Fund Manager Q&A
July 2020

Japan – a land of economic stagnation and rising opportunities?

***Sophia Li, Portfolio Manager,** joined FSSA Investment Managers as a graduate in 2009. Over the years, she developed an extensive coverage of companies in North Asia, leading to the launch of the team's dedicated Japan strategy in 2015.*

This Q&A was developed for the Japan strategy's 5-year anniversary.

What attracted you to launch a dedicated Japan strategy?

Japan has been overlooked by global investors, due to macro headwinds such as an ageing population and anaemic GDP growth. Japan is also only considered as part of a global asset allocation strategy; or sometimes as a macro trade due to the misperception of its high cyclicality. However, in our view, Japan offers a deep investment universe of high quality companies that generate sustainable growth.

Secondly, Japan is very much under-researched. More than 40% of companies do not have any local coverage. Therefore, we believe it is the perfect country for us to generate active returns for our investors, especially with our bottom-up stock picking approach and benchmark agnostic investment philosophy.

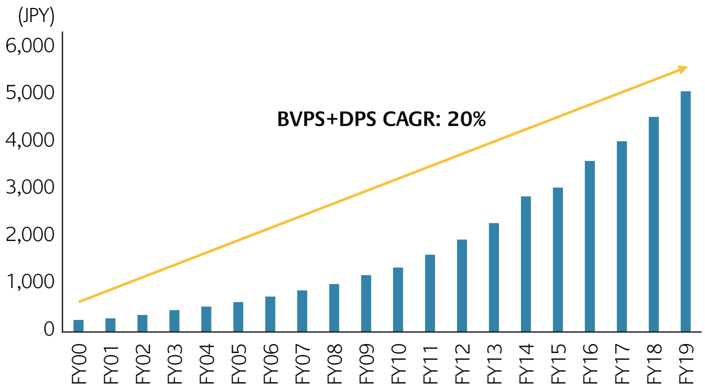
Personally, I have a strong passion for the Japanese culture and back then, I was thrilled by the idea of building a franchise from scratch. We have a famous saying in our team, that if you put a fence around people, you will only get sheep. Therefore, I think it is the autonomous culture of our team that has given me this great opportunity to launch a dedicated Japan strategy.

Japan, from an economic macro point of view, has been stagnant for the past two decades. How do you counteract that kind of lens in your strategy?

We have always told our investors that investing in a number of high-quality Japanese companies is not equivalent to investing in the economy itself. After going through decades of economic stagnation, a large number of companies have emerged in Japan with the ability to grow their earnings without relying on leverage or the macro economy.

A good example would be Nitori, which is the largest private-label furniture retailer in Japan. Nitori has grown its book value per share plus dividend by more than 20 times in the past two decades. The chairman believes that economic conditions should never be a part of their growth assumptions.

Nitori: Long-Term Compounded Growth
Book Value Per Share + Dividend Per Share



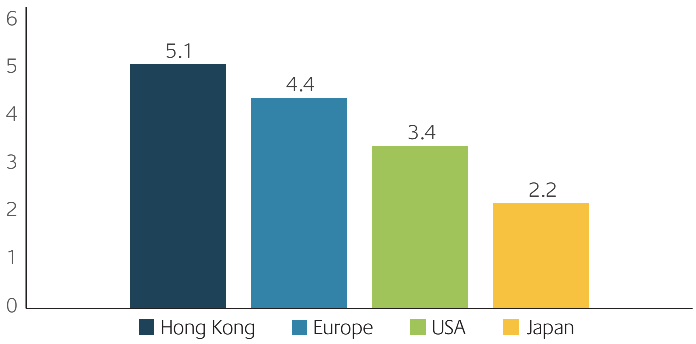
Source: Bloomberg, as at 30 June 2020

In summary, it is the global expansion, the product innovation, the unique business models, the strong management teams and an increasing focus on return on invested capital that have contributed to the growth of good companies in Japan.

What have been the greatest opportunities over the past five years?

Japan is an under-researched market and the companies are less sophisticated in terms of investor relations compared to other developed markets.

Japan Market Analyst Coverage
# of Analyst Per Covered Company



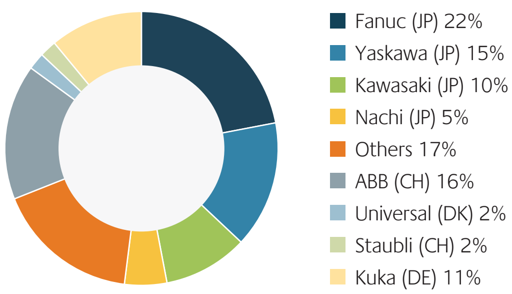
Source: Bloomberg, Jefferies as at 30 June 2020, primary listed companies only

Every year we host around 200 to 300 corporate meetings, which serves as the foundation of our idea generation process. Over the years, we have managed to find a number of hidden gems that have created phenomenal investment returns for clients.

Among the companies that we like, there are strong, global franchises that have dominant market share in industries driven by secular growth. For example, machine vision, medical equipment and semiconductor products.

Japan is a global leader in industries that require precision manufacturing and state of the art technology. For example, more than 50% of industrial robots globally are made by Japanese firms and we believe that penetration will continue to rise.

Industrial Robot Market Share By Company



Source: CLSA, as at 31 December 2019

Secondly, despite the ageing population, strong Japanese consumer brands should benefit from better demographics elsewhere, such as in Asia, which accounts for more than 60% of the global population. Chinese consumers are particularly fond of "Made in Japan" products, which focuses on innovation, quality and have strong attention to details.

There are even more investment opportunities amongst the purely domestic companies. Examples include e-commerce, which has a very low penetration rate of only 7%, and discounted private-label retailers, which would benefit from the entrenched mindset of deflation amongst the Japanese consumers.

Lastly, software as a service (SaaS) is growing rapidly from a low base - thanks to very low penetration rate of only 14% in Japan, compared to more than 50% in the United States. In short, "no growth" in Japan is the biggest misconception amongst global investors.

What about the greatest challenges over the past five years?

Occasionally, the Japan market suffers from high volatility caused by the high turnover from foreign investors. Stock performance could deviate significantly from the fundamentals. However, we consider market volatility or mispricing as our friend rather than our enemy, thanks to the strong conviction that we have built up amongst the companies that we own.

Another challenge would be the sector or style rotation in Japan. However, because of our benchmark agnostic investment philosophy and the high active share of the strategy, this does not pose a huge challenge for us.

We do not really try to catch all the waves; instead we only focus on investing in companies that are run by strong management teams and have long-lasting franchises.

Looking back at our performance since inception, our strategy is not all-weather – the majority of active returns were generated by being resilient during down markets.

Japan does not score very highly on ESG metrics. What are your takeaways from having researched companies in this context over the past five years?

In my view, there are mainly two key corporate governance issues inside Japanese firms. There is a lack of internal controls and checks and balances at the board level; and a lack of focus on shareholders' return.

Today, most Japanese companies still believe that the companies are actually owned by employees and that their purpose is to serve customers and the general society. Therefore, from time to time, they may prioritise the interest of all stakeholders above shareholders. In other words, Japanese companies have actually done quite well in terms of environmental and social responsibilities.

However, since the corporate governance reform began in Japan many years ago, Japanese firms have made the effort to improve the overall corporate governance. For example, they have returned more cash back to shareholders and increased the number of independent directors and female board members. Besides that, they have also disposed of non-core or loss-making assets to improve their return on equity.

Any change happens quite slowly in Japan. After multiple conversations with companies in our portfolio, we have seen improvements, for example, in Pigeon, which increased the number of independent directors on the board and abolished the retirement allowance of the board members, replacing it with a performance-based incentive system.

Source: Company data, as at July 2020