Sumitomo Mitsui DS Asset Management

A new TOPIX: the underappreciated puzzle piece in Japan's equity market reform efforts

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Japan Equity Research Team

SMD-AM

We are one of the largest investment management companies in Japan, offering discretionary investment management, investment trusts and advisory services to a range of institutional investors, pension funds, government agencies and retail investors worldwide.

A short summary

Japan's primary stock index, the TOPIX, is undergoing a major transformation. A multi-year restructuring programme is set to almost halve the number of its constituent companies by 2028, creating a more concentrated and globally competitive benchmark. In addition to improving the index, these reforms may trigger changes in capital allocation relevant for company management and investors in Japanese equities.

For years, the TOPIX was more of a broad census than a selective index. At its peak, it comprised almost 2,200 companies, including a long tail of small, domestically focused firms. This resulted in a fragmented market that lacked appeal to foreign investors. The inefficiency was stark: an estimated 60% of constituents did not even earn their cost of capital. When compared to more streamlined developed market counterparts like the S&P 500 the need for an index of better-governed, more profitable companies became undeniable.

The background to reform

The TOPIX was launched in 1969 as a comprehensive market-cap weighted index whose universe was all domestic common stocks listed on the 'First Section' of the Tokyo Stock Exchange. Historically, the TSE was made up of four categories: First Section, Second Section, Mothers and JASDAQ (Standard and Growth). The First Section was intended to be an exclusive club for high-quality blue chips, with stringent listing and maintenance criteria. However, over time this lapsed and the First Section gradually became home to more than half of all listed companies.

In the first stage of reform, the entire First Section was transferred to the Prime market on a probationary basis. Then, in April 2022, all constituents were consolidated into three new sections:

- **Prime market:** Comprises companies with high liquidity, strong governance, and a commitment to constructive dialogue with global investors. These firms are expected to lead the global economy.

- **Standard market:** Companies with a solid business foundation and certain level of market capitalisation and liquidity. These firms play a central role in the Japanese economy.

- **Growth market:** Designed to house smaller companies with high growth potential, which also carry higher investment risk.

A more competitive landscape

The TOPIX's evolution into a more carefully curated index, with rigorous, liquidity-focused stock selection criteria based on free-float adjusted market cap and annual traded value ratio is the biggest anticipated change on the horizon.

Free-float adjusted market cap considers only the value of shares readily tradable in the market and excludes shares held by stable shareholders, such as parent companies, cross-shareholdings, and internal executives. The idea is that companies are incentivised to focus on improving shareholder returns. As we have noticed some companies explicitly expressing their intention to remain in or to join the TOPIX, early signs suggest it's working.

Qualifying stocks from any of the three markets can enter the TOPIX. The more competitive landscape is expected to stoke action from company management, especially among smaller and mid-sized companies seeking a listing. Although many global investors eschew it as a benchmark in favour of the more widely used MSCI Japan, we estimate over ¥100tn (approx. £500bn) of AUM is held in passive TOPIX-linked strategies alone.

It is anticipated these planned reforms could improve the overall return on equity (ROE) of the index by roughly 20% if constituents divest from unprofitable businesses. The first phase of the reforms concluded in January, which involved a multi-stage, gradual reduction in the weighting of companies with a tradable share market capitalisation below ¥10bn. This has already reduced the number of TOPIX constituents from more than 2,100 to around 1,700.

Japan's collaborative efforts

While concerted, cooperative efforts are taking place between the stock exchange, the regulator, and Japan's government, the real structural changes happening in Japan's public markets are not purely due to such top-down initiatives. The economic uptick witnessed in recent years – namely the move from deflation to inflation – coupled with this index reform are together underpinning a surge in corporate activity.

The increased level of M&A activity seen in Tokyo today is drawing more international attention to Japanese equities as an asset class. Over the past 12-18 months, the number of takeover bids and management buyouts (MBOs) have both spiked sharply upwards. In the case of smaller companies in particular, MBOs are becoming more common as private equity (PE) funding gains traction.

Business owners are securing PE backing, which allows them to buy the remaining stake in their company and take it off the public market. In some cases, these deals will be looking to improve the company's operations, readying to relist in future.

A broader alpha opportunity?

At Sumitomo Mitsui DS Asset Management, while we run strategies that span the market-cap spectrum, this reform programme is most relevant to our small- and mid-cap (SMID) equity platform. And our SMID team is viewing these changes as net positive.

The lead manager thinks it will not only improve the overall quality of the index, but anticipates the dispersion between winners and losers will widen such that – as an active manager – a richer opportunity set to discover alpha will prevail.

We see these reforms as a viable pathway to set-up Japanese companies for greatness; positioning them for international expansion, higher levels of sustainable profitability, and bringing the quality of the market in line with global standards.

Contact Details

Sumitomo Mitsui DS Asset Management (UK) Ltd.
100 Liverpool St., London EC2M 2AT, United Kingdom

www.smd-am.co.uk - uksales@smd-am.co.jp

Richard HAXE
Managing Director, Head of Business Development
+44 20 7507 6431
richard_haxe@smd-am.co.jp

Alex BARRY
Executive Director, Head of Sales, UK and Ireland
+44 20 7507 6419
alex_barry@smd-am.co.jp

Chloé CHOQUIN
Director, Business Development
+44 20 7507 6424
chloe_choquin@smd-am.co.jp

Thomas CARTWRIGHT
Director, Business Development
+44 20 7507 6440
thomas_cartwright@smd-am.co.jp

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