

JAPAN SMALL VALUE

An Island of Potential in a Sea of Expensive Assets

Usonian Japan Equity and Asset Allocation Teams | July 2021

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THE OPPORTUNITY LIES IN VALUE AND SMALL

Small Value stocks have lagged the broad market leaving them attractively priced

JAPAN SMALL VALUE TRADING AT AN UNUSUALLY WIDE DISCOUNT



The massive snap-back in asset prices around the world has left it increasingly difficult to find attractively priced equities. Fortunately, those willing to look to Japan will find small cap value stocks to be an island of potential in a sea of otherwise expensive equity markets. There are three main drivers of our view: cheapness, improving return on capital (ROC), and alpha.

- **Cheapness.** While the broad Japanese TOPIX index has delivered 12% annualized returns over the past decade – better than the MSCI ACWI – value stocks *within* Japan have lagged. MSCI Japan Value has underperformed MSCI Japan Growth by 80% cumulatively.¹ Further, the global small cap rally of the past year largely bypassed Japan. The combination has left this market trading at a significant discount to its own history. As the display above indicates, Japan small value stocks, which normally trade at a 25% discount to the market, are now sitting at a 45% discount – their largest in 20 years.
- **Improving ROCs.** The group’s attractiveness is supported by undeniable signs of improving ROC. For decades, Japan has suffered from a combination of low profit levels and inefficient balance sheets, but today we are witnessing structural and cultural shifts wherein corporate Japan has “gotten religion.”
- **Alpha.** Despite being the world’s second largest equity market (by market cap and number of companies), Japanese stocks are relatively underappreciated, under-researched, and under-owned. Approximately 40% of companies have no analyst coverage and foreign investors are generally underweight Japan. Further, improving corporate governance, better transparency, and a new willingness to work with engagement-oriented activist investors makes this a high-alpha pool to fish in. Our team has already identified a robust portfolio of companies that are cheap, have improving ROCs, and balance sheets with one-third the debt loads of typical value portfolios.
- The combination of expected multiple expansion and rising ROC leaves Japan Value and Japan Small Value among GMO’s most attractive 7-Year Asset Class Forecasts.

1

Ten years ending 4/30/2021, the MSCI Japan Value Index underperformed the MSCI Japan Growth Index, in local terms, cumulatively.

Disclaimer

Chart as of 6/30/2021 | Source: GMO. Price/Scale is based on multiple valuation metrics. Value represents the cheapest half of the market. Small represents the smallest third of the market by market capitalization.

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