The GPIF and the future of the Japanese equity market

Interview with Dr. Konari Uchida

Dr. Uchida is a professor specialising in corporate finance and corporate governance at Kyushu University Economics Department. His approach involves the application of data analysis to corporate governance, and his papers and remarks are quoted frequently. He advises the Japanese government on economic and business-related matters.

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Deloitte: It was announced that the policy asset mix for GPIF will be changed from the 2015 financial year. As a result, the proportion of Japanese equities will increase from the current 12%, to 25%. How do you evaluate this change?

Dr. Konari Uchida

I think that this is a welcome change. The public pension system is a system that is supposed to continue indefinitely. I think that it is preferable to manage public pension assets over the long term with equities that have the potential to create profit over the long term. However, the use of equities means that there are certain issues that need to be resolved.

Deloitte: What issues need to be resolved?

Dr. Konari Uchida

There are two. The first is companies having the ability to increase profits. The second is companies placing importance on shareholder returns.
Let me start by explaining the first issue. The ability to increase profits is the ability to maintain and improve Earnings Per Share (EPS). Japanese companies should be more mindful of profitability indicators such as EPS than they have been in the past. It is important that companies go beyond simply increasing profitability and reach profitability levels that exceed capital costs, which are normally shouldered by shareholders.

Deloitte: Are you suggesting that current market profitability is insufficient?

Dr. Konari Uchida

I made simple calculations, so my answer won't be precise, but please consider the following analysis. The Price to Earnings Ratio (PER) in the current market is 17-18. Assuming that the current level of profitability were to persist indefinitely, back-calculating from this PER would give us an expected return on equity (capital cost) of 5.7%. The yield on Japanese government bonds, which serves as an alternative to the risk-free rate, is approximately 0.47%. As such, the risk premium of equity is approximately 5%, which is a reasonable level considering the past risk premium.

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Deloitte: That is indeed a reasonable level if you consider current share prices. In that case, there really is no major problem, correct?

Dr. Konari Uchida
The current level of share prices is supported by this expected return of 5.7%, or rather this low risk-free rate of 0.47%. In other words, if profitability remains at its current level, then it is not unreasonable to expect an increase in share prices beyond current prices. It is therefore critical to accelerate business growth and improve profitability moving forward. Several policies have been enacted under Abenomics. Share prices went up as a result of these policies, but profitability also needs to be increased. The government will likely take more action on the economic front from this point forward, but it remains to be seen if such action will produce positive results.

Deloitte: Do you think that the Japanese version of the stewardship code will help to raise profitability?

Dr. Konari Uchida
I think that the Japanese stewardship code will play a major role. The GPIF complies with this code. I believe that this is absolutely the correct action to take.

Share prices are not decided by profitability alone. Remember the second issue that I said needs to be resolved: companies placing importance on the shareholder returns. To do this, companies should effectively use non-core assets on their balance sheets. If companies have extra cash and investment securities, they can then conduct share buybacks to boost shareholder returns, as is done in Europe and the United States.

Compared to other countries, Japan has a relatively low PBR. It was around 1.1 the last time I checked. This could be indicative of too many assets being held in proportion to profitability. In that case, it would be reasonable for companies to pass on surplus cash through share buybacks or other means and reduce assets for the benefit of shareholders. The GPIF is pre-empting other pension funds by complying with the Japanese stewardship code, and by linking the pursuit of shareholder returns to the revitalisation of the Japanese stock market.

Deloitte: These changes to the policy asset mix allow the GPIF to invest up to 5% in alternative assets (real estate, private equity, etc.). What is your view on this?

Dr. Konari Uchida
Diversification of investment assets generally serves to improve the risk-return profile. From this perspective, we should welcome the opportunity to diversify using new assets. However, it is necessary to put in place a system for monitoring new assets. We will do this in the case of the GPIF while moving forward with alternative assets. In this respect, I think that it is reasonable to set an initial limit of 5% for alternative assets.

Deloitte: Given its large size, what effects will the GPIF have on the Japanese market in the future?

Dr. Konari Uchida

Since the GPIF is a ¥130 trillion fund, it goes without saying that its effects are significant. I believe that raising the proportion of Japanese and overseas stocks, as we have done this time, will have a positive effect on returns over the long term. However, it is somewhat unfortunate that we couldn't raise the proportion of Japanese stocks earlier, as doing so would have produced a higher return. Moving forward, the GPIF expects, as an asset owner, to ask companies to improve their ability to increase profits and place importance on shareholder returns. I believe that doing so will further shift the emphasis of the Japanese stock market towards investors and create greater returns. The Japanese stewardship code and corporate governance code are also moving forward. We expect that these measures will provide strong support for the GPIF reforms and result in a virtuous cycle.