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Arcus

Buffett buys Japan – The ultimate endorsement of Abe's legacy

Summary

Two significant pieces of news have emerged from Japan since the stock markets closed last Friday. Firstly, Prime Minister Shinzo Abe announced that he would shortly be standing down on account of long-term health issues. Then, Berkshire Hathaway announced that it had acquired stakes worth USD 6bn in Japan's five largest trading companies. In this note, Peter Tasker reflects on the implications of these two events and why Warren Buffett buying into Japanese companies is the ultimate endorsement of Abe's legacy.

As Japanese Prime Minister Shinzo Abe prepares to leave office, his term cut short by illness, his policies have received an unexpected endorsement. Warren Buffett, the most successful investor in history, has just revealed stakes in all five of Japan's major trading houses. The total amount invested, USD6 billion, is slightly more than he recently put into gold miner Barrick.

Buffett is no stranger to Japan. Indirectly he owns the unlisted Tungaloy, which is a subsidiary of Iscar, an Israeli tool-maker. Veterans of the Japanese stock market will remember Tungaloy as Toshiba Tungaloy, Japan's premier manufacturer of carbide cutting tools. Founded in 1929, the company is one year older than Warren Buffett. Iscar, now wholly owned by Buffett's Berkshire Hathaway, bought Tungaloy in 2008.

In November 2011, Buffett made a highly publicised visit to Tungaloy's Fukushima factory, which had been badly damaged by the devastating earthquake and tsunami. At a press conference, he had sympathetic and encouraging words for the Japanese people and noted the quality of Tungaloy's operations.

However, what he did not do was make any investments in Japanese stocks. This was unsurprising. At the time, corporate Japan had a poor record of sustained profitability, the economy having experienced two "lost decades" of deflationary stagnation after the bursting of the bubble economy.

Buffett is nicknamed "Snowball" – also the title of a fascinating biography of the man – because he believes in the concept of compounding, one of the foundational concepts of value investing. Just as a small snowball can grow larger and larger as it rolls down a hill, so constant good returns can accrete into a large sum over time.

As of 2011, there were no large companies with track records solid enough to match Buffett's criteria. Things are very different now. In his statement, Buffett was unusually effusive, declaring himself "delighted to have Berkshire Hathaway participate in Japan's future", and hinted at exploring co-investment opportunities and increasing his stakes in the trading companies later. He also made it clear that this was his personal call, not a decision by one of his portfolio managers.

Prime Minister Abe must have been happy to hear the news. Back in September 2013, he rang the bell for the start of trading at the New York Stock Exchange and exhorted investors to "buy my Abenomics", referring to the package of reflationary measures that he had introduced at the start of that year.

It was a bold calculated bet, establishing that the performance of the Japanese stock market would be a crucial measure of Abe's success. No previous Japanese leader had elevated the stock market in such terms. Indeed, politicians in most countries are leery of commenting on stock markets because their gyrations are so unpredictable.

In normal circumstances, such caution is sensible. But when the Abenomics bull market started in November 2012, economic conditions in Japan were anything but normal. After two decades of chronic financial crisis and deflationary stagnation, Japan's nominal GDP was no higher than it had been twenty years previously and the TOPIX Index of stock prices was languishing at roughly the same level as in 1983. As far as international investors were concerned, Japan had dropped off the radar screen.

Put simply, Abe's plan of resurrecting Japan as a confident, independent geopolitical player would never succeed without economic revival – and that could not happen without a decisive end to the long drawn-out bear market in stocks.

So now that the Abe era is coming to an end, how does his track record stack up? Between December 2012 and September 2020, TOPIX produced an annualised total return (including dividends) of 8.6% in dollar terms. That is a far cry from the 14.7% generated by America's S&P Index, which has been in one of the longest and strongest bull markets in history. However, if we compare Japan's performance with the 5.9% generated by the rest of the world – as measured by the MSCI World ex USA Index – it looks highly creditable.

Furthermore, the rise in Japan's stock market has been driven by improved corporate fundamentals, not any inflation of valuations. From 1954 to 2012, Japanese profit margins moved in a 1% to 4% range, which is exceptionally low by international standards. But as of 2019, margins had soared to 6%. The biggest improvement was in not in the export sector but amongst the overwhelmingly domestic non-manufacturers, as sectors like construction stopped taking on low-margin work.

The valuations speak for themselves. Until Covid-19 burst upon the scene, TOPIX's price-to-earnings ratio was at fifty year lows. The current price-to-book-value ratio of 1.17 tells a similar story. And Japanese book value is mainly backed by tangible assets, including a vast stockpile of cash, rather than the "goodwill" from M&A activity and other intangibles that makes up 70% of US book value.

Likewise, for the first time in living memory, Japanese stocks are offering a solid real dividend yield of 2.4%. Pre-Covid-19, this was enhanced by share buybacks amounting to between 1% and 2% of market capitalisation. Japanese pay-out ratios are still low by European let alone American standards, so more progress is likely if and when corporate confidence recovers from the Covid-19 shock.

Abe was not directly responsible for all these changes in corporate behaviour, but his espousal of governance reforms changed the weather in terms of the relationship between company managements and investors. Japan's stewardship code and governance code are not compulsory, but peer pressure is a powerful force.

Today, nearly all listed companies have investor relations departments and most are willing to answer in-depth questions about company operations. This was far from the case in the early years of this century. In a poacher-turned-gamekeeper move, some companies have recruited ex-investment bank personnel to staff their IR departments. A few are foreigners, which, again, would have been unthinkable in former times.

Abe also converted the Government Pension Investment Fund ("GPIF") from a sleepy backwater, whose main function was hoovering up Japanese government bonds, into a sophisticated multi-strategy asset manager. The GPIF, usually reckoned to be the world's largest pension fund, is now a trailblazer for governance reform and Environmental, Social and Governance ("ESG") principles in Japan and a role model for other domestic pension funds.

Abe's record is by no means flawless. Two unnecessary hikes in the consumption tax, the last enacted just as the Covid-19 virus was emerging in China, crushed the economy's reflationary momentum. Inflationary expectations – as measured by 5-year inflation swaps – have round-tripped from sub-zero to 1.4% and back again. All the monetary policy innovations of Bank of Japan Governor Haruhiko Kuroda were for naught without expansionary fiscal policy working in tandem.

Overall, though, Abe leaves Japan's investment scene in far better shape than he found it. If his successor continues in the same vein – hopefully adding fiscal policy to the mix – investors should be well pleased. Warren Buffett seems to think so too.