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In previous opinion pieces I have outlined why I think it will be difficult to revitalise the Japanese economy. Nothing in the new “Abenomics” reform package has inspired me to change my mind and therefore I still think that the most likely scenario is for a relatively slow growth Japan.
It is important however to point out that it is not always necessary to have a vibrant and rapidly growing economy in order to make decent returns from investing in individual companies.
In the past I have mentioned activist investors (such as Steel Partners) as a possible way of generating good returns from cheap stocks but as Daniel Loeb has discovered with Sony there still appears to be very little appetite for this way of unlocking value.
Mr. Abe seems to believe that a new corporate governance code might be another way to help unlock value but I believe that the proposed code using what is known as a “comply or explain” system has proven to be deficient here in Ireland (as well as the UK) and I therefore have serious doubts as to whether it will work in Japan. I honestly believe that Japanese boards will remain a cosy old boys club and any changes will be superficial.

There is however something that is new that might be a catalyst for improved returns for some quoted Japanese companies. This new development is the JPX-Nikkei 400 Index that was introduced in January.
The Japan Exchange Group and the Tokyo Stock Exchange are responsible for this new index. Here is how they describe its aim:
The new index will be composed of companies with high appeal for investors, which meet requirements of global investment standards, such as efficient use of capital and investor-focused management perspectives. The new index will promote the appeal of Japanese corporations domestically and abroad, while encouraging continued improvement of corporate value, thereby aiming to revitalize the Japanese stock market.

Here is how they construct the index.
(1)1000 stocks are selected based on trading value in the past 3 years and the market value on the selection base date (the end of June) of the Annual Review, (2)Each stock is scored by 3-year average ROE, 3-year cumulative operating profit and market value on the selection base date with the weights on the each indicator 40%, 40%, 20% respectively, (3)400 stocks are selected by the final ranking with the scores calculated in (2) and qualitative factors from the perspectives of corporate governance and disclosure. In case of delisting of the components due to a merger or bankruptcy etc, new stocks shall not be added in principle. When the Annual Review is conducted, the number of components is back to 400, therefore the index is calculated with less than 400 components until then.

The important thing to note about the index is that Return on Equity (ROE) has a 40% weight in determining the companies that go into the index.
This ROE requirement has already resulted in changed behaviour at a number of companies and the big question on my mind is whether this changed behaviour will spread to other similar companies. If this were to happen it could help to unlock some of the value that exists in the Japanese market.

Here is a section from a Bloomberg article that gives an example of the changed behaviour:
Amada was one of 74 firms on the ***Nikkei 225 Stock Average (NKY)*** *that wasn’t selected for the JPX-Nikkei 400, which picks members based on profitability and use of cash and is a*

benchmark for the 128.6 trillion yen ($1.3 trillion) Government Pension Investment Fund. The company is seeking to more than double its return on equity by March 2016, exactly the response hoped for by the government and the ***Tokyo*** *bourse, the index's planners.*
According to Bloomberg the company can increase its ROE because it has pledged to "*pay out about half its profit in dividends and spend the other half on stock buybacks.*
The important thing to note about Amada is the fact that it is a market leader and is financially strong. As Bloomberg also noted:
Amada ***held*** *more than $1 billion in cash and equivalents at the end of March,*
Amada can pledge all of next year's earnings to dividends and buybacks because of this financial strength. Notice however it has not made any commitment to use any of the existing cash. This shows the limits of how far they are prepared to go.
In the past I have been frustrated by companies like Amada because they do not need so much cash and yet they have refused to give the money back to shareholders. I have even written about another cash rich company, NTT Docomo and their acquisition policies and yet I notice that they are being complemented for their recent actions:
Mobile carrier NTT DoCoMo's recent share buy-back was a refreshing effort by a Japanese firm to accommodate shareholder interests. T. Rowe Price Portfolio Manager Archibald Ciganer sees this as a strong indication of real change in Japan's corporate environment. The increasing focus on shareholder value makes corporate Japan a more credible investment opportunity.

Amada and NTT Docomo aren't the only cash rich company in Japan. I hope most of these cash rich companies want to be part of the JPX Nikkei 400 and therefore I hope they will follow the Amada and NTT lead. I am going to take a serious look at some of these companies to see if I can find the next Amada!

Amada Chart

There are however plenty of Japanese companies that are not cash rich. In fact a large number of Japanese companies are not as fortunate as Amada and NTT. They are neither market leaders nor cash rich. I do not believe that these companies will be prepared to do what is necessary to increase their ROE because in a large number of cases this would involve closing factories and making workers redundant. Loyalty to employees is so ingrained at a cultural level that I don't think many companies will be inclined to take the necessary steps. (I have written about this in my opinion pieces on Asahi Chemical and anyone interested in the slow pace of change at Asahi Chemical can read about their restructuring plans for their low ROE chemical business at: http://www.asahi-kasei.co.jp/asahi/en/news/2013/e140225_2.html)

I therefore remain cautious in my opinion as to how the Nikkei 400 will impact upon the broader market and I think some commentators might be getting too optimistic.

Readers might be asking themselves why it is so important to a company like Amada to be included in this new APX Nikkei 400 index. It appears that the government has managed to pull off a coup by managing to get this new index to be used as a benchmark by the biggest pension scheme in the world (the Government Pension Investment Fund – GPIF).
This is attracting a significant amount of attention:
"GPIF is changing in several ways, or at least I sense their will to change," said Kazuyuki Terao, Tokyo-based chief investment officer at Allianz Global Investors Japan Co. "JPX-Nikkei 400 is designed to encourage investment in stocks with high return on equity, which aims to change corporate governance using the power of the market. Plus, they're trying to boost returns."

The JPX-Nikkei 400 looks increasingly likely to change the behavior of many companies as they seek inclusion in the gauge, Naoki Kamiyama, an equity strategist at Bank of America Corp.'s Merrill Lynch unit, wrote in a June 2 note.

The government has sent out an important signal by making the APX Nikkei 400 a benchmark for the GPIF. I think that companies will want the prestige of being part of the index and will want to be part of the GPIF portfolio of holdings.
I am not sure however if the government would back companies making people redundant in order to boost their ROE. I therefore assume that the government are not aggressively attacking the jobs for life culture and accept that there are constraints that will prevent a significant increase in ROE.

Another example of the cultural difficulties that will prevent Japan from changing rapidly was highlighted at Takeda Chemical. Takeda recently decided to appoint a French national as Chief Executive but here is what the Telegraph had to report on the proposal:
110 members of the Takeda family and former executives have signed a letter of protest to the present board of the 230-year-old company in protest at the approval. According to the Yomiuri newspaper, their opposition is based on the belief that Mr. Weber could sanction the sale of the company to a foreign company and its technologies would be transferred overseas and lost.
The Yomiuri quoted one of the Takeda family as saying that "Weber does not know anything about the Japanese health care industry." "He does not know about the tradition and [corporate] culture of Takeda Pharmaceutical, either," he said. "It is absurd to install such a person as president," the newspaper said.

These are some of the reasons why it is Tricky to know what will happen to the Nikkei!