

Kai Lam
Vice-President & Portfolio Manager

SPECIAL REPORT

Japan: Opportunities Emerging for the Patient, Tactical Investor

We recently returned from Japan, where we visited 16 companies from a number of industries and attended presentations from business and political leaders on a variety of topics ranging from corporate governance to pension fund trends.

While the factors that are currently benefiting Japan are well documented – a weaker currency, lower energy prices, increased inbound tourism and improved corporate governance – the greatest insight we derived from the visit related to the *pace* of change in Japan, both from an economic and corporate culture perspective.

Positive changes are indeed happening, but it is important to monitor the pace of these changes relative to expectations.

POSITIVE INDICATORS

Japanese companies continue to benefit from the lower Yen, lower energy prices and loose government monetary policies, including “quantitative easing”.

Japanese inbound tourism is also booming. While the government has targeted 18 to 20 million visitors by 2020 – the year Japan is slated to host the Summer Olympics – they may achieve that target much sooner. In the first quarter of this year alone, Japan had 4.1 million visitors, up 43% from the previous year. This boost in tourism will likely be positive for several industries, including travel and leisure, transportation, consumer goods and retail.

Japanese firms are also benefiting from the increase in equity allocations from pension funds. With a long-term negative outlook for fixed income returns due to rising interest rates, equities now appear to be the less risky choice. For this reason, the Government Pension Investment Fund (GPIF), which manages money for Japan’s national pension system and for private-sector employees, increased its equity allocation last year from 24% to 50%, with half of this invested in domestic stocks. While the pace of GPIF’s equity buying will slow from here, other public pensions have indicated that they will follow suit, ensuring continued near-term support for the asset class.

The sticky issue of corporate governance is also moving in the right direction. Japan has long lagged many developed countries in

SUMMARY

- We recently returned from Japan, where we visited 16 companies from a number of industries
- Positive changes are indeed happening, but it is important to monitor the pace of these changes relative to expectations.
- Japanese companies continue to benefit from the lower Yen, lower energy prices and loose government monetary policies
- Japanese firms are also benefiting from the increase in equity allocations from pension funds
- Even for companies that do not comply with the new corporate governance code, penalties are light
- The failure to deploy cash was also an issue
- We see significant long-term potential for the Japanese market
- We believe that investment in the Japanese market will reward investors willing to take a patient, tactical approach

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governance standards, with no requirement for outside directors and a tendency to fill boards with corporate managers. Governance reforms recently put in place are having some impact and should lead to more shareholder-friendly behaviour.

While we saw little consistency from one company to another, the overall trend is toward improved shareholder communication, an increase in independent board members and a greater number of companies deploying cash for share buybacks and higher dividends. We also saw more companies adopt the use of stock options and Employee Share Ownership Plans (ESOPs) as a means of increasing alignment between employees and shareholders.

THE NEGATIVE SIDE

While the corporate governance reform has significant potential, change is likely to occur over an extended period of time. This is due to a lack of incentive for management to enact significant change beyond the new corporate governance code's minimum requirements.

Even for companies that do not comply with the new code, penalties are light. Companies are required to provide a report in which they “comply or explain” their adherence to the code. For the most part, it is not that difficult for them to rationalize why they have violated the code.

In addition, while a number of companies we visited have incorporated rising Return on Equity targets and improved shareholder returns, compensation is generally not tied to achieving these short- to medium-term objectives. Even for companies that have introduced stock options and ESOPs, they are rarely significant enough in size to motivate material change in behaviour.

The failure to deploy cash was also an issue. The vast majority of companies we met with had ‘bulletproof’ balance sheets and free cash flow. But companies gave numerous reasons why this cash will not be deployed. These included potential acquisitions – even though companies felt prices were either too high or acquisition targets were unavailable – and higher capital expenditure investments, even though capital expenditures could be easily funded by internal cash flow or with minimal impact on cash on the balance sheet.

In addition, many companies – particularly in financial services – have a system of cross-shareholding (or holding one another's shares) as a means of cementing business relationships. These holdings can add significant risk to the company during periods of equity market volatility. Companies wishing to unwind these holdings were, for the most part, afraid of jeopardizing their business relationships with their customers. For this reason, the reduction of these holdings will be a negotiated process, and will only be reduced at a relatively slow pace going forward.

The overall trend is toward improved shareholder communication

Even for companies that do not comply with the new corporate governance code, penalties are light

Many companies have a system of cross-shareholding

Special Report – June 2015**THE OPPORTUNITY**

We see significant long-term potential for the Japanese market – with public pension support for equities, favourable government monetary policies, a weak currency and a significant increase to inbound tourism. And from a portfolio perspective, Japanese markets have recently demonstrated very low correlations with other global markets, which can help to lower overall portfolio volatility.

But growth through reform is the only real sustainable growth path in Japan – and the pace of progress will likely be slow. At the moment, change in corporate governance is more politically motivated, without real incentives to drive a faster pace of advancement.

Shareholders need to take a more active role in pressuring management teams to take risk or improve capital efficiency. And independent voices on company boards must provide greater compensation incentives for managers to improve returns, provide higher shareholder payouts and reduce conservatism.

For now, it's important to monitor any progress against market expectations, which may assume a faster rate of change than is likely to occur. For this reason, investors should be tactical about their positions. That means favouring companies that have already demonstrated a willingness to increase shareholder returns, generate strong free cash flow, are moving towards better capital efficiency and operate in industry segments with positive tailwinds.

We believe that investment in the Japanese market will reward investors willing to take a patient, tactical approach. The pace of change may be slow, but the direction of change remains positive.

**Investors should be tactical
about their positions**

Kai Lam

Vice-President & Portfolio Manager

Mr. Lam is a Vice-President & Portfolio Manager focusing on global equities. Mr. Lam received a Bachelor of Commerce degree with First Class Honours from Queen's University. He has also earned his Chartered Financial Analyst (CFA) designation. Prior to joining Gluskin Sheff in 2001, Mr. Lam was Vice-President of Research with Thornmark Asset Management focusing on North American equities. Prior thereto, Mr. Lam was with CIBC World Markets as an Institutional Equity Research Associate.

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PROVEN¹

\$1 million invested in our flagship GS+A Premium Income Portfolio in 2001 (its inception date) would have grown to approximately \$5.5 million² on April 30, 2015 versus \$2.8 million for the S&P/TSX Total Return Index³ over the same period.

Similarly, many of our other long-standing investment strategies have outperformed their relevant benchmarks.

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For further information, please contact research@gluskinsheff.com

Notes:

1. Past returns are not necessarily indicative of future performance. Rates of return are those of the composite of segregated Premium Income portfolios and are presented net of fees and expenses and assume reinvestment of all income. Portfolios with significant client restrictions which would potentially achieve returns that are not reflective of the manager's portfolio returns are excluded from the composite. Returns of the pooled fund versions of the GS+A Premium Income portfolio are not included in the composite.
2. Investment amounts are presented to reflect the actual return of the composite of segregated Premium Income portfolios and are presented net of fees and expenses.
3. The S&P/TSX Total Return Index calculation is based on the securities included in the S&P/TSX Composite and includes dividends and rights distributions. This index includes only Canadian securities.

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