



# Three Market Drivers for the Next Three Years

Major changes in the Japanese equity market appear supportive of a positive, long-term outlook.

May 2019

## KEY INSIGHTS

- The Japanese equity market is undergoing significant structural change, and this could have positive longer-term implications for investors.
- Rising activism, improving governance, and resurgent entrepreneurship could continue to drive Japanese equity returns for years to come.
- The structural change occurring in the Japanese equity market is positive, meaningful, and permanent.



**Archibald Ciganer**  
*Portfolio Manager,  
T. Rowe Price Japan Fund*

The Japanese equity market is undergoing significant change, with positive longer-term implications for investors. An improvement in Japan's business environment and in company fundamentals is already evident—reflected in record company profits, increasing shareholder returns, and substantial inflows of foreign investment. Three important market influences have emerged in recent years—rising activism, improving governance, and resurgent entrepreneurship—that we believe will underpin Japanese equity returns over the years to come.

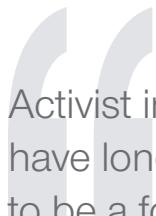
For all the market improvement and investment inflows into Japan in recent years, there are many who continue to see it as a “fast money” market—a short-term bet on currency or macroeconomic cycles. This perception

of Japan as a transient, opportunistic investment was highlighted again in late 2018. When global equities sold off sharply, Japanese equities fell further than any other major equity market.

However, a range of factors suggest that this short-term view is misplaced. Record company profits, rising dividend payments and share buybacks, and increasing merger and acquisition activity tell a very different story—one of more durable change and improvement.

## Shareholder Activism Encouraging Shifts in Management Behavior

Many Japanese companies have historically been managed inefficiently, hindered by tradition and a conservative management culture. Activist investors have become increasingly prominent in recent years, looking to take advantage of this inefficiency to unlock value for shareholders.



Activist investors have long proven to be a force for change in the U.S. equity market and are beginning to make an impact in Japan.

— Archibald Ciganer

Portfolio Manager,  
T. Rowe Price Japan Fund

Activist investors have long proven to be a force for change in the U.S. equity market and are now making an impact in Japan. Pressure from foreign investors for improved returns and corporate governance reforms has encouraged activists in their quest for better management of Japanese companies. Prime Minister Shinzo Abe has thrown his support behind activists, stating that active engagement helps improve shareholder value and that more constructive dialogue with companies is a trend that he expects to strengthen.

Japan's deeply ingrained tradition of respect and a relationship-based corporate culture have historically restrained shareholders from openly confronting company management. For those bold enough to launch a challenge, proposals were typically defeated. They were either blocked by friendly shareholders, or they failed as a result of domestic funds not voting their shares to avoid upsetting corporate relationships.

However, this landscape is rapidly changing, primarily due to the attraction of high levels of untapped shareholder value. Activist investors are pushing poorly managed firms to unlock this value by advocating increased shareholder distributions or better investments of cash stockpiles to seek higher rates of return.

Significantly, this push for change comes at a time of generational transition in corporate Japan. Company leaders are gradually being replaced by younger, more progressive management teams that are more receptive to shareholder engagement.

A record 42 Japanese public companies faced shareholder proposals in the June 2018 proxy season, beating the previous record of 40 set just a year earlier.<sup>1</sup> The season also saw a record 10 companies face shareholder proposals brought by activist shareholders.<sup>2</sup>

While still in the early days, the prominence of activist investors is growing. Their positive approach and constructive attitude have seen them steadily gain support from other shareholders.

Meanwhile, in May 2017, a revision was made to Japan's Stewardship Code that now requires institutional shareholders to publicly disclose their proxy votes for each individual investment. This makes it far more difficult for institutional shareholders to justify voting against, or abstaining from, any rational and appropriate shareholder proposal. As many activists' proposals target reasonable and constructive outcomes, such as financially sensible dividend increases or strengthening corporate governance, these now stand a better chance of institutional support.

Government guidance introduced in 2018 regarding transparency around corporate "strategic shareholdings" (such as relationship-based cross-shareholdings), should also encourage activist investors. This practice has long been targeted as an area of concern, but in the wake of the new guidance, the number of cross-shareholdings in the Japanese equity market has already started to decline.

### **Improved Corporate Governance Strengthens Capital Discipline**

New governance codes have been implemented with unexpected speed and determination, effectively

<sup>1</sup> Mitsubishi UFJ Trust and Banking Corporation, as of July 2018.

<sup>2</sup> IR Japan, Japan's largest proxy advisor, as of July 2018.

---

## 2018 VOTING SEASON— NEW RECORDS

# 42

Japanese companies facing shareholder proposals.

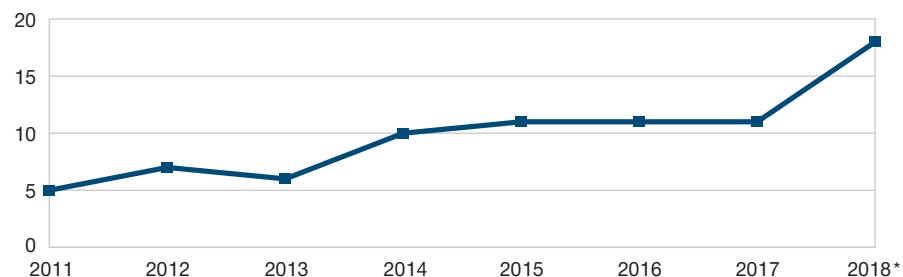
# 10

Japanese companies facing shareholder proposals brought by activist investors.

### (Fig. 1) The Potential to Unlock Untapped Value in Japan Is Driving Change

Number of Japanese company meetings with capital efficiency-related proposals on ballot

As of December 31, 2018



\*Data for 2018 to June 30, 2018.

Source: Institutional Shareholder Services.

changing the playing field for Japanese companies. Where there was previously little in the way of guidance, a clear framework now exists, urging companies to focus on financial management and improving returns to shareholders.

For a long time, the Japanese market trailed the U.S. and Europe in terms of total returns paid out to shareholders. However, the gap is closing rapidly. Companies are paying higher dividends and increasing share buybacks. In turn, higher returns on equity are attracting more foreign investment to the extent that foreign investors are now the largest shareholder class in Japan.

This is a significant development. Foreign investors expect a level of shareholder focus and capital discipline comparable to European or U.S. counterparts. With foreign ownership increasing, the influence of these shareholders is set to strengthen, driving even higher standards among Japanese companies.

A striking example of this influence can be seen in the makeup of Japanese company boards. Twenty years ago, you would be hard pressed to find a single company with an independent director

on its board. Today, nearly all Japanese companies have at least two external, independent directors. This shift has been largely driven by the expectations and influence of foreign investors. At the same time, a younger generation of company leaders is adopting a more investor-friendly approach to corporate governance. This includes conducting an increasing number of company meetings in English, providing additional comfort for foreign shareholders.

The crucial point is that the improvement in Japan's business environment is a virtuous circle—the more the investment landscape improves, the greater the potential returns for investors, which can attract greater inflows into the market.

### The Return of Japan's Entrepreneurial Spirit Is Creating New Leaders

Japan's business environment has always been somewhat of a paradox—with a traditionally conservative culture sometimes at odds with the country's strengths in technology and innovation. However, for much of the past two decades, weak growth and inflation have largely suppressed the entrepreneurial spirit.

[Over recent decades]...the traditional belief that established corporations are enduringly stable and provide jobs for life has been challenged.

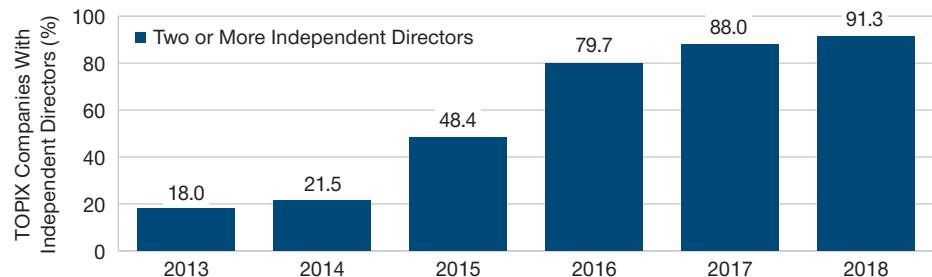
— Archibald Ciganer

Portfolio Manager,  
T. Rowe Price Japan Fund

## (Fig. 2) From the Top Down—Improving Corporate Governance Is a Clear and Irreversible Trend

Independent directors now sit on most Japanese company\* boards

As of December 31, 2018



\*In the Tokyo Stock Exchange First Section (TOPIX) Index.

Source: Japan Stock Exchange.

In recent years, however, Japan's steady economic and market recovery has seen somewhat of a reversal in this trend, with the emergence of a growing number of start-up and niche businesses. This trend has also been encouraged by a cultural shift. While young people once preferred to join big, multinational corporations attracted by the promise of security and lifelong employment, today's youth are increasingly following their western counterparts in leaning toward smaller, more entrepreneurial companies. Meanwhile, with tech giants like the FAANGs (Facebook, Amazon, Apple, Netflix, Google) taking market share from once powerful Japanese companies, the traditional belief that established corporations are enduringly stable and provide jobs for life has been challenged.

While it is unlikely that Japan will regain the kind of broad reputation for innovation it enjoyed in the 1980s, there are certain areas where it is clearly a global leader. Factory automation, for example, is dominated by Japanese companies. In the technology and chemical component fields, Japanese companies have a long history of innovation, and this leadership is proving valuable as countries like China look to leverage this expertise.

Established Japanese companies are also increasingly looking to start-ups and smaller companies as potential M&A or investment opportunities. Highly specialized industries like artificial intelligence, automation, and robotics have seen tremendous investment and growth. This success is inspiring the next wave of forward-thinking entrepreneurs, with more start-ups and IPOs within broader market areas such as consumer discretionary and fintech.

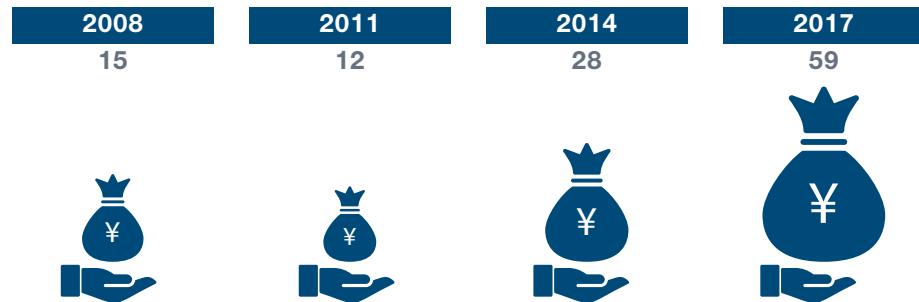
The Japanese government is also keen to cultivate entrepreneurship. Over the past decade, it has launched several funding initiatives designed to help start-ups and smaller companies expand and grow, both domestically and overseas. In 2013, for example, the Cool Japan Fund was launched with around USD 1 billion of public money expected to be allocated over the course of its life cycle.

These are not short-term deviations or trends, but meaningful, irreversible shifts in the Japanese investment landscape. The positive effects of these changes are already being felt, and their ongoing influence is the primary support for our constructive, longer-term outlook. Many investors

### (Fig. 3) Japan's Entrepreneurial Spirit is Rising

Number of start-up fundraising rounds of at least ¥1bn in Japan

As of December 31, 2017



Source: Techinasia.com.

seem to underappreciate the impact of these changes. For us, this disconnect is an opportunity. We believe there are excellent opportunities for active,

research-driven investors to discover quality companies in a supportive—and improving—Japanese market.

#### WHAT WE'RE WATCHING NEXT

Our view is that we remain in an environment of solid global growth—a backdrop that should help the best of corporate Japan to perform reasonably well. However, we are mindful of the escalation in trade war rhetoric between the world's largest trading partners, and we continue to monitor developments closely. While we are hopeful that trade war concerns will subside, the quality bias of our investment approach should hold us in relatively good stead, even if tensions were to escalate, undermining the supportive growth environment.

#### INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit [troweprice.com](http://troweprice.com).

## T. Rowe Price®

### Important Information

The specific securities identified and described are for informational purposes only and do not represent all of the securities purchased, sold or recommended for the portfolio, and no assumptions should be made that the securities were or will be profitable.

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action. The views contained herein are those of the authors as of May 2019 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

This information is not intended to reflect a current or past recommendation, investment advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Investors will need to consider their own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

**Past performance is not a reliable indicator of future performance.** All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc.

© 2019 T. Rowe Price. All rights reserved. T. Rowe Price, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.