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When Bigger Isn't Always Better

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The Case for Japanese Small Cap Stocks

The potential for global small caps to deliver outsized returns relative to their large cap peers has been hard to ignore – in fact, they've become a bright spot in institutional portfolios as investors grapple with muted market performance and growing concerns about geopolitical risk and volatility. In that context, Japan stands apart from other markets. They provide a rich opportunity set of under-researched small cap companies that are far less exposed to shaky global trade dynamics and currency fluctuations than their large cap counterparts. At the same time, with its 3,000 small cap listed equities[1], Japan provides ample room for bottom-up fundamental active managers willing to invest the time and resources to separate the long-term winners from the rest of the pack. In this paper, we make a case for taking a small cap approach to Japan, including these top five reasons that make them a compelling addition to a small cap portfolio:

[1]Japan listed companies with market cap less than US$ 3bn as at 3 May 2018, Bloomberg. (3254 companies in total)

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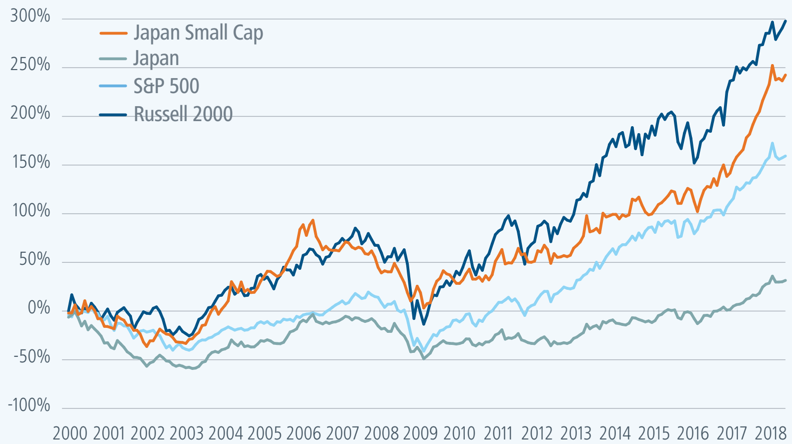
Reason #1 – Resilience and Downside Protection

While the story of Japan's economic growth has for decades been one of deflation and economic stagnation, its small cap stocks have followed a different narrative. Returns for Japan's smallest listed companies have been very strong relative to their large company counterparts. Since 2000, the TOPIX Small Cap index has returned 7.3% per annum, compared to 1.5% for the large-cap-biased TOPIX and 5.7% for the S&P 500 (Figure 1).[2] And while the TOPIX Small Cap index has trailed the Russell 2000's 8.3% annualized return, it has done so with less volatility, particularly during periods of falling markets.

Figure 1: Total investment returns

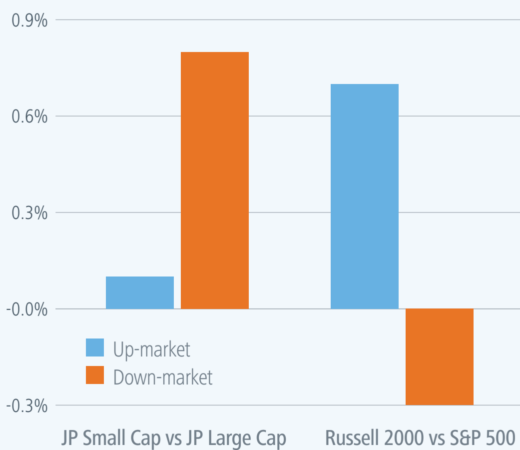


Source: Bloomberg. Notes: Total shareholder return in US$ since 1 January 2000 to 4 May 2018. Japan indices are TOPIX and TOPIX Small Cap. Rebased to 100 on 31 December 1999.

The TOPIX Small Cap index has also proven more resilient in down markets during the same time period. In the months where the TOPIX fell, the small cap index outperformed by an average of 0.8% (Figure 2) compared to other markets where smaller cap stocks tended to be more volatile and underperformed in falling markets (Figure 3). The Sharpe ratio of Japan small cap stocks compares favorably to Japanese large caps, as well as small and large cap US stocks (Figure 4).

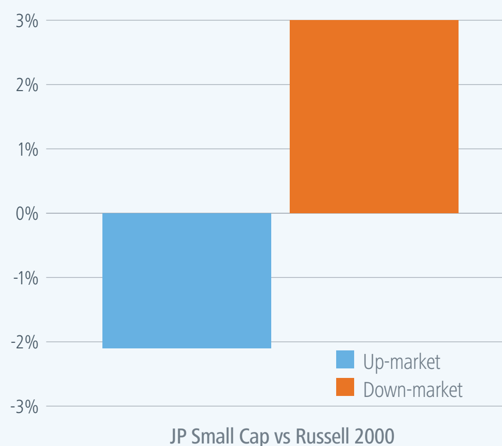
Contributing to small cap stocks' resilience is the fact that they are more exposed to Japan's stable domestic economy than large cap stocks. That local exposure means they are largely insulated from the volatility of the global economy. At the same time, the yen is viewed as a "safe haven" currency and also tends to perform counter-cyclically, strengthening in times of market weakness. But companies in Japan that are domestically focused don't experience much of an impact from the strong currency – in fact, they can even benefit from the yen's strength when it reduces costs for imported commodities.

Figure 2: Japanese Small Caps are resilient in up- and down-market environments



Source: Bloomberg, IG. Notes: Up-market & Down-market determined by Topix & S&P 500 monthly USD total return for Japan small cap & the Russell 2000 respectively. Notes: Data is from January 2000 – May 2018.

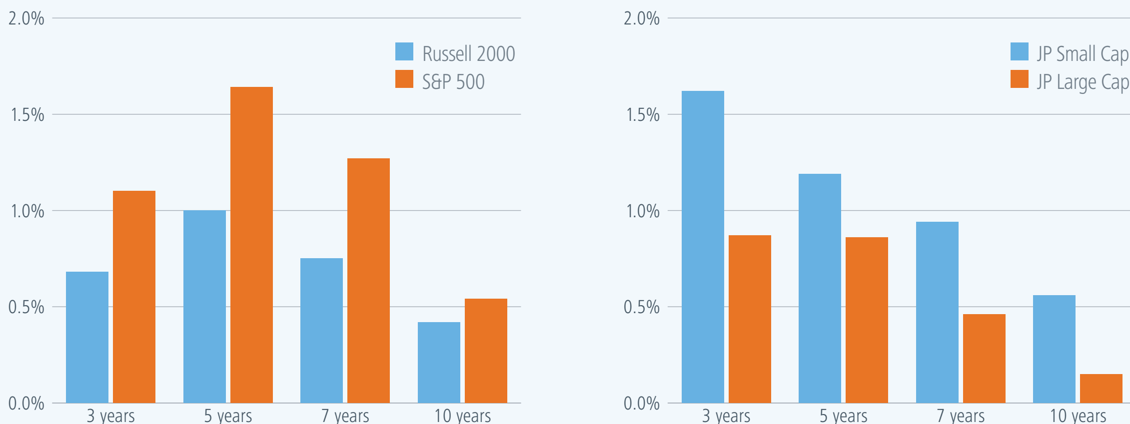
Figure 3: Japanese Small Caps have outperformed US small caps in down markets



Source: Bloomberg, IG. Notes: Up-market & Down-market determined by the S&P 500 monthly USD total return. Notes: Data is from January 2000 – May 2018.

[2]Total return basis in US dollars

Figure 4: Sharpe Ratios: Historic Risk/Reward favors Japanese Small Caps



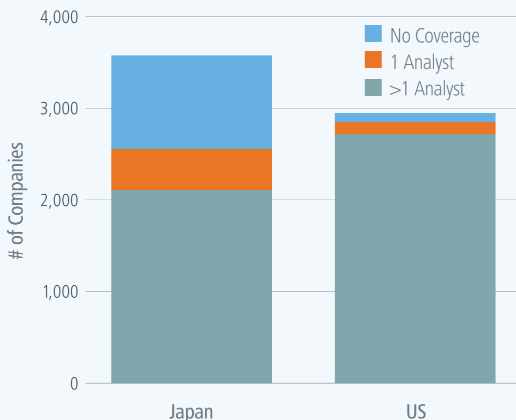
Sources: Morningstar Direct, eVestment Alliance. As at December 31, 2017. Trailing periods Sharpe Ratio calculated using Citigroup 3-Month T-Bill, Results in USD.

Reason #2 – Minimal Analyst Coverage

A good number of Japanese small cap stocks aren't covered by sell-side analysts, opening up opportunities for active, fundamental managers to find mispriced companies. Of the approximately 3,500 listed companies in Japan, over 3,000 can be considered small caps – and a large percentage (41%) of those is either covered by only one sell-side research analyst or is not covered at all[3]. Of those that are covered by an analyst, the smallest companies are even less well-researched, attracting minimal sell-side analyst resources compared to large-cap companies. To put this in perspective, the percentage of U.S. companies in the Russell 3000 not covered by sell-side analyst recommendations is a slim 8% (Figure 5).

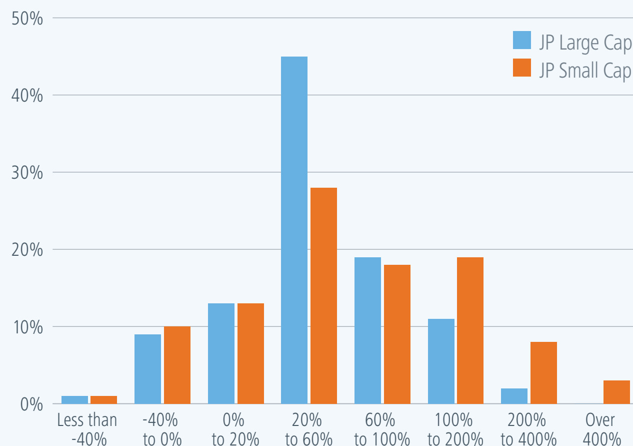
That lack of coverage stems from the business model of sell-side firms – the volumes of trading in large-cap stocks generate the bulk of bank and broker commissions. With the aggregate commission pool for equity research unlikely to grow due to regulatory pressures and passive investing, we expect the breadth of research coverage to narrow further, creating even greater opportunities for active managers in the small cap space. We think this opportunity is evidenced by the significantly wide return dispersion as shown in Figure 6.

Figure 5: Japan companies are under-researched compared to US peers



Source: Bloomberg.

Figure 6: Japan company return dispersion over 3 years is wider for small cap companies



Source: Bloomberg. Notes: 3 Years to December 31, 2017.

[3]Screen of Japan companies listed on TSE1, TSE2, JASDAQ and TOPIX MOTHERS with 1 or 0 sell-side analysts providing a Bloomberg recommendation, as at 4 April 2018.

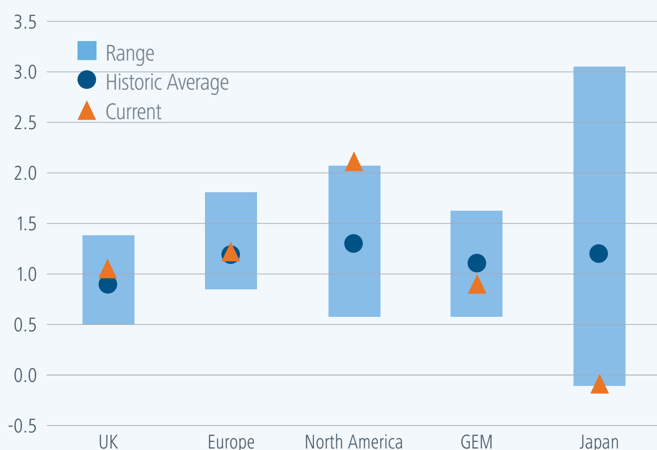
Reason #3 – Solid Valuations and Balance Sheets

Since the start of 2013, the TOPIX Small Cap index has delivered a 135% price appreciation in yen terms. Breaking this down, just 35% of this return was due to P/E multiple expansion: the majority owed to a doubling of earnings per share.

Meanwhile, the outlook for the U.S. is beginning to darken. As the U.S. Federal Reserve tightens monetary policy and as this period of economic expansion peaks, the chances of the U.S. heading into a recession are growing. By contrast, the Bank of Japan is unlikely to tighten monetary policy any time soon. Meanwhile, Japanese corporates have considerably more room to improve balance sheet efficiency, creating another opportunity for future outperformance of Japanese small cap equities (Figure 7).

At the same time, the degree to which U.S. small- and mid-cap companies have re-leveraged their balance sheets (Figure 7) since the Financial Crisis is likely to be negative for their future equity returns, especially given the lofty earnings multiples on which U.S. companies trade.

Figure 7: Japan balance sheet strength is unrivaled (Net Debt to Equity Ratios for Small & Mid Caps)



Source: JPMorgan, Factset, Bloomberg, IG. Notes: Data is from 1990 to 2017.

Reason #4 – Reforms in the Boardroom

Corporate governance reforms are an important part of the story for Japanese equities – and they are here to stay. This is especially important in light of future P/E multiple expansion – companies today don't yet reflect the full impact of Japan's reforms (Figure 8).

Falling under the so called "third arrow" of Abenomics, these reforms were ushered in by Japan's Prime Minister Shinzō Abe when he was elected in late 2012[4]. The reforms have sought to increase Japan's return on equity (ROE), improve the composition of boards with more outside independent directors and women, improve shareholder returns, reduce historic cross-shareholdings amongst 'keiretsu' companies, promote a more meritocratic and less age-based management structure, and improve disclosure.

While politicians come and go (and Mr. Abe's tenure is now precarious) the push to improve corporate governance has been embraced by the Japan Financial Services Agency (FSA), the Tokyo Stock Exchange, and, to some extent, company management teams. Crucially, the reforms also appear to have gained support, not just at the government level in Japan but also with the public and in the media. This contrasts with other countries in the West where political momentum appears to be shifting in the opposite direction as populist economic policies gradually start to favor labor over capital.

Japan's reforms have so far had a slow and steady impact on the performance of companies: in the 2017 fiscal year, ROE was the highest since 2008 while the cross-shareholding ratio was at its lowest (Figure 9). Looking ahead, we expect the TOPIX ROE in fiscal year 2018 to reach 10% – the highest in over three decades.

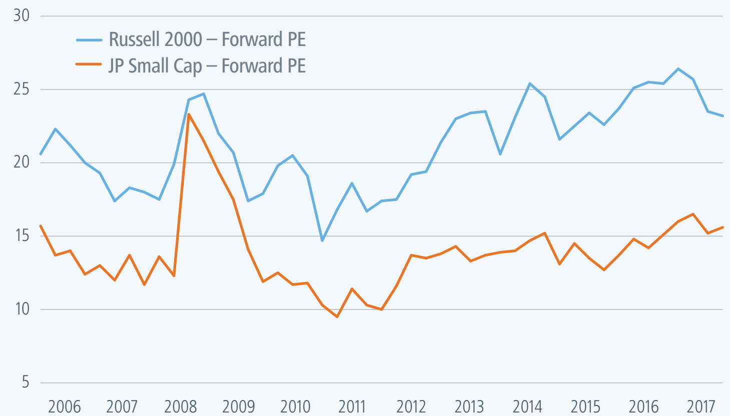
This is all good news for all Japanese companies, including small caps.

[4]The Three Arrows being 1) easy monetary policy, 2) fiscal stimulus and 3) structural reforms.

A second round of governance reforms is expected this summer when the US$1.5 trillion Government Pension Investment Fund (GPIF) potentially gets the power to reward corporate governance champions and punish laggards. Small caps will reap considerable benefits from this: owing to its vast size, the GPIF is a major shareholder of many small companies.

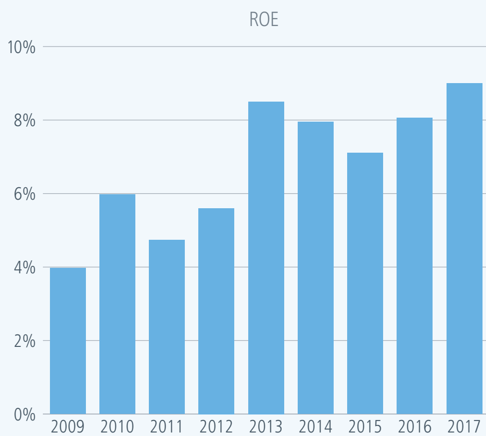
Although Japan is never likely to match its governance policies with a region like the U.S., we believe the direction and momentum of change are more important for share price formation than a side-by-side, point-in-time comparison. Japan starts from a low base: as this low-hanging fruit gets picked and reform efforts deepen, it could continue to drive outperformance.

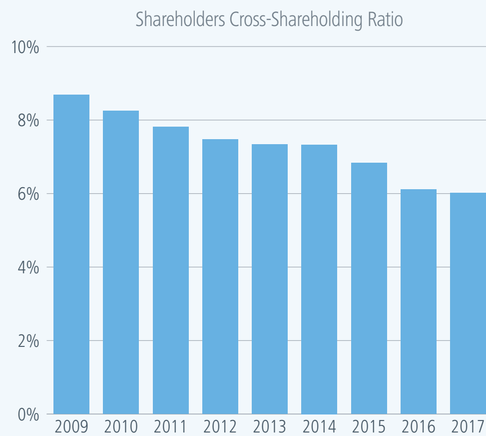
Figure 8: Modest P/E multiple expansion does not reflect Japan reforms



Source: Bloomberg.

Figure 9: Governance Reforms and Improved Performance: ROE and Cross-shareholdings





Source: SMBC Nikko, QUICK, Toyo Keizai.

Reason #5 – Domestic Focus and Shifting Services Sector

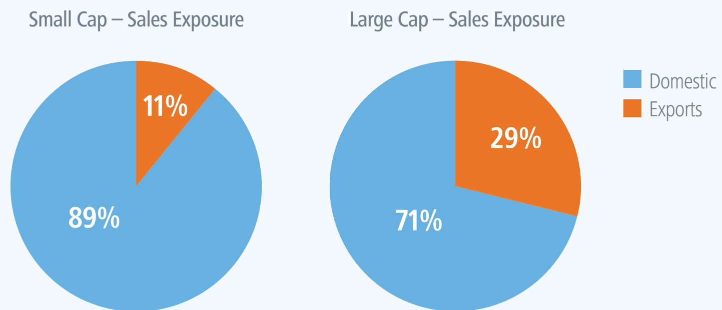
Japan's small caps are more exposed to the domestic economy than their large-cap peers, meaning they are less susceptible to fluctuations in global trade and rising trade frictions out of Washington. The median small cap company in Japan generates 89% of its sales domestically compared to just 71% for large caps (Figure 10).

Japan's small cap companies are also more services-oriented than their large-cap peers which tilt more toward manufacturing and exports. While the country's industrial giants compete on a global basis, their profits ebb and flow with global trade and the yen. Service business profitability, however, has been on a steady uptrend since bottoming in 2009 and has even accelerated since 2013 under the policies of Abenomics. Another key advantage: barriers to entry for foreign competitors are very high, creating a moat, of sorts, for domestic players.

But the service sector is not without its challenges. Consumers are notorious for demanding low prices, high quality service and for switching to alternative products or services based on the slightest imperfection. This, combined with a highly competitive environment, low levels of inflation, and management reluctance to raise prices, has historically hindered the profitability of services companies.

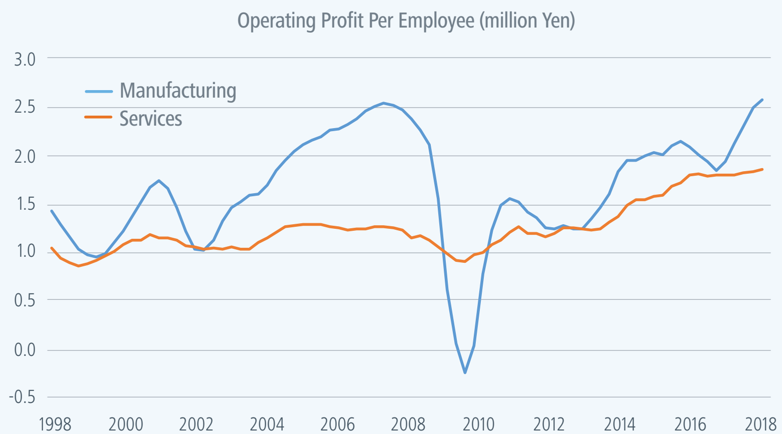
That is changing, however – the belated adoption of automation technology and the growing willingness of companies to raise prices are contributing to increased profitability and higher returns on capital in recent years (Figure 11). Moreover, the service sector is benefiting from a growing demand among Asian (mainly Chinese) tourists who are less price sensitive (Figure 12). This trend will likely continue with the arrival of the Tokyo 2020 Olympics and the introduction of casino gambling at Integrated Resorts some time after 2020.

Figure 10: Median Company Sales Exposure – Small Caps Skew Domestically



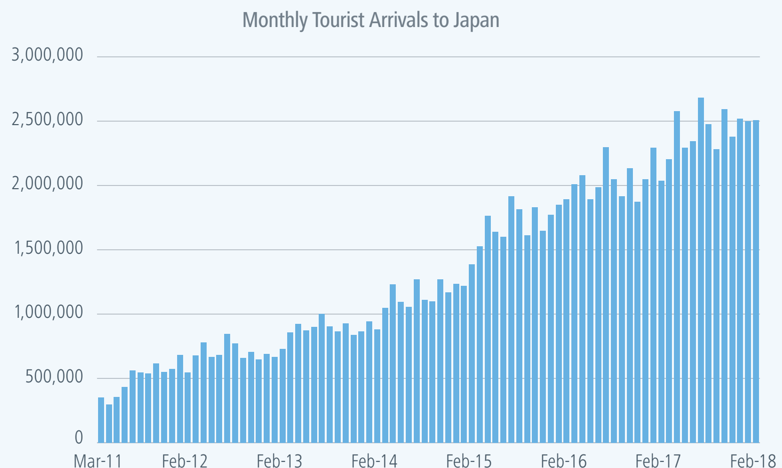
Source: CLSA, FactSet.

Figure 11: Steady improvement in profitability of domestic services companies



Source: Japan Ministry of Finance.

Figure 12: The number of monthly foreign visitors to Japan has increased ~4x since 2011



Source: Japan Ministry of Land, Infrastructure, Transportation & Tourism.

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Are there risks?

While the outlook for Japanese small cap equities is positive, there are two main risks:

A potential policy error – A rapid tightening of monetary conditions by the Bank of Japan and a subsequent reduction of liquidity would cause small cap earnings multiples to contract. However such a change is unlikely – as recently as April the Bank of Japan cited downside risks to their inflation forecasts, making it difficult for the Bank to tighten policy aggressively any time soon.

Abandonment of reform agenda – Given that Japan's corporate governance reforms are tied (at least in name) to Prime Minister Abe under the 'Abenomics' banner, the loss of his seat as Prime Minister would deal a temporary shock to the entire equity market. Small caps would not be spared. However, the importance of these reforms has been ingrained in Japanese regulatory institutions and boardrooms and, as such, an about-face is unlikely even in the event that Mr. Abe were to leave office before his term expires in 2021. At the same time, any resulting sell-off could provide a buying opportunity.

Conclusion

The Japanese economy, long hampered by deflation and low growth, appears poised to benefit from critical tailwinds such as corporate governance reform and changes in the consumer landscape. Small cap stocks have, and should, continue to deliver excellent risk-adjusted returns in this improving landscape – and their exposure to Japan's domestic economy adds a layer of downside protection in a world where uncertainty and political risk is high. We believe Japan should be a critical component of small cap exposure for investors, but active management is key – poor analyst coverage and the mispricing it engenders means there should be much room to add value through fundamental research.

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