Thematic Insight

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Japanese stocks look appealing for investors eyeing up small caps

- **In the US, Opinions are split on the sustainability of the rally in small caps. But given the concentration of market capitalization in megacaps such as the Magnificent Seven, we see increasing value in adding small caps to portfolios as a way of diversifying investment.**
- **For investors looking at small caps, Japanese names in this sector look attractive. Although margins for Japanese small caps are lower than those for the large caps, many of these small caps are in good financial health, are leading companies operating in niche markets, and offer higher profit growth. With industry reorganization continuing apace, winners in domestic demand sectors should be able to expand sales and profits through market share growth.**
- **We see some concerns that the second stage of TOPIX revisions may result in a selloff by passive funds, but do not expect this to be a major drag on share prices as Japanese small caps look significantly undervalued. Over the long term, we expect the revisions to lead to heightened management awareness of corporate governance and increased corporate value.**

US market: Signs of a rebound for small caps

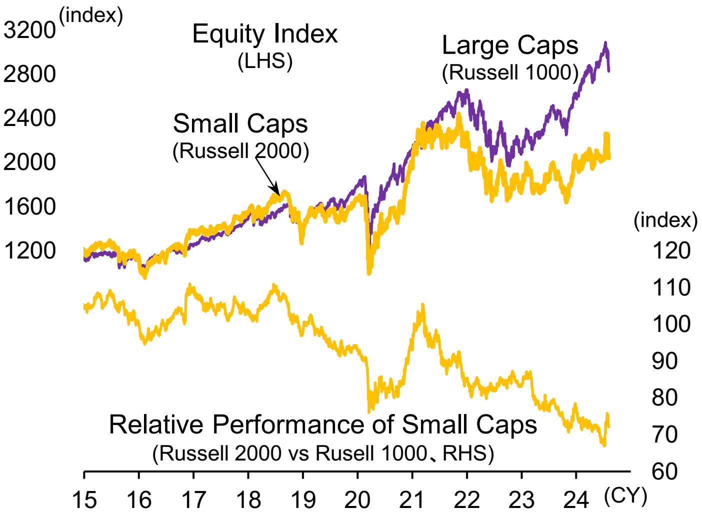
In the US, large-cap growth stocks corrected in July, while small caps staged a major rebound. This was particularly apparent on 11 July when the Nasdaq Composite Index fell 1.95% while the Russell 2000 rose 3.57%. The return differential of 5.52% between the two indices was the largest one-day divergence since 1990. Over the roughly four-year period since the start of the pandemic, apart from a correction in 2022, large-cap growth stocks such as the Magnificent Seven have driven market returns, while small-cap stocks have performed poorly (Exhibit 1). Investor interest is growing in whether stock selection trends will shift.

With many investors still skeptical about the prospects for a sustained rally for small caps, it is also said that the rebound in share prices was mainly driven by covering of bearish positions. Many US small caps are highly sensitive to the wider economy, while also having relatively low profitability. Over the past 10 years, pretax profit margins averaged 12.9% for large caps and 4.3% for small caps (Exhibit 2). Margins also turned negative for small caps during economic downturns. There is a risk that earnings could fall short of expectations as risks arise of a gradual slowdown in the economy.

In addition, US small caps typically have weak balance sheets. The average debt-to-equity ratio of small caps has exceeded that of large caps since the 2000s. Although the ratio has improved slightly since the pandemic, it is currently at 107.4% (Exhibit 3). Rapid monetary tightening has pushed up interest rates, and small caps may be susceptible to such high interest rates when loans and bonds are refinanced. Although the FRB is expected to start cutting rates again in September, relative returns of small caps have not always improved in the past following the initial rate cut due to concerns about earnings and the economy.

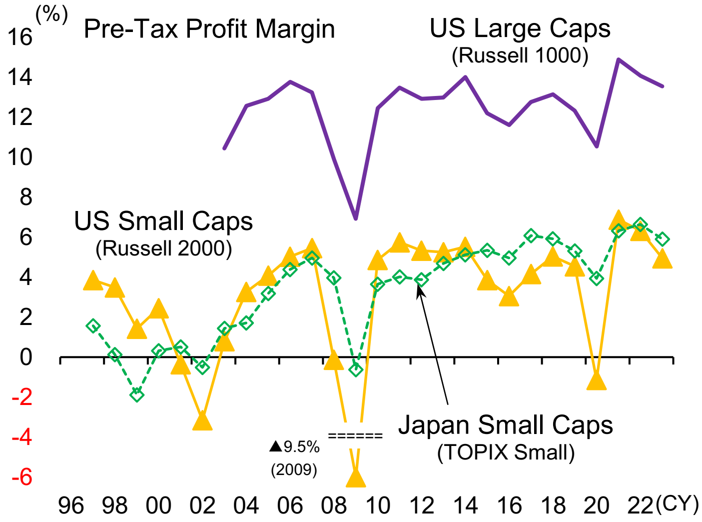
However, small caps look significantly undervalued. The 12-month forward P/E for small caps is 17.6x (MSCI USA Small) and 21.2x for the large caps (MSCI USA). The relative P/E for small caps vs large caps has fallen to 0.83x, the lowest since 2004 (as of end-June; Exhibit 4). In the US, the forward P/E for small caps tends to exceed that of large caps even during periods of economic expansion. We believe concerns about earnings structures and financial positions may already be priced in.

Exhibit 1: In the U.S., There are Signs That the Relative Returns of Small Caps Have Hit Their Bottom



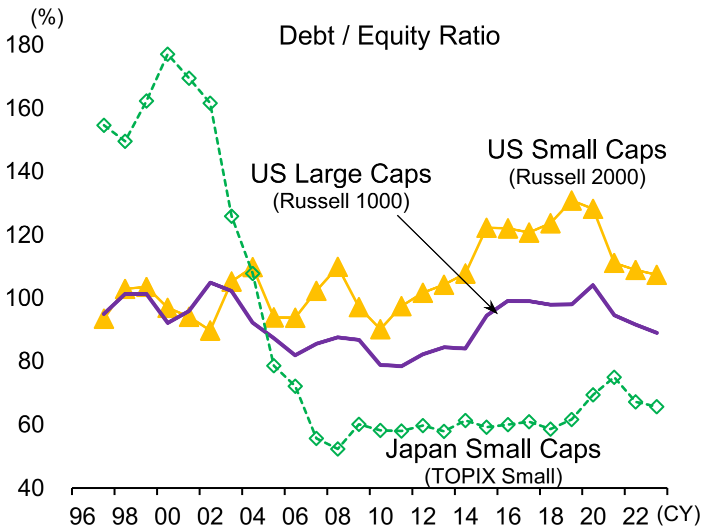
Note: Universes are Russell 1000 for large caps, Russell 2000 for small caps; data as of July 26, 2024.
Source: Bloomberg, MUFG: Trust Bank

Exhibit 2: Small-cap Stocks in the U.S. Have Relatively Low Profitability



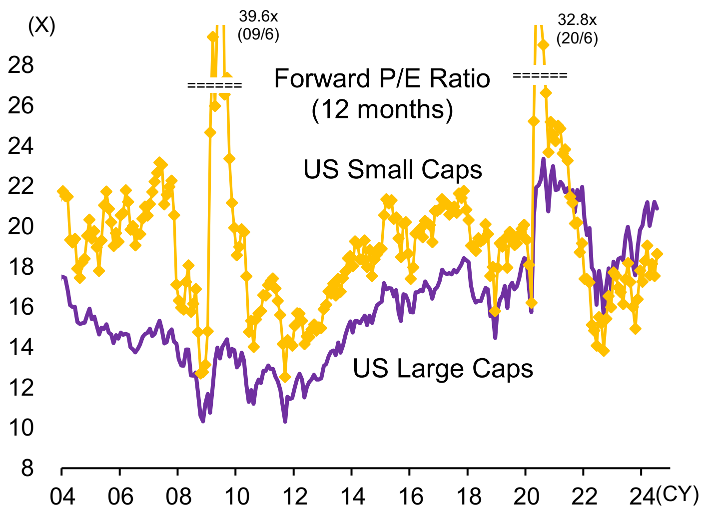
Note: Universes are Russell 1000 for US large caps, Russell 2000 for US small caps and TOPIX Small for Japan small caps; data as of 2023.
Source: FactSet, MUFG: Trust Bank

Exhibit 3: Small-cap Stocks in the U.S. Often Have Weak Financial Structure



Note: Universes are Russell 1000 for US large caps, Russell 2000 for US small caps and TOPIX Small for Japan small caps; data as of 2023.
Source: FactSet, MUFG: Trust Bank

Exhibit 4: However, Small-cap Stocks in the U.S. Are Attractively Valued



Note: Indexes are MSCI USA for large caps and MSCI USA Small for small caps; data as of July 2024.
Source: FactSet, MUFG: Trust Bank

US market: Focus on the mega caps

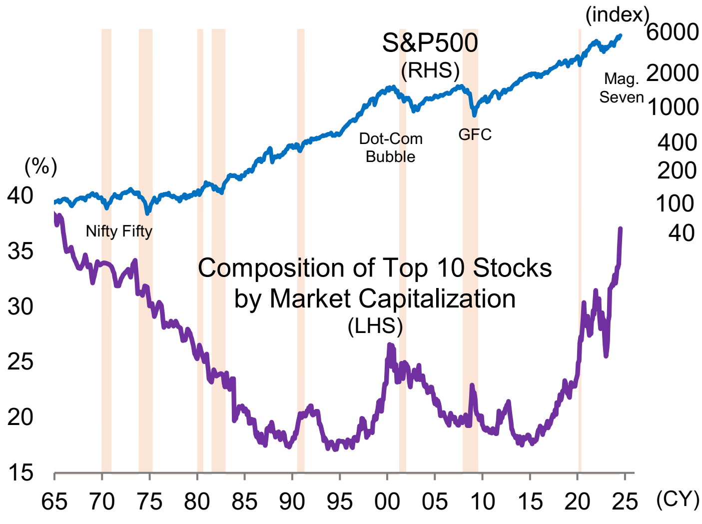
In the US market, there is a marked concentration of market capitalizations from a limited number of large-cap growth stocks known as the Magnificent Seven (Mag. Seven). As of end-June 2024, the 10 largest stocks by market cap accounted for 37% of the overall market (Exhibit 5). This is a higher level even than in the early 1970s, when the market was termed the Nifty Fifty market. In the aftermath of this period, the Dow Jones Industrial Average and S&P 500 were range-bound, while small caps rose from the mid-1970s.

Furthermore, many investors did not expect strong profit growth in large caps which were generating massive profits until around the mid-2010s. The forward P/Es for Apple (until mid-2018) and Microsoft (2010 to 2014) were below the market averages (MSCI USA). However, valuations are currently 29.7x (Apple) and 33.6x (Microsoft), which are above the market average of 21.2x (June 2024; FactSet). Nvidia and Tesla are trading at forward P/Es of 40.3x and 70.0x, respectively. Large-cap growth stock P/Es are not at the extreme levels they were around 2000 during the dot.com bubble, but they look hard to justify without the assumptions of strong profit growth.

Given the current geopolitical tensions and sticky inflation, the investment environment looks similar to that at the end of the 1990s during the dot.com bubble. At that time, the market was favoring large-cap IT-related stocks, which we believe was due to expectations for profit growth amid a strong sense of uncertainty. Financial conditions were relatively supportive, but except for financial stocks, IT-related names were seen as the only stocks with reliable earnings prospects amid rising costs following a prolonged economic expansion in the US and weak overseas economies in the wake of currency and financial crises in Asia and Russia. As investors tend to focus on the earnings outlook, the share prices of large-cap IT-related stocks rose to overvalued levels.

If we take a look at the supply-demand balance, we consider it likely that the megacaps have been pushed up by an increase in the assets of index equity funds. Megacaps are said to have a tendency toward lower weightings in actively managed funds than in the benchmarks. As a result, the shift from actively managed funds to index funds has likely led to increased weightings for megacaps. AUM in developed-market equity index funds rose to $15.6 trillion, exceeding the $14.0 trillion of actively managed funds (Exhibit 6). It is also possible that factors that have so far provided a boost from a supply/demand perspective will decline going forward.

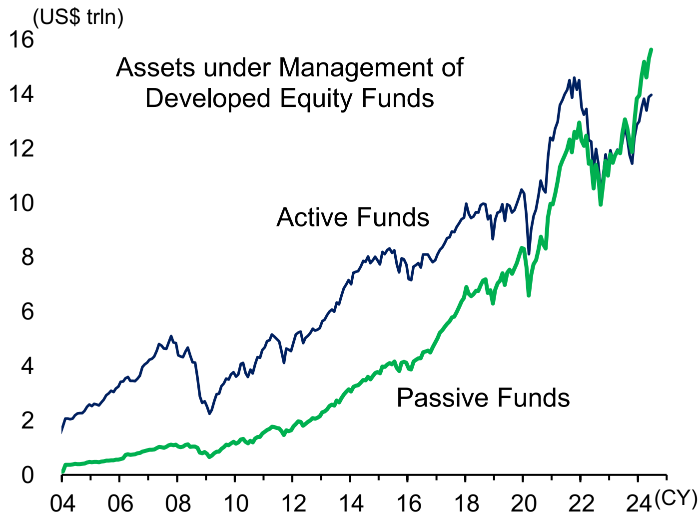
Exhibit 5: Concentration of Market Capitalization in a Few Large Growth Stocks is Notable, in the U.S.



Note: Universe is S&P500; composition shows the proportion of top 10 stocks in terms of market capitalization; shaded areas indicate recessions; data as of June 2024.

Source: J.P. Morgan Securities, MUFG: Trust Bank

Exhibit 6: Net Asset of Passive Equity Funds Have Surpassed Those of Active Equity Funds



Note: Universes are developed equity funds in the world, including ETFs ; data as of June 2024.

Source: EPFR, MUFG: Trust Bank

Taking a long-term perspective, Bridgewater has highlighted the difficulty of a company maintaining its position as a market champion (The Life Cycle of Market Champions, June 2024). The top 10 stocks by market cap in the US market in various eras shows that railway stocks were the standout in 1900, chemicals in 1930, autos in 1960, oil stocks in the 1980s, and telecom stocks in the 2000s (Exhibit 7). Assuming a market share of 100% of the top 10 companies by market cap at the start of each decade, the share of each cohort then fell to an average of 58% after 20 years and to 38% after 40 years (averages since 1900). The companies with the largest market caps have longer-term returns below the market average. Bridgewater cites the following reasons for low returns: 1) a failure by champions to carry out technological innovation in response to structural changes in society and demand and 2) stricter regulations as symbolized by the ones behind the breakups of Standard Oil (1911) and ATT (1984).

Some expect the Mag. Seven to continue to achieve strong profit growth by keeping a technological edge through massive upfront investment and acquiring companies at an early stage that could potentially end up as rivals. However, it is not always possible to stay ahead in businesses where technological innovation is so intense. Each company already has an overwhelming market share in its core businesses, and it will be difficult for them to increase sales through market share gains. Moreover, the Mag. Seven are increasingly competing against each other in business areas where growth is expected, such as AI. Even if stiffer regulations do not emerge regarding monopolistic positions, it will not be easy for the companies to maintain strong profit growth.

Views are split on the sustainability of the small-cap rally, but in the US we think it is worth increasing weightings from an investment diversification perspective.

Exhibit 7: Few Market Champions Have Managed to Stay on Top for Decades

1960

Company Name	Secotr	Share of Mkt Cap
AT&T CORP	Telecom Services	5%
GENERAL MOTORS CO	Auto and Parts	5%
DU PONT (E I) DE NEMOURS	Chemicals	4%
EXXON MOBIL CORP	Oil	3%
GE	Aerospace and Defense	3%
INTL BUSINESS MACHINES CORP	Computer Services	2%
MARATHON	Oil	2%
TEXACO INC	Oil	2%
FORD MOTOR CO	Auto and Parts	2%
UNION CARBIDE CORP	Chemicals	1%

1970

Company Name	Secotr	Share of Mkt Cap
INTL BUSINESS MACHINES CORP	Computer Services	6%
AT&T CORP	Telecom Services	4%
GENERAL MOTORS CO	Auto and Parts	3%
EASTMAN KODAK CO	IT Manufactures	2%
EXXON MOBIL CORP	Oil	2%
SEARS ROEBUCK &CO	Retailers	1%
INFORMATION DISPLAYS INC	IT Manufactures	1%
XEROX HOLDINGS CORP	IT Manufactures	1%
PAUL REVERE CORP	Life/Health Insurance	1%
TEXACO INC	Oil	1%

1980

Company Name	Secotr	Share of Mkt Cap
INTL BUSINESS MACHINES CORP	Computer Services	4%
AT&T CORP	Telecom Services	3%
EXXON MOBIL CORP	Oil	3%
GENERAL MOTORS CO	Auto and Parts	1%
SCHLUMBERGER LTD	Oil	1%
AMOCO CORP	Oil	1%
GE	Aerospace and Defense	1%
MOBIL CORP	Oil	1%
STANDARD OIL CO	Oil	1%
ATLANTIC RICHFIELD CO	Oil	1%

1990

Company Name	Secotr	Share of Mkt Cap
EXXON MOBIL CORP	Oil	6%
INTL BUSINESS MACHINES CORP	Computer Services	5%
GE	Aerospace and Defense	5%
AT&T CORP	Telecom Services	4%
ALTRIA GROUP INC	Tabacco	3%
MERCK & CO	Phamaceuticals	3%
AMOCO CORP	Oil	3%
BRISTOL-MYERS SQUIBB CO	Phamaceuticals	3%
NABISCO GROUP HOLDINGS CORP	Food Producers	2%
DU PONT (E I) DE NEMOURS	Chemicals	2%

2000

Company Name	Secotr	Share of Mkt Cap
MICROSOFT CORP	Computer Software	3%
GE	Aerospace and Defense	3%
CISCO SYSTEMS INC	IT Components	2%
INTEL CORP	Semiconductors	2%
EXXON MOBIL CORP	Oil	2%
WALMART INC	Retailers	1%
INTL BUSINESS MACHINES CORP	Computer Services	1%
CITIGROUP INC	Banks	1%
MERCK & CO	Phamaceuticals	1%
LUCENT TECHNOLOGIES INC	IT Components	1%

2010

Company Name	Secotr	Share of Mkt Cap
EXXON MOBIL CORP	Oil	2%
MICROSOFT CORP	Computer Software	2%
WALMART INC	Retailers	1%
PROCTER & GAMBLE CO	Personal Care	1%
BERKSHIRE HATHAWAY	Investment Companies	1%
APPLE INC	IT Manufactures	1%
JOHNSON & JOHNSON	Phamaceuticals	1%
GE	Aerospace and Defense	1%
ALPHABET INC	Internet Services	1%
INTL BUSINESS MACHINES CORP	Computer Services	1%

2020

Company Name	Secotr	Share of Mkt Cap
APPLE INC	IT Manufactures	4%
MICROSOFT CORP	Computer Software	4%
AMAZON.COM INC	Internet Services	3%
ALPHABET INC	Internet Services	3%
META PLATFORMS INC	Internet Services	2%
BERKSHIRE HATHAWAY	Investment Companies	2%
VISA INC	Business Services	1%
JPMORGAN CHASE & CO	Banks	1%
JOHNSON & JOHNSON	Phamaceuticals	1%
WALMART INC	Retailers	1%

2024

Company Name	Secotr	Share of Mkt Cap
MICROSOFT CORP	Software	5.5%
APPLE INC	Technology Hardware	5.3%
NVIDIA CORP	Semiconductors	4.8%
ALPHABET INC	Internet Services	3.8%
AMAZON.COM INC	Internet Services	3.3%
META PLATFORMS INC	Internet Services	2.1%
LILLY(ELI) & CO	Pharmaceuticals	1.4%
BROADCOM INC	Semiconductors	1.1%
JPMORGAN CHASE & CO	Banks	1.0%
TESLA INC	Autos	1.0%

Source: Bridgewater: “The Life Cycle of Market Champions” June 2024
https://www.bridgewater.com/research-and-insights/the-life-cycle-of-market-champions

Attractiveness of Japanese small caps (1): fundamentals not really inferior

When looking at investment in small caps on a global perspective, we believe Japanese small caps look attractive.

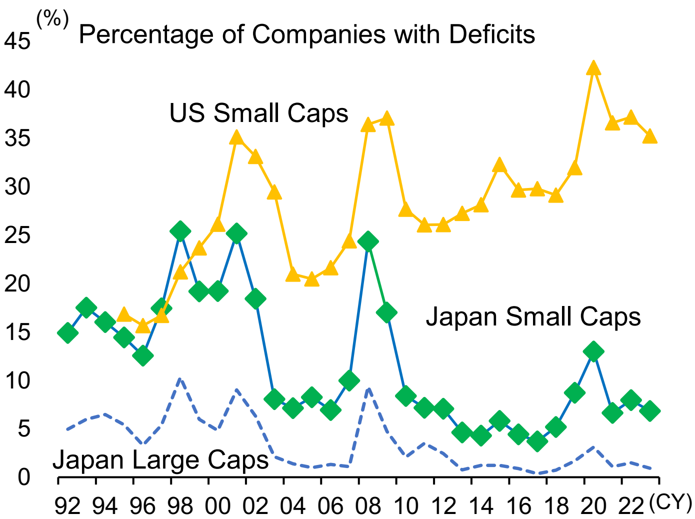
Firstly, Japan's small caps do not necessarily have weaker fundamentals. The number of lossmaking companies has shrunk since the 1990s and the TOPIX Small Index shows that the proportion of lossmaking companies was 25% at the end of the 1990s, but this has declined to 6.5%-8.0% since FY21 (Exhibit 8). The ratio of lossmaking US small caps (the MSCI USA Small Cap Index) has risen from around 20% in the mid-2000s to around 30% now at a time of economic recovery. While upfront investment and stock options are likely to play some part in this, we believe that a substantial number of companies are inferior in terms of competitiveness in their core businesses.

Pretax profit margins in Japan are lower for small caps than large caps, but the range of fluctuation is not as great as in the US (see Exhibit 2). Moreover, Japan's small caps have strong balance sheets. Debt-to-equity ratios show the US is 107.6% (Russell 2000), while Japan is 65.8% (MSCI Japan Small Cap Index, 2023 data for both; Exhibit 3). The ratio for small caps in Japan is slightly lower than for large caps (MSCI Japan Index).

The reasons for this are firstly, listed companies with low profitability have been forced to carry out bold restructuring since 1997 due to financial system instability, which resulted in the bankruptcy of several companies, particularly in the construction and retail sectors. It is fair to say there has been a shakeout of companies with poor profitability and weak financial standing.

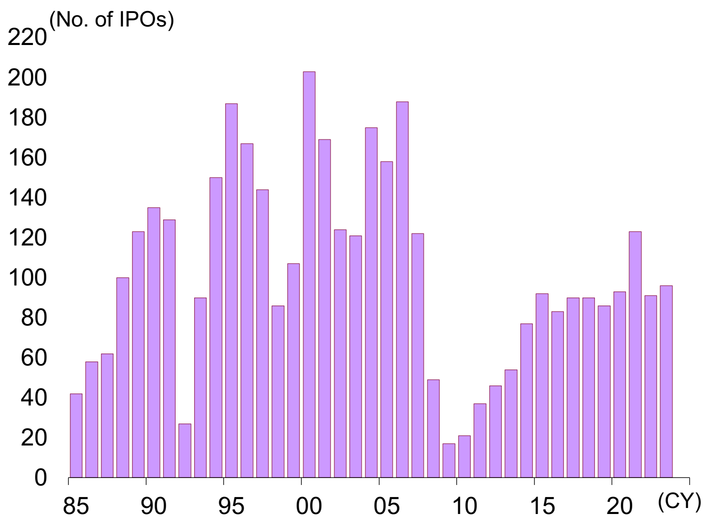
At the same time, leading companies in niche markets and companies with unique business models have listed. The number of IPOs in the 2000s was between 120 and 200 per year. While this declined sharply around the time of the global financial crisis, the number has remained between 80 and 100 per year since 2015 (Exhibit 9). Many such companies are in the information/communications and services sectors, with 68.2% of all companies listing since 2018 coming from these two industries. Comparing the industry composition of the TOPIX Small Index today with 1995—a time prior to the financial system instability—we see a lower proportion of companies from sectors such as construction, banks, textiles & apparel, steel, and other materials, as well as electric appliances and machinery. Meanwhile, there has been a sharp rise in the weighting of information & communication, services, retail, and wholesale trade (see Exhibit 10; QUICK AstraManager). In Japan, the industry composition of small-cap indices has changed significantly as a result of IPOs, and we believe many of these companies have excellent profitability and strong balance sheets.

Exhibit 8: Japanese Small-caps Have a Low Proportion of Companies with Deficits



Note: Universes are TOPIX Small for Japan small caps, TOPIX 500 for Japan large caps and Russell 2000 for US small caps; data as of 2023.
Source: Nomura Securities, FactSet, MUFG: Trust Bank

Exhibit 9: In Japan, IPOs have Continued Relatively Steadily Over the Last Three Decades



Note: Data as of 2023.
Source: Nomura Securities, MUFG: Trust Bank

In the US, private equity has a more significant position, and there is a tendency to lock in emerging companies with potential for business expansion and profit growth, and stop them from listing at an early stage. However, private equity companies in Japan have little capital to deploy, leading companies aiming for business expansion to conduct IPOs and go public at an early stage to secure funding.

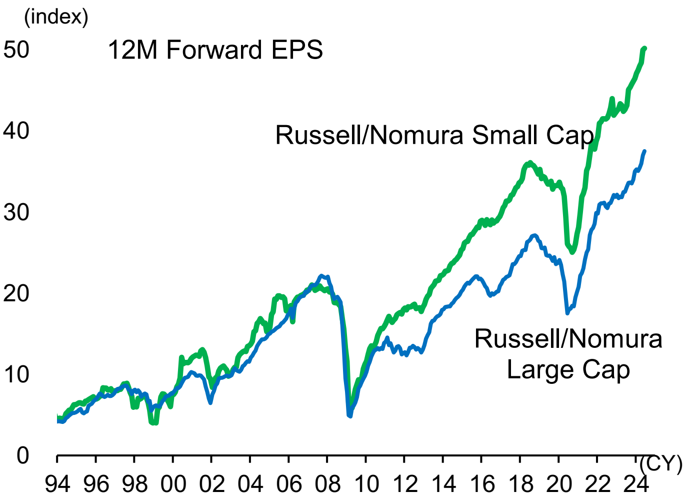
Many observers see little prospect of profit growth in small caps with a high weighting of domestic demand because domestic demand is not growing due to population decline and an aging society with fewer childbirths. This overlooks the fact that profit growth is not necessarily low for Japanese small-cap stocks. Over the past 10 years, EPS growth has been 7.9% annually for small caps, which is higher than the 7.3% for large caps (Exhibit 11). There are some small caps that have unique business models and are leading companies in niche markets, which can deal with social issues such as Japan's aging society and labor shortages. These companies may then expand their overseas businesses in response to rising incomes in emerging markets, particularly in Asia.

Exhibit 10: Industry Composition of Japanese Small Caps has Changed Significantly

Industry	Dec. 1995 No. of Stocks (%)	Dec. 1995 Market Cap. (%)	Dec. 2010 No. of Stocks (%)	Dec. 2010 Market Cap. (%)	Jul. 2024 No. of Stocks (%)	Jul. 2024 Market Cap. (%)
Construction	10.1	10.5	6.8	5.9	4.6	5.5
Foods	4.5	4.2	3.4	3.3	3.5	3.2
Textiles & apparels	4.8	3.5	2.8	1.8	2.1	1.6
Chemicals	8.4	7.5	6.7	7.2	6.3	5.8
Iron & Steel	3.4	3.9	1.9	1.8	1.5	1.4
Machinery	9.6	9.2	7.5	6.8	6.6	7.2
Electric appliances	9.7	10.0	8.6	9.7	6.2	6.7
Information & comm.	0.0	0.0	6.2	6.3	11.9	11.2
Wholesale trade	6.7	5.2	10.2	7.7	9.0	8.2
Retail trade	4.7	4.8	10.1	10.9	9.7	10.2
Banks	5.6	9.8	3.4	5.0	3.4	5.4
Real estate	1.8	1.8	2.9	3.4	3.8	3.2
Services	2.6	3.0	7.1	6.1	11.9	8.6

Note: Universes are stocks in TOPIX Small Index.
Source: QUICK AstraManager, MUFG: Trust Bank

Exhibit 11: Small Caps have Provided Stronger Earnings Growth than Large Caps



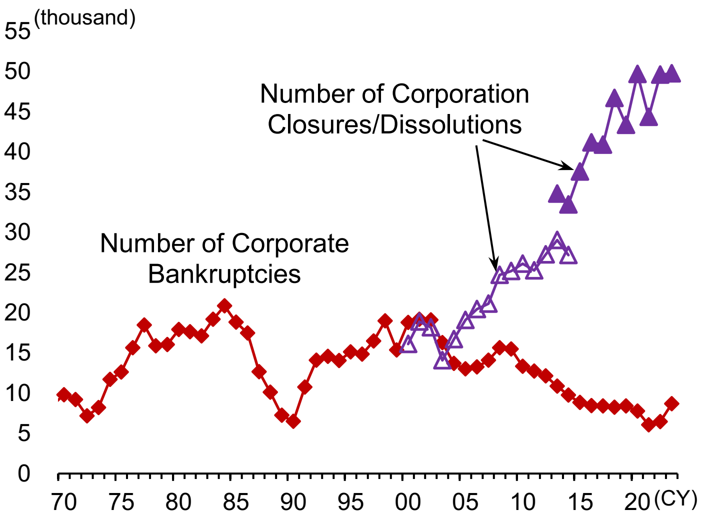
Note: Universes are Russell/Nomura Large Cap and Small Cap; data as of June 2024.
Source: Nomura Securities, MUFG: Trust Bank

Attractiveness of Japanese small caps (2): Industry reorganization and market share gains for winners

Secondly, we cite industry realignment in Japan. Many observers say industry revitalization has not progressed much in Japan due to the low interest rate environment. However, while corporate bankruptcies in Japan are trending low, more companies are closing or suspending business. The number of bankruptcies was only 8,690 in 2023, while the number of closures has been rising from around 2015, reaching 49,788 in 2023 (Tokyo Shoko Research; see Exhibit 12). Much of this is due to aging management and a lack of staff. Looking at factors behind the bankruptcies (reasons for business closures are not disclosed), the number related to labor shortages has been gradually increasing since the latter half of the 2010s, reaching 145 in 1H 2024 (see Exhibit 13).

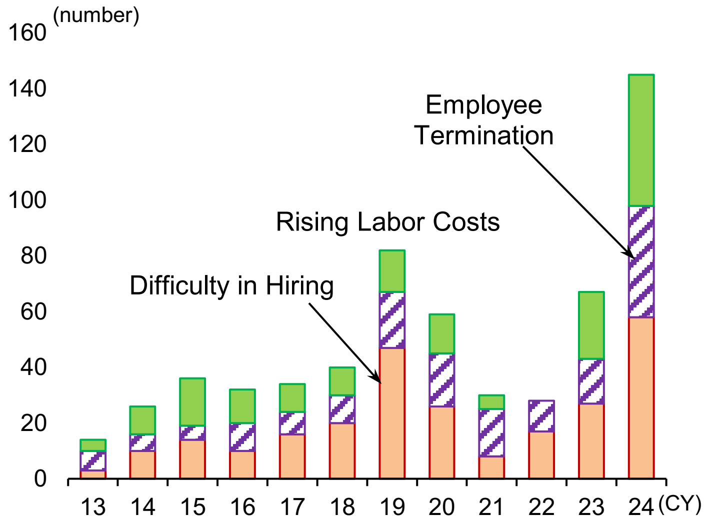
Despite a decline in the working-age population in Japan in the past quarter century, the labor participation rate for women has risen, particularly among those who have finished raising their children. The labor participation rate of women of working age (15-64) rose from 59.6% in 2000 to 75.1% in 2023 (OECD). This ratio is not only higher than the US and France, but also than the UK. This means better compensation will be required for the labor participation rate to rise further. Wage levels are higher at large corporations, but wage growth has been higher at SMEs over the past 10 years than at large companies. Facing chronic labor shortages, SMEs with low profitability that cannot improve compensation appear to have decided to close or suspend business.

Exhibit 12: Number of Corporate Closures and Dissolutions Have Been Increasing



Note: Number of corporate suspensions/dissolutions are counted differently up to 2012; data as of 2023.
Source: Tokyo Shoko Research, MUFG: Trust Bank

Exhibit 13: More Companies Going Bankrupt Due to Labor Shortage

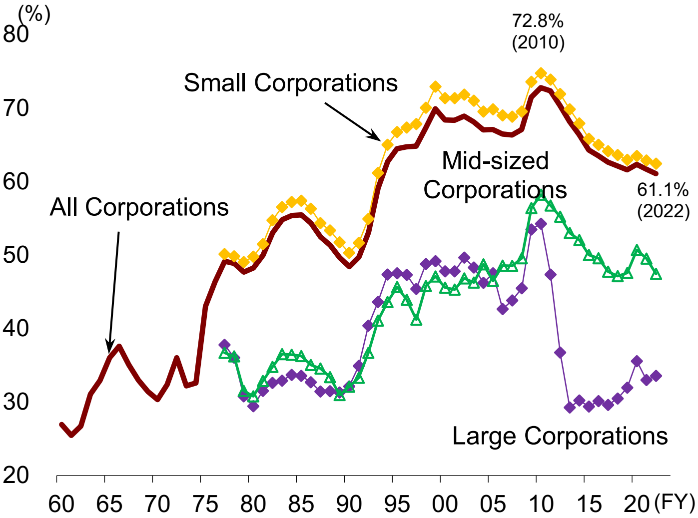


Note: Number of cases from January to June for each year is calculated; data as of 2024.
Source: Tokyo Shoko Research, MUFG: Trust Bank

The ratio of lossmaking companies that do not pay corporate taxes has been decreasing since 2012, including among SMEs (Exhibit 14). Companies with weaker profitability are being forced to exit their businesses due to labor market discipline, and we believe this has led to progress in industry revitalization. Against this backdrop, companies with high productivity can be expected to grow sales and profits through market share gains. We think that the excessive competition, which was one of the reasons for the low profitability of domestic demand-oriented companies, is being corrected, and it is expected that highly productive companies will be able to secure appropriate margins. The perception that domestic demand-oriented companies cannot increase their profits due to weak domestic demand is not necessarily correct.

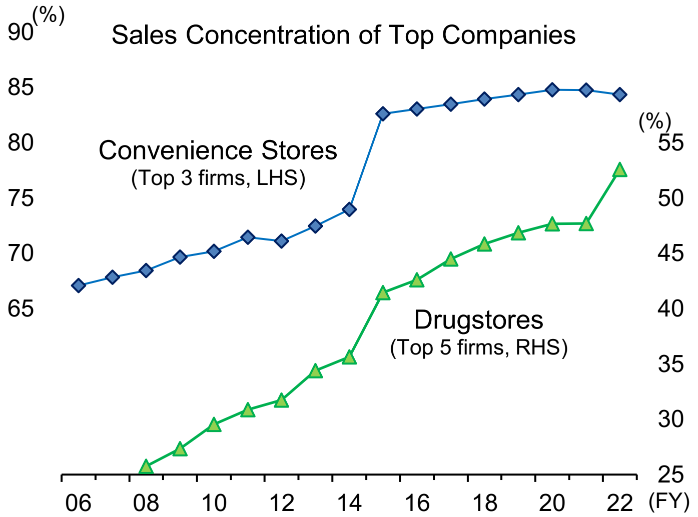
Progress is being made in restructuring and industry consolidation among listed companies. In the convenience store industry, the share of industry sales of the top three companies rose from 67.1% in 2006 to 83.1% in 2015, while the share of the top five drugstores rose from 25.8% in 2008 to 52.6% in 2022 (Exhibit 15). Some listed companies are facing pressure from activist investors. The number of activist funds in Japan has risen to 72 (as of May 2024; Exhibit 16). In addition to activist investors, there are many domestic and overseas institutional investors supporting managements that emphasize asset efficiency and cost of capital. We thus expect industry reorganization to progress through business reorganization and acquisitions. In the drugstore business, Tsuruha decided to merge with Welcia, an Aeon subsidiary, in response to demands by hedge fund Oasis Management.

Exhibit 14: Proportion of Companies with Deficits, Including Unlisted SMEs, has Peaked



Note: Large, mid-sized and small corporations are those with capital of over 100 million yen, 20 million to 100 million yen, and 20 million yen or less, respectively; data as of FY2022.
Source: National Tax Administration Agency, MUFG: Trust Bank

Exhibit 15: Top Companies Enjoy Higher Market Share in Convenience Stores and Drugstores

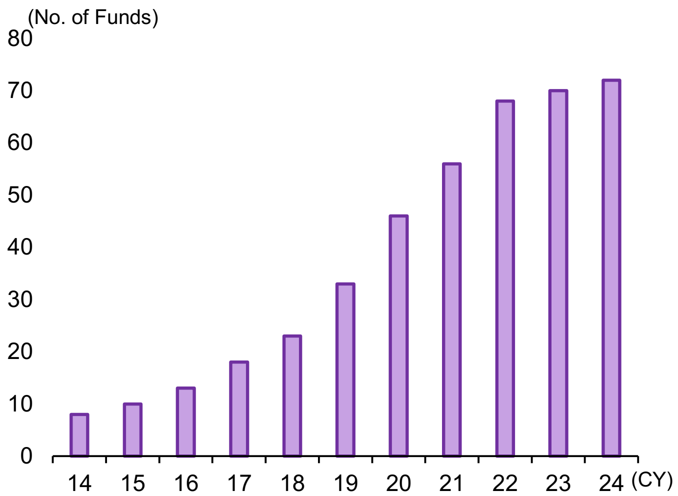


Note: The top five drugstore operators differ by fiscal year; data as of 2022.
Source: METI, Home Center Institute, company data, MUFG: Trust Bank

On the policy front, we highlight support measures for medium-size companies. The Ministry of Economy, Trade and Industry (METI) decided on a package to promote growth for medium-size companies (March 2024). The package includes support for large-scale growth investments such as labor-saving measures, tax incentives to encourage wage hikes for medium-size companies, and tax incentives to concentrate management resources at medium-size companies with strong management capabilities (medium-size companies are defined as ones with 300-2,000 employees). We expect industry-wide productivity to improve as a result of industry reorganization spurred by medium-size companies through M&A with SMEs, which have been struggling with business succession.

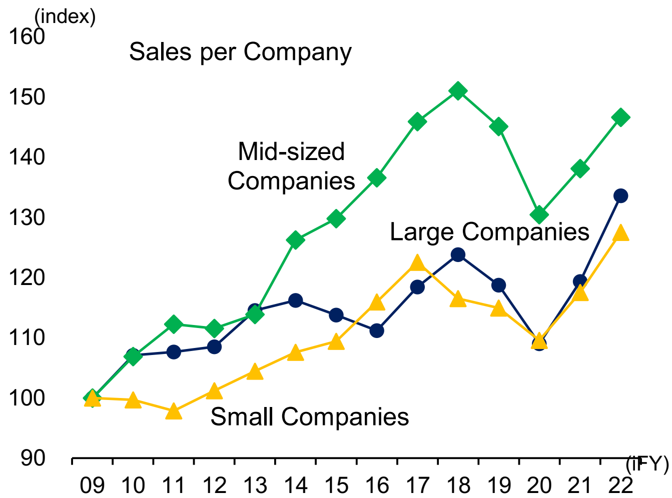
Productivity is generally low for unlisted SMEs, but the situation differs for medium-size companies. According to the 2023 White Paper on Small and Medium Enterprises, sales at medium-size companies (capital of ¥100m to ¥1.0b) are growing faster than at large companies (Exhibit 17). Given that SMEs may not be able to make labor-saving investments to deal with labor shortages, we think that medium-size companies with strong management and financial resources can step into the breach. Based on the classification by capital in the Financial Statements Statistics of Corporations by Industry, large companies account for 81.2% of the TOPIX Small Index and medium-size companies account for 16.7%. From a macroeconomic perspective, only 2.1% of listed small/mid-cap stocks are classified as SMEs.

Exhibit 16: Number of Activist Funds is Increasing in Japan



Note: Data as of May 10, 2024.
Source: IR Japan HD, MUFG: Trust Bank

Exhibit 17: Sales Growth Rate of Mid-sized Companies has Been Higher Than That of Large Companies

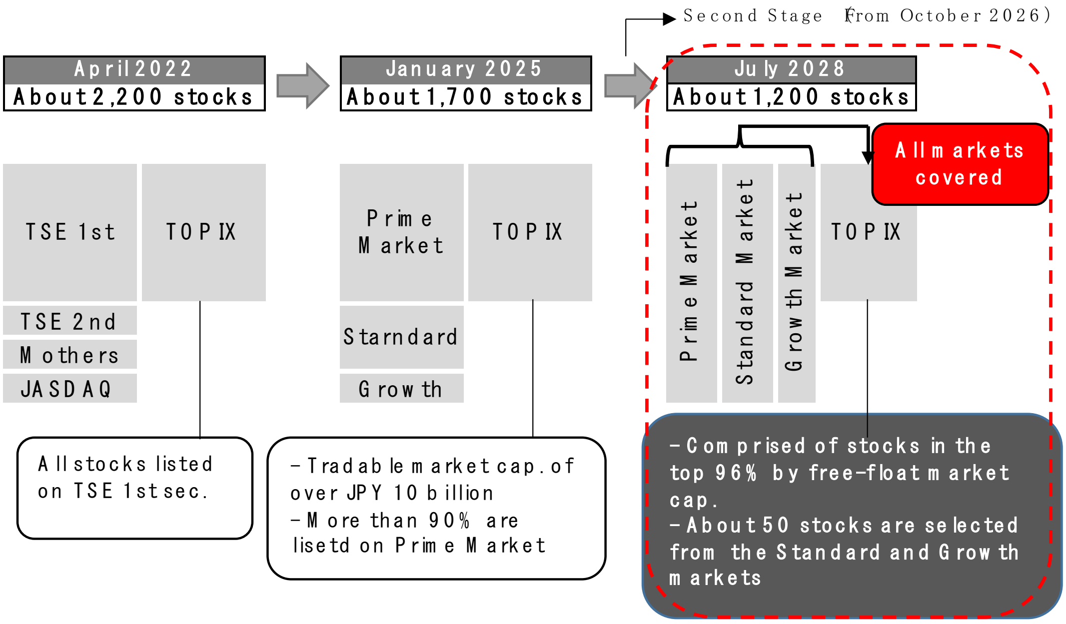


Note: Figures are the sales revenue divided by the number of companies indexed with fiscal year 2009 set at 100; data as of FY2022.
Source: MOF, MUFG: Trust Bank

Should we be concerned about the TOPIX changes leading to weaker supply-demand for small caps?

A considerable number of investors have flagged concerns about deterioration in the supply-demand balance for small-cap Japanese stocks over the next two to three years. In June 2024, the Japan Exchange Group (JPX) announced a second phase of revisions for the TOPIX (scheduled to be implemented in stages from January 2025 to July 2028; Exhibit 18). The key points in the original proposal are: 1) expanding the target market to include the Standard Market and the Growth Market in addition to the Prime Market, 2) carrying out an annual periodic review, and 3) basing the selection criteria on traded value and free-float market cap. As a result of the revisions, the number of stocks included in the TOPIX is expected to decline to around 1,200 by July 2028. As part of this process, passive funds are expected to sell off small caps that will be excluded from the new TOPIX.

Exhibit 18: Overview Diagram of the TOPIX Revision

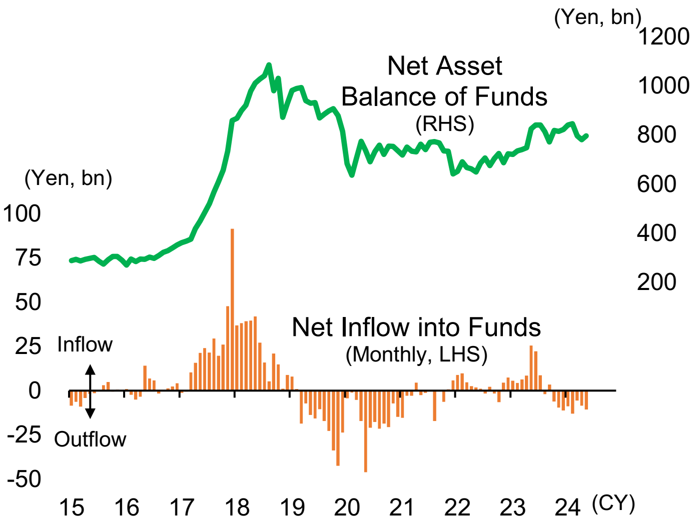


Source: TSE MUFG: Trust Bank

However, negative supply-demand factors have already become apparent. First, following a boom in 2017-2018, specialized publicly offered small-cap funds had major redemptions in 2019-2020 (Exhibit 19). Annual capital outflows are estimated to have reached roughly 19% of the initial asset balance in 2019. The first phase of the TOPIX revisions have been underway since 2022, and the number of stocks included in the TOPIX will fall from around 2,200 to around 1,700 by January 2025. Passive funds have already sold small caps. This has made small caps look clearly undervalued. The forward P/E multiple for the Russell/Nomura Small Cap Index is 14.6x compared to 16.5x for the Russell/Nomura Large Cap Index. The relative P/E for small caps vs large caps is 0.88x, the lowest level since 2008 (Exhibit 20). During the second stage of the TOPIX revisions, we expect some sales from passive funds, but do not expect this to have a major negative impact on small-cap share prices.

From a long-term perspective, we expect the TOPIX revisions to increase awareness of corporate governance among management and boost corporate value. The ratio of stocks with P/Bs of less than 1x is 31.8% for the TOPIX 500 and 45.4% for the TOPIX Small (June 2024; Exhibit 21). Putting in place a governance structure that includes outside directors and information disclosure involves costs. In the case of small-cap stocks, there are many companies where the management is also a major shareholder. As a result, compared to large-cap stocks, there has been a tendency to place less emphasis on the interests of minority shareholders, leading to lower evaluations from investor. Although outside directors now make up more than half the board of directors at 38.6% of large caps, this proportion is only 30.2% at small caps (Exhibit 22). If passive funds reduce their holdings and opportunities increase for management to engage with active investors, highly profitable small caps have the potential to increase their corporate value through improved corporate governance as they understand the demands of minority shareholder interests.

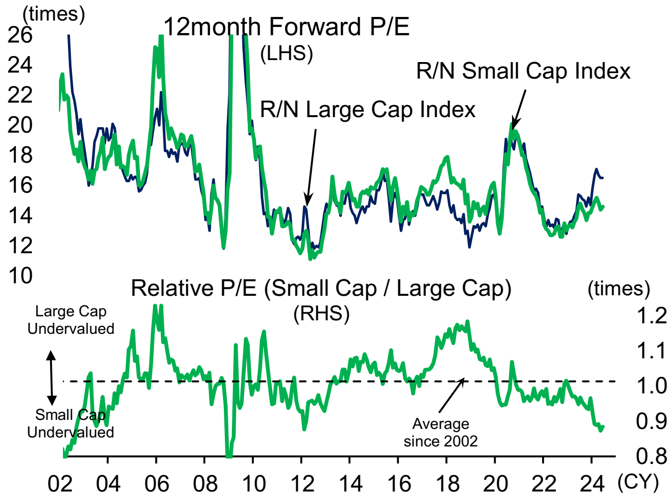
Exhibit 19: Small-cap Investment Trusts Have Suffered from Significant Redemptions



Note: Japanese investment trusts, small-cap investment trusts are as defined by Morningstar; data as of June 2024.

Source: Morningstar, MUFG: Trust Bank

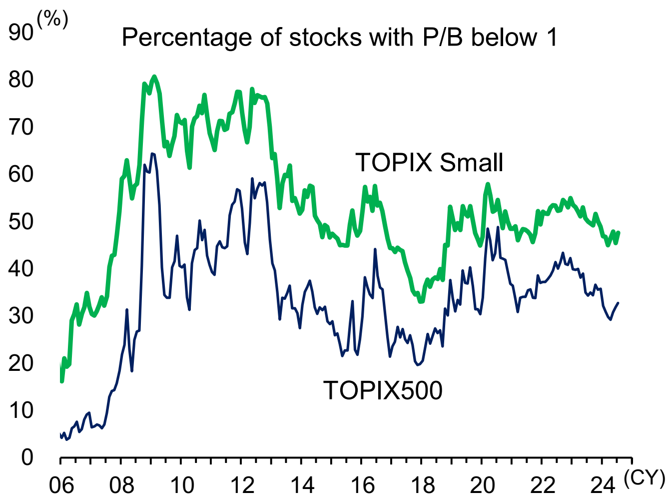
Exhibit 20: Small Caps are Cheaper Than Large Caps in Japan



Note: Universes are Russell/Nomura Large Cap and Small Cap; Forward P/E is based on earnings forecast over the next 12 months; data as of June 2024.

Source: Nomura Securities, MUFG: Trust Bank

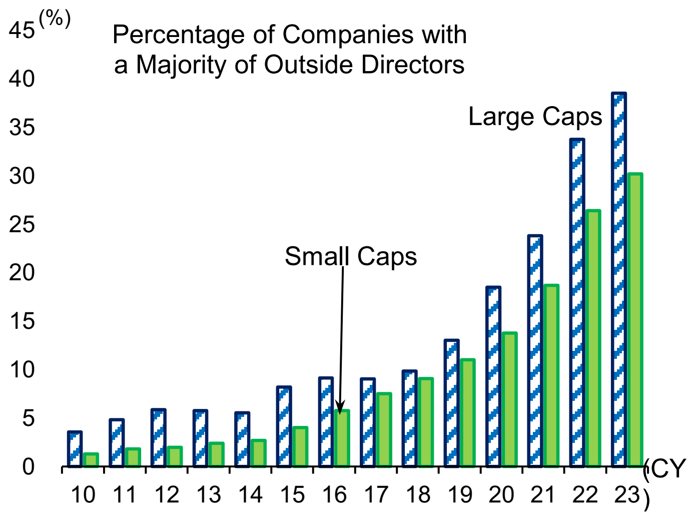
Exhibit 21: Small Caps Have Higher Proportion of Stocks With P/B Below 1



Note: Data as of June 2024.

Source: Nomura Securities, MUFG: Trust Bank

Exhibit 22: Small Caps Have Lower Proportion of Companies with a Majority of Outside Directors



Note: Universes are TOPIX 500 for large caps and TOPIX Small for small caps; data as of June 2023.

Source: Bloomberg, MUFG: Trust Bank

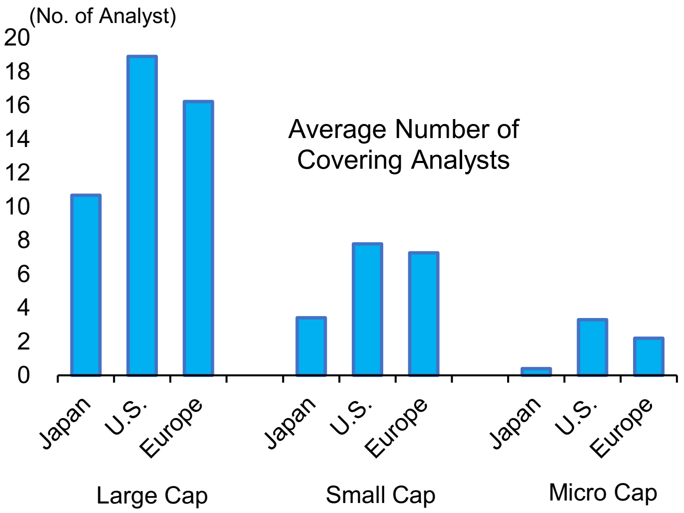
Japanese small caps are a good match for active funds

Actively managed funds are likely to be a good fit for Japanese small caps. One of the conditions for active management to generate returns is the inefficiency of information. Globally, it is more difficult to obtain analyst information about small caps than for large caps, which means that information on business strategy or earnings forecasts is often not reflected in share prices. In terms of analyst coverage by size and region, we see that the average number of analysts covering small caps in Japan is 3.4, well below the 7.8 and 7.3 figures in the US and Europe (see Exhibit 23). Among micro caps, the 0.4 average in Japan compares to 3.3 in the US and 2.2in Europe. Share price movements at small caps tend to be greater in response to earnings results announcements, as analysts' earnings forecasts are not very accurate. In addition, it is more difficult for foreign investors to invest in small- and mid-cap stocks in Japan as there is less English-language disclosure than for large-cap stocks, and share price formation is not efficient for a considerable number of companies. We believe high returns are likely based on an analysis of the fundamentals.

At the same time, Japanese small caps still have a certain global presence. The weighting by market capitalization of Japanese stocks in the MSCI ACWI (made up of MSCI's large-cap stocks) has fallen to 5.1% as a result of the yen's depreciation and lagging performance versus US stocks. In contrast, the weighting of Japanese stocks in MSCI’s small cap and micro cap indices was 12.2% and 26.8%, respectively (as of June 2024; Exhibit 24). The small-cap index includes 1,710 companies in the US, 863 in Europe, and 862 in Japan. The micro cap index has 1,158 stocks in the US, 1,533 in Europe, and 2,077 in Japan. When investing in small caps, Japanese stocks offer a wide range of options for stock selection.

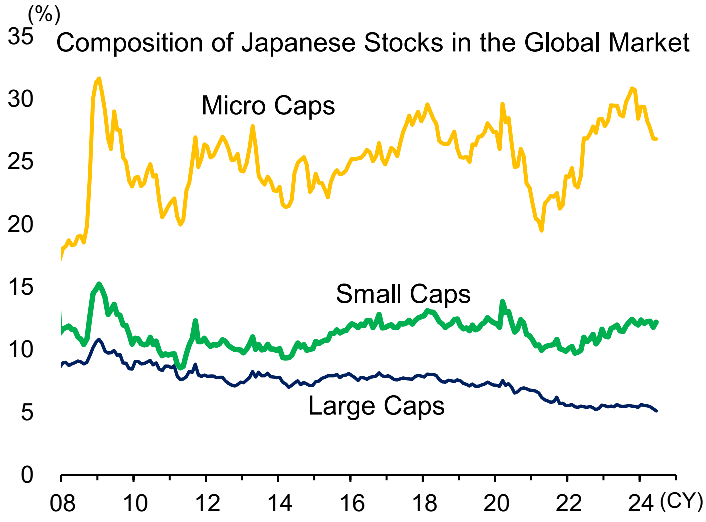
For those considering small-cap investment in developed markets, we think Japanese small caps look like an attractive option.

Exhibit 23: Limited Sell-side Analyst Coverage Hides Attractively Valued Small Caps



Note: Universes are companies in MSCI Large and Mid Cap, Small Cap, and Micro Cap Index in the U.S., Europe and Japan; data as of June 2024.
Source: FactSet, MUFG: Trust Bank

Exhibit 24: In the Small-caps Segment, Japan has a Significant Presence in the Global Equity Market



Note: Universes are stocks in MSCI Large and Mid Cap, Small Cap, and Micro Cap Index; data as of June 2024.
Source: MSCI, MUFG: Trust Bank