

William Blair Strategy Discussion: Japan's Abenomics: Promise or Reality?

Ken McAtamney, Partner, Portfolio Manager
Olga Pomerantz, Economist
Stephanie Braming, CFA, Partner

Introduction

Braming: At William Blair, we have invested in a select group of high returning Japanese companies over time, even as Japan more broadly struggled with deflation and stalling economic growth. After Japan suffered from more than two decades of underperformance, Prime Minister Shinzo Abe entered office in December 2012 with a broad mandate and introduced his “three arrows strategy,” or “Abenomics,” for revitalizing Japan. The three arrows of Abenomics are monetary easing, a flexible fiscal policy and an economic growth strategy.

Abe's strategy of three arrows refers to an old story about a 16th century feudal lord, Motonari Mori, who impressed on his sons that three arrows bundled together are hard to break. The analogy is rooted in Japan's cultural symbolism, and is designed to deliver a strong message to Abe's domestic constituency, as every school child is familiar with this story, while the legend is subject of many movies, and popular culture in general.

The following discussion will assess the three arrows policies of Abenomics. It will also discuss whether its promise has translated into improving sustainable growth and changing corporate behavior, highlight potential milestones to measure success, and discuss investment and portfolio structure implications.

Assessing the “Three Arrows”

McAtamney: Why are the Japanese government and the Japanese people undertaking these extreme measures now? Why do we believe the probability for successful reform is as high as it has been in a generation? After 20 years of anemic economic growth (slightly less than half the developed world average) and persistent deflation, Japan's economy has dropped to 3rd in the world, now trailing China.

Further, debt as a percentage of GDP now stands at 250% – the highest level in the developed world – with its well-documented demographic burden in clear sight to compound the problem. These events have combined to lead to a sense of urgency and last fall's re-election of Prime Minister Abe on the premise of a radical economic approach to reverse these problems. Thus far he has gained momentum with the upper and lower houses of the Diet being majority dominated by his party; he has placed his like-minded reformer Kuroda to lead the central bank; and his popularity has remained very high, well above 60%. Importantly for Japan, this is a level of political stability that has not been seen in the last decade since the Koizumi era.

Japan is a consensus-driven society, so it can take a great deal of time to reach the difficult conclusion that change is worth the perceived risk. On the other hand, once that commitment is made, the Japanese remain resolute. Our experience on the ground in Japan has revealed a level of unity and engagement among the “ruling elite” that we have not previously seen. Politicians, corporations, and the media all are engaged and aligned in working toward this cause. While perhaps not unanimous in priority or solutions, a shared concern and commitment give hope that ultimately constructive solutions will be pursued. Thus the static forces of inertia have given way to relatively dramatic action – and the progress so far is palpable. It is certainly an interesting starting point.

How Did We Get Here and What Have We Seen So Far?

Pomerantz: The following summary will describe Abenomics in the context of the country's structural challenges as well as identify areas of potential change.

Historically, persistent deflation has made cash hoarding an attractive proposition at the corporate level. As a consequence, aggregate investment

spending has lagged depreciation since the mid-1990s. Over time, old and outdated equipment manifested itself in stalled productivity gains, which ultimately led to a loss of competitiveness.

In this context, the key structural reform is ending deflation, which is the objective of Abe's first arrow (focused on monetary policy). On this front, much has already been achieved. At the beginning of this year, the government changed the Bank of Japan's mandate, obligating it to targeting inflation of 2% per annum. Under the new governor, the central bank has publicly committed to reaching the 2% inflation target as quickly as possible and not stopping balance sheet expansion until 2% inflation is well entrenched in the domestic economy. While headline CPI turned positive this summer, core (i.e., services) prices continue to decline, although month on month momentum is trending in the right direction. The government expects Japan's economy to emerge from deflation in the next one or two quarters, or by Spring 2014. Perhaps more obvious to foreign investors has been the associated depreciation of the yen, which benefited Japan's exporters as the stock market rerated by nearly 25% in USD terms between November 2012 and April 2013.

In concert with the first arrow, the goals of the third arrow, "growth strategy" pillar, are to return aggregate annual capex spending in Japan to the average of 2002-2007 levels, which implies a 10-15% increase on current levels. This is not about expanding domestic production, but rather about upgrading existing facilities. We are all familiar with Japanese companies' bloated balance sheets. In aggregate, this cash pile equates to approximately 40-45% of GDP, and each company faces the following options:

1. Continue to accumulate cash
2. Increase wages
3. Pay down debt
4. Return cash to shareholders
5. Invest

As deflation ends, option one (to continue to accumulate cash) will no longer make sense.

The key purpose of the third arrow is to facilitate corporate restructuring by deregulating key sectors, such as electricity supply, changing the tax code and labor market policies. Energy reform is a key pillar of

the growth strategy as energy costs represent a major headwind to corporate Japan. Electricity costs to corporate Japan increased by over 30% since 2010. The government will announce the desired energy split by source moving forward. Nuclear is likely to remain part of the energy mix. So far, 18 out of 50 nuclear facilities already applied to the new regulator for an onsite inspection schedule. Longer term, we expect electricity retail to be liberalized by 2015 and distribution and generation split by 2020.

Industrial policies are usually implemented through the tax code, and Japan is no different in this regard. Changes in taxation and incentive schemes are meant to serve as the more immediate signal to the corporate sector. Here, we expect revisions to incentivize carve-outs, formation of limited liability companies, and M&A activity. Government policies are likely to encourage consolidation in industries where the number of players is too large by international standards and profitability within the sectors is comparatively low. A host of industries fall in these brackets, including LCD makers, water (drinking & sewage), railways, diagnostic imaging equipment, heavy machinery, semiconductors, and telecom equipment. While a meaningful reduction in the corporate tax rate is subject to meeting growth targets and therefore is unlikely in the near term, the government is likely to propose rolling back the 2% temporary increase levied in the aftermath of Fukushima disaster one year early, in March 2014 instead of March 2015, as currently scheduled.

With respect to labor market policies, we can expect a major shift away from the policy of maintaining workers in current employment toward incentivizing worker mobility (migration to new companies, industries). Current government subsidies for headcount maintenance are ¥110 billion in FY2012, while those for incentivizing movement are only ¥240 million. Flipping these amounts should be enough to facilitate meaningful change. The second proposal in this area is aimed at underutilization of female labor force (the famous M curve). This can affect up to three million highly skilled workers; not insignificant in Japan's context.

Our proximity to companies as equity investors is a big advantage in terms of monitoring progress on corporate restructuring in Japan. We will get a sense of how and to what extent companies are changing before their actions are aggregated into data releases.

We will be looking for increased M&A activity, corporate restructuring announcements, investment plans and wage increases, together with reaching and sustaining inflation in the services sector.

Portfolio Positioning and the Implications of Abenomics Moving Forward

McAtamney: Back in the 1980s when the US and UK began to go through the Reagan- and Thatcher-led deregulation and economic reforms, Japanese corporate ROEs were around 9.5%, just slightly below that of the U.S. and the U.K. However, Japanese corporate performance has deteriorated broadly with average ROEs of under 4%, which is less than half of the rest of the developed world averages, and far lower than Chinese companies over the same period (12%). With the decline in returns has been a commensurate decline in valuations, such that after peaking in 1989, the Japanese market has lost almost two-thirds of its value. Economic malaise, deflation and declining valuations have made it profitable for global or international investors to pay little attention to the Japanese stock market over that time.

Given William Blair's focus on high return, value creating growth companies, our investments in Japan have been limited to a relatively small number of corporate leaders whose performance could compare favorably to a global peer group. This focus generally favored leading global manufacturers and exporters like industrial, technology and automotive companies (e.g., Daikin, Makita, Denso and Orix); complemented by a few companies innovative enough to withstand the headwinds (e.g., small, domestic companies such as Park24, Miraca, United Arrows, Ship Healthcare). Like many global investors, we tended to be underweighted the broad indices, averaging about two-thirds the index weight on average.

Currently, even with the past 12 month stock market run, the forward price/earnings multiple on the Japanese market is 14 times versus the rest of the world at 13 times. It is a slight premium but well below its normal five to six multiple point premium. However, we need to see clear catalysts for corporate improvement and growth as a precondition for our investment. Abe's focus on defeating deflation combined with prospects of corporate reform has generated near-term growth and profit opportunities, certainly at least for the exporters. We have responded by sending several team members –

18 visits in the last 12 months – to Japan to accelerate our field research with the joint goals of addressing the important progress of the third arrow growth initiatives and identifying companies who might benefit the most from the reform measures and stronger growth. Companies in the Healthcare, Consumer and Financial sectors in particular may benefit from one or more of the aforementioned reforms. Thus, earlier in the year we increased our Japanese positions and added new ones in companies that appear well-positioned, to bring most of our portfolios to near or overweighted the respective benchmarks. Some companies we have invested in include, but are not limited to, include Yahoo Japan, a leading internet and e-commerce company; Fuji Heavy, the maker of the popular Subaru brand of automobiles; Nihon M&A, a boutique investment bank; and Lawson, a leading convenience store operator.

We are intrigued by the prospects for corporate reform, improving returns and shareholder focus. The Japanese corporate community has a large number of companies with innovative products or unique services that should be in demand both in their domestic economy and abroad. Yet the corporates themselves have suffered from inefficient balance sheets, complacent managements and seemingly indifferent shareholders. If the value in the corporate offering can be converted into stronger returns and profits (we sometimes refer to this as “waking up the zombies”) then we will continue to be very interested going forward. This appears to be more than likely the case. Interestingly, the market rally we have seen in the last 12 months, which in local terms is up over 60%, has been dominated almost exclusively by foreign investors. We believe skepticism among domestic investors combined with general investment malaise in the equity markets there created an opportunity for broader market participation going forward if we actually do realize the anticipated progress. Thus, with the potential for stronger domestic growth, increasing global competitiveness and structurally improving returns, the Japanese stock market could look very attractive in a global context over the next several years.

Questions and Answers

Braming: We have all been to Japan in the last several months. When I was there in June, there seemed to be a cautious optimism combined with concerns about the ability of these policies to really take hold. You were both in Japan more recently. What were your impressions?

McAtamney: We have spent extensive time on the ground in Japan this year, as I referenced earlier. In September, there were seven or eight of us there at various times including a number of us working together. What really got our attention was the diverse participation in the initiatives. There was a sense of urgency and alignment amongst the various factions of people working together. Whether or not they are ultimately successful, I believe this alignment is a very important precondition. It is something we did not expect to see.

We saw a number of participants outside of our typical field research (company managements and people in the business community). We met with several government officials and bureaucrats representing all facets of the government. We also spoke with a number of some non-politically motivated participants just to get a balanced perspective.

That being said, we actually have seen very little progress, very little tangible moves forward thus far other than a fair amount of plans both general and specific. I believe October is going to be very revealing in that we should start to see more specific initiatives or more detailed plans announced. One thing that we have done is expand our eligibility list of companies to make sure that we are paying as much attention to as broad an array of potential beneficiaries as possible. We have some action items to add companies to our research agenda to prioritize those companies that we think would benefit from the potential change.

Pomerantz: In addition I would add that the mood on the street was cautious excitement, something we have not seen in Japan in a long time.

Ordinary people in shops, taxi drivers, these folks seemed genuinely excited by the existence of strong leadership, which has been absent in Japan for a while, along with the associated hope that this leadership can deliver the promised changes.

Within the government, I was positively surprised by the scope and depth of proposed reforms in a common sense of purpose. That was evident everywhere, from the Financial Services Agency (FSA) to the Ministry of Economy, Trade and Industry (METI), which is a very powerful ministry of economics and trade in Japan.

Finally, it is also very interesting to note how well the message is being marketed by the cabinet office and the Prime Minister and how aggressively the media is involved in portraying and emphasizing change in Japan. This message is for both foreign investors and its domestic constituency.

Braming: We have certainly seen the monetary policy take hold in Japan over the last several months. Now perhaps the recent tax policy changes can provide some clarity for investors on the third arrow.

Question: Will Abenomics benefit large cap, small cap, or both?

Pomerantz: The impact of a reflating economy and the associated weakness of the yen benefits larger companies first. This is evident in the government's popular Tankan surveys where larger companies are much more upbeat and excited about the changes. They have already significantly revised their investment plans for the next year. However, this is not nearly as evident or as broad based in the small company, local or regional players yet. This pattern is not dissimilar to the 2002 to 2005 timeframe when the Japanese were attempting to reflate their economy under Prime Minister Koizumi's leadership. In that time period, smaller local firms followed suit with a lag of about a year.

Question: The relationship between Japan and China seems to be deteriorating, yet China would seem to be a big customer for Japan. Any thoughts of how important that is if you saw, for example, continued fighting over the land claims for the islands? Would that change your view?

Pomerantz: The relationship between Japan and China is one of the things that may have contributed to Japan finally waking up and realizing that its economic slide has contributed to its political irrelevance or less relevance than in the past.

While we expect both governments to be reasonable and responsible global citizens, what struck me

during my recent trips to China and Japan is that people are very aware of deep economic ties. The Japanese were among the first foreign investors in China in the late 1970s and early 1980s. People in both countries are keen to expand personal ties, university ties, and travel to both countries. Over time, as Japan recovers from its malaise and as China shows itself to be a good responsible global citizen, hopefully they can put these differences behind them.

Question: Developing countries have younger, growing populations while Japan's population is shrinking at a rate of 1%. Does this tailwind in demographics for developing countries translate into a headwind for Japan? How important is domestic consumption to these Japanese reforms, or are they based mostly on increasing productivity and exports?

Pomerantz: Increasing productivity is the key pillar of the story. This is not limited to Japan. It can be extended more broadly to any developed economy where demographics play a less favorable role than in the emerging market economies. The third pillar, the growth pillar strategy of Abenomics, is designed to address the decrease in 0.6% growth as a result of shrinking labor force.

There are several things that the government can do to address this. One of the things that I mentioned briefly was the famous M-Curve. In Japan's context, many highly qualified women cease to be part of the labor force once they reach childbearing age. This is not because they no longer want to participate as productive workers but because there are very few childcare facilities. The waiting times for these facilities are very long. One of the things the government is thinking of doing actively is increasing private sector participation in providing childcare. This would have a meaningful impact on the number of highly skilled and productive people that can be employed. We hope to hear more about this initiative between now and the end of this calendar year.

Braming: That was only one of the things that was highlighted when I visited Japan in June. In fact, Prime Minister Abe had an op-ed in the Wall Street Journal recently about "womenomics" as opposed to Abenomics, so clearly it remains an area of focus.

Question: Can you talk about the effects of Abenomics on the currency relative to other currencies? What are your expectations in terms of the currency on a go-forward basis?

Pomerantz: The impact of Abenomics on the currency has obviously been to weaken the yen vis-à-vis a number of other currencies, but this need not be the case for much longer. One of the key signs that Abenomics is working will be when the yen ceases to depreciate or it stabilizes or it even begins to appreciate in nominal terms while the stock market continues to perform. That will be one of the signs that inflation has become relatively well-entrenched and that corporates believe in the sustainability of growth of the Japanese economy.

McAtamney: Part of the objective, ultimately, is to strengthen the underlying domestic economy so that it could be, in terms of an end market for Japanese companies, a bigger market than it has been.

When you think about the participants in the equity markets in Japan, it has been primarily driven by international investors. But the domestic sovereign wealth fund, or the government pension plan, of Japan has over \$1 trillion USD in assets. Over two-thirds are invested passively in Japanese government bonds. A small minority of that fund is actually invested in equities of any sort. We believe this will be part of the reforms as a more active and engaged board moves to change the composition of that Fund, which ultimately could favor investing in equities generally but also very specifically investing in Japanese equities.

Braming: They have also announced these NISA accounts, which are like IRAs where individuals may put \$10,000 into these accounts per year as a way to promote retirement savings. We have personally seen demand for additional equity managers to potentially help in the platforms of servicing those accounts. It seems clear on numerous fronts they are trying to move forward to stimulate demand for equities, in particular amongst domestic constituents.

Question: Do you see Japan securing the 2020 Olympics as a "fourth arrow" for its economy or is it simply a confidence boost?

McAtamney: In terms of creating buy-in and positive sentiment, I do think securing the Olympics was a large symbolic gesture and one that did not go unrecognized by the population. Part of the reason they were successful in their bid was the government engagement with business leaders to get behind this initiative and to impress the IOC about the concerted

commitment across all areas of the Japanese constituency.

This highlights the previously discussed alignment of various factions around a common cause. While at this point this might be symbolic in nature, I think, ultimately it is a good representation of a general positive mood overall in Japan.

We have thought about this from a different area of reform that has been talked about in a great deal of detail. This is around the nature of improving and developing more infrastructure projects and having more private participation in those projects, PPP-like arrangements that are used in other parts of the world that have been relatively absent in Japan. Infrastructure build around the Olympics could be a catalyst for more of that activity.

Braming: One of the planks of the plan is to increase tourism to Japan. Certainly having a world stage with the Olympics could be a positive for that as well.

McAtamney: I think London is probably a good example of that.

Braming: The theme of "Cool Japan."



Stephanie G. Braming, CFA, Partner

Stephanie Braming joined William Blair & Company in 2004 as the International and Global Equity Specialist. She participates in the team's decision-making meetings, conducts portfolio analysis and is responsible for communicating current portfolio structure and outlook to clients, consultants, and prospects. Prior to joining the firm, Stephanie was a Principal at Mercer Investment Consulting, where she was responsible for the strategic investment direction of her public fund, corporate, healthcare and foundation clients. In addition to her client responsibilities, Stephanie served on Mercer's United States Research Rating Committee, which assessed research ratings for investment manager strategies. Prior to her role at Mercer, Stephanie worked at the Federal Reserve Bank of Chicago. She is a member of the CFA Institute and the CFA Society of Chicago where she recently served on the Society's Board of Directors. Education: B.A. DePauw University; M.B.A., University of Chicago Booth School of Business.



Olga Pomerantz

Olga Pomerantz joined William Blair & Company in 2009. She is responsible for economic research across all regions and sectors. Prior to joining the firm, Olga was a Senior Economist at the National Institute of Economic and Social Research in London, UK, where she was responsible for macroeconomic forecasting and thematic research projects for international organizations and government bodies. Education: B.A., University of Chicago; M.S.c Economics, London School of Economics and Political Science.



Kenneth J. McAtamney, Partner

Ken McAtamney is a co-portfolio manager for the William Blair Global Leaders and International Leaders strategies. He joined William Blair & Company in 2005 and previously served as co-director of research, as well as mid-large cap Industrials and Healthcare analyst. Prior to joining William Blair, Ken was a Vice President for Goldman Sachs and Co., responsible for institutional equity research coverage for both international and domestic equity, and he was a Corporate Banking Officer with NBD Bank. Education: B.A., Michigan State University; M.B.A. Indiana University.

This material is provided for general information purposes only and is not intended as investment advice or a recommendation to purchase or sell any security. Any discussion of particular topics is not meant to be comprehensive and may be subject to change. Any investment or strategy mentioned herein may not be suitable for every investor. Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Information and opinions expressed are those of the presenter. Information is current as of the date appearing in this material only and subject to change without notice.