JAPAN HERE AND NOW

10 JULY 2014

Reform: Government Pension Investment Fund (GPIF), Japan

Prime Minister Abe has urged Japan's Government Pension Investment Fund (GPIF), the world's largest, to reallocate some of its USD1.26 trillion assets into riskier assets as Mr Abe seeks to end nearly two decades of deflation.

In this note DSBI seeks to comment on the subject matter and the implications it may or not have for DSBI's Japan Equity Fundamental Active strategy.

GPIF Reform

The GPIF reform is part of the growth strategy associated with the strengthening of corporate governance and corporation tax rate reduction, which aims to increase capital efficiency. While this reform is receiving much attention as a possible market driver to support the Japanese equity market by increasing allocation to Japan equities, it should receive recognition from the viewpoint that the government is moving forward with the reform in anticipation of entering a sustained inflationary environment, and to help address the increasing pension costs from an aging population.

Despite the GPIF being the world's largest pension fund with USD1.3 trillion in AUM, it has less than 80 staff, many of whom lack the same investment experience as their private sector counterparts, and their pay structures is determined by law with ceilings, which does not help to attract strong recruits from elsewhere. The investment committee members work on a part time basis and only meet once a month for in the region of 3 hours. They give advice to the President of the GPIF, as there is currently no executive board to decide on the running of the GPIF. To put this into perspective, Norges Bank Investment Management, the arm of Norway's central bank that manages the world's largest sovereign wealth fund has USD840 billion in AUM and has over 300 staff, many of who have extensive investment experience.

The GPIF working group made the recommendation on the GPIF reform to the government in November of last year, which was approved by the cabinet the following month. The government is awaiting consultant reports advising on the new structure of the GPIF on matters such as the number of staff and pay ceilings. A number of events are expected to happen from autumn onwards, including the establishment of a new portfolio allocation and the creation of an executive board. It is difficult to estimate the market implication of the reform. However, Citi's forecast shows by increasing the allocation to Japan equities, and to reach their TOPIX forecast of 1540 (about a 20% increase from the current level) by the end of 2015, it will help reduce the selling pressure of Japanese equities in the order of 4 trillion yen (about USD40 billion); this equates to approximately 5 months' worth of net purchases by foreign investors from October 2012 to May 2014 (20 month period).

How does Masashi Kamohara, Senior Portfolio Manager, Fundamental Active, see the GPIF reform and what effect does it have on the portfolio?

Overall, Masashi sees the GPIF reform as positive for the market but will not be taking any specific action relating to this. This is because his standard investment philosophy is to hold stocks whose earnings and return on equity (ROE) are expected to rise, and these kinds of stocks are likely to be included in the indices adopted by the GPIF (e.g. JPX400). There will be a continued focus on beneficiaries of continuing monetary easing by the Bank of Japan (BoJ) and the recovery in CAPEX and construction investments.

An increase in Japan equity allocation does not necessarily imply an immediate increase in purchases by the GPIF, as they are selling JGBs for pension payments (which indirectly increases their Japan equity allocation ratio), and the actual allocation is likely to be within the permitted range of the new policy allocation. The current actual allocation is around 17% (the current permitted range is 12±6%), and the new target range is 20%±10%(proposed by the chairman of the GPIF reform working group). 17% is already within the permitted range. Hence, the main positive point about the new allocation is that it will reduce the selling pressure of Japan equities, as it has to go up 30% before the GPIF has to sell.

The chairman of the GPIF is proposing to change the allocation to foreign bonds from a target range of 11%±5% to a flat 10%, and the allocation to foreign equities from a target range of 12%±5% to a flat 20%. There is a curiosity as to why no permitted range has been given for the two asset classes. It will at least imply selling of yen to buy foreign equities, assuming that there is no currency hedging.

There are other public pension funds and corporate pension funds with assets that together total nearly 1.4 times that of GPIF (about USD1.3 trillion). Many will follow the GPIF's allocation, and with persistent inflation expectations, they are expected to decrease allocation to JGBs and increase allocation to riskier assets including Japanese equity.

Only time will tell how effective the GPIF reform will be but at DSBI we believe this along with other growth measures is pacing Japan in the right direction.

Contact Information

Primary contacts	Benjamin Ellis Alex Mander
Direct telephone number	Benjamin Ellis: +44 20 7597 7024 Alex Mander: +44 20 7597 7038
Switchboard number	+44 20 7597 7000
E-mail address	benjamin.ellis@daiwasbi.co.uk alex.mander@daiwasbi.co.uk
Website	www.daiwasbi.co.uk

Notes

Issued by Daiwa SB Investments (UK) Ltd.

Registered in England and Wales. Registered office 5 King William Street, London, EC4N 7JA; registered number 1660184. Authorised and regulated by the Financial Conduct Authority.

Past performance is not a guide to future performance. An investment's value and the income deriving from it may fall, as well as rise, due to market fluctuations. You may not get back the amount originally invested.

The data contained in this document is for information purposes only. It is correct to the best of our knowledge at the date of issue, is based solely on information which you have provided to us and may be subject to change. The client legal agreement will take precedence over this document. This document is not legally binding and no party shall have any right of action against Daiwa SB Investments, in relation to the accuracy or completeness of the information contained in it or any other written or oral information made available in connection with it. Nothing in this document or any related presentation shall be deemed to constitute investment advice, nor shall we be deemed to be an investment advisor unless formally appointed as such, or as discretionary investment manager, by way of written agreement.