

# Japan: The “blood-red supermoon” of investing

## KEY POINTS

- In a world with few compelling trades, we believe that Japan stands out for its rare combination of beta and alpha potential.
- Looking beyond central bank stimulus, fundamentals are improving broadly in Japan, including the domestic economy, corporate governance, and corporate earnings expectations.
- In our view, zero-sum arguments against active management do not apply in Japan for several reasons: The market is not dominated by institutional investors, it is less liquid than other markets, and the objectives of market participants vary widely.
- Market breadth, lack of sell-side research, and relatively high stock-specific risk help make Japanese equities one of the most attractive markets for alpha opportunities.
- We think Japan’s alpha potential is enhanced by the current inflection point in fundamentals and valuation disparities in risk factors.

### BROWN ADVISORY-WMC JAPAN ALPHA OPPORTUNITIES FUND

INVESTOR: [BIAJX](#) | ADVISOR: [BAJAX](#) | INSTITUTIONAL: [BAFJX](#)  
INCEPTION: 03/04/2014 | FUND ASSETS: \$2.213B (12/31/15)

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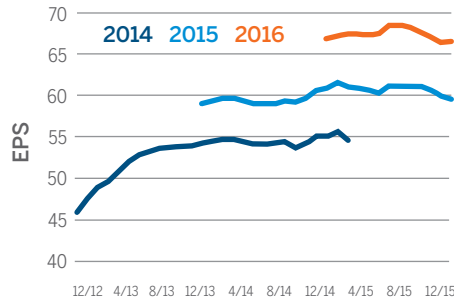
## Overview

At the end of September, the world experienced the first blood-red supermoon eclipse since 1982, and the next one isn't expected to occur until 2033. In this rare phenomenon, a supermoon (a full moon at its perigee or closest point to the earth) coincides with a total lunar eclipse and takes on a scarlet hue caused by the refraction of light as it passes through Earth's atmosphere. What does this have to do with investing? In talking to clients over the past year, we have heard again and again that there is no compelling trade or “killer app” investment opportunity. But we would argue that Japanese equities are the blood-red supermoon of investing—a standout beta opportunity coinciding with equally compelling alpha potential.

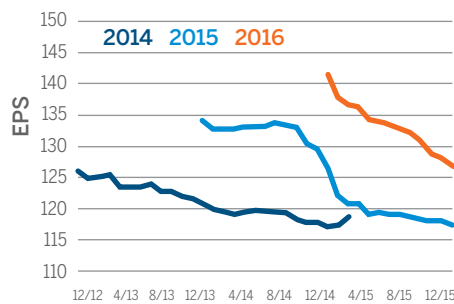
As we discuss in this paper, the factors that make Japan an attractive beta, including the high degree of skepticism around the market and the fact that it appears to be at an inflection point, compound the alpha opportunity. As a result, Japan continues to be one of the largest risk exposures in the multi-manager solutions that our team manages for clients as well as in our firm's other equity strategies. With this in mind, one of the great ironies of the past couple of years is the amount of money that has flowed into passive/ETF vehicles that invest in Japan. If active management is to be used anywhere, we think Japanese equities should be at the top of the list.

**Japan Earnings Surprise Positively**  
 FIGURE 1

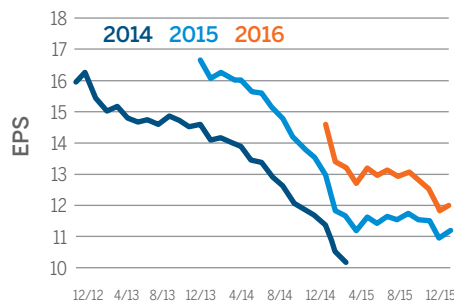
**JAPAN: EARNINGS EXPECTATIONS**



**S&P 500: EARNINGS EXPECTATIONS**



**EUROPE EX UK: EARNINGS EXPECTATIONS**



SOURCE: FACTSET

**JAPAN: A BETA NO LONGER TO BE IGNORED**

Prior to Prime Minister Abe’s election in late 2012, a common refrain among investors at Wellington Management was “Japan is a great alpha market but a lousy beta.” For most of our investment careers, the Japanese equity market has been a setting sun amid generally rising global stock markets. In fact, one of the most consistent sources of outperformance for global equity managers over the past quarter century was to simply underweight Japanese equities. However, the consistent underperformance of the market produced sell-side research apathy, which, coupled with weak corporate governance, led to Japan being one of the most inefficient developed markets. As a result, there were significant opportunities to add value through fundamental research and security selection. Among our firm’s global and international equity strategies, security-selection alpha in Japan contributed significantly above its respective weight, and the alpha in our Japan-only strategies was on average the highest of any category at the firm (of course, past performance does not guarantee future results).

Since Abe’s election, Japan has reversed course and been one of the best-performing markets in local currency terms. Many still view this as purely the result of central bank stimulus and currency depreciation, and also point out that Japan is among the most heavily indebted countries with a rapidly aging population. The positive fundamental changes, however, are difficult to ignore. Given the weakness in the yen and rising labor costs overseas, an increasing number of companies, including Canon, Sharp, Daikin, Nissan, and Honda, are bringing back overseas production.

More importantly, the domestic economy in Japan is improving, the labor market is tightening, and wages are rising. For the first time since World War II, the recovery is being driven by services and domestic demand, rather than manufacturing and exports. Corporate governance is also improving at an accelerating rate.

In addition, while earnings expectations in the US and Europe disappointed as 2015 progressed and estimates were slashed, earnings in Japan actually improved over the course of the year. Robert Scherfke, our macroanalyst who (along with Paul Cavey on our Global Bond team) does a phenomenal job covering Japan for our firm, provided FIGURE 1. It shows the progression of calendar-year consensus earnings expectations over time for the MSCI Japan Index, MSCI Europe ex UK Index, and the S&P 500 Index for 2014, 2015 and 2016. For example, in the fourth quarter of 2014, consensus expectations indicated that the stocks in the S&P 500 would earn roughly US\$135 in 2015, an increase of more than 17% over 2014 actual earnings. Rolling forward to the fourth quarter of 2015, consensus expectations for 2015 earnings were down to about US\$115, essentially unchanged from 2014 earnings. The pattern was very similar in the euro area. In contrast, earnings expectations for Japanese stocks increased over the course of 2015, almost by double digits. Earnings expectations for 2016 still appear quite high in the US (12% growth), while in Japan they look very achievable, with a growth rate that is basically the same as in 2015.

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**HAS ACTIVE MANAGEMENT ADDED VALUE IN JAPAN?**

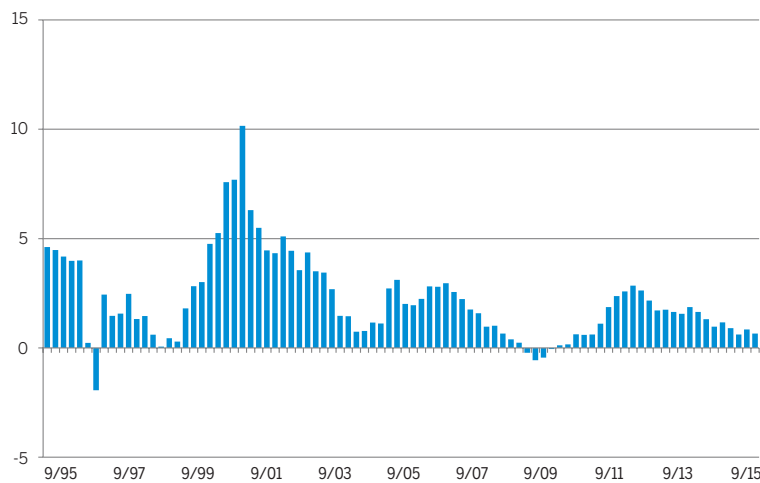
FIGURE 2 below shows rolling three-year returns versus the Tokyo Stock Price Index (Topix) for the median Japanese equity manager, drawn from a widely used institutional consultant database. On average, the median manager added more than 3.3% of value annually over these rolling periods during the past 20 years. The consistency of the alpha was also high: The median manager added value in 92% of the rolling three-year periods.

This data likely reflects survivorship bias, but we would also argue that this is part of the reason the median manager performed well; given how poorly the Japanese market did during the two decades prior to Abe’s election, only exceptional managers survived.

**Active Returns for the Median Manager of Japanese Equities**

FIGURE 2

**ROLLING 3-YEAR RETURN OF MEDIAN MANAGER VS TOPIX (%)**



SOURCE: EVESTMENT. JAPAN EQUITY UNIVERSE AS OF SEPTEMBER, 30 2015. THE UNIVERSE CONSISTED OF 251 FUNDS.

**IN A “ZERO SUM” WORLD, HOW CAN JAPANESE EQUITY MANAGERS ADD VALUE CONSISTENTLY?**

One of the most common arguments against active management in general is that it is a “zero sum” game. The premise of this argument is that the market is dominated by active managers all seeking to outperform the market index. Therefore, for every manager that outperforms, another manager has to underperform by an equal and opposite amount—a notion that calls to mind Newton’s Third Law of Motion (for every action force, there is an equal and opposite reaction force). Throw in active management fees and transaction costs, and the median manager by definition must underperform. In some market segments, there clearly is merit to the zero-sum argument; large-cap US equities, for example, are heavily researched, highly liquid, and largely dominated by institutional investors at this stage.

However, three core tenets of the zero-sum argument do not appear to be valid in Japan (or in other market segments including many fixed income sectors). First, the Japanese market is not dominated by local institutional investors striving to outperform the market. Individual investors, insurance companies, cross-shareholdings, foreign institutional investors, and the government and its extended agencies are also significant shareholders.

Second, not everyone has the same investment objective. For example, retail investors in Japan have historically been heavily momentum oriented, preferring to own stocks of successful companies and shunning those that are out of favor. (This bias and the pricing distortions it creates likely help explain the historically high returns to value-factor investing in Japan.) More recently, Japanese retail investors have shifted to safety and income investing as they look for bond substitutes (more later on the pricing anomaly this is creating). As taxable investors, insurance companies also have to focus on realized gains/losses and income, while cross-shareholdings are driven more by strategic business goals than total-return objectives.

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**...core tenets of the zero-sum argument do not appear to be valid in Japan.**

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Meanwhile, the majority of institutional investments in Japan are now made by foreign institutions striving to outperform various global indexes or macro/absolute return funds trying to generate a positive return. Beta from the Japanese equity market may be more important to them than alpha, with liquidity being another primary consideration. For their part, many government entities have focused on investing in companies with high returns on equity and other marks of good governance, to help promote societal objectives (in order to foster improved governance, a new index, the JPX Nikkei 400, was created with the encouragement of government entities). Overall, this diverse set of owners with varying objectives and degrees of sophistication may mean that the price discovery process in Japan is much less efficient than it is in the US large-cap market.

Third, the Japanese market is much less liquid than other markets. In the US, the average annual share turnover of the average company in the Russell 3000® Index was 220% over the past 15 years. For the average company in the Topix, it was 121% over the same period. This suggests there can be a significant premium for providing liquidity in the Japanese market (and the relatively low liquidity is also highly supportive of value-factor investing).

**WHY HAS JAPAN BEEN A CONSISTENTLY STRONG ALPHA MARKET?**

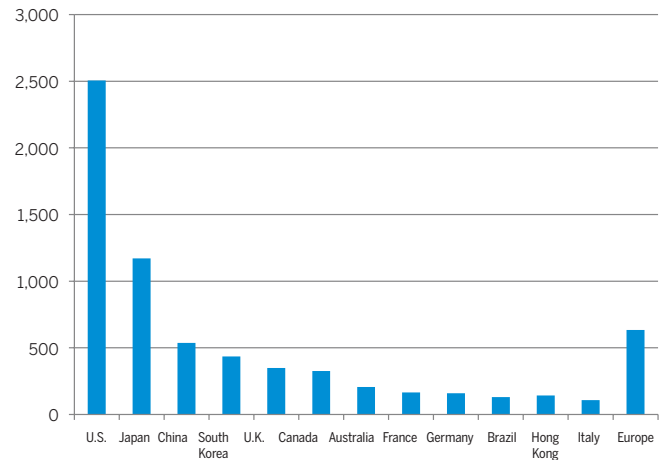
Stock picking tends to work best in markets that are broad, are not well researched, and include companies with a high degree of stock-specific risk. Japan scores well on all three of these metrics.

**Market breadth**—FIGURE 3 shows the number of companies in various markets around the world, using MSCI Investable Market indexes for consistency. With almost 1,200 listed companies, Japan is the second broadest market, trailing only the US market. In fact, Japan has more companies than all the European countries in FIGURE 3 combined.

**Lack of sell-side research**—Japan’s long period of stagnation dampened investor interest and made sell-side research unprofitable. As a result, only about half of stocks in Japan’s Topix are covered by at least one sell-side analyst versus approximately 95% of stocks in the US-based Russell 3000® Index depicted in FIGURE 4. As Japan emerges from dormancy, many foreign investors are finding that the research shortage makes it challenging to get up to speed on individual companies. For managers with good proprietary research resources, we think this makes Japan the best developed market in the world in which to pursue a fundamental edge. Our firm’s global industry research group actively covers 76% of the Japanese market and our various portfolio management teams collectively own more than 500 companies in Japan.

**Japan Is By Far the Broadest Market After the U.S.**

FIGURE 3  
NUMBER OF STOCKS

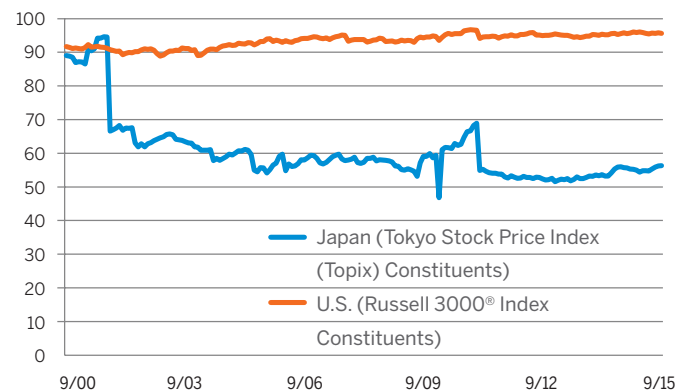


SOURCE: FACTSET AND WELLINGTON MANAGEMENT. AS OF SEPTEMBER, 30, 2015. BASED ON THE COMPONENTS OF THE MSCI ACWI INVESTABLE MARKET INDEX.

**As Japan emerges from dormancy, many foreign investors are finding that the research shortage makes it challenging to get up to speed on individual companies.**

**A Shortage of Research on Japanese Equities**

FIGURE 4  
PERCENT OF NAMES COVERED BY THE SELL SIDE

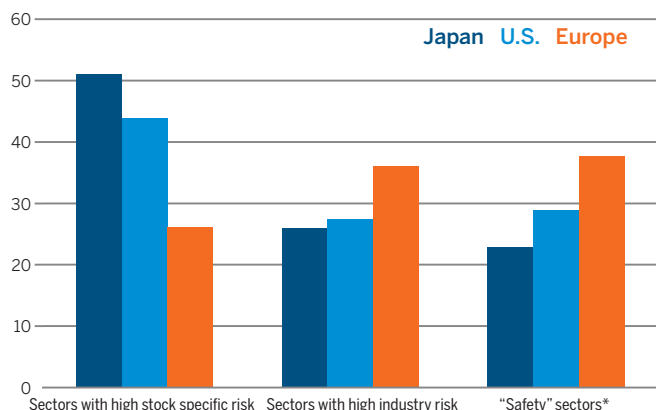


SOURCE: FACTSET, AS OF SEPTEMBER, 30 2015.

**Japan Dominated by High Stock-Specific-Risk Stocks**

FIGURE 5

PERCENT OF INDEX



**SECTORS WITH HIGH STOCK-SPECIFIC RISK:**

Technology, consumer discretionary, industrials

**SECTORS WITH HIGH INDUSTRY RISK:**

Energy, materials and financials

**"SAFETY" SECTORS\*:**

Consumer staples, health care, utilities and telecom

SOURCE: FACTSET AND WELLINGTON MANAGEMENT, AS OF SEPTEMBER, 30 2015. THE INDEXES USED FOR THE NOTED REGIONS ARE AS FOLLOWS: JAPAN = MSCI JAPAN, US = RUSSELL 1000, EUROPE = MSCI EUROPE. SECTOR CLASSIFICATIONS REPRESENT THE OPINIONS OF THE STRATEGIC SOLUTIONS TEAM, ARE BASED ON AVAILABLE INFORMATION, AND ARE SUBJECT TO CHANGE WITHOUT NOTICE.

\*\*"SAFETY" IS A PROPRIETARY FACTOR DEVELOPED BY WELLINGTON MANAGEMENT THAT IS EVALUATED BY COMPARING THE RETURNS OF COMPANIES WITH TOP QUINTILE SAFETY CHARACTERISTICS VERSUS COMPANIES WITH BOTTOM QUINTILE SAFETY CHARACTERISTICS WITHIN A RESPECTIVE INDEX. A "SAFE" STOCK IS DEFINED AS HAVING LOW BALANCE SHEET LEVERAGE, LOW PRICE, AND LOW EARNINGS VOLATILITY. **ALL INVESTMENTS INVOLVE RISK.**

**More stock-specific risk**—More than 50% of the Japanese market is in sectors where stocks tend to have a high degree of stock-specific or idiosyncratic risk (technology, consumer discretionary, and industrials), compared with 45% in the US and a meager 25% in Europe, as featured in **FIGURE 5**. On the other hand, Japan has relatively low percentages in the resource and financial sectors and “safety” sectors (e.g., consumer staples, health care), where stocks tend to be driven more by their risk-factor or industry orientation than security-level considerations (the footnote below **Figure 5** explains how the portfolio manager assesses “safety”). We think the combination of these three factors makes the Japanese market one of the best for potential alpha generation.

**WHY DO WE BELIEVE THE ALPHA GENERATION POTENTIAL IN JAPAN IS SO STRONG CURRENTLY?**

After 20 years of struggling with deflationary forces, significant bad loans in the financial system, a very expensive currency, and poor corporate governance, Japan is, in our view, at an inflection point with improving economic and market fundamentals thanks to the policies enacted by the Abe administration. Inflection points like this may provide exceptional opportunities for active managers—particularly those with extensive research resources and experience—to gain a fundamental edge, since recent history won't be relevant as a guide for estimating revenue growth, operating leverage, normalized margins, and other metrics. We have seen strong alpha from active managers in similar situations—in emerging market equities from 2003 through 2005, for example.

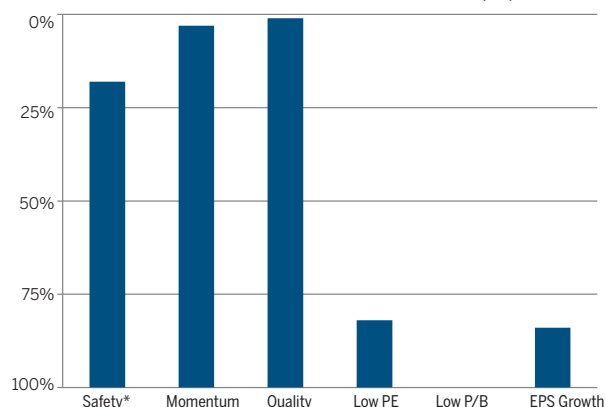
In addition, the wave of indexation tilted toward the high-quality segments of the Japanese market combined with the retail investor focus on safety and income has created massive valuation disparities. As part of our risk-factor research, we look at the relative valuation of various factors. We calculate the median projected P/E of the top quintile of stocks exposed to a factor and compare it to the median P/E of the market segment being evaluated. We then rank that ratio historically on a percentile basis (using the past 10 years in the following example). **FIGURE 6** uses this methodology to compare the relative valuation of selected factors in Japan (a low percentage is expensive and a high percentage is cheap).

Within Japan, defensive, momentum, and quality factors are about as expensive as they have ever been, while fundamental factors like valuation (P/E or P/B) and growth (consensus long-term growth rates) are incredibly cheap. Normally, we see this pattern during a period of extreme

**Japan Factor Valuations**

FIGURE 6

**MSCI JAPAN VALUATION PERCENTILE RANKS (%)**



SOURCE: FACTSET AND WELLINGTON MANAGEMENT, AS OF DECEMBER 31, 2015. \*SEE PAGE 5 FOR OUR DESCRIPTION OF SAFETY.

market duress such as 2008 or the third quarter of 2011. To see it in the current market environment in Japan (the Topix was up 40% over the past 18 months) is highly unusual from a risk perspective. In most other markets where we have seen substantial quantitative easing and an improving economy (such as the US or the UK in recent years), value and other fundamental risk factors have tended to exhibit strong returns.

What might be the catalyst for the attractively valued risk factors in Japan to begin to outperform? Many investors' recent interest in exposure to Japan has been focused on Abenomics and the unfolding macro story, but much of that story has played out in our opinion. Today, we think the reason to own Japan is the improving micro story. As noted, Japan is the only major market where overall corporate earnings expectations went up rather than down over the course of 2015 and look reasonable for 2016. It takes time for the sell side and investors to initiate research coverage, but fundamental results like these are strong inducement.

We also expect demand for passive exposure to Japan to dissipate over time; we believe much of the demand was driven by institutional investors' need for liquidity and administrative efficiency, given the large sums and short time frames involved. We would expect to see more placements in "smart beta" strategies in areas such as value and small cap, and in actively managed strategies—all of which should contribute to a reversion in the extreme valuations of various risk factors.

**WHAT IS THE "BEAR" CASE ON JAPAN?**

We believe that China clearly is the largest source of uncertainty in the global markets today. The magnitude and pace of the country's economic slowdown, the extent of the bad loans in its financial system, and the degree of currency devaluation still to occur pose significant downside risk for the global economy—and particularly for Japan and other countries in Asia, given the meaningful business interests and competitive dynamics.

In addition, the underpinning of the Japan macro story is the end of the deflationary spiral that has been a key source of Japan's economic stagnation. Given the low unemployment rate and improved profitability within Japan, we expect to see continued wage increases and other improvements related to core inflation. However, the magnitude and pace of quantitative easing in Japan has been such that there is little the Abe administration can do incrementally if these improvements do not persist. Nonetheless, in a "no killer app" world, we think the risk appears to be worthwhile.

**About the authors**

The members of the Investment Strategy and Risk Group conduct original research on portfolio- and risk-management topics, spearhead Wellington Management's internal investment oversight processes, and analyze key trends and risks across our equity, fixed income, and asset allocation product suites. In addition, members of the group serve as the lead portfolio managers on several team-managed solutions offered by the firm.

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## TOP 10 PORTFOLIO HOLDINGS

Shown as a % of total assets as of 02/29/2016

1. Cash & Equivalents	6.51	6. Honda Motor Co Ltd	1.47
2. Fujitsu Ltd	2.69	7. Nippon Telegraph & Telephone Corp	1.47
3. Mitsubishi UFJ Financial Group Inc	2.17	8. Nippon Television Holdings Inc	1.40
4. Takeda Pharmaceutical Co Ltd	1.94	9. T&D Holdings Inc	1.39
5. SoftBank Group Corp	1.59	10. Nintendo Co Ltd	1.21

SOURCE: U.S. BANK. FUND HOLDINGS INCLUDE CASH AND EQUIVALENTS AND ARE SUBJECT TO CHANGE AT ANY TIME AND SHOULD NOT BE A RECOMMENDATION TO BUY OR SELL ANY SECURITY.

The JPX-Nikkei Index 400 Index is composed of companies with high appeal for investors, which meet requirements of global investment standards, such as efficient use of capital and investor-focused management perspectives. The MSCI ACWI Investable Market Index (IMI) captures large, mid and small cap representation across 23 Developed Markets (DM) and 23 Emerging Markets (EM) countries. With 8,704 constituents, the index is comprehensive, covering approximately 99% of the global equity investment opportunity set. The MSCI Europe ex UK Index captures large and mid cap representation across 14 Developed Markets (DM) countries in Europe. With 336 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across European Developed Markets excluding the UK. The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. With 311 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan. The Russell 3000® Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000® Index is constructed to provide a comprehensive, unbiased, and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected. The Russell 1000® Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000® Index represents approximately 92% of the U.S. market and is constructed to provide a comprehensive and unbiased barometer for the large-cap segment and is completely reconstituted annually to ensure new and growing equities are reflected. The Russell 3000® and Russell 1000® Index are trademarks/service marks of the Frank Russell Company. Russell® is a trademark of the Frank Russell Company. The S&P 500 Index represents the large-cap segment of the U.S. equity markets and consists of approximately 500 leading companies in leading industries of the U.S. economy. Criteria evaluated include: market capitalization, financial viability, liquidity, public float, sector representation, and corporate structure. An index constituent must also be considered a U.S. company. Tokyo Stock Price Index, commonly known as TOPIX, along with the Nikkei 225, is an important stock market index for the Tokyo Stock Exchange (TSE) in Japan, tracking all domestic companies of the exchange's First Section. It is calculated and published by the TSE. An investor can not invest directly into an index.

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