China overshadows Japanese managers' efforts to tout local strategies

Japan-focused strategies, once a major standalone market within global portfolios, are now being subsumed into wider regional and developed market funds

By Lisa Kim | September 19, 2022

The rise of China's stock markets, which has dominated the thoughts of global investors and reshaped approaches to investing in Asia, has left some Japanese asset managers fretting that it is increasingly difficult to sell their own local fund products to overseas investors.

While global investors traditionally selected Japan equity funds often alongside Asia ex-Japan strategies, executives at Japanese fund firms now compete with China equity funds and Asia ex-China funds.

"It's getting more difficult to get a result or sell pure Japanese equity products," says a top official at a Japanese asset management company who deals with global corporate strategy.

"About 10, 20 years ago, global investors thought Japanese equity as one equity asset class. But currently, there is China and then ex-China, and Japanese equity is now regarded as a part of the Asia equity," says the official, who requested not to be named.

With investors increasingly viewing Japan as part of the wider Asian market, the official says the firm has turned to include Japanese equities in Asian equity products and highlight its expertise in Japanese investments.

Even though China has faced unprecedented challenges over the past two years due to draconian Covid-19 measures and a widespread regulatory crackdown, which has raised concerns among global investors, the long-term growth trends are evident.

The size of China's stock market has grown rapidly over the past five to 10 years, while Japan's security market and the wider economy have stagnated. China's stock market capitalisation soared by 335% over the 10 years to reach Rmb91.61 trillion (US$13.13 trillion) at end-2021, while the value of Japan's stock market rose 188% over the same period, according to exchange data.

As China A-shares' weighting in global indices also continues to expand, global fund managers have been **rolling out** more products that carve out China, allowing investors to allocate more strategically to the Chinese market. For example, **Goldman Sachs Asset Management** introduced the **Goldman Sachs** Emerging Markets Ex-China Equity in June this year.

An official at another large Japanese asset manager says the importance of the Japanese market has been "shrinking for decades" and that there are alternative markets in Asia besides China competing for investment from global investors.

The official adds that investing in Japanese funds is considered part of the wider developed market allocation in global investor portfolios, with China and Asia ex-China strategies gaining traction.

"That puts us in, I guess, a more difficult position because we're becoming just a part of global allocation," the official says.

Flows into Japan-domiciled equity funds have been flat over the past few years.

Japan-domiciled equities funds had assets of ¥399.8 billion (US$2.8 billion) as of last month, down 20.1% from ¥482.8 billion in August last year, partly due to a fall in the valuation of the country's stocks, according to **Morningstar** data.

Last month, Japanese equities funds **bled** ¥45.6 billion from the previous month, even as net inflows into open-ended, Japan-domiciled funds increased by over ¥70 billion, according to Morningstar's estimates.

Japanese equity funds posted a median return of minus 18.3% as of end-August, data show.

Consultants have noticed a change in how global institutional investors approach Japan mandates, which are being swept up as part of large portfolios.

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"About two decades ago, our clients' portfolios would have a dedicated Japan allocation. That has since shifted, and the Japan exposure in our clients' portfolios is now largely being accounted for via global or international mandates," says Wilson Chen, Singapore-based managing director at **Cambridge Associates**.

Chen says institutional investors' dedicated Japan mandates are increasingly in niche areas, particularly engagement strategies and small and mid-caps.

When it comes to China, his firm has been delivering a different message to clients.

"As China capital markets started to open up to foreign investors, particularly in the last 10 years, we've advocated for our clients to add dedicated China public equity and private investment mandates to their portfolios," Chen says.

Despite the challenges of selling their strategies on the global stage, Japanese asset managers say there are several reasons domestic equity funds remain compelling for global investors.

Noriko Harada, head of global business development at **Asset Management One**, says many hidden small-cap stocks are waiting to be discovered among a sea of around 3,000 Japan-listed stocks.

"Japan is quite an under-researched market. There's a lot of undiscovered small and micro-cap stocks, which I think only a manager like us on the ground in Japan can access," Harada says.

"So you can say that Japan is an advanced country, but there is something to be found still," she adds.

Go Ikeda, chief manager of **Mitsubishi UFJ Kokusai Asset Management**'s investment planning division, says the Japanese economy is recovering thanks to the lifting of Covid travel restrictions, and that Japanese equities are trading at "attractive" valuations.

"From a medium to long-term perspective, Japanese companies are in the phase of accelerating corporate governance reforms, which leads to utilise capital efficiency and enhance corporate value," Ikeda says.

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