



# Japan: valuable source of global diversity for investors

Uncertainty over the U.S. economy has led many investors to regain their appreciation for the benefits of international diversification. As a result, Japan - the world's second largest economy - is beginning to attract more attention from global corporate and portfolio investors. While the long term implications of this trend remains to be seen, the Nikkei 225, Japan's primary market index - has outperformed the U.S. Dow Jones Industrial, S+P 500 and NASDAQ, as well as most major European, indexes over the past year.

Following almost a decade of sluggish growth and stagnation since the collapse of its bubble economy in the early 1990s, Japan is showing signs that it is emerging from its troubles. Dramatic changes in its regulatory infrastructure have lead to a surge in foreign direct investment. While still small compared to the levels seen in the U.S. and other major economies, incoming investment is playing a leading role in changing the corporate dynamic and the way that business is conducted.

Further change is indeed necessary and substantial steps need to be taken to build on the momentum that has been achieved. Nevertheless, the growing attractiveness of Japan's affluent and highly sophisticated market - containing more than 125 million

consumers with JPY 1,400 trillion in personal assets - is increasingly recognised by foreign businesses as the opportunity and potential that it represents.

Recent developments include:

- maintaining progress in achieving comprehensive economic reform
- revising commercial code to allow adoption of US-style corporate governance system
- adopting new market accounting standards
- initiating measures to enhance labour flexibility and pension portability

## Japan perceived as source of potential growth in the face of market turmoil

As the U.S. economy continues to work off the excesses of the late 1990s Internet bubble, foreign corporate and portfolio investors are coming to more fully appreciate the underlying attractiveness of the world's second largest economy.

Japan has a Gross Domestic Product (GDP) that is about half that of the U.S. or Europe and more than four times the size of China.

Despite its economic problems, per capita income in Japan remains larger than the U.S. and key European nations. On average, households headed by persons in their sixties hold assets averaging about JPY60 million, of which roughly JPY20 million is accounted for by financial assets. This combination of scale and income level makes Japan an ideal market for the upscale goods and services that constitute a major portion of U.S. exports.

Japan also possesses one of the best-educated work forces in the world. 49.3% of its students go on to Universities and Junior Colleges. This compares to only 45.9% in the U.S. and 21% in Singapore. Japanese workers are also extremely diligent. According to the International Labour Organisation, Japan firms lost only about 5% as many man/days to strikes and labour unrest as companies in the U.S. in 1999 and Japan consistently ranks as one of the safest countries in the world.

Recognition of this trend has caused FDI inflows into Japan to increase significantly in recent years. The value of transactions rose from JPY598 billion in 1997 to JPY3,283 billion in 2000, an increase of over 500%. The number of M&A transactions has also grown substantially, from 531 transactions in 1995 to 1241 in 2000.

*This article is an abstract from a report prepared by JETRO New York in July 2002. Whilst targeting an American audience, the messages are pertinent for European investors.*

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## Foreign direct investment is beginning to change the business dynamic in Japan

Only a few years ago foreign companies and investors considered Japan to be a relatively closed market. They found it very difficult to establish themselves and to acquire the human resources needed to succeed in an environment in which the most promising candidates sought to enter a lifetime career path with a few select Japanese government or corporate entities.

A rising number of foreign companies -- which have entered Japan through either greenfield or the acquisition of Japanese assets, have begun to radically change entire sectors and the way that business is conducted. Change is most visible on the consumer level and firms such as Starbucks, Toys-R-Us, Walmart, Costco and the Gap have dramatically changed the face of Japanese retailing. Citibank and other U.S. financial institutions as well as foreign-owned Shinsei Bank and Kansai Sawayaka Bank have introduced major innovations in the field of financial services.

Equally notable is the success achieved by Carlos Ghosn at Nissan, who one Japanese government official has described as 'a Japanese national hero'. Less well known is the success of major U.S. pharmaceutical firms such as Johnson and Johnson, with \$1.5 billion in 2001 revenues and Pfizer, which ranks third in overall pharmaceutical sales in Japan and first in cardiovascular and second in anti-infective sales.

In addition to resuscitating specific troubled enterprises, foreign investment is helping to introduce new business models and prac-

tices in Japan. It is changing the way in which Japanese firms market, finance and operate their enterprises and is presenting more options to Japanese consumers.

Employment practices are also changing, with many prominent students from prestigious Japanese universities now preferring to begin their careers with foreign firms. This was simply unheard of in the past. It is also encouraging a shift away from lifetime employment to an environment that allows mid-career transition.

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## Japan offers safe haven and upside potential to corporate and portfolio investors

While Japan has far to go in delivering on the promises of reform measures enacted in recent years, investors have begun to realise the stage is being set for an environment that can lead to an increased valuation of Japanese assets.

Many perceive Japan to be a relative safe haven during a turbulent time. While the long term implications of this trend remains to be seen, the Nikkei 225, Japan's primary market index has outperformed the U.S. Dow Jones Industrial, S+P 500 and NASDAQ, as well as most major European, indexes over the past year.

A key advantage is the ability of Japanese markets to provide a liquid source of diversification for investors seeking a safe haven in view of current market trends. Additionally, Japanese government spending and a comparatively lower cost of leverage can enhance the return for equity investors in Japanese securities. Finally, foreign direct investors can obtain very low-cost financial leverage to enhance potential returns and can hedge their yen investment back to U.S. dollars.

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## Aim to accelerate the involvement of foreign investors in coming years

For more than 50 years, Japan maintained its own style of employment and financial systems, with corresponding corporate governance and other institutions and practices. Today, however, in recognition of the need to speak a common language with other global trading and investment partners, all these systems are changing. The objective is to shift from a system that gave priority to high efficiency to a new system that facilitates the smooth transfer of resources from low- to high-productivity sectors. Drastic reforms have been made to help Japan transform itself into a more market-oriented system. In the years to come, Japan hopes to build on these efforts, to accelerate both its ongoing restructuring and reform efforts as well as the important involvement of foreign companies and investors.

Combined with its leading edge in numerous technologies and manufacturing processes, along with its high quality, highly motivated workers and well-maintained industrial infrastructure, Japan represents an excellent place to track market trends and to sell U.S. products and services. In addition to the attractions of its own domestic market, Japan can also serve as a hub for expansion to the vast Asian market.

U.S. corporate and portfolio investors who are seeking to expand their international market presence and to achieve greater diversity in their portfolio investments will find a welcoming environment and source of future growth that is perhaps unmatched in the world. It is by no means far-fetched to say that no global business strategy can be complete without investment in Japan.