HOW SAFE IS THE JAPANESE MARKET?

A NEW GAME: PICK THE 'SYSTEMIC RISK'

by ANDREW AGNEW and RONALD LAYARD-LIESCHING

Australian portfolio managers, looking to increase their international exposure, face the question of how much should be invested in Japan – and at what risk?

The dichotomy of views about Japanese investment is nowhere seen more clearly than in attitudes towards Japanese stock prices. Many analysts view the Japanese market as "bigger than the South Sea Bubble". For most Japanese institutions, a major fall in Japanese equities is, quite simply, inconceivable.

If global markets are efficient, how can the large investor groupings in the world hold diametrically opposed views on the risk-and-return prospects for the world's largest equity market? And, more important, what should an Australian fund manager do about it?

These are clearly not academic questions: their conclusions translate directly into performance results. A recent Intersec survey shows international managers of US pension funds underperforming the world index by more than 10 per cent a year for the past five years. You would fire domestic managers who performed so poorly!

However, there is safety in numbers for the poor-performing international managers. There are two overriding reasons for the poor average performance:

- The main reason is that more than 95 per cent of US managers have been severely underweight in Japanese equities.
- A secondary factor is that managers on average underperform local indexes – this occurs particularly in Japan.

Based on world market capitalisation, an investment fund should currently have 63 per cent of its non-US international investments in Japan. The average Japanese weight taken by international fund managers has been close to 31 per cent, a full 32 per cent below the market capitalisation weight.

Because it is the consensus of such a large group of managers to underweight Japan, there has been a widespread move to redefine the investment benchmark. The current flavour-of-the-month is a GDP-weighted index which weights Japan at – guess what – 31.6 per cent in the world ex-US.

Before we accept the consensus, let's look at the real issues. The starting point is our objective: investing internationally to improve long-run risk/return; that is, to obtain the economic diversification benefits of investing in the other 98 per cent of the total world equity markets outside Australia.

The three real benchmark issues are:

- On pure risk/return grounds, how large a Japanese exposure would a fund want?
- To what extent is the Japanese market really overvalued?
- Systemic risk – is Japan going to have a major financial crisis?

The Japanese market is an extremely diversifying investment for any country's international portfolio. To underweight Japan you have to be very pessimistic about future returns from Japan, relative to the other markets.

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Japan is on its own because Japanese shares are overwhelmingly owned by Japanese institutions.

Within the three economic power blocks of the world – Japan/S-E Asia, the US and Europe – we can expect a "law of one price" to prevail: one valuation basis for all shares. Between these blocks, the enormous wedges of divergent economic policy will lead to continued massive valuation differences. This not only offers investors continued risk diversification benefits from international equity investment, but also holds out the prospect of high returns by exploiting these different pricing bases.

At the heart of the dichotomy of valuations of the Japanese market is the different social environment in Japan compared with those elsewhere. There are several key differences. First, the social discount rate is much lower in Japan. Individuals in Japanese society look for a much longer payback period for their personal effort.

The same is true at a corporate level. There is little corporate prestige in profits in Japan. There *is* corporate prestige in market share, in being the market leader. This means that Japanese corporations have repeatedly beaten international competitors in textiles, steel, shipbuilding, autos, electronic goods, chips and banking.

It is a three-stage process: first they build market share at initially low or negative returns (viewed from a Western accounting basis), and then they benefit from huge economies of scale and vertical integration.

Next, prices rise due to the resulting quota, tariff, voluntary restraint agreement, orderly marketing agreement or whatever US import controls are called now. The list of industries given is vertical integration up the value-added chain. In the third stage these industries are exported from Japan.

The low social discount rate also boosts the Japanese financial markets. The moment that the Japanese economy generated an excess of savings over physical investment, this low social discount rate translated into a low nominal interest rate.

In contrast, many Western economies operate with a very high discount rate. This principle is seen at the level of personal spending, the "use the plastic, you deserve it" philosophy. It also operates at the level of the Western economy, where no weight is put on the future taxation burden of internal and external indebtedness in policy formation.

The Western economy operates on a free-market, arm's-length, mark-to-market basis. Essentially, *all* assets of Western corporations are available for purchase by anyone with sufficient borrowing power. Even assets that are combined in one corporate entity can either have their returns unbundled through new security structures, or the asset can be literally bought out by another company.

The Japanese financial markets, however, certainly do not at present operate on a Western-style free-market, arm's-length, mark-to-market basis. There are very few hostile takeovers. There are extremely high levels of cross-holdings of shares. Most estimates from Japanese sources put the cross-holding at around 20 per cent; foreign estimates suggest that as much as 40 per cent of all equities in Japan are actually cross-held by other Japanese companies. Thus the total estimate of Japanese market capitalisation is inflated by this double counting.

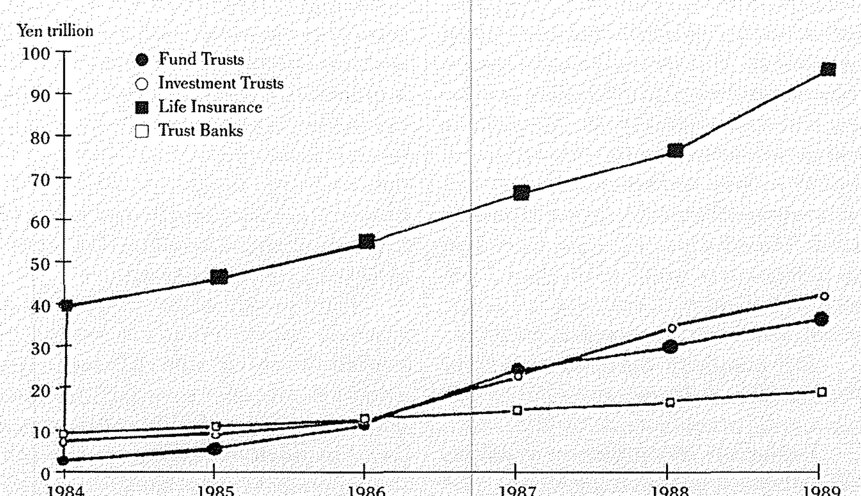
But before you multiply Japanese market capitalisation by 0.8, note three facts:

- The cross-holdings create leverage in the same way that debt creates leverage – so if you adjust for cross-holdings, why not adjust for international corporate debt as well?
- Everyone dealing in Japanese shares knows how difficult it is to buy large blocks of certain sectors: the Japanese market prices already discount cross-holdings.
- Japanese stocks are actually diversified portfolios of stocks. Portfolios are less risky than single stocks.

There is very low liquidity in Japanese equities compared with the other markets. This is because so many shares are "tightly held" (purchased as long-term investments and not traded). The free float of shares is very limited compared with other major equity markets. Japanese stock brokers (trading in Japan) are allowed to act only on an agency – not a principal – basis. It is beginning to change, but there is not yet the level of liquidity provided by the principal market-makers as in the US or UK.

The liquidity problems are reinforced by rotation of trading activity through certain sectors: if Japanese brokers are bullish on a group of stocks they may be reluctant or unwilling to accept sell orders in this group. The concentration of liquidity is one of the factors behind the so called "ambulance stocks": certain stocks with low free floats can rise dramatically in a very short time. Japanese clients who have had problems with a brokerage firm can find themselves the beneficiaries of such a rise (hence the term "ambulance stock"), and of course friendly politicans may also be offered such investments. Unfortunately it is difficult for foreigners to learn about these situations, and generally the stock will subsequently perform very poorly relative to the market. Obviously it is easiest to purchase these shares after they have made their move.

Japanese institutions' asset growth



Source: Japanese Business Section, County NatWest.

This stock-rotating is one factor behind the exceptionally poor performance by non-Japanese managers managing funds in Japan. A recent Intersec survey showed the median return was 8.9 per cent a year below the TSE index over the past four years.

New issues are another area where the pre-placement can give high guaranteed profit to investors. These benefits are given only on the basis of mutually beneficial relationships. For example, in the recent Recruit scandal, this and other hot issues were being given as sweeteners to Japanese institutional investors who had been "requested" to purchase NTT shares by brokers under pressure from the Ministry of Finance to place the NTT stock.

Although such activities may seem to be unacceptable in the 1980s environment of anti-trust law, full disclosure requirements and stock exchange regulations, it is interesting to reflect how similar these activities are to those in the US in the 1920s, when many of the huge US industrial conglomerates and fortunes were established.

Almost everyone has built statistical models of the Japanese equity market. You can build a "hidden earnings" discount model based on the high growth prospects, low discount rate and very low equity risk premium in Japan. You finally justify the level of the Japanese market – and then the market rises another 40 per cent. The fact is that conventional Western market valuation models don't work for Japan!

Back to the drawing board. We know the Japanese market has been driven up by liquidity: excess personal sector savings combined with high liquidity and low inflation. We can test the quantitative impact of these variables using regression. This strongly confirms the view that inflation and liquidity are the key variables. Interest-rate movements and growth are secondary. Inflation and liquidity alone account for 45 per cent of the annual fluctuation in the Japanese index. Over the past 17 years, 1 per cent on inflation was worth more than 2 per cent off the index, 1 per cent on money growth was worth 2 per cent on the index.

At the moment, the model says there should be a 22 per cent rise in the Japanese market from a year ago.

But beware of computerised analysis – the relationships are changing. Over the past 10 years the Japanese market has become twice as sensitive to inflation. In addition, don't look for a model to forecast a crash – conventional regression models are based on the assumption of "stationarity" (no crashes). Nonetheless, watch inflation figures closely: if a rise in inflation provokes a government tightening in liquidity, then there will be only one way for the Japanese market to go.

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There is limited "mark-to-market" accounting in Japan. So, for example, many of the assets of companies and banks, such as shareholdings or real estate, are held at historic book cost. This means that the reported book value of Japanese company assets is grossly understated by Western standards. Remember that the value of real estate in Tokyo alone is more than all US real estate – but it is on the books of Japanese companies at historic cost.

Note one important investment consequence of this practice: Western analysts point out the very low capital base of the Japanese banks. Although there will be many convertible bond issues to raise capital, the fact is that any amount of required capital is available at an accountant's pen-stroke.

The accounting differences are further reinforced by the rapid amortisation of investment in plant and equipment by Japanese companies. These heavy write-downs severely deflate reported earnings and plant values and are another major reason for the apparently excessive price/earnings ratios. The Japanese tax system penalises the reporting of earnings; investors do not need high dividends, so there is a hidden capitalisation of earnings growth in the company, rather than distribution of earnings as in Australia.

The flip side of the failure to mark assets to market occurs in investment portfolio losses. It is a well known – and arithmetically obvious – fact that there have been billions of dollars of investment losses by Japanese institutions investing in US bonds. The yen has risen over the last five years and US bond prices have fallen. These losses are not reported because the bonds are held at historic cost. A move to mark-to-market accounting would cause unacceptable losses. A change in accounting would be greeted with the same enthusiasm as asking US Moneycenter banks to mark their LDC debt to market.

Most scenarios for a collapse in Japanese equity prices are based on some event leading to problems across the whole Japanese financial system; this is what central bank regulators call "Systemic Event Risk". From a Western perspective, it is easy to hypothesise events that could occur. These range from a Tokyo earthquake through more real possibilities such as US import controls, a new Recruit scandal or a huge loss by a major Japanese group speculating in financial markets.

From a Western perspective, the financial risks appear to be enormously heightened by the high P/E multiples and the extensive cross-holdings between members of Japanese company groups. In the West we have seen, in every major market cycle, conglomerates with similar high cross-holdings which rise to unsustainable multiples and then collapse when the cashflow halts and banks pull credit lines. This phenomenon is the reason so many Western commentators see the Japanese equity market as a "pack of cards".

In fact, this view of the Japanese market is deeply flawed. As discussed above, the cross-holdings and close relationships between Japanese companies form a very strong mutual support system. Earnings are massaged down in Japanese conglomerates and the hidden asset base is built up. In contrast, the Western conglomerates which come to grief do so through artificially boosting earnings by leveraging with debt and stripping assets – until they run into cashflow problems.

It is only in a free market that self-feeding runs of prices and confidence arise. Basically, a crisis will develop only if individual investors put their own interests first and try to sell. In a crisis in Japan it would clearly not be in the interest of Japanese institutions to have a massive fall in the Japanese equity market — and thus no Japanese institution would exacerbate a crisis by selling. What about foreign selling? It has already been done; foreigners hold less than 6 per cent of the Japanese market. US selling of Japanese stocks would clearly have less impact than Japanese selling of US stocks!

A Western response to this analysis

is to say that it must only be a matter of time before the vastly over-inflated Japanese stocks, trading at P/Es of more than 100, come back to reality. The obvious question is: whose reality? It seems no more unreasonable to have Japanese stocks trading at multiples of more than 100 than to have US financial institutions with negative net worth trading at zero prices.

To be flippant about it, there is the Golden Rule: those who have gold rule. . . and set the rules. So Western companies could be evaluated on a *Japanese* basis and not vice versa!

But this is too glib an analysis. Clearly the Western and Japanese markets operate on totally different valuation bases. The one growing change in the Japanese market is financial deregulation. The so-called "village" system in Japan of mutual dependency and help is beginning to be broken up. The rapid growth in the financial free market means that the ability of the establishment to control Japanese equity prices is declining sharply. That is why it is critical to watch the growth in stock index futures, upcoming investment deregulation and growth in the more flexible Tokkin funds.

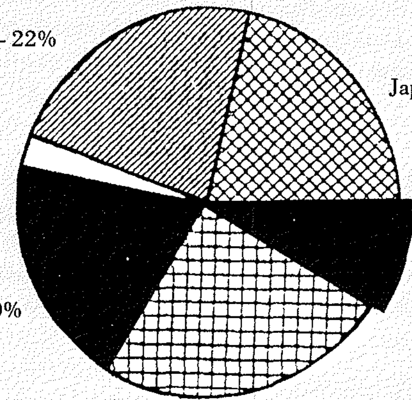
The conclusion on systemic risk is that it is a real risk – and a rising risk. Major Japanese and Western companies must eventually move to a common valuation basis.

This does not imply that Japanese equity prices will fall. Indeed, already the top companies globally appear to be moving from a one-market base to a supranational basis of stock valuation. Just as there is an S&P membership effect in the US, there will be an "international portfolio stock" membership effect in the next five years.

Finally, a word of caution for Japanese pessismists. We know that more than 90 per cent of Japanese international investment is in bonds – the bulk in US bonds. We know that the initial Japanese strategy was simply to buy and hold US long bonds. We know now that the Japanese bond holdings are of shorter maturity and there is very active US bond trading. Only five years ago no-one considered the impact on the US bond market of Japanese bond trading – US bond traders thought *Gensaki* was a drink!

If there were a market crisis in Japan, the equity market would halt and Japanese institutions would pull their money back from the US. So do not conclude that you can eliminate Japanese systemic risk from your portfolios by underweighting Japan: In a crash the markets that fall furthest are those where the market-makers have least capital and where there are free markets: that market is *not* Japan.

Japanese institutional distribution of outstanding assets
as at December 1988



Source: Japanese Business Section, County NatWest.

Investment fund trustees have the serious responsiblity of balancing the return opportunities available against their best judgment of the risks. We know that the current average percentage of US pension funds invested internationally will rise from close to 7 per cent to more than 10 per cent in the next three years. In Australia, the currency uncertainties may lead to as much as an average of 30 per cent being invested offshore. On a market capitalisation basis, 44 per cent of this money should be in Japanese equities!

There *are* strong arguments for reducing the Japanese weighting in the benchmark.

The valuation arguments do indicate that a minority of Japanese companies are substantially overvalued; however, this has to be set against the price benefit and protection of the high level of cross-holdings of shares in Japan.

This overvaluation in Western terms must also be seen in the context of a change in the whole basis of global stock valuation: historically, as industrial economies developed, there was a shortage of capital so investing institutions were in a dominant position. Basically investors determined prices based on investor risk/return criteria.

Now the industrial countries are PICs: post industrial countries. The net result is that borrowers and borrowing conditions are equally important in determining stock prices. We see this in the flood of LBOs in the US and the high Japanese equity prices. Beware of historic analysis, as Nietzsche put it: you start up looking backwards, you end up thinking backwards.

The conclusion is that there is no one "right answer" for Japanese weighting. GDP weighting may well be a more comfortable level for many trustees currently to accept but GDP has no special merit. One might just as well look at book values of different markets or comparable earnings measures to form an international benchmark.

Japanese equities have not only been the best performing international market; they are also a powerful and increasingly diversifying asset for an Australian investment fund. This means that for funds with a small percentage (less than 5 per cent) international, there is a strong case for a full capitalisation weighting in Japan. For funds with a high percentage international (more than 15 per cent), there is a much clearer case for underweighting Japan. This is particularly the case if a Japanese "event" would affect the plan sponsor's earnings. The extent of underweighting depends on the judgment of the extent of the market overvaluation and the level of concern over systemic Japanese risk.

It is unacceptable to underperform in international investment simply because everyone else did. If you underweight Japan heavily, then document your rationale. You may need to defend it! □