M&G Investments

M&G Insights

Japanese equities: Optimistic about returns

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Carl explains why M&G Investments is optimistic about the longer-term risk/reward opportunities in the Japanese equity market, and how the M&G team uses a unique approach incorporating "value-added shareholdership" to enhance the chances of outperformance in the strategy.

Since the advent of "Abenomics" in 2013, which kick-started the reform of corporate management attitudes and business practices in Japan, listed companies have (even if gradually) been implementing real internal reform and focusing more on delivering improving returns on capital and higher profit margins for their investors. Higher efficiencies, lower costs, the reduction of "lazy" capital on balance sheets and more effective company-investor relationships have all contributed to the impressive 9%-10% annual earnings growth reported by Japanese companies over the past decade – beating the S&P 500. This has been largely independent of the country's GDP growth and other macroeconomic trends, which have generally been weak. Although we do not know if this will repeat itself in the next 10 years, at M&G we believe that the drivers of that profit growth have not been exhausted, and that there is significant scope for more improvement. In fact, we are optimistic that compounding double-digit returns can potentially be delivered over the next decade by choosing the right companies at attractive valuations, with additional value provided by our active engagement with company management.

Plausible mid-teen returns

Why do we believe the Japanese equity market can deliver total annual returns in the mid-teens (possibly around 15% p.a.) going forward? There are several key driving factors:

1. **Earnings growth:** In the most recent reporting periods, many companies have indicated they are aiming to compound their earnings per share (EPS) growth by between 7% and 20% p.a. over the longer term, primarily by becoming more efficient and competitive. Although some will over- and undershoot their targets, based on their concrete plans we estimate that collectively it is plausible to achieve a conservative 8% p.a. compound return from earnings growth.
2. **Dividend yields:** Currently, company dividend yields are at 2.4% p.a., which we see as a reasonable and sustainable level with the potential to rise given the still relatively low payout rations prevalent in Japan. This is a valuable addition to total return.
3. **Dividend growth:** In the last decade, dividends have grown faster than earnings as payout ratios have increased. Based on our research, we estimate an additional 1% p.a. in compound returns from dividend growth over time.
4. **Share buybacks:** The last component of the total return should come from share buybacks as companies put the spare cash on their balance sheet to work or convert expensive assets like real estate to cash, for example. With the market buying 2%-3% of itself back every year, we could expect an extra 3% p.a. of total return to come from the share price increases stemming from this.

Adding these four drivers together, we derive a plausible compound total return of roughly 15% p.a. over the next 10 years or so that investors could benefit from. Note that this estimate is independent of shorter-term economic and business cycles, since company growth is coming from self-help. Also importantly, this does not include the possibility of a re-rating of companies or the market by investors, or any additional alpha derived from astute stock-picking. The Japanese equity market is fairly inefficient, creating stock mis-pricings that the M&G team can take advantage of when appropriate.

How does M&G create alpha?

With 20 analysts and fund managers in the M&G Asia Pacific investment team, supported by numerous specialists in ESG, dealing, technology, etc. we have real depth of experience and knowledge based across the region and in London that we employ to choose the stocks with the best chances of outperformance for our strategy. While being benchmark-cognizant in our approach, we are high-conviction stock-pickers, with a strong focus on portfolio construction and pricing of risk, such that the Fund's risk and return are driven by company-specific characteristics. We are also valuation-conscious, selecting stocks that we believe are being mispriced by the market (usually due to the differentiated perspective we have based on our research and understanding of the company), and include a margin of safety to help mitigate losses when we (inevitably) make mistakes.

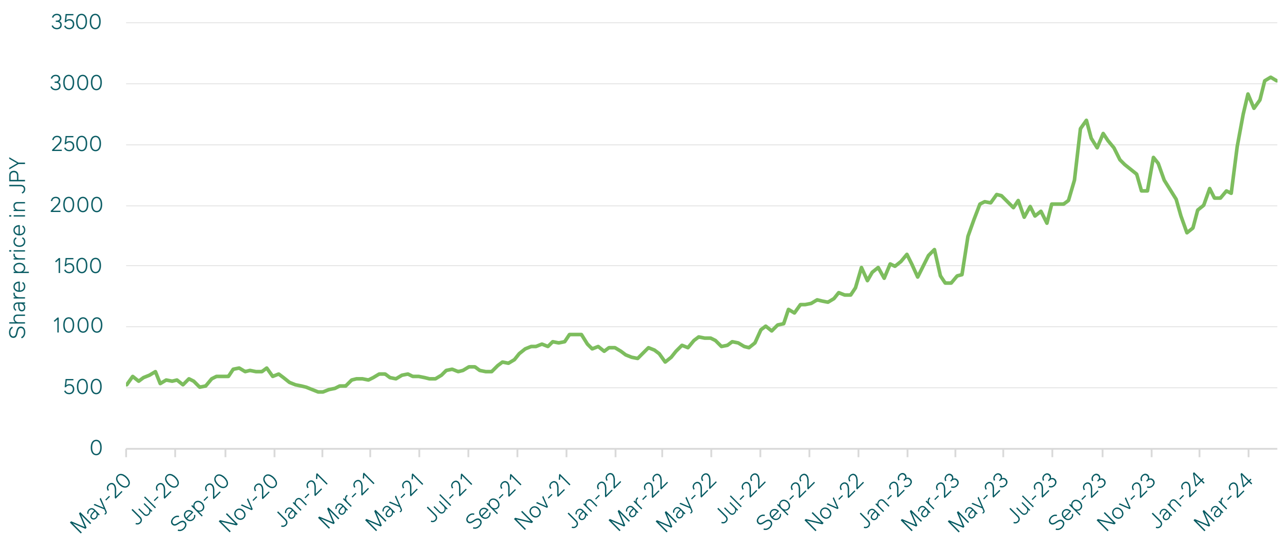
We also seek to add alpha through our engagement-oriented, value-added approach as shareholders. We have been refining our global engagement programme since 2005, but have only been able to apply it effectively to our Japanese holdings in the past five years or so, as corporate behaviour has been transforming. This window of opportunity, in which companies have become more accepting of investor advice, has allowed M&G to actively participate in value creation for companies in which we invest, with demonstrable results. And this trend has been accelerating, reinforced by ongoing government policy and regulations offering carrots and sticks to help keep businesses on an improving path.

Sanrio: Pencil cases versus TikTok

An excellent example of how our process has allowed us to add value to our client portfolios is our investment in Sanrio, which owns the popular Hello Kitty brand. The company had been highly successful with its merchandising since its creation in 1974, reaching higher global merchandising revenues than even Disney with Mickey Mouse, and close to those recorded by the Frozen franchise. Yet the company had been in a "steady as she goes" state for many years, relying on its traditional sales base and channels to maintain its ongoing operations and with little expansion. As a consequence, its market capitalisation was still relatively small, at around US$1 billion. When Sanrio's 93-year-old founder/Chair/CEO stepped down in 2020 and his 31-year-old grandson took over, we decided to buy the stock based on only one positive metric: growth potential. Although its valuation was not cheap, we recognized that its share price did not adequately reflect the potential value of the Hello Kitty brand. The company had not been living up to its potential because management hadn't kept up with social and technological change and was not using its intellectual property (IP) effectively: for example, it was still putting the Hello Kitty brand on pencil cases, not on TikTok.

Graph 1

Sanrio: An ongoing success story



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Past performance is not a guide to future performance.

Source: M&G DataStream April 2024

As Graph 1 shows, after we purchased Sanrio stock at between 500-600 yen per share in March 2020, its share price rose steadily. As part of our active, value-added shareholdership approach, over the course of several in-depth engagements with management we were able to help them find expert outside IP managers for advice on how to improve. We also advised them on other strategic measures, such as focusing more on its other operations in order to diversify its revenues. Today the group is generating record profits and its share price has risen to around 3,000 yen per share. We did take some profit in our holdings in early 2023 when the share reached 2,500 yen but added back exposure again in late 2023 and early 2024 ahead of the company's results announcement in February 2024, which resulted in a 56% rally in the share during the first quarter of the year. Our engagement programme helped us develop a deep understanding of Sanrio, working with the company to unlock value and create an excellent investment opportunity.

Is it too late to invest?

The Japanese equity market has rallied by approximately 50% over the past 18 months, with investors having recognized its excellent value as company earnings grew. However, even after this strong rally, the price-earnings ratio (P/E) of the TPX 100 is only trading in line with its long-term history at around 16.3X, and breaking it down further, 48% of listed companies have P/Es of less than 15X. and 24% are trading at P/Es above 30X. In our view, valuations remain reasonable, having risen from exceptionally cheap levels and compared to the US, where the S&P 100 has a P/E of 25.8X, and only 15% of listed companies are trading at P/Es below 15X.

So, with nearly half of Japanese listed companies trading below the market's long-term P/E, we believe there are still plenty of opportunities for experienced stock-pickers to identify attractively valued companies. Corporate behavioural change is continuing to manifest in investment opportunities, not only through improved use of capital, but also through changes to commercial strategy. These factors reinforce our case for the plausibility of compound total returns of around 15% p.a. to be delivered by Japanese equities over the next decade, with the management team of the strategy aiming to continue taking advantage of these attractive factors going forward. South African investors have access to some of the best investment ideas via the M&G Global Equity Fund (in US$) and the M&G Global Equity Feeder Fund (in rands).