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Japanese Equities: A Long-Term Opportunity for Stock-Pickers

Structural drivers remain in place for idiosyncratic alpha, despite severe recent volatility.

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The famous Irish poet and playwright, Oscar Wilde, once wrote, "There is only one thing in life worse than being talked about, and that is not being talked about." He was not referring to Japan equities here, of course—though he had planned to visit the country—the sentiment still applies. Japan equities have been out favor for many years following the bursting of the bubble in 1990. There have been a handful of false starts. Japan's innovative and export-heavy market has captured investors' attention on occasion, and there have been attempts to tackle corporate governance issues. For much of the period since 1990, valuations have looked attractive, though perhaps for good reason. Lingering considerations around the country's economic growth profile, deflation, and corporate governance standards proved persistent. That is changing. Real structural shifts are in motion and interests are aligned for further improvements. Japan is likely to be a stock-pickers' market for the next five to 10 years. Experts will benefit from the story of the ongoing return of assets, and its sequel: The return on assets, which is ongoing. These both create opportunities for active stock-pickers, and we believe even more so for those who pursue constructive engagement, perhaps more so in the mid-cap space.

We concede that it has not been easy sailing. Unevenness is apparent in investment styles between "growth" and "value," and large caps versus small caps. Single-stock dispersion has been notable. Japanese equities were a classic case of a bifurcated market for many years prior to 2021. Growth dominated value, then a violent rotation took place. Some managers have been caught out. Yen dynamics have played an important role, too. But perhaps even more important has been the significant changes to company governance. After a long period of strong index returns and depressed index-level volatility, a historically unprecedented market selloff followed in August 2024, only for a strong subsequent rebound to occur. In light of such fractious recent markets, it might be understandable that prospective investors show signs of trepidation. However, corporate governance reforms will continue to unlock previously unrealized value. This process will unfold over many years to come. Meanwhile, economic conditions have changed since the long period of deflation. Expectations have been altered. The benefits of all this are likely to be felt unevenly across the market.

In addition, and unlike many other developed markets, market concentration in Japan is lower. It is thus easier to express investment convictions across most names, perhaps apart from the largest index constituent Toyota Motors. Elements of cyclicality will persist in some areas, as Japan is a connected economy, but there are many companies operating in secular growth areas, many of which have declined in value recently. These also serve a role, particularly for those looking to benefit from a somewhat style-neutral exposure to the country. This is an appropriate way to play the ongoing story.

This article summarizes some of the major trends that have contributed to change views on Japan in recent years, and their impact on the Japan equity universe. It also highlights some funds that Morningstar sees as interesting options to gain exposure to this market.

Key Takeaways

► As long-term investors, we remain sanguine in the face of recent and extreme market volatility: There is a strong case for structurally driven long-term returns and idiosyncratic alpha.

► Corporate governance changes are tangible, but more progress is expected in the coming years, particularly in small and mid-caps. Structural change is truly afoot and improvements to shareholder returns will continue.

► A bifurcated market? "Value" stocks have led the market in recent years while many "growth" stocks have fared less well. Small caps have not kept up with large caps. The market rotation since 2022 has been violent, and dispersion of returns in Japan equities has been high. This supports a blended approach for Japanese equity exposure, perhaps with a tilt toward value plays that are more exposed to corporate governance reform.

► Active management and engagement are expected to lead to outperformance. Japan will be a stock-pickers' market and Japan equity funds have a place in portfolios.

What Happened in Early August 2024?

The dust is settling on a bout of historically high volatility in the first days of August 2024. So, what happened? Put simply, a sudden strengthening of the Japanese yen and the unwinding of crowded trades in some Japanese equities—some with significant leverage—was the cause for a few days of tumultuous performance. The most immediate cause of this was the Bank of Japan's decision to raise rates on July 31, 2024. This took some market actors by surprise, and we understand this caused many market participants to reverse their yen carry trades, some of which funded their Japan equity positions. It is postulated that leveraged positions held by Japanese retail investors, CTAs, hedge funds, and investment banks were closed. The impact reverberated across global markets. As we saw during the 2008 global financial crisis, the yen carry trade is important to the global financial system. The effect in Japan was huge. Equity volatility soared. The selloff was historic but short-lived. It appears to have been more technical in nature and not driven by a deterioration to company fundamentals. The change in exchange rate should naturally lead to some mechanistic earnings downgrades across some areas of the market, particularly exporters and the beneficiaries of cheap Japanese tourism. Overall, however, the picture is unchanged. Structural drivers supporting stronger shareholder returns remain in place. Considering this, and as long-term investors, short-term volatility does little to impact our view. We still think selective active fund managers will benefit from structural changes over the coming five to 10 years.

A Japanese Macro Story: A Return to Nominal GDP Growth

Change is underway in Japan. Economic growth as measured by GDP was anemic since the bursting of the economic bubble in the 1990s, averaging around 1% per year. The macro picture is beginning to change. Structural changes implemented under President Shinzo Abe's economic reform program since 2012 are finally taking hold in earnest. The country is now out of deflation and GDP growth averaged positive 3.5% in 2022 and 2023. The normalization of policy is taking place.

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Negative No More: An Exit From Experimental Policy

The Bank of Japan exited the net zero interest-rate policy on March 19, 2024, rising its overnight rates to the 0% to 0.1% range. This was the first rate hike in about 17 years. A further hike to 0.25% came on July 31, 2024.

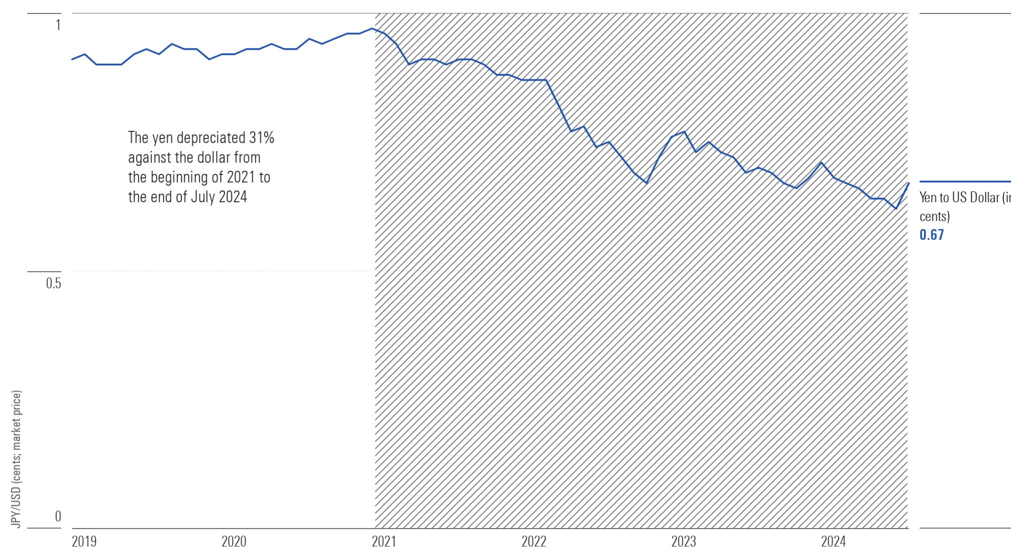
In a prior move away from another nonconventional monetary policy, the Bank of Japan took a step back from yield-control measures in November 2023, when it dropped its 1% cap on 10-year yields. Its quantitative easing program remains in place for now, but the rate of purchases is expected to decline.

To a certain extent, higher rates have provided a tailwind to Japanese banks, who are now earning a positive nominal return on their reserves. Despite recent rate decisions, relative yields between Japan and the US remain wide, and the allure of the yen-dollar carry trade—borrowing in yen at low interest rates to reinvest in higher return assets and trades—had remained a popular trade for much of 2024. Many market participants we speak to have seen the yen as being very cheap for a long time.

Yen Weakness: Recovering From a 38-Year Low

While equity index price levels surpassed previous highs earlier this year, the yen was at its cheapest level against the dollar for over 38 years. It had depreciated 36% against the dollar from the start of 2021 to the end of June 2024 and the exchange rate remains way below its 20-year average, despite a slight rally in early August 2024. The interest rate differential between Japan and the US remains wide.

Exhibit 1: Yen to US Dollar (in cents) Exchange Rate, at Market Price (January 2019 to July 2024)



Source: Morningstar Direct. Data as of July 31, 2024.

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The impact on Japanese equity markets has been significant. Auto exporters were bolstered and foreign assets on balance sheets have, of course, increased in yen terms. Currency weakness can be a thorn in the side for foreign investors, as those who were unhedged can take a hit where portfolio earnings are primarily domestic.

Another facet is that yen weakness raises the relative costs of overseas investments. This has prompted many Japanese companies, including Toyota, Denso, and Shin-Etsu Group, to turn their attention home with sizable investment plans. Investments in semiconductor manufacturing in Japan have risen, too, which will lend support to other areas of the economy, including construction.

Inflation and Inflation Expectations: Breakeven Rate at Highest Since 2004

In June 2024, Japan's inflation reached 2.8%, down from 3.2% in 2023. Elsewhere, the 10-year breakeven inflation rate—the gap between nominal yields on conventional bonds and real yields on inflation-linked bonds—has been rising. In 2024, it surpassed levels last seen in 2004.

Yen weakness has been an important factor. So have covid disruptions. There are also other factors at play that may create a more persistent and positive change in mindset for Japanese companies and consumers. The annual wage negotiations that take place each spring, called Shunto, show that for the first time in many years, salary increases are taking hold. Unions have negotiated some of the largest wage increases in over 30 years. Broadly speaking, only the largest companies have pushed through wage increases—this includes Toyota, Nippon Steel, and Nissan. Though smaller companies have so far proved more reluctant to follow suit, that should change. The government is encouraging support for raising prices that permit smaller companies to pass through rising costs. This should provide some breathing room for wage increases, which may mark the beginning of a virtuous cycle of rising nominal incomes and sustained reflation.

Reshoring Trend Beneficial for Japan Inc.

Amidst growing geopolitical tensions, some companies are reducing their reliance on China as a manufacturing hub. In 2020, subsidies were unveiled to encourage repatriation of manufacturing, or to set up operations in countries in the Association of Southeast Asian Nations, such as Vietnam and Indonesia—these fall under the umbrella of the China Plus One, a supply chain strategy that encourages companies to diversify their supply chain and manufacturing activities away from China to mitigate risk. The impact of this strategy has been mixed to date, but there has been a ramp up in international collaboration and alignment of geostrategic interests for derisking of supply chains, particularly in semiconductors. This has resulted in increased investment in semiconductor wafer production—including new plants from semiconductor giant TSMC and the world's second-largest semiconductor manufacturer Samsung Electronics. Policies aimed at reshoring stand to benefit from the domestic investment in the Japanese economy. Nonetheless, the degree of interdependence between Japan and China should not be understated, particularly in electronics.

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Third Arrow Takes Hold: Corporate Governance Improvements Are Tangible

Former Japan Prime Minister Abe introduced the Three Economic Arrows in 2012. The "Third Arrow" was to improve corporate governance. Arguably, not much progress was made until recently. Then, in 2021, the government revised the Corporate Governance Code and the Guidelines for Investor and Company Engagement. The Tokyo Stock Exchange restructured its market segments in 2022, including the formation of the Prime, Standard, and Growth markets, introducing more rigorous standards relating to liquidity, corporate governance, and company performance (profitability and shareholder returns). These initiatives are intended to promote long-term value creation and to strengthen investor-company interactions.

In 2023 the Tokyo Stock Exhchange requested that the management of publicly traded companies focus more on their cost of capital, return on invested capital, and their share price. Where appropriate, a plan should be in place to make improvements. This has been an important driver in pushing reforms. There has also been a widespread adoption of this plan on the Prime Market, where standards are more stringent, whereas implementations of this plan have been slightly slower for the standard market. As of June 30, 2024, 81% (1,335 companies) of the prime market and 40% (638 companies) of the standard market—including those in the process of considering—had disclosed information regarding the cost of capital and stock price.

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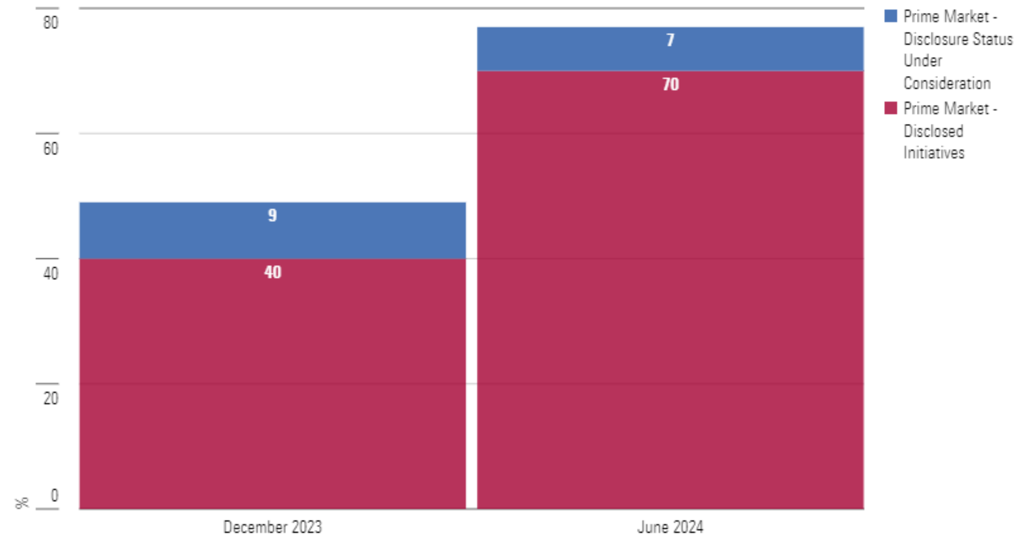
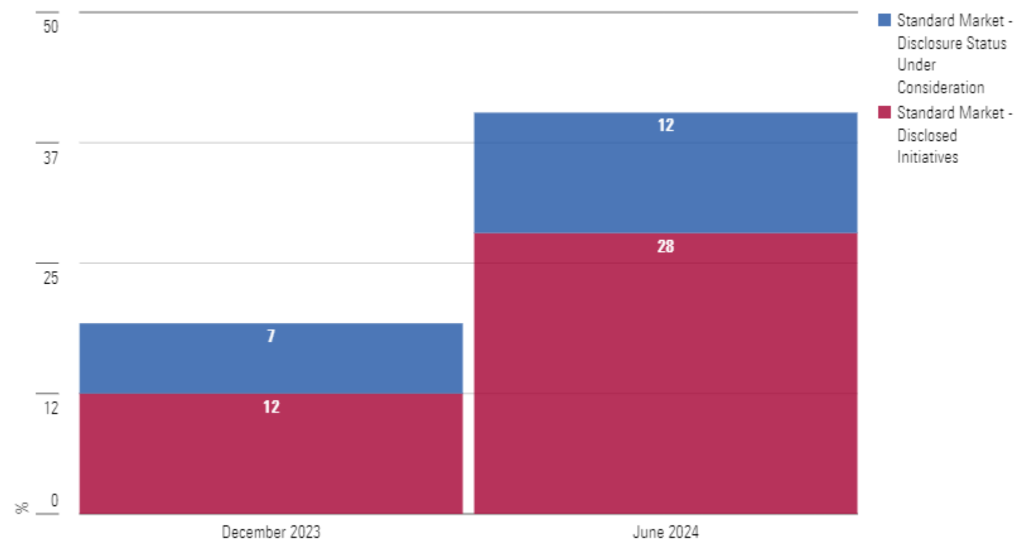
Exhibit 2 Status of Disclosure on Action to Implement Management That is Conscious of Cost and Capital and Stock Price





Source: Tokyo Stock Exchange, Inc. Listing Department. Data as of July 12, 2024.

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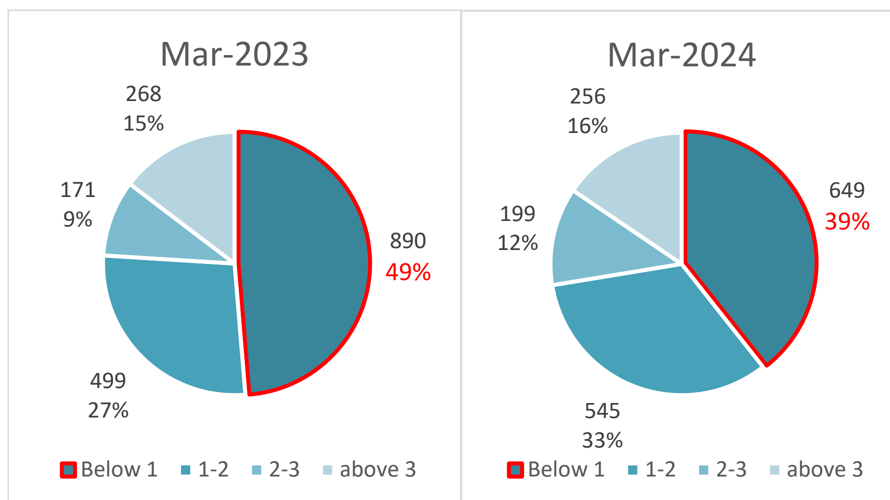
Price/Book in the Crosshairs

In 2023, the Tokyo Stock Exchange firmed up plans to materially reduce the number of companies trading at below book value. Japan has long stood at out on this front versus other major developed markets. Listed companies on both the Prime Market and Standard Market are being urged by the Tokyo Stock Exchange to achieve a price/book ratio of greater than one or else publicly disclose initiatives to meet this goal. Failure to comply would result in a delisting or a move to a lower section of the Stock Exchange. We are still in the early stages of change, but the targeted efforts to address systematic undervaluing of Japanese companies is taking hold, and value is being recognized. According to Nikkei, between March 2023 and March 2024, the number of listed companies in the Prime Market with a price/book ratio below one decreased from 49% to 39%.

Exhibit 3 Number of Companies With Price/Book Ratio Below One, Listed on the Topix Prime Market



Source: Nikkei. March 31, 2024.

English Disclosure Is Improving

The Tokyo Stock Exchange also saw a need to increase the number of English disclosures on the prime market. This removes a major impediment for some foreign investors. In the wake of revision of the Corporate Governance Code in 2021, listed companies on Prime Market have disclosed information in English; however, there are still informational and timing gaps between the information disclosed in English and Japanese.

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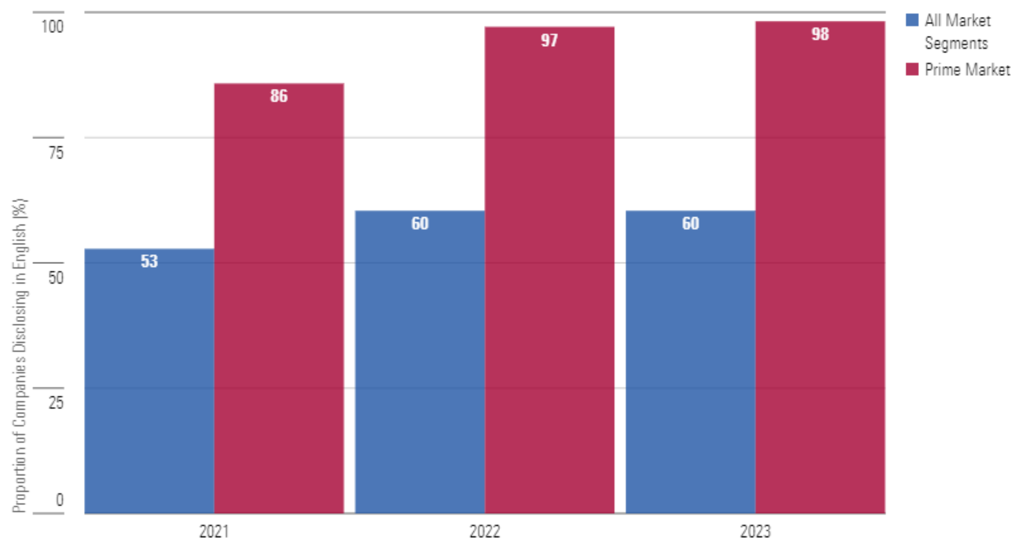
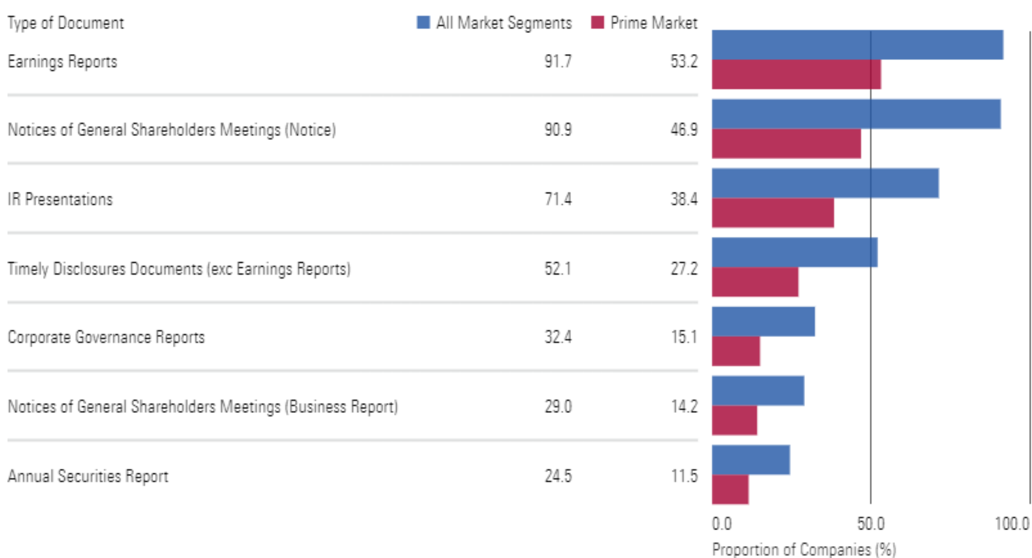
Exhibit 4 Summary of English Disclosure Implementation





Type of Document	All Market Segments	Prime Market
Earnings Reports	91.7	53.2
Notices of General Shareholders Meetings (Notice)	90.9	46.9
IR Presentations	71.4	38.4
Timely Disclosures Documents (exc Earnings Reports)	52.1	27.2
Corporate Governance Reports	32.4	15.1
Notices of General Shareholders Meetings (Business Report)	29.0	14.2
Annual Securities Report	24.5	11.5

Source: Japan Exchange Group. Dec. 31, 2023.

The Number of Independent Board Directors Also Increasing

There has also been a marked improvement in the number of independent directors on company boards in comparison with other major markets in developed countries. TSE data shows that in 2023 some 99% of company boards in the Nikkei 400 had at least one third or more independent directors. In 2014, it was just 6%. The number of boards that have many independent directors remain comparatively low, although it improved from under 2% in 2014 to around 20% in 2023. Overall, independent oversight and governance has improved, and the increase in the number of voluntary nomination committees gives confidence that the trend will continue.

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Activism and Engagement Are More Accepted

Importantly, engagement has become more accepted in Japan in the last decade. There have been some notable entrants in the activist space, including recognizable foreign names, such as Elliot, ValueAct, 3D Investment Partners, and Palliser Capital. They have been pushing for the realization of shareholder value.

There are interesting opportunities here. In some cases, the value of long-held real estate has been depreciating over decades, sometimes to essentially zero. Meanwhile, "strategic investments" in other companies' shares are on occasion vastly undervalued. The differences can be stark: company book values can be immensely understated. Such assets must be sold for this value to be realized. Engagement thus has the potential to generate outsize returns.

The involvement of activists is encouraging engagements from more traditional long-only funds, too. We've been hearing that companies have become more proactive in their responses to engagement activities aimed at improving shareholder returns. In the future, even among funds with similar investment styles, there may be differences in medium- to long-term performance based on whether they engage in such activities.

Shareholder Return Improvements Expected to Continue

Return on equity at the index level has increased since the introduction of the Corporate Governance Code, particularly for large caps. The return on equity for the Morningstar Japan TME Index stood at around 12% at the end of June 2024. This is a significant increase from 10 years ago, albeit from a very low base. Reportedly, many companies now target a minimum return on equity figure of 8%. Many already exceed this level, particularly in larger caps.

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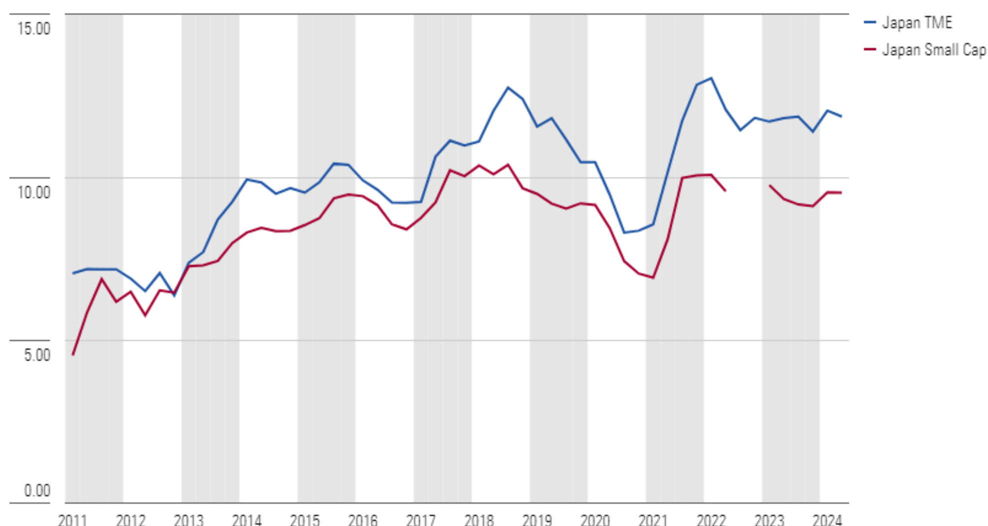
Exhibit 5 Return on Equity for Japan Indexes



Source: Morningstar Direct. Data as of June 30, 2024.

Enhancements to capital allocation are expected to continue over the coming years. This will be a significant driver for share price performance. One way to think about the ways this will unfold is through the lens of the three-step DuPont approach to modeling returns on equity, which includes:

Asset Turnover: The efficiency of assets used to generate sales. This is beginning to improve but remains depressed by nonproductive assets, high cash levels, and noncore assets. In particular, cross share holdings are a rarity in other developed markets but have been important in Japan to maintain intercompany relationships. In many instances, these cross share holdings are being unwound, and assets are being returned to shareholders.

Financial Leverage: The use of debt within the capital structure remains low. Japanese corporates have tended to adopt a conservative approach to debt. Moreover, they have built up significant piles of cash in the last two decades. Buyback activity is leveraged. Companies are improving capital efficiency through share buybacks. Between January and May 2024, the number of share buybacks surged 60% year over year to 9 trillion yen, with expectations for the full year reaching a record high.

Profit Margins: There have been substantial improvements in the last decade. Quarterly profits for the final quarter of 2023 reached record highs. A key driver of increased corporate profitability in the last decade has been deleveraging and the related, sizable decrease in interest expenses paid by companies. In some instances more recently, margins have begun to benefit from companies' willingness to pass on higher prices, indicating that operating profits may be on the rise. Yen dynamics of course play a role, too. Regardless, the proportion of cash flows going to equityholders has increased.

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Return on Equity Remain Below Global Indexes

While return on equity is improving in Japan, at the index level it remains significantly below that of global indexes. The latter is, of course, boosted by some very high-return companies, particularly in the technology sector, but there is potential for more improvements in Japan in the coming years.

Exhibit 6 Return on Equity for Global and Japan Indexes

Index	ROE % (30/6/2024)
Morningstar Japan TME	11.9
Morningstar Global TME	27.4
Morningstar Japan Small Cap TME	9.5
Morningstar Global Markets Small Cap TME	11.6

Source: Morningstar Direct. Data as of June 30, 2024.

Smaller companies arguably have more scope to see improvements in the coming years. Structural changes are yet to take hold to the same extent than their large-cap cousins. Indeed, while some 33% of companies in the Morningstar Japan TME Index have ROEs below 8%, that figure rises to 47% for the Morningstar Japan Small Cap TME Index. As a result, the small-cap segment may prove an interesting area for investors and for constructive engagement.

At this point, the large tail of smaller companies in Japan must be recognized. Here, the return of assets and return on assets story continues to unfold. We might also expect to see an uptick in consolidation, especially since the prevalence of so-called poison pills has also declined. The large build-up of dry powder in private equity in recent years may find a home here, aiming to tap into Japan's structural change story. Will consolidation lead to the formation of some new national champions? Perhaps. In any case, we think it may prove difficult for mainstream global equity funds to fully tap into this area. Japan equity specialists are better placed to benefit in this part of the Japan equity market, particularly those with a small/mid-cap bias.

A Wider Investable Universe?

Within an equity fund context, there might be a broadening of the investment universe considered by Japan equity fund managers, and for some global and regional equity funds, too. The developments discussed previously are likely to reduce the number of companies excluded from the investment universe due to poor quality, and in turn the field may be widened for many active stock-pickers. New stocks may need to be added to some outfits' research coverage, and with this may come more efficient pricing of equities.

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What Has This All Meant for Japan's Equity Markets?

Breaking Through Previous Highs …

In 2023, the Morningstar Japan TME Index rose a staggering JPY 28.4% and a further 21.4% in the first half of 2024. Those who hedged their exposure would have done very well, but even those who didn't hedge their exposure also would have benefited. For example, in GBP the index rose by 13.4% in 2023 and by 7.3% in the first half of 2024.

To some, the scars of the bubble era and subsequent bust may loom large. When charted, the rate of the ascent over the last decade may remind some of the heady 1980s. However, there has been fundamental support for this. In many areas, earnings estimates paint a positive picture for the future, too. Meanwhile, by some measures, the Japanese market remains undervalued versus global markets across traditional valuation multiples. There are no obvious warning signs of irrational exuberance at play at the market level. Strong performance has not been uniform, and dispersion has been somewhat extreme both in style and market cap.

The August 2024 bout of extreme volatility was short-lived. The market quickly found a floor after a few days of record selloffs. At the time of writing, market index levels were close to their previous highs. Investors saw opportunities to buy into companies at cheap valuations. While we cannot rule out some more periods of market instability in the years to come as quantitative easing truly ends, strong fundamentals and valuation support should help assuage longer-term fears of sustained selloffs.

Valuations Were Not Extreme

Supporting the view above on recent volatility, and despite strong market performance, valuations do not appear excessive at face value. Price/book ratios have increased, but for good reason and not excessively. Meanwhile, price/earnings ratios for Japanese equities remain below that of global references. Many do not think the market looks overvalued, especially given strong earnings estimations. The recent and extreme selloff does not appear to have been caused by relative valuations or, in many cases, by changing fundamentals. Of course, there has been some mechanistic adjustments to foreign earners.

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Exhibit 7 Price/Equity Valuations for Japan and Global Indexes

Source: Morningstar Direct. Data as of June 30, 2024.

A Tale of Style: Value vs. Growth

The rally in value equities to end June 2024 follows a lengthy period of underperformance. There was a sharp reversal since the covid vaccine rollout in 2021. The relative fortunes of growth and value have been extreme.

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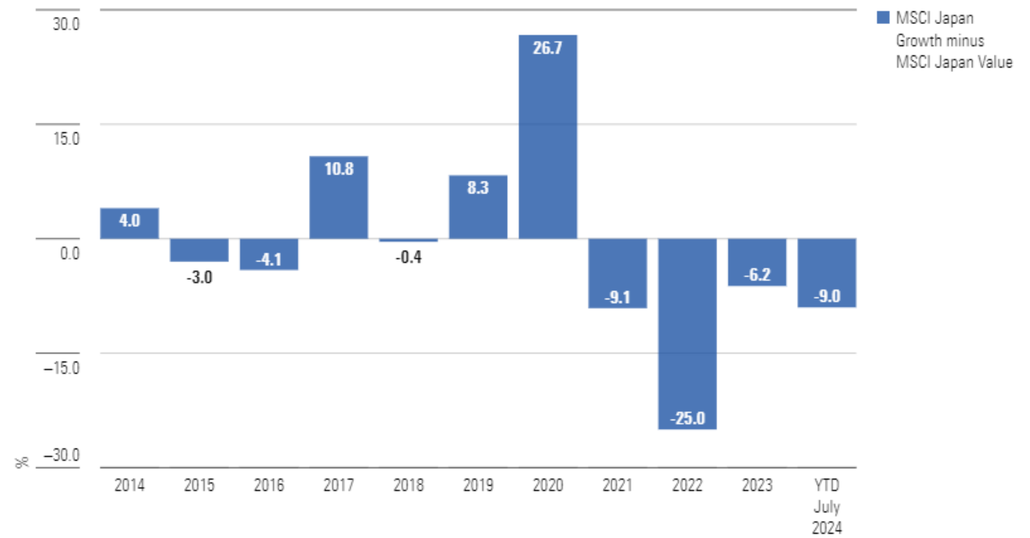
Exhibit 8 Index Total Returns: MSCI Japan Growth Minus MSCI Japan Value



Source: Morningstar Direct. Data as of Aug. 8, 2024.

A Tale of Size: Value vs. Growth

Meanwhile, small caps, though delivering positive returns, have lagged their large-cap counterparts, as shown by comparing the total return of the equal-weighted index against the broad market-cap index. This of course has not been a uniquely Japanese phenomena, but it has been an important facet, nonetheless.

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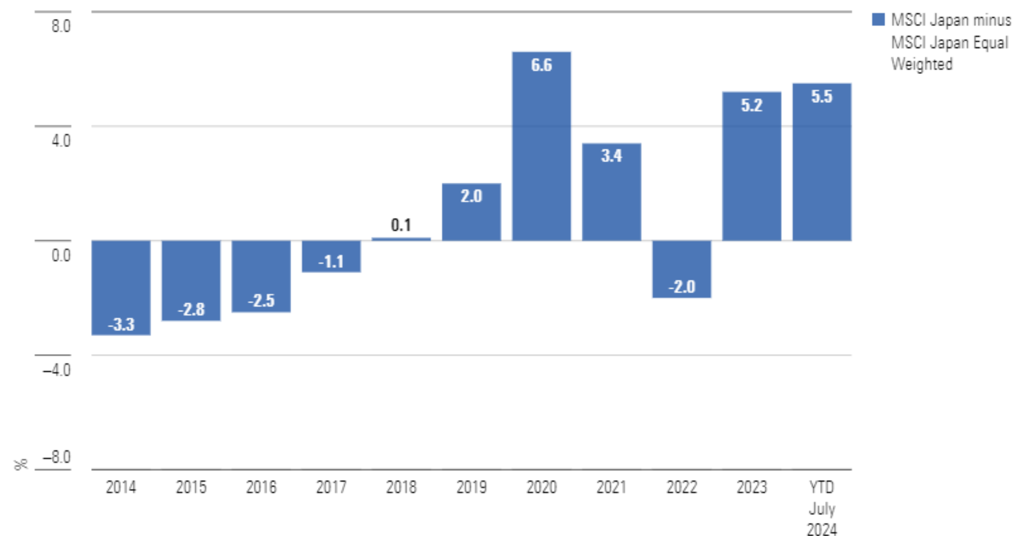
Exhibit 9 Index Total Returns: MSCI Japan Minus MSCI Japan Equal-Weighted



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What Areas of the Market Have Driven Returns in the 18 Months Since 2023?

Looking at the Morningstar Japan TME Index's performance, the largest index constituent, Toyota Motor Corporation, has been a standout performer, though it has provided a slight headache for active managers, many of whom do not hold it or find it hard to justify overweighting it given its large index weighting. Many prefer Toyota Industries, which is highly correlated.

Financials have performed very strongly, too, rising 92% in yen terms in the 18 months to June 2024. Mega banks have been beneficiaries of rising yields, while the three dominant insurers have benefited from growth that outstrips economic growth.

Another bright spot was technology. In particular, companies with exposure to the semiconductor and hardware space excelled, though expectations have been set high. This includes the likes of DISCO Corp, Tokyo Electron, and Advantest. Many are part of the value chain for artificial intelligence, and some have posted price performances comparable with the much-vaunted "Magnificent Seven" stocks over the 18 months to end June 2024.

In contrast, more defensive areas of the market, such as healthcare, underperformed. Some consumer stocks sold off. This includes the likes of Yakult, Shiseido, and Pola Orbis. Quality-growth managers have been impacted.

What Has This Meant for Japan Equity Funds? A Huge Dispersion of Returns

The most obvious impact of recent market dynamics has been the significant dispersion of manager returns. We sometimes look at the dispersion of fund category performance (75th versus 25th percentile and 95th versus 5th percentile). Here, EAA Japan Large-Cap Equity funds stand out as among the largest in terms of return dispersion in recent years. The growth versus value and large versus small-cap dynamics have been a significant contributor to this.

While prior to 2022, growth-biased funds had performed very strongly for several years, it reversed violently as market leadership turned sharply toward value. Through the lens of the Morningstar Style Box, even within "blend" funds, there has been marked dispersion, too. Those with more of a quality bias did not participate as fully in the market rally. Some commonly held quality-growth stocks, mostly in consumer staples, have performed very poorly amidst rising inflation, weak yen, and a weak Chinese consumer. This has had an impact but may present an opportunity for long-term-minded managers who are willing to stick with plans to turn things around.

Which Active Funds Do We Find Interesting?

We think there are strong reasons to consider Japan as a stock-picker's market. Good active management should position portfolios away from those stocks that are adapting more slowly to ongoing governance reforms. Nevertheless, investment styles and related factor premiums are

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important. This supports the case for a more balanced approach to Japanese equities: a blend of a growth- and value-biased fund, or an all-in-one, more corelike approach. Within this context, below we present a handful of Japan equity funds we think are among the more compelling ways to invest in Japan, though there are others we like too.

In the large-cap value space, we draw attention to the Man GLG Japan CoreAlpha Fund. We see positives stemming from the combination of a well-structured, contrarian value investment process and the continuity provided by veteran portfolio manager Jeff Atherton, who took the mantel in January 2021. Since he took over as lead portfolio manager, he has made some important process enhancements, which have been applied to good effect. There is now a greater appreciation of catalysts that help drive rerating, including metrics such as return on equity and earnings quality, as well as corporate governance changes. These changes play directly into many of the themes discussed in this article. This value fund has performed strongly in recent years.

For large-cap Japanese growth equities, there are a number of strong options. We acknowledge that many funds that invest in this area of the market have suffered from weak relative returns in recent years given the extreme market dynamics previously discussed. We stay long-term, but where appropriate have updated our views. On a forward-looking basis, however, we see optimism from many secular growth opportunities, which persist in areas relating to Asian premiumization, automation, and online companies, among others. We think growth-biased funds continue to serve a role for those looking to offset the style biases from a pure value fund. Here, we highlight JPM Japan Equity. It benefits from a topnotch lead portfolio manager, a well-resourced supporting team, and a time-tested investment approach. The well-codified, quality-growth investment approach is long-established and has also been employed successfully across related JPM Asia-Pacific and JPM Emerging Markets equity strategies. Lead portfolio manager Nicholas Weindling has managed this strategy since 2007. He adheres to the strategy's long-standing growth-oriented approach through various market environments and is unfazed by shorter-term headwinds. He has an impressive track record across multiple market cycles. This is one of the most well-resourced Japan-dedicated equity teams under our coverage, and the manager fully uses his best ideas and is often willing to pay high multiples for them. As such, the portfolio's average expected growth and return on equity, as well as its valuation, have consistently been markedly higher than the Topix. The approach has delivered solid long-term results, although it may also result in lumpy and volatile results at times, amplified by the strategy's salient growth tilt. Indeed, the strategy faced severe stylistic headwinds since 2021, which put a dent in medium-term results. We remain confident that the strategy can add value over the long run for investors who can stomach the recent setbacks.

For a more corelike option, there are a few funds we cover actively. The most popular of these in recent years is the M&G Japan Equity fund. Managed by Carl Vine, this fund takes a blended approach to investing in Japan. Both Vine and deputy manager David Perrett joined in 2019 after M&G acquired Port Meadow Capital Management, a pan-Asian long-short equity-focused hedge fund they founded in 2014. Almost the entirety of their experience has been in the pan-Asian long-short space, and so this Japan long-only mandate represents something of a change in tack. However, the amassed research catalog and experience working to tighter risk budgets remain highly relevant and advantageous. The supporting team is large, and a unique element is Dr. Ryohei Yanagi, the team's corporate engagement

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consultant. As a drafting member of the Ito Review, Yanagi is inextricably linked with reform in the region. A "core universe" of around 700 names has been curated across Asia, Japan representing roughly 250 of these. The team understands these businesses operationally, but more important is how effectively it has assessed these businesses on an ex-ante basis historically. The unique valuation framework is built on mental modeling, rather than financial modeling, deriving expected value from scenario and probability analysis, rather than a hypothetical fair value from discounted cash flows. Unlike many peers in the space, the team isn't wed to any style, and aggregate portfolio positioning derives from bottom-up opportunities. We expect the portfolio to sit within the large-cap-blend portion of the Morningstar Style Box. The team's engagement playbook is thoughtful, and its desire to be the "shareholder of choice" is amply evidenced. Performance has met expectations. We do, however, note that it has attracted vast inflows in recent years, and capacity is something we keep an eye on.

We also point to Zennor Japan as a potentially highly compelling equity proposition in Japan large caps, though with a mid-cap bias. We have followed this fund since its launch in 2021. While not under active coverage currently, it rightly retains a spot on our prospects list. The fund is managed by two veteran investors in James Salter and David Mitchinson. They bring highly complementary skill sets. Salter is a renowned Japan value investor and was a co-founder of Polar Capital and longtime manager of the Polar Japan Equity fund. Meanwhile, Mitchinson is a growth investor, with experience spanning several reputable shops, including many years at JPMorgan, mentioned previously. The duo makes for a strong pairing. Their accumulated acumen is a big part of the appeal, and alignment of interests here is strong. In a sense, it might best be explained as a special situations approach, investing across three "buckets": overlooked assets, mispriced cash flows, and underearners. It plays directly into many of the themes discussed in this paper, while value-growth biases are kept in check. Performance has been strong to date, despite a bias to domestic earners and mid-caps. The duo also run the more recently launched Zennor Japan Income fund (launched in 2023), which we also have on our radar.

Finally, an investment strategy we are beginning to explore is the closed-ended AVI Japanese Opportunity Trust, which launched in 2018, And its open-ended UCITS sibling, the AVI Japan Special Situations fund, which launched in April 2024. This strategy invests only in small- and mid-cap Japan equities, and it takes an activist approach. This is a punchy portfolio of 25-35 stocks that sits firmly in the lower-end of the market-cap spectrum. These are asset-backed opportunities where value can be unlocked via active engagement. CEO and CIO Joe Bauernfreund is lead manager, with support from a dedicated research team of six. Performance since the trust launched in 2018 has been strong, and the portfolio manager is in charge of his own destiny via his activist approach and significant margin of safety on valuations.

Where Does That Leave Us?

So, where does this leave us? Well, let's come back to Oscar Wilde, who had himself always intended to visit Japan but never got the chance. He famously declared in his essay "The Decay of Lying" in 1889 that "the whole of Japan is pure invention." The same cannot be said about market performance in the last few years. Market returns have been underpinned by the ongoing structural corporate governance reforms. Many market participants anticipate a continuation of strong future returns. We hear surprisingly bullish views from both the value and growth camps. Earnings forecasts in aggregate

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remain encouraging, even if we might expect some downgrades for exporters due to a strengthening yen. We think those with more of an active engagement mindset may be able to best capitalize on reforms, but momentum is in play and all participants will benefit from improvements to shareholder returns over many years to come. Index-level concentration is far lower in Japan than many other major markets, permitting active managers to more easily express their relative convictions. Dispersion of performance might remain high, and there are reasons to believe that active management is the most valid way to invest in Japan, whether via a combination of two specialist funds targeting value and growth, or a more corelike solution. Further, some small/mid-cap exposure may prove profitable as reforms trickle down the market-cap spectrum and the market readjusts. The recent bout of market volatility is not something to ignore. Nor is the possibly changed shape of the Bank of Japan's rate-setting policy function. Despite this, we suggest investors remain long-term. There are multiple causes for optimism, spanning the growth companies—which are now better priced—traditional value plays, corporate governance reforms, and active engagement. The latter may be an important source of idiosyncratic alpha. Japan equity funds may continue to serve a useful role within a broader portfolio.

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