Hosking Post
Japan: The Best Game in Town

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JEREMY HOSKING'S THOUGHTS ON THE RECENT JAPANESE STOCK MARKET DRAWDOWN

Spoiler Alert: buy more, it is the best game in town……

"It's only when the tide goes out you discover who's been swimming naked."

Charlie Munger, RIP

I was as surprised as anyone when I turned on the screen yesterday (August 5th) to find the Nikkei 225 and nearly all of my Japanese investee shares down 12% or more. Two important questions arise:

1. Why has the biggest drawdown in the current global "correction" occurred in the World's least overvalued market?

2. In the era of the "brilliant and selective stock picker" (Ha ha), why were ALL shares down more or less equally?

Maybe there are four different categories of investor who would have long positions in Japanese equities in one form or another:

Category 1: Specialist Japan-only portfolios, either long-only or hedge funds who (due to the manager's legacy expertise) can best achieve risk-free annual alpha within a Japan constrained environment. Brutalised by a 40-year bear market, I would say the value of funds managed within this cohort is small (thanks to the lost decades for the Japanese stock market) and could not account for a short-term 10% appreciation of the yen and a short-term 15% broad based fall in the stock market. Moreover, Japan-only hedge funds would have liabilities in the form of securities borrowed and sold short. As almost no shares rose on the day, hedge fund liquidation could not, surely, have been a factor?

Category 2: Long-only global investors. Within the dominant institutional paradigm, managers focus on a limited number of 'above average' companies as defined by conventional metrics (e.g., RoCE, RoA). There are very few above-mean RoE firms in Japan, in any event. The overwhelming proportion, by number of firms, under-earn the average and are not attractive to the investment committees of 'very smart' global investors, hired by leading institutions.

Category 3: New arrivals in Japan following the TSE March 2023 price/book interventions, such as Hosking Partners, but including the growing number of activists. The activists are, at this point, modestly sized firms which, sensibly, gain influence by concentrating their fire power on a limited number of investee targets. Think Oasis Management Company investing in Hokuetsu (mid-sized paper firm). Even in the case of Elliot Advisors, there is great focus on selectivity (think Daily Nippon Printing).

By reason of elimination none of the above can be the guilty parties. Which leaves:

Category 4: Large but possibly dozy institutions (Japanese and international) who have been running large, legacy currency mismatch strategies. Since Japanese inflation and interest rates have been nailed to the floor for longer than anyone can remember, these in-place positions may have become rather long term and highly profitable. Accordingly, oversight may have become complacent. Funding would be via in-house deposits or insurance premia or via third party yen denominated bank loans. Even though everyone expected Japanese interest rates to rise this year, the actual (tiny) 0.15% increase, when it came, perhaps caused a disproportionate but crowded over-reaction within this category of investor. The assets of this group may well have been held via index funds or ETF's and thereby be consistent with the remarkable breadth of the panic-stricken share-price decline. Mark-to-market kneejerk reaction may also be a factor, hence the market weakness on August 5th being greater than that on August 2nd.

If Category 4 'investors' are responsible, it seems that while the drawdown is/has been severe, its duration is likely to be short. Moreover, this setback (on this writer's view) broadens and lengthens the bull case-runway for the Japanese stock market, which we have written about previously here.

Back to Basics

No evidence has emerged, in our work over the past 18 months, that the valuation case for most Japanese equities is flawed. What becomes ever more apparent, however, is that this story will take a long time to play out in its entirety. Thus, it may be that only patient investors can benefit… To re-cap, company enterprise values which are close to zero (or below) and a long laundry list of "not-required" corporate assets that can be monetised and returned to shareholders produce an investment case that cannot be undone by macroeconomic adversity, or by valuation excesses. Short-term price fluctuations, such as those seen recently, only enhance the investment case.

As for valuation excess risk, it is the undervaluation that is excessive! The key process is the pace at which Japanese companies can buy back their shares. Given both negative or zero enterprise values and the instant impact nature of a buyback at a discount (remember your calculus), it would be wonderful if buybacks with infinite returns could be bigger and faster, especially for the 'Instant Gratification' brigade. Stock market liquidity, corporate habits, and Japanese boardroom conservatism suggest it will be slow, however successful investors turn out to be in speeding the process up. For example, we do not remember a firm for which RoA was/is a key corporate metric (yet), while RoE is already commonplace.

One particular Japanese phenomenon is the buyback/cross-shareholding identity. In the Anglo-Saxon corporate and investor mindset, share buybacks are a key factor in balance sheet asset lightening and valuation improvement, much to the benefit of corporate managers on stock option-based compensation. In Japan, it used to be thought that the cross holding unwind would be an overhang. However, it is now clear and common practise that share buybacks will comfortably absorb it. Other things being equal, one would expect the abundance of sellers to delay but (NB) not negate the valuation effect of buybacks, especially as it accelerates RoA improvement.

In recent months it has become clear that it is the unwind that has right of way, rather like uphill-bound traffic on a narrow road bridge, so much so that companies can buy abundant quantities of their own shares at a discount. The effect of this will be to enrich long-term investors all the more, as companies retire even more shares for each tranche of monetised surplus assets, but it clearly almost eliminates share buybacks as a short-term improver of corporate share price performance.

In conclusion, it seems as though investors, especially those with a duration advantage, will benefit greatly from increasing Japanese stock market exposure on the current setback.

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