The Japanese experience

Four papers from Japan’s Security Analysts Journal provide an interesting window into the Japanese financial services sector. The four papers all won the 2005 prize. JASSA Editor JOHN ARBOUW provides a summary.

 Management earnings forecasts are often an exercise of hope over reason. In Japan, as required by stock exchanges, most managers announce forecasts for the following year’s sales, ordinary income, net income, and dividends.

Earnings forecasts greatly influence market expectations, but even management earnings forecasts sometimes diverge from actual earnings that are reported the following year.

So if Japanese management forecasts are notoriously inaccurate do they in fact tell us anything? In a paper published in Japan’s Security Analysts Journal, Kobe University PhD student Katsumihiro Muramiya looked at the correlation between “Management Forecast Accuracy and Cost of Equity Capital”.

According to the empirical results of Muramiya’s paper, firms with lower management earnings forecast accuracy have higher implied cost of capital that equates the current stock price to book value and the present value of expected future residual income. “However, this result may be caused by the correlation between the proxy for management earnings forecast accuracy and risk factors such as earnings volatility,” says Muramiya. His paper takes into account earnings volatility, other risk factors, and mispricing variables known to affect cost of capital, and he analysed the relationships.

He finds that management earnings forecast accuracy is negatively associated with cost of capital. This result leads to the conclusion that management earnings forecast accuracy explains cross-sectional variation in the cost of capital and is therefore a different factor from determinants which previous studies suggest are associated with cost of capital. In addition, the negative association between management earnings forecast accuracy and cost of capital is robust in an asset-pricing test using realised returns.


His paper, “Evaluating Active Fund Managers Using Time Series of Ex-ante Risk Estimates”, looks at the knowledge gap between investors and managers and says that investors can reduce this informational disadvantage using time series of some ex-ante risk statistics pertaining to the portfolio.

To achieve this, Nakashima suggests, it is necessary to have reliable time series of risk estimates. In his paper he shows the importance of ex-ante risk estimation in a multi-period setting, and proposes a framework that enables the good use of time series of risk estimates to evaluate active fund managers.

Junichi Iwamoto, Chief Researcher, Pension Research Institute, The Sumitomo Trust & Banking Co, looks at “Factors Driving Correlations Between Fixed Income and Equity Returns”, and using actual market data to conduct factor decomposition of equity and fixed income returns, he finds that the correlation between real interest rates and expected dividends has the most significant influence.

The method attempted in the article is the factor analysis of returns, but this method involves some issues including the interpretation of the research result by historical data. One is the estimation method of expected inflation rates. The other one is the state of the economy.

The article used long-term data for over 16 years for the analysis. During these years, except for a few years at the beginning, nominal interest rates constantly declined and the Japanese economy remained sluggish. Hence, there is no doubt that a different result would be obtained if there is significant change in the economy in the future.

In his paper, Katsunari Yamaguchi, President, Ibbotson Associates Japan, Inc and Visiting Professor, Sendai University Graduate School of Economics, looks at “Supply-side Estimate of Expected Equity Return on Industrial Japan Analysis of Aggregate Accounting Data over Four Decades”.

This study measures historical equity returns over 42 years on the Japanese market by a supply-side approach using accounting data for 24 industries.

In the Japanese economy, a supply-side estimate of equity risk premium was almost zero over the last three decades since the 1970s. The primary causes for this low risk premium were declining ROE over time and, more importantly, the excessively high corporate income tax rate imposed by the Japanese government on shareholders’ earnings.

Yamaguchi suggests that in order to supply sufficiently high return to investors for shouldering risk, not only has the corporate sector to make efforts to raise ROE, but the government has also to adopt a tax policy to lower the corporate tax burden so that it does not unreasonably hurt shareholders. 

The full papers can be accessed at www.finsia.edu.au/Membership/MembershipInformation_and_News

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