Institutional Investor

Big Asset Shift of Japan’s GPIF Is Secret Weapon of Abenomics

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Dramatic change is coming to one of the conservative cornerstones of modern Japan. Since the Meiji Restoration the trains have run precisely on time, the sakura cherry trees have blossomed on cue in early April, and Japanese citizens have placed the bulk of their savings in stodgy government-controlled pension funds, which in turn invest in Japanese government bonds (JGBs).

I noticed the pink buds of *Prunus serrulata*, or Japanese cherry, from the window of the Shinkansen that brought me from Kyoto to Tokyo to interview the president of Japan’s Government Pension Investment Fund, the world’s largest pension plan. My bullet train left Kyoto and arrived in Tokyo exactly on time. But the GPIF, a onetime pillar of conservatism, is no longer simply shoveling funds into JGBs.

“The GPIF is a big whale in a small lake,” says a longtime Japanese macro fund manager who deals with the Bank of Japan every day and spoke on condition that his name not be used. “In just six months they moved ¥8 trillion ($67 billion) from Japan’s bond market into other assets. This is the biggest politically driven portfolio shift I’ve ever seen, and they pulled it off without roiling these markets.” Not that he was complaining; like many other portfolio managers, he had been long the Nikkei 225 index and short the yen for the past 18 months, earning a tidy profit on both sides of the trade.

The GPIF is diversifying at a pace that’s astonishing for a fund of its size: With ¥131 trillion in assets, it’s more than three times bigger than the California Public Employees’

Retirement System and more than $200 billion larger than Norway's giant Government Pension Fund Global, the world's biggest sovereign wealth fund. In the last six months of 2014, while slashing its JGB holdings, the fund increased its exposure to Japanese stocks by ¥5 trillion, to foreign equities by ¥7 trillion and to foreign bonds by ¥4 trillion.

This colossal rebalancing looks set to continue to ripple through asset markets. How much more money will move and how much longer it will move are questions of great interest to any investor with exposure to Japanese stocks, the JGB market and the yen's exchange rate against the dollar and other currencies.

To get a better understanding, I went to GPIF in late March to interview the man behind the fund's dramatic reshaping: president Takahiro Mitani.

GPIF's offices are surprisingly modest for such a financial leviathan. They are housed on the second floor of a gray office building in Kasumigaseki, the government district just south of the Imperial Palace. There is no receptionist, and employees — fewer than 100, a legacy of the days when GPIF did little more than buy JGBs — sit at metal desks in an open-plan office space.

Mitani-*san* greeted me in a conference room, looking remarkably calm and collected for a man who had navigated his way through three years of bruising politics to transform the fund's investment mandate. He was rumored to be on his way out. Maybe that's why he's so relaxed, I thought.

Last year the fund's investment advisory committee — acting partly at the behest of the government, which appoints several of its members — endorsed sweeping changes to GPIF's portfolio allocation, setting new targets of 35 percent for domestic bonds, 25 percent for domestic equities, 15 percent for foreign bonds and 25 percent for foreign equities. By comparison, actual allocations were 67.4 percent, 11.1 percent, 8.4 percent and 10.1 percent, respectively, with the rest in short-term assets, at the end of 2011, just before the fund started to diversify. After last year's changes the fund still held 43.1 percent of its assets in domestic bonds; it had lifted its allocation to Japanese stocks to 19.8 percent, foreign bonds to 13.1 percent and international stocks to 19.6 percent.

Mitani and I went back and forth in a combination of English and Japanese. I kept careful mental track because the numbers were large, and even after 40 years of speaking and working in Japanese, the translation can be tricky: The counting units for large numbers are 10,000 (*ichi-man*) and 100,000,000 (*ichi-oku*). Combined with an exchange rate of roughly ¥120 to the dollar, it can make the ends of your hair hurt.

I asked Mitani to explain the logic behind the shift in the portfolio.

"Our committee examined various sets of asset allocations which met the necessary rates of return in two macroeconomic scenarios, an upside and a downside case, and analyzed these with multiple risk metrics," he told me. "This diversification strategy was authorized by the Ministry of Health, Labor and Welfare," the government department to which GPIF reports.

By "necessary rate of return," Mitani meant a new portfolio return bogey of 1.7 percent, up from 1.1 percent, recommended by the advisory committee. As the advisory committee explained at the time in its report, "Japan's public pension scheme is basically managed as a pay-as-you-go system, where the contributions paid by working generations support elder generations. Given decreasing birthrate and ageing population, funding the pension benefits solely by the contribution from working generations would unduly weigh on them, thus the fiscal plan was drawn up to use [GPIF] to fund the benefits to later generations."

In other words, GPIF — like almost every other institutional investor on the planet — is now reaching for yield. And this reaching for yield is an important cog in the machinery of Abenomics.

Investors around the world have been closely following Japan's markets since the end of 2012, when Prime Minister Shinzo Abe took power and embarked on his ambitious, and untested, reform program aimed at lifting the economy out of its long deflationary slump. Abenomics' first two policy arrows, fresh fiscal stimulus and a massive new round of bond purchases by the Bank of Japan, have given a modest boost to the economy and a bigger bump to the stock market. The benchmark Nikkei 225 has surged by 130 percent since mid-November 2012, when Abe ignited a rally with his campaign pledge to reflate the economy.

"I'm bullish on Japan in 2015 for five reasons," said Masaaki Kanno, chief Japan economist at J.P. Morgan and a former BoJ official, as he sized up Abenomics for me. "The global economic conditions are favorable, and real workers' income is going to rise by about 1.7 percent for the first time in quite a while. Manufacturers are starting to respond to the weaker yen, we are making progress on corporate governance reform, and the BoJ is giving full support to raising asset prices. GPIF and public pension money is flowing into equity and foreign asset markets."

Those flows seem likely to continue for some time yet. The pension fund is still some ways from its new allocation targets, and those targets, in turn, are the midpoints of fairly wide ranges. "The GPIF new target for domestic equities is 25 percent, but there is no reason they would necessarily have to stop there," Kanno notes. "The new guidelines give them the latitude to go as far as 30 or even 34 percent."

Yet plenty of skepticism persists about the ultimate success of Abenomics. My old friend John Greenwood, London-based chief economist at asset manager Invesco and a longtime scholar of Japanese macroeconomics, explains one of the reasons: "Despite the Bank of Japan's balance sheet doubling in size since March 2013, commercial bank balance sheets and M2 have only expanded by 6 or 7 percent since then, or 3 percent per annum, which implies nominal GDP can only grow by 1 to 2 percent per annum after allowing for velocity changes."

The third arrow of Abenomics, structural reform, is arguably the most important part of the program but is also the most difficult to pull off. The reforms include measures designed to encourage investment; increase labor participation, especially among women; and enhance productivity. The government is counting on GPIF to help propel the third arrow by increasing its holdings of Japanese equities and using its clout as a shareholder to push for better governance and improved performance at the country's leading companies. This raises knotty political questions about the appropriate risk-and-reward profile for a public pension fund, how to best tactically manage the portfolio that is selected and how much the fund should be an instrument of government economic policy.

"With all three Abenomics arrows, we are engaged in a giant economic experiment that nobody has ever tried before," confides a Japanese economist. He cut his teeth as an official in Kasumigaseki before moving to a lucrative job in Tokyo's Marunouchi financial district, and like many of my interlocutors he is reluctant to go on the record with doubts about the government's strategy. "All these policies have to fit together in just the right way: the fiscal stimulus, the quantitative expansion, the deregulation and structural reforms to enhance productivity," he says. "Then we have to end them in just the right sequence, with a higher consumption tax for fiscal consolidation and a tapering by the BoJ. The GPIF is part of that machinery."

The pension fund's return target is a real one, defined as the growth of nominal wages plus 1.7 percent. If Bank of Japan governor Haruhiko Kuroda succeeds in getting inflation back up to his 2 percent target, which implies a similar growth in wages, Mitani's nominal return target will rise commensurately. Can GPIF hit its goals, and does Abenomics have to succeed for the pension fund's new portfolio strategy to be effective, I asked.

Mitani parried politely. "Our asset allocation is not dependent upon a single economic scenario. Instead, an upside case and a downside case were chosen among the various scenarios in the actuarial valuation," he noted. "Our new policy asset mix is optimal in that the asset mix will achieve a 1.7 percent real investment return in both the upside and the downside case."

So far, the portfolio is delivering better than promised. GPIF generated a return of 9.96 percent between March 31 and December 31, 2014, the first three quarters of Japan's fiscal year, thanks to the fund's holdings of Japanese equities and foreign exchange gains on its offshore assets.

Even more interesting is how the market has reacted to the pension fund's new strategy.

Like clockwork, when an official statement came out in Tokyo that GPIF was moving ahead with its portfolio rebalancing, Japanese equities jumped up and the yen slid down.

My Teneo Intelligence colleague Tobias Harris built a model using the Kensho data analytics system to measure the effect of official statements from GPIF over the past two years. Using 19 such statements over that period, he found that the Nikkei 225 rose by an average of 1.17 percent in the day following an announcement. Conversely, the JGB market on the London International Financial Futures Exchange and the yen each took a mild hit, dropping 0.02 percent, on average.

What a brilliantly lucrative and simpleminded trade, I thought. Just watch for public statements affirming GPIF rebalancing, buy the Nikkei and short the yen, then close out the position in 24 hours and pocket a clean 1 percent. How much longer would this go on?

"Do you think GPIF will continue to diversify the portfolio so aggressively?" I asked Mitani. "I'm not quite sure whether the word 'aggressive' is appropriate to describe our investment policy," he replied. "We will watch the market and take necessary actions as appropriate. Of course, we are mindful about our asset size."

I followed up: "If Abenomics does work out as we all hope it will, isn't this going to be a risky transition period as interest rates normalize to higher levels?"

"We will monitor our actual portfolio carefully, examine any change of economic condition and consider necessary actions," he said. "While taking into consideration the capital loss of domestic bonds, to be materialized in the prospect of an interest rate increase, we anticipate the expected return of domestic equities will also increase in accordance with inflation and are confident of achieving the targeted return."

I'VE SPENT A LOT OF TIME in Japan, as a student and later as a diplomat and high-tech manager, and I profoundly enjoy the country. Yet I'm feeling a bit older than the first time I touched down in Tokyo, in the fall of 1973. This time, after spending much of a sleepless 12-hour flight from New York reading about pension politics and Japanese demographics, I landed at Narita International Airport looking for signs of an aging Japan. Instead, I had the opposite impression. Everybody looked young, from the All Nippon Airways pilots to the immigration officials to most of the people on the fast train into Tokyo.

One of my longtime Japanese friends laughed out loud when I mused at this paradox over dinner at the Hotel Okura. "*Dankai no sedai*!" he said. "Of course they all look young to you. That's because you're one of the old people now. Shinn-*san*, you're an aging baby boomer — one of us, the dankai no sedai."

The minister of Health, Labor and Welfare is another longtime Japanese friend and fellow traveler in the dankai no sedai. Yasuhisa Shiozaki and I were neighbors at Harvard University three decades ago, when he was at the John F. Kennedy School of Government and I was at the business school. We stayed in touch over the decades as I watched him leave the BoJ and take up a political career, representing his district in Ehime Prefecture, on the southern island of Shikoku, and rising rapidly through the ranks of the Liberal Democratic Party.

He and Prime Minister Abe are also fast friends. They served as private secretaries to their respective fathers, who were ministers in the Nakasone cabinet in the 1980s and then served in the Diet together for decades. In 2006, during his short-lived first government, Abe appointed Shiozaki as his chief cabinet secretary.

Shiozaki is a serious policy maven. For years he has been thinking about the role of pension funds in promoting better governance. I spent time with him in Tokyo in the late 1990s, when I was researching a book on corporate governance. He explained to me back then that shareholder-centric governance reform was crucial to raising the country's long-term economic growth. The core argument of *Political Power and Corporate Control*, which I co-authored with Peter Gourevitch of the University of California, San Diego, was that pension funds are the principal driver of corporate governance reform across all countries and asset markets. I recall Shiozaki telling me that until Japanese pension funds got serious about corporate governance, very little real reform would take place in Japan. Now, as head of the MHLW, he's in a position to do something about it.

"Shortly after becoming minister Shiozaki personally attended a meeting of the pensions section of the MHLW's Social Security Council to argue in person for reforming GPIF," says Teneo's Harris. "It's rare for a minister to attend such advisory councils in person, so his attendance signaled that GPIF reform was his top priority. But he still faced resistance from within the MHLW about both rebalancing the portfolio and how the fund is governed. The MHLW's bureaucrats are determined to prolong the process as long as possible in the hope of forestalling reform."

In this sense, the GPIF reforms constitute one act in a very long drama of contestation between Japan's elected politicians and the powerful bureaucrats in government ministries. This clash figures prominently in Abenomics. The conservative mandarins in the Ministry of Finance despised the widening of the fiscal deficit that came with the first arrow. The equally conservative mandarins at the Bank of Japan were appalled by the prospect of a new, sustained round of bond purchases, or quantitative and qualitative easing (QQE), in governor Kuroda's words. By the same token, the MHLW mandarins are just as displeased with the prospect of GPIF portfolio rebalancing and governance reform. Their disagreements are not just about regulatory turf battles; they also reflect sincere differences on financial and economic policy, including the prudence and effectiveness of Abenomics.

"Minister Shiozaki wants to diminish the MHLW's power over GPIF by transforming it from an incorporated administrative agency under the supervision of the MHLW to an authorized corporation, similar to the Bank of Japan, accountable to both the Diet, which would approve the fund's top managers, and the MHLW," Harris says. "He hopes that by weakening the MHLW's control of the fund it will be possible to replace its bureaucratic managers with professional investors."

The pension fund's rebalancing is one subplot of a much bigger and more dramatic play. The Bank of Japan has been engaged in some version of quantitative easing longer than most people realize, and it began to expand its asset purchases in late 2011. Kuroda cranked up the policy dramatically on April 3, 2013, just two weeks after assuming the governor's post, by publicly committing the central bank to making sustained JGB purchases — the Japanese equivalent of European Central Bank president Mario

Draghi's "do whatever it takes." Eighteen months later he raised the annual target for expanding the monetary base, just as GPIF's portfolio rebalancing out of JGBs was getting into full swing.

The Ministry of Finance has long viewed the domestic banking, insurance and pension system as a convenient place to stuff the seemingly endless quantities of JGBs that funded endless government deficits during Japan's so-called lost decades. This mechanism allowed Japan's debt-to-GDP ratio to climb to a towering 227 percent by 2014 without risking a sovereign debt meltdown. "The Ministry of Finance has been writing IOUs for an additional debt burden of 10 percent of GDP every year since the financial crisis," one London-based trader says. "But as long as the Japanese owe these bonds to themselves, there's never going to be a run on the Bank of Japan."

Kyle Bass, founder and principal of Dallas-based hedge fund firm Hayman Capital Management — and a persistent Japan bear — is skeptical of such reasoning. "If debt monetization is regarded as taboo by major central banks, why is there not more concern about the BoJ buying 150 percent of the net debt issuance of the Japanese Federal Government, even if it is on the secondary market?" he wrote me in an e-mail. "What does it take to convince prudent asset managers that the BoJ is subsidizing endless deficits by the government?"

In fact, the central bank now holds about a quarter of all outstanding JGBs. The BoJ's balance sheet as a percentage of GDP is now more than twice the size of the Federal Reserve's or the ECB's. So I knew my conversation with Mitani would have to get around to the role of the Bank of Japan sooner or later. Mitani knows the BoJ intimately, having worked there for many years before joining GPIF.

"How important was the BoJ's QQE in enabling GPIF to reduce its JGB holdings?" I asked.

He answered carefully: "While acknowledging that the BoJ policy currently provides us with a favorable market environment," he said carefully, "I would like to remind you that our asset allocation is independent of such policy."

Although the JGB market has been remarkably firm, with ten-year yields dropping by a quarter point over the past year, to just 33 basis points in early April, there certainly has been a run of sorts on the yen, though this is an intended feature of Abenomics, not a bug. A weaker yen is supposed to stimulate Japanese exports and growth and boost inflation toward the 2 percent target. Will GPIF rebalancing accelerate this process or perhaps even knock it off the rails?

Hayman's Bass thinks so. "If the GPIF and [Japan's] Post Bank engage in their stated plans to divest yen based assets, which are primarily JGBs, in order to invest in higher-yielding foreign assets, then by our calculations this asset shift from yen to other currencies could exceed 3.5 percent of GDP," he wrote me. "If the current account is running at +.5 percent to +1 percent, with outward portfolio flows set to exceed –3.5 percent of GDP, there is a material risk that the yen could have a 'disorderly' move in 2015. And this in turn could disrupt the JGB marketplace."

If GPIF pushes to the upper limits of its new foreign bond and equity allocation targets, as J.P. Morgan's Kanno suggests, as much as an additional ¥25 trillion could flow out of the Japanese currency and into foreign-currency-denominated assets. I put the question to Mitani: Could portfolio rebalancing erode Japan's current-account surplus and undermine the yen? He smoothly brushed this concern aside, replying, "We understand that the foreign currency market is so large that it will not be influenced by our [outward] investment activities."

IN JUNE 2014 A HIGH-PROFILE panel of economists advising the Financial Services Agency and the Ministry of Finance on revitalizing Japan's financial system — a group set up at the request of Abe's Cabinet Office — focused its attention on GPIF. Reforms were needed to make the giant pension fund a more sophisticated investor, the panel recommended in its report: "Further efforts should be made by establishing a governance structure to enhance the independence and expertise of these funds as quickly as possible, reviewing the personnel and remuneration systems and utilizing professional asset managers, as well as reviewing the investment portfolio in light of the progress of the governance reform."

"We really need to add experts," agreed Shiozaki in an August 2014 speech before he assumed the helm at the MHLW. "GPIF has less than 100 people, and it's been said only seven of them are investment professionals, like the Seven Samurai," a clever reference to Akira Kurosawa's classic 1954 film. (He might have added that only two of the samurai survived the final battle with the marauding bandits.)

I asked Mitani how he had managed to diversify GPIF's portfolio so quickly with such a small staff.

He looked at me patiently: "Our rebalancing strategy had no specific time frame and was prudently executed with sufficient attention to the market impact. We have revised our compensation structure to attract and retain new professional managers. However, it will take us a couple of years to strengthen our human resources. Also, we will seek larger new office space to accommodate our members."

One of those new members is Hiromichi Mizuno, who was appointed to the newly created post of CIO in January. Japanese media reports viewed this as a controversial hire. According to magazine *Shukan Bunshun*, Mizuno lacked both the policy experience of a ministerial mandarin and the hands-on experience of a portfolio manager but was nonetheless appointed CIO by the chief cabinet secretary's office. Mizuno obtained an MBA at Northwestern University's Kellogg School of Management and then worked with a European private equity firm, Coller Capital.

The third arrow of Abenomics is structural reform and deregulation to spur higher real growth. As Shiozaki pointed out long ago, corporate governance reform is crucial for sustained economic growth.

"Japanese labor productivity, especially in the service sector, must rise to offset the falling labor force," says J.P. Morgan's Kanno, sifting through the growth data. He showed me a graph illustrating how Japan's manufacturing productivity is more than twice that of the service sector, which has been virtually flat for most of the lost decades. But manufacturing employment is shrinking while service employment is growing. "For this we need much better allocation of capital and labor resources, which means we need higher return on equity and better corporate governance," concludes Kanno. It is striking that the average ROE of companies on Japan's Topix has been just half that of the businesses on the S&P 500 for the past two decades.

As Ira Millstein, éminence grise of corporate governance and prime mover of the OECD governance codes, has repeatedly insisted, if you can get agreement by institutional investors that they should exercise their rights as shareholders, then market pressure will improve companies' governance and ROE. Things appear to be unfolding in exactly that sequence in Japan.

In May 2014, GPIF publicly endorsed Japan's new Stewardship Code for institutional investors. The fund's policy statement said the GPIF "suggests to the external managers that they should recognize the importance of corporate governance and that the voting rights should be exercised to maximize the long-term interest of shareholders. GPIF asks each external asset manager to prepare detailed policies on exercise of voting rights and to exercise such rights appropriately based on those policies. GPIF does not make decision on individual voting rights in order to avoid direct influence on the management of private sector firms. Instead, it entrusts individual exercise of shareholder voting rights to its external asset managers."

Within 12 months of GPIF's acceptance of the Stewardship Code, the Tokyo Stock Exchange announced a follow-on governance code requiring listed companies to adopt a "comply or explain" policy for appointing outside directors. "Companies that fail to include at least two outside directors will be compelled to explain to their shareholders why they have not complied," says Teneo's Harris. "If they fail to explain, they will be publicly identified and possibly fined by the TSE. Since only 21.5 percent of the 1,814 companies in the TSE's first section have two or more outside directors and 700 have no outside directors at all, a significant number of listed companies will have to adapt."

I reviewed Mitani's answers to my questions with a former BoJ official who now serves as a director of a private Japanese technology company, and asked him how Abenomics was likely to end.

"There are only a few ways out, and not all of them are good," he replied. One path is partial default or a JGB write-down by the Japanese government — "theoretically possible, but not in the cards for now," he added. Another way out from under the debt burden is the success of Abenomics, with rapid inflation. "Or we could actually get fiscal consolidation in time," he said. "But will fiscal consolidation take place soon enough? If not, who will buy all those JGBs if the BoJ tries to taper like your Fed? The answer is administrative guidance to the Japanese trust banks, insurance companies and pension funds to buy and hold JGBs."

"What do we call that in economics English?" I asked.

"I think your technical term is 'financial repression.'"

J.P. Morgan's Kanno agrees that Abenomics will require some fancy footwork and very good luck to succeed. "I believe there is a successful exit path for the BoJ from QQE, although it is a narrow path," he says. "If the BoJ's taper starts sometime in 2018, by that time it will have a huge portfolio of low-yielding JGBs just when inflation and interest rates start to rise. It is not inconceivable that the BoJ would then have negative equity and would have to be recapitalized by the Japanese government."

"What are you most worried about?" I asked.

"With QQE the BoJ has been buying time for the government to accelerate growth through higher productivity and achieve fiscal consolidation by increasing the consumption tax and spending cuts, especially on social-security-related expenditure," Kanno said. "The biggest risk is that QE may have spoiled the politicians and allow them to kick the can down the road while avoiding any serious economic reforms."

Invesco's Greenwood is less anxious about the ultimate exit path from QQE: "The BoJ needs to ensure a smooth handover of the credit creation baton to the banks. For the government all that is really necessary is for the budget deficit to narrow to a percentage of GDP that is lower than the growth of nominal GDP. If this position can be maintained, then the government debt-to-GDP ratio can gradually come down."

By the time the BoJ tapers in 2018, GPIF will have dramatically reduced its exposure to low-yielding JGBs, although it, too, will take a major balance-sheet hit when real interest rates rise and those low-yielding JGBs still in the portfolio are suddenly worth a lot less. Presumably, those book losses will be more than offset by the higher yields of the rebalanced portfolio — an accomplishment that the advisory committee experts, fund president Mitani, minister Shiozaki and a number of hardworking technocrats will take pride in. As I was leaving Japan, a friend e-mailed me that Mitani had just been reappointed president of GPIF "for an indeterminate period."

From our conversations it is clear to me that policymakers are acutely aware of the risks inherent in Abenomics. There isn't a lot of discussion of plan B, if it doesn't work. In fact, I'm not sure there is a plan B.

The day after my talk with Mitani, I took an excursion on the gleaming Namboku subway line to pay my respects to the long tail of the demographic curve. I went to O-Okayama, a tony suburb southwest of central Tokyo, to visit my 94-year-old mother-in-law, Hideko Hashigami, in her assisted-living facility.

She is a beneficiary of GPIF, as are most of the 26 percent of the Japanese population who are 65 years or older. Nearly half of that cohort are 75 or older, and fully 50,000 Japanese are centenarians.

It was exercise time in the ward when I arrived. The white-haired ladies sat in a half circle, rotating their arms to a slow cadence, and the room was set to 26 degrees Celsius (79 Fahrenheit). I thought, This is the old Japan I've been looking for since my arrival at Narita.

I'd visited my mother-in-law's former house in Kyoto before coming to Tokyo, and I showed her photos of the early cherry blossoms in her garden. She sighed, saying she'd like to see it again, but she was too frail to travel. She would probably never see it again, she said; she hoped the gardeners would take good care of it.

It struck me, quietly but poignantly, that here was the very essence of aging: knowing some things are very important and need to be taken care of but realizing that you can no longer do them yourself — and hoping that somebody younger will do the right thing.

All of us in the dankai no sedai will face this over time. Pensions are one of the really big things we count on somebody doing right. Mitani, Shiozaki and Japan's financial technocrats are making a big bet. Let's hope for all of us that they get it right. •

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