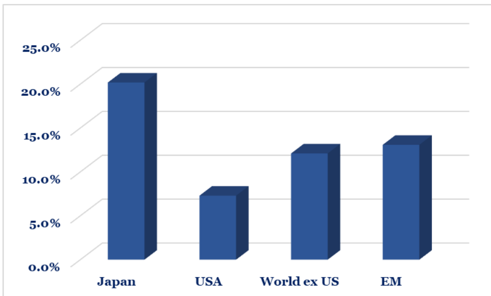
Haven Global Partners, LLC
Investment Insights: November 2023

When Cash is Not King

Historical data show that global equity market leadership tends to run in long cycles with new winners and losers every decade. The Emerging Markets outperformed in the 2000's while the last decade was dominated by US equities. One only has to go back to the 1980's to find a period when Japanese equities led global markets, when the Topix index was up more than 750%. Since then, the Japanese equity market has languished, and even today the Topix is trading below the peak it reached in Dec 1989.

Over the last year, however, Japanese equities have started to work again, outperforming the US, Emerging Markets as well as international Developed Markets (Exhibit 1). This begs the question: will the rally persist, and can Japan be the "must own" asset class of the next decade?

Exhibit 1. Trailing One Year Performance: October 31, 2023

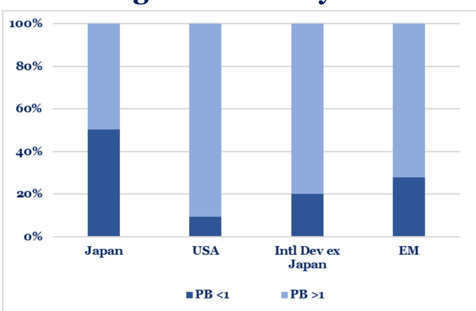


Source: Bloomberg

It is fair to question the recent rally in Japanese equities as there have been several false starts since Japan peaked in 1989. For example, between 1998 and 2000, Japanese stocks rallied, only to give back the gains when the Tech, Media and Telecom bubble burst. The most recent outperformance was from 2012 to 2017, when PM Shinzo Abe embarked on his three arrows economic reform, known as Abenomics. The rally fizzled as investors grew weary of the reforms driven by political uncertainty.

We think that this time could be different, driven by two reforms undertaken by the Japanese government and which, in our view, could be more impactful. First, the Tokyo Stock Exchange has initiated rules to have companies that are persistently trading below book value to share an improvement plan and report their progress. These companies will also be required to disclose their cost of capital and capital efficiency numbers.

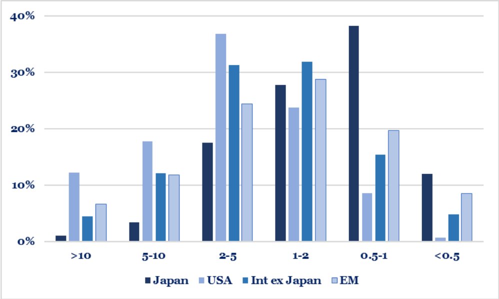
Exhibit 2. Percentage of Stocks by Price to Book Value



Sources: Bloomberg, Topix, MSCI

As presented in Exhibit 2, approximately 50.5% of the companies in the Topix Index are trading below book value while a comparable number for the US is 9%. Similarly, about 20% of stocks in international Developed Markets ex Japan and 28% in Emerging Markets are below book value. More specifically, about 38% of the stocks in the Topix are trading at a price to book value between 0.5x and 1x and 12% are below 0.5x (Exhibit 3). Japanese companies are notorious for hoarding cash, which makes their balance sheets inefficient. This not only suppresses return on equity (ROE), but also impedes growth. Thus, a greater focus on capital efficiency should lead Japanese companies to generate higher ROE's.

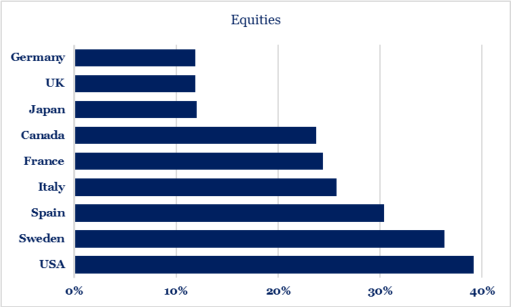
Exhibit 3. Distribution of Stocks by Price to Book Value

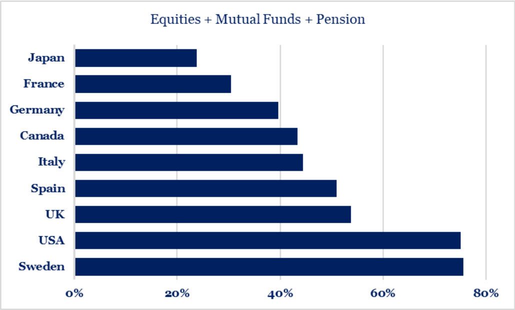


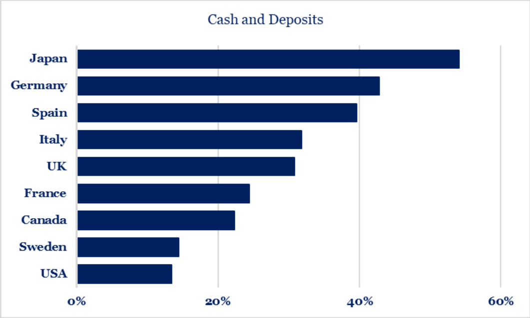
Sources: Bloomberg, Topix, MSCI

Second, the government of Prime Minister Fumio Kishida plans to double financial asset-based income for individual investors. The objective is to create an environment to jumpstart a "virtuous cycle of growth and asset-based income." The plan is to double household participation in financial investments and double the amount invested in 5 years.

Exhibit 4. Household Investments: 2022







Source: OECD

According to the Bank of Japan, only 13% of Japan's ¥2,000 trillion of household assets are held in equities. This compares with almost 40% for US households. Furthermore, more than half of the household assets in Japan are held in cash and low yielding deposits (Exhibit 4). Hence, there is a big opportunity in Japan to shift household assets from risk-free low yielding assets to equities.

We believe that a more efficient use of cash through a combination of the above two reforms – increased capital efficiency in businesses and broader participation in equities by households – could have a longer lasting positive impact on the Japanese equity market into the next decade. For businesses and investors, it is often said that "Cash is King". But in the case of Japan, there is too much cash.