Thematic Insight

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Mitsubishi UFJ Trust and Banking Corporation

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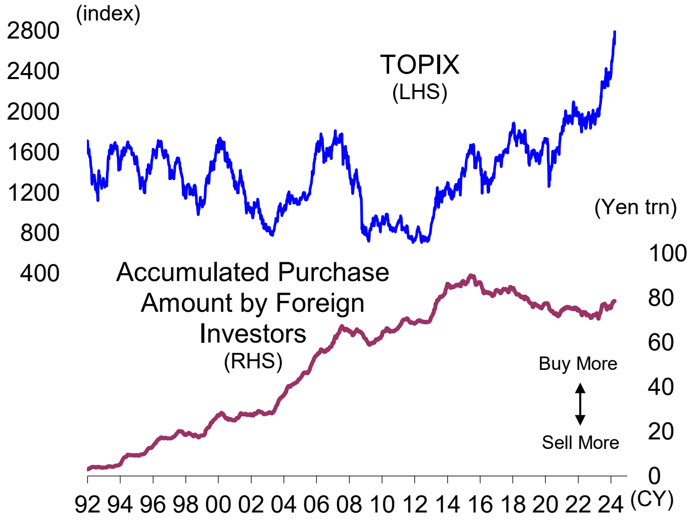
Japanese stocks rise despite absence of foreign investor buying

- **Japanese stocks rose despite foreign investors net selling a total of about JPY15trn from 2015 through 2022. We attribute this to curbs on equity financing, an increased amount of share buybacks, a peaking in the unwinding of cross-shareholdings by financial institutions, and an inflow of money from individuals aimed at accumulating assets. The supply-demand balance for Japanese stocks is improving.**
- **Foreign investors have a significant presence, accounting for around 67% of the total agency trading value. In the near term, we see the risk of a near-term pullback in Japanese stocks in line with a correction in global stock markets. Over the long term, however, we think it would be prudent to increase exposure to Japanese stocks when the market corrects.**

The Nikkei 225 marked an all-time high for the first time in 34 years. In terms of supply-demand, foreign investors were the main factor behind the rise in Japanese stocks. Overseas investors were also net buyers in Apr-Jun 2023 and January this year, driving overall market gains. However, from 2015 through 2022, Japanese stocks remained on an uptrend while foreign investors were net sellers to the tune of around JPY15trn in the cash market (Exhibit 1).

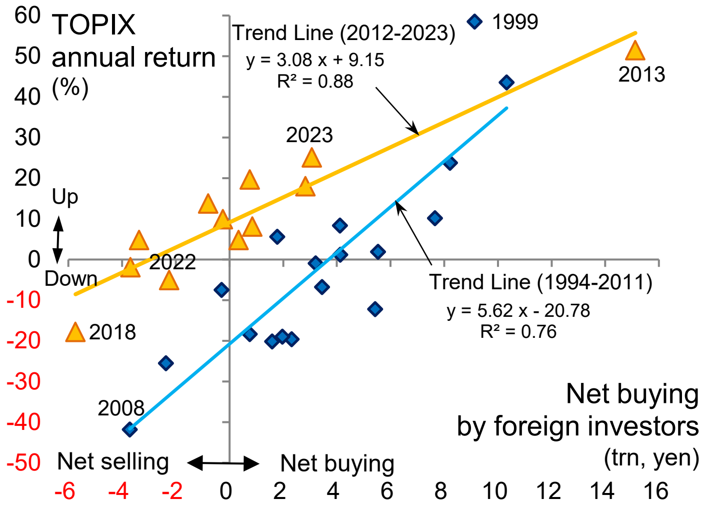
Since 1994, there has been a positive correlation between annual TOPIX performance and net buying by foreign investors. Japanese stocks tended to rise in years when foreign investors were net buyers. Splitting this up into the period between 1994-2011 as well as 2012-2023, the trend line shifted upward for the latter period and the slope has moderated (Exhibit 2). The Y-intercepts for the trend lines show that TOPIX was down 20.8% in the first period and up 9.1% for the second period, when foreign investors were neither net buyers nor net sellers. In this report, we look at the factors why the Japanese stock market has become less reliant on foreign investors.

Exhibit 1: Foreign Investors Had Been Net Sellers From 2015 to 2022



Purchase amount is accumulated value since the beginning of 1990; data as of Mar. 29, 2024.
Source: TSE, MUFG: Trust Bank

Exhibit 2: Impact of Foreign Investors' Transactions on Japanese Equity Returns Has Been Smaller



Note: Net purchases by foreign investors and the TOPIX return based on annual data from 1994-2023.
Source: TSE, MUFG: Trust Bank

Decline in equity financing and an increase in share buybacks

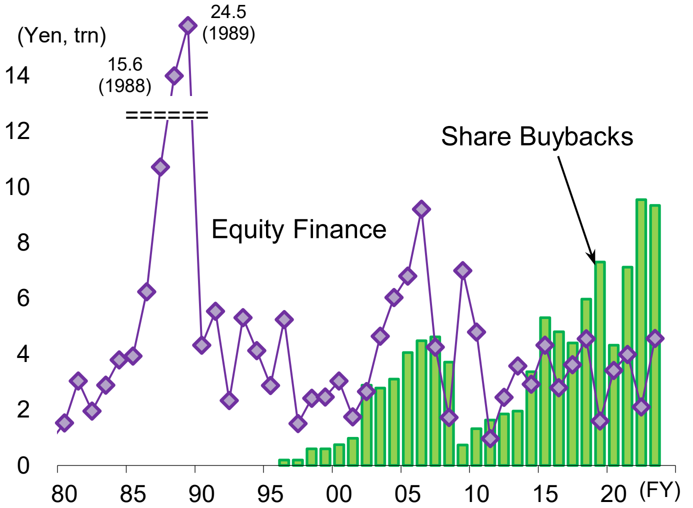
As potential upside catalysts for Japanese stocks, we first consider a decline in equity financing and an increase in share buybacks.

Until the 1990s, many companies in Japan viewed equity financing, such as public offerings and convertible bonds, as a low-cost means of raising funds, by looking at dividend yields and coupons. At that time, corporates tended to consider equity financing as share prices rose in response to Japan's high economic growth rate and the marketing stance of securities firms. During the asset bubble peak in 1988 and 1989, annual financing reached JPY15.6trn and JPY24.5trn, respectively (Exhibit 3).

Japanese stocks then fell sharply and the Japanese economy was in a prolonged slump, prompting companies to cut back on capex, which resulted in waning demand for equity financing (Exhibit 4). Although annual financing exceeded JPY6trn in 2004-2006 and 2009, it generally trended in the JPY2-5trn range. Since the Japanese stock market started its most recent upward trend in 2013, annual financing has remained within this range, and the ratio of financing to market cap was below 1%.

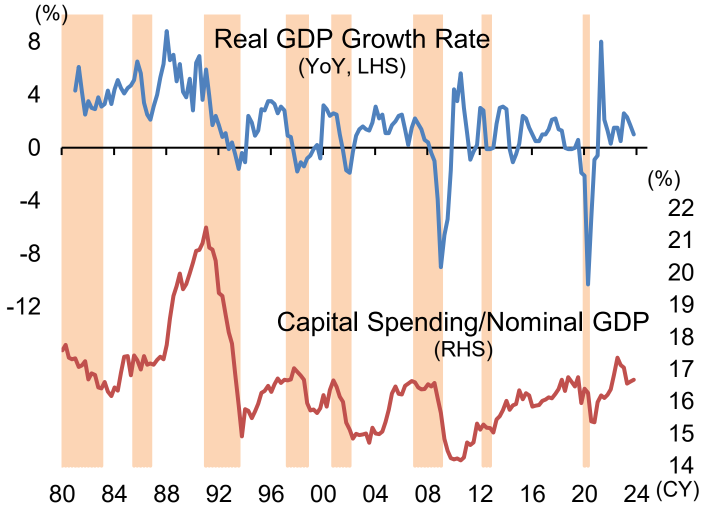
Meanwhile, listed companies increased share buybacks as a result of growing pressure from domestic and overseas institutional investors to return profits to shareholders. The overall value of share buybacks has consistently exceeded equity financing since 2015 (Exhibit 3). In 2023, buybacks totaled JPY8trn and financing was JPY4.6trn.

Exhibit 3: Value of Share Buybacks Has Exceeded Equity Financing Since 2015



Note: Equity finance includes secondary public offerings since FY2002; figures for 2023 are calendar year.
Source: Japan Securities Dealers Association, I-N Information Systems, MUFG: Trust Bank

Exhibit 4: Companies Reduced Capital Spending Amid Economic Downturn in the 1990s



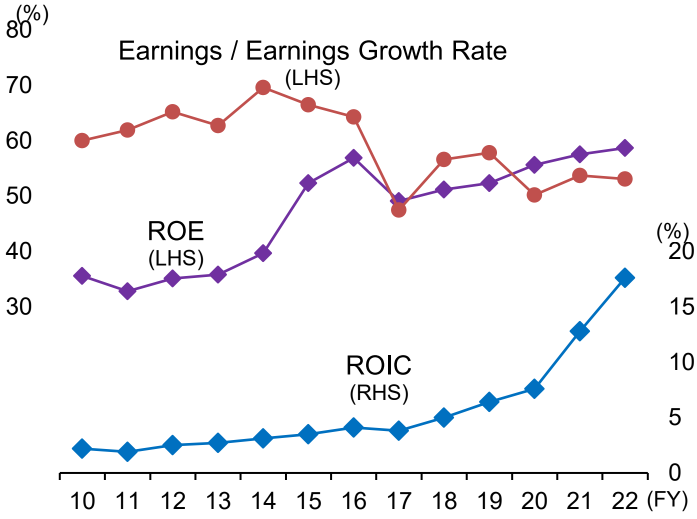
Note: Shaded areas indicate recession; data as of Dec. 2023.
Source: Cabinet Office, MUFG: Trust Bank

One reason for this is that Japanese companies have become more aware of their cost of capital. As the presence of foreign investors and domestic pension funds and investment trusts becomes more significant amid unwinding of cross-shareholdings, companies have often seen sharp declines in their share prices after announcing equity financing. The cost of capital for equity is high. Dialogue with institutional investors has enabled management to start to understand shareholder value and the interests of minority shareholders.

More companies are focusing on capital efficiency. The percentage of companies disclosing ROIC (return on invested capital) in their medium-term plans, is still not as high as ROE or profit/profit growth targets, but rose from 3.8% in FY17 to 17.6% in FY22 (Life Insurance Association of Japan, Exhibit 5).

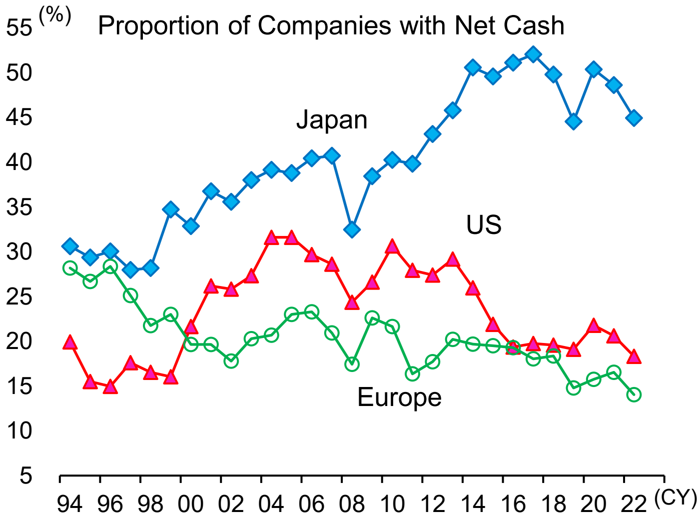
In addition, most of Japan's major listed companies have solid balance sheets. The ratio of companies with positive net cash has been trending downward in the US and Europe, and is currently below 20%. In Japan, this ratio rose through the late 2010s and stood at 44.9% in 2022 (Exhibit 6). Excessive shareholder returns are not desirable, but there is still plenty of room for Japanese companies to continue share buybacks.

Exhibit 5: More Companies Emphasizing ROIC as a KPI in Their Mid-term Business Plans Recently



Note: Universe is 1,200 listed companies with largest market caps; other options include "sales/sales growth rate," "profit margin on sales,' "dividend payout ratio," etc.; data as of 2022.
Source: Life Insurance Association, MUFG: Trust Bank

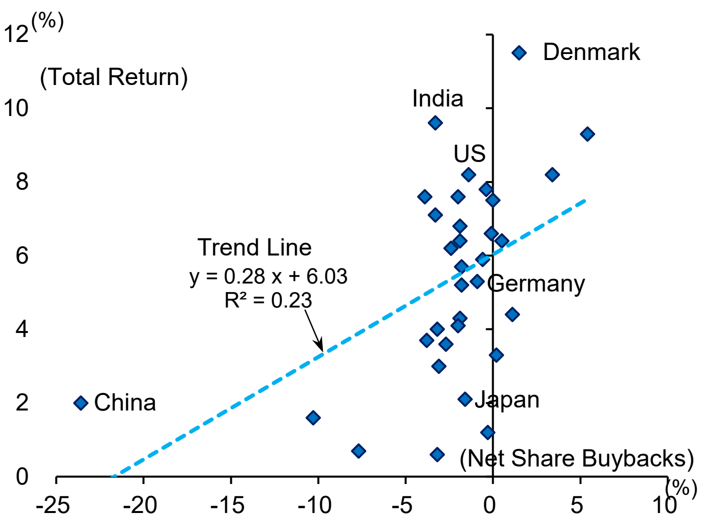
Exhibit 6: Japanese Companies Have Strong Financial Positions



Notes: Universe is companies included in MSCI USA, MSCI Europe and MSCI Japan Index (excluding financials); data as of Jun. 2022.
Source: FactSet, MUFG: Trust Bank

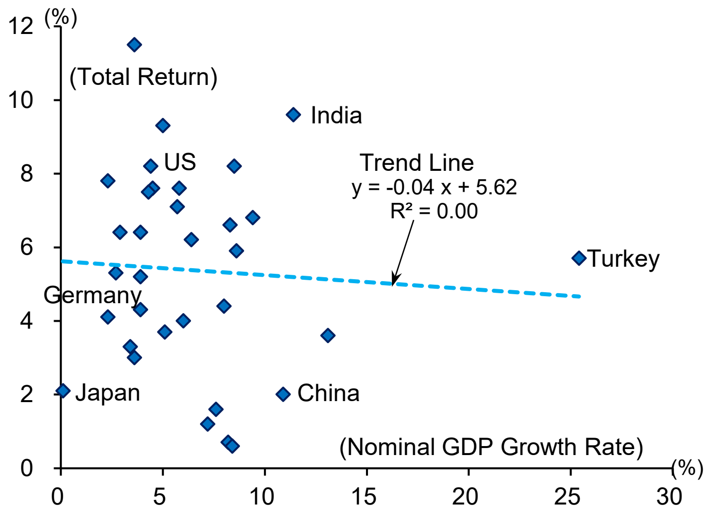
Equity financing and share buybacks also have a strong impact on returns in overseas markets. According to BCA Research, share buybacks are the most important of seven factors for total stock returns among 33 major countries, and the impact of nominal GDP growth is limited (1997 to 2022). In China and Poland, nominal GDP growth was high, but returns were low because of the large scale of equity financing (i.e., net share buybacks were in significant negative territory; see Exhibits 7 and 8). In these countries, startups have provided a boost for economic activity rather than listed companies, so investors may have been unable to reap the benefits despite the high growth rates.

Exhibit 7: Net Share Buybacks Influence Equity Returns in Major Countries



Note: Universe is MSCI Index of 33 countries, including the US, China, Japan, Germany, and the UK; based on data from 1997 to 2022; annualized total return including dividends; share buybacks less equity financing.
Source: BCA Research, MUFG: Trust Bank

Exhibit 8: However, Economic Growth Rates are Not Relevant



Note: Universe is MSCI Index of 33 countries, including the US, China, Japan, Germany, and the UK; based on data from 1997 to 2022; annualized total return including dividends; annualized nominal GDP growth rate.
Source: BCA Research, MUFG: Trust Bank

Financial institutions unwinding cross-shareholdings, corporate pension funds investing in Japanese stocks

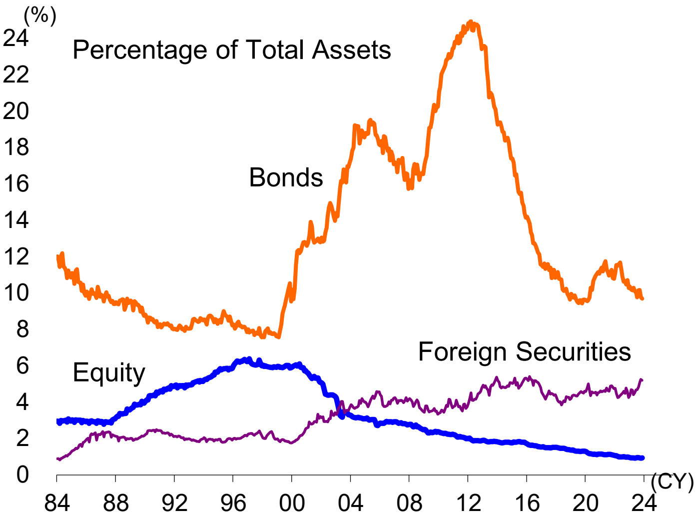
Secondly, the worst appears to be over in terms of selling of Japanese stocks as financial institutions unwind their cross shareholdings and corporate pension funds reduce equity weightings.

Since the late 1990s, banks and life insurers sold off their shareholdings in response to stricter rules on shareholders' equity and disposal of non-performing loans. Since FY97, city and regional banks and life insurers have been net sellers of Japanese stocks, by an average per year of JPY712bn and JPY623bn, respectively. Between FY99-03, when non-performing loans heightened concerns about the financial system, net selling by city and regional banks was between JPY1.3trn and JPY2.2trn.

The value of stockholdings held at banks nationwide fell from JPY47.49trn in FY96 to JPY23.9trn in FY15, and the percentage of total assets fell from 6.2% to 2.3% (Exhibit 9; JPY21.49trn, 1.6% of total assets in FY22). The value of shares held by life insurers fell from JPY32.02trn in FY96 to JPY19.81trn in FY08, from 17.1% to 7.6% of total assets (Japan Post Insurance has been included in industry data since FY09). Amid demands still ongoing to sell down strategic shareholdings, banks and life insurers continue to be net sellers of shares, but we do not think they are under pressure to do so.

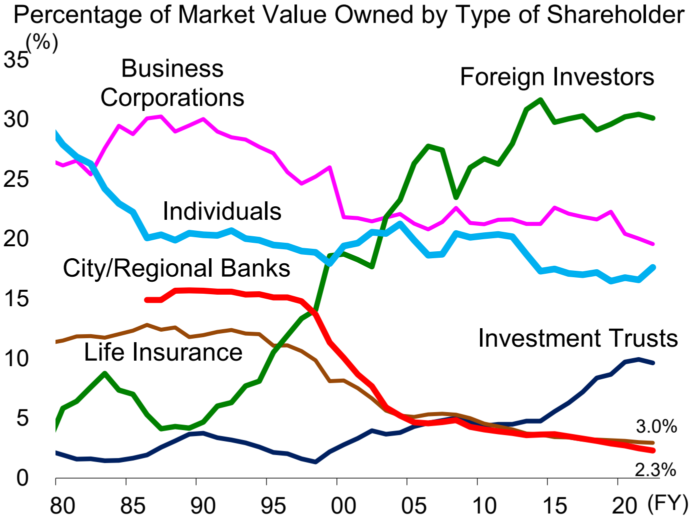
The TSE's Shareownership Survey shows ownership of shares by banks (excluding trust banks) fell from 15.1% of all assets in FY96 to 3.7% in FY15 and 2.3% in FY22. Stocks at life insurers as a proportion of all assets was 11.1%, 3.4%, and 3.0%, at those times (Exhibit 10). Even if banks and life insurers continue to sell off their shareholdings, we see limited risk that this will cause deterioration in the overall supply-demand balance for Japanese stocks. The combined ownership ratios of banks, insurance companies, and non-financial corporations, which are considered cross-shareholdings, fell from a peak of 69.1% in FY87 to 38.7% in FY22 (Exhibit 11). This ratio is on par with around 1960, (and is not a precise comparison, as the ratio was based on number of shares prior to 1970).

Exhibit 9: Banks Have Reduced Equity Holdings in Their Balance Sheets



Note: Bonds include JGBs, local government bonds, and corporate bonds; figures show the percentage of total assets; data as of Dec. 2023.
Source: BOJ, MUFG: Trust Bank

Exhibit 10: Banks and Insurers Have Decreased Their Presence as Shareholders



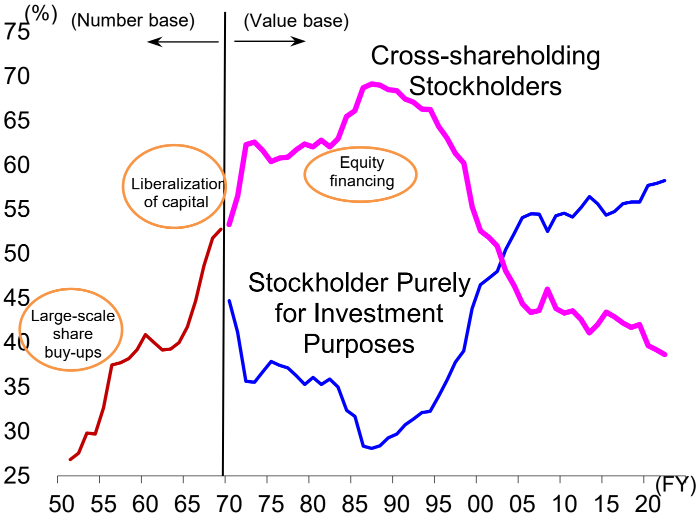
Note: Data as of FY2022.
Source: TSE, MUFG: Trust Bank

Furthermore, corporate pension funds have also sold off their Japanese equity holdings. Trust banks, which reflect trends in pension funds, were net sellers by JPY1.8-5.8trn annually in FY03-06 and FY12-13 (the net buying in FY14-15 was largely due to public pension funds). Corporate pension funds' domestic equity weighting fell from 36.5% in FY99 to 11.7% in FY15 (Exhibit 12).

Stock prices around the world fell sharply after the IT bubble, and the average yield of corporate pension funds fell into negative territory for three consecutive years (FY00-02). With the introduction of the retirement benefit accounting system in 2000, the decrease in pension assets due to market declines began to impact the profit and loss and shareholders' equity of the parent company. Against this backdrop, corporate pension funds reduced their pension obligations (e.g., by returning the substitutional portion of the employees' pension services) and reduced investment risk by lowering the assumed rate of return, and sold off Japanese equities. During the 2008 global financial crisis, the yen appreciated amid a global stock market correction, and the reduction of risk assets accelerated as the benefits of diversified investment failed to emerge.

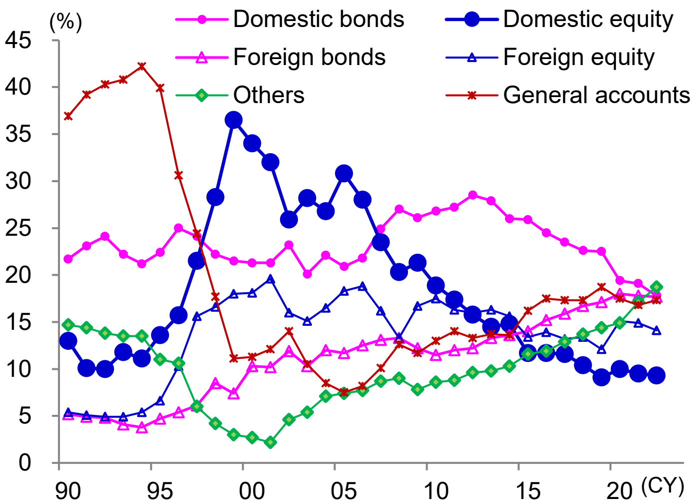
Corporate pension funds' domestic equity weighting fell to 9.3% in FY22. We think selling pressure on Japanese stocks has clearly declined as a result of the unwinding of cross-shareholdings and pension funds lowering their domestic equity weightings.

Exhibit 11: Decline of Cross-shareholding Stockholders and Rise of Pure Stockholders



Note: Cross-shareholding stockholders are the total for banks/trust banks (ex. pension funds and mutual funds), life insurers, and business corporations; investment stockholders are the total for retail investors, pension funds, mutual funds, and foreign investors; data as of FY2022.
Source: TSE, MUFG: Trust Bank

Exhibit 12: Domestic Corporate Pensions Have Reduced Domestic Equity Exposure



Note: Based on the Employees' Pension Fund up to 2003, and the total of the Employees' Pension Fund and defined benefit corporate pension from 2004 onward; others include alternative investments, convertible bonds, loans, etc.; data as of FY2022.
Source: Pension Fund Association, MUFG: Trust Bank

Individual investor capital flows into Japanese stocks

Finally, we think flow from individual investors have been coming into Japanese stocks since the mid-2010s.

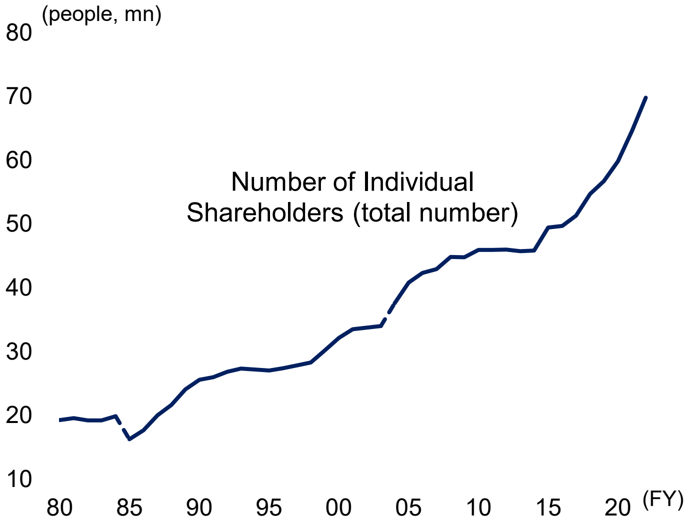
According to the TSE's Shareownership Survey, growth in the number of individual shareholders was sluggish from FY08, but then rose from 45.82mn in FY14 to 69.82mn in FY22 (Exhibit 13). The number of shareholders increased mainly due to IPOs for newly listed companies and through stock splits until FY16, but subsequently increased due to the number of shareholders at other companies, reaching 4.41mn in FY22 (Exhibit 14). In other words, many individuals are investing in the stock market (i.e., the secondary market) and becoming shareholders.

The individual investor ownership ratio fell in the early 2010s, but remained flat at around 17% from FY14 and rose 1.0ppt YoY in FY22. According to a survey on household financial decisions, the value of stocks held since 2021 has been in the JPY3mn range, or roughly 20% of financial assets (households of financial assets; some impact may be from change in survey methodology from mail-based to internet-based; see Exhibit 15). It appears that individual investors are increasing their equity holdings.

The large amount of net selling in cash equity transactions may have led to a misunderstanding that individual investors are selling Japanese stocks. However, net selling could be seen as one way to counter equity financing. It is not uncommon for individual investors to sell shares on the secondary market in order to secure funds to buy shares in a public offering or secondary offering. It is said that around 70-80% of equity financing deals goes to domestic individuals. Assuming that around half these funds come from existing equity holdings, we estimate net selling of JPY1.0-1.5trn per year for cash transactions associated with public offerings and secondary offerings.

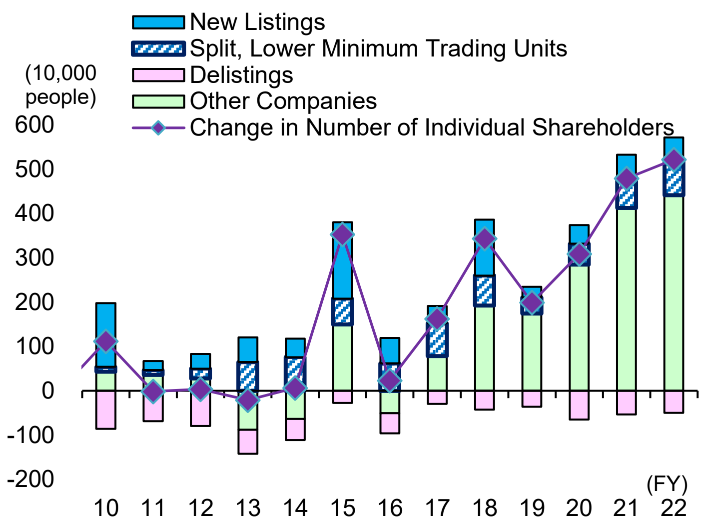
In addition to some speculative investors, some general retail investors also engage in margin trading. A growing number of individual investors buy stocks on margin when they do not have extra funds on hand, and then carry out the trades into cash accounts once they have available funds. If these stocks rise and investors take profits, the buying is done via margin trading and selling in the cash market. With the exception of 2008, when the global financial crisis hit, margin trades saw net buying and cash transactions net selling. In years when margin trading was large, the amount of net selling using cash transactions increased (Exhibit 16).

Exhibit 13: Significant Increase in Individual Shareholders



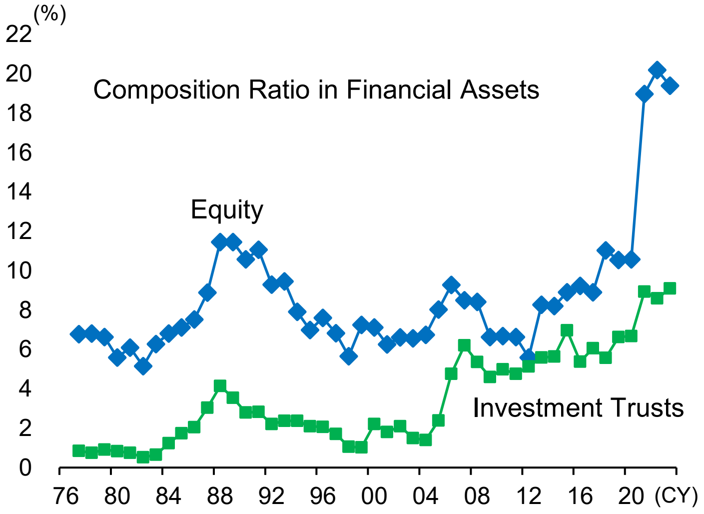
Note: Figures are cumulative total number of shareholders; data as of FY2022.
Source: TSE, MUFG: Trust Bank

Exhibit 14: Factor analysis for Changes in Number of Individual Shareholders



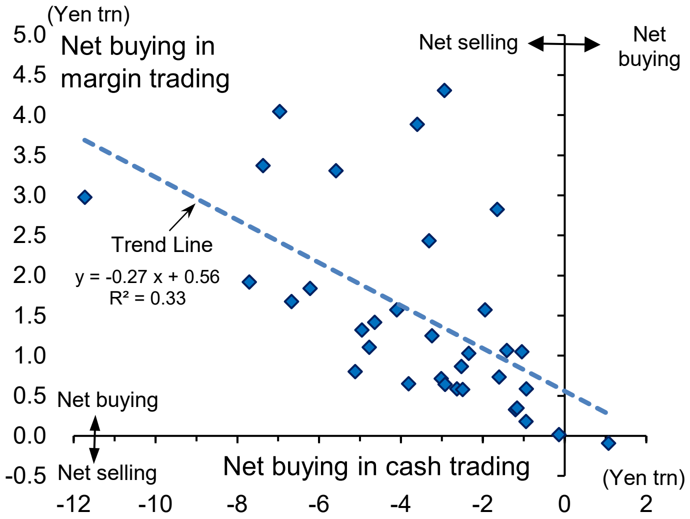
Note: Universe is all listed companies; figures are cumulative total number of shareholders; data as of end-FY2022.
Source: TSE, MUFG: Trust Bank

Exhibit 15: Increase in Equity and Investment Trust Exposure



Note: Universe is households with financial assets; data as of 2023.
Source: Central Council for Financial Services Information, MUFG: Trust Bank

Exhibit 16: Net Buying in Cash and Margin Trading are Negatively Correlated



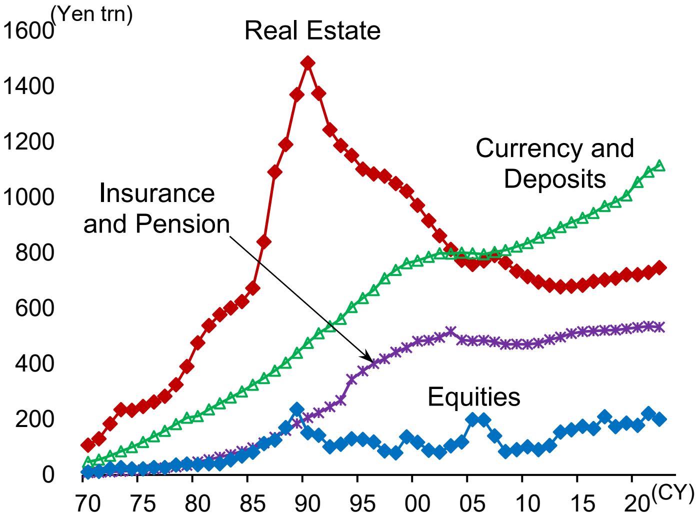
Note: Net purchases in cash and margin trading based on annual data from 1990 to 2023.
Source: TSE, MUFG: Trust Bank

Japanese individuals are often said to be risk averse because cash and deposits account for a large proportion of their financial assets. Until the 1980s, however, individuals took on risk through real estate to accumulate assets. According to the National Accounts Report, the value of real estate held by households reached JPY1,485trn in 1989, accounting for 54.3% of total assets. Cash and deposits totaled JPY476trn, or 17.4% of the total (Exhibit 17). The proportion of cash and deposits, including real estate and other non-financial assets, was not extremely high given the requirements to have some liquid assets.

Subsequently, in the late 1990s, the number of individuals who viewed real estate as a better asset than cash, deposits and stocks declined as a result of the prolonged decline in land prices (the Ministry of Land, Infrastructure, Transport and Tourism's survey of people's attitude toward land issues; Exhibit 18). In addition, problems arising from population decline and an increase in the number of empty homes have come to the fore, raising awareness of the difficulty of managing real estate assets. We believe there are growing needs for asset formation through investment in marketable securities rather than real estate. However, because a deflationary economy persisted through the 2010s, it was not a bad decision to hold assets in cash and deposits in order to maintain real purchasing power.

Households currently hold JPY747trn in real estate and JPY1,116bn in cash and deposits, accounting for 23.1% and 34.5% of total assets (as of FY22). We expect more individuals to build up assets using marketable securities such as Japanese equities, given risks that cash and deposits and bonds will be unable to maintain real purchasing power if the economy moves into inflation.

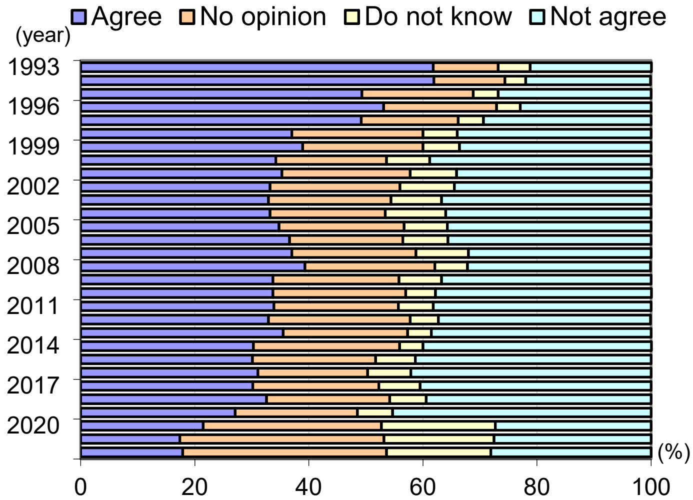
Exhibit 17: Asset Formation by Individuals in Real Estate Through the 1980s



Note: Equities based on market values; data as of 2022.

Source: Cabinet Office, MUFG: Trust Bank

Exhibit 18: Less Individuals Believe Real Estate are Profitable as an Asset



Note: Proportion of responses to the statement that real estate is a more profitable asset than savings or stocks; data as of FY2022.

Source: Ministry of Land, Infrastructure, Transport and Tourism, MUFG: Trust Bank

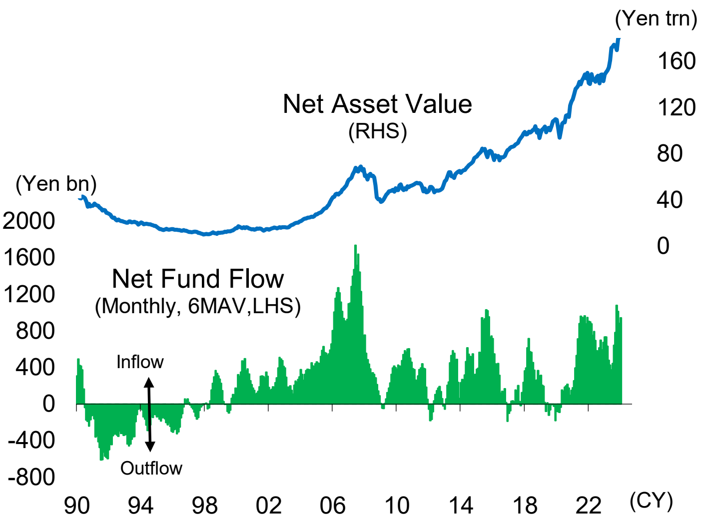
Another channel for retail investors investing in Japanese equities is equity investment trusts. Money flowed out of publicly offered equity investment trusts in the 1990s due to a decline in share prices, but since 1998 there has been sustained inflows of funds (excluding BoJ ETF purchases; Exhibit 19). In 2005-2007, 2015, and 2021-2023, when share prices rose and the yen weakened, there were net inflows of more than JPY7trn per year.

However, investment trusts have made almost no purchases of Japanese stocks. Since 2000, the trading activities of investment trusts on the cash market, including privately offered investment trusts, have remained largely flat. Individual investor capital has flowed into non-Japanese assets via investment trusts (in Japan, funds that invest in assets that could see impairment of the principal are classified as equity investment trusts). Specifically, in the mid-2000s, funds flowed into foreign bonds such as global sovereign open-end funds, followed by US REITs in the mid-2010s (mainly monthly dividend funds), and US stocks and other foreign equities from 2021 onward.

Going forward, we see a strong likelihood that some retail investor flow will go into Japanese stocks via equity investment trusts. Individual investors tend to shift toward assets with high actual returns. Over the past 10 years, the annualized return (including dividends) for Japanese stocks has been 8.6% (TOPIX; as of end-2023). The yen weakened during this period, but currency-adjusted returns were lower compared to those for US stocks but higher versus European and emerging markets (MSCI; Exhibit 20). The media often referred to the "lost decades" of the Japanese economy and the stock market, but the perception of Japanese stocks is not bad for individual investors, particularly younger generations. In 2023 on a standalone basis, Japanese stocks outperformed US stocks in terms of currency-adjusted returns.

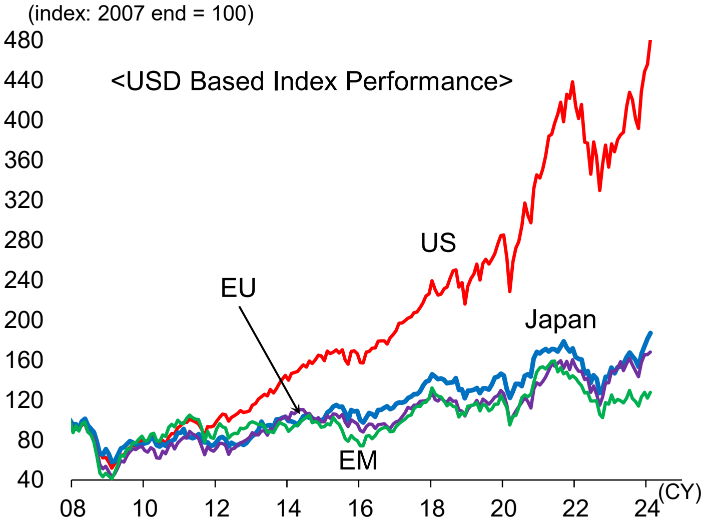
The USD/JPY rate is currently around JPY150/USD. We do not expect the yen to weaken further, given that the BoJ is taking a cautious stance on revising its monetary easing policy, and Japan's trade deficit has shrunk sharply. As long as the US economy remains solid, the dollar is unlikely to weaken or strengthen sharply against the yen, but investing in Japanese stocks without forex risk is still attractive.

Exhibit 19: Fund Inflows into Equity Investment Trusts are on the Rise



Note: Net inflows are inflow less cancellation and redemption amounts (excluding BOJ ETF purchases); 6 month average; data as of Jan. 2024.
Source: Investment Trusts Association, Japan, MUFG: Trust Bank

Exhibit 20: Japanese Equity Performance Has Been Better Than Europe and EM Equity Performance

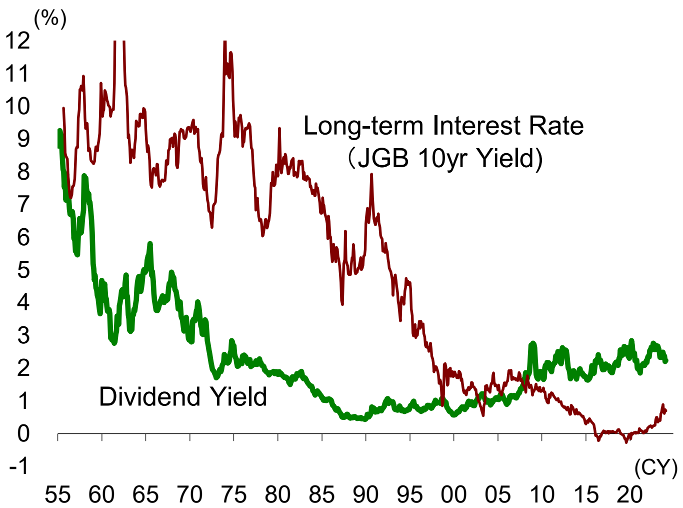


Note: Indices are MSCI USA for the US, MSCI Europe for the EU, MSCI Emerging Markets for EM, and MSCI Japan for Japan; data as of Feb. 2024.
Source: MSCI, MUFG: Trust Bank

The forecast dividend yield for the TOPIX is 2.2%, well above the yield on government bonds (as of 29 February; Exhibit 21). We think Japanese stocks remain attractive to individual investors who focus on income gains.

Against this backdrop, the NISA scheme was enhanced and made permanent from January 2024 (Exhibit 22). In the past, regular NISAs had a tax-free holding period of five years, but NISAs will become permanent and the tax-free period will become indefinite. Second, annual investment allowances will be expanded. The annual allowance will be increased from JPY1.2mn to JPY2.4mn for General NISAs and from JPY400,000 to JPY1.2mn for Tsumitate NISAs. The total tax-free allowance is JPY18mn. This will support long-term investment in individual stocks and investment trusts for the purpose of asset formation.

Exhibit 21: Dividend Yield is Clearly Higher Than Bond Yield



Note: Dividend yield is weighted average for TSE1 firms; based on actual results through 1987, current-FY forecasts from 1988; long-term interest rates are JGBs and telephone-telegraph bonds, data as of Jan. 2024.
Source: BOJ, TSE, MUFG: Trust Bank

Exhibit 22: NISA (Nippon Individual Savings Accounts) Scheme to Contribute to Long-term Investment

	Tsumitate NISA Used together	Growth NISA
Annual limits	JPY 1,200,000	JPY 2,400,000
Period of tax exemption	indefinite	indefinite
Lifetime investment limits (Total)	JPY 18,000,000 ※Managed using book value balance (recycable)	
		JPY 12,000,000
Account opening period	Permanent	Permanent
Investment options	Investment trusts suitable for long-term accumulation	Listed stocks, investment trusts, etc.
Target age	18 and over	18 and over
Relationship with the current system	Investments through end-2023 will be subject to the current taxation scheme (i.e. new taxation rules will not apply).	

Note: NISA (Nippon Individual Savings Account) was significantly enhanced in January 2024.
Source: FSA, MUFG: Trust Bank

Foreign investors' presence and points to watch for when investing in Japanese stocks

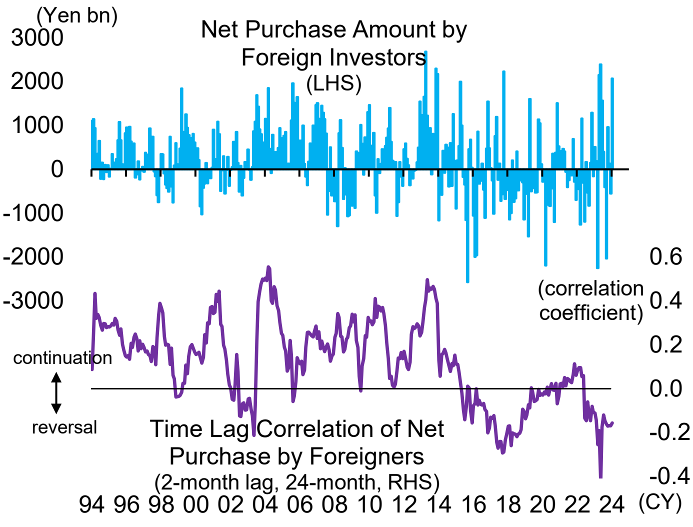
That said, foreign investors' trading activity remains important. Foreign investors accounted for 67.6% of the cash market trading value in 2023. Japanese stocks account for 5.5% of the total market cap of the global market. If some foreign investors allocate funds to Japanese stocks, the supply-demand balance will improve and share prices will rise sharply in the short term.

However, we note that trading behavior by overseas investors is different from the general perception. When overseas investors were sustained net buyers in the past, it was 18 months in 1998-2000 and 23 months in 2004-2006. However, the correlation between monthly net purchases and net purchases two months ago has been negative since 2015 (Exhibit 23). If foreign investors become net buyers, they may turn into net sellers a few months later. They were net buyers by JPY1.6-2.4trn per month between April and June last year, but turned into net sellers to the tune of JPY2.0trn in September. It is said to be long-term investors that focus on fundamentals, but trading trends are no longer sustainable.

We attribute this to diversification of foreign investors. Hedge funds and other investors focused on short-term trading gains have played a large part. Decisions made by these investors differ from pension funds in many respects. With ETFs expanding globally, individual investors who do not specialize in investment decisions determine capital flows into Japanese equity ETFs. We also think the global rise in passive investment is another factor. For passively managed funds, macro data and policy trends, which have an impact on the market as a whole, are more important than fundamentals and valuations for individual stocks. Many investors tend to make investment decisions based on similar statistics and events, so trading tends to be skewed.

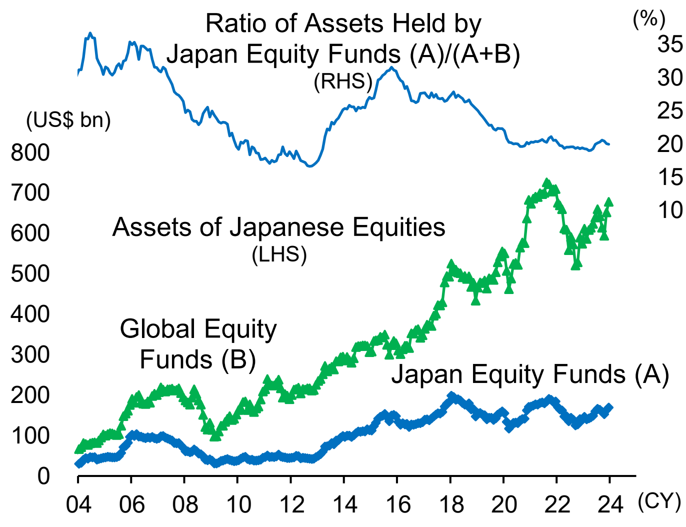
Second, the number of funds managing only Japanese stocks is relatively low, and a growing number of global equity funds are investing in Japanese stocks. We think this is because globalization has increased the correlation between developed-market equity returns and diminished the significance of asset allocation decisions by country. Looking at investment trusts and other funds for which data are available, we see that the value of Japanese stocks held by global equity funds is roughly four times that of funds specializing in Japanese stocks (EPFR; Exhibit 24).

Exhibit 23: Net Purchase by Foreign Investors are NOT Sustainable Recently



Note: Time lag correlation is a 24-month correlation coefficient between the net purchase value in the cash market and the net purchase value two months later; data as of Jan. 2024.
Source: TSE, MUFG: Trust Bank

Exhibit 24: More Japanese Equities are Held by Global Equity Funds



Note: Universe is foreign domicile equity funds; data as of Dec. 2023.
Source: EPFR, MUFG: Trust Bank

An increasing number of funds around the world are making investment decisions based on a direct comparison of individual companies. If Toyota's share price were to rise by 20-30%, we would expect more investors to conclude that Tesla and Volkswagen are relatively undervalued. We do not think Japanese stocks alone will continue to rise.

We attribute the buying of Japanese stocks since the start of the year to the rise in US stocks since November. If the stock market rises in the country of an investor, they tend to become more active in overseas equity investments. This reverse is also true. If US stocks correct, US investors are likely to become more cautious on Japanese stocks, leading to a slowdown in buying. Foreign investors continue to hold the key to Japanese equities in the short term. If the US economy clearly slows, Japanese stocks are likely to correct amid a global stock market correction.

The main reason for the Nikkei 225's all-time high is the improved earnings of Japanese companies. From a long-term perspective, this is contingent on a sustained improvement in earnings, but we expect Japanese stocks to advance even without major net buying by foreign investors, given curbs on equity financing, increased share buybacks, the peak-out of unwinding of cross-shareholdings by financial institutions, and an inflow of retail investors to accumulate assets. We think it would be desirable to increase the weighting of Japanese stocks if they are judged to be undervalued without being overly influenced by foreign investor trading trends.

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