

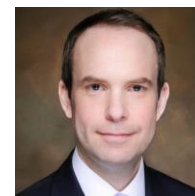


PASSIVE INVESTING IN JAPAN AND THE COST THAT NO ONE IS TALKING ABOUT

OCTOBER 2018

Laurence Taylor

T. Rowe Price Japanese Equity Strategy



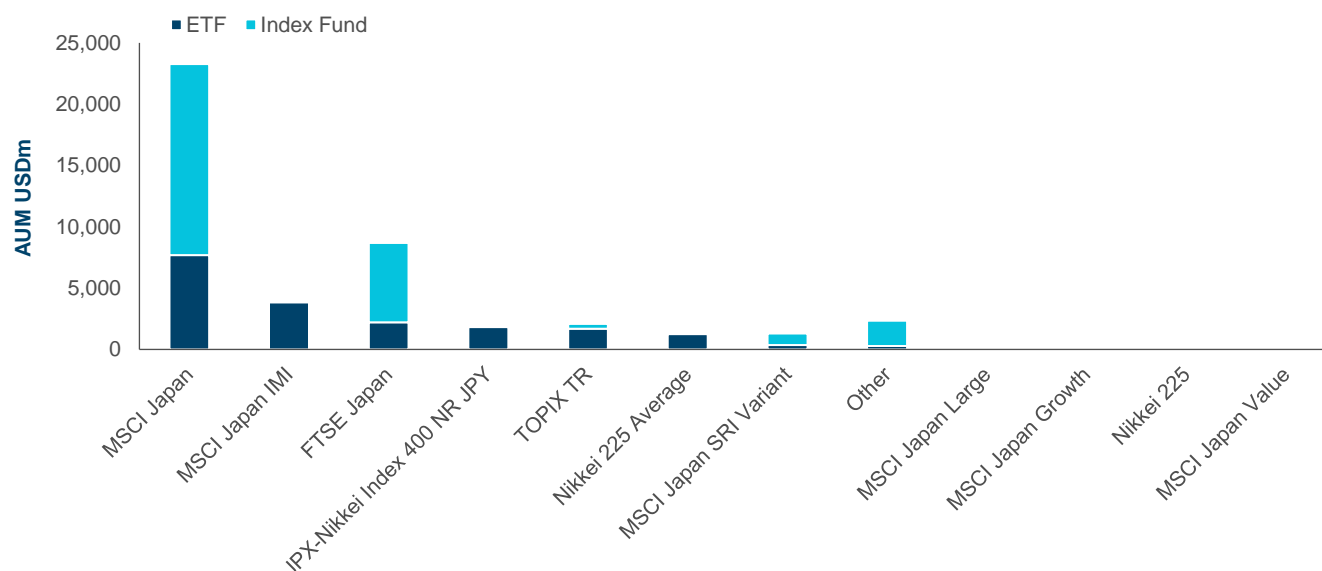
An interesting, and somewhat under-acknowledged, aspect of the Japanese equity market is its high association with passive investing. Indeed, for non-domestic investors, Japanese equities and passive investing have traditionally gone hand in hand given that (i) Japan is often confusing/misunderstood and (ii) many investors often want to trade Japan on a short-term, liquid basis rather than investing over the long term in Japan's best domestic and export-oriented companies.

Certainly, the irony here is not lost on us, as it is these very reasons that make Japan such a compelling proposition for active managers.

Passive and exchange-traded fund (ETF) investing still dominate non-domestic Japanese equity exposure (Figure 1). This is suboptimal in our view, especially given that passive exposure is often benchmarked against the MSCI Japan Index, which is only representative of the largest market capitalization segment of Japan.

Figure 1: Passive Investment Flows in Japan are Heavily Biased

As of July 31, 2018



Source: Morningstar Direct.

For passive investors, this has led to the unintended consequence of being exposed to the full absolute volatility characteristics of Japan, given the larger-capitalization segment tends to the most cyclical area of the market. The higher liquidity of the MSCI Japan Index also leads to being fully exposed to the ebbs and flows of international investor sentiment (and, hence, the full impact of passive investor flows as they churn in and out of Japan). Over the trailing 3-, 5-, 7- and 10-year periods, benchmarking to the MSCI Japan Index also led to lower returns versus an all-cap approach utilizing the broader (in economic terms) TOPIX Index.¹

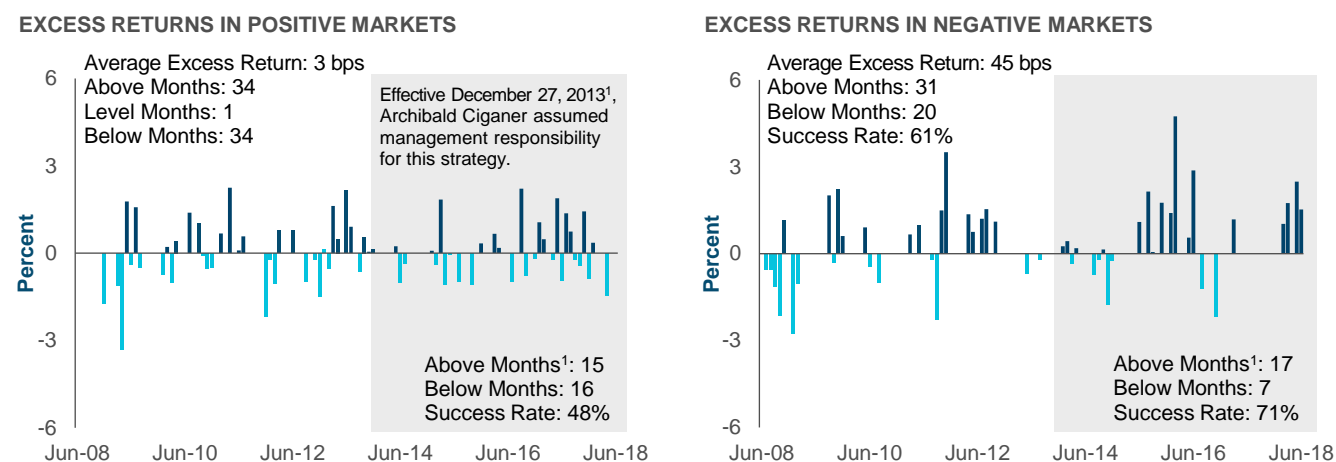
Why is the MSCI Japan Index so widely used then? Because it is easier and cheaper to replicate for passive managers and commands a lower fee. Replicating a broader, all-cap index like TOPIX would mean more focus on smaller-cap stocks, adding time, difficulty, and cost. The pivotal question here is: Are investors aware of the return sacrifice and the volatility premium associated with passive investing in Japan versus alternatives? Only individual investors can answer definitively, but we believe that, in many cases, this is not the case.

Meanwhile, the changing nature of Japan, together with the market inefficiencies mentioned, has created a fertile environment for bottom-up, quality-oriented, and long-term-focused stock pickers in Japan.

Our approach to exploiting the opportunity in Japan is to use our local and global research knowledge to find stocks that are on the right side of change or undergoing positive transformation. We then construct a high conviction strategy using our best ideas to create a growth- and quality-oriented portfolio of stocks that can potentially deliver fundamental improvement over the long term. While Japan does ebb and flow on global macro data, we can demonstrate that bottom-up cash flow and earnings fundamentals matter over the long term.

Figure 2: Strong Performance Capture in Negative Markets Argues for an Active Approach

Japan Equity Composite (gross of fees) vs. TOPIX Index. June 30, 2008, through June 30, 2018



Past performance cannot guarantee future results.

¹Portfolio manager, Archibald Ciganer, assumed responsibilities on December 27, 2013, whereas composite and index returns are as of December 31, 2013 due to data availability.

Figures are calculated in U.S. dollars.

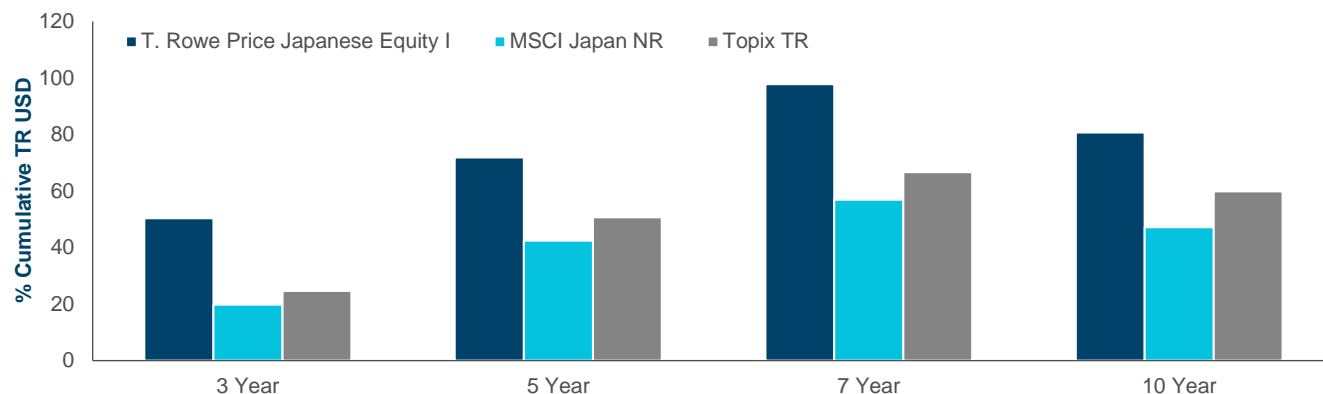
Sources: T. Rowe Price and Tokyo Stock Exchange.

The strong performance capture in a negative market of the T. Rowe Price Japan Equity Composite (Figure 2), coupled with robust, net of fees alpha generation over three, five, seven and 10 years, certainly seems to rebut the case for passive management in Japan (Figure 3).

¹Sources: T. Rowe Price and Morningstar Direct, as of 31 July 2018.

Figure 3: The Numbers Tell the Active Versus Passive Story in Japan

Cumulative Passive Returns vs. T. Rowe Price Japanese Equity, as of July 31, 2018



Past performance cannot guarantee future results.

Sources: T. Rowe Price and Morningstar Direct.

While still a dominant force in the market, we believe that passive investing in Japan, at a minimum, carries opportunity cost. This is a consideration worth active thought, especially given the maturity of the global equity cycle and the very real structural changes that are happening in the Japanese economy and equity market. Both these fundamental realities require active management in our opinion.

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