

# Where Japan leads, others will follow

Global equity investors have been underweight Japan for decades. Conventional wisdom says Japan is a country burdened with a stale corporate culture and stagnant growth and should therefore be avoided. However, such criticisms are inaccurate and outdated.

By John Vail

While many global investors still only see the Japan of the past, they are missing out on the way Japan is shaping all our futures. Fears that Shinzo Abe's 'three arrows' corporate reform programme would wane after his departure as prime minister in 2020 have proven unfounded. A decade of reforms has created a more shareholder-friendly environment and helped companies to deliver vastly improved profit margins thanks to superior technology, stronger corporate governance and – particularly from within the Asia-

**'A decade of reforms has created a more shareholder-friendly environment and helped companies to deliver vastly improved profit margins.'**



Pacific region – better economic growth. Moreover, Japan's corporate culture will not be allowed to return to its past complacency. In April, the Tokyo Stock Exchange underwent a significant restructuring, ensuring Japan's top companies are motivated to keep improving their business operations and adhere to corporate governance standards, or risk being demoted or delisted.

Accountability is a growing theme in Japan. Shareholders are now more vocal, and sometimes even hostile, towards the companies in which they invest. Also, the lines between shareholder activism and stewardship are increasingly blurred since ESG considerations have become a primary concern at board level. Research suggests that engagement activity by large institutional investors aimed at companies with potential areas of improvement, such as

governance, low return on assets (ROA) and excessive cash holdings, has a positive impact, resulting in higher return on equity (ROE), more independent directors and proportion of shares owned by management. Within Japan's changing landscape, engagement is also becoming a significant source of differentiation for investors. Identifying and engaging with undervalued companies on ESG-related issues, such as decarbonisation, managing human capital and enhancing governance frameworks, should improve company fundamentals, enhance corporate value and ultimately lead to higher returns.

## **Japan's influence as a free trade promoter**

But the investment case for Japan goes far beyond corporate improvements. Japan's large capital reserves and its financial capabilities are significant tools for geopolitical influence.

## ‘Japan’s greatest contribution in recent times has been to take the lead in addressing critical societal issues soon to be felt by many other nations.’

Since well before the Abe era, Japan has been engaged in skilful diplomacy, not only with the United States and China, but also with the Middle East and India, in offering a credible investment alternative to China. While Japan remains the largest trading partner and most influential neighbour of China, Japan is also an essential partner for US policy towards China.

As a feature of this partnership, the US and Japan have pledged to further increase their inter-reliance in critical supply chain areas, while also cooperating on expanding export control mechanisms. Moreover, for decades, Japan has consistently sought to keep its currency from rising against the dollar, fearing the effects of a strong yen on its export sector. This alliance should ensure Japan faces little pressure from the US regarding currency appreciation.

### Stable conduit to long-term Asian growth

Japan occupies a unique place in the world, serving as a bridge between east and west, and between developed and emerging markets. Because of its proximity, Japan has deep cultural and economic ties with other countries in the Asia-Pacific region. Japan is uniquely positioned as a familiar developed market

that is reaping the benefit of emerging market growth trends, while not necessarily being exposed to the same accompanying risks.

For example, other Asian countries depend on Japanese technology as well as shared supply chains for economic progress. As Japanese companies grow their businesses overseas, and other Asian-Pacific countries, including China, rely on Japanese technology to achieve their economic development goals, Japan’s economic ties with Asia’s growth journey should continue to strengthen.

### Japan’s contribution to global challenges as an investment opportunity

Arguably, Japan’s greatest contribution in recent times has been to take the lead in addressing critical societal issues soon to be felt by many other nations. Japan’s demographic challenges are well-known. But unsurprisingly, Japan has responded with humane and intelligent approaches to healthcare and is also ready to accelerate the transition from fossil fuels to low carbon alternatives. Japan is also embracing some traditional old ways of thinking about sustainability and the circular economy that will prove invaluable as the world looks to make the difficult transition towards a green economy.

With nuclear energy as a politically difficult option, hydrogen is expected to play a key role in ensuring Japan achieves its ambitious goal of carbon neutrality by 2050. In April 2022, Japan’s hydrogen association HyS-TRA announced the completion of the world’s first maritime transport of liquefied hydrogen, including its loading and unloading, in Kobe, Japan. Such state-of-the-art technologies could transform Japan into a hydrogen-led society – setting an example for other countries looking to achieve their net zero goals.

### A country with renewed geopolitical and economic confidence

At a time of global uncertainty and disruption, Japan has a great deal to offer to the rest of the world. The Japan of today is one where a decade of corporate and stock market reforms are bearing fruit and where successive governments have prioritised revitalising the Japanese economy. Japan’s willingness to take the lead with diplomacy and international relationships has given it significant geopolitical authority and presented an important counter-narrative to the protectionism prevalent in other key markets.

This in turn has contributed significantly to Japan’s economic growth, creating a positive feedback loop. And, in the race to become carbon neutral, Japan is taking the lead in developing the technology capable of achieving net zero ambitions. The world wants to do business with Japan. Investors are just beginning to recognise the investment potential this brings. ■



**John Vail**

Chief Global Strategist,  
Nikko Asset Management

## SUMMARY

The economic and corporate reforms started under Shinzo Abe remain locked-in, laying the foundations for future commercial success.

Japan’s reputation as a reliable and trusted neighbour has helped it become Asia’s leading voice on free trade and investment.

The changes taking place in Japanese society have opened the door for companies with the knowledge and technology to tackle and solve social issues.

Japanese companies are overcoming demographic challenges through innovation, while developing hydrogen as a green energy source demonstrates the scale of its ambition.