Month In Focus 082016

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Revisiting Japanese Shares

A Viewpoint from the Investment Team

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Japanese shares have been, and continue to be a key holding in our portfolios. As valuation driven investors, we are often asked, what is it about Japanese shares that led us to such high levels of conviction? And importantly, with the strength in Japanese shares since we first initiated our position in 2012, *does the investment case for Japanese shares still stack up*?

The Investment Case – 2012

We initiated a position in Japanese shares in 2012. At the time, we felt that:

- **Japanese shares offered attractive valuations.** This followed a period of sustained weakness in the Japanese share market, which coincided with the European Financial Crisis and the aftermath of the Fukushima nuclear disaster in 2011
- **Earnings were at very depressed levels**, with the potential for revenue and profit margin improvement. This was due to Japanese company management teams becoming more focused on delivering better return outcomes for shareholders and no longer needing to repay historically high levels of borrowings.

How has that played out?

Japanese shares have enjoyed a tremendous run. In the four years to June 30 2016, the MSCI Japan Index (with dividends reinvested) is up more than 70% in local currency terms. Importantly, we have seen an improvement in profit margins and earnings – consistent with our initial investment case. In addition:

- Company earnings have broadly kept pace with share price increases. This differs to other regions (most notably the U.S.) where increases have largely been driven by someone else paying a higher price for your shares, which have had little to no increase in earnings. In other words, Japanese shares have been backed by actual increases in company profitability.
- Dividends and buybacks in absolute terms have been increasing. To highlight this point, dividends were more than 50% higher at June 2016 versus December 2012.

So where to from here?

We are looking for profit margins, earnings growth, and/or capital management initiatives (which increase returns to shareholders via increased buy-backs and/or dividends) to remain steady and/or improve further over time. We believe this is achievable, for the following reasons:

- Japanese companies are flush with cash and have ample scope to increase dividends and/or buybacks.
- Profit margins and return on equity (ROE) currently lag western peers offering the opportunity for upside through improved governance. This is particularly the case for domestic-focused companies (as opposed to the exporters).
- Under 'Abenomics', the Japanese government is adopting a pro-corporate governance stance, underscoring the cultural change to improve governance, (notwithstanding that the structural reforms will likely take some time to implement). In this respect, we would view the recent upper-house election result, in which the Abe-led coalition won with a strong majority, as renewed endorsement of this structural reform.
- An increasing focus on industry consolidation and offshore mergers and acquisitions is delivering earnings growth.

Conclusion

The outlook for Japanese shares remains positive, supported by attractive valuations and compelling fundamentals. Japanese company management teams continue to focus on improving shareholders returns. Accordingly, Japanese shares remain a significant position in our portfolios.

For further information on investment management products and services, please contact our Distribution Team on +61 2 9276 4550 or email AUDistribution@morningstar.com

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