the post-war era. Nevertheless, Japan's potential growth is being hampered by its ageing population and a loss of impetus from public investment. The rise in consumer spending is set to be only moderate, and despite strong private investment and automation efforts, growth may not pick up much beyond 1% in 2019.

Japan retains a proven edge in various industries

Japan is the third-largest economy in the world, and accounts for 10% of global market capitalisation. It lies at the heart of a dynamic Asian economy and trades heavily with fast-growing China. With the rise of automation and thanks to its unique long-standing involvement in automation, Japan has become a hub for robotic research. This is a sector which has the ability to drive structural change and threaten some more complacent global competitors.

2. Corporate governance reforms starting to have a meaningful impact

Reforming corporate governance to generate stronger returns

By bolstering the attractiveness of Japanese companies, changes in corporate culture are contributing to making Japan an attractive long-term investment.

Corporate governance has been a key focus of Prime Minister Shinzo Abe's overall economic revival program. His conviction was that reforming corporate governance and strengthening shareholder rights would help companies make better capital allocation decisions, and thereby generate higher returns and boost overall growth. This represents a clear break with previous approaches to corporate governance in Japan, whose companies have suffered from a reputation for being slow to embrace change. Overseas investors have long been calling on listed firms to be more transparent about their governance and the independence of their management.

New rules to bring Japanese companies closer to global standards

Since 2014, Shinzo Abe's administration has pushed forward historic structural reforms, starting with the adoption of the Stewardship Code which was followed by the Corporate Governance Code in June 2015. The Stewardship Code is a voluntary code of conduct for institutional investors and fund managers "to promote the sustainable growth of companies through investment and dialogue". The Corporate Governance Code defines fundamental principles for listed companies with the aim of attaining "sustainable corporate growth and increased corporate value over the mid- to long-term". Companies have to disclose relevant information in accordance with those principles in a spirit of "comply or explain".

The Stewardship Code was revised in 2017, urging the disclosure of more detailed proxy results. Institutional investors and asset owners are required to assume a higher level of fiduciary responsibility, with the aim of enhancing the return on equity (ROE) of the companies they are invested in. As for the Corporate Governance Code, a revised version was introduced in June 2018 to move Japan closer to global governance standards. The main changes focus on unwinding cross-shareholdings, broader adoption of compensation and nomination committees, and greater diversity on boards.

Change won't happen overnight, but there is some evidence that reforms are slowly creating a more dynamic corporate environment, with clearer financial targets, rising shareholder returns and an increasing number of independent board members.

An index fulfilling investor-focused criteria

The launch of the JPX-Nikkei Index 400 was warmly welcomed in 2014. Operated by the media organisation Nikkei Inc. and the Tokyo Stock Exchange, the index is composed of 400 companies selected on the basis of investor-focused criteria, such as efficient use of capital and investor-centric management approaches.

According to the new selection rules announced in December 2018, inclusion in the index will now be based on constituents' three-year average return on equity (ROE) and three-year cumulative operating profit, and on the disclosure of an English version of their corporate governance reports.

Strong domestic allocation from pension funds

Japanese pension funds, public and private, have been allocating a greater portion of their assets to equities, which provides another powerful support to the Japanese stock market.

This has notably been the case with Japan's Government Pension Investment Fund (GPIF). With JPY 156.4 tn under management and a time horizon of 100 years, the GPIF is the world's largest pension fund. As part of Prime Minister Shinzo Abe's general push for structural reforms, his asset allocation policy was amended in 2014 to raise the fund's maximum exposure to equities from 24% to 50% (Japanese and foreign equities' stakes have since both risen from 12% to 25%).

Given its predominance, the GPIF is also playing a critical role in enforcing the Stewardship Code through its external asset managers.

3. Searching for alpha opportunities in Japanese equities

Assessing the drivers of growth

In the environment described above, identifying price discrepancies between intrinsic value and market price is an important driver of alpha generation for investment managers. Investors therefore need managers with proven expertise in assessing growth, its drivers and how it could impact the fundamentals of companies.

Inefficiencies effective active managers can exploit

There is a large pool of stocks to pick from in Japan. Foreign investor volumes can dominate Japanese markets, with sentiment often being driven by risk-on/risk-off factors. This creates opportunities for active managers to generate sustainable alpha through a measured approach.

Seasoned teams and strong track records

At UBP we have a long history of partnerships with leading Japanese active equity managers. They are focused, benchmark-aware portfolio creators with a high active share, favouring fundamental and bottom-up processes with an approach unrestricted by sectors and market caps. Those attributes are critical for alpha generation in the Japanese equity universe.

The research teams perform fundamental analyses on more than 1000 Japanese equities a year, which they choose according to their understanding of the edge the companies have in their respective industries. The shortlist for building the portfolio is then based on the Discounted Cash Flow (DCF) and five years' future earnings growth of the companies analysed. The teams cultivate a collegial approach, encouraging original contributions and individual ideas. This style contrasts with that of traditional money managers and helps to underpin strong model investment portfolios.

Cédric Le Berre
Multi-Management & Fund Research
Investment Specialist – External Managers

Union Bancaire Privée, UBP SA
Rue du Rhône 96-98 | P.O. Box | CH-1211 Geneva 1
T. +41 58 819 21 11 | F. +41 58 819 22 00
www.ubp.com

Dedication | Conviction | Agility | Responsibility

Disclaimer

This is a marketing document and is intended for informational and/or marketing purposes only. This document is confidential and is intended only for the use of the person(s) to whom it was delivered. This document may not be reproduced (in whole or in part) or delivered, given, sent or in any other way made accessible, to any other person without the prior written approval of Union Bancaire Privée, UBP SA or any entity of the UBP Group ("UBP"). This document reflects the opinion of UBP as of the date of issue.

This document is for distribution only to persons who are Qualified Investors in Switzerland or Professional Clients, Eligible Counterparties or equivalent category of investors as defined by the relevant laws (all such persons together being referred to as "relevant persons").This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. It is not intended for distribution, publication, or use, in whole or in part, in any jurisdiction where such distribution, publication, or use would be unlawful, nor is it directed to any person or entity to which it would be unlawful to direct such a document. In particular, this document may not be distributed in the United States of America and/or to US Persons (including US citizens residing outside the United States of America).

This document has not been produced by UBP's financial analysts and is not to be considered as financial research. It is not subject to any guidelines on financial research and independence of financial analysis.

Reasonable efforts have been made to ensure that the content of this document is based on information and data obtained from reliable sources. However, UBP has not verified the information from third sources in this document and does not guarantee its accuracy or completeness. UBP accepts no liability whatsoever and makes no representation, warranty or undertaking, express or implied, for any information, projections or any of the opinions contained herein or for any errors, omissions or misstatements. The information contained herein is subject to change without prior notice. UBP gives no undertaking to update this document or to correct any inaccuracies in it which may become apparent.

This document may refer to the past performance of investment interests. Past performance is not a guide to current or future results. The value of investment interests can fall as well as rise. Any capital invested may be at risk and you may not get back some or all of your original capital. In addition, any performance data included in this document does not take into account fees and expenses charged on issuance and redemption of securities nor any taxes that may be levied. Changes in exchange rates may cause increases or decreases in your return.

All statements other than statements of historical fact in this document are "forward-looking statements". Forward-looking statements are not guarantees of future performance. The financial projections included in this document do not represent forecasts or budgets, but are purely illustrative examples based on a series of current expectations and assumptions which may not eventuate. The actual performance, results, financial condition and prospects of an investment interest may differ materially from those expressed or implied by the forward-looking statements in this document as the projected or targeted returns are inherently subject to significant economic, market and other uncertainties that may adversely affect performance. UBP disclaims any obligation to update any forward-looking statement, as a result of new information, future events or otherwise.

It should not be construed as advice or any form of recommendation to purchase or sell any security or funds. It does not replace a prospectus or any other legal documents that can be obtained free of charge from the registered office of a fund or from UBP. The opinions herein do not take into account individual investors' circumstances, objectives, or needs. Each investor must make his/her own independent decision regarding any securities or financial instruments mentioned herein and should independently determine the merits or suitability of any investment. In addition, the tax treatment of any investment in the fund(s) mentioned herein depends on each individual investor's circumstances. Investors are invited to read carefully the risk warnings and the regulations set out in the prospectus or other legal documents and are advised to seek professional advice from their financial, legal and tax advisors.

The tax treatment of any investment in the Fund depends on your individual circumstances and may be subject to change in the future.

The document neither constitutes an offer nor a solicitation to buy, subscribe for or sell any currency, funds, product or financial instrument, make any investment, or participate in any particular trading strategy in any jurisdiction where such an offer or solicitation would not be authorised, or to any person to whom it would be unlawful to make such an offer or invitation.

Telephone calls to the telephone number stated in this presentation may be recorded. When calling this number, UBP will assume that you consent to this recording.

UBP is authorised and regulated in Switzerland by the Swiss Financial Market Supervisory Authority and is authorised in the United Kingdom by the Prudential Regulation Authority. UBP is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority.