THE BACKGROUND TO JAPANESE PORTFOLIO INVESTMENT IN AUSTRALIA

By J.G. Morris

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Merrill Lynch, Bache & Co., White Weld, Cazenove, Vickers da Costa — these are the overseas brokers we know. But what of Nomura, Nikko, Daiwa and Yamaichi — these are the new breed. But who they are, what they represent and how their operations could affect us is still largely unknown in Australia.

First, a warning, or at least an explanation. When we deal with British, American and European people, we are dealing with people having similar ethics and codes of behaviour to our own, derived from a common basis of civilization in the Mediterranean area. With the Japanese people it is different. Japan is a different country to the Western Democracies with markedly different cultural origins and different modes of behaviour, extending through social and business relations. In Japan, codes of loyalty and obligation predominate and these are as valid as our ethics of what is good and what is bad. There is a close relationship between the business and government sectors in the form of controls, aids and discussions, although this is far removed from a socialist model.

In turning to the Securities Industry, we should be aware of differences which exist between those operating in that industry in Japan and those operating in Australia.

Japan has one major Stock Exchange, in Tokyo which was established in 1878, and a number of lesser Stock Exchanges. After a close-down at the end of World War II, stock exchanges were re-established in 1949 in Tokyo, Osaka and Nagoya, followed by exchanges in five smaller cities. Tokyo Stock Exchange is by far the largest exchange handling 75% of total turnover; hence our problem of having two leading exchanges of roughly equal size and influence is unknown in Japan.

Daily share turnover on Tokyo Stock Exchange is at considerably higher levels than we know here. In March this year for example, daily turnover ranged from a low of 104.4 million shares to a high of 376.7 million shares. The average for the month was turnover of around 200 million shares per day with the average value of each transaction being a little under Aust. 50¢. In terms of turnover, therefore, the Japanese are used to a considerably freer market than we have here in Australia.

Brokers in Japan have corporate status and are known as Securities Companies. A licence for a corporation to enter the securities business must first be obtained from the Japanese Ministry of Finance. There are four kinds of licence:-

(1) Dealing on one's own account.

(2) Brokerage activity.

(3) Underwriting and distribution of securities.

(4) Selling securities as a member of a syndicate which distributes securities.

Of the 83 member firms of Tokyo Exchange, 46 are licensed in all four categories, while 36 member firms function as dealers, brokers and distributors. Australian brokers may well be asked by interested Japanese securities companies, in which of the four categories they operate.

In having corporate status, Japanese securities companies frequently have as shareholders, organizations which are important in other spheres; these links are worth investigating. If we take as an example Yamaichi Securities Co. Ltd. which is the third or fourth largest of the Japanese securities companies, we find that the major shareholders include the Industrial Bank of Japan, Fuji Bank and Mitsubishi Bank. In fact each of the major securities companies have banks among their principal shareholders.

Next in line of progression we find that each of the major securities companies operates investment trusts and these are usually managed by subsidiary investment trust management companies.

Trustees for the Japanese investment trusts are Trust and Banking Corporation or Trust Banks. These trust banks are different institutions from the city banks. Thus, we have both, for example, the Mitsubishi Bank and Mitsubishi Trust & Banking Co., both separate institutions. Frequently, to add to the somewhat confusing situation, the trust banks also often have share interests in the securities companies. Separately, the city banks frequently have share interests in the trust banks, while certain of the securities companies also have share interests in the trust banks. Curiously, some of the larger securities companies have share interests in certain of the smaller securities companies. No doubt you will agree that there is a fairly complex interlinking of share interests between the major city banks, the trust banks and the securities companies.

And now to digress for a moment. The principal Japanese securities companies are bigger than their counterparts in this country. Using Yamaichi as an example, which is the third or fourth largest securities company in Japan, we find that it was established in 1897, its paid capital is ¥ 9,800 m. or about $A25 m. It was 5,500 employees and 84 offices including four overseas offices. It is a member of all eight stock exchanges in Japan. Brokerage commissions alone for the year ended September 30, 1970 amounted to $US42m. In terms of employees and offices it is probably ten times as big as its local counterpart.

Before turning to the potential for Japanese portfolio investment in Australian securities I think it is essential that we appreciate the somewhat complicated structure of the Japanese Securities Industry. Let me recapitulate briefly; Japanese stockbrokers are corporate entities known as securities companies and most have leading banks as their principal shareholders. The bigger securities companies operate their own investment trusts managed by subsidiary investment trust management companies. Trust banks come into the picture as trustees for the investment trusts.

Until April 1970, portfolio investment by Japanese companies or individuals abroad was not permitted, this being exactly the same position in which we still find ourselves in Australia. However, in April of last year the Japanese Minister of Finance authorized the four leading investment trusts, i.e. those associated with Nomura, Nikko, Daiwa and Yamaichi Securities Companies to invest abroad in eight named centres, including Sydney, up to a maximum of $US100 million. It was thus a very limited liberalization. A few months ago, two additional investment trust management companies, Asahi and Taiyo were also permitted to invest abroad as were the leading life and non-life companies. As from July 1, Japanese individuals and institutions also were permitted to invest abroad - I will be referring to this later.

To those concerned, the chance to invest overseas has brought a multitude of problems. If the position has been reversed and we, as Australian investment analysts, had been advised suddenly that we could invest in eight overseas stock exchanges, each in a different country, we can begin to comprehend the magnitude of the problem faced by the Japanese analysts in understanding different laws, different regulations, different economies and different sets of companies, each in eight countries.

It is widely accepted that the growth in Japanese overseas reserves and the resulting pressure for an upward revaluation of the yen have been the underlying reasons for the relaxation of restrictions on overseas portfolio investment. In recent months, there has been considerable public discussion in Japan as to the possibility of revaluation. In this atmosphere, with a possible exchange risk hanging over their heads, the Japanese securities companies have exhibited a natural reluctance to commit funds abroad. Despite this, the securities industry has had to bow to pressure from a Ministry of Finance more anxious than ever to reduce overseas reserves, by pushing the companies into portfolio investment abroad. Thus, in the past month or so, the Big Four Securities Companies, through their Investment Trust Management Companies have shown a renewed desire to invest abroad.

At this stage, we should understand that securities bought by Japanese investment trust companies are held in custody in the country of purchase. Parties to the necessary custodian agreements are nominally the foreign custodian company concerned and the Japanese trust bank acting for the investment trust in Japan. In fact, the Japanese party to the agreements is invariably, on a de facto basis at least, the Ministry of Finance as the trust banks concerned cannot sign the relative agreements without the prior approval of that Ministry. Similarly, when a Japanese broker undertakes investment abroad for his individual clients, he also will have to execute custodian agreements in the countries where the scrip is to be held.

In respect of custodian agreements in Australia, the various custodian agreements in this country have been, or are being, negotiated with bank nominee companies. In view of the strong links existing in Japan between the securities companies and Japanese banks it was perhaps natural that in the absence of Japanese bank branches in Australia, for Australian bank nominee companies to be appointed. Custodian business of three of the four largest Securities Companies, Nomura and Daiwa, in respect of their Investment Trust dealings and Nikko in respect of clients business in Australian securities will be handled by Wales Nominees, while additionally, we have other custodian agreements currently in the pipeline for various securities companies both in respect of individual and trust business.

Arriving at a custodian agreement acceptable to both parties has not been easy. In the case of one agreement which the Wales Nominees Company was working on, we were presented in the first place with what was originally a domestic type of custodian agreement used by the trust bank in Japan. However, by the time it came to us it had been used as a basis for effecting a custodian agreement in Canada. It was already a compromise between Japanese and Canadian requirements. We had to find a further compromise which allowed for Australian legal requirements and procedures and was at the same time still acceptable to the Ministry of Finance in Tokyo. One of the most difficult areas of difference was that we had no fixed settlement days for stock exchange transactions in Australia.

Perhaps by this time you may have come to the conclusion that the Ministry of Finance in Tokyo keeps a firm hand on the reins. Certainly in Japan, Government departments exercise far more control over commerce and industry than anything we know in Australia. In dealing with one's counterpart in Japan, one must always work on the assumption that behind the counterpart or trading partner is a Government department, usually the Ministry of International Trade & Industry (M.I.T.I.) or the Ministry of Finance (M.O.F.). It is not dictation in isolation but control after consultation. Thus, in the case of liberalization in controls over foreign portfolio investment by the Ministry of Finance, this liberalization was authorised after consultation with leaders in the Securities Industry. It is of interest that these consultations frequently bring in their wake what appear to us as inspired leaks. One is usually made aware of the next move which M.O.F. has in mind.

When I was in Tokyo in April and early May I heard from all sides that from early June this year M.O.F.would permit portfolio investment abroad by individual Japanese investors. A few weeks ago we had a press report which suggested that this would be authorized through the top 20 securities companies in Japan, and possibly in association with a Depository Receipt System as found in New York. There were also strong indications that the present ceiling on Japanese portfolio investment abroad of $US100 m. would be either abolished or stepped up considerably.

To give you some idea of the difference in size between the 1st and 20th ranking Securities Companies on the Tokyo Exchange; turnover figures for February this year showed that Nomura Securities, the biggest broker, handled 1744 million shares, while the 20th, a securities company called Koa, handled 91 million shares.

Well, July 1 has come and gone, and with it the first tangible evidence of dealing for individual clients by the Japanese Securities Companies on overseas markets. One press report quoted Nomura having taken several orders for B.H.P. shares.

We still lack firm details of the new arrangements. However, it seems likely that the six largest securities companies can invest abroad on behalf of their clients in securities of nations belonging to the Organization for Economic Co-operation & Development. The next fourteen securities companies, in order of size, will be permitted to deal in specific overseas markets only. Of this 14, only two securities companies, initially at least, will be able to deal in Australian securities, and then only when they have convinced M.O.F. that they are sufficiently conversant with the Australian market.

Separately, to investment abroad by the leading investment trusts and by individual Japanese investors through the top 20 securities companies, we also have a third and somewhat indirect variety. That is each of the four largest securities companies are now participating in international investment funds. Each of the four funds is permitted to invest up to 50% of net assets in overseas securities and each uses well-known international finance houses to advise on the foreign investments. These foreign investments can of course include Australian securities.

In the case of Nomura, its international fund is Associated Japanese International Fund of which the relative overseas advisors are Bankers Trust, Merrill Lynch and Rothschild. The initial amount of the fund sought was ¥15,000 million or a little under $A38 million. The other three international funds, those associated with Nikko, Daiwa and Yamaichi, are a little smaller and each was seeking (a month or so ago) ¥10,000 million or around $25 million.

We are now faced with a number of questions. The first is that with a growing licence to invest in overseas stocks, what use will the Japanese investor make of that licence? If he decides to invest a proportion of funds abroad, in which overseas centre will he invest, and in what category of stock will he invest, in his chosen centre or centres?

What do we offer in Australia as a prospective home for Japanese portfolio investment? First, we have to live down the poor publicity which has attached to our industry overseas. Once over that hurdle, we find that our industrial stocks have little to offer that cannot be bettered in Japan itself or in London, or Paris, or New York. What we do have, however, is a number of well-established mining stocks that cannot be duplicated in the markets open to the Japanese other than possibly in Canada. Hence, Japanese interest in Australian stocks initially at least could be limited to a fairly narrow sector of our markets.

Taking a somewhat longer view, it is quite possible that the strong correlation which currently exists between Tokyo and Wall Street and to a lesser degree between London and Wall Street may yet be mirrored more closely in Australia. At present Wall Street has comparatively little influence on our price levels and Australian share markets are today well out of line with most other world stock markets. I found some evidence in Tokyo that investment thinking for the longer term was certainly considering the possibility of an international switch of investments from one world market to another where one market was significantly out of line. This reasoning if it is followed out in practice has some very interesting possibilities for us in Australia.

In considering possible Japanese portfolio investment in Australia, there are basically three factors to consider, in existing conditions - (1) Our mining market offers an avenue for investment not available in Japan, (2) The possibility of an upward revaluation of the yen is a restraining influence, but conversely, (3) There is strong Japanese Government pressure to invest abroad and the Japanese people respond to Government pressure to a much greater extent than we are accustomed to.

Allowing for the interplay of these three factors, we can see that from a Nil base, Japanese portfolio investment in Australian stocks could grow to sizeable proportions. And the more publicity given to such investment the greater the influence likely on our share prices. Neither we in Australia nor the Japanese brokers have any real idea of the proportions to which this portfolio investment by the Japanese could grow to in Australia. But if the portfolio investment grows as fast as direct Japanese investment in Australia, for which growth has been forecast from the present $70 mill. to over $200 million in the next few years, then its influence over a period of years could well become very significant.

In dealing with the Japanese Securities Industry we are dealing with an industry sophisticated in operation, complex in structure and giving a meticulous attention to detail. Given goodwill and understanding our association must prosper and be of mutual benefit to the Securities Industry both in Japan and in Australia.

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ACCOUNTING RESEARCH FOUNDATION

A member of our Victorian Branch, Mr. R.C. Clift, has been awarded a grant to finance research on his doctoral thesis "An Investigation Into the Nature and Quality of Information Utilized by Advisers in the Stockbroking Industry in Victoria."

Congratulations of the Society are extended to Mr. Clift who has already done a great deal of work in this area and whose further research should be of wide interest. An address early this year to the Victorian Branch was published in our January issue.

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