



# In a More Uncertain Environment, Focus on Fundamentals

Maintaining perspective on long-term opportunities.

June 2022

## KEY INSIGHTS

- The global rotation into more value-oriented equity market sectors over the past 18 months has been particularly pronounced in Japan.
- The value rotation has worked against our focus on bottom-up fundamentals of those companies demonstrating secular growth and transformation.
- The broad market outlook in Japan remains positive, in our view, with various long-term, secular investment themes expected to underpin returns.



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Japan Equity Strategy*

The global trend of rapid, post-pandemic growth, inflation, and rising interest rates over the past 18 months has had a tangible impact on equity markets, specifically driving a sharp rotation into more value-oriented sectors. This has been particularly apparent in Japan, where the shift away from growth and into value has been among the most pronounced of any major global equity market. This trend has worked against our focus on bottom-up fundamentals

of those companies demonstrating secular growth and transformation.

However, we have full conviction that our active, research-driven process can continue to help add value in Japan over a longer-term investment horizon. Moreover, we expect the Japanese market to be supported by policy stimulus, relatively subdued inflation, ongoing digital transformation increasing productivity, and improving return on equity (ROE) trends.

## Five Factors Underpinning Japanese Equities

Recent volatility does not alter Japan's long-term outlook



**Political  
Stability**



**Long-term  
Themes**



**Digital  
Transformation**



**Improved  
Productivity**



**Positive ESG  
Credentials**

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# JPY 56 tn (USD 490 bn)

Record stimulus  
announced by  
PM Kishida.<sup>1</sup>

## Focus on Fundamentals

Our investment philosophy is underpinned by the belief that long-term growth in company earnings and cash flow creates shareholder value. Accordingly, we seek to deliver long-term performance for investors, typically over a three- to five-year time horizon, within the under-researched Japanese equity market. We do this by identifying and investing in companies that we believe exhibit sustainable growth and business improvement and a positive environmental, social, and governance (ESG) profile and by actively investing across the full capitalization range.

## Stable Politics With Stimulus Support

At a broad market level, we continue to believe that the outlook for Japanese equities remains favorable. The post-pandemic recovery in the global economy is supportive of Japan's cyclical, export-oriented industries, while the reopening of the domestic economy should also receive a further boost from the government's record JPY 56 trillion (USD 490 billion) fiscal stimulus package, the first major policy announcement from new Prime Minister (PM) Fumio Kishida.<sup>1</sup>

After the recent leadership change and the general election, Japan now faces an expected period of political calm. Signs point to policy continuity under new PM Kishida, while the prospect of further economic stimulus has also been welcomed by investors.

## Long-term, Secular Themes

While it is difficult to speculate on how long the current rotation into more value-oriented sectors in Japan might last, we believe that the long-term, secular investment themes could continue to play out, which should underpin the performance of many of

the quality companies. What's more, valuations of many of these companies have fallen over the past 18 months to levels that now look particularly appealing, in our view.

In the near term, recession risks in the U.S. have increased, which has knock-on implications for Japan, so we think it is prudent to reduce some cyclical risk exposure.

## Japan's Digital Transformation Continues Apace

The onset of the pandemic shone a spotlight on Japan as lagging other major markets in terms of its technological advancement and efficiency in some areas of the economy. More positively, however, this has created a sense of urgency around government plans to invest heavily in upgrading and advancing Japan's lagging information technology (IT) infrastructure and capabilities.

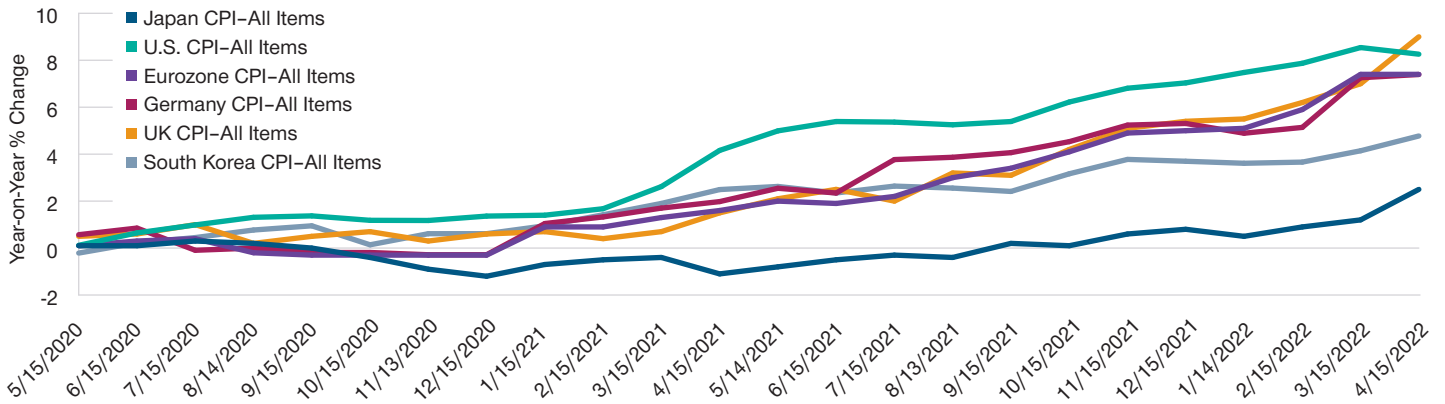
Digital reform is the government's top policy objective, seen as crucial to the modernization of Japanese business and industry, and to closing the technology gap that exists with other major global market economies. To this end, a dedicated Digital Agency government portfolio was established in September 2021, tasked with, among other things, reforming the culture of over-administration and improving business efficiency through digitalization. The agency is being resourced from the private sector, rather than being run by government bureaucrats, which is a positive change from the past.

We believe that this initiative will have a halo effect, accelerating the pace of digital transformation and creating ample, multiyear investment opportunities. For example, the government's ability to effectively manage the coronavirus health crisis was decidedly hampered by outdated and cumbersome IT infrastructure and

<sup>1</sup>Source: Reuters, November 2021.

## Japanese Inflation Likely to Be More Subdued

(Fig. 1) Comparative major market annual inflation rates



As of April 15, 2022.

CPI = consumer price index.

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“...the pandemic has not derailed Japan from its path of improving corporate governance. This is driving a significant improvement in capital allocation, which has the potential to be a powerful driver of stock prices over the next stage of the economic cycle.”

myriad non-compatible local government administration systems. As such, many health care industry companies we look for have the potential/may benefit directly from the government’s digital reform agenda.

### Prioritizing Improved Productivity

The Japanese workforce, at large, was also caught unprepared in terms of its ability to transition to a new home-based working environment during the pandemic. The sudden necessity to work from home brought on by the coronavirus once again highlighted the inadequate nature of Japan’s technology capabilities.

More broadly, Japan’s workforce is shrinking, meaning economic growth will need to come from greater productivity going forward. This should be significantly enabled by more extensive application of digital technology and by adopting more flexible and efficient work practices. Deeply ingrained, traditional work practices continue to impact corporate performance, so efforts to create a more productive, efficient work environment are likely to be rewarded over the long term.

### Progressive ESG Credentials

The focus on higher ESG standards in Japan has become a powerful market trend and one that is not subject to any economic environment or cycle. Government efforts, particularly via its mammoth Government Pension Investment Fund (only allowing investments with strong ESG characteristics), have resulted in a greater market awareness about corporate stewardship and responsibility.

### Return on Equity Expected to Improve

Importantly, the pandemic has not derailed Japan from its path of improving corporate governance. This is driving a significant improvement in capital allocation, which has the potential to be a powerful driver of stock prices over the next stage of the economic cycle.

Japanese companies are slated to repurchase over USD 32 billion worth of shares this fiscal year—double the amount from last year and the largest buyback in 16 years. We expect Japanese companies to resume their strong focus on buybacks over the

coming quarters, which is crucial in attracting greater international investment. ROE in Japan declined during the pandemic, but with Japanese company earnings highly geared to the global economy, we believe that we will again see improvement in this metric over the coming quarters.

**A True Active  
Management Opportunity**

The reopening of the Japanese domestic economy is expected to support the stock market, while added stimulus

measures under new political leadership could provide a further substantial tailwind. Improved governance standards and a growing focus on sustainability also contribute to our positive long-term outlook. As we enter the next stage of the equity cycle amid a broadening global economic recovery, we believe that Japan is a compelling active management case, particularly as the market remains under-researched and under-owned and continues to display positive change dynamics.

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