FREE KIC NO. 66 APRIL 11

SHAKING THINGS UP

Last April when I wrote my annual update on Japan I happened to give it the title "Shaking Things Up – Japanese Style". I can assure you that when I talked about "Shaking Things Up" I was referring to the economy and I was not making any predictions about earthquakes.

When I was a regular visitor to Japan there was often talk as to when the "big one" would hit Tokyo. History suggested that they occurred roughly every 70 years and as the last big one happened in 1923 there was a feeling that it could happen any day. The Kobe earthquake of 1995 made people aware of how difficult it is to prepare for big earthquakes. I visited Kobe shortly after the earthquake and saw some of the damage for myself.

In my opinion the Kobe earthquake and the recent earthquake highlight both the good and the bad in Japanese culture. With regard to the good I believe they show the great strength of character of ordinary Japanese people and the great sense of community. With regard to the bad I believe the problems at the Fukushima nuclear power plant highlight the lack of leadership at Tokyo Electric Power (TEPCO) and I think this is representative of Japan in general.

TEPCO is a major Japanese utility but it has a management team and board of directors consisting of old men that have worked in the company all their working lives.

Here is a picture of the Chairman Katsumata and other directors at a news conference held on March 30th:

Katsumata joined TEPCO in 1963 and his whole career has been with the company. In all there are 20 directors. All of them are Japanese and male. It appears that 18 are lifetime employees. The annual report does not give any of the ages of the directors but I would guess that it is highly unlikely that any director is under 40. Responsibility seems to end up in the hands of people by virtue of their age and not because of their leadership skills. Loyalty to the company creates a culture of secrecy that includes lying about safety and accidents.

In my opinion these old men do not want to change. They seem to want to maintain the status quo and in a world of rapid and dynamic change I believe that Japan is potentially condemning itself to stagnation. (Regular readers will be familiar with this theme because it goes all the way back to my first opinion piece in October 2005.)

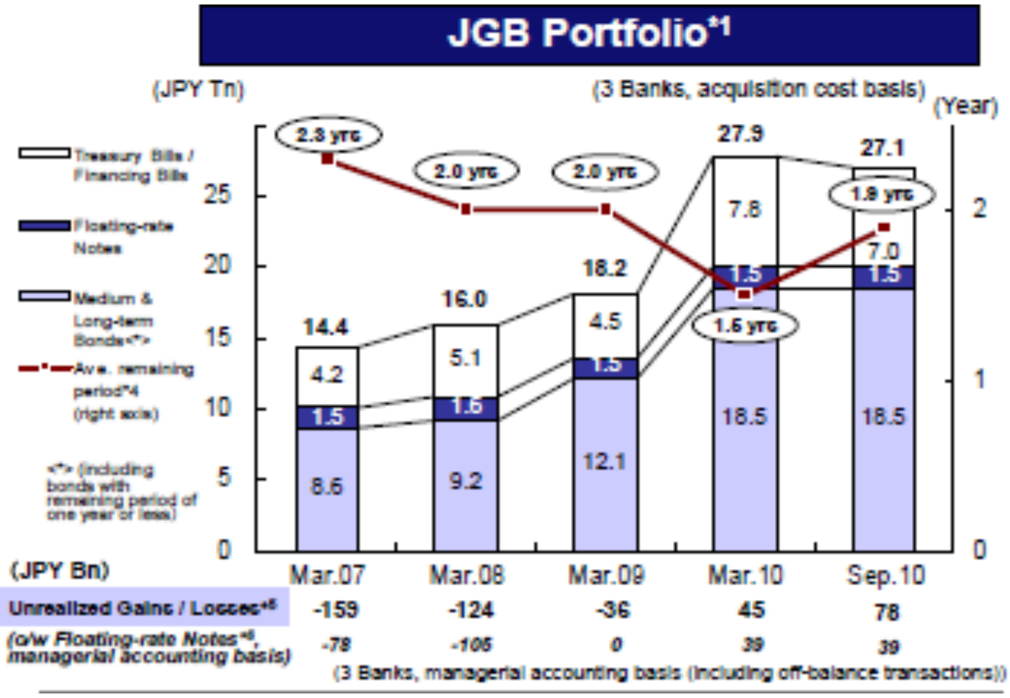
No one knows for sure how much it is going to cost to rebuild the devastated areas but it is bound to be substantial. This is at a time when the Japanese government has already got a high debt to GDP burden and continues to run a big budget deficit.
The following table shows Japan relative to other countries:

Figure 3. General Government Debts and Deficits, 2010

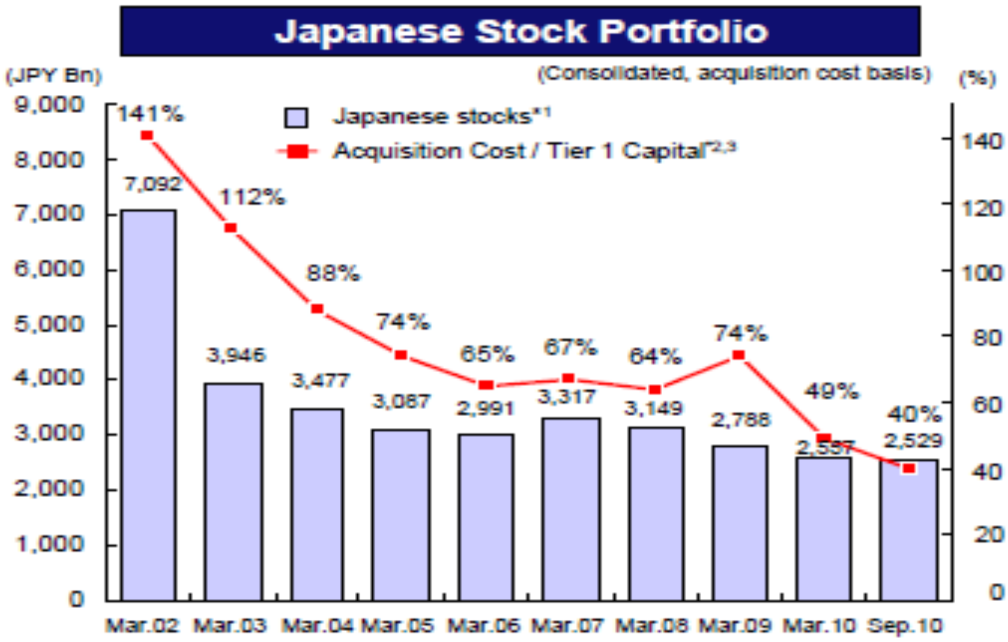
	% of 2010 GDP				
	Gross Debt	Net Debt	Budget Balance	Structural Balance*	Cyclically Adjusted Primary Balance*
Belgium	100	91	-4.8	-3.4	0.2
France	84	74	-8.0	-5.0	-4.1
Germany	75	59	-4.5	-3.1	-1.0
Greece	130	110	-7.9	-7.4	-1.5
Ireland	94	55	-17.7	-8.6	-6.1
Italy	118	99	-5.1	-3.6	0.7
Japan	226	121	-9.6	-7.6	-6.2
Portugal	83	79	-7.3	-6.1	-3.0
Spain	63	54	-9.3	-7.5	-5.7
United Kingdom	77	69	-10.2	-7.9	-5.4
United States	93	66	-11.1	-8.0	-6.5
Hungary	78	71	-4.2	-1.1	2.4

* % of Potential GDP. All numbers refer to the general government. Budget Balance = General government net lending/borrowing. Sources: IMF Fiscal Monitor November 2010 for Cyclically Adjusted Primary Balance for all countries and Structural Balance for Hungary, IMF WEO October 2010 for all other data.

From looking at this table you might wonder how is Japan funding government debt because it appears to have the worst fiscal position of all the countries listed (and these numbers are pre-earthquake!)
The simple answer to this question is that the savings of Japanese corporations and individuals fund the government. They do not need money from foreigners. Japanese corporations and individuals are prepared to lend money to the government for 10 years in return for a 1.2% interest rate.
Not all Japanese corporations directly buy government bonds but they do put their cash on deposit with the local banks and the banks buy the bonds. The Japanese banks currently have far more deposits than loans and therefore seem to think that the safe thing to do with those excess deposits is give the money to the government. The directors of these banks are the same generation of old men as at TEPCO and I believe that they will continue doing this for as long as they can even though I do not believe that this is the prudent thing to do.
The following graph shows an example of how Mizuho bank has increased its holdings of Japanese Government Bonds (JGBs) and this is typical of the major banks:



At the same time they are buying JGBs Mizuho is selling equities. Here is a chart of their equity holdings:



Given the cheapness of Japanese equities we have a situation where Mizuho is selling cheap equities and buying what appears to be expensive JGBs. This just seems to be another one of those situations unique to Japan.

This situation could continue for many years. It is possible that I will be writing about this in opinion pieces many years from now.

These budgetary issues are going on at a time of continued change in political leadership. Last April I wrote about the failure of the then Prime Minister Hatoyama to bring about change and here we are a year later and the new Prime Minister Kan appears to be struggling as well. Kan was supposed to be different because he had not come from a political dynasty but unfortunately it already appears that his days are numbered due to a collapse in his popularity. In other words there is still no sign of strong political leadership.

Once more I have painted a picture of a leaderless, stagnating society with a stock market that fails to get me excited but at this stage I am used to it because it is now 15 years of talking about the same old problems and coming to the same old conclusions.

The only slight glimmer of new hope that I came across during the year was the announcement of a joint venture between Tokio Marine & Fire (the biggest Japanese non-life insurance company) and a London based partnership called GO.
Here is a description of GO from their website:
Governance for Owners (GO) is an independent partnership dedicated to adding long-term shareholder value for clients by exercising owners rights.

Here is a section from a press release highlighting what they are hoping to do:

Tokio Marine Asset Management and Governance for Owners LLP announce launch of Japan Engagement Fund

Tokio Marine Asset Management (TMAM) and Governance for Owners LLP (GOL) announce their intention to launch the TMAM-GO Japan Engagement Fund (JEF). The fund will invest in underachieving quoted companies in Japan and engage with management and boards by utilising a Japanese way of engagement to improve long-term performance.

The JEF is a collaborative venture between TMAM, GOL as well as Governance for Owners Japan KK (GO Japan), GOL's Japan based subsidiary. The fund will invest in 10-30 small to mid-cap Japanese companies, with an investment time horizon of 3-4 years, and aims to be a leading shareholder in each firm. It is a pooled fund which will allow institutional investors in Japan and internationally to co-operate in helping to add long-term value to Japanese companies. A major client of TMAM intends to invest at launch and discussions are beginning with a number of other potential investors. The fund has the potential to grow over time to JPY100 billion (US$1.2billion).

I am going to watch their progress with great interest because there was another part to the same press release that attracted my attention:

Peter Butler, CEO at Governance for Owners LLP continues:

"This is a further step towards our goal of finding a 'Japanese way' to add long term value to Japanese equity investments. Our collaboration with TMAM, which commenced in 2008, has proved highly successful and we believe now is the ideal time to start an engagement fund to help improve corporate performance in Japan. Blending the experience and expertise of both organisations – coupled with management of the JEF by an experienced 'on the ground' investment and engagement teams – will be instrumental to the JEF's success."

I have no idea what he means when he refers to a “Japanese way” to add long term value. I can make a guess that it is a non confrontational way because I have written in previous opinion pieces about the failure of investors using a confrontational approach but there is nothing to tell me exactly what they do intend to do.
I wish them luck because I am frustrated by the way Japanese companies ignore shareholders and if they succeed it might encourage more Japanese investors to “add long term value”. Like most things in Japan I would guess that this will be an extremely slow process but I hope I’m wrong because if the time comes I hope to be ready to pounce and buy lots of really cheap shares..