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JAPAN'S NATIONAL STRATEGY: HIGHER STOCK MARKET RETURNS

Summary

- Japan is intent on democratising investment, with domestic equities the main focus
- Financial inducements to investors dovetail with greater shareholder returns as encouraged by the Tokyo Stock Exchange's new market structure
- The explicit emphasis on companies with suboptimal capital structures should bring value stocks into focus

Disclaimer

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Change in Japan can seem slow and undramatic by Western standards, but the result often amounts to a significant and durable transformation in attitudes and ideas. That has certainly been the case with corporate governance and the role of capital markets. A series of gradual reforms, few of them compulsory, have created new relationships between investors and company managements. The process continues to build.

Last year, the Tokyo Stock Exchange ("TSE") set up a new market structure, dividing listed stocks into three categories, each with its own rules – the Prime section for blue chips, the Standard section with somewhat laxer listing requirements, and the Growth section for younger companies that could not be expected to maintain stable levels of return on equity and other metrics.

The general response from investors at the time was one of disappointment since many companies took advantage of the transitional arrangements, which allowed companies to "explain" if they were unable to "comply" with the new requirements. That judgement now looks over-hasty. The TSE has recently released a discussion paper that goes much further and clarifies the long-term strategic direction.[1]

It starts by making it plain that the TSE itself has an active role to play in restructuring corporate Japan. M&A (Mergers and Acquisitions) is welcome.

"In Japan's economy, the lack of a smooth transition of personnel and capital resources to growing areas has led to a prolonged slump in productivity... individual listed companies can not only take measures independently, but they can also consider ways to increase productivity by exchanging factors of production and by implementing M&As with other companies. It is important for TSE to make a framework to encourage such efforts and thereby contribute to the improvement of productivity in the Japanese economy as a whole."

The TSE goes on to cite the recent significant expansion of the "NISA" (Nippon Individual Savings Account), originally modelled on the UK's ISA (Individual Savings Account) scheme. In a mid-January speech, Japanese Prime Minister Fumio Kishida declared that it was now "national strategy" to support individual investors and targeted "a doubling" in investment returns – a deliberate allusion to Japan's feat of doubling GDP (Gross Domestic Product) in the 1960s. To that end, the annual limit on NISA investment will be trebled and the tax-free period made permanent.

The UK's scheme, which has been going for several decades, is considered highly successful. As of 2020, according to HM Revenue and Customs[2], the total value of assets in the scheme was GBP 620 billion. Of that, roughly half was in stocks and shares. Given the relative size of financial assets and population, it would not be ridiculous for a Japanese equivalent to reach a long-term target of Yen 100 trillion in marketable securities. On a relative size of financial assets basis, a successful Japanese NISA would be even larger.

The policy predates the Kishida administration. The Japanese establishment is fully aware of the economic burden of its ageing population and believes that higher private investment returns can reduce the strain on the public finances. Tax breaks are an important inducement, but it is vital that that Japanese stocks are seen as an attractive asset class for the idea to work.

[1] https://www.jpx.co.jp/english/news/1020/p1j4l400000014ul-att/p1j4l400000014x9.pdf
Exchange & beyond Summary of Discussions on Measures to Improve the Effectiveness of the Market Restructuring Tokyo Stock Exchange, Inc. January 30, 2023.

[2] HM Revenue and Customs (His Majesty's Revenue and Customs, or HMRC) is a non-ministerial department of the UK Government responsible for the collection of taxes, the payment of some forms of state support, the administration of other regulatory regimes including the national minimum wage and the issuance of national insurance numbers (Source: Wikipedia).

In its recent paper, the TSE panel commented as follows:

"At this time, the government has decided to fundamentally expand and make permanent the NISA program in order to achieve financial inclusion, whereby the benefits of the financial and capital markets are widely available to all citizens, and the foundation has been established for households to actively shift their assets from savings to investments… Under these circumstances, in order to ensure the effectiveness of the market restructuring which was implemented for the purpose of contributing to the improvement of listed companies' corporate value, and to make this an opportunity for real change, it is essential that TSE continue to work on reforms with a sense of urgency…"

Here the panel warns that the transitional period will soon end and that non-compliant companies will risk delisting. Steps will be taken to make the process as smooth as possible, but delisting would be traumatic and shameful for the company involved. Senior management would do anything to avoid such a fate.

Finally, in a section that should gladden the hearts of value investors, the panel demands that companies whose stocks are trading below their book value should do something about it.

"Considering that the purpose of this market restructuring is to contribute to the improvement of corporate value of listed companies, it will be meaningless unless we address the fact that about half of all listed companies have a PBR (Price-to-Book Ratio) below 1… in particular, companies with a PBR consistently below 1x should be required to disclose their policies and specific initiatives for improvement."

Note that 53% of TOPIX (Tokyo Stock Price Index) constituents currently trade below book value, with 37% below 0.75x and 16%, or 348 names, trading below half book value. If managements were to take these admonitions seriously, the result would be a bonanza of large-scale share buybacks, the quickest and simplest way to raise the Price Book Ratio.

	Number of Stocks	% of TOPIX
< 1x PBR	1,152	53%
< 0.75x PBR	808	37%
< 0.5x PBR	348	16%

Source: Bloomberg as of 9th February 2023

Shame and marginalisation are powerful incentives in Japan. We expect a positive response from a wide range of companies as managements sense which way the wind is blowing.