TIFF INSIGHTS

On Japan – A View from TIFF's Investment Team

TIFF's Investment Team travels to Japan to explore investment opportunities first hand.
Trevor Graham and Brad Calder

Background

TIFF has long been invested in Japanese equity markets, holding an overweight allocation versus our equity benchmark, the MSCI ACWI Index, over the past few years. Japan is the third largest equity market (7.9% of the MSCI ACWI Index as of October 31, 2017[1]) and third largest economy in the world.

Despite Japan's size and economic maturity, its stock market is relatively inefficient. Many small publicly traded companies in Japan would likely be private companies in other markets. For example, relative to GDP, Japan has roughly twice as many publicly traded companies as the U.S. Companies with market caps of less than $2 billion account for triple the percentage of the investable market as in the U.S.[2] Due to a combination of the many small public companies and decades of disappointing returns, equity research coverage of Japan tends to be thin. Many Japanese companies have poor track records in capital allocation primarily due to holding excess cash on their balance sheets for extended periods of time. Ex-cash, many Japanese businesses trade at low valuations. However, the path to more efficient capital allocation is often unclear and the overcapitalized balance sheets obscure the valuation process.

In addition, management priorities tend to be different in Japan than in the U.S. In the U.S., the top priority for most publicly traded businesses seems to be maximizing shareholder value. In Japan, however, the top priorities seem to be maximizing value for employees and customers, with shareholders often a distant third. We choose not to opine on which approach is better as a societal matter - maybe each is optimal for its own culture. However, as stewards of capital, we remain focused on the priority that management teams assign to achieving our key objective, long-term shareholder return.

Inefficiencies and quirks of Japan aside, this curious market contains some outstanding businesses. For the reasons we've noted, certain great Japanese businesses have traded at attractive valuations. As a result, TIFF has maintained an off-benchmark, high active share allocation to Japan that has added value to our comprehensive portfolios over time.

Kicking the Tires

We traveled to Japan this fall to review our existing investments and to gather information related to public policy changes implemented over the past few years. Since Shinzo Abe's election as prime minister in 2012, he has led a well-publicized "three arrows" program to boost economic growth. The first two arrows deal with fiscal and monetary policy. The third arrow is a package of public policies designed to improve capital allocation and increase long-term shareholder return. In May 2014, Japan instituted a Stewardship Code that encourages institutional investors to engage with corporate management and publicly disclose their proxy voting. In June 2015, the country instituted a Corporate Governance Code that encourages companies to have at least two outside directors, disclose return on equity targets, and report whether those targets were met, among other guidelines. We went to Japan to evaluate whether these reforms are resulting in substantive changes to corporate behavior.

[1] Source: MSCI

[2] Source: TIFF analysis of Factset data.

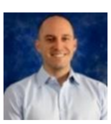
We met with multiple Japanese investment managers, several corporate management teams, the Japanese Financial Services Agency (an important financial regulator) and Institutional Shareholder Services (a global provider of advice on corporate governance and proxy voting). Through these various conversations and the analysis and research we did both before and after the trip, we've drawn several conclusions.

1. Most importantly, the various corporate reforms in Japan are directionally beneficial to investors. However, the cold, hard truth is that old habits die hard. Our hope that there would be meaningful change to Japan Inc. over the next few years now seems inconsistent with our actual observations from the field.

2. We observed that top-down guidelines from the government, while well-intentioned, are a bit of a blunt instrument. For example, the guideline that encourages companies to have at least two outside directors is a prudent idea. However, effective outside directors should have relevant business experience. Many of the outside directors in Japan, at least so far, seem to be accountants, lawyers or professors versus operators of businesses. Also, in the case of some larger boards, two outsiders may not be enough to impact decisions.

3. Our discussions in Japan revealed some additional challenges related to alignment of interests. Meaningful incentive compensation for CEOs and their direct reports continues to be very rare. An overwhelming majority of total compensation for this group continues to be standard salary. Aside from disclosure of the aggregate total compensation for certain employees, no compensation detail is provided to shareholders and Japan's financial regulators do not have any plans to introduce a document analogous to the U.S. proxy statement. Guaranteeing lifetime employment, one of the rational reasons for holding excess cash, continues to be an important objective for many companies. While the composition of boards may be changing incrementally, departing executives are still influential in determining who will replace them.

Although the Japanese government is creating incentives for beneficial change, true impact likely won't be felt until the priorities of management change. We currently like our Japanese investments more so due to the manager's value-oriented expertise than their geographic focus. Based on our recent research, we are skeptical that corporate governance reforms alone will result in higher returns on equity. As a result, we don't plan to increase our exposure to this important market in the near term. We will, however, continue to monitor developments and hope to see more fundamental change in the future.



Trevor Graham serves as a Managing Director, overseeing marketable equity-oriented assets across TIFF's investment programs.

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About TIFF
TIFF is a mission-driven, not-for-profit organization dedicated to delivering comprehensive investment solutions to foundations, endowments, and other charitable institutions. Since its inception in 1991, TIFF has exclusively served the non-profit community by providing experienced manager selection and access, risk-sensitive asset allocation, and integrated member service to institutions with long-term investment horizons.
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