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Q&A
With portfolio manager
Seung Kwak

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FOR PROFESSIONAL INVESTORS ONLY

Japan: New year, new risks?

Seung Kwak is an equity portfolio manager at Capital Group. He has 30 years of investment experience and has been with Capital for 12 years. Before joining Capital, he served as the Chief Investment Officer–Japan and the lead portfolio manager for Japan portfolios for Zurich Scudder Investments. He holds a master's degree in international relations from Yale University and a bachelor's degree in philosophy from Middlebury College. He also holds the Chartered Financial Analyst® designation. Seung is based in Tokyo.

Investors in Japanese equities were taken on a bumpy ride last year. What does the new year hold? Seung Kwak, portfolio manager for Capital Group's Japan Equity strategy, offers his views on:

- The outlook for Japan's stock market
- China's economic evolution and the investment opportunities it presents
- How portfolio holdings with exposure to the decelerating Chinese economy are holding up
- Japan's virtuous cycle of reflation
- Improving corporate governance and what this suggests for Japanese equities

Would you say that 2015 was a rollercoaster year for investors in Japanese equities?

Markets were indeed choppy but if it is any comfort, Japanese equities were far from alone. China's slowing economy and the US Federal Reserve's interest-rate decision unsettled markets everywhere, with sentiment particularly bearish in August and September. The Tokyo Stock Price Index (TOPIX) plunged 15% in Japanese yen terms over those two months, while the Standard & Poor's 500 Composite Index and the MSCI Europe Index shed 9% and 11% respectively in local currency terms.

That said, the TOPIX ended the year up 13%, thanks largely to steady gains earlier in the year and a sharp rebound in October. It may come as a surprise to some, but Japan was one of the better-performing equity markets in the developed world last year.

Will it be any different this year? The focus on the US rate cycle looks unlikely to change and China is still experiencing slower growth.

Risks remain largely external to Japan. We are monitoring not only the impact of the US rate hike and China's slowing economy but also the direction of oil

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prices. Overall, however, there is room for optimism. The US raised interest rates because growth has perked up. That is good for Japanese businesses, many of which have high exposure to the US economy. Exporters could also get a boost if the rate increase drives further yen weakening.

As for China, it is true that growth is decelerating. But that is partly intentional and partly inevitable; it is undergoing a huge government-led restructuring drive to move to a more balanced and sustainable growth path. The country's economic evolution is throwing up new investment opportunities. Among these is China's burgeoning tourism sector, underpinned by the country's growing middle class. Factory automation, too, is rising amid double-digit wage inflation and a shrinking workforce. On that note, the yen's depreciation has given Japanese automation companies a competitive edge over their Chinese rivals; prices have become more affordable and Chinese manufacturers need only to pay a moderate premium for better quality products.

And are you investing in the Chinese tourist boom through the Japan Equity strategy?

We are. We expect China's outbound travel boom to continue as more countries relax visa rules to attract Chinese tourists. The Abe administration has done more than just loosen visa restrictions: it has also allowed more cruise ship visits and increased flights between China and Japan, particularly services by low-cost carriers.

But equally important are Chinese tourists' changing priorities. Increasingly, they are venturing farther (beyond Hong Kong and Macau), travelling for longer, and are keener to experience different cultures. Safety and value for money have also become more important to tourists. Japan is a clear beneficiary of this shift. In 2014, 2.4 million Chinese tourists visited Japan. That figure exceeded 4.5 million last year. Yet they only represent a tiny fraction of the more than 100 million Chinese outbound travellers and the 68 million who visited Hong Kong and Macau in 2014. Given that just 4% of China's 1.3 billion people have passports, there is a very long runway for growth.

And it is not just Chinese tourists who are coming to Japan. Overall inbound visitor numbers have risen rapidly and came close to hitting the government's target of 20 million tourists by 2020 last year. The portfolio has exposure to this theme in two ways: via companies with hotel businesses and those that sell properties in Japanese cities to foreigners. Some of the new positions we initiated over the past year include Seibu Holdings, a train operator that manages the hotel chain Prince Hotels, and Kyoritsu Maintenance, which operates budget business hotels as well as student and employee dormitories. We also have exposure to companies that have gained from greater tourist spending.

The Japan Equity strategy has significant exposure to Japanese manufacturers, many of which have operations in China. Have your views about these companies changed in light of the decelerating Chinese economy?

Our investments in the machinery sector are selective and exposed to a wide variety of areas that have benefited from secular growth trends. We have investments in the broader automation market, such as factory automation in Asia (including China), and automated construction and agricultural equipment; many of these companies have exposure to international markets beyond China. Among our holdings, for example, farm machinery manufacturer Kubota generates a notable portion of its profits from the US, while Topcon, "We are very careful about investing in companies that not only do well in good times but can also emerge stronger from tough periods. And we are constantly monitoring their developments."

a manufacturer of smart infrastructure and positioning products, has seen steady sales growth in North America and Europe, as well as Japan.

The strategy also has exposure to several parts and component suppliers in industries ranging from airlines to smartphones. Some of our smartphone component makers sold off in the latter half of last year owing to excessive concerns that China's downturn would drag down the entire market. True, smartphone unit growth has slowed but, in our opinion, the transition to faster connectivity (3G to 4G) and advanced features (such as fingerprint sensors) will likely require more and higher quality components, which is why we remain optimistic about the smartphone market. We believe the rise of the Internet of Things, where devices can interact with one another, should underpin the long-term prospects for businesses in this sector too.

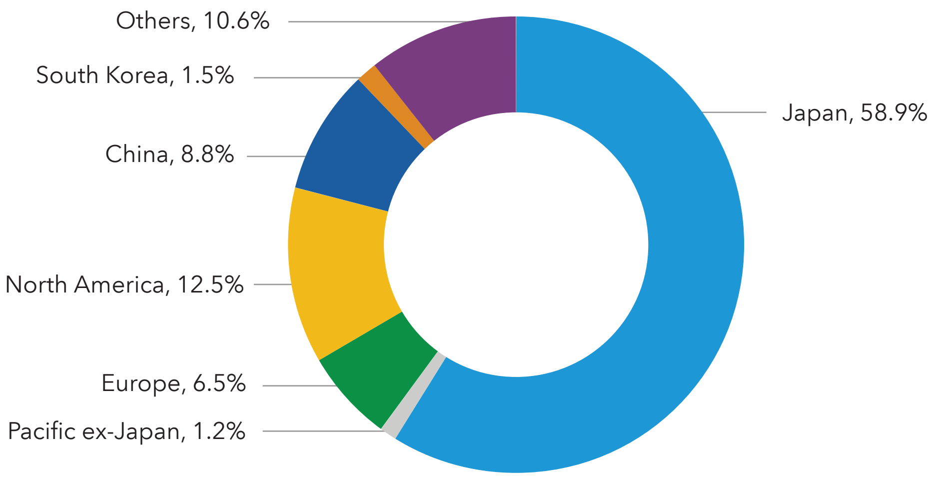
Overall, therefore, our views about our positions are largely unchanged. This is to be expected: we are very careful about investing in companies that not only do well in good times but can also emerge stronger from tough periods. And we are constantly monitoring their developments.

We visited several core holdings in Hamamatsu, Nagoya, Kyoto and Osaka following last summer's stock market correction. We met with company managements to assess the health of their businesses, and also travelled to Hong Kong to see Chinese companies, which gave us a deeper perspective on the broader market environment and reaffirmed our views of the fundamentals of our Japanese holdings. This in turn gave us the confidence to add to attractively valued positions where we expect fundamentals to stay strong even with a slowing China.

I should also add that the strategy's economic exposure to China is still modest at less than 10%. Comparatively, the strategy has far greater economic exposure to the domestic market. And that is increasing in view of external risks.

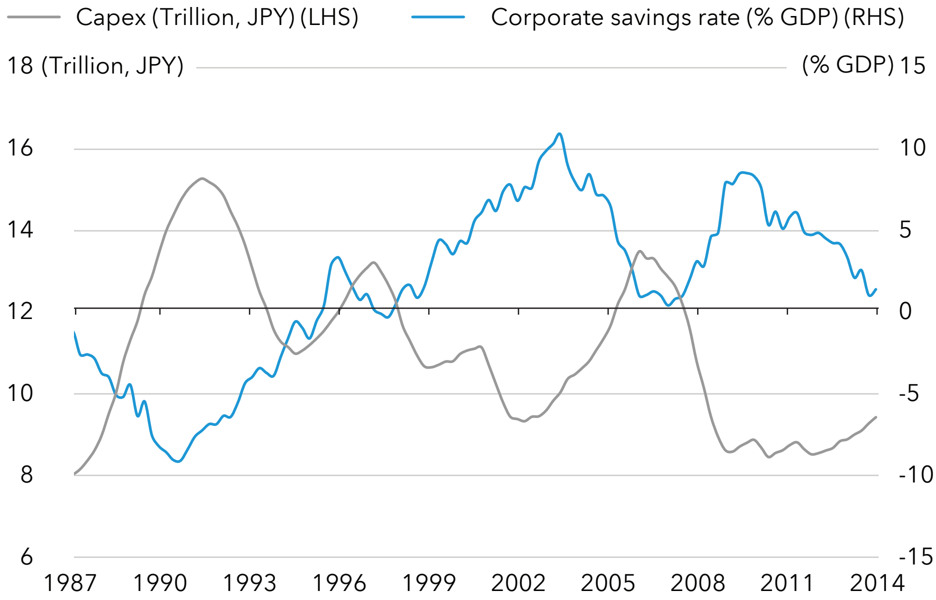
Exhibit 1: According to revenue analysis, the strategy has a relatively modest exposure to China and a far greater exposure to the domestic market.

Economic exposure



Data as at 31 December 2015.
Capital Group Japan Equity Composite representative account.
Source: Capital Group

Exhibit 2: Japanese firms are ramping up capital expenditure while reducing savings.



Data as at 31 March 2015.
Calculated based on four-month moving averages.
Sources: Ministry of Finance, financial statements statistics of corporations by industry, Thomson Reuters, UBS

"The emphasis on good corporate governance is having an impact. Shareholder value is improving as surplus cash is being returned to shareholders. We expect improving return on equity (ROE) to boost shareholder value further."

So are you optimistic about the outlook for Japan's economy?

Overall, the picture is brighter than the headlines suggest. We believe that Japan is still on the path towards the virtuous cycle of reflation, where prices, wages and profits rise together.
The so-called 'core-core' inflation rate, which excludes food and energy prices, has turned positive thanks largely to massive monetary policy stimulus.
An increasing number of firms have also been able to raise prices and pass on the higher costs to consumers.

We believe that as an inflationary mindset gradually takes root, companies, households and institutional investors alike will rethink how they manage their assets. Already, the corporate savings rate, which had risen to a historic high following the Global Financial Crisis, has been declining and is now near zero.
This reflects business confidence in future activity as company investments increase and capital spending picks up.
Government-led initiatives such as tax-free investment accounts have also resulted in more individuals shifting their cash into equities.

At the same time, we are keeping a close watch on Abe's growth strategies. Progress has been slower than many had hoped but changes in laws and regulations will take time. Encouragingly, labour market reforms are still underway, and more women are returning to the workforce. Separately, the emphasis on good corporate governance is having an impact. Shareholder value is improving as surplus cash is being returned to shareholders. We expect improving return on equity (ROE) to boost shareholder value further.

But corporate governance still seems to be a problem in Japan: just look at the recent Toshiba scandal.

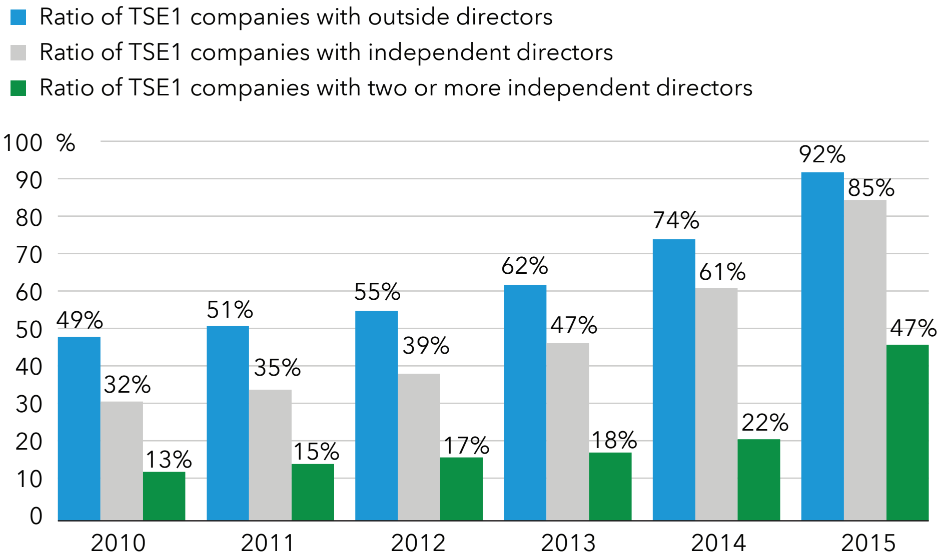
Toshiba's accounting scandal is unfortunate but that should not undermine the reform efforts by the rest of corporate Japan. We are convinced, from our regular conversations with company management, that attitudes are changing. Many investment managers, ourselves included, have adopted the new stewardship code of conduct for institutional investors, and with increasing shareholder pressure, firms are being spurred to action.

The old system of cross-shareholdings, where firms hold each other's shares to strengthen business ties, is breaking down. At the same time, companies are appointing more external directors to improve oversight, as suggested by the Corporate Governance Code that was introduced last June. These changes are notable. In 2010, less than half of the largest listed Japanese firms had outside directors. By 2015, that proportion had grown to 92%. The ratio of companies with two or more external board members more than tripled during that period.

Greater outside and investor scrutiny should prompt top management to focus more on capital efficiency and ROE. Admittedly, the average ROE for Japanese companies, at around 9%, is still low compared with more than 12% for US and European companies. But we believe that ROE can enter double-digit territory, leading to rising valuations and higher share prices. All in all, corporate governance in Japan still has some way to go but there are grounds for hope.

Exhibit 3: Moves to improve corporate governance bode well for shares.

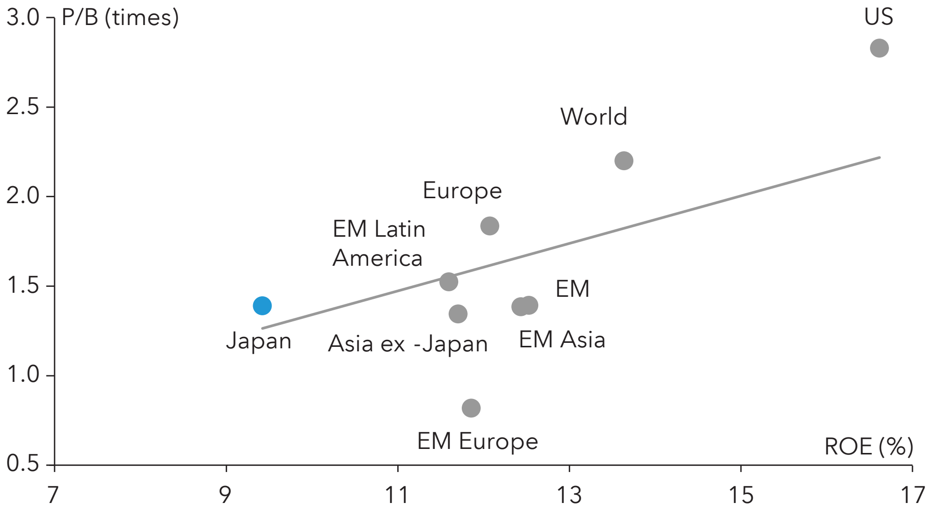
Companies with two or more outside directors



Note: Figures for years prior to 2015 are based on corporate governance reports. The figure for 2015 incorporates information in independent directors/auditors notifications submitted by listed companies on or before 16 June 2015. An outside director is designated as an independent director under the Tokyo Stock Exchange (TSE) listing rules. To protect the interests of general shareholders, TSE requires listed companies to file highly independent outside directors/auditors as independent directors/auditors. Source: TSE

Exhibit 4: We believe greater outside and investor scrutiny should prompt top management to focus more on capital efficiency and ROE.

Comparing return on equity (ROE) and price-to-book ratio (P/B) of major markets



Data as at 30 November 2015.
Sources: MSCI, IBES and Capital Group