WORKING PAPER:

Breaking the Deflationary Spiral and Re-Igniting the Virtuous Investment Cycle

Action framework for companies and stakeholders

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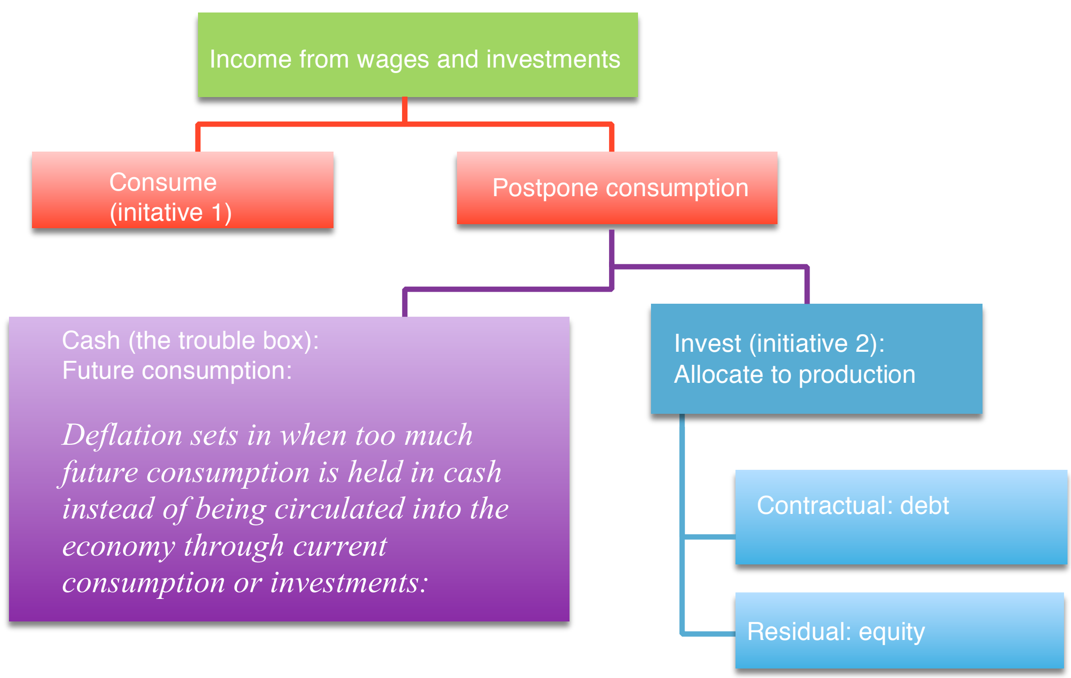
The exit from deflation has proven elusive for the Japanese economy. This paper proposes three corporate initiatives to break the deflationary spiral.

1) Appoint a new breed of more globally minded, technology literate talent into the boardroom.
2) Consolidate domestic industries to create investments that match consumer risk profiles.
3) Align incentives among talent and stakeholders to reward effective risk management.

Deflation is the economic equivalent of metabolic syndrome; it is not a single affliction, rather a cluster of overlapping conditions. Just as metabolic syndrome is not strictly a physiological condition but influenced by lifestyle choices and mental states, deflation is not strictly a macro-economic phenomenon. Deflation has many facets; one of which can be described as the aggregation of isolated decisions to defer consumption and investment in favor of hoarding cash to prepare for perceived difficult times ahead. The origins of this risk aversion are not just economic, they are also political, cultural, psychological, and demographic. These actions can be rational in the micro economic sense, but they are disastrous in the macro and ultimately become a self-fulfilling prophecy, generating another turn on the deflationary spiral.

Exhibit 1: Consumer's View of the Economy



Just as deflation is the aggregation of isolated actions, we believe that corporate-level micro initiatives, once widely accepted by stakeholders, can unlock financial and human capital to flow to their highest and best uses, ultimately breaking the grip of deflation. While it is possible for companies to prosper without these initiatives, in order for aggregate change to occur, a few outliers are not sufficient; the entire distribution needs to shift. These initiatives provide a framework for specific actions that management can initiate and stakeholders can monitor and support, providing a way for corporate governance to act as an accelerator and not as a brake on performance.

Academics define creativity as the ability to develop ideas that are non-consensus and not easily accepted; the difference between creative ideas and crazy ones is how they withstand the test of time and scrutiny. Here are three creative/crazy ideas to break the spiral:

1) Appoint a new breed of more globally minded, technology literate talent into the boardroom.
2) Consolidate domestic industries to create investments that match consumer risk profiles.
3) Align incentives among talent and stakeholders to reward effective risk management.

1) Appoint a new breed of more globally minded, technology literate talent into the boardroom.

Raise Consumption: Create New Demand Curves; Not Just Reduce Costs

For the past 25 years, with too few exceptions, the corporate sector has been instrumental in adding to the momentum of the deflationary spiral. Unable to ignite the aspirations of customers with products and services that create new demand curves, companies have focused on lowering prices and squeezing costs in a race to the bottom. In the beginning, this retrenchment was a necessary one-time adjustment to wring out excess capacity, but deflation has since run out of control. One effect of this cost squeeze has played out in reducing wage levels and security, making consumers reluctant to spend. By focusing on costs instead of value, companies have not only failed in creating new demand curves, they have insured the destruction of aggregate demand. Recent changes in the corporate code will require companies to bring outside directors into the boardroom. To comply with the new guidelines, over 2000 new directors will be needed.

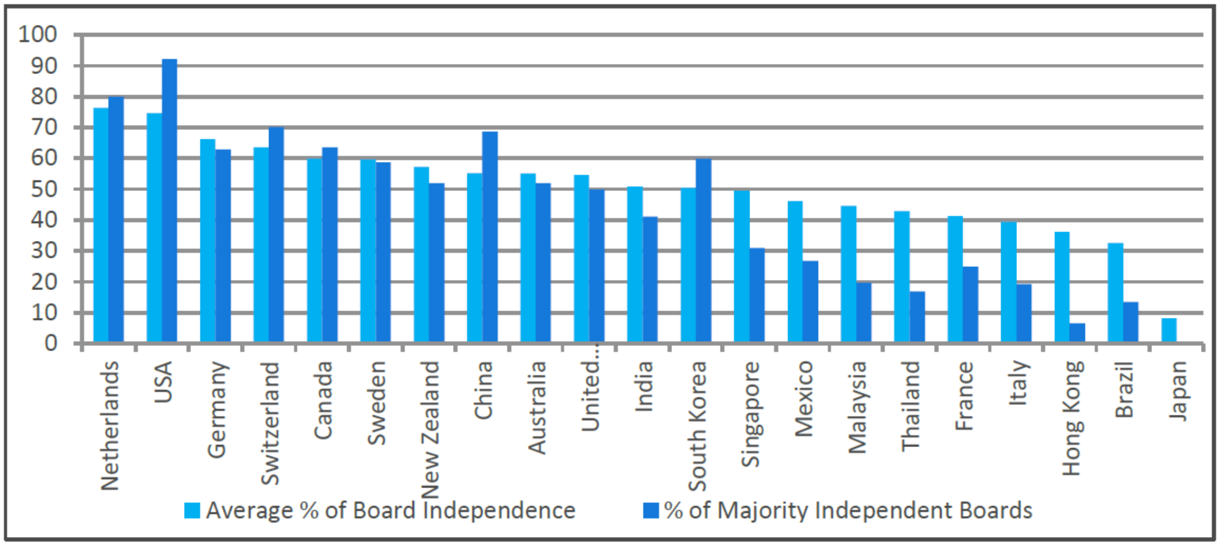
Exhibit 2: Board Composition in Japan; Outside Directors

Companies with at least:	One outsider	Two outsiders	One Independent outsider	Two Outsiders (1 independent)	Two Independent Outsiders
Nikkei 225	97%	72%	77%	64%	47%
JPX400	88%	55%	68%	48%	36%
TOPIX	77%	36%	53%	28%	19%
ISS coverage	72%	32%	47%	23%	16%

Source: Institutional Shareholder Services data post 2014 AGM season

One hope is that outside executives will spur a new wave of corporate efficiency through the spread of best practices. It is clear that relative to the rest of the world, there is a distinct lack of outside voices in the Japanese boardroom (exhibit 3). But even if outside voices lead to increased efficiency, efficiency alone does not create new demand and will not break the deflationary cycle. A different kind of voice will be needed.

Exhibit 3: Board Independence; Global Comparison



Source: Institutional Shareholder Services data

Japan, along with the rest of the world faces two great challenges; globalization and technological change. The success of lower wage manufacturing competitors and global technology firms has contributed to deflation as prices fell but the value added and profits of this success accumulated overseas. Japan cannot continue to respond by cutting costs. Instead it must innovate and generate new demand. But can a generation of seasoned executives who have done little besides cut costs in their own careers now pivot and spark innovation elsewhere? It is more likely that innovation will emanate from new executives who have fresh ideas and experience addressing the challenges posed by globalization and technological change. This new generation must accelerate the development of their risk management capabilities, not just in their own companies, but outside it as well. They need to be the new directors in Japan. They need to be a new voice to help companies shift their focus from just cost reduction to increasing value added.

Incumbent senior management will likely protest, “Why should we take our most promising talent and share it with the outside?” In a deflationary world where scarce resources are hoarded rather than utilized, this reticence is natural, but this type of thinking prevents innovation from moving beyond company mission statements and into concrete action. For those new executives, the hours spent outside as directors will accelerate their development much faster than if they were to spend it in another set of internal meetings. They will learn new leadership and delegation skills where they must create change by using their eyes and noses to identify issues but refrain from using their hands to control the process. They will wrestle with critical issues of defining core competencies and determining key performance metrics. They will recognize future leaders and contemplate the most effective ways to develop and retain them. They will determine how to reward success and how to spread the teachings from failure in a way that fosters future innovation rather than propagating risk aversion. They will learn the limitations of their current decision frameworks while gaining exposure to new ones. They will motivate through the strength of their ideas and not through the cultivation of internal political capital.

By using the 3000 boardrooms of public companies as experiments in accelerating innovation, new ideas should be realized faster while the board participants also accelerate their own development. Ultimately, some of the best people will become so attractive that other companies may recruit them away, but even this would be a good wake up call. It will force companies to realize that all employees face an opportunity cost by committing to the status quo. Rather than take talent for granted and force it to lay dormant for some vague future, each company will need to compete to retain and attract the best talent for their business today. Creating liquidity in the market for human capital will allow the best talent to flow to the best uses. This will make each company better, forcing it to constantly develop their best people while building robust networks throughout the economy. Ultimately, this can put Japan squarely into the post-deflationary track of driving value creation and innovation, not just cost reduction and demand destruction.

Chairmen who must incorporate this new breed of director may protest that their ideas are unseasoned and disruptive. But if executives cannot learn to channel this dissent and manage it in a positive direction, are they really qualified to act as a chair? Traditionally, the introduction of new management into Japanese companies has been a result of crisis. The analogy to organ transplants is often drawn, and in the same breath, organ rejection is invoked. This paints an image of binary outcomes where failure is fatal and even success implies a chronic convalescence.

But this is a false dichotomy, especially for outside board positions. Introducing diversity at the board level is more analog and less invasive in nature, akin to recent medical innovations such as fecal transplants. By introducing diverse bacterial flora into the corporate ecosystem, self-defeating allergic responses may be mitigated; inflammation and stress levels may fall as the body learns to cope with a greater biodiversity. The cost of treatment is much lower. There is much less disruption, and if the treatment is ineffective, it eventually passes through the system with minimal physical trauma.

Introducing outside executives to take on board positions can create a virtuous cycle where outside companies become more innovative and executives develop faster. By developing new demand curves, customer wallets are gladly opened and the stagnant purchasing power can re-circulate back into the economy. Virtuous cycles are needed to combat deflation. Providing opportunities to develop oversight skills will help talent to develop their own human capital. It will make them better executives; it will make the corporate environment better. That would not only be good for the companies and investors but for Japan too.

2) Consolidate domestic industries to create investments that match consumer risk profiles

Increase Investments: Create Dominant Domestic Companies to Satisfy Latent Demand

There is nothing wrong with global companies, but Japan currently suffers from a lack of dominant domestic companies to invest in. This is not a problem that is unique to Japan; the domestic economy of most countries lack the critical mass required to sustain a diversified portfolio. But as a country, Japan possesses the third largest economy and its reliance on exports is actually the third lowest in the G20. So Japan is blessed with the economic critical mass to support dominant domestic companies that could generate ¥ denominated earnings and consequently ¥ dividend streams, but most domestic industries remain too fragmented for dominant companies to emerge.

Exhibit 4: Comparison of Japanese and US Domestic Industry Concentration and Investability

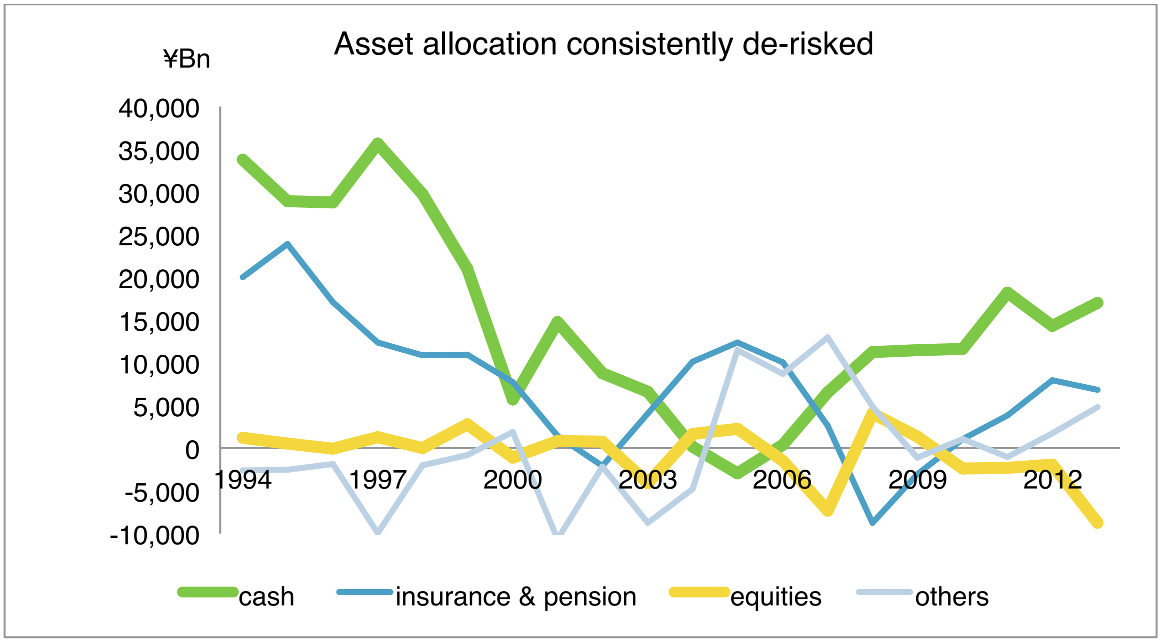
% Japan of US	Companies	Total Mkt Cap	Max Mkt Cap	Median Mkt Cap	Avg Mkt Cap
US total market	12,694	$29T			
Japan total market	3,831 (30%)	$5.2T (18%)			
US utilities	170	$770Bn	$52Bn	$1.8Bn	$5.1Bn
Jpn utilities	30 (18%)	$97Bn (13%)	$14Bn (27%)	$1.1Bn	$3.2Bn
US food drug retail	60	$510Bn	$120Bn	$0.58Bn	$8.5Bn
Jpn food drug	92 (153%)	$54Bn (11%)	$7.0Bn (6%)	$0.16Bn	$0.59Bn
US restaurants	106	$340Bn	$92Bn	$0.16Bn	$3.2Bn
Jpn restaurants	92 (86%)	$29Bn (9%)	$2.8Bn (3%)	$0.16Bn	$0.32Bn
US healthcare providers	138	$530Bn	$110Bn	$0.08Bn	$3.8Bn
Jpn healthcare	27 (20%)	$3.8Bn(0.7%)	$0.67Bn(0.6%)	$0.064Bn	$0.14Bn
US industrial transport	107	$498Bn	$89Bn	$0.61Bn	$4.7Bn
Jpn industrial transport	82 (76%)	$59Bn (12%)	$8.9Bn (10%)	$0.11Bn	$0.72Bn

This fragmentation not only prevents recognition of the investment opportunity by investors, it propagates deflation. As assets are stranded in sub-scale ventures, the operators of the assets lose confidence in their value. They convince themselves to accept lower returns in a shrinking market so they lower prices to attract share. To preserve any hope of generating a return, they cut costs. But again, these costs are predominantly wages, so cost reduction shrinks aggregate demand, deepening the economic metabolic syndrome.

Excessive competition not only propagates deflationary pricing, it also retards investment into distinct strategies. Exhausted competitors' value propositions converge around similar business models. Faced with many marginal choices instead of a few compelling differentiated ones, the consumer trudges down the deflationary route, reducing consumption, increasing saving, and slowing down the economic metabolism. Conversely, industry consolidation and value chain re-engineering will create companies with the sufficient critical mass to effectively invest in new concepts that can generate new demand curves that are essential to breaking the deflationary spiral.

Shifting to the investor side, it is clear that the Japanese consumer is unique. In the aggregate, they have large sums of capital but are constantly de-risking their asset allocation. Despite the recent rise in the stock market, the consumer has largely taken the gains of that wealth effect and bolstered their cash positions or invested overseas rather than allowing those gains to compound in the Japanese equity market. Saving for a rainy day instead of prudently taking on risk to preserve and enhance purchasing power is an obvious propagator of deflation. Clearly, the Japanese consumer is avoiding Japanese equity risk. But it is not that the Japanese consumer is completely risk averse. Overseas securities investment trusts have seen inflows of ¥34.5trillion since the end of 2006, but over that same time period, domestic equity funds have seen a ¥1.2trillion outflow. It seems that the current Japanese equity market does not present the right type of risks for Japanese households.

Exhibit 5: Historical Consumer Asset Allocation



Source: Cabinet Office: Capital Finance Accounts classified by Institutional Sectors Households (Including Private Unincorporated Enterprises)

What are the right risks for the Japanese consumer? Investments are meant to cover future consumption. So unless there is a plan for mass-scale emigration, their future consumption stream will be predominantly ¥ denominated. Therefore, Japanese consumers should look for ¥ denominated earnings streams to cover those future liabilities. But TOPIX is dominated by capital-intensive exporters. These companies primarily generate foreign currency revenues and have a ¥ cost base. So they are actually short the currency that the Japanese consumer wants to go long. In other words, buying Japanese stocks actually increases their exposure to ¥ liabilities; the very exposure that they want to avoid.

Stated in another way, export earnings streams and consequently the broad Japanese stock market is negatively correlated with the Japanese economy. All other things equal, if the

Japanese economy and stock market prosper, Japan becomes a more attractive place for consumption and investment, attracting an inflow of capital, causing the ¥ to rise. But a rising ¥ reduces the earnings power of the exporters. These lower earnings translate into poor stock market performance. As a result, it is difficult to propagate a self-reinforcing wealth effect where a strong economy builds a strong equity market, and strong returns encourage further investment. Instead of building confidence to produce and consume more, the export-centric broad stock market acts as a natural circuit breaker to the anti-deflationary wealth effect.

Exhibit 6: Classic Wealth Effect

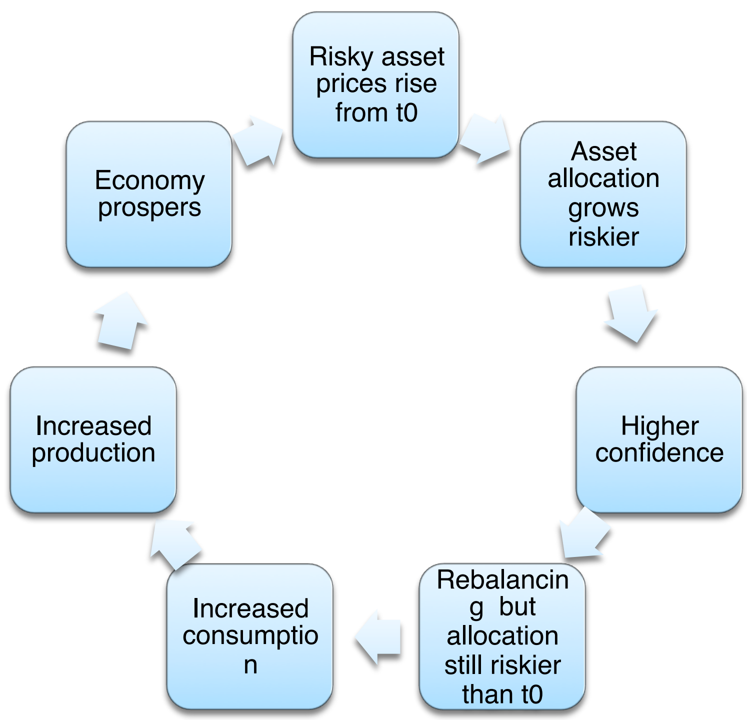


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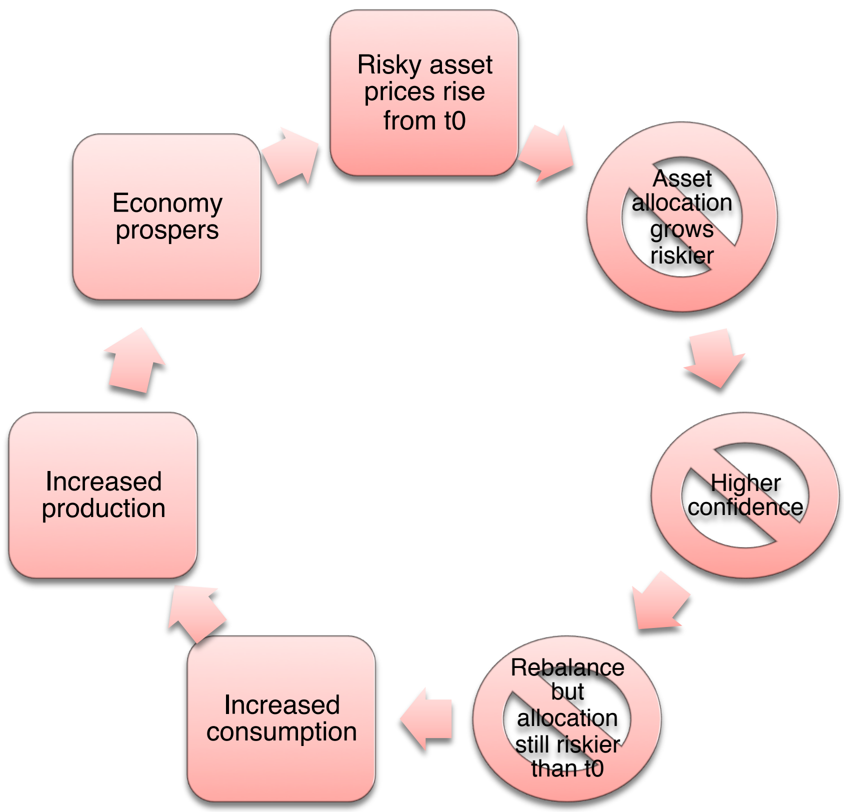
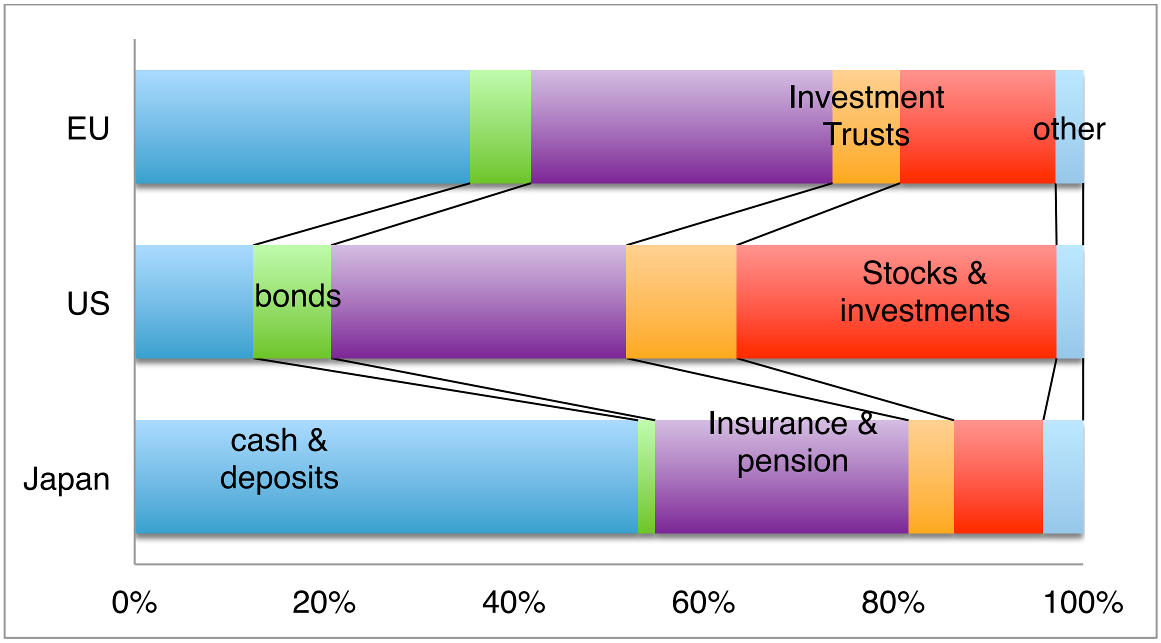
Exhibit 7: Japan Wealth Effect Circuit Breakers



Through consolidation, not only would these new leaders in the Japanese domestic industries provide new consumption alternatives, they would also become ideal investment alternatives. These companies would generate ¥ revenues against a ¥ cost stream, matching the risk profile of the Japanese consumer. Instead of putting their deferred consumption into cash or sending it overseas, consumers could re-deploy their capital into the domestic economy where it could generate innovation and growth. But until a significant number of such alternatives emerge, is it any wonder that cash does not flow into the domestic equity market, exacerbating the economic metabolic syndrome?

Exhibit 8: Household Financial Assets; Global Comparison



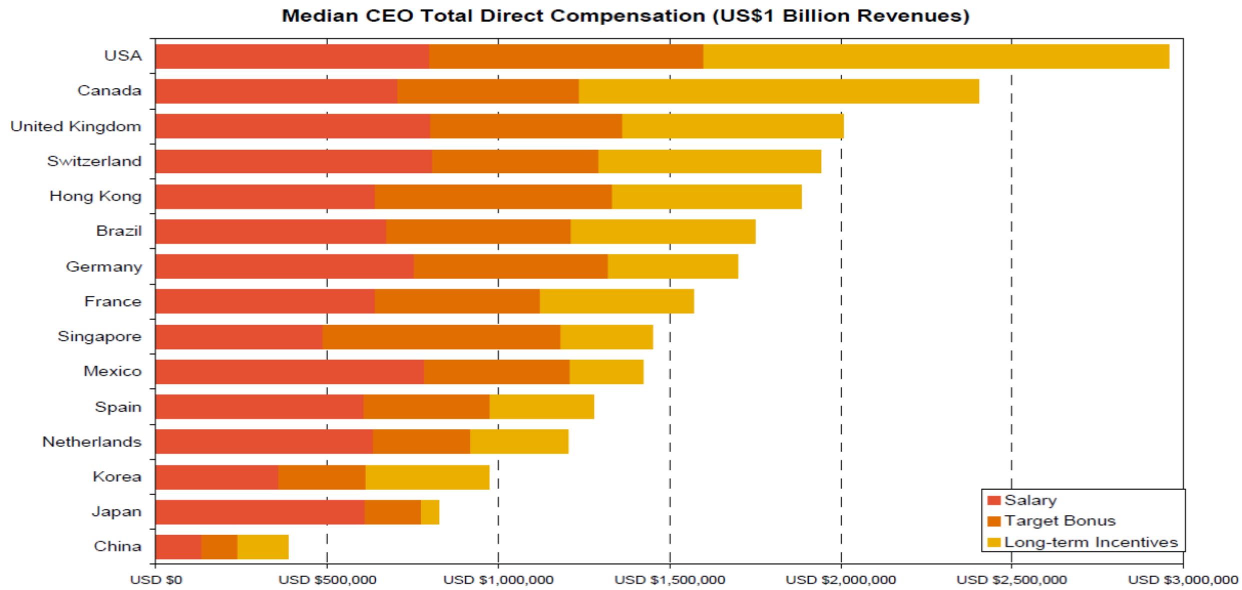
(Note) "Others" refer to the remaining balance of financial assets after deducting "cash and deposits", "bonds", "investment trusts", "shares and contributions", and "insurance and pension reserves."
(Source) Statistics Office of the Bank of Japan, "Statistics on Fund Flows as Compared between Japan, US, and Europe" (March 2014)

3) Align incentives among talent and stakeholders to reward effective risk management.

Pay for performance, long term thinking and accountability to make 1) and 2) easier

One Japanese CEO remarked that in Japan, CEO stands for *Cheap* Executive Officer. But the amount that CEOs are paid is not the most important contrast with other countries. It is <u>how</u> they are paid. With a high variable component generally linked to long term share price performance, the compensation of the overseas CEO is linked to overall firm performance.

Exhibit 9: Japanese CEO Compensation Differs in Level and Composition



(Source) Towers Watson

But in Japan, senior employees take a large but fixed share of value added in terms of compensation and fringe benefits, and when they retire, they take a lump sum of capital directly out of the company. In contrast, junior employees are left holding a residual claim in the form of a longer maturity, structurally subordinated tranche of compensation. As time passes, junior employees become the senior employees, and a swap of equity for debt gradually occurs as they exchange their residual claims for contractual obligations that are structurally senior to a new generation of subordinate employees. And the cycle re-commences.

Today's executives need to take prudent risks to insure the long term viability of the enterprise. But too often, senior employees do not want to risk endangering their ability to claim their now senior contractual stake. Their actions are justified by their narrow self-interest. If they take risk and succeed, their upside is not meaningfully enhanced, but if they fail, their social standing and economic security is jeopardized. For the rest of the company, if current leadership has not prudently managed risk but eliminated it instead, then the company's economic metabolism falls. As this risk aversion spreads, deflation intensifies.

And here is the real conflict of Japanese corporate governance. Japanese management practices are often praised for taking the long view. But this is rarely happening. The current risk aversion of senior employees is mortgaging the future of the next generation and, consequently, the country. If companies are unable to generate sufficient returns on equity through risk management, they need to return it so that it can be allocated to someone who will. Otherwise the deflationary spiral tightens again. Pensions and contractual obligations must be honored, but today's secure financial capital is not a reward for past deeds. Instead, human and financial capital need to be put to work into productive uses. Otherwise, there will not be sufficient economic activity to support the cost structure for today's new hires when they become senior. Thinking like creditors and preserving value is a rational plan of action for self-serving senior executives with a short time horizon; they are thinking of realizing what has been promised to them. That is how contractual capital thinks. But junior employees cannot afford to think like creditors; therefore responsible senior executives cannot think that way either.

Exhibit 10: Capital Source and Structure Diagram

	Financial	Human
Contractual	Debt: No upside, fixed return but senior to equity claims	Labor & senior Japan management: Little upside, large, short maturity payout
Residual	Equity: Upside and downside risk, subordinate to debt	Talent: Upside and downside risk, subordinate to labor, More upside but very long maturity

Contractual claims of debt and labor are structurally senior but should not allocate capital

When companies are run for contractual stakeholders:

- *risk elimination takes precedence over risk management*
- *value preservation crowds out value creation*
- *entrepreneurs grow frustrated*
- *innovation slows*
- *deflation takes hold*

Imagine that you are a partial owner in an expensive ocean liner. You expect the captain to make all the right decisions to keep your investment safe while maximizing earnings. You do not know how to distinguish what makes one captain better than another. But you know that there are lots of small decisions that can either make the ship more valuable or crash it on the rocks.

There are many ways in which bad captains can enrich themselves at your expense. They could take bribes and let passengers ride for free. They could pay higher than market rates for goods and services and take a kick back. But even if your captain isn't a crook, what is the incentive to look hard to find instances of corruption or waste that shrink the size of the pie? After all, why disrupt the camaraderie of the ship for the benefit of anonymous shareholders or junior employees.

So how should you compensate this captain who you must trust and cannot easily monitor? Pay for performance. By paying for performance, the interests of residual stakeholders and managers become aligned. Rational managers would not be tempted by the risky illegitimate ways in which they could enrich themselves. Once executives understand that their compensation is at risk, just like the entire enterprise, they will break out of their deflationary mindset. This will nudge them to take the long-term view and focus on the prudent value growth of the entire company, not just trying to preserve current value.

Behavioral economics has taught us that we are all susceptible to the *mere exposure effect*; the tendency to express undue affinity for concepts and things merely because we are more familiar with them. The CEO cannot interact with residual capital on a regular basis but is much more familiar with cohorts, retirees, bankers, and other contractual stakeholders. Because of the *mere exposure effect*, all executives are at risk of making strategic decisions that benefit those that they are familiar with at the expense of those far away. Paying for performance helps to align the interests of managers with residual capital when making strategic decisions. Ultimately, *the mere exposure effect* can be the root of long term peril of everyone, both far and near. By deferring difficult decisions that may be unpopular with those near by, unsustainable conflicts are propagated and the day of reckoning, while pushed out in the future, becomes more devastating. So paying for performance is actually in the long interests of all long-term stakeholders.

While at first glance, our three creative /crazy ideas seem completely unrelated, they share common characteristics:

1) They are not macro prescriptions; there is little ability to drive such changes through political top down reform. While changes in taxation policies or regulatory oversight could provide greater incentives, the actions are inherently idiosyncratic, micro in nature, and must be executed at the individual company level.

2) Each of these ideas violates social norms of Japanese corporate life. New outside directors violate traditional sensibilities of the "vertical society." Industry consolidation and pay for performance violate the concept of in-group harmony. But arguably each of these sensibilities has mutated into cancerous forms, crowding out healthy innovation and transparency while allowing deflation to become entrenched into the fabric of society.

3) The implementation of these initiatives must extend throughout the corporate enterprise: each of these moves will require courage and persistence to challenge the status quo. Entrenched interests will be threatened by these moves. Sustaining such initiatives is beyond even the most effective management teams by themselves. All stakeholders have a role to play. Labor and creditors; the contractual capital providers must concede that taking on new strategies and risk is

preferable to the status quo because bold action is required to maintain the long term vibrancy relevance of their organization. And residual capital providers; equity investors, junior employees, and most of all, senior executives must take the time to understand these strategies and be willing to think long term in the evaluating them rather than demanding short term results or be fatalistic about the status quo.

This list of actions is neither definitive nor complete. Deflation is a complex condition that can mutate into different forms. We hope that others will publicly challenge our framework to improve upon it. But we believe that the task of uprooting deflation is not longer in the hands of the policy makers. The monetary backdrop has been prepared; private institutions and consumers must now take leadership rather than wait for a third arrow of de-regulation to provide a panacea.

None of these initiatives are simple. In fact, many companies, even after adopting these measures, will continue to struggle. But in the aggregate, the benefits of the successful ventures will far exceed the costs of the setbacks. As these success stories emerge, these creative/crazy ideas will become the new normal. As these outliers that take on prudent risk are held up as aspirational benchmarks, shifting the entire distribution of outcomes shifts as risk appetite steadily rises. Prudent investment risks are engaged and excess liquidity begins to re-circulate. In this way, these micro moves can drive a macro impact as the economy shifts from deflation to reflation, breaking the deflationary spiral and re-igniting a virtuous investment cycle.