

Should Japanese equities be an overweight in portfolios?

Ability to generate uncorrelated returns



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We are unable to predict what trends and macro forces will drive stock prices in 2017. However, in our view the strong macro headwinds which impacted Japanese equity markets in 2016 created an environment in which markets may again become focused on the fundamental value of individual stocks.

While we are constructive on Japan equities, we are not convinced by the broad-based arguments, including cheap valuations, which suggest Japan equities should be overweight in a portfolio.

The first half of 2016 saw a massive outflow of foreign capital and the Topix index ended at -19.48%.

To put this into context, while the post-Abenomics period from December 2012 until Q4 2015 brought net inflows from foreign investors of approximately ¥20trn, about half of this was sold off in the first half of 2016.

During this time, foreign money was leaving the Japanese equity markets about 50% faster than during the 2008 global financial crisis.

Are Abe's arrows hitting the mark?

The second half of the year, however, was dominated by the Bank of Japan's ETF purchasing scheme, which was increased to ¥6trn annually. The Topix recovered and ended at -1.85%.

Our view is Japan equity strategies should continue to play a key role in our clients' portfolios, but more due to their ability to generate uncorrelated returns.

At a micro-trend level, we like the [strengthening of the corporate governance culture](#) and the introduction of new indices that reward companies for return on equity (ROE) and profitability.

Another index is planned for 2017, which will include small and mid caps with high ROE. We also see government policies supporting those companies, via tax incentives for example, with higher capex and share buy-back programmes.

Our conviction in Japanese equities lies in the uniqueness of the opportunity underpinned, among other factors, by the size and depth of the market; around 3,500 listed companies, of which at most one third are covered by analysts.

As a result, [mispricing of individual stocks is high across sectors](#).

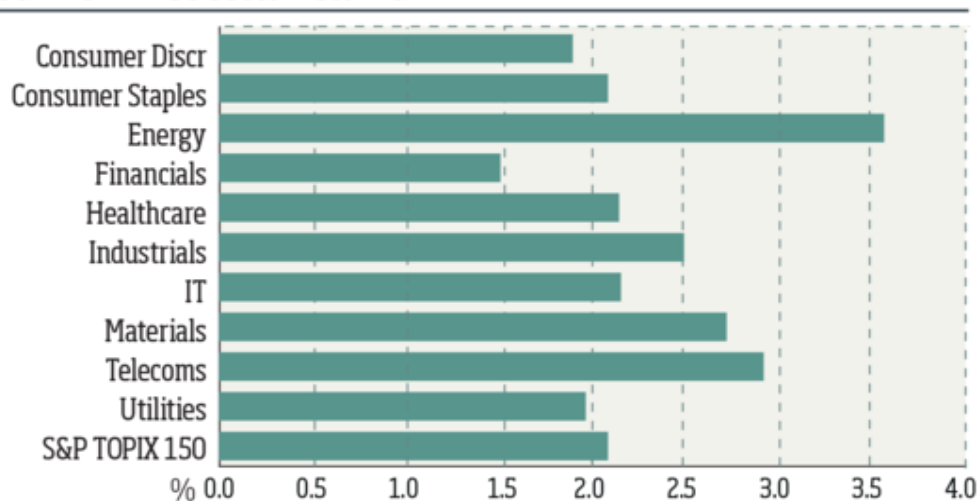
Bull Points

- Robust opportunities sector-wise where there is a significant technological advance in industries with a high barrier to entry that operate with bigger margins and strong cashflows
- Tourism will continue to increase, especially from China

Bear Point

- Impact of economic and geopolitical events, especially in the US and China, on valuations in Japan

S&P TOPIX 150 sector returns



9 January 2017 - 15 January 2017. Source: Morningstar