Gain an active advantage in Japan.

Many stock markets around the world offer active managers room to generate superior returns. But among them, Japan stands out. We believe its equity market is particularly inefficient. Reforms are also shaking up the once stagnant economy, creating new winners and losers in the corporate sector. That said, stock-picking still demands skill and discipline. Managers aiming to come out ahead will in our view need nothing less than exceptional research and a long-term perspective.

Prime Minister Shinzo Abe's reflationary policies have brought Japan's stock market to a level of health not seen in decades. Even with the recent pullback, the TOPIX has gained more than 70% in Japanese yen terms since end-2012, when 'Abenomics' started raising hopes for Japan's economic recovery. Investors are rightly interested in gaining exposure to Japan. But how they do so matters.

Adopting a passive strategy may seem attractive. An exchange-traded fund, for instance, would simply track a stock market index in Japan. But why should investors settle for market returns? Japan has traditionally been a stock picker's market, and it still is. Active managers that are adept at identifying opportunities and managing risks stand a good chance of beating the index over time.

The sheer size of Japan's stock market makes it a fertile hunting ground. It is the fourth-largest in the world by market capitalisation (US$4.6 trillion) and comprises more than 3,800 listed companies.[1] But there are more reasons why conditions in Japan favour an active approach.

Information advantage

Japan's stock market is inefficient and mispricing opportunities can be captured by active managers armed with superior research and insights.

What drives stock market efficiency? Research coverage is a key factor. The more analysts there are following a company, the faster information is likely to be shared. In that respect, Japan trails other developed markets like the US and UK significantly. On average, 13 analysts follow each company in the Nikkei 225 Index, compared with 23 in the S&P 500 Composite Index and also 23 in the FTSE 100 Index.[2]

Research coverage tends to be even thinner for small- and mid-cap companies in Japan (see Exhibit 1). Many securities houses that downsized after the Global Financial Crisis cut

1. As at 14 September 2015. Source: Bloomberg
2. As at 31 August 2015. Source: Bloomberg

their research in this space to focus on larger companies instead. Within the transportation equipment sector, for example, just 4 out of 15 major securities houses follow auto parts maker Exedy. But all 15 track Toyota Motor.

The small- and mid-cap space is vast, which means there are ample opportunities for quality research to pay off. Over 90% of companies listed on Japan's stock market have a market capitalisation of less than US$4 billion.[3]

Exhibit 1: Research coverage is thin for Japan's small- and mid-cap companies

Research coverage examples

Sector	Company	Market capitalisation (US$ bn)	Research coverage
Transportation equipment	Toyota Motor	230.8	15
	Exedy	1.2	4
Electrical appliances	Hitachi	32.5	13
	Hoshizaki Electric	4.3	2
	Obara	1.1	0
Precision instruments	Terumo	9.2	12
	Asahi Intecc	2.1	3
	Nakanishi	1.2	0

Research coverage reflects the number of securities houses out of 15 major ones that officially rate stocks. As at November 2014. Source: Capital Group

Small firms, big reach

Japan's small- and mid-cap sector is home to numerous quality companies with solid growth prospects. Several are vital to global value chains. Some offer purer exposures to certain industries compared with large diversified conglomerates. Through extensive bottom-up research, active managers can uncover hidden gems.

Exedy is a case in point. The company receives little analyst coverage, yet it is one of the world's largest producers of clutches and torque converters, having differentiated itself with the quality of its parts. In its last financial year, net sales crossed US$2.1 billion, setting a new company record.

Likewise, few investors may have heard of Sysmex, but it is the world's leading supplier of blood tests, ranking above healthcare giants such as Abbott. Over the years, Sysmex has gained market share with its highly efficient medical diagnostic tools and is pursuing further growth across various geographies and product lines.

Many small- and mid-cap companies trade at a discount to the market, making them seem even more attractive. But it pays to be careful. Certainly, some companies are undervalued because the market has overlooked them. But there are also those that simply have poor prospects. Active managers make a real difference when they can separate value finds from value traps.

Abenomics effect

In recent years, Abenomics has become a chief driver of investment opportunities in Japan, across companies large and small. Part of the agenda involves long-term reforms that are difficult to price into the stock market. This makes Japan a prime venue for forward-looking stock pickers that can identify companies poised for change.

3. As at 31 August 2015. Source: Bloomberg

Already, new corporate governance measures are starting to have an impact. They take aim at low profitability, ineffective boards, and other forms of poor corporate behaviour that have undermined investor confidence for years. Most companies that pledged to adopt these measures have been rewarded by the stock market. But anticipating which companies will do so is no mean feat.

Local insights provide the key. Knowing a company's financials is one thing, but understanding its culture and focus is quite another. It takes on-the-ground research, including regular meetings with top executives, to discern management's views on Abenomics and detect potential changes in corporate direction.

Some companies that took steps to shape up were once seen as unlikely reform candidates. Fanuc, a world-leading industrial robot maker, surprised the market when it raised its dividend payout ratio and proposed share buybacks. It also set up a new shareholder relations department to boost communications with investors.

Still, overhauling corporate mindsets across Japan will take time. Its corporate governance still lags behind other developed countries. The recent discovery of accounting irregularities at electronics group Toshiba is a reminder of the gaps that exist. Active managers that can harness research to spot – and avoid – questionable firms have a valuable role to play.

Risk management

Indeed, limiting losses matters. But a passive approach provides no protection in this regard: investors tracking an index fully capture the market's decline.

Passive investors are also vulnerable to unintended exposures. In February 2011, for example, investors mirroring the MSCI Japan Index would have had a 1.43% exposure to Tokyo Electric Power (TEPCO), whether they were positive about the electricity provider or not. It was then the ninth-largest company in the index. In March 2011, a massive earthquake set off a nuclear disaster at TEPCO's power plant in Fukushima. As the company sank into the red, its share price plummeted. In August 2015, it made up just 0.35% of the index.

In contrast, an active strategy can better protect against downside. The most successful managers consciously manage their exposures and invest according to their strongest convictions – not the index. They have the flexibility to avoid companies in the index with lofty valuations, or invest in non-index companies that show resilience. They can also hold cash to preserve capital during downturns. In fact, it is often during broad market declines that these managers deliver exceptional value.

What the numbers say

Historical data present a compelling case for long-term active investing in Japan. Over 3-year, 5-year, 10-year and longer periods, the median return from Japanese equity active managers outpaced the TOPIX (see Exhibit 2). How did Capital Group fare in that environment? The results for our Japan Equity Composite were consistently in the top quartile over those periods.

Selecting an active manager

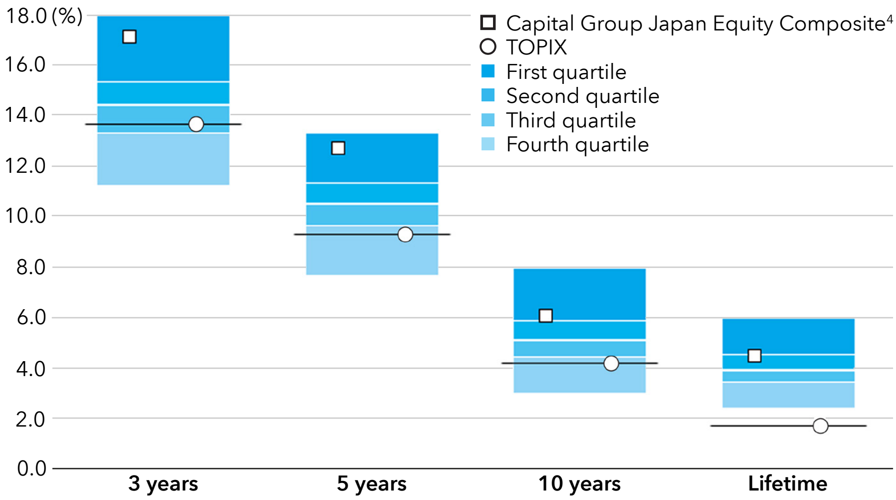
Of course, not all active managers beat the index in the long term. It is therefore crucial for investors to identify those with the qualities to come out ahead.

Strong research skills are a prerequisite for success, especially in Japan. Given the stock market's inefficiency, quality research goes a long way towards uncovering attractive opportunities.

This is why we commit significant resources to finding insights on the ground. Our industry analysts research companies from the bottom up and maintain frequent communication with managements. They monitor not

Exhibit 2: Active managers in Japan have a history of outpacing the market

Returns over 3 years, 5 years, 10 years, and 18 years 6 months to June 2015



4. Annualised returns in US dollar terms, before fees.
Comparison with the Japan Equity (overseas investors) universe.
As at 30 June 2015. Sources: Mercer, Capital Group

Investment results in US$ terms, %	**Japan equity[5]** Before fees	After fees	**TOPIX[6]**
Annualised lifetime return	4.5	3.8	1.7
3 years p.a.	17.1	16.4	13.6
5 years p.a.	12.7	12.0	9.3
10 years p.a.	6.1	5.5	4.2

Data as at 30 June 2015. Past results are not a guarantee of future results.
5. Results shown for the Capital Group Japan Equity Composite, from inception at 31 December 1996. Before fees: gross of management fees. After fees: net of highest management fees. Actual investment results net of management fees may differ depending on investor profile and size of investment.
Source: Capital Group
6. The benchmark shown is the TOPIX Total Return Index. Source: Datastream

just companies based in Tokyo, but also lesser known firms in other parts of Japan. For instance, the search for hidden gems often leads our small- and mid-cap analyst Akira Horiguchi to remote areas that other investors usually neglect. Akira, who is also one of three portfolio managers for our Japan Equity strategy, frequently visits Japanese companies' overseas operations for a fuller picture of their health. Such rigorous research is a key part of our investment approach.

Having an integrated global research network compounds the information advantage. Because Japanese companies tend to be reserved, research findings elsewhere can shed more light on their prospects.

Our research structure fosters close collaboration between our Japan Equity analysts and the rest of our equity, fixed income and macroeconomic analysts around the world. The sharing of diverse perspectives helps them sharpen their investment ideas. They are also able to assess Japanese companies within a broader context to identify those that stand to benefit from a global trend, or are undervalued compared with their peers abroad.

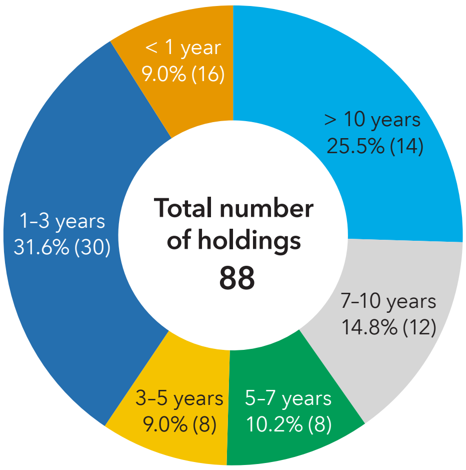
Take Japan's aircraft part suppliers as an example. Managers looking only at their conservative financial forecasts would have projected limited growth ahead. However, global research led our Tokyo-based Japan Equity portfolio manager Seung Kwak to a different conclusion.

Our London-based aerospace analyst found aircraft manufacturer Boeing facing a multiyear backlog of orders, which to Seung signalled a potential hike in demand for aircraft parts. Seung's visit to Boeing in the US yielded more insights backing those views. We have exposure to a number of Japanese aircraft part suppliers through our Japan Equity strategy.

When we identify high-conviction investment opportunities, we are prepared to invest for the long haul. Our Japan Equity strategy reflects this approach: more than half of the portfolio comprises companies that have been held for more than five years (see Exhibit 3).

Exhibit 3: Our Japan Equity strategy's long investment horizon

Holding period distribution



Based on Capital Group Japan Equity Composite representative account. Number in percentage represents weight of holdings (may not add to 100% due to rounding). Number in brackets represents number of stocks.
As at 30 June 2015. Source: Capital Group

Key takeaways

Through the decades, there have been clear advantages for active investing in Japan. We believe its stock market is inefficient, and its under-researched small- and mid-cap sector yields particularly interesting opportunities. More recently, Abenomics has injected new life into the corporate scene.

Select active managers have delivered superior returns over an index. We believe that strong research capabilities, a collaborative global network, and a long-term perspective are among the defining features of successful managers. These are also the main tenets of our investment approach.