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30 Years as a Contrarian Investor in Japan

Questioning the Role of Corporations and Stakeholder Capitalism

Masaaki Tezuka, CFA
Chief Portfolio Manager,
Japan Active Core Strategy

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Masaaki Tezuka is the Chief Portfolio Manager running our Japan Active Core strategy, one of Nomura Asset Management's flagship products.

Portfolio management has been more than a job for him, and his success has been driven by his passion and a sense of duty to investors. From the beginning of his professional career, he has continued to seek the true value of corporations, while also questioning their role - does a corporation exist simply to generate profits for its shareholders? To whom does a corporation belong? After three decades of managing equities, he is still searching for answers.

For decades, Japanese companies have faced persistent criticism of their cross-shareholdings - a unique system of interlocking share ownership between Japanese companies. Such arrangements blurred the boundaries of ownership and responsibilities of senior executives, and undermined the interests of minority shareholders. In addition, as Japanese corporations mainly relied on banks for financing, their `main bank` were able to solidify their influence and control over them. As Japanese companies have shifted their focus towards generating shareholder value, many of these outdated practices have started to disappear. However, many companies still wonder whether they should solely focus on profits.

Mr. Tezuka has always believed that corporations need to think beyond the bottom line and have a duty to consider their impact on their employees, the environment and the broader society in which they must operate. The pursuit of the common good through altruism will ultimately benefit shareholders.

Managing equities for Nomura`s Japan Active Core strategy since September 1990, Mr. Tezuka has been integral to the global expansion of the strategy, successfully winning and managing money for institutional clients around the world. He has also served as Chairman of the Japanese Stock Selection Committee (JSSC) for more than 10 years, from 1999 to 2009. He is a CFA charter holder and has a Master of Commerce degree from Waseda University in Tokyo.

In this paper, Masaaki Tezuka offers his perspective as a seasoned investment professional on how investing in Japanese listed companies has changed over the past 30 years.

1. Reflecting on Thirty Years of Investing in Japanese Equities

My 'right way' to invest is to thoroughly understand the dynamics that drive the Japanese market and its companies through painstaking fundamental research. There are no short cuts.

It is fair to say that the last three decades have been tumultuous for Japan. The Heisei era began with the jarring transition from the post-war growth period to the bursting of the asset price bubble in the early 90s. The country has endured a prolonged period of economic stagnation along with the more acute shocks of the Great Hanshin Earthquake (Kobe) of 1995, the Global Financial Crisis in 2008, and the Great East Japan Earthquake and tsunami in 2011.

In spite of the surrounding turmoil, success as a portfolio manager still means being able to identify investment opportunities and beat the markets consistently over the long term. Compared to 30 years ago, portfolio managers are today flooded with information, while facing a shifting regulatory framework and a chorus of experts constantly informing them of the `right way` to invest.

My 'right way' to invest is to thoroughly understand the dynamics that drive the Japanese market and its companies through painstaking fundamental research. There are no short cuts. By doing this, we play to the strengths of our team, who are able to succeed by cutting through the market noise and focusing on implementing a strategy to win.

Despite going through massive changes in technology and structural shifts over the years, our investment philosophy has survived the test of time by challenging the prevailing trends in financial markets. I would describe myself as a contrarian investor, but our approach is also flexible and we adapt to changes in the markets.

The Japan Active Core strategy combines both top-down and bottom-up investment approaches. From our bottom-up approach, we focus on companies with strong products and services that are able to add value and drive consistent profitability. This can be either through top-line growth or through process optimisation to reduce cost structures. At the same time, we look closely at business cyclical trends from the macroeconomic perspective. We then invest in large cap companies that are best placed to take advantage of those cyclical shifts.

In summary, we believe equity markets can only be described as partially efficient over the long run, with inefficiencies in the short term that active investment managers are able to exploit. We seek to invest in well-managed companies that offer good value, as I truly believe this is the best way to achieve consistent outperformance over time.

2. How Japanese Companies Started to Focus on Pursuing Profits

> ` Driven by the corporate governance code and the growing stake in Japanese companies held by international investors, there has been a huge shift in the mind-set of CEOs'

Prevailing opinion about the role of corporations has progressed since the 1970s when the late Nobel Laureate Milton Friedman stated that a publicly traded company's only social responsibility is to increase profits and maximise shareholder value. In Western markets, there has been a transformation in collective attitudes towards capitalism and the responsibilities of publicly traded companies. The global financial crisis in 2008 was a watershed moment, and the coronavirus pandemic could be another one. Maximising profits at all costs is no longer enough.

Japan has been an outlier, where corporate governance has historically revolved around banks. Japanese corporations typically had fewer sources of financing outside of the banking system, and so it was common to build long-term relationships with their main banks. Corporations were more dependent on bank financing, leaving many to focus on the priorities of their lenders rather than their shareholders.

Alongside this dependence on bank financing, a unique system of cross-shareholdings also evolved in Japan, whereby interlocking share ownership between Japanese companies effectively blocked hostile takeovers. Cross shareholding had become a longstanding practice and allowed companies to ignore outside shareholders' interests.

The end result was a lack of transparency and accountability from Japanese companies.

With Japan's closer integration into global capital markets since the "Big Bang" financial liberalisation reforms began in 1996, the influence of banks has waned over the decades. In 2018, revisions to the corporate governance code were introduced to challenge these cross-shareholding relationships; they required companies to provide justification for holding shares and offer plans for the unwinding of their holdings.

In many cases, senior executives in Japan have only recently started to appreciate the importance of shareholders. Driven by the corporate governance code and the growing stake in Japanese companies held by international investors, there has been a huge shift in the mind-set of CEOs. They are now increasingly under pressure to produce returns and are accountable to outside shareholders.

From my perspective, Japanese companies only started to shift their focus to profit maximisation following the collapse of Lehman Brothers in 2008. Typically, they had chased revenue and market share growth. Abenomics was also a catalyst for corporate governance reforms, and these are likely to be part of its enduring legacy. ROE levels have started to increase, and are now comparable with those of western equity markets.

Two major changes have supported these developments, particularly in the manufacturing industry:

1. Shift in Cost Structures

In the manufacturing industry, the systematic hiring of high school graduates as permanent employees was superseded by the hiring of temporary and contract workers. With temporary workers comprising an increasing share of a more flexible workforce, the cost of labour shifted from a fixed cost to a variable cost. This enabled companies to adjust and lower their cost base.

2. Rise of China

Thirty years of rapid economic development has generated a huge increase in demand from neighbouring Asian countries.

Japanese listed companies have flourished, boosting profits from the growth of neighbouring Asian countries - by 180 percent since the late 1990s, while Japan's nominal GDP(Gross Domestic Product) increased by a mere four percent during the same period.

Exports of plant and equipment have grown, and consumer goods manufacturers have also benefitted from the emergence of a new middle class in the developing economies of Asia. Offshoring of production has been another consequence of the rapid economic development of Japan’s closest neighbours.

Besides focusing on increasing returns, companies have also strengthened their investor relations. If a company’s willingness to hold meetings with investors is a barometer of how “shareholder-friendly” it is, then we have definitely experienced a warming of corporate attitudes to institutional investors and a greater willingness to engage.

3. My View on the Role of Corporations and their Stakeholders

To a certain extent, I agree with Milton Friedman`s view on the role of corporations. A corporation can only sustain itself in the long run by remaining profitable and by satisfying its stakeholders.

The key difference is that I also believe companies have a wider role and must operate as part of broader society. Their ability to add value goes beyond making money for their shareholders. A sustainable company should be profitable by selling goods and services that are relevant to consumers, thereby benefitting society.

Likewise, there are companies that do little to mitigate their negative externalities, and there are firms that engage in business practices that are socially or environmentally harmful. This is not a sustainable way to manage a company, and these are the companies we tend to avoid.

Employees are Key Stakeholders

Employees are long term internal stakeholders that are deeply vested in the sustainable success of the companies they work for. They share a common concern with their employers and as internal stakeholders, are critical to the long-term success of their companies. After all, a job can be more than just earning a living, for many it also provides a sense of belonging and purpose.

On the other hand, although we do invest for the long term, the fact is that shareholders are generally able to enter or exit positions relatively easily, in contrast to the longer-term commitment of employees of the companies we invest in.

Employees are key internal stakeholders, and I believe that a company with committed employees that are appreciated and take pride in what they do at work, will eventually lead to top line growth and profitability. Employee satisfaction is therefore just one of several non-financial metrics that can determine a company's investment performance over time.

4. Staying Relevant and Putting Our Clients First

> ` The critical question is whether ESG factors are real or merely cosmetic. I am somewhat concerned about the trend for companies to use ESG as a PR or investor relations tool to divert attention away from other critical issues surrounding their business.'

As institutional portfolio managers, we are long-term stewards of capital. I spend a considerable amount of time thinking about my duty as a portfolio manager.

In essence, my duty is to deliver long-term excess returns based on fundamental analysis. Investment management is a business where we are bound by our fiduciary duty to serve our clients' needs first; and ultimately, my job is to deliver returns for our clients.

So what are the characteristics of the companies that we look to invest in?

- Businesses with **distinguished business models**, offering **competitive products and/or services**, with a dominant market position and pricing power.
- **Capable management** that have a clearly defined strategy, with implementation knowhow.
- **Attractive valuations** relative to the stock's own historical trend, as well as peer groups (both regionally and globally).

In recent years, I have spent time examining how ESG can be applied to investing in Japanese companies. With the goal of understanding companies beyond their financial statements, ESG has become integrated into our investment process at the core level through the Japan Stock Selection Committee (JSSC).

Being long-term investors, we have certainly looked at many of the same material issues, although in the past we did not refer to them

with the ESG label. We have tended to focus primarily on corporate governance, especially given our strong emphasis on management quality. We have also looked for long-term investment opportunities in new and emerging energy efficient technologies.

Combining fundamental research with a thorough understanding of ESG risks and opportunities allows a portfolio manager to make better informed investment decisions. However, good ESG characteristics alone will not lead to outperformance. Research suggests that outperformance of sustainable investing strategies over the longer term is still inconclusive.

Even before the pandemic, we have seen a surge in inflows into ESG related funds and ESG fund launches. This has led to the outperformance of ESG-related stocks, or companies with certain investment attributes such as quality or growth.

This is unlikely to last, as I have experienced before – long periods of factor outperformance from `herd mentality`, eventually give way and are typically followed by long periods of underperformance.

The critical question is whether ESG factors are real or merely cosmetic. I am somewhat concerned about the trend for companies to use ESG as a PR or investor relations tool to divert attention away from other critical issues surrounding their business. This isn't to say we are ESG sceptics – good management is a necessary condition for us to invest in a company and sustainability can confer some competitive advantages.

5. ESG Perspectives from Japan

> ` In terms of corporate governance reforms, putting committees in place and taking steps to improve diversity of the board are extremely important, but ultimately, the effectiveness of governance measures should only be judged by their results.'

Japan is often said to be behind the rest of the developed world in ESG practices. However, the reality is more nuanced, and so it is worth examining the historical context.

ESG as a concept took some time to gain traction in Japan, and has taken a slightly different trajectory. The focus on corporate governance has been promoted by a strong official push from the Abe government. The Stewardship Code and Corporate Governance Code introduced in 2014 and 2015 respectively are having a material impact on attitudes of Japanese corporate management. However, efforts remain underappreciated in many other areas, particularly with regard to the Environment.

Corporate Governance: A New Generation of Leaders

Governance is crucial to the sustainability of a company and can determine corporate Environmental and Social behaviour too. Over the course of my career, I have met senior executives who were unwilling to take account of the interests of shareholders, and some that even lacked basic understanding of the financial markets.

There has been a major push to improve corporate governance in recent years, and a new generation of energetic, result-oriented leaders has entered Japan's boardrooms. I am more convinced that corporate Japan is no longer being run by thosewho shun their shareholders.

There is some hard evidence to support this given the rising number of M&A deals we have seen over recent years, and the trend towards the consolidation or disposal of listed subsidiaries. Parent-subsidiary listings and cross-shareholdings have diminished as these improvements in governance have taken hold.

In terms of corporate governance reforms, putting committees in place and taking steps to improve diversity of the board are extremely important, but ultimately, the effectiveness of governance measures should only be judged by their results. From my perspective, a way to confirm the effectiveness of a board is, quite simply, whether or not the board is able to fire its CEO.

I frequently meet with the top management of companies with the aim of understanding their businesses and corporate strategy. And they are increasingly coming to me and my colleagues to seek advice on promoting positive corporate behaviour that benefits both the company and its shareholders. I expect this trend to accelerate going forwards.

6. The True Meaning of Governance

> ` I have made mistakes early in my career of taking a contrarian view on companies that have been involved in corporate scandals, believing they had repented, reorganised and would recover in the long run. If there is one thing I have learned the hard way, it is that corporate culture does not change overnight.'

In Japan, governance is still the main focus of ESG, and from my experience of engaging with Japanese companies, past performance does serve as a guide to future performance. I believe strong management teams that have been able to achieve their goals by implementing their strategies well will be able to do so in the future. On the other hand, there are some companies that never achieve their targets or incur great losses, yet no one is held accountable.

This is when I start to question the effectiveness of the board. An effective board will be able to prevent the executive management team from taking excessive risks and squandering the firm`s resources. They can even fire an ineffective management team. Intuitively, by the time the board fires the management team, it would have been too late as the stock price of the company would have plummeted.

This is the reason why I steer clear of companies with weak management teams and poor corporate governance. I have made mistakes early in my career of taking a contrarian view on companies that have been involved in corporate scandals, believing they had repented, reorganised and would recover in the long run. If there is one thing I have learned the hard way, it is that corporate culture does not change overnight.

Below are some examples of the companies you could expect to see in the portfolio.

Sony Corporation

Sony is a global conglomerate, one of the world's largest manufacturers of consumer and professional electronic products. The conglomerate leads the world in many areas including video games, music, movies; it also has a dominant position in the image sensor market.

Facing fierce competition from other Asian rivals, Sony went through years of losses, failing to deliver results. It was only in recent years where the company really started to turnaround by executing restructuring measures to stem underperforming businesses and focus on their strengths. With a sharp focus on finance, Kenichiro Yoshida, CEO, the company’s former CFO, has been successful in bringing Sony back into profit.

Sony has also faced external pressure, notably from activist investor Third Point, to breakup the company by spinning off various units. In 2013, Third Point called for the company to spin off its entertainment unit, and more recently, the activist has pushed Sony to spin off its semiconductor business. While Sony engaged with the activist investor, they have rejected these proposals by insisting that these units were a core part of Sony.

In general, Japanese manufacturers have been able to successfully position themselves upstream, as providers of critical components to other global businesses. For example, Sony produces image sensors which are crucial to the success of Apple`s iPhones.

Despite years of restructuring, Sony remains an innovative global powerhouse. In gaming, Sony launched the PlayStation 5, a next generation gaming console that has been able to capture the growth in `nesting` demand seen this year. Japanese animated film `Demon Slayer`, which was co-distributed by Sony`s music unit, became the latest blockbuster to break box office records in Japan despite the pandemic.

Nitori Co., Ltd

Nitori is the largest retailer in Japan for furniture, interior goods, kitchenware, and home accessories. Founded in 1967, the firm's focus on reasonable prices and simple design proved a winning formula, as the company expanded to over 550 stores across Japan and over 60 stores overseas.

Famous for its affordable prices, Nitori's effective operating model has been able to support low prices with competitive product quality. Most of Nitori's products are developed by their internal team, which also handles the entire process from product planning, production, to final delivery. The company has an excellent logistics system, with a proprietary delivery network and operates its own production facilities in Southeast Asia.

More recently, the pandemic has helped boost its sales even further as customers spend more time at home. Management has done an excellent job in terms of pursuing profit growth, producing returns for their shareholders over the years.

Through its environmental policy, the company has implemented various initiatives to reduce CO_2 emissions, increase energy efficiency, and minimise packaging waste. The company also retains talent by investing in their employees through `Nitori University`, providing educational opportunities. They have increased compensation for their employees and aim to create a `working environment in which employees can work with pride`.

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