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Views from the Japan Equities Small Cap Desk

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Tipping point for growth markets

An unusual characteristic I found in recent small-cap stock markets is an acute imbalance of selective buying by investors. An appetite for some stocks is so strong while the direction of the bias shifts frequently from one end to the other. Growth stocks represented by the Tokyo Stock Exchange (TSE)'s Mothers index would be the only winners on one day, and value stocks would advance and growth stocks plunge amid the overall sagging trend on another day. I believe these wide fluctuations are hinting at a tipping point in the market.

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Institutional investors including myself have access to a variety of information every day. Data I regularly peruse is attribution analysis by quantitative analysts at brokerage companies. It ranks factors of stock price fluctuations based on the analysis of which stocks and with what characteristics surged or plunged including which financial metrics was more plainly reflected in the market.

Looking at the efficacy ranking of financial metrics, we realise that the result has been polarised in recent months. This indicates investors would hunt down growth stocks with high PERs, high PBRs and huge growth potential and ignore value stocks on one day but growth stocks would decline while value stocks are relatively stable on another day. The gap between these two days is widening.

While investors in general call the former "growth market" and the latter "value market", I call the former 'high day' and the latter 'low day.'

I tend to gain higher returns on low days because I focus on investments in value stocks. But I feel pressured to outperform small-cap indices and peer funds on low days while I feel more relaxed on high days by persuading myself that it should be all right as long as I do not underperform other funds by a large margin.

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Growth stocks including those listed on the TSE's Mothers market led the broader market during the recovery phase in the April-June quarter when persistent 'high days' left me in hardship. I managed to catch up with the benchmark thanks to rebounds in my portfolio shares that had been oversold but lagged far behind funds of industry peers that mainly invest in the TSE Mothers index or growth stocks.

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However, we started to see extreme ‘low days’ in July. Growth stocks that had been enjoying sustained climbs plunged while value stocks showed relatively stable price movements, allowing me to easily regain the losses until June. Unfortunately, this trend was short-lived. ‘High days’ came back the next day or the following week, distancing me again from other funds in investment returns.

Speculation is rife over why the phenomenon such as high day or low day occurs. While I believe it has something to do with the US Nasdaq stock market given its power to lead the global stock price recoveries, domestic small-cap stocks seem to be moving independently from it on many days. Some experts advocate theories that dig into more fundamental factors such as ‘Growth market comes when US long-term interest rates decline’ and ‘Growth market comes when the coronavirus pandemic gets worse.’ But neither one of them sounds probable to me.

I can also present a more objective view that these nonessential discussions themselves reveal a standstill in the market.

The bias of selective buying toward growth stocks started two years ago, much earlier than the recovery stage in April 2020. This long-lasting bias created a record gap between growth stock prices and value stock ones. With growth stocks locked in stalemate, the force to stem the prevalent tide and the force to rectify the extreme valuation gaps seem to be acting on strongly right now. The recent market movement reminds me of a spinning top swinging wildly before falling over.

I anticipate and hope that equity markets will hit a tipping point soon. Regardless, I will maintain my strategy to focus on value stock investments.

Source: Based on article by Tatsuro NIGAURI, published in The Nikkei Online Edition on 11 October 2020

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Tatsuro Nigauri is a Japanese small-cap equities manager with three decades of experience managing money based in Tokyo. He joined the firm in Oct 2002 and has managed the Japan Equity Small Cap Absolute Value strategy since its inception in 2004 and the UCITS funds since their launch in 2017. He started his career as a research analyst at the Daiwa Institute of Research in 1991. Nigauri is an award-winning manager and has received many accolades, including the Lipper Fund Awards Japan (2012, 2013 and 2016), the R&I (Rating and Investment Information) Fund Awards (consecutive years from 2012-2019) and the J Money Fund Awards (2016 and 2017).
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