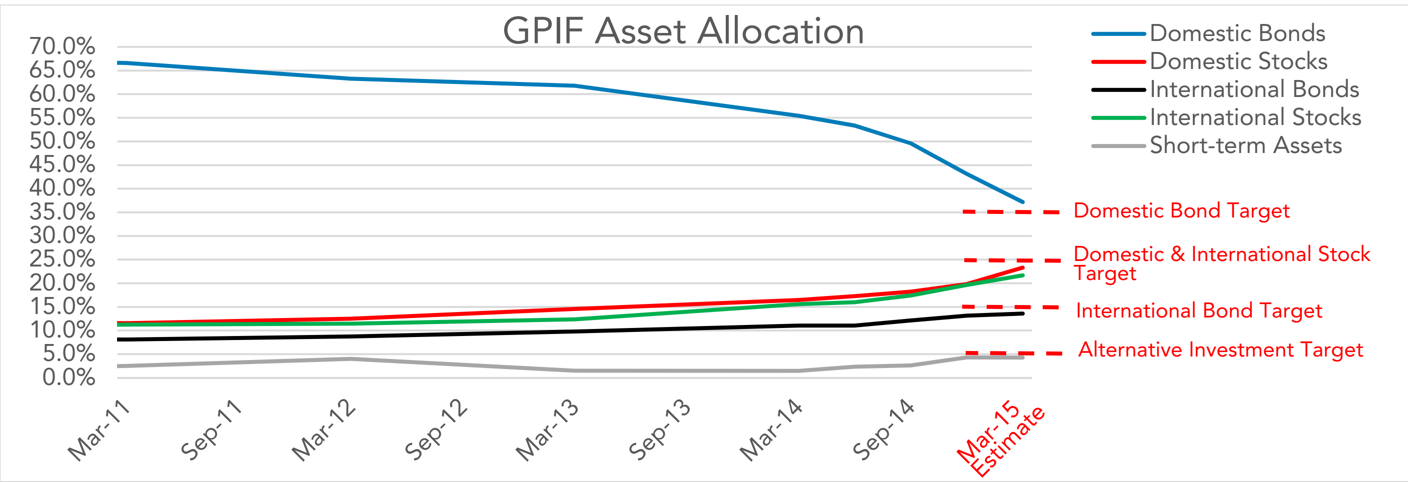
HORSEMAN CAPITAL MANAGEMENT

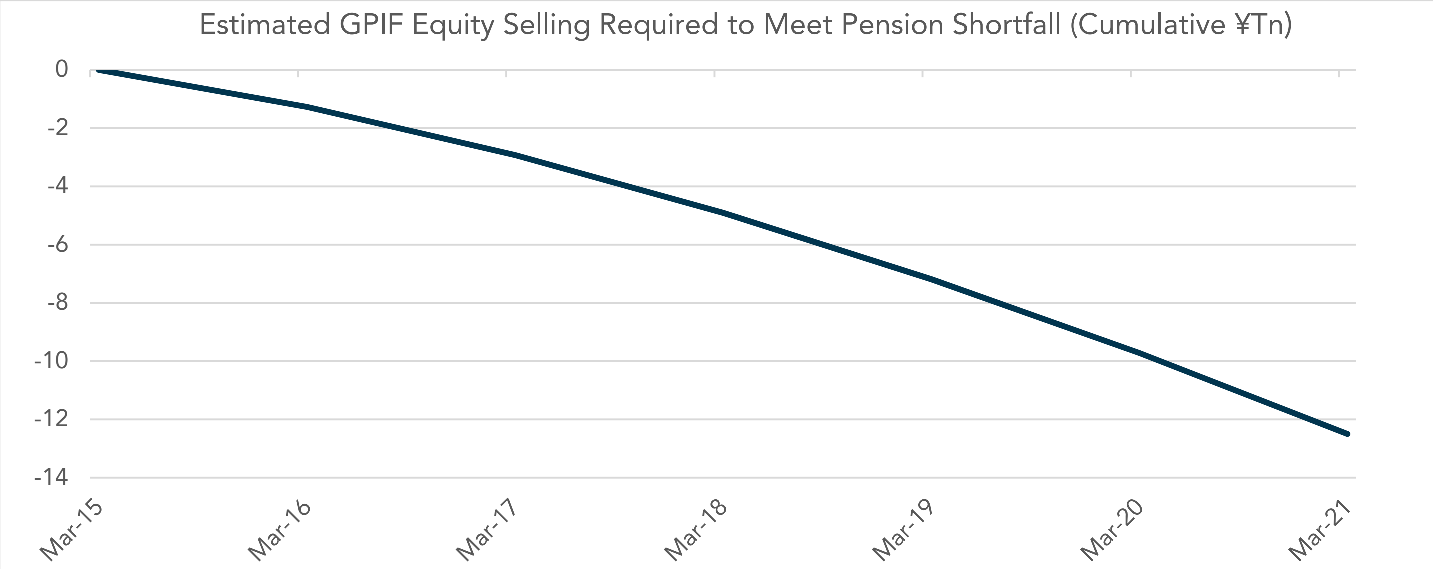
Japan – GPIF will soon start selling equities and buying Yen

There has been a significant amount of media focus on the positive market effects from Japan's Government Pension Investment Fund (GPIF) shift to "risk assets". As most Japan watchers know, the GPIF is the largest pension fund in the world and the shift sees a doubling of its weighting towards equities compared to pre-Abenomics levels. What has not been flagged in the media is that the shift is now almost completed. Nor has it been highlighted that once the shift is completed then the recently purchased equities and foreign risk assets will be sold down over time to cover the pension shortfall. It is undoubtable that the GPIF has generated some of the most significant flows pushing up Japanese equity prices and weakening the Yen of late. We are now likely to see a complete reversal of the equity buying over what I estimate will be as little as four years due to pension shortfall dynamics explained below. At the same time a strengthening Yen, as foreign currency position are reduced to cover the shortfall, should compound the downside for Japanese equities.

I have long been aware of the potential tailwind for Japanese equities and agree that the GPIF was too focused on low yielding Japanese Government Bonds. Managed correctly over a number of years, with the interest of pension contributors in mind, this shift should not have moved markets on its own accord. As everyone in markets knows, pushing up the price of assets as you buy them is not exactly looking after the best interests of your underlying investor. Recent data from the GPIF shows that they purchased Japanese equities in the quarter to December 2014 at nearly triple the rate of the prior quarter (¥1.7tn versus ¥0.6tn). If we assume the shift has continued at the same pace again this quarter, and include returns seen in different asset classes so far this year, we can estimate the portfolio as at the end of this month of March 2015. As the chart below shows, the world's largest pension fund has almost completed what is probably the largest ever shift into risk assets ever seen in less than five months after the new targets where announced. Extraordinarily quick going.



Once the GPIF reaches its new target weightings the equity buying pressure will turn to equity selling due to the pension shortfall. Most media articles hype up the GPIF equity buying but fail to mention that the pension fund already has a shortfall which forces it to sell down assets. With the money the fund pays out to pensioners greater than the money it takes in from pension contributors. The difference in 2013 was ¥4tn or 3.1% of the funds' total assets. With low investment returns of 2.2% in 2013, the shortfall has to come from selling down around 0.9% (¥1.14tn) worth of total assets. The pension shortfall, and subsequent asset sell down, is set to increase at an accelerating rate due to demographic pressures. Almost all residents of Japan between 20 and 60 years old are required to be "contributors" to the Basic Pension component of the GPIF's reserve fund. Meanwhile most people over 65 years of age are "beneficiaries" of the Basic Pension. The population of "contributors" is forecast to decline -2.8% by 2019 whilst the population of "beneficiaries" will increase +10.7% by 2019. There are complicating factors in the Employee Pension component of the fund as it relates to percentage of salary, differing retirement ages and non-working spouse pensions however the demographic pressures are largely the same. With these complications in mind I have created a simple model to provide a rough idea of how fast the shortfall and subsequent asset sell down will increase (using the average contribution and benefit against change in number of "contributors" and "beneficiaries"). I add back a 2% total asset return in each year, which is the average return seen at the GPIF since inception. Under these assumptions the combined asset sell down required to cover the pension shortfall from March 2015 to March 2019 will be ¥28.7tn. If the GPIF sticks to the 25% targeted asset weighting towards domestic equities then it will have to sell down ¥7.2tn of domestic equities (25% of ¥28.7tn) by March 2019. This amount is similar to the total equity purchases by the GPIF over the last three years. In other words all of the recent buying pressure will have more than reversed in the next 4 years. As the chart below reflects this sell down accelerates beyond 2019.



The GPIF's actuaries estimate there will be ¥20tn of "expected pay-outs" between 2015 and 2019 using far more favourable Cabinet Office assumptions such as a 3.7% nominal return on investments and a 2.8% annual wage increase. This would mean on their assumptions that ¥5tn of equities need to be sold down by 2019, or 65% of the recent equity purchases would be reversed. The GPIF's actuaries and our numbers do not disagree on the direction of the asset sell down just the speed at which it occurs. The sell down could even be faster than our estimate if wages (which impact contributions) return to their long term declining trend in Japan with worsening demographic pressures (rather than our assumption of flat wages). Or if markets returns are lower than the 2% average. Both of these risks I see as highly likely. The GPIF on its more favourable assumptions actually estimates that the reserve fund assets will eventually be sold down to a level equal to only one year of distributions.

There is of course a potential scenario whereby the shift into equities continues beyond the target weightings towards the minimum and maximum permissible boundaries by asset class. Yasuhiro Yonezawa the chair of GPIF investment committee has suggest publically at the Nomura Investor Conference that *"(the fund) may be able to engage in tactical allocation … but in principle it will be targeting median values" (Source: Nomura Research)*. If a "tactical" shift did continue past the target (median) values at the same rate as the last quarter the GPIF would reach the minimum 25% weighting in domestic bonds in less than a year. At which point I estimate equities would be around 29% of assets. From that point, without a change to the maximum/minimum weighting bands, the GPIF would be forced to sell equities at a faster rate than the chart above (to cover 29% of the shortfall rather than 25%). Any further Japan and/or global equity rally would essentially bring the date at which bonds reach the minimum weighting forward. Data showing the GPIF shift has been faster in this current quarter than last would also bring forward this date.

There are numerous comments in the media of the GPIF "whale" buyer being a larger factor in the equity market this year. Sales traders that we speak to at the coal face of markets increasingly refer to an even stronger "invisible hand" lifting Japanese Equities and the interesting timing following the appointment of the new aggressive CIO Mizuno San. The Tokyo Stock Exchange flow data indicates an acceleration in daily net purchases by Trust Banks. Trust Banks largely transact on behalf of pension funds, including corporate pension funds who we hear have been selling equities, which would mean GPIF net buying is understated in this data. Trust Funds have accounted for 70% of net purchases by investor type in Japanese equities over the last 5 months, a substantial increase from historical levels and the largest buying force in Japanese equities by a significant multiple. This is certainly enough to have pushed the equity market significantly higher. We note that the Topix Index has outperformed MSCI World Ex Japan by 14.9% since the new targets where announced on 31st October 2014. By way of reference the Japanese small cap Mothers Index attracts little GPIF buying and is down -5.74% this year, an indication of what Japanese stocks would be doing without GPIF demand?

It is not just domestic equity markets which have been impacted, the GPIF has been the dominant flow in Yen currency markets. The GPIF sold around ¥2.3tn of Yen in the last quarter to buy foreign assets. This is 50% larger than Japan's Current Account Surplus of ¥1.5tn in the same quarter. The GPIF certainly acknowledges it is large enough to move currency markets with the GPIF Director of Planning recently suggesting *"with the fund's assets being so big, we have a problem with whether the market can absorb it if we start doing things such as currency futures"* (Link: [Washington Post: Zero Yen Hedge Policy Astounds Japan Pension Fund's Adviser]). It is slightly confusing to me that the GPIF is willing to sell Yen outright to buy foreign assets but not willing to offset this in a currency neutral transaction, by buying Yen via the futures at the same time (the likely counterpart hedging of the futures would result in Yen buying). As with Japanese equities the Yen pressures will soon reverse as the GPIF has to sell the recently purchased overseas assets and buy Yen to cover the pension shortfall.

Over the last few weeks in London I have watched the Narcissus plants (including the Daffodil) bloom. Narcissus plants were introduced to the UK from sunnier Mediterranean climates and often bloom well before spring truly starts. Only be buffeted by the inevitable March cold snap and wither before summer truly starts. Interestingly in Japan they are often called se-chu-ka (midst-the-snow flowers) where they face similar frosty reception to an early bloom. I also can't help but think of Narcissus in Greek Mythology who became so enthralled with his own image that he stopped hunting and withered away with nothing left but a yellow flower in his place. I was recently told that Prime Minister Abe has had a "QUICK" stock market screen installed in his office, which "he looks at a lot". Presumably as he associates his success and popularity with stock market performance. The below cartoon is my attempt to capture the image that springs to my mind of the modern day Narcissus. The Appendix to this note includes background information on how Abe San managed to boost the equity buying and Yen selling of a supposedly independent pension fund. Like the Narcissus plants, and Narcissus himself, Abe's search for short term gains will likely lead to long term pain. For Narcissus the distraction of his own image meant he neglected what was important in the real world. That Abe is distracted by short term popularity gains from a rising equity market is a crying shame. He was already facing a near impossible task in reforming Japan. Which would have required pushing through measures painful in the short term in return for much needed long term economic gains. Abe San's own buying power with the GPIF will soon turn into selling pressure. It is hard say exactly when this will be but it looks likely within the next few quarters. I think this quote, from Mr Nick Leeson formerly of Barings Bank and someone with experience in trying to push up the Nikkei, makes an interesting argument from a historical context that you do not necessarily have to wait for the buyer's flows to reverse before shorting. *"My position was so big in the Nikkei that I was becoming too obvious, and the market was beginning to discount my purchases and sell against them because they sensed I'd soon have to unwind – and they didn't want to be hung with me" (Nick Leeson, Rouge Trader 1996).* Japanese equities remains an attractive short for this and more fundamental reasons I am happy to discuss.

APPENDIX 1. Background on the GPIF.

The GPIF shift is arguably one of the few policy actions that Prime Minister Abe has actually implemented fully from the original Third Arrow. It remains striking to me that plans for the Government Pension Investment Fund even be included in the Third Arrow presentations given the money belongs to those private individuals that have made pension contributions. Almost all registered Japanese residents of working age are required to contribute, it should probably be called the PPIF (Peoples Pension Investment Fund). Some have publically expressed their concerns around the motives of this shift including Nobusuke Tamaki, a former GPIF official *"The [GPIF] shouldn't be used as a tool for short-term-oriented intervention in asset markets. It's not a piggy bank for short-term policy purposes. Each penny of the GPIF is pension money"* (link: [WSJ: Giant Japanese Fund]). The President of the GPIF Takahiro Mitani has also made some rather blunt remarks by Japan standards *"some people want us to move away from JGBs and to move towards stocks, [But] our purpose is not to support the level of stock prices in Japan. Their expectation for us may be a little too convenient."* (Link: [Financial Times Japan pension fund warns of unfair Abe pressure]). Mitani San has since been side-lined, with the higher risk asset allocation targets being set by a largely new Investment Committee. The majority of the old Committee members, including the Committee Head, were replaced by individuals handpicked by

Prime Minister Abe (7 of the 8 members). The actual process of shifting into risk assets (I.E. the rate of buying) is being implemented by the GPIF's first ever Chief Investment Officer Hiromichi Mizuno, again handpicked by Abe San. A recent bill proposed by the Ministry of Health Labour and Welfare to install a GPIF governing board independent from political interference has been declined for now by the Abe Cabinet.

The Topix Index is up +109% since 2012 and MSCI World Ex Japan up +123% in Yen terms with the weakening Yen. A reversal of GPIF equity buying and Yen selling could lead to substantial losses on aggressively purchased risk assets. This would bode very poorly for political stability. Recently one of Prime Minister Abe's chief advisors Yasutoshi Nishimura attempted to justify the GPIF asset reallocation in a public forum. To which the head of the Japanese Trade Union Confederation Nobuaki Koga countered *"Mr. Nishimura, I wish you hadn't talked about GPIF. The money in the pension reserve fund is something labour and management built up … I think that there will be opposition if people's money is being invested in a high risk way, in an organization in which the opinions of labour and management are not reflected."* His comment elicited the only spontaneous clapping of the night (link: WSJ pension-fund-debate). Japan's careful management of what pension reserves it does have is highly critical with pension payments accounting for 12.7% of national income and over 20% of household consumption in some prefectures (MHLW Pension Report). A ratio set to rise with demographics as pension pay-outs increase… until they can't increase that is. Prime Minister Abe may have only brought that date forward.

INFORMATION

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