

Research Trip to Japan
March 2011
Kyoto, Yokohama and Tokyo

Prior to our leaving for our 2011 research trip, we were often asked – “Why Japan”? When we toured China two years ago, it was obvious why we were going, and people were excited to hear about our study of the country that seems to be affecting everything from interest rates to the cost of cotton.

On the other hand, Japan has been a declining market for nearly twenty years. The stock market capitalization of the Nikkei is less than 25% of what it was at its peak in the early 1990’s. Yet at that point, we all thought the Japanese were taking over the world. This is very similar to thoughts about the Chinese today.

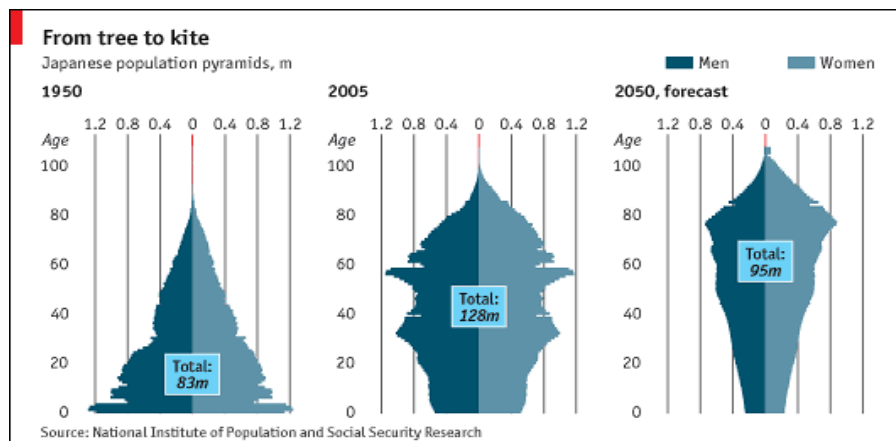


The final reason for an in depth look at Japan is their demographic challenge. Any study of Japanese population growth indicates there are substantial problems ahead. What can we learn from the decisions they have (or have not) made?

We approach any research trip not as an attempt to uncover “hot ideas” but to learn more about a region and how their strengths, weaknesses and decisions may affect our understanding of the global macro-economy. That said, let’s first look at four primary challenges facing Japan.

Demographics

Japanese demographics are abysmal and getting worse. At present, one third of the population is over 65, and the birthrate is not enough to support this aging population. Immigration is virtually a non-started in such a homogeneous nation. Rather than belaboring you with statistics, I will simply provide a chart showing the population’s aging over time.



The young in Japan face challenges beyond simply supporting their parents. There are employment challenges in a stagnant economy and a stultifying culture that does not foster entrepreneurial activity. This has led to a tremendous amount of insecurity as young professionals seek to find a job with one of the major national companies within their first three years out of school. If they do not, it's very difficult to find gainful employment.

On top of the problems with aging, there is also the urban / rural divide (think Tokyo and Osaka versus the rest of the country). There is a tremendous amount of depopulation in rural Japan, and the countryside is ramshackle with poverty and abandoned projects.

Prior to moving to the next issue, let's also consider the needs of the elder class, including the pension system and the National Health System. While the NHS is considered excellent and has kept health care inflation at reasonable levels, it is still not charging as much as is needed to remain solvent. But, unlike the US (where health cost inflation is our primary budgetary concern going forward), the budgetary challenge in Japan is the pension system which is underfunded partially due to issues with enforcement. This is a function of mis-management in the past and lack of trust. Concerns over funding these programs are another key reason to understand Japan.

Politics

The government programs designed to serve the elderly is a good segue into the **political system** in Japan. Political gridlock in Japan is challenging to say the least... many of the problems are legacies of the system enacted after World War II that gave disproportionate power to rural / conservative voters (does this sound familiar?). But, the politicians elected under this structure are not really the ones who have power... those are the bureaucrats.

The bureaucrats are the ones who actually write legislation and have a tenure that exceeds those elected to office. Bureaucrats are silo-ed into ministries, and no one fosters relationships among these ministries. There is an information gap with the politicians since the bureaucrats are the ones with tenure who wrote the legislation. This results in legislative ideas from elected politicians being passed around to a number of Ministries as the bureaucrats "throw up sand" in an effort to avoid having to enact change.

While there is may be no political change agent, there is low approval for status quo politically. Because of the aforementioned issues, change in Japan is not revolutionary but incremental - there is slow but consistent progress.

Government debt / Deflation

Of the economic challenges to Japan, some of the most consequential are **deflation** and **debt**. One issue may be slightly deceptive, but the other is real and consequential.

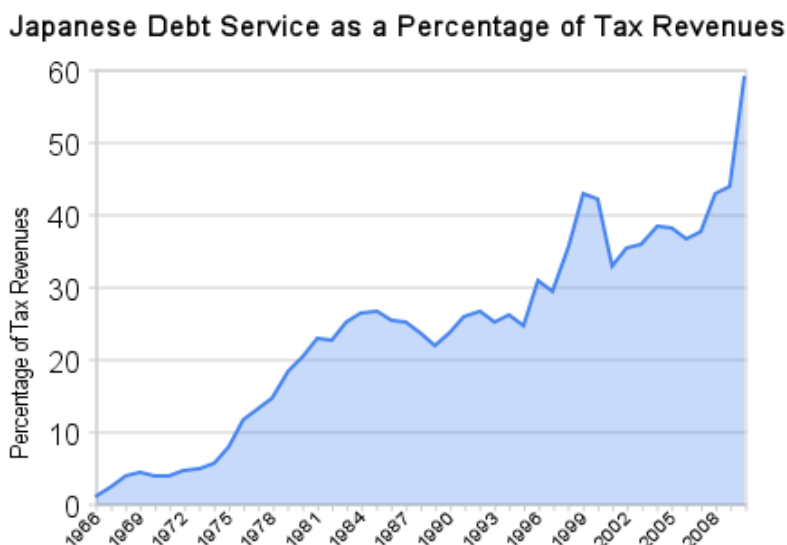
For 20 years, there have been minimal salary increases and bonuses; at the same time, the rates paid to savers have been insignificant (especially in the recent past). Consumers simply do not have the funds or assets to spend, and a significant sign of that is supermarket sales being down on a ten year basis. But, also consider that prices were far too high at the peak of the cycle.

Another potential factor in deflation is the cost structure and inefficiencies in Japan. While this might sound counter-intuitive to all you've heard about Japanese process engineering, this is a reference to inefficiency within their domestic economy. There are too many middlemen between the Japanese consumer and the products they desire. As these layers are eliminated and these costs are reduced, prices decline. While part of the deflation story is undoubtedly the younger generation unable to consume because of stagnant wages (and the older generation not spending), we believe that falling prices could also be a function of more efficiencies being built into the system.

Let's take a personal example... while walking through an open-air market in Kyoto, my wife saw some bananas she wanted for a snack. Three smallish bananas cost 290 Yen (~\$3.75). Later during my trip, I was in China where six healthy bananas were 6 Yuan (~ \$1) which is about the same price you would pay for a similar weight of bananas in the US. What explains the cost difference between the bananas in Japan and those elsewhere? By way of comparison, I swear I saw a \$100 cantaloupe at a Japanese department store! (They wouldn't let me take a picture.)

While deflation is an issue, the greater macro-economic issue the Japanese have to deal with is **debt**. Currently, their government debt is twice their gross domestic product (GDP) – in the US, we are justifiably worried about our ratio being one to one. This means there are a lot of Japanese government bonds (JGB) available, and bond issues are presently greater than tax revenue. The unbelievable thing is that these bonds have incredibly low interest rates; at present, you can loan money to the Japanese government at 2.2% per year for 30 years (no, thanks).

Low rates are made possible by the fact that JGB are 98% owned by the Japanese, with many owners being quasi-government organizations and corporations with high cash levels. The government has a vested interest in keeping rates low because debt payments as a percent of GDP are very high; the chart below (from SeekingAlpha) illustrates this challenge using another metric.



It has been said that because the Japanese own their own bonds, there can't be a run on Japanese bonds. But, all government modeling is based on the assumption that rates will remain low; modeling out debt servicing cost with a 1% increase in cost of funding is not something anyone particularly wants to do. With lower savings rates among a declining percentage of the young, are these realistic assumptions?

Critically, there is a generational gap between savings. The young are not saving like their predecessor generations. Their quality of jobs is not as good, and wages have not increased in tangible ways for them. Therefore, there is really no way for them to save and no incentive - personal savings are being wiped out because higher rates would bankrupt the government.

Corporate Japan and Shareowner rights

Corporate Japan is not especially responsible to shareowners. This issue has multiple dimensions. First, it is important to note that there is a dichotomy between industries in Japan – there are those that are internationally competitive with an export focus and streamlined processes, and there are those focused on domestic services. 80% of the economy is domestic services which operates at an estimated 60% of capacity. These companies exist not for shareowners but for the “societal good” which includes maximum employment. This over-staffing was evident in a number of businesses we visited during our time there. Another badge of honor for many Japanese firms is the amount of taxes paid, and any hints of tax avoidance are frowned upon.

It is really important to note that there is a very high level of pride in jobs and service level. The challenge is that many entities are simply over-staffed and, therefore, less productive than they could be. With employment a primary goal, there is naturally low business metabolism in Japan with few start-ups and few existing operations that close.

Because there is little creative destruction, there is minimal opportunity for entrepreneurialism, which is not supported in Japan by society or the capital markets. For starters, many private businesses make just enough to pay interest on their very low interest loans. Low margins and lack of cultural support keep many from taking a risk that is considerable. Failure is accepted within certain bounds, but business failure is shame – to be avoided at all costs in this society.

How can Japan be an attractive investment idea?

While these are considerable challenges, what are the *possible ways out*? If you have any interaction with the Japanese people, you simply want them to succeed and find a solution to some of their challenges. The Japanese are wonderfully hospitable, and they're extremely welcoming to guests. My personal experience during the earthquake underscored this point even more.

To the right is a picture of the order on the Saturday morning after the quake as thousands of “salary-men” make their way home on foot in dark blue suits.

Let's look at some possibilities for success...



Energy – Japan has always been resource poor, so they are on the vanguard of new energy resources. As commodities become more precious, this focus may benefit them as leaders in many alternative energy activities.

China - is dependent upon Japan for technology and capital goods. This is a sensitive historic relationship, but there is significant possibility of mutual benefit.

Privatization of government assets / FDI – If some of the many government assets were privatized (and maybe sold via Foreign Direct Investment), there is tremendous potential for the expansion of private credit and the reduction of public debt. This change would be sweeping for Japanese society and their sense of civic obligation.

Hostile Mergers and Acquisitions – Since many managers run companies with incentives that are not profit related, perhaps outside investors will force Japanese companies to conform to market forces. Again, this would likely be a challenge to Japanese sensitivities.

Entrepreneurial activity – There is a recent trend among young Japanese women who have travelled outside Japan and are worldly and educated. Japanese society is quite chauvinistic, and there are not the opportunities for Japanese women that there are for men. Some women who have spent time elsewhere are slowly deciding to start something on their own.

Alternatively, there is a generation of under-employed Japanese who weren't able to get jobs at the "good companies" and are now considered unemployable. These people have been in the bottom third of Japanese society, so many have street smarts, business savvy and no prospects unless they do something on their own.

Finally, there is **Japan as a contrarian idea**. Most institutional investors have now given up on Japan and consider it a Beta play on global markets; often it's used as part of a carry trade... 23% of the index is Japan; they underweight to 5 – 10% and push the rest towards Emerging Markets.

But, some now think Japan is cheap; there are great firms with quality exposure to broader Asian growth. Japanese exposure during financial crisis was low due to their natural conservatism, and most bad debts on bank balance sheets seem to now be accounted for. **But, even as you consider this idea, there's always the Yen.** The currency tends to be a global barometer of risk meaning that profits from a rising market can be eliminated if the currency weakens as investors become less risk averse.

Conclusion

In conclusion, while Japan is a country with tremendous potential and high-quality companies, there are too many challenges that, as of yet, do not have solutions. Unfortunately, progress on some fronts with respect to these issues will likely pressure other areas such as interest rates or government debt or present some cultural challenges in a society where these rules are paramount.

There are simply no easy answers. In my opinion, there will be solutions to many of these problems, but not soon enough to make the nation attractive to investors with a longer-term time horizon.