



# The Alpha Potential in Japan's Small Caps

Many investors already have exposure to the Japanese economy's new era, ushered in by corporate reforms and increasing integration with broader Asia. While these growth drivers apply across the market capitalization spectrum, a compelling alpha opportunity may exist in Japan's small-cap market.

The potential to generate alpha by investing in Japan's small companies is driven by multiple factors: thin sell-side research coverage, an undersize venture-capital funding environment and low correlations to other asset classes.

## Thin Research Coverage

After years of lackluster equity performance and declining commission rates in Japan, many sell-side firms focused resources on a limited number of large caps in Japan, primarily those with trading volumes that justify the costs.

Geography also plays a role. Most Japan-focused sell-side firms are based in Tokyo. Companies elsewhere tend to be overlooked until they reach a certain size. As a result, the universe of small-cap Japanese equities is largely uncovered by sell-side analysts, leaving the field open for active managers to find undiscovered companies with growth potential.

Of the more than 1,900 Japanese small-cap equities for which FactSet Research Systems tracks analyst coverage, 75% are not covered by any third-party sell-side research providers or have just single-analyst coverage. Compare that with the small-cap market in the U.S., where 70% of companies are covered by three or more analysts, leaving only 22% with one or zero analyst coverage. In fact, among small caps, Japan has less analyst coverage than the U.S., Western Europe or even Asia ex Japan.

This information asymmetry creates a potential advantage for fundamental active managers, as exciting companies with underlying characteristics that can fuel long-term, sustainable growth often are overlooked by investors.

## Limited Startup Funding

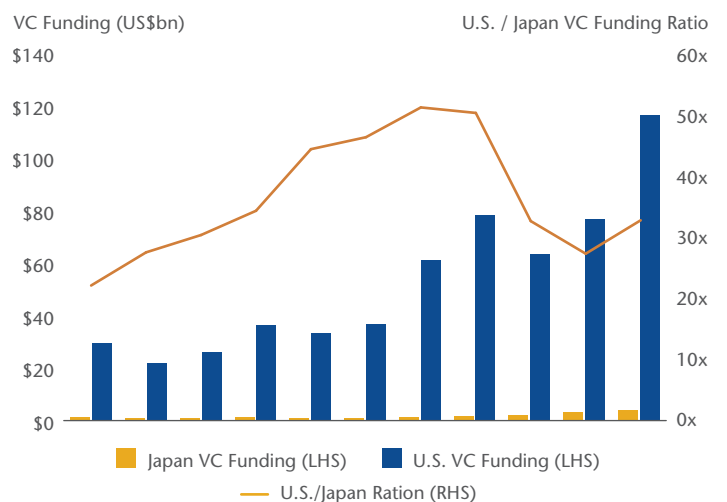
Although sell-side analyst coverage of small-cap companies in Japan is thin, there is no lack of companies to cover. In fact, Japan features a steady flow of small-company listings on public exchanges. Early- and middle-stage companies—and even companies with decades of history that want to launch a new phase of rapid growth—frequently turn to public listings to raise capital, given the country's limited scope of venture capital and startup funding.

The gap in startup funding is significant. The market capitalization of listed U.S. companies is approximately six times larger than the market capitalization of listed Japanese companies—but the disparity in venture capital is meaningfully more pronounced: Venture capital investment

**FIGURE 1. STARTUP FUNDING IN JAPAN STILL LIMITED**

Despite recent growth in Japan VC funding, it is still only a fraction of U.S. VC funding

Venture Capital (VC) Funding in Japan vs. the U.S.



Sources: Japan data from Entrepedia; U.S. data from PwC/MoneyTree; data as of 2018

**FIGURE 2. LOW CORRELATION WITH S&P 500 PROVIDES DIVERSIFICATION**

Correlation Weekly USD (Dec 2008-Dec 2018)

	S&P 500	Stoxx 600	MSCI EAFE	MSCI Asia ex Japan	Topix	Topix Small	MSCI Japan	MSCI Japan Small	MSCI India	MSCI China	MSCI Frontier
<b>S&amp;P 500</b>	1.00	0.81	0.81	0.66	0.49	0.38	0.50	0.39	0.52	0.60	0.41
<b>Stoxx 600</b>	0.81	1.00	0.97	0.72	0.54	0.42	0.55	0.43	0.60	0.62	0.48
<b>MSCI EAFE</b>	0.81	0.97	1.00	0.78	0.70	0.57	0.71	0.59	0.64	0.69	0.50
<b>MSCI Asia ex Japan</b>	0.66	0.72	0.78	1.00	0.59	0.49	0.60	0.52	0.76	0.93	0.47
<b>MSCI China</b>	0.60	0.62	0.69	0.93	0.53	0.44	0.54	0.47	0.63	1.00	0.43
<b>MSCI India</b>	0.52	0.60	0.64	0.76	0.42	0.35	0.43	0.37	1.00	0.63	0.42
<b>MSCI Japan</b>	0.50	0.55	0.71	0.60	1.00	0.87	1.00	0.89	0.43	0.54	0.35
<b>Topix</b>	0.49	0.54	0.70	0.59	1.00	0.90	1.00	0.91	0.42	0.53	0.35
<b>MSCI Frontier</b>	0.41	0.48	0.50	0.47	0.35	0.30	0.35	0.31	0.42	0.43	1.00
<b>MSCI Japan Small</b>	0.39	0.43	0.59	0.52	0.91	0.98	0.89	1.00	0.37	0.47	0.31
<b>Topix Small</b>	0.38	0.42	0.57	0.49	0.90	1.00	0.87	0.98	0.35	0.44	0.30

Indexes are unmanaged and it is not possible to invest directly in an index.

Source: Bloomberg

in the U.S. is more than 40 times greater than in Japan, as of the end of 2017. Historically, the venture-capital landscape in Japan has been constrained by several factors, including cultural and language barriers, unfavorable tax and corporate laws and a bank-centric financial system that favors conservative investment strategies.

As a meaningful number of small Japanese companies turn to public markets for funding, alpha-seeking investors can benefit from a wider opportunity set—and many of these small, innovative companies start small and grow bigger, rewarding investors along the way.

## Low Correlations Provide Diversification Potential

Japan small-cap stocks historically have enjoyed low correlations with other major markets, creating an environment with potential for diversification and alpha generation. In terms of correlation to the S&P 500 Index, Japan small-cap stocks posted similar marks over a 10-year period as frontier markets (such as Bangladesh and Pakistan). At the same time, Japan small caps are more liquid than frontier markets—a discernible advantage for most investors. The average daily trading volume of the Tokyo Stock Exchange Mothers Index, for example, typically is \$1 billion to \$3 billion, eclipsing the trading volume of the frontier markets in aggregate and even surpassing markets in South Korea and India.

## The Alpha Environment in Small-Cap Japan

The characteristics described above lay the groundwork for alpha generation in Japan—but have portfolio managers historically been able to capture the resulting opportunities? In any given market, one or two managers will be able to identify alpha, even in efficient markets such as the U.S.; we hypothesize, however, that the small-cap market in Japan has a robust alpha profile for long-term investors—one in which more than a select few can potentially identify alpha.

To validate this premise, we first gathered data on average investment-manager alpha generation in Japan relative to one of the most efficient environments: U.S. Large Blend (Core). According to Morningstar investment-manager category averages, the average Japan equity manager achieved alpha far in excess of that realized in the U.S. Large Blend (Core) category over the three- and five-year periods ending March 31, 2019. In fact, alpha generation was negative for the average U.S. Large Blend (Core) manager during these periods.

Next, we broadened the universe to compare alpha generation of the average Japan manager against Europe, Asia ex Japan, U.S. Large Growth and China. As illustrated below, Japan led the pack in terms of alpha generation over the five-year period and ranked third over the three-year period.

We believe the Japan small-cap market is a unique environment where multiple factors combine to create a fertile hunting ground for alpha. As investors ask how best to harness Japan's growth potential during its newest economic era, we believe the country's small companies are a key component of the answer, providing investors with a powerful opportunity to help meet long-term goals for growth.

**FIGURE 3. ANNUALIZED CATEGORY AVERAGE ALPHA GENERATION**

Morningstar Category	3 Years	5 Years
U.S. Open End Japan Stock	0.89	1.95
U.S. Large Blend (Core)	-1.24	-1.50
U.S. Open End Large Growth	-0.15	-1.17
U.S. Open End Mid-Cap Growth	0.47	-0.65
U.S. Open End Small Cap Growth	2.18	0.85
U.S. Open End Europe Stock	-1.84	-0.69
U.S. Open End Pacific/Asia ex-Japan Stock	0.79	0.90
U.S. Open End China Region	1.36	0.22

As of March 31, 2019

## A New Era in Japan's Economy

**Corporate reforms are resulting in improvements in governance, capital allocation and shareholder-return policies**—In part, the long malaise in the Japanese market was brought about by antiquated business practices and conceptions. For decades, Japan's corporations and their boards primarily focused on safeguarding market share, head count and influence—all while hoarding cash, at the expense of profits and shareholder returns.

Today, the landscape is markedly different. With the advent of Prime Minister Shinzo Abe's economic restructuring, sweeping corporate reforms and new Corporate Governance Code, we see increasing pressure from the government, investors and peers on many of Japan's longtime laggards to abandon weak businesses, diversify their boards and put cash to work, especially through dividends and buybacks.

From a bottom-up, fundamental perspective, we are seeing important signs of change in management behavior, including more-thoughtful and productive capital allocation decisions, a long-absent focus on ROE, more engagement with investors and better shareholder-return policies. All of these should benefit investors over the long term.

**Japan is increasingly integrating with broader Asia**—Over the past 15 years, Japan has become more integrated with the emerging economies of Asia than ever before. This deepening integration is propelled by multiple factors, including continued economic liberalization, tech-driven productivity gains and new entrepreneurship. As a result, we see incomes continuing to rise across emerging Asia. We expect this to continue to expand the already vast middle class, which now enjoys more leisure time, more disposable income and a taste for more sophisticated products and services.

A growing segment of Japanese companies are well-positioned to access this growth in incomes and rising productivity. Many Japanese corporations have meaningful operations in broader Asia—especially in consumer products, household products and high-quality branded consumer products—which meet the evolving demand and growing sophistication of the rising middle class in Asia. Consequently, we see a growing set of opportunities among Japanese companies that benefit from the country's increasing integration with the rest of Asia.

## Index Definitions

**The S&P 500 Index** is a broad market-weighted index dominated by blue-chip stocks in the U.S.

**The MSCI EAFE Index** is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

**The STOXX Europe 600 Index** is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 18 countries of the European region: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

**The MSCI All Country Asia ex Japan Index** is a free float-adjusted market capitalization-weighted index of the stock markets of China, Hong Kong, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Singapore, Taiwan and Thailand.

**The MSCI Japan Index** is a free float-adjusted market capitalization-weighted index of Japanese equities listed in Japan.

**The Tokyo Stock Price Index (TOPIX)** is a capitalization-weighted index of all companies listed on the First Section of the Tokyo Stock Exchange.

**Tokyo Stock Exchange Mothers Index** is a capitalization-weighted index of all stocks listed on the Mothers Section and is calculated using the same methodology as the TOPIX.

**The MSCI China Index** is a free float-adjusted market capitalization-weighted index of Chinese equities that include China-affiliated corporations and H shares listed on the Hong Kong exchange, and B shares listed on the Shanghai and Shenzhen exchanges and P Chips and foreign listings (e.g. ADRs).

**The MSCI India Index** is a free float-adjusted market capitalization index that is designed to measure the performance of the large and mid -cap segments of the Indian market.

**The MSCI Japan Small Cap Index** is designed to measure the performance of the small cap segment of the Japanese market. With 926 constituents, the index represents approximately 14% of the free float-adjusted market capitalization of the Japan equity universe.

**The TOPIX Small Index** is a capitalization-weighted index designed to measure the performance of the stocks listed on the First Section of the Tokyo Stock Exchange, excluding the TOPIX 500 stocks and non-eligible stocks.

**The MSCI Frontier Markets Index** captures large and mid cap representation across 29 Frontier Markets (FM) countries. The index includes 110 constituents, covering about 85% of the free float-adjusted market capitalization in each country.

Indexes are unmanaged and is not possible to invest directly in an index.

## General Definitions

**Alpha:** An investment term to describe a strategy's ability to outperform the market, often referred to as excess return.

**Correlation:** A relationship or connection between two asset classes. A correlation of one (1) indicates a perfect historical correlation between two asset classes. A correlation of less than one (1) indicates lower correlation.

Investing in smaller-size companies may involve additional risks such as more volatility and less liquidity than larger companies.

Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

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