Why we like the Japanese stock market

Few people talk about the Japanese market these days. Most investors are mesmerised by the American market; if they look at Asia at all, the focus is rather on China. Nevertheless, attractive investment opportunities can sometimes be found where no one else is looking. That is in accord with the well-known maxim that only unpopular assets can be truly cheap. In our view, the Japanese market may be just such a case.

Japan is seen by many as a country with slow GDP growth, an old and declining population, high debt, often struggling with deflation, and overall as a country with less long-term potential than, say, China. But it is also true that the Japanese have perhaps the longest life expectancy, a healthy population, an absence of poverty and obesity, low levels of corruption and crime, the best infrastructure in the world, and a cultured, homogeneous and educated population.

From an investment point of view, the Japanese market is still living in the shadow of the gigantic stock market bubble of the late 1980s. Even after more than 30 years, the overall market is still down by a quarter from its all-time peak. But there is another, alternative view of Japanese stocks.

Let's think about what the following products have in common?

Cars, televisions, headphones, laptops, smartphones, watches, kitchen appliances, routers, scanners, photographic devices, electric toothbrushes, Tesla batteries, HP printers, Boeing airplanes, and every Apple product.

What they have in common is that all have a high content of Japanese components. You could stick a "Japan inside" sticker on all of them.

According to Ulrike Schaede (from whose book *The Business Reinvention of Japan* I draw some information and terminology for this text), when you buy an iPhone or other smartphone, a quarter to a third of its content is from Japan (the most of any country). But among Japanese companies we can find also others that are less visible but with much more dominant market positions. For example, specialty chemicals necessary for producing semiconductors, such as fluorinated polyimide, hydrogen fluoride, and photoresist, are almost monopolistically supplied by Japanese companies JSR and TOK (80–90% global market share). Small electric motors for cars: 80%. Carbon fibre: 66%. Advanced sensors: 40–70%, depending on type. Certain areas of medical and office automation equipment: more than 70%. Machines and equipment for LCD panel production: as much as 90%. These are all global market shares of Japanese companies. A whole range of global manufacturers are strongly dependent on Japanese supplies.

Indeed, without fanfare, quietly, and while not drawing the attention of the broader investment public, a kind of a strategic redirection process has been taking place among Japanese companies over the past two decades. This is something Ms. Schaede calls "aggregate niche strategy" in her book. Many firms have found their relatively narrow, and at times perhaps seemingly inconspicuous, market segment, and have built a strong, often leading position within it. In aggregate, this completely changes the nature of the Japanese market.

Simultaneous with this strategic redirection, a kind of organisational renewal is going on within Japanese firms. Traditional attitudes and values, such as lifetime employment, hierarchies based upon tenure, the status of women, and so forth are gradually being reassessed and firms are becoming more flexible, innovative, and efficient.

For investors, all these changes are only meaningful and beneficial if they are reflected in growing profitability of companies. A glance at the statistics relating to the Nikkei 225 index suggests that this is the case. At the end of November 2021, the Nikkei closed at 27,821. The P/E of the overall market as measured by market capitalisation was 13.5. It was 16.7 based upon index weights. These are very low numbers. Some might argue that the P/E of the Japanese market must be low because “after all, Japan is stagnating”. But according to the Nikkei figures, the current profits of the companies included in the Nikkei 225 index are about 75% higher than five years ago and more than triple what they were a decade ago. So, that stagnation thing might not be quite what it’s made out to be. The Japanese economy may be stagnating, or better to say growing slowly, but the profits of Japanese companies are growing very significantly.

We noticed the trend in strategic changes and changes in the Japanese business culture already in 2017, and since that time we have held an investment within Vltava Fund in the Nikkei 225 index. This investment opportunity has so far performed very well, but this fact remains underappreciated by investors. Even today, this second-largest stock market in the world remains perhaps the lowest priced of them all. Low valuations, rising profitability of Japanese companies, increasing returns on capital, and low debt make it very attractive and with great long-term potential.

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