Wealthpin Pro

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Introduction

Hello! And welcome to this month's edition of Wealthpin Pro. Today, we're going to be looking at an opportunity that's a little different than usual. Today, we're going to be talking not about investing in a stock, but rather, investing in a culture, a nation, or you could even say, a fundamental block of the global economy. In short, we're going to talk about investing in Japan.

For years, despite being the third-largest economy in the world, Japan's equity markets have long been considered a backwater for foreign investors. However, over the last year, a number of long-standing historical factors have suddenly changed. This, coupled with new, inventive government policy, is causing Japanese equity values to rise. Investors now have a unique opportunity to ride along with Japanese equities as their values rise to meet the value of their underlying companies.

How We Got Here (A History)

The Japanese stock market collapse, also known as the bursting of the asset price bubble, was a prolonged financial crisis that began in the early 1990s. This collapse had deep roots in the economic policies and trends of the 1980s, a period marked by rapid economic growth in Japan. During this time, the country experienced a significant asset price bubble, fueled by a combination of easy monetary policy, speculative investment, and a belief in the perpetual growth of asset prices, particularly in real estate and stock markets.

The Bank of Japan, attempting to curb inflation and speculative investments, sharply increased interest rates in the early 1990s. This move led to a severe contraction in asset prices, triggering the collapse of the stock market and a real estate market crash. The Nikkei 225, a key stock market index, plummeted from its peak at the end of 1989, losing a significant portion of its value over the next few years.

The aftermath of the collapse was devastating for the Japanese economy. Banks and financial institutions faced massive bad debts due to their heavy exposure to real estate and equities. This led to a credit crunch, as banks became reluctant to lend, further exacerbating the economic downturn. The government's response, which included bailouts and fiscal stimulus, was often seen as inadequate and slow.

The reason for the prolonged stagnation, often referred to as the & “Lost Decade” (or decades), lies in several factors. Japan faced structural issues such as an aging population, deflationary pressures, and a rigid corporate culture that hindered innovation and adaptation. Additionally, policy responses were not aggressive enough to address the deflationary spiral and banking sector problems effectively. The cumulative effect of these issues was a long period of economic stagnation, from which the Japanese stock market and economy struggled to recover fully.

What’s Been Happening The Past Year

In the last year, the Japanese stock market has seen a remarkable resurgence, marked by several key developments and changes. As of 2023, Tokyo stock prices were up by 28 percent, indicating a significant recovery. This was the highest rate of gain since 2013, when the Bank of Japan introduced massive monetary-easing measures.

Several factors contributed to this positive shift.

Factor #1:

Firstly, the Tokyo Stock Exchange (TSE) emphasized the need for companies to focus on sustainable growth and enhancing corporate value, particularly targeting those with a price-to-book ratio below one. This move encouraged companies to adopt strategies such as investing in research and development, human capital, and business restructuring. This focus on corporate governance and sustainable growth has been a key driver in revaluing companies and boosting investor confidence.

For instance, In March, the Tokyo Stock Exchange (TSE) issued a directive to companies whose stock exhibited a price-to-book value lower than one. These companies were instructed to devise and communicate strategies to enhance their financial metrics.

A price-to-book value of one signifies that a firm's market price is equivalent to the value of its assets as recorded on the balance sheet. A value less than one suggests that the stock might be undervalued, trading for less than the worth of its assets.

Notably, a larger proportion of Japanese companies, compared to their European and American counterparts, trade with a price-to-book value under one. For instance, over a third of the companies listed on the Topix, a major Japanese stock index, fall into this category. In contrast, only 6.6% of American companies and just under 25% of European firms have a price-to-book value below one.

Increasing a company's price-to-book value requires convincing shareholders of the company's value and potential for growth. Several strategies can be employed for this, including share buybacks, increasing dividends, business investments, and focusing on research and development.

Japanese companies are particularly well-positioned to implement these strategies. Half of the companies on the Topix index report having net cash, a stark contrast to less than 20% of American and European firms. Additionally, there is evidence that Japanese firms are responding to the TSE's call to enhance profitability and shareholder value. By mid-July, nearly a third of the largest companies on the Topix with a book value below one had reported initiatives aimed at increasing shareholder value.

Factor #2:

Another significant factor has been the return of inflation. After decades of low inflation and even deflation, Japan is now experiencing moderate inflation. This change is seen positively, as it instills confidence in corporate investment and consumer spending, shifting away from the deflationary mindset that discouraged spending and investment.

Over the past year, global equity markets have been significantly impacted by inflation and monetary policy tightening. However, in Japan, the recent experience of rising inflation could be a beneficial disruptor, helping to shift the long-standing deflationary mindset of companies and consumers, and revealing new opportunities for equity investors.

Japan's economy and stock market have been plagued by deflation for more than thirty years.

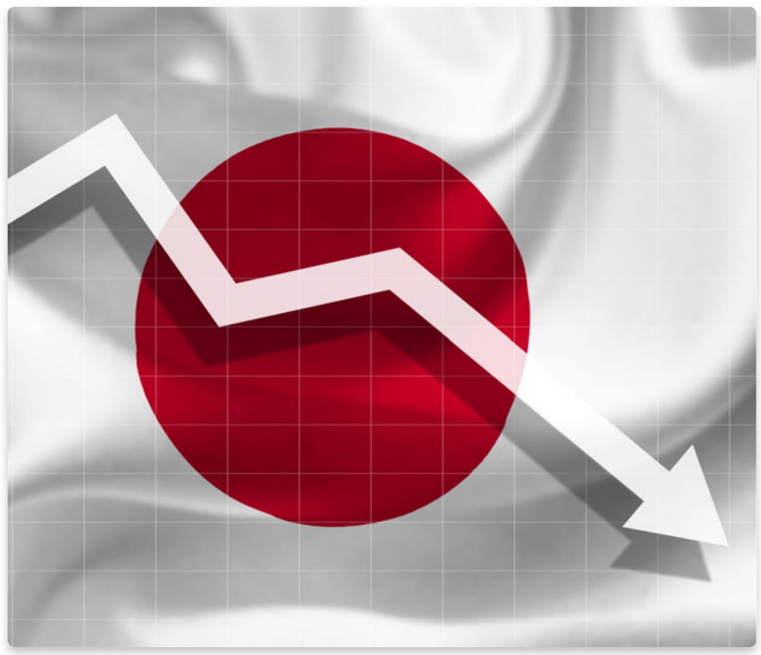
Previous attempts to emerge from this deflationary spiral were thwarted by various global and domestic events, including the global financial crisis, untimely increases in value-added tax, and the COVID-19 pandemic. The current global inflationary trend, however, appears to be having a more profound and lasting impact on Japan, potentially marking a significant turning point.

This inflationary shift coincides with noticeable improvements in corporate governance and profitability within Japan. Additionally, factors like demographic changes, geopolitical tensions, adjustments in global supply chains, and the yen's position are collectively creating new sectoral opportunities.

The market's positive response is evident. As of September 30, 2023, the TOPIX index in Japan had risen by 25.7% in yen terms, outperforming the MSCI World Index's 12.1% increase in US-dollar terms. This growth suggests that inflation is beginning to catalyze widespread changes in the Japanese economy, potentially paving the way for a sustained stock market recovery.

Considering that many Japanese equities are still valued lower than their global counterparts and that many global institutions have underweighted Japanese stocks, there's a growing belief that a significant revaluation of Japanese companies could be on the horizon.

In Japan, the current inflationary environment is causing discomfort among consumers, as wages have not kept pace with the increasing cost of living. This inflation not only affects individuals but also increases procurement costs for businesses, leading to a tighter monetary policy and higher borrowing expenses. Yet, this shift from a stagnant price and low-interest rate environment might be the catalyst for significant economic changes.



Businesses in Japan, traditionally hesitant to raise prices due to competitive pressures, are now passing on increased costs to consumers rather than absorbing them, a shift initially seen in sectors heavily reliant on imported materials like paper and steel. This change is supporting higher stock prices and is now being observed across more domestically focused industries, aligning consumer price inflation more closely with producer price inflation.

The labor market is also under transformation. Workers, who have long accepted minimal wage increases, are unlikely to remain satisfied, especially as the working-age population decreases. It's expected that real wages will eventually increase, leading to greater consumer spending power.

Additionally, there's a notable trend in consumer financial behavior. With bank deposits offering negligible interest, people are likely to shift their savings to higher-yielding assets. As of March, Japanese households had around 2,043 trillion yen in financial assets, with a majority in bank deposits and a smaller fraction in equities. Even a modest shift in this allocation could lead to substantial inflows into the stock market. The planned expansion of Japan's individual saving account scheme (NISA) in 2024 is likely to facilitate this transition, potentially resulting in significant market impacts.

As Japan navigates a diminishing workforce and faces the prospects of rising wages and capital costs, there's an increasing necessity for corporations to enhance their productivity. This situation is seen as a chance to drive growth in sectors like IT services and human resource services, where efficiency gains are crucial.

Moreover, Japanese companies are under pressure to strategically utilize their significant cash reserves. By the end of 2022, corporations constituting 53.5% of Japan's market capitalization reported net cash positions, a stark contrast to 39.4% in the US and 22.8% in the Eurozone. While there has been a trend towards higher dividend payouts and stock buybacks, redirecting cash back to shareholders, the current inflationary context is expected to simplify the process for management to reinvest these funds effectively in their businesses.

Enhancements in corporate governance, spurred by reforms such as the 2014 Stewardship Code, have led to more disciplined approaches to capital deployment. Management teams are now better positioned to make strategic decisions in reinvesting cash, balancing the need to return value to shareholders with the imperative of sustainable business growth.

Factor #3:

Foreign investment has also played a crucial role in the resurgence of the Japanese stock market. Foreign investors, including prominent figures like Warren Buffett, have shown increased interest in Japan, adding to the optimism surrounding its economic prospects.

Between April and June, there was a significant uptick in investment from foreign funds into Japanese stocks, fueled by expectations of stock market reforms.

During this period, Japan's stock market experienced a remarkable streak of 10 consecutive weeks of net foreign investment in cash and futures. The total foreign investment amounted to 7.9 trillion yen (about $53 billion). Two key factors influenced this influx: investor interest related to Tokyo Stock Exchange (TSE) initiatives and the favorable response to Warren Buffett's interview about Japanese equities with Nikkei Asia in April, as highlighted by Goldman Sachs Research.

Despite recent trends of net selling of Japanese stocks by foreign investors, the overall foreign investment flow for the year remained positive.

Looking ahead, it is anticipated that both foreign investors and corporations will continue as net buyers of Japanese stocks. Moreover, domestic individual investors are projected to become net buyers in 2024, coinciding with the introduction of the new Nippon Individual Savings Account (NISA) in January of that year. The new NISA is designed to encourage small-scale investments.

Analysts Kirk and Tatebe suggest that the high inflation and consequent reduction in real yields on bank deposits will likely motivate Japanese households to invest in the stock market, particularly with the launch of the expanded 'new NISA'. They foresee a steady increase in households' exposure to the stock market over time, with the new NISA playing a significant role in this trend.

This influx of foreign capital is partly due to Japan's more modest inflation increase compared to the United States and the euro area, and the Bank of Japan's reluctance to raise interest rates significantly. Additionally, Japan's economic indicators, like the upward revision of its GDP growth rate and strong domestic demand, have further fueled optimism.

In summary, Japan's stock market recovery in the last year can be attributed to a combination of improved corporate governance, return of inflation, significant foreign investment, and positive economic indicators. These factors have collectively contributed to a more optimistic outlook for Japan's financial markets and overall economy.

One Little Issue

While the potential for growth in Japanese stocks is notable, an important factor to consider is the performance of the Japanese yen. As of the end of 2023, the yen has weakened considerably, declining by approximately 13% within the year and 33% over the past five years against the US dollar, according to Bloomberg data.

This weakening is also evident when looking at the broader Japanese yen index, which measures the yen's performance against a basket of G10 currencies. In 2023 alone, this index has decreased by about 12%, and over the last five years, it has fallen nearly 21%.

The devaluation of the yen has implications for foreign investments. A weaker domestic currency like the yen means that when foreign investments are converted back into the investor's local currency, the returns might be lower.

For instance, while the Nikkei 225 index has seen a significant rise of 28% in 2023, outperforming the US blue-chip index's nearly 19% increase for the year, the picture changes when considering longer-term performance in US dollar terms. Over a five- year period, the Nikkei still lags behind the US blue-chip index when the performance is adjusted for the weakening yen.

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So, What's The Investment?

The question hovering over all this talk is:

How do you invest in the Japanese economy? Sure you could invest in individual companies, but if you're trying to capture alpha on the macroeconomic trends of an entire nation, how would you do that?

Well, the answer is an exchange-traded fund, or ETF. There are plenty of Japan-focused ETFs, all with different sector focuses, assets-under-management, etc. However, the one I like the most is:

TRADE IDEA:
FIDELITY JAPAN FUND (NYSE: FJPNX)

PRICE AT PUBLICATION: $15.86
ASSETS UNDER MANAGEMENT: $643.2 MILLION
52-WEEK RANGE: $14.39-$16.76

For investors looking to tap into the Japanese economy's potential, the Fidelity Japan Fund (FJPNX) stands out as an excellent choice, offering a blend of strong management, diverse holdings, and solid performance metrics.

The fund was started in 1992. Which I like — that means the fund has durability. And it's been managed since 2014 by Kirk Neureiter, which means it has someone with a decade plus of experience at the helm. As of January 2024, the fund has net assets of approximately $643.2 million, reflecting substantial investor trust and commitment.

One of the key strengths of FJPNX is its diversified portfolio, which encompasses a wide range of sectors, including industrials (20.98%), Information Technology (19.58%), Consumer Discretionary (18.18), and Financials (12.55%), among others.

Major Market Sectors [8] AS OF 12/31/2023

	Portfolio Weight	TOPIX Total Return Index
Industrials	20.98%	24.24%
Information Technology	19.58%	13.70%
Consumer Discretionary	18.68%	18.18%
Financials	12.55%	11.80%
Materials	6.83%	6.20%
Health Care	6.63%	7.49%
Communication Services	4.77%	7.27%
Consumer Staples	3.24%	6.74%

Information on 2023 GICS Changes

*Source: Fidelity

Its top holdings are notable Japanese companies like Sumitomo Mitsui Financial Group Inc., Sony Group Corp, Hitachi Ltd, Renesas Electronics Corp, and Tokio Marine Holdings Inc. This broad exposure ensures that investors benefit from various aspects of the Japanese economy.

Top 10 Holdings [8] AS OF 12/31/2023

35.21% of Total Portfolio

84 holdings as of 12/31/2023 | 83 issuers as of 12/31/2023

SUMITOMO MITSUI FINL GROUP INC	4.94%
SONY GROUP CORP	4.62%
HITACHI LTD	4.03%
RENESAS ELECTRONICS CORP	3.94%
HOYA CORP	3.26%
SHIN-ETSU CHEMICAL CO LTD	3.23%
TOKIO MARINE HOLDINGS INC	3.09%
ORIX CORP	2.98%
DENSO CORP	2.57%
TECHNOPRO HOLDINGS INC	2.54%

*Source: Fidelity

FJPNX's performance also underlines its appeal. The fund has shown a 5-year average return of 7.92% and a 1-year return of 15.8%. While past performance is not a guarantee of future results, these figures indicate a consistent track record.

The fund's expense ratio, at 0.95%, is competitive, balancing the cost of professional management with the potential for growth. Additionally, FJPNX offers a dividend yield of 0.84%, adding an income component to its growth potential.

Considering all these factors, FJPNX presents a balanced, well-managed opportunity for investors seeking diversified exposure to the Japanese market, combining growth potential with an established track record.

Which is why we're going to add it to the ol' model portfolio.

To your wealth,
Alex Reid
Founder, Wealthpin Pro