Japan Getting Into “Zen” Zone

Stockholm (HedgeNordic) – Towards the end of last summer, Warren Buffett’s Berkshire Hathaway unveiled stakes of more than five percent in five Japanese companies, his largest ever investment outside the United States. Buffet’s investment could be a testament to the fact that the Japanese stock market is full of “value plays” – great companies with solid business prospects and cash-rich balance sheets trading at low valuations relative to intrinsic value, operating in a market with improving governance.

Relying on a Benjamin Graham-inspired approach, Oslo-based money manager Trond Hermansen had been eyeing “value plays” in the Japanese market long before Graham’s protégée, Warren Buffett, unveiled his investments in Japan. The long/short equity fund – **Sector Zen** – he co-manages with analyst Lars Solberg under the umbrella of hedge fund house Sector Asset Management has capitalized on many of these value plays. “Although Sector Zen invests in Japan, the fund has more to do with stock picking and finding value in individual situations,” explains Hermansen. “That is the focus of the fund, and because of all the changes going on in Japan at the moment, we believe that this is a very good investment opportunity set for the kind of investment strategy that we employ.”

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Ben Graham-Inspired Approach

Benjamin Graham’s guideline of investing when you are getting more than you are paying for will never go out of style, but his original approach of focusing on the balance sheet and finding net-nets – stocks selling for prices well below net current asset values – may have gone out of style everywhere but Japan. According to Hermansen, the original Graham approach “goes hand in hand with the situation in Japan, because there are a lot of listed companies in the Japanese market that are overcapitalized.” On aggregate, the Japanese market is the most overcapitalized in the world among the major global markets.

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“We also look at the earnings- and cash flow-side of things, but there is so much hidden value on the balance sheets of Japanese companies, and that is why we believe this approach is interesting,” Hermansen explains the rationale behind his Graham-inspired approach. “If you look at value investing in a general sense, it used to work extremely well in Japan for decades. But since the global financial crisis, value has not worked anywhere on a passive basis,” acknowledges the fund manager. “On a more selective basis, value investing has still been working, but under a slightly different approach than before and on a more individual basis.”

The Case for Japan

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After decades of being avoided by investors for reasons dating back to the late 1980s, the Japanese stock market is finally getting attention again as those reasons are dissipating. Despite Japan being the world's third-largest economy, having strong institutions and solid rule of law, it has been difficult for investors to get comfortable with Japan "partly because of the excessive cross-ownership within the market," argues Hermansen. "The cross-ownership, this so-called Keiretsu system, has meant a lack of transparency, accountability and governance."

"In the past, the Keiretsu system used to protect companies and served as an effective takeover defense mechanism," explains the fund manager. "We believe that is also a cultural thing. Japanese companies are often very, very conservative," points out Hermansen. "Because of the lending bubble in the 1980s, companies have been extremely focused on paying down debt and not taking up any new debt. They would rather just sit on a pile of cash and be safe during the next downturn," he elaborates. "But obviously too much idle cash on the balance sheet is not very good for shareholder returns."

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Japanese companies have been allowed to maintain and build overcapitalized balance sheets for too long, "but that is changing," argues Hermansen. "Nowadays, companies have to comply more with shareholder demands than they used to." There are top-down and bottom-up forces driving improvements in governance and stewardship in the Japanese stock market in recent years. "From the top-down side, there are a couple of reforms or so-called codes that were introduced," says Hermansen.

"Domestic investors signing up to the stewardship code is very important."

The Japanese Financial Service Agency (FSA) launched the Japanese version of "Stewardship Code" in early 2014. "The stewardship code handles how you act as an investor in listed companies, and that is very important in Japan," says Hermansen. "Domestic pension funds, for instance, have not been accountable in the past for how they vote on AGMs. These days, most of them are more transparent and increasingly vote in line with good corporate governance principles." elaborates the fund manager. "Domestic investors signing up to the stewardship code is very important."

"One year later, in 2015, we also had the establishment of the first version of the corporate governance code," continues Hermansen. "That code handles how you are acting as a listed company and that is extremely important because again, most of these 3,600 listed companies in Japan have really not been questioning why they are listed in the proper sense." As a result, companies are increasingly focused on creating returns for shareholders. "This corporate governance code has been revised on several occasions, and there is a new revision coming out shortly," says Hermansen.

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"As a part of that push for better governance, the Japanese government has also come up with several initiatives," adds Hermansen. As part of the Japanese government's "Action Plan of the

Growth Strategy” released in June 2019, the government also addressed cross-ownership and the parent-subsidiary dual-listing situation in particular. “We believe it is a game-changer that from the top-down you have much more focus on how to improve the governance,” considers Hermansen.

Sector Zen’s Core

Whereas Warren Buffett has found attractive “value plays” among the largest listed businesses in Japan, the opportunity set is even larger and more appealing among the smaller businesses. With the Japanese stock market asymmetrically skewed, with 80 companies taking up about half of the country’s stock market capitalization, “a lot of small and midcap stocks, which might have a perfectly viable business, are simply neglected by investors,” argues Hermansen. “They are not big enough in terms of daily stock market liquidity, for instance, to be profitable for the sell-side houses to focus much on,” he elaborates. “The lack of sell-side coverage leads to undervaluation and what we believe is the huge opportunity in Japan.”

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Hermansen’s Sector Zen seeks to maintain a portfolio of 40 to 50 of such opportunities. “We look for situations where there is scope for change,” Hermansen starts to explain the stock selection process. “First of all, the valuation has to be attractive. But we also like companies with strong balance sheets permitting financial improvement or companies with scope for improvement in returns by taking necessary measures,” he elaborates. “We also look for hidden value on balance sheets in terms of equity, real estate portfolios, among others.”

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“In addition to reviewing the combination of balance sheet quality and valuation metrics, we also like companies where the ownership structure is open to change,” emphasizes Hermansen. “That is why we have been particularly focusing on listed subsidiaries of large listed companies,” he continues. “Because then we believe there is a high likelihood of one or two exit strategies to unlock the value, either the parent company acquires 100 percent of the subsidiary, or they are looking to sell the company to somebody else,” says Hermansen. “That is the core of our strategy.”

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Among the companies with no dominant shareholder in the ownership structure, Sector Zen seeks to invest alongside activist investors. “If you have one or two activist investors invested in a company, it is quite likely that they will make shareholder proposals and the Japanese media will write about those,” says Hermansen. The number of activist funds following or focusing on Japan has more than doubled over the last two or three years, according to Hermansen. “This is a complete game-changer in terms of the investor base, which has led to the cross-ownership level coming down to a level that is more attractive for outside investors,” he elaborates. “The combination of top-down pressure and bottom-up pressure makes the investment opportunities highly attractive in our opinion."

This article featured in HedgeNordic's "Finding Alpha in Equities" publication.