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## Weekly Market Flash

### Bank of Japan Goes Full Hedge Fund

May 20, 2016

Japan was in the news this week mostly for the upside surprise in first quarter GDP; at 1.7 percent, the real growth rate was well ahead of expectations and a reversal of the 4Q2015 contraction. Will better-than-expected growth temper some of the recent chatter about more aggressive foreign currency intervention to bring down the yen? Will Prime Minister Abe go ahead with a second consumption tax hike next April, despite the negative fallout of the previous increase in the tax two years ago? Is domestic consumption, which drove the improved GDP numbers, here to stay, or will these numbers prove as fleeting as April cherry blossoms when the first revision comes out?

Important questions, all. But another news bulletin from Tokyo came to our attention this week, causing us to ponder whether there is anything truly surprising left in the world. The Bank of Japan (BoJ) is gearing up to be one of the largest shareholders in Corporate Japan, with the launch of a new series of exchange traded funds (ETFs) designed explicitly by and for the BoJ. Meet Haruhiko Kuroda, BoJ Governor and hedge fund spiv.

#### Biggest Shareholder in the Room

For some time now, the Bank of Japan has been a player in the ETF market. Up until recently this activity was generally under the radar, and entailed mostly plain vanilla ETFs that track major blue chip stock indexes like the Nikkei 225. But the volume of purchases has grown steadily over the past couple years, such that the BoJ is now the beneficial owner of about 55 percent of the total volume of Japanese ETFs. That makes it a larger shareholder in Japanese companies than either BlackRock or Vanguard, two of the largest passive index investors in the world. In fact, the BoJ is one of the top 10 shareholders, on the basis of size of holdings, in 200 out of the 225 companies listed on the blue chip Nikkei index. In financial markets parlance, the BoJ is already the “Tokyo Whale.”

But today’s launch of two new ETFs takes the central bank’s involvement in the business of Japan to an entirely new level. These ETFs, dubbed “Human and Physical Capital Funds”, are not your typical plain-Jane ETFs designed to passively track a benchmark index. Companies selected for inclusion in the ETFs will have to meet certain standards of compliance with BoJ policy goals. These include more cash deployed into new business investment and increased wages for company employees. In other words, the central bank is trying to induce companies to do more to stimulate Japan’s economy, by holding out the carrot of buying (and thus lifting the price of) its shares.

#### “Human and Physical Capital” is the New Smart Beta

The methodology is thus somewhat analogous to the factor-investing approach pursued by so-called “smart beta” strategies. But most smart beta strategies are at least premised on the idea that whatever factors they employ – minimum volatility, momentum, enhanced dividends or whatever else – have some demonstrable success case as value-added factors. There is no empirical evidence to suggest that a factor fund based on a set of explicit central bank stimulus goals would be a worthwhile investment. After all, high labor costs and outside capital expenditures are generally rather poor predictors of stock price outperformance.

And that is a problem for the Bank of Japan, because legally it cannot purchase more than 50 percent of any individual ETF. Other investors will have to pony up for the remaining 50 percent of these Human & Physical Capital Funds. Japan does have some very large institutional investors in the public sector, including the massive \$1.7 trillion Japan Post and the Government Pension Investment Fund – so there could be some concerted aligning of investment policy statements to support the BoJ. Private sector investors, though, may see little reason to make targeted investments in companies whose corporate strategy decisions owe more to central bank pressure than to actual economic opportunities.

## Reductio Ad Absurdum

That leads to the larger question of why any central bank should ever become so closely intertwined with the stock market. It is one thing to buy up bonds in the secondary market, as all central banks with quantitative easing programs have been doing for the past seven years. But stocks and bonds are fundamentally different capital instruments, and the big difference is that equity investing correlates to corporate ownership.

We noted above that the Bank of Japan is already one of the top 10 shareholders in the vast majority of Nikkei 225 companies. Institutional shareholders play an important role in corporate governance, which in turn influences the specific strategic and operational decisions companies – private sector companies! – make about how to generate future cash flows from the asset base in place. Having a government-related entity (whether or not nominally independent of other government agencies) as a potentially decisive voice in this regard is troubling. What happens if a company in the Human and Physical Capital Fund builds a factory to produce products for which there is insufficient market demand? Does the central bank step in and place orders for Company ABC's widgets because nobody else wants them?

It sounds patently absurd. Then again, until recently it would have struck any reasonable person as absurd that central banks would be masquerading as hedge funds. Yesterday's absurdities would appear to be today's norms.

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