LEGG MASON
GLOBAL ASSET MANAGEMENT

August 2015

WHY ABE'S ECONOMIC REVOLUTION IS HELPING TO PUT THE FOCUS BACK ON GROWTH

After a strong year for the largest and most well-known companies in Japan, Hideo Shiozumi, manager of the Legg Mason IF Japan Equity Fund[1], expects the focus to shift to companies that can show credible strong growth, especially those in the small and mid-sized part of the market.

Japanese equities have become a focal point for investors since the introduction of Prime Minister Shinzō Abe's expansionary policies (coined Abenomics) at the end of 2012.

Mr Abe's policies have caught the attention of domestic and international investors who have welcomed the country's efforts to tackle its long-running deflation problem, and inject new life into the very heart of Japanese society.

Abe's programme of revitalising Japan - a series of fiscal and monetary policies, supported by economic reforms - has crucially started to encourage economic growth and to push up prices.

It has also had an impact on employment. The jobless rate has tumbled to its lowest level since the late 1990s according to the most recent data and the number of jobs on offer exceeds the number of candidates looking – this bodes well for wage inflation – an important driver for greater future consumer demand.

Abe's trump card has been to change the corporate mindset with a series of smart policies to encourage institutional investors to only consider companies that meet better corporate governance and return on equity objectives.

Corporates have taken notice and changes are afoot, with a real emphasis on improving companies' return on equity by reducing cash piles, buying back stock, and sweating assets better. This is something both domestic and international investors have welcomed. Forward estimates for return on equity are all climbing, with the full year 2016 estimate of 8.7% for the Topix, the country's benchmark index, well ahead of the 4.6% in the summer of 2014.[2]

Indeed, since the introduction of Abenomics there has been a strong appreciation for the country's equity markets, with the Topix almost doubling since the start of 2013.[3]

The largest companies have driven much of this performance, especially the exporters that have enjoyed the benefits of the tumbling yen making their goods cheaper. Conversely smaller companies, which are more domestically focused, have lagged behind albeit offering solid returns.[4] We think this yen benefit is well priced into securities and investors are now rotating into small and mid-sized companies that can offer genuine growth and are tapping into the changes in Japan's domestic economy.

Brokers changing views

Already, we are seeing a number of brokers changing their coverage on smaller companies as they recognise the benefits of Abenomics are spreading to the wider economy.

We think growth companies, regardless of size, are in an excellent place for expansion for a number of reasons. Japan needs to compensate for a declining and ageing population by focusing on services and industries which can deliver sustained value creation and increase profitability for its companies – the end result being that Japan can continue to prosper as a nation.

The underlying philosophy for the Legg Mason IF Japan Equity Fund*, since its launch in 1996, has been to invest in the "New Japan"; those domestically-orientated companies that can best take hold of the growth opportunities attune to the changing of the economic and social landscape of Japan. We see substantial opportunity in companies in the healthcare and medical technology sectors - many of which are the high capital and intellectually intensive areas in which Japan can compete.

Stocks examples include Sosei Group, the biopharmaceutical business which is working to develop cutting edge medicines, as well as technology company Cyberdyne which creates robotic exoskeletons used in hospitals and nursing homes to assist with physical mobility.

In addition companies that are helping to disintermediate the market (cut out the middle man) and reduce prices to the end consumer, such as low cost discounters and internet retailers, are helping to change consumer behaviour and buying patterns. For example, Don Quijote, the popular themed discount store or kakaku.com, the price comparison site. These companies have shown persistent growth.

It is here that our fund is positioned. We believe the best opportunities for investors now are in businesses focusing on the next ten years of Japan's economic expansion, rather than the last ten. These companies typically have higher growth rates and return on equity than the larger, more established names in Japan. In fact the average return on equity of the Fund is more than double that of the market.

Pension fund boost

We are seeing a strong rotation from fixed income into equity from both institutional and individual investors, helping to support the Japanese stock market.

Domestic pension schemes have started to allocate substantially more to equity assets as they raise their investment return objectives. The flow of money should continue as more pension schemes follow suit. In addition, many global pension and professional investors have had historically low exposure to Japan's market due to previous insipid equity returns. This is now changing as the world wakes up to the opportunities that Japan is creating.

In addition enormous pools of assets are still sitting in low interest bearing accounts and many institutions such as Japan Post Bank and Japan Post Insurance have a tiny percentage of their clients' money in the equity markets. As individuals start to realise their fixed income assets are earning little and take advantage of government tax free savings allowances for investments, we are likely to continue to see a profound shift of assets into Japan's equity markets.

Again, we expect such buyers will follow moves by brokers to focus on smaller companies, and therefore we remain confident our strategy can deliver strong performance over the next three to five years.

Of course there will be ups and downs, as is the nature of investing, but as time goes on we get more convinced that the right method is to put large sums into enterprises we know something about.

Conversely, we feel it is a mistake to think that investors can limit their risk by spreading too much between companies which they know little about, and which they have no reason to have special confidence in.

The Fund has always followed this mantra, with our compact portfolio (which currently has just 37 holdings) delivering 231.6% over the last five years to investors, versus 51.0% from the average fund in the sector.[5]

We believe we are only in the second phase of a long stock market rally that is slowly absorbing the benefits of Abenomics – and our Fund will continue to be a key participant in those companies grabbing their opportunities and rewarding those investors with long-term horizons.

The views expressed are opinions of Hideo Shiozumi of the date of this material and are subject to change based on market and other conditions without notice and may differ from other portfolio managers or from those of the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of further results or investment advice.

[1] The Fund changed its name on 29 June 2015. The Fund was previously called the Legg Mason Japan Equity Fund

[2] Source: Daiwa Securities, August 2015

[3] The index has risen from 859.80pts to 1,687.6pts between 28 December 2012 and 11 August 2015. Source: Bloomberg, August 2015.

[4] The Topix is up 37.3% in the year to 11 August 2015, versus gains of 30.6% for the Topix Small Index. Source: Bloomberg, August 2015.

[5] The Legg Mason IF Japan Equity Fund (A share class) returned 231.6% over the last 5 years versus the IMA Japan sector average of 51.0% (data from 31 July 2010 to 31 July 2015). Source: Morningstar, August 2015.