Fund repositions to take advantage of an improving and more mature Japanese economy, including a search for growth opportunities among the smaller-cap companies.

A Focus on Finding Opportunities in a Recovering Japanese Economy

An interview with Seung K. Kwak, portfolio manager, The Japan Fund

Japan's economic woes have paved a rocky road for U.S.-based investors in the country. But there are signs that Japan is emerging from its historically longest downturn. And with Japan's economy second only to the U.S. in terms of productive capacity, investors seeking to diversify their portfolios internationally should have some exposure to the Japanese stock market.

While many international funds have major holdings in Japan, another route to the Japanese market is through investment in a single-country fund. Three U.S. low-load mutual funds focus on Japan, according to AAII's "Individual Investor's Guide to Low-Load Mutual Funds." Of these, The Japan Fund is by far the oldest. It was started in 1962 as a closed-end fund and was converted to an open-end no-load fund in 1987. In contrast, T. Rowe Price Japan was started in 1991, and Fidelity Japan started in 1992.

The Japan Fund's record against its new competitors is mixed: It outperformed both funds in 1993, but underperformed both in 1994 and 1995. In recent quarters, it has outperformed the other two, reflected in the annual returns for the year ending March 31, 1996, of 5.7% for The Japan Fund, 3.3% for T. Rowe Price Japan, and 3.2% for Fidelity Japan. The return figures reflect The Japan Fund's greater emphasis on smaller-capitalization stocks compared to the other two funds, which tend to focus on large-cap stocks.

Currently, the fund has $510 million in assets.

In early May, portfolio manager Seung Kwak discussed the management of the fund with Maria Crawford Scott.

What are the investment objectives of the fund?

The investment objective is long-term capital appreciation. And since this is a country fund, our objective is to give investors the best opportunities available in Japan. We're not restricted to any one market sector, and we find opportunities among all of the available Japanese stocks, which is a universe of some 2,000 companies. Currently we have about 65 stocks that range from small- to large-caps.

What percentage do you usually commit to small-capitalization stocks and large-capitalization stocks?

There are guidelines within the prospectus—for instance, for the over-the-counter market, which is like the Nasdaq in the United States, the guidelines restrict us to a maximum of 30%. Currently, we're approximately 60% invested in stocks that are listed in the Tokyo Stock Exchange First Section, which are larger-cap companies. And we have about 20% in stocks listed in the Tokyo Stock Exchange Second Section and about 19% in over-the-counter markets, both of which tend to be smaller-cap companies.

Do these percentages vary?

Yes, they do. It really depends on the opportunities and valuations that we find. What has happened in Japan is that the stock market has shown a recovery from last year, and the large-cap stocks have led the recovery. Some of the smaller stocks we think are still lagging in valuations and in terms of price appreciation, so right now there are very attractive opportunities in small and medium-sized companies.

What criteria do you use in selecting individual stocks?

We have four main screens. The first one is a proprietary valuation model that screens for the cheapest opportunities. The second screen is based on global industry trends—we have global industry analysts in New York, Boston, and L.A, and we select Japanese companies that will benefit from these trends. The third approach is to find companies that will benefit from any longer-term structural changes. And the fourth screen is based on our view of where the market is in the macroeconomic cycle.

What kinds of factors does the valuation model consider?

We back-screened the typical valuation measures—price-earnings ratio, price-to-book ratio, dividend yield,

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The Japan Fund is managed by Scudder, Stevens & Clark. For information, contact The Japan Fund Service Center, P.O. Box 2291, Boston, MA 02107-9913; 800/535-2726. It is not part of the Scudder family of funds, but offers optional participation in those funds, including full exchange privileges.

price-to-cash ratio—to see which ones fared best in the Japanese market over the past 10, 15, and 20 years. We started from there because we didn't want to work with a presumption that the price-earnings ratio is necessarily a good indicator. We found four parameters that were the most statistically successful predictors, and our model is based on those parameters; it is proprietary, but there are no unusual measures.

Based on these valuation parameters, we rank the universe of 2,000 Japanese stocks into quintiles, and we look at the cheapest segment to find opportunities. At that point, the other two analysts and I visit each of these companies, and do a very thorough bottom-up, in-depth financial as well as fundamental analysis. Out of those 400, we typically buy 30 or 40. So, it's about a 10-to-1 ratio: for every 10 companies that we research, we actually end up buying one or two.

Compared to our competitors, we tend to concentrate our holdings a little more. Where we may have 60 to 70, they may have 100 or more. It's not so much that we want to concentrate our holdings, but we really put considerable effort into research of individual companies, and when we have a conviction we don't find too much sense in putting in 0.2% or 0.5%, we would prefer to put 2% or 3% in it. If you are "playing" an industry, you can diffuse your individual stock holdings, putting in 0.2% to maybe 10 electronics companies to come up with a total of 2%. But we tend to be more bottom-up oriented.

What are the factors you look for when you visit a company?

There are several factors. One is the passive vs. active factor. Some companies have great results just because of the environment—they just happen to be there, and there's no confidence that the company could replicate those earnings successes outside of that environment. On the other hand, at other companies if you talk to the management and hear their strategy, their deployment of resources, their financing schemes, and their marketing schemes, you get a sense of active management input, that they're in control of their destiny and that they've made it happen.

The other factor is a competitive strand. Competitive situations constantly change, and that is especially crucial for long-term investors, which we are. Even though a company is successful today, two years down the line there might be a new competitive product or new entrants into the market, and we want to assess the competitive situation vigorously. So we ask them about their current competitors to see how much knowledge they have of the competition, and we ask them what they are trying to do to defend their share against the competition.

The last factor that we examine is a company's long-term vision, to see whether the company has a real financial goal in mind several years down the line, and how they plan to get there.

Balance sheets, profit and loss statements, the annual report and other financial reports give us a sense of how the company has done in the past and what the situation is now. But we find that we really can't get a sense of a company's future unless we talk to the management.

A number of your screens also involve an analysis of the major economic trends. How has the composition of the fund's investments changed over time?

In the late '80s and early '90s, the fund had strong performance based on our very large retail and consumer stock exposure. But in 1992 and 1993, deflation hit Japan and this was the time when we began restructuring the portfolio from a more retail-driven portfolio to a more manufacturing- and technology-driven portfolio.

Through 1994 and 1995 we've re-positioned the portfolio for an economic recovery, and right now, we are focusing on five basic "themes," if you will. The first are global companies, many of which are technology companies such as Canon or Hitachi, that can benefit regardless of the economic conditions or currency fluctuations in Japan. The second theme is companies that have restructured themselves and are well-poised to benefit from economic recovery. These tend to be large-cap manufacturers, like certain steel companies.

Third, we have smaller-growth companies, which we call the "new blue chips" in Japan. We think that, as Japanese markets become increasingly mature, there is a new breed of entrepreneurs that we hope will be the future Sonys and future Hondas in Japan. The fourth theme is cash-rich and cash-generating companies, to take advantage of certain structural changes taking place, such as stock buy-backs, which are beginning to be implemented for the first time in post-war history. The fifth area, which we've added since late last year, is construction-related stocks. We feel construction is starting to turn around after the massive downturn.

The repositioning hurt us in 1994 through early 1995, when the recovery aborted. But from the second quarter of 1995 through now, the fund has been doing quite well because the recovery is underway and we are enjoying the fruits of our restructuring.

Do you find that the small stock market in Japan is less efficient than the large-cap market?

Yes. First, there's a paucity of information. There is much less media and analyst coverage of the stocks, and as a result, there are many more surprises. For instance, when the economy drops, there are much sharper earnings revisions downward, and similarly, when the economy goes up, there are much sharper upward revisions. Second, there is simply more volatility, both on the upside and the downside.

The way we try to deal with this is to identify companies that we really like, get in at reasonable valuations and then sit on the company over two to three years so that we can ride through the volatility and participate in the trend.

In your current top holdings you have several finance companies that lent to the small companies.

Yes. We've done a lot of research in the financial sector because in Japan, the banks make up 25% of the market. So most investors who are competing against the market index want to hold some banks, regardless of whether they like them or not, to minimize benchmark risk [the risk that the portfolio will not behave similarly to the market index].

As a firm, Scudder has the tradition of investing based on research conviction. Due to the scarcity of publicly available information in the past as well as serious questions we had about valuation, we have shied away from the banks in the last five years. But we did realize that if the banks were in trouble, the authorities would do their most to help them, because if the banks went down, the economy would go down. So we felt they would probably implement a regime of low interest rates, which they did. With that perception, we sought to find beneficiaries of lower interest rates that didn't have the problems that the banks had. And that's how we arrived at Nichiei Co. and Shohkoh Fund & Co., which are lenders to smaller- and medium-sized companies, which have the biggest demand for capital in Japan.

At the same time, these companies lend on credit, not land collateral. And that was the whole problem with Japanese banks—their loans were based on land collateral value that dropped 50% to 60% in the last three to four years, so many of the loans went bad.

What would cause you to sell a stock?

We look at the quintile rankings produced by our valuation screen, and the red flag goes up if a holding appears in the most expensive quintile. At that point, we go back to our analysis to assess whether this valuation can be justified, and if not, we would sell. So that's one reason.

The second reason we would sell would be changing fundamentals. We always have an investment thesis with every stock, a clear reason why we bought it, and it is reviewed every three to six months. And if that reason changes, we would sell. For instance, we may have bought the stock because we expected earnings growth to accelerate, and if our confidence in earnings acceleration changes, then our thesis begins to erode. At that point we would sell.

What about a big price drop? Would that cause you to sell?

No. What happens is that we track all our stocks daily relative to the market, and if the relative price drops by 10%—for instance, the market is up 10% and the stock is flat, or the market is flat and the stock drops 10%—we have to review the stock and make sure that the investment thesis is intact and that we are not missing any information. Now, if the stock's relative price falls and we can't see anything wrong with our thesis or find any negative news, we may even consider adding to our position.

Do you hedge the currency?

When the yen kept on appreciating relative to the dollar, it was beneficial for our shareholders and so we didn't hedge. But in the last two years, we have become increasingly concerned about the yen. For that reason, we've implemented a hedging strategy in the last two years that is more of an exception given the 30-year history of the fund.

When we first implemented the strategy, I used a forward hedge [currency forwards obligate the seller to sell and the buyer to buy at a specified rate at a specified future date]. But the timing was bad—the hedge was premature. What we do now is to structure our hedge using yen puts [a put gives the purchaser the option to sell at a specified price by a specified date]. The put price is like an insurance premium, and we have protection in case the yen drops, but if the yen appreciates, the fund would benefit from the appreciation above the cost of the premium. So, it's asymmetrical—you get much larger protection on the downside and much less penalty if the yen appreciates. And I've kept the premium to no more than 2% of the fund's value, so that the maximum loss would be less than 2% from the hedging and yet, if the yen does depreciate, the potential is 6%, 8%, or 10%, depending on how much the yen depreciated.

What's your longer term outlook for Japan?

We're positive on the Japanese economy. Japan has gone through the longest recession in its post-war history, but we don't think it will last forever and there are indications the economy is beginning to come out of it. That's my first point.

Secondly, we find the Japanese opportunities extremely rich. There are some companies that are mature and slowing down, but there is also a new breed of company that is growing at 20% to 30% and they are likely to be the blue chips of tomorrow. We find these encouraging.

The third point is a caveat, and that is that looking out over the next few years, there may still be some currency risks. If you look at the actual return in Japan over the last year, the market has gone up close to 50% in local currency terms. But at the same time, the yen has depreciated from 85 to 105 to the dollar—about a 30% decline. Through much of The Japan Fund's history, U.S. investors have been able to gain both ways, both on the currency and on the market, but in the last couple of years, what's been given in stock returns has been taken away in currency. That's a new dynamic that we're mindful of, and we see that as one of the risks.

The Japanese economy is becoming mature and the numbers show that the growth rate in Japan has come down from 7% to 8% in the '70s to 4% to 5% through the '80s and now it's down to 1% to 2%. Our thinking is that the long-term opportunities are with the small-caps. In the short run, they are sensitive to the economy and they are sensitive to ups and downs in the market as a whole, so there's the volatility factor. But as a trend, if you hitch on to the right stocks in the growth area of Japan, I think you could do well.