July 2016

By Yasushi Ishikawa, Head of Alternative Investment Fund Management Department

nikko am
Nikko Asset Management

THE NIKKO AM URAP INDEX:

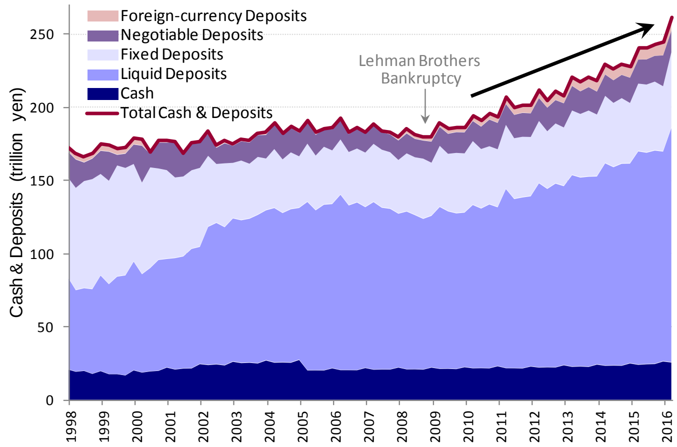
Identifying Stocks Which Show Consistent Improvement in ROE

In February 2014, Japan's Financial Services Agency released its "Principles for Responsible Institutional Investors"—otherwise known as Japan's Stewardship Code—with the stated aim of promoting the "sustainable growth of companies through investment and dialogue". The Code was adopted in May 2014 by the Government Pension Investment Fund (GPIF), the world's largest pension fund, in order to improve engagement between the firms that manage assets on its behalf and the companies they invest in. The Code has subsequently been adopted by many other asset owners and asset managers in Japan.

Furthermore, in August 2014, Japan's Ministry of Economy, Trade and Industry published the final report of the Ito Review, which was a series of formal discussions on the theme of "Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors". This report concluded that the low return on equity (ROE) of Japanese companies, which is about half the levels of their counterparts in the US and Europe, is a result of a lack of dialogue between institutional investors and the companies they invest in. Therefore, we expect that increasing dialogue between investors and corporate management would improve the capital efficiency of many firms.

At the same time, the number of companies in Japan with the potential to improve their capital efficiency has been increasing in recent years. Since the Global Financial Crisis, Japanese companies have continued to pile up their cash positions. The following chart shows the changes in the amount of accumulated cash at non-financial companies, broken down by asset type. Total cash and deposits increased from JPY 180 trillion (USD 2.0 trillion) at the end of 2008 to JPY 261 trillion (USD 2.3 trillion) as of March 2016. This represents a 45% increase in cash positions (JPY base) in just over seven years, mainly in liquid deposits yielding very low interest.

Japanese Companies' Accumulated Cash Since Global Financial Crisis

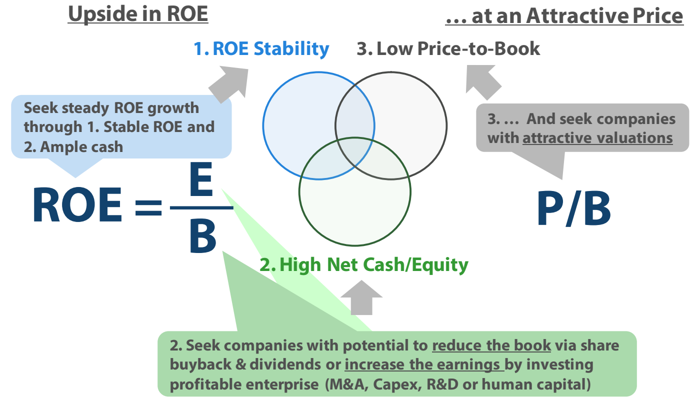


Source: Nikko Asset Management, Bank of Japan, as of 31 March 2016

However, as institutional investors increasingly engage with corporate management, more firms with excess cash on their balance sheets will feel compelled to use the cash to improve ROE and achieve sustainable growth. This is most likely to take the form of share buybacks and increased dividends or value-creating investments, such as M&A activity.

The Nikko AM URAP Index is designed to capture alpha (excess return over the market) from companies that are expected to consistently improve their ROE in this environment of increased company-investor engagement. URAP stands for "**U**pside in **R**OE at an **A**ttractive **P**rice," and the index focuses on names with the following three characteristics: (1) ROE stability; (2) high net cash as a percentage of equity; and (3) a low price-to-book ratio. These three characteristics are shown in the diagram below.

Nikko AM URAP Index Methodology



Source: Nikko Asset Management

Companies with high net cash have the potential to improve their ROE by using it for share buybacks (i.e. reducing their equity) or by making investments to boost their earnings, which could include engaging in M&A activity, capital expenditure, or spending on research and development. At the same time, we also take ROE stability into account in order to identify stocks that can consistently improve their ROE. However, high-ROE stocks tend to trade at a premium and their subsequent return will often underperform the market. Therefore, we also take the attractiveness of a stock's valuation (namely, its P/B ratio) into consideration in order to avoid the inclusion of overly expensive stocks.

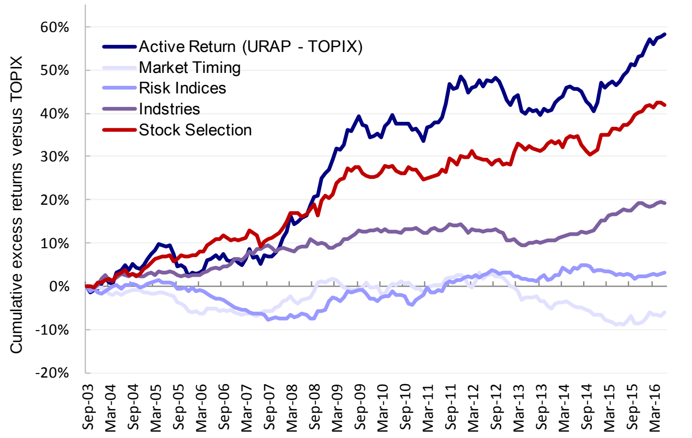
As for the index's methodology, we rebalance its constituents twice a year— at the end of March and September. To begin with, the 400 most liquid stocks are selected from the constituents of the TOPIX 500. Of these 400 names, we then select 100 stocks based on a score which takes into account the three aforementioned characteristics. The names are then weighted based on these scores (as opposed to weighting them according to market capitalization). Sector weights, according to the GICS 10 sector classifications, are then capped at 25%.

The dark blue line in the chart below shows the cumulative excess return of the URAP index over the TOPIX from October 2003 to June 2016 (before accounting for fees and transaction costs). The annualized excess return for the period is 4.65% with a tracking error of 5.11%, resulting in an information ratio of 0.91. The annual turnover due to semi-annual rebalancing is relatively low at 38% (one way).

Considering the fact that the index universe is composed of the 400 most liquid stocks in the Japanese market, we don't anticipate that factoring in transaction costs will cause significantly deterioration in performance[1]. As mentioned above, 2014 is a milestone as it marks the introduction of Japan's Stewardship Code and its subsequent adoption by the GPIF. Since then, the URAP index's outperformance appears to have become more consistent: in 2015 excess return was 11.05% with an information ratio of 2.06; while year-to-date excess return for the first half of 2016 was 4.84%, with an annualized information ratio of 2.55.

The next chart also shows the cumulative contributions of Barra risk model factors Market Timing, Risk Indices, Industries, and Stock Selection. It is worth noting that most of the excess return comes from Stock Selections after removing the contributions of Market Timing (beta), Risk Indices, and Industries.

Nikko AM URAP Index: Cumulative Contribution to Active Return



Note: Returns are JPY based, before fees and trading costs. The simulation period is from October 2003 through June 2016. TOPIX with Dividends is used as benchmark. The data is based on historic simulation and is not a guarantee of future investment returns.

Source: Nikko Asset Management

Factors such as Value, Size, Momentum and Volatility, which tend to be the focus of smart beta indices, are included in the Risk Indices. However, we can see that the contribution from Risk Indices has been less consistent. This implies that the URAP index captures a different source of alpha than factor premium or anomaly—sources which have already been commoditized as smart beta vehicles.

We believe that our thorough understanding both of Japanese market structures and changes in the environment for investors (and securities-issuing companies) allows us, via the smart beta approach, to capture sources of excess return. Indeed, this is indicated by the performance shown above. We will continue to confirm the validity of this approach by carefully monitoring future performance.

About the Author

Yasushi Ishikawa joined Nikko Asset Management in March 2016 as Head of Alternative Investment Fund Management Department.

Prior to joining Nikko Asset Management, he was Executive Director, Senior Quantitative Strategist in Quantitative Research Department under Financial Engineering & Technology Research Center in Nomura Securities where he developed quantitative research and strategies mainly in global equities (including smart beta products) and their marketing for 16 years, including international positions in London and New York for 11 years.

He holds a B.A. (Physics) from the University of Tokyo and a Master of Science (Physics) from the Graduate School at the University of Tokyo. He is also a chartered member of the Securities Analysts Association of Japan (CMA).

[1] For example, if we assume 50bp as a transaction cost, the deterioration in performance would be estimated as about 0.38% per year based on the calculation; (one-way turnover, 38%) x (both ways, 2) x (transaction cost, 50bp).

Important Information