Change in Political Leadership and the Outlook for Japan

Prospects for stocks look bright amid expected policy continuity.

November 2021

KEY INSIGHTS

- Given tentative moves toward economic reopening and supportive political developments, we believe the prospects for Japanese stocks look bright.
- Our positive outlook is predicated on social and economic normalization following the coronavirus pandemic and expectations of policy continuity under new leadership.
- The high degree to which Japanese corporate profits are levered to the global economic recovery adds to our optimism about the country's stock market.

Archibald Ciganer, CFA
Portfolio Manager,
Japan Equity Strategy

Japan has had a challenging year. After outperforming in 2020, the country has disappointed investors in 2021 due in part to the delayed rollout of its COVID-19 vaccination program, as well as the public's negative reaction to the government's decision to host the Olympics amid concerns about the spread of the coronavirus. With his popularity hovering around all-time lows, these factors ultimately contributed to the decision by Prime Minister Yoshihide Suga to resign in September.

Taking stock, however, the Olympics are now behind us, Japan's vaccination drive has overtaken that of many developed market peers, and there have been some positive political developments—against this backdrop, Japan has started to outperform.

In a recent webinar, Portfolio Manager Archibald Ciganer shared his thoughts on the state of play in Japan—in particular, what the leadership change means for investors and whether it is likely to derail any of the positive reforms that the country has pursued in recent years. He also explained how he had been managing his portfolio in this challenging period and discussed where he sees future opportunities. The following is a summary of the question and answer session.

What is life in Japan currently like with respect to the pandemic?

Things are gradually returning to normal, and the economy should slowly reopen from here. The states of emergency were fully dropped for the first time in over six months at the end of September, and trains, shops, bars, and restaurants are already filling up.

Japan was late to roll out an effective COVID-19 vaccination program due to challenges in gaining regulatory

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approvals for vaccines, securing sufficient supplies, and administering the rollout. However, since May, the country has caught up rapidly, and its vaccination rate (the percentage of the population that is fully vaccinated) is now higher than that of the U.S. and Europe, meaning that the impact on society and the economy of any new uptick in cases should be more manageable.

What impact is the recent change in leadership likely to have?

Following the resignation of Suga, former Foreign Minister Fumio Kishida was elected leader of the ruling Liberal Democratic Party (LDP) at the start of October after defeating vaccination minister Taro Kono and two other candidates in the leadership runoff, effectively becoming Japan's new prime minister.

The result disappointed markets and the domestic populace, which had hoped for accelerating change under perceived reformer Kono. Kishida was viewed as the continuity candidate and a safe pair of hands, who was favored by the powerful group of LDP lawmakers who elected their new leader.

Elections for the powerful lower house of parliament were held on October 31, with the LDP retaining control given its large majority and single-digit support rates for Japan's opposition parties. The party's focus heading into the election had been on minimizing losses, following Suga's resignation and perceptions that his government's response to the pandemic had been badly managed. Elections for the upper house of parliament will be held before summer next year. We do not anticipate that there will be significant changes between now and then that could result in the loss of further support for the LDP.

Ultimately, we regard the election of Kishida as somewhat of a missed opportunity to accelerate change. The power structure within the LDP (which includes former Prime Minister Shinzo Abe among its key figures) is unchanged, and the "Abenomics" program of aggressive monetary easing, fiscal stimulus, and structural reform remains on track. The pace of reform is likely to be steady rather than spectacular from here, in our view. We are not concerned about recent media speculation about Kishida's potential policies, such as an increase to the country's capital gains tax (which he confirmed is not being considered).

Have you made any changes to the portfolio as a result of recent developments?

We have not made any substantial changes to the portfolio and continue to do what we have always done: bottom-up stock picking on an individual thesis basis.

In terms of positioning, we have moved toward less cyclical exposure as the recovery was priced in early and valuations reflected that. We introduced a lot of cyclicals in mid-2020 ahead of the global recovery that came through and most of the stocks had outperformed significantly, moving to valuation levels we no longer deemed attractive in some cases.

Overall, given a more stable environment, most sectors appear priced in line with fundamentals. There are some pockets of weakness in services; however, if the domestic economy reopens quickly and foreign tourists come back soon, these sectors could still outperform this year.

What is your current view on small-cap companies?

The relationship between small- and large-cap stocks in Japan tends to be cyclical, so our typical approach is to be invested in both. Small-cap stocks can offer the potential of outsized returns, while large-cap stocks tend to offer transformation qualities and can provide a more stable return profile at a lower risk level.

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We hold several small-cap companies in the portfolio, and any uptick in small-cap sentiment should help boost performance.

What have been the drivers of portfolio performance?

Portfolio performance this year has been disappointing (it is only the second year of underperformance since Archibald Ciganer started managing the strategy in December 2013, the first being 2014). Much of this year's underperformance is a reversal of 2020 when growth outperformed value significantly and the portfolio registered sizable outperformance.

We have had a fairly unique scenario when the correlation between industrials and financials turned negative, which is extremely uncommon. We seek to structure the portfolio in such a way that it is not overly affected by a macro cycle. We have had an overweight position in industrials and an offsetting underweight position in financials, in the hope that when financial stocks outperform, industrials will too, in order to try to provide some protection from a macro upside.

While this approach has tended to benefit portfolio performance, this year, interest rate expectations rose on global reflation prospects, leading financials to outperform, while, at the same time, the spread of the delta variant of the coronavirus led to supply chain issues and brought industrial production to a halt in many parts of the world. We expect the correlation between industrials and financials to turn positive again as the delta wave subsides.

Are you still excited by Japan's digital transformation?

We continue to seek out opportunities that can benefit from Japan's digital reform. The country has woken up to the fact that it is behind its developed market peers when it comes to digitalization, and it is catching up quickly—this is a government priority, underpinned by the fact that digital reform is needed to move the economy forward. Given Japan's shrinking workforce, growth will need to come from better productivity, including the more extensive use of digital technology.

The launch of Japan's first Digital Agency in September was a significant step toward upgrading the archaic systems used by most local and public entities. The Digital Agency is a huge project that should set a standard for innovation in Japan and, we believe, push corporations to modernize more quickly.

The agency is being resourced from the private sector rather than being run by bureaucrats, which is a positive break from the past. We believe these measures will have a halo effect, accelerating the pace of digital transformation and creating ample multiyear investment opportunities. We do not believe the change in Japan's leadership will alter this course in any way.

Has the pandemic derailed Japan's corporate governance reforms?

We believe Japan's corporate governance reforms remain on track, and we continue to see continued improvement in standards.

Capital allocation is changing and is likely to be a powerful driver of stock prices over the next stage of the cycle. Although we saw fewer buybacks over the past year as a result of cash flow shortages caused by the pandemic, the reduction is lower than we would have expected and much less than in previous crises. Japan might not reach the record level of share buybacks it registered in 2019 this year, but we expect companies to resume the pace of buybacks once the impact of the pandemic subsides.

We have seen fewer companies cutting dividends than we did compared with the 2008–2009 global financial crisis. Regarding return on equity (ROE), Japanese corporate earnings are highly geared to the global economy, more so than the European corporate sector, for example. Japan's ROE lags Europe, but we expect it to catch up. It will be more difficult to reach U.S. levels of ROE, where the focus on shareholder return and shareholder pressure is greater and where there are simply more globally leading companies.

What is your view on Japanese equity valuations and the outlook for the market?

In our view, the consensus probably underestimates the earnings impact of the recovery and Japan's operating leverage to the global economy. We think profits will surprise to the upside and the market will react to that, with consensus earnings moving up. Japan's accelerating COVID-19 vaccination program is likely to continue lending support to the stock market, while added stimulus measures under new political leadership could provide a further tailwind. Improved governance is also contributing to our positive long-term outlook.

We believe the anticipated global economic recovery will continue to build and broaden through 2021 and beyond and that we will slowly return to some semblance of normality. Given Japan is one of the most cyclical and open markets, highly levered to the health of the world economy, we believe it will be a major beneficiary of the prospective global recovery.

GIPS® Composite Report

Japan Equity Composite

Period Ended December 31, 2020
Figures Are Shown in U.S. dollar

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Gross Annual Returns (%)	-7.52	11.69	31.91	-6.59	16.16	11.25	33.43	-11.64	27.37	34.31
Net Annual Returns (%)[1]	-8.03	8.00	31.20	-7.10	15.53	10.64	32.71	-12.13	26.68	33.59
TOPIX Index Net (%)[2]	-12.65	7.36	26.85	-3.63	6.00	3.12	26.15	-14.02	18.79	12.62
MSCI Japan Index Net (%)[2]	-14.33	8.18	27.16	-4.02	9.57	2.38	23.99	-12.88	19.61	14.48
TOPIX Index (%)[2]	-12.50	7.54	27.03	-3.33	9.00	3.46	26.55	-13.73	19.25	13.04
MSCI Japan Index (%)[2]	-14.19	8.36	27.35	-3.72	9.90	2.73	24.39	-12.58	20.07	14.91
Composite 3-Yr. St. Dev.	17.22	13.37	14.19	12.66	12.81	11.89	11.33	13.45	12.15	17.46
TOPIX Index Net 3-Yr St. Dev.	16.64	14.05	14.44	12.82	12.97	12.56	11.95	11.75	10.49	15.23
MSCI Japan Index Net 3-Yr St. Dev.	16.97	14.45	14.70	12.88	13.26	12.89	12.31	11.57	10.33	15.29
TOPIX Index 3-Yr St. Dev.	16.64	14.05	14.44	12.83	12.96	12.56	11.94	11.78	10.49	15.22
MSCI Japan Index 3-Yr St. Dev.	16.97	14.45	14.70	12.89	13.25	12.89	12.31	11.59	10.34	15.27
Composite Dispersion	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	0.74
Comp. Assets (Millions)	247.4	195.6	361.3	302.9	372.8	453.1	1031.5	1615.1	3435.8	5843.7
# of Accts. in Comp.	3	2	2	2	2	2	2	6	8	8
Total Firm Assets (Billions)	493.1	579.8	696.3	749.6	772.4	817.2	1000.2	972.7	1218.2	1482.5[3]

[1] Reflects deduction of highest applicable fee schedule without benefit of breakpoints. Investment return and principal value will vary. **Past performance is not a reliable indicator of future performance**. Monthly composite performance is available upon request. **See below for further information related to net of fee calculations.**

[2] Primary benchmark is TOPIX TSE First Section Index Net and secondary benchmark is MSCI Japan Index Net. Effective June 1, 2019, the composite's benchmark changed from gross to net of withholding taxes. The change was made because the firm viewed the new benchmark to be more consistent with the tax impacts of the portfolios in the composite. Historical benchmark representations have been restated.

[3] Preliminary—subject to adjustment.

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Gross performance returns are presented before management and all other fees, where applicable, but after trading expenses. Net of fees performance reflects the deduction of the highest applicable management fee that would be charged based on the fee schedule contained within this material, without the benefit of breakpoints. Gross and net performance returns reflect the reinvestment of dividends and are net of nonreclaimable withholding taxes on dividends, interest income, and capital gains. Effective June 30, 2013, portfolio valuation and assets under management are calculated based on the closing price of the security in its respective market.

Previously portfolios holding international securities may have been adjusted for after-market events. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

Dispersion is measured by the standard deviation across asset-weighted portfolio returns represented within a composite for the full year. Dispersion is not calculated for the composites in which there are five or fewer portfolios.

Some portfolios may trade futures, options, and other potentially high-risk derivatives which generally represent less than 10% of a portfolio.

Benchmarks are taken from published sources and may have different calculation methodologies, pricing times, and foreign exchange sources from the composite.

Composite policy requires the temporary removal of any portfolio incurring a client initiated significant cash inflow or outflow greater than or equal to 15% of portfolio assets. The temporary removal of such an account occurs at the beginning of the measurement period in which the significant cash flow occurs and the account re-enters the composite on the last day of the current month after the cash flow. Additional information regarding the treatment of significant cash flows is available upon request.

The firm's list of composite descriptions, a list of limited distribution pooled fund descriptions, and a list of broad distribution pooled funds are available upon request. GIPS® is a registered trademark of CFA Institute. CFA institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.

A portfolio management change occurred effective December 27, 2013. There were no changes to the investment program or strategy related to this composite.

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Fee Schedule

Japan Equity Composite. The Japan Equity Composite seeks long-term capital appreciation primarily through investment in large-, mid-, and small-cap companies traded in Japan markets, with faster earnings growth and reasonable valuation levels relative to market/sector averages. The market cap of holdings within these portfolios will typically be between $4 and $20 billion. (Created June 2006; incepted December 31, 1995.)

First 50 million (USD)	55 basis points
Next 50 million (USD)	50 basis points
Above 100 million (USD)	45 basis points on all assets[1]
Above 200 million (USD)	37.5 basis points on all assets[1]
Minimum separate account size	50 million (USD)

[1]A transitional credit is applied to the fee schedule as assets approach or fall below the breakpoint.

Risks—the following risks are materially relevant to the portfolio:

Currency risk—Changes in currency exchange rates could reduce investment gains or increase investment losses.

Small and mid-cap risk—Stocks of small and mid-size companies can be more volatile than stocks of larger companies.

Style risk—Different investment styles typically go in and out of favour depending on market conditions and investor sentiment.

General Portfolio Risks

Capital risk—The value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

ESG and Sustainability risk—May result in a material negative impact on the value of an investment and performance of the portfolio.

Equity risk—In general, equities involve higher risks than bonds or money market instruments.

Geographic concentration risk—To the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk—A portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

Investment portfolio risk—Investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management risk—The investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

Operational risk—Operational failures could lead to disruptions of fund operations or financial losses.

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