Rediscovering Reliability:
Nomura Asset Management on Japan

Yuichi Murao, CFA
Senior Managing Director
CIO, Japan Equities
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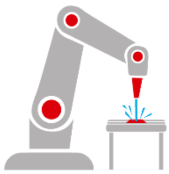
Higher inflation. Disrupted supply chains. Heightened geopolitical tensions. Within today's challenging and uncertain environment, Japan offers unique advantages. In this paper, CIO Yuichi Murao explores how technological leadership, evolving corporate governance, and attractive valuations of Japanese companies create appealing opportunities for investors.

A Key Player in Supply Chain Recovery

Japan has established its status as a reliable alternative manufacturing partner that can contribute to supply chain recovery and offer resilience against geopolitical upheaval.

The global pandemic exposed weaknesses of existing supply chain arrangements, and widespread disruptions drove governments to secure domestic production of semiconductors.

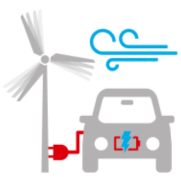
Japan is home to world-leading manufacturers that cover a wide range of industrial technologies critical to the global supply chain. As the pandemic recedes, Japan has established its status as a reliable alternative manufacturing partner that can contribute to supply chain recovery and offer resilience against geopolitical upheaval. The inflows of new capital investments into semiconductor production equipment have proven a boon to Japan's manufacturers.



Furthermore, competitive Japanese exporters aim to utilize their strategic positions as reliable partners to bring stability to global supply chains, including cutting-edge semiconductors amid the global chip shortage. Particularly, these companies stand to benefit from increased investments, as countries seek decouple their supply chains and avoid the ill effects of potential trade tensions in the future.

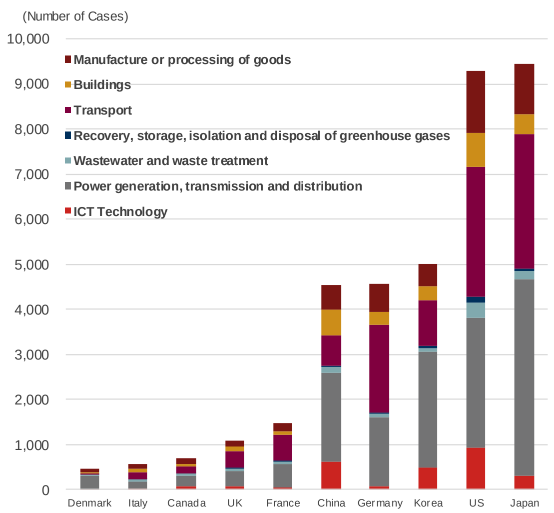
Competitive Edge in Technologies for Decarbonization

In addition to accelerating its own decarbonization efforts, Japan's technologies may play a role in other fast-growing Asian economies that are heavily reliant on coal.



While Japan is making large contributions through its technical prowess in the pandemic's wake, its potential to offer solutions to global issues extends far into the future. Japan announced a plan to achieve carbon neutrality by 2050 and committed to cutting greenhouse gas emissions by at least 46% by 2030. Given the country's competitive edge in energy efficiency and renewable technologies, these goals will provide a structural tailwind. Following the 2011

Climate Change Mitigation Patents by Country



Source: From 2015 to 2017 (average). Nomura Asset management based on Ministry of Economy, Trade, and Industry's "White Paper on International Economy and Trade".

Fukushima nuclear incident, Japan has been highly dependent on fossil-fuel power generation, leaving ample domestic potential for the introduction of cleaner alternative sources. In addition to accelerating its own decarbonization efforts, Japan's technologies may play a role in other fast-growing Asian economies that are heavily reliant on coal. There are potential opportunities such as carbon-reducing fuels (hydrogen) to displace natural gas, and ammonia as a coal replacement for potentially carbon-free energy.

Changing Demographics as a Driver of Innovation

For decades, Japan has often been characterized by its aging population, but in truth, this is a looming issue for many developed economies in the modern age. As a pioneer in adapting to this demographic shift, Japanese companies have the opportunity to expand into overseas markets with off-the-shelf business models. The need to lower the cost of care for an aging population has spurred innovation with new technologies by tapping into Japan's historical advantage in industrial manufacturing.

Re-Opening to Tourism

Japan is an attractive tourism destination whose borders have remained closed throughout the pandemic. As conditions improve and travel restrictions ease, the tourism industry is expected to roar back with pent-up demand, particularly from Asian countries, as the restart of travel across Asia will likely translate to improved sentiment and economic growth. Many tourists are expected to flock to Japan for the first time in two years.

Stronger Focus on Corporate Governance and Shareholder Returns

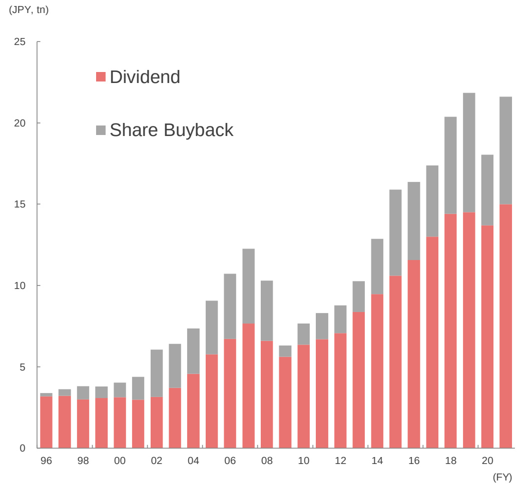
Over the past decade, Japanese companies have embraced corporate governance and taken measures to strengthen their dialogues with shareholders. The introduction of the Shareholder Stewardship Code in 2014 and the Corporate Governance Code in 2015 have enhanced focus on corporate governance reforms, resulting in improvements in governance and shareholder return policies.

The Corporate Governance Code was further revised in 2021 to bring it in line with ESG trends, recognize Sustainable Development Goals (SDGs), and reflect drastic changes brought about by the global pandemic. The Code now requests Japanese firms to disclose the climate change impact of their businesses in line with the TCFD framework. It also stresses the importance of diversity, for both board members and human capital.

Building on this progress, the Tokyo Stock Exchange introduced revised listing requirements to drive further reform when it restructured its market segments in 2022. In order to be listed on its top section, a company will need external directors comprising at least one-third of its board, at least 35% of its shares to be free-floating, to engage more actively in dialogue with investors, and to conduct disclosures in English.

At Nomura Asset Management, we have also stepped up our engagement efforts with our portfolio companies to drive further reforms. A majority of Japanese listed companies now have independent directors, compared to a decade ago. There have also been results from increased pressure from shareholders and the government to utilize cash through dividends and share buybacks and to improve the diversity of their boards.

Shareholders' Return (Dividend + Share Buyback)



Note: FY1996 - FY2021. For all listed companies' ordinary shares excluding preferred shares buybacks as well as shares purchased from the Resolution and Collection Corporation. FY2021 share buyback is actual as of the end of March 2022, and dividend forecast is as of the end of Mach 2022. Source: Nomura Asset Management based on Nomura Securities data.

Corporate Restructuring and Transformation

The evolving approach to corporate governance is also reflected in a clear shift in CEO mindsets to focus on their shareholders, enabling their companies to enhance returns and set their sights on innovative growth strategies. Japan is in the midst of a boom in M&A activity, and Japanese companies have made significant progress in corporate restructuring and transformation. Many Japanese companies went into the pandemic with large reserves of cash and have reshaped themselves by divesting their non-core assets, thereby allowing corporate management to focus on shareholder returns to unlock the true value of their businesses.

One of the most significant trends is the consolidation of "parent-child listing". This is a prevalent structure where both the parent company and its subsidiary are publicly-listed.

Corporate governance reforms are forcing companies to review their listed subsidiaries, which has led to a significant number of transactions, management buyouts (MBOs), or sales of subsidiaries.

The Macro Picture: Inflation, Currency, and Debt

> *The broader Japanese stock market is heavily weighted toward global manufacturers, and the depreciation of the yen may provide a boost to export-driven companies.*

As inflation surges across much of the world, consumers in many developed nations are grappling with higher prices. Despite this, consumer price increases in Japan remain relatively low, particularly when compared to the elevated levels in the United States. On the other hand, inflationary pressure on energy and raw materials prices are impacting Japan as well.

There is a widening gap between the Bank of Japan's (BOJ) policies and those of other major countries, as many of BOJ's central bank peers remove monetary easing measures. This gap may have contributed to the Japanese yen depreciating to a two-decade low against the U.S. dollar earlier this year. Despite Japan's reliance on imported energy, investors have historically welcomed the weakening of the Japanese yen, as this strengthens Japan's cost competitiveness. The broader Japanese stock market is heavily weighted toward global manufacturers, and the depreciation of the yen may provide a boost to export-driven companies.

An Overlooked Market

> *Despite robust corporate fundamentals and earnings forecasts that are comparable to other developed markets, many stocks in Japan remain undervalued due to a lack of coverage by research analysts and sparse information for investors.*

Perceptions of low economic growth a high level of public debt, and an aging population may have led investors to overlook the country as an investment opportunity. Indeed, Japan may have a high level of public debt, but 90% is held by Japanese investors and in its own currency. These perceptions may have also been reflected in Japan's relatively low current valuations. Despite robust corporate fundamentals and earnings forecasts that are comparable to other developed markets, many stocks in Japan remain undervalued due to a lack of coverage by research analysts and sparse information for investors.

Furthermore, the Japanese stock market does not only represent the domestic Japanese economy. It offers exposure to global secular trends. Japan continues to play a strategic role in the global portfolio, through resilient and innovative companies with strong balance sheets, many of which are relatively cheap.

Our View

During the past years, we have collectively experienced an unprecedented pandemic, accompanied by lockdowns, supply chain disruptions, and geopolitical tension. Financial markets remain volatile, while rising interest rates and higher inflation compound the uncertainty. Despite this, we are confident that Nomura Asset Management's collected expertise and experience equip us to devise strategies to navigate these challenges.

Focus on Quality: We uncover attractive, quality companies regardless of style, whether value or growth. While the re-opening of the economy is beneficial for sectors that suffered during the pandemic, we believe there is room for technology sectors with secular growth to deliver stellar returns going forward.

Inflation Winners: We believe adequate preparations should be made for elevated inflation through sectors which have historically performed well in an inflationary environment. Essential businesses that possess the ability to pass on rising costs to consumers are key. There may be tactical opportunities for sectors that historically have a higher correlation to inflation such as Financials, Real Estate, Industrials, Energy, and Shipping.

Re-Opening: The re-opening of the economy represents a significant opportunity, primarily for sectors that suffered the worst during the pandemic. These sectors include Aviation, Hospitality, and Retail.

Capturing Secular Growth: Japan is home to globally competitive companies that are critical to global supply chains. Industries in automation, electronics parts, and materials supporting these ecosystems are likely to benefit as demand for automation is expected to accelerate beyond the manufacturing sector, on the back of need to reduce human contact and mitigate labor shortages.

Knowledge and Experience to Pick Winners

For individual companies, we see opportunities across a broad spectrum – quality, value, and growth stocks. In this period of heightened uncertainty, our view is that quality companies with sustainable profits, solid balance sheets, and pricing power will have the advantage and the ability to pass on higher costs to their customers. These factors will help them navigate this environment. Identifying companies with pricing power that are able to pass on rising costs to their customers is not an easy task. It requires a significant amount of firsthand knowledge and research. Our deep commitment in both resources and approach allows us to actively monitor a vast number of companies and diverse business groups to select winners for our clients.

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