Lindsell Train

Is Japan a 'Buy'?

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The dividend yield of the Japanese stock market is rising, partly because dividends are growing but also more recently because share prices are falling. Having sunk to a low of 0.8% in January 2006 the yield on the TOPIX index is today standing at 1.5%.

At this level it now exceeds the yield on 10 year Japanese government bonds, a fact not unnoticed by a clutch of financial commentators who have also pointed out that historically this crossover of equity and bond yields has preceded a huge rise in the price of shares. So should investors be hastening to increase their exposure to Japan at this time?

The answer lies not in the emergence of this positive yield gap but instead in an analysis of the attributes of different companies in the market. Suffice to say high dividend yields and dividend growth are a powerful combination to create value in any market environment.

First, let's look at why the yield argument above does not necessarily support a rising market. There are three reasons why we think the commentators may have it wrong:

1. Today's dividend yield is still below the more important 30 year bond yield of 2.3% - more important because this bond has a duration nearest to that of a stream of equity earnings (arguably infinite) and is therefore a more appropriate benchmark of competing value.
2. Recent falls in bond yields are associated with a slowdown in the economy and continued deflation, both events that could harm earnings and dividends. Having hit a low in 2002, corporate earnings have recovered so strongly that they are now at a new multi-year peak, both in absolute terms and as a proportion of GDP. If the Japanese economy is indeed decelerating earnings will fall and with that the momentum behind the recent increases in dividends. This may already be happening: TOPIX annual dividend growth peaked at 31% in January 2007 and has fallen since to 12% in October.
3. Finally, dividend yields of 1.5% are not yet high enough to tempt yield hungry investors, such as Japanese pensioners, to allocate more of their savings to equities.

It is this last reason that we think is key. Over the last 15 years there has been no inflation in Japan. The CPI Index is almost the same level today as it was in September 1992. With no inflation, equities lose one of their most important roles, as a generator of real returns, as opposed to nominal returns earned from bank deposits and bonds. Why bother to take on that "extra risk" in equities, risk that could and would have resulted in material losses as markets fell from 1996-1998 and 2000-2003? Capital preservation is still a priority for the Japanese, which is why today savers continue to invest over 50% of their financial assets in bank deposits. After all, since 1992 over that same 15 year period a ten year deposit would have returned approximately 35% and a 1 month deposit 10%, using 10 year generic bonds and 1 month Yen LIBOR as proxies. Nothing startling, but completely risk free and a mild enhancement of purchasing power in an inflation-free environment.

So what will make Japanese equities appeal again to domestic investors who have consistently sold shares since the late 1980's? Higher inflation, reducing the relative attraction of bonds and deposits, would be one catalyst. But with the Japanese population due to decline materially over the next 30 years it seems improbable that demand-pull inflationary forces would emerge. Cost-push inflation is more likely but that would have to accompany a weaker Yen - more of a possibility in our view, but not one likely to materialise in the immediate future.

With or without inflation we think the Japanese stock market needs higher dividends - not only higher starting yields, but also steadily growing dividends, reflecting the business performance of the underlying company. Only then will investors take on extra equity risk. What they should be looking for are stable and predictable business franchises, with strong balance sheets and high and constant returns on capital, because such companies are more likely than others to grow dividends consistently. Not coincidentally, these are the type of companies we favour in our portfolios. Moreover, we have the unusual opportunity today of accessing these businesses for our portfolios at higher than average market yields. The portfolio's average yield is just 2% but with, say, 10% dividend growth per annum, the future yield after five years would be in excess of 3%, a much more enticing yield if competing assets such as bonds and cash offer the same yield as they do today. And of course there should be plenty more growth in year 6 and beyond. We already have examples of this with our experience over the last 4 years. For instance, Canon's yield based on dividends projected for this year on the cost of the position established in 2004 is 3.4%, well above any bond or deposit yield. Even with a downturn in profits Canon's dividend is unlikely to be cut. More likely it will continue to grow in the future.

Turning to those companies without such strong franchise characteristics, especially industrial cyclical companies lacking sustained pricing power, conventional wisdom would predict such shares be priced at a higher starting dividend yield than average to compensate for the risk that either dividends do not grow or that they may even fall. But today, many such companies - that often rely to a greater or lesser extent on borrowings to finance the business - trade at dividend yields below the market. Taken together with the comments earlier about the risk of earnings declining from peak levels, such dividend yields clearly fail to compensate for future risks. We think such companies are highly vulnerable to further imminent price falls.

This is the paradox of the Japanese market: good, cash generative, conservatively financed businesses trade at higher dividend yields than vulnerable, capital intensive, debt laden ones. Buying the former and avoiding the latter will, we hope, prove a remunerative strategy; but buying the 'market' as a whole may not.

Our optimism for our cash generative companies is buoyed by the observable shift in the way they are using their huge excess cash reserves. These cash piles have historically detracted from the overall return on capital of the businesses, but now, egged on by shareholders, the companies are beginning to be required to put cash to better use. Initially, the reserves support higher payout ratios and may underwrite stable dividends in years of poor profitability. But such is their scale - adding up to no less than 30% of the combined market capitalisation (ex-financials) of our current portfolio - that companies are also now using excess cash to buy back shares and expand business scale through acquisitions. Given the low level of deposit rates in Japan it is almost impossible for companies not to enhance return on equity with such moves. Although these new initiatives have been ongoing over the last three years we think most of our companies could do much more in optimising the use of existing balance sheet cash and investing future retained earnings and thus we expect these policies to extend many years into the future, enhancing returns for shareholders.

In conclusion, then, we think that the argument for an imminent rise in share prices in Japan across the board is falsely based. However, we are confident that concentrating investments on "exceptional" businesses (and we have 27 in our portfolio) should at best deliver handsome returns over the longer term and at worst, if accompanied by an economic downturn, deliver huge outperformance of the overall market.

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