

## **PM'S MONTHLY PERSPECTIVES VALUE + ALPHA GROUP**

### **Market Outlook & Investment Strategy**

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In November, the TOPIX advanced on the back of declining concerns over the US midterm elections, dovish comments by US Fed Chairman, Jay Powell and yen depreciation. In the beginning of the month, the TOPIX advanced as concerns about Democrats controlling both chambers and pursuing fiscal austerity measures receded after the Republicans won a majority in the US Senate. However, telecom stocks plunged following an announcement by **NTT Docomo** that it will cut mobile telecom rates by up to 40 per cent. In the middle of the month, the TOPIX declined due to an escalation of trade frictions between US and China. In addition, investors were disappointed by a series of worse-than-expected earnings reports by US retailers, gaming and **Apple** related companies. At the end of the month, the TOPIX rebounded helped by dovish comments by Powell, ease of concerns regarding both Italy and Brexit, and yen depreciation.

**Governance: Nissan's ex-chairman Carlos Ghosn was arrested. I am sure the governance in compensation at Japanese companies will improve from now on.**

Carlos Ghosn was arrested on charges of breaching the Financial Instruments and Exchange Act (falsifying company securities reports). Though Japan's Financial Services Agency obliges companies to disclose directors' compensations over JPY100 million, Mr Ghosn understated his pay in financial statements by JPY1 billion for five years, thus accumulated JPY5 billion. He may have tried to avoid criticism against the huge amount of compensation. The company was going to pay the remaining JPY1 billion to Mr Ghosn by increasing his retirement benefits, signing consulting contracts or contracts to avoid competition and so on. According to the Financial Instruments and Exchange Act, companies have to disclose information about compensation through securities reports when the amount is confirmed even if it will be paid after the retirement, which **Nissan** allegedly breached. Greg Kelly, the ex-representative director of Nissan, reportedly admitted that he has signed consensus documents about giving rewards to Mr Ghosn after his retirement every year but both Mr Ghosn and Mr Kelly are denying their allegations by saying that those documents were not official and whether Mr Ghosn would get compensation after his retirement was not decided. Hiroto Saikawa, the chief executive of Nissan, said that misconducts focussing on Mr Ghosn include not only the understatement of compensation but also improper expenditures such as abuses of corporate funds for private purposes.

Though these allegations are still under scrutiny, the governance structure at Nissan has been weak. The fact that there were few external board members from the beginning and no nomination or compensation committees were seen as a problem. There is a guideline on corporate investments, the Corporate Governance Code, which outlines a code of conduct for listed companies in Japan, however Nissan didn't observe certain rules around management compensation.

Since executive compensation at Japanese companies is smaller than those in other countries, this topic hasn't come up for discussions. However, the news of Mr Ghosn's arrest has sparked lively discussions amongst the media about how and who should decide the amount of management compensation. Therefore, the importance of governance concerning compensation will increase in Japan. I expect that the effectiveness of the compensation committee will increase, pay-for-performance principles will be established and in turn governance concerning compensation will improve.

**Earnings: Telecom stocks plunged following an announcement by NTT Docomo, on plans to cut telecom rates, although we believe that the concerns are excessive.**

Japanese telecom stocks dropped sharply across the board on 1 November. SoftBank tumbled by -8%, NTT Docomo and NTT fell by -15%, meanwhile KDDI also sank by -16%. The trigger was an announcement by NTT Docomo. The company said at an earnings briefing that it would return as much as JPY400 billion a year to customers by cutting rate plans by 20-40% from the April-to-June 2019 quarter. Market participants' worry is that if this policy is implemented, not only will the company's operating income will decrease by up to -40%, earnings across the industry might lose steam in the long term.

Our portfolio was underweighted in telecom stocks at the end of October, but we have an overweight position in them now after purchases made following the plunge on 1 November. We increased the weight of telecom stocks due to three reasons (forecasts) below.

- 1) **We believe that operating income at NTT Docomo will not decrease by -40%.** NTT Docomo's revenue is comprised of low-margin handset sales and high-margin telecom rates. And what the company is going to cut by 20-40% is the handset-related price, which means its profits won't decline that much. In addition, the company is going to expand non-telecom businesses such as video delivery services and wallet services while working on cost reduction, which is also likely to push up its profits.
- 2) **Industry peers are insulated from negative effects.** The announcement by NTT Docomo came against the backdrop of administrative guidance which requires telecom companies to introduce 'separate plans' by severing a relationship between handset purchase prices and communication fees. However, peers such as KDDI and SoftBank have already adopted separate plans, which suggests that their rate plans are unlikely to be cut along with NTT Docomo. In fact, KDDI announced at an earnings briefing that it naturally aims for an increase in profit as a private company.
- 3) **Valuations are low.** Even if the operating income of NTT Docomo does flatten for the next few years as announced, the earnings per share (EPS) of telecom companies are expected to increase as most of them are aggressive in stock buybacks. We think that sectors with stable profits with increasing EPS deserve a price/earnings (PE) ratio of 10, while the current valuation of telecom stocks is lower than 10. For example, KDDI was trading at 9.1 times the projected earnings for this term per share.

Our basic strategy for telecom stocks is to buy at a discount and aim to sell at a slightly overpriced level, as telecom stocks are vulnerable to political measures. When telecom stocks surge on the back of a significant increase in profits, the government tries to impose regulations on telecom companies with an intention to cut telecom rates.

**Investment Strategy**

We expect that the Japanese equity market will rally again while the global economy continues to grow steadily, the Bank of Japan maintains an accommodative monetary policy, and the market remains at an affordable level. Over the long term, companies need to make continuous efforts in structural reforms. Major risks will include sharp spikes in the yen caused by external factors, including the escalation of trade frictions and the risk of bubble bursting in the Chinese property market. Taking these points into consideration, we maintain our overweight positions in cyclical sectors, such as materials and industrials (commercial & wholesale trade).

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The author's biography has been provided below:

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Mr KAMIISHI joined Daiwa SB Investments in 2009 and covered US & European equities as a strategist from 2010 to 2013. He moved to Hong Kong in 2013 as an analyst for the auto & industrials sector in Asia Pacific ex-Japan equity. In 2015, he returned to Japan and covered the IT & services sector as a Japan equity analyst. In 2016, he became a portfolio manager in the Value + Alpha group.

Mr KAMIISHI obtained a BA degree in Economics from Keio University (2009) in Japan.

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