News and Events

Hedge Fund Monthly

Shareholder Returns A Secular Trend in the Japanese Stock Market: A Long / Short Perspective

Jens Muenster, Trident Pacific Capital

There are many ways for a successful long/short hedge fund manager to generate absolute returns. Some managers are very good stock pickers based on fundamental analysis and visiting hundreds of companies every year; some make excellent timing decisions based on technical analysis without ever visiting a single company; and others manage to combine the two successfully. While much of this depends on the talent and skills of the individual fund manager, one of the most promising ways to achieve absolute returns is to catch and ride on a so-called secular trend.

A secular trend is defined as an up or down long-term market trend, with no regard for seasonal variations, prices or quantities of commodities, the stock market, and other influential factors. Secular trends come in many forms, can last for a long time and are not always easy to spot. The current rise in commodity prices (induced by 3 billion goods-hungry consumers from China and India becoming part of the global economy) or the demise of the fixed line telephone business model due to the appearance of e-mail/IP phones (who remembers a company called ATT?) are classical examples of ongoing secular up and down trends.

As a Japan long/short manager our particular interest is in secular trends specific to Japanese equities. We do believe that in Japan we are in the early phase of a secular up trend of increasing shareholder returns driven by record free cash flows, return on equity and changing management attitudes.

Most of the macroeconomic news flow on Japan is mixed with good news followed by bad news and vice versa. This is not likely to change. Given Japan's developed economic state, the debt problem of the government and the changing demographics, moderate GDP growth is unlikely to change. However this macro-economic noise is misleading as it does not match the micro-economic picture. The following table shows the trend development of return on assets (ROA), leverage and return on equity (ROE) since the fiscal year 1990:

Fiscal Year	ROA %	Leverage (X)	ROE %
90	1.95	3.75	7.30
95	1.12	3.71	4.17
00	1.38	3.39	4.67
03	2.15	3.07	6.58
04 (E)	2.60	3.00	8.23
05 (E)	3.20	3.00	10.00

06 (E)	3.50	3.00	11.00

Source: Tokyo Stock Exchange based on 1,173 first section non-financial companies with consolidated data available; various sell-side research and own calculations.

Japanese companies have surpassed their peak level of return on equity of the bubble era. At the same time free cash flow (defined as operating cash flow less investment cash flow) is growing and at record levels:

Fiscal Year	Free Cash Flow in Yen (trillion)
00	6.8
01	8.4
02	15.2
03	18.5
04	20
05 (E)	22
06 (E)	24

Source: Tokyo Stock Exchange based on 1173 first section non-financial companies with consolidated data available; various sell-side research and own calculations.

In the 80s, free cash flow by Japanese companies was used for real estate investment and overseas expansion while over the last ten years, the dominating use was to reduce excess debt. When asked today what free cash flow will be used for in the future, Japanese companies answered:

Capital Expenditure	40%
Share buy-backs/Dividends	30%
Debt reduction	25%
Merger & Acquisitions	5%

Source: Tokyo Stock Exchange; various sell-side research.

Japanese companies as a group have increased their efficiency as witnessed by growing and record return on equities. As debt reduction and balance sheet repair is coming to an end, circa 70% of available free cash flow will be used for investments and share buy backs/dividend payments.

The risk of inefficient real estate investments as seen in the 80s is small as the memory of paying back excess debt over the last decade is still vivid. Aggressive overseas expansion is not planned either as Japanese companies on average generated 29% of their operating profits overseas in the last fiscal year and most deem this sufficient. Many corporate managers fear being targets of M&A activities and some have opted to propose measures to thwart hostile takeover bids such as expanding the maximum number of shares they can issue. The number of Japanese companies seeking a higher upper limit was about 150 in the current round of shareholder meetings, however some were turned down. In addition, influential investors such as the Japan Pension Fund Association – one of the largest domestic fund managers in Japan – voted against most of these proposals.

In the current or next diet session, the government is expected to introduce a so-called "company law" which would significantly reform the existing commercial code. Among many changes to modernise the corporate law, some deal with the issue of dividends. Under the proposed law, companies will be able to pay dividends on a quarterly basis and can make decisions about dividends solely through a resolution of the board of directors.

While there will undoubtedly be cyclical swings in the Japanese economy going forward, the underlying trend of Japan becoming more shareholder focused is here to stay. To benefit from this secular trend, as a long/short manager we look for companies with consistent high and growing levels of free cash flow and a management which is willing to pass this back to shareholders as a long candidate. When we come across companies with limited and shrinking free cash flow levels and a management unwilling or unable to pass this back, the company is likely to become a short candidate. This strategy is likely to generate excess or alpha return irregardless of the daily and monthly gyrations of the stock market indices though we use these gyrations to maximise our returns.

Lastly, when we talk to institutional investors, especially overseas investors, about a more shareholder-friendly corporate Japan, the majority remains skeptical, which is of course typical of early stage secular trends.

If you have any comments about or contributions to make to this newsletter, please email editor@eurekahedge.com

[Top]