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What do Japanese equity investment and Olympic judo have in common?

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Executive Summary

Today, Japanese equity investment requires evaluation of companies from the vantage point of a CEO with a global perspective. Japanese asset management companies have entered an era they are unlikely to survive without investment strategies based on accurate assessment of Japanese companies within a global context.

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Some years ago, the term "Wimbledon effect" was coined to refer foreign financial institutions' dominance over local counterparts in the City of London. The term was an analogy between London's financial sector and the Wimbledon tennis tournament, which at the time had not been won by a British player for many years. The term is now used to describe any situation in which domestic companies fall prey to foreign rivals amid free-market competition in their home country.

NOTE

1) I heard this analogy from the CEO of a major Japanese asset management company.

A similar phenomenon is occurring in the sphere of Japanese equity investment. Call it the "judofication" of Japanese equity investment[1]. Just as judo, a sport once practiced solely in Japan, became an Olympic event, Japanese equity investment, previously the exclusive domain of Japanese asset management companies, has become a competition involving many foreign asset management companies also (and Japanese companies often end up as losers). What are the factors behind this change?

Why Japanese investors choose foreign asset managers

2) The 11 also include two smart beta fund managers.

3) Two of the nine are foreign companies managing the pension fund's assets as subadvisors of Japanese asset management companies.

4) Engagement means constructive, purpose-driven dialogue based on a deep understanding of the investee company and its business environment.

5) The four also include long-term concentrated investment funds that invest based on their assessment of investees' long-term value.

As an example, one of Japan's major public pension funds recently replaced many of its Japanese equity managers. Of its eleven[2] newly hired active managers, nine[3] were foreign asset management companies. Among the nine were four companies with no portfolio managers in Japan. The investment strategies selected by the pension fund are unconventional, not traditional styles such as value or growth. For example, the new managers include at least four that invest in concentrated portfolios of companies with high cash-flow-generative capacity based on their assessment of investee companies' longer-term value. These four include so-called value-up funds that seek engagement[4] with investees[5]. Another of the foreign asset management companies without portfolio managers in Japan has consistently delivered excess returns by investing in small-cap stocks based on quantitative analysis while minimizing transaction costs.

Why do Japanese institutional investors select foreign asset management companies for investment strategies involving Japanese equities, including even asset managers without a physical presence in Japan? One reason is that global comparative analysis now plays an important role in selection of longer-term equity holdings. Another reason is that having an on-the-ground presence in Japan is no longer necessarily an advantage in terms of stock selection.

The asset managers recently hired by the major public pension fund include companies that invest in not only Japanese but also global equities. Within such companies, teams that invest in global equities have been investing in carefully selected Japanese companies capable of successfully competing with global rivals, based on their analysis of the international competitive landscape transcending their respective home countries. These global investment teams constantly exchange opinions with fellow teams that invest exclusively in Japanese equities, thereby improving each other's ability to identify companies truly capable of longer-term earnings growth from a global perspective. As a result, such companies possess competitive investment skills even with respect to investing solely in Japanese stocks.

I heard from a London investment bank executive that having a physical presence in Japan offers little if any advantage. He said that the CEOs of over 200 Japanese companies visit London to meet with investors every quarter. In London, investors have more opportunities to meet with top Japanese executives than in Tokyo, where their access is typically limited to the director in charge of investor relations. One reason that top Japanese executives place importance on overseas investors is that overseas investors' ownership stakes in their companies have increased. Another, perhaps even more important, reason is that the executives are able to obtain valuable information by talking with overseas investors.

For example, a certain Japanese CEO said that of the investors he has met that are able to deeply discuss his company's long-term value, including capital structure optimization, 80% are foreign investors and 20% are Japanese. He went on to say that Japanese investors never share opinions that are helpful in managing his company, so he now talks about business strategy and other such matters with overseas investors only. Overseas investment managers' investee companies include not only Japanese companies but many foreign companies that Japanese CEOs view as competitors. Overseas investment managers thus occupy the same vantage point as Japanese CEOs and often have valuable insights regarding business strategy.

For long-term investors, another advantage of not being present in Japan is physical distance from information that is merely short-term noise. Quantitative investment funds also are able to do their analysis and trading from anywhere. Being located in Japan offers no particular advantage to quant funds.

Japanese managers need to upgrade their skills

Are traditional Japanese equity managers as skilled as their foreign counterparts? When evaluating Japanese companies, they likewise compare the companies with foreign rivals but, because overseas companies are outside of their investment universe, they do not analyze them as diligently as an investment manager for whom the companies are potential investees. In short, Japanese equity managers' comparative analysis is shallow. Overseas expansion is now common even among companies that have historically been dependent on domestic demand. While many Japanese companies have long had a global focus, Japanese equity managers are out of sync with this focus[6].

6) In contrast to foreign asset management companies' globalized investment style, Japanese asset management companies' Japanese equity managers' investment style is likened to Galapagos Island species by some in the asset management industry.

Japanese equity managers in Japan lack global analytical skills because they have had not made enough effort to identify companies that will truly enhance their value from among Japanese companies that, as a whole, have failed to grow in value for the past 20 years. Many Japanese equity managers have been focused on outperforming a benchmark index representative of the overall equity market, such as the TOPIX, as their investment target. Repetitive short-term trading timed to profit from share price fluctuations may have been an effective means of outperforming one's benchmark while the overall market was cycling up and down within a trading range. The skill set required to outperform in such a market environment did not include the ability to identify companies that will grow in value over the longer term.

Given such a situation, what should Japanese asset managers do to survive in the Japanese equity investment space? As one way to improve their longer-term stock selection capabilities, Japanese equity managers should acquire global equity investment skills, even if they invest solely in Japanese equities. Even in the Japanese equity market, it is no longer possible to assess a company's longer-term growth potential without dispassionately analyzing the company in comparison to global peers. To survive, it is important for Japanese equity managers, with the exception of those able to deliver large excess returns through short-term trading, to evaluate companies from the standpoint of a CEO with a long-term, global perspective. Japanese equity managers need to adopt investment strategies that revolve around accurately evaluating Japanese companies in a global context.

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