KENSHO INVESTMENT GROUP

June 14, 2023

CEO Insight: In Japan, Capitalism Works

Government, business and the stock exchange work together to increase shareholder and stakeholder value. In this way, everyone benefits from the free market economy.

Japanese stocks are currently on a roll, with the Nikkei 225 up 23% since the beginning of January and the broader TOPIX up 18%, hitting new 33-year highs several times (as of June 9). Foreign investors bought Japanese stocks for a net 27 billion euros in April and May. The rally was sparked in April by U.S. investor Warren Buffett, who increased his holdings in Japan's top five trading houses. He pointed to low asset prices in Japan.

Strong economic data confirmed his view. In the first quarter of 2023, gross domestic product grew by a revised 0.7% quarter-on-quarter in real terms. On an annualized basis, economic output rose 2.7%. In an international comparison, Japan takes the lead this year: The World Bank expects Japan to grow 0.8%, twice as fast as the eurozone. The International Monetary Fund and the OECD are forecasting growth of 1.3% for Japan, and zero growth at best for Germany.

This positive development is based on solid foundations: Japan practices stakeholder capitalism, which goes far beyond pure return on capital and the welfare of large shareholders. This approach has caused the stock market to underperform for a long time. But it has also helped Japan avoid the concentration of wealth and rising inequality seen in Western countries.

For two decades, companies have been restructuring and cutting costs. At Toyota, they talk about "wringing out dry towels." As a result, the companies in the TOPIX have increased their operating profits elevenfold since 1995, even though their sales have barely grown on average. By comparison, companies in the U.S. S&P 500 increased their operating profits sixfold over the same period, while their revenues tripled.

However, costs have not been cut at the expense of workers. Since the financial crisis, Japan's unemployment rate has halved to 2.6%. At the same time, 4.5 million new jobs have been created. According to Japan economist Jesper Koll, the pay gap between workers and managers is also widening much less than in the West. The CEOs of the 50 largest companies receive on average 50 times the average income of their company's employees. The ratio for CEOs of all TOPIX companies is only 12 times. In the US, CEOs of S&P 500 companies receive an average of 400 times more than their employees.

Shareholders are also benefiting from this trend, helped by a reduction in corporate taxes. Companies have been paying out more and more over the past decade. In the fiscal year ending March 31, 2024, they are expected to pay 15.2 trillion yen (101 billion euros) in dividends. This would be the third consecutive annual record. Last fiscal year, the companies also announced record share buybacks of 8.5 trillion yen (57 billion euros). At the same time, companies gave their employees a share of the higher profits through generous wage increases.

The Japanese government and the Japan Exchange Group, which operates the stock exchange, did their part with corporate governance reforms. In particular, the Stewardship Code of 2014 sharpened the focus of institutional investors on return on equity. Financial groups in particular, but also companies, have reduced their cross-shareholdings. More recently, the Tokyo Stock Exchange has required all companies with net asset value higher than their market capitalization to disclose their improvement initiatives.

Retail investors are also getting involved. The government introduced NISA accounts for tax-advantaged investments in 2016. It recently raised the cap on equity investments exempt from capital gains and dividend taxes to ¥8 million (€60 million) from ¥6 million, and the tax-free period to 20 years from 5 years.

Even after the recent rally, Japanese equities remain relatively cheap on a price-to-book basis. The same goes for residential and office real estate. Not only do they offer attractive yields of currently 3.5% in the residential sector compared to the 10-year JGB below 0.5%. For the first time in three decades, real estate prices are rising across the board. The positive impact on the economy should not be underestimated, as over 80% of Japanese people own their homes as their single largest asset.

Under these conditions, Japan is proving to be a pioneer of a functioning capitalism where everyone wins. Value is created for both institutional and retail investors. Managers and employees benefit equally. This trend is continuing: Prime Minister Fumio Kishida's government has just pledged to prioritize economic growth over tax reform. Japanese equities and real estate are likely to outperform assets in Europe and the US for some time to come.

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