The Japan Update

August 2014

Improved ROE could spur Japan stocks higher

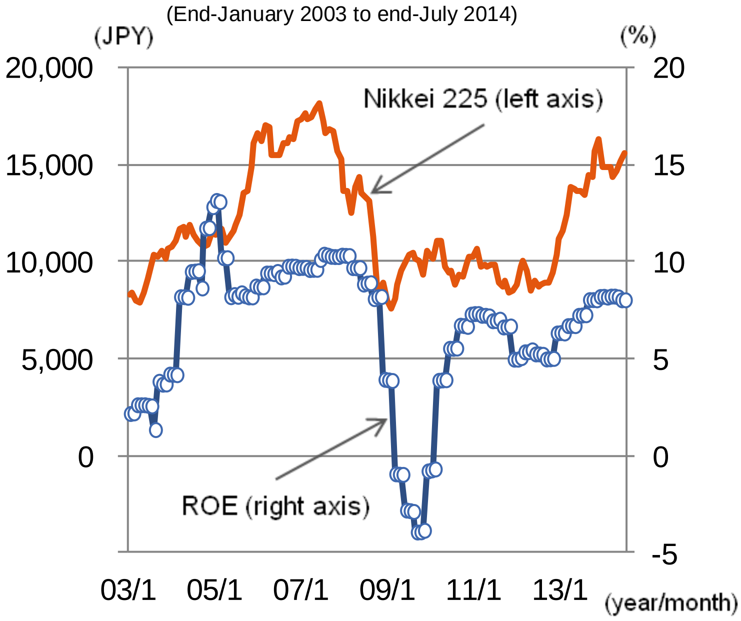
As part of its growth strategy, the Japanese government has proposed strengthening corporate governance. The proposal aims to enhance the profitability of private sector firms and ultimately to improve the economic lot of the general population. Against this backdrop, Japan's Financial Services Agency and the Tokyo Stock Exchange began in August to draft guidelines on corporate governance.

One benchmark for the success of the corporate governance initiative will be whether or not the return on equity (ROE) of Japanese companies can be brought up to global standards. ROE is an indicator of how effectively a company makes use of its capital; typically, the higher a firm's ROE, the greater its earnings power will be. Currently, the ROE of Japanese stocks (specifically, components of the Nikkei 225) is approximately 8%, which pales in comparison to roughly 19% for U.S. stocks (Dow Jones Industrial Average components). This is likely one reason why Japanese stocks still lack appeal for overseas investors. Taking the situation into account, the government has drafted Japan's Stewardship Code, which encourages institutional investors to improve the management of the companies they invest in through the exercise of voting rights. It has also amended laws to facilitate the appointment of outside directors in order to bolster management oversight. The government's ultimate aim is to urge companies to take steps that will improve their profitability, such as actively investing their already-high cash reserves, rather than just hoarding more cash.

Thanks to the bold monetary easing policy which has been implemented by the Bank of Japan since last year, Japan's economy is edging closer toward ending deflation and realizing price inflation. With the onset of inflation, the value of money will fall, undercutting the incentives for companies to accumulate surplus funds. We can therefore expect to see more and more companies using their excess cash to make investments, execute M&As, and provide higher returns to shareholders in the form of increased dividends or share buybacks.

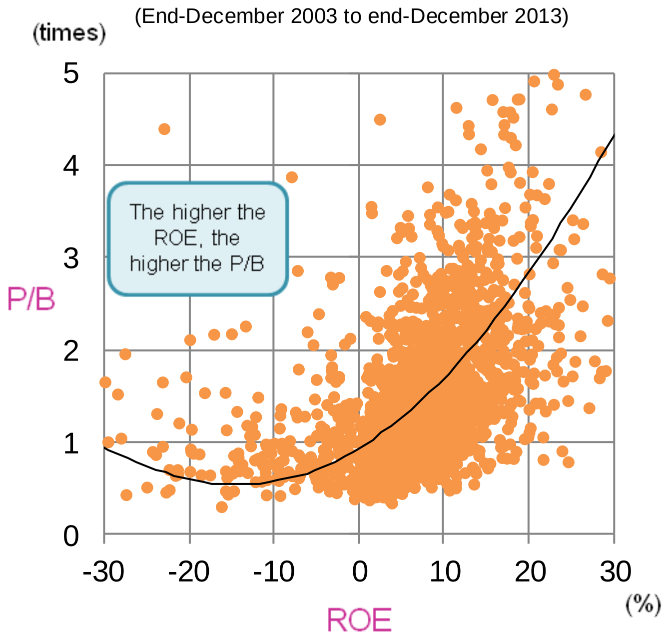
While Japanese stock prices and ROE of underlying businesses have tended to follow a similar trend, looking at the relationship between ROE and the price-to-book multiple (P/B) in the Japanese market, we can see that a higher ROE also tends to correlate with a higher P/B. We can therefore assume that increases in ROE will probably lead to higher stock prices. If Japanese companies, which have so far built up cash reserves in preparation for future uncertainty, are pushed into making more active use of their surplus funds by the government's initiatives and because of impending price inflation, we could see stock prices climb higher as companies' ROE improves.

Nikkei 225 Price Movements & ROE



ROE is calculated for Nikkei Stock Average constituents.

Correlation Between ROE and Japan Equity P/B



Year-end data for Nikkei Stock Average constituents (as of end-July 2014) is used both for P/B and ROE. With outliers removed, ROE in the +/- 30% range and P/B below 5 times were plotted on the graph above.

Sources: Nikkei, Inc.; Tokyo Stock Exchange, Inc.; Nikko AM.

The charts above are based on past data and do not guarantee future outcomes.

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Important Information:

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