HENNESSY FUNDS

JAPAN *White Paper*

Japan's Economic Revival

Over the past several years, Prime Minister Shinzo Abe and his Liberal Democratic Party have implemented a host of bold economic policies including significant monetary and fiscal stimulus as well as structural reforms. The Japanese government has remained steadfastly focused on reversing almost two decades of slow growth and deflation in the world's third largest economy. These efforts have begun to produce results and economic conditions are showing improvement. While progress should be measured over a period of years, we believe the Japanese economy will return to a healthy rate of growth. With the potential for a stronger positive economic backdrop, we believe Japan today represents an attractive opportunity for investors.

Executive Summary

We believe Japan is on the path to economic revival. Following a long period of stagnant economic growth and deflation, Prime Minister Abe and his government initiated an ambitious economic revitalization plan centered on monetary and fiscal stimulus and structural reform, which has resulted in measurable progress.

GDP has seen steady expansion for over 18 months, and inflation has stayed above zero for over four years. The yen has depreciated, helping to drive a recovery in corporate profits growth. Corporate governance initiatives have led to a renewed focus on return on equity and strong growth in the amount of cash companies are returning to shareholders in the form of dividends and share buybacks. Japanese companies are also using overseas acquisitions to power growth.

Structural reforms are seen as key to achieving a higher rate of economic growth in Japan. The government is working on labor market reforms and other initiatives including agricultural reform, deregulation aimed at boosting the tourism industry and support for technological investment and innovation.

We believe these efforts to improve Japan's economic structure and corporate culture could provide investors with an opportunity to benefit from the growth of one of the world's largest economies.

I. Reversing Course From the "Lost Decade"

Following World War II, the Japanese economy experienced a three-decade long period of growth and prosperity. Japanese firms were studied around the world as models of efficiency and superior management techniques. But, in 1989, a bubble in real estate burst, and the Japanese real estate and equity markets crashed. Despite lasting two decades, the ensuing period of stagnant economic growth and deflation became known as the “Lost Decade.”

Japan’s long deflationary “supercycle” weighed heavily on consumer and corporate spending and investing. With prices spiraling lower each year, there was no incentive for individuals to purchase new products, and as a result, no incentive for companies to invest in new capacity. Confidence plummeted, as consumers and companies went on the defensive. Consumers hoarded savings and cash levels on companies’ balance sheets climbed.

The country’s heavily regulated corporate environment exacerbated its economic situation. Businesses were burdened with government restrictions, anti-competitive laws, and high taxes. A culture of lifetime employment and the Japanese system of interlocking business relationships and shareholdings made it difficult for the Japanese economy to respond to the market crash.

An additional challenge for the country was its growing elderly population, which translates to a shrinking workforce. According to the Ministry of Internal Affairs and Communications, the Japanese workforce peaked in 1997 and by the end of 2012 had fallen by almost 5%.[1]

The “Lost Decade” was also characterized by political instability, with 15 prime ministers, many serving a year or less. Since the 2012 election, Prime Minister Shinzo Abe and the Liberal Democratic Party have brought political stability, swift action on policy and gradual economic progress.

To help the country overcome its significant long-term growth challenges, the government unleashed an ambitious economic revitalization plan. Under Prime Minister Abe’s leadership, the plan was dubbed Abenomics and focused on three “arrows”: monetary easing, fiscal stimulus and structural reforms.

The Three Arrows Of Abenomics

1. **Monetary Easing.** The first arrow was designed to stimulate economic growth and inflation and devalue the yen. Implemented measures included bond purchases and a negative-rate policy.
2. **Fiscal Stimulus.** In hopes of jumpstarting the economy, the government proposed lower taxes and spent trillions of yen on infrastructure investment, reconstruction and other projects.
3. **Structural Reforms.** To stimulate longer-term growth, Japan implemented reforms in the labor market, tourism industry, corporate governance and the healthcare market.

1. Labour force and labour force participation rate by age, Statistics Bureau, Ministry of Internal Affairs and Communications.

II. Abenomics Drives Progress

Positive effects of monetary and fiscal stimulus were immediate and included the following developments.

Yen Depreciation

The depreciation of the yen—an overall decline of 35% from the beginning of 2013 to the end of 2016—was the first immediate success of Abenomics and its decline caused an increase in corporate profits and merger and acquisition (M&A) activity.

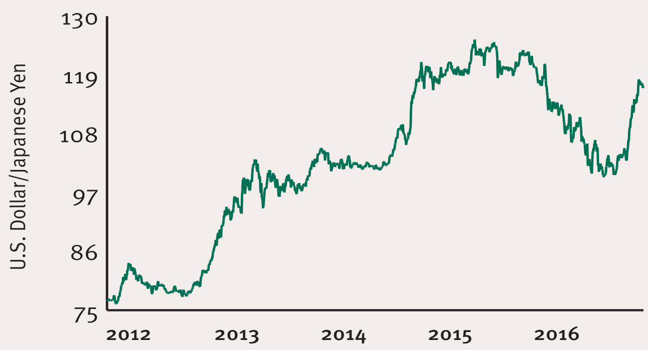
Many public companies in Japan are heavily export-oriented. Therefore a weaker yen has had a positive effect on the value of Japan's largest companies' export earnings, and also indirectly benefited smaller and more domestic-focused Japanese companies.

Moreover, from 2008 through 2011, a period of significant yen appreciation, Japanese exporters made considerable efforts to boost their profitability. Companies restructured their businesses, cut costs and streamlined operations to be profitable at approximately 75-80 yen to the U.S. dollar. As a result, the recent yen weakness has had an amplified effect on profits. Between mid-2012 and mid-2015, corporate profits rose by just over 40% annually and were still growing at 17% annually in the last quarter of 2016.[2]

Lower Corporate Tax Rate

The Abe administration has also lowered taxes to help boost profits and attract foreign investment in Japan. The corporate tax rate in Japan has been reduced from 40.7% in 2011 to an effective rate below 30% in 2016. Corporate tax reform will likely continue.

U.S. Dollar Strengthening vs. Yen



Source: Investing.com

Improved Corporate Governance

Prime Minister Abe has taken a strong stance toward improving corporate governance and his government has introduced two major reforms in three years. In 2014, the Japan Stewardship Code was implemented with the goal of promoting best practices in the way that institutional investors discuss, disclose information and interact with the companies in which they invest. This set of guidelines has provided a code of conduct for institutional investors, outlining how to engage in constructive dialogue with public companies to improve shareholder returns.

In June 2015, Japan adopted the Corporate Governance Code aimed at encouraging companies to appoint independent board directors and exerting pressure to bring Japanese accounting standards closer to those in the West. In addition, the Code sought to improve transparency by asking corporations to provide English-language disclosures.

2. Corporate profits defined by TOPIX Earnings per Share. Source: Bloomberg.

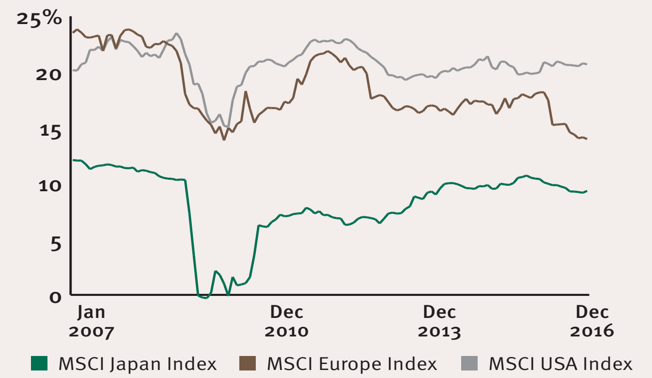
These initiatives have started to make an impact. The world's largest pension fund, Japan's Government Pension Investment Fund (GPIF), along with over 200 domestic and foreign institutional investors, have adopted and agreed to the Stewardship Code. According to Japan's government, over 2,000 companies adopted Japan's Corporate Governance Code, and nearly all TOPIX 100 companies now have independent directors sitting on their boards.[3]

In addition, the JPX-Nikkei Index 400 was launched in 2014 to shift the cash-hoarding mindset of Japanese companies toward more shareholder friendly practices. The JPX-Nikkei selects companies based on return on equity, thereby encouraging companies to be more cognizant about efficiently allocating capital and open to returning capital to shareholders through stock buybacks and dividends.

Rising ROE, Dividends and Buybacks

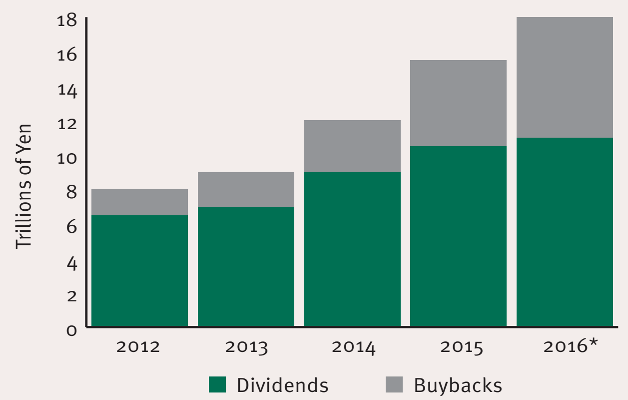
As a result of these initiatives, investors are beginning to see more shareholder friendly practices. Morgan Stanley estimates that in 2016 total buybacks and dividends by Japanese companies reached a record high of 17 trillion yen ($150 billion).[4] The dividend payout ratio, the portion of earnings paid out in dividends, for the Tokyo Stock Price Index (TOPIX) has risen from a low of 26% at the beginning of 2014 to 36% at the end of 2016. Listed Japanese companies engaged in buyback transactions totalling a record $41.8 billion in the first nine months of 2016, an increase of 40% from the same period in 2015.[5] Return on equity for companies in the TOPIX has also risen, from a low of 3.3% in mid-2012 to 8.5% in June of 2017.[6] This rise is due in part to the depreciation of the yen, but it is also due to the success of the Abe's initiatives in triggering a shift in the corporate mindset in Japan.

Japan's Return on Equity has Lagged Europe and the U.S. but has Improved



Source: Morningstar

Increasing Dividends and Buybacks



Source: Morgan Stanley, Bloomberg.com
**Estimate as of December 2016.*

3. Abenomics, The Government of Japan, March 2017.
4. Chu, Kathleen and Ito, Komaki. "Abenomics Bears Have It All Wrong, Soros Alumnus Says," Bloomberg.com, December 6, 2016.
5. "Japan Inc.'s stock buybacks climb to record," Nikkei Asian Review, October 19, 2016.
6. Bloomberg.

M&A Activity Powering Growth

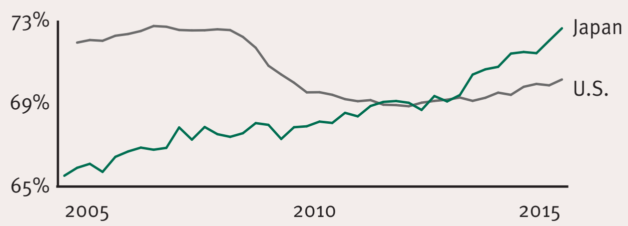
Since the end of the Financial Crisis, Japanese companies have used their cash to reduce debt and strengthen their balance sheets. In 2010, the net debt to profits ratio was 6x. In mid-2017, the ratio stands at 1.5x.

With less debt and management reluctant to increase capital spending, cash has been building up on balance sheets. In 2016, Japanese companies had approximately 240 trillion yen ($2.1 trillion) of cash and deposits[7] on their balance sheets, and recently have been using these cash reserves to buy companies overseas. In addition, historically low interest rates have allowed companies to leverage their balance sheet to pursue M&A activity. From 2014 through 2016, overseas acquisitions made by Japanese companies have doubled in value. Japanese companies spent over $100 billion on takeovers of foreign businesses in both 2015 and 2016.[8]

III. Structural Reforms

While progress has been made, Japan continues to face structural, demographic challenges. Steadfastly determined to direct Japan in the path of long-term economic growth, the government introduced "Abenomics 2.0" in 2015. Underscoring Japan's commitment to tackle the country's structural issues, Prime Minister Abe set a goal to boost nominal GDP to 600 trillion yen ($5 trillion) by 2020.[9] Three key engines of economic growth were identified.

Labor Participation Rate for Females between ages 15-64: Japan vs. U.S.



Source: Organisation for Economic Co-operation and Development

1. Boost Productivity

The Japanese labor market needs to both raise reform to drive productivity and counter the effects of a low birth rate, an aging population and declining workforce. To that end, the government has made it a priority to encourage women and retired workers to return to the workplace.

To encourage new mothers to remain in the workforce, the government has increased child care capacity as well as parental leave benefits. These initiatives have started to have an impact. From 2012 to 2016, 1.5 million Japanese women joined the workforce, and a higher percentage of women are employed in Japan than in the U.S.[9]

In an effort to keep older workers on payrolls, Abe's government raised the official retirement age from 62 in 2016 to 65 by 2025. This move is likely to have been popular with seniors, as 71% of them report that they would like to work past retirement age.

7. Nohara, Yoshiaki, "Japanese Companies and Households Continue to Pile Up Cash," Bloomberg.com, September 25, 2016.
8. Soble, Jonathan, "Corporate Japan Is on Foreign Buying Spree. Toshiba Shows Pitfalls." The New York Times, March 14, 2017.
9. Abenomics, The Government of Japan, March 2017.

Japan is also reforming its two-tier labor market where some workers have guaranteed lifetime employment and other non-full time workers have few rights. Currently, part-time and temporary contract employees make up approximately 40% of the total workforce, with many being paid less than full-time employees for the same work. Prime Minister Abe has sought to improve this labor market inequality by encouraging the notion of “equal pay for equal work,” where companies pay the same wage for workers doing the same job and reduce the pay differential between part- and full-time workers.

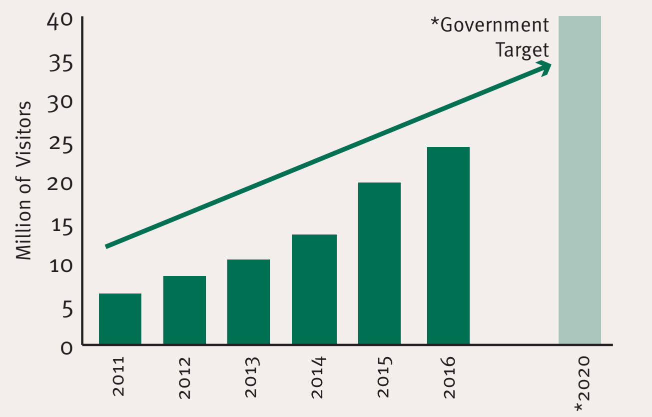
2. Drive Innovation

Progress is being made toward deregulating certain sectors, such as agriculture, a sector that has seen its first major reform and deregulation in 60 years.

Japan's government is also supporting innovation in the technology industry, promoting the Internet of Things, Big Data, artificial intelligence and investment in robotics. Additional areas of focus are the healthcare and energy industries.

In addition, the government has been actively promoting tourism in an effort to increase the number of foreign visitors and their spending. In 2016, a record 24 million tourists visited Japan, an increase of more than 20% compared to 2015 and beating the government’s 2016 target of 20 million.[10] Government officials are hoping to attract 40 million visitors spending over $60 billion by 2020, the year that Tokyo will host the Summer Olympics.

Rising Tourism in Japan



Source: Japan National Tourism Organization

Japan’s tourism industry today equates to only about 0.8% of the country’s GDP, and it is small compared to that of many other developed countries. For example, in France, the world’s top tourist destination with 83 million foreign tourists annually, tourism accounts for 7% of GDP. Despite being the third largest economy in the world, Japan is ranked 22nd in the number of inbound visitors, which leads us to believe that the tourism industry in Japan has ample room to grow.[11]

Casino resorts could further boost tourism growth. In December 2016, the Japanese parliament approved a bill to legalize casino gambling. The Asia-Pacific region has become the largest casino gambling market, with revenue in Macau and Singapore reaching nearly $29 billion and $5 billion, respectively, in 2015. According to Hong Kong-based investment bank, CLSA, if Japan opened just two resorts in major population areas, annual gaming revenue could potentially climb to over $25 billion, which alone could add more than 0.5% to GDP.

10. Japan National Tourism Organization; Abenomics, The Government of Japan, March 2017.
11. International tourism, number of arrivals, The World Bank.

In Japan, resorts that combine gambling with shopping and convention halls could see significant growth in tourism and revenue.[12]

3. Attract Foreign Investment

Japan's vision is to become the "most business-friendly country in the world."

To make Japan a global hub for trade and investment, the government has implemented measures to encourage increased foreign direct investment. These include promoting Japan's business strengths including its research and development capacity; simplifying complex regulations and procedures; attracting highly skilled foreign professionals; and improving the living environment and educational support for foreign nationals.

Final Thoughts

We believe now is the time to consider an investment in Japan. As the government continues to implement its structural reforms, while maintaining expansionary monetary and fiscal policies, we believe the economic revival may continue. While no single policy can improve an economy, we believe that structural reforms collectively can make a meaningful impact. Results will take time to materialize, requiring patience and a long-term time horizon. Nevertheless, the Abe government remains committed to its program and its target of long-term economic growth in Japan.

Japan's economy is changing. As reforms are rolled out, Japan has the potential to become a more efficient and more competitive economy. In this new business environment, we believe many Japanese companies will embrace change and have the potential to be successful. For long-term investors looking to take advantage of Japan's significant growth potential, we believe it is wise to own select, high-quality, well-run Japanese businesses.

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Masa has been Portfolio Manager of the Hennessy Japan Fund since 2006, and has been an analyst and fund manager with SPARX Asset Management since 1999. Prior to joining SPARX, he was employed by the Long Term Credit Bank of Japan (currently Shinsei Bank) and LTCB Warburg (now UBS Securities). Masa received a Bachelor's degree in Liberal Arts from the International Christian University.

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12. Einhorn, Bruce, Huang, Grace and Wei, Daniela. "Japan's Big Bet on Casinos," Bloomberg Businessweek, December 21, 2016.

*"CMA" designates Chartered Member of the Security Analysts Association of Japan.

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About Hennessy Funds

Founded in 1989, Hennessy Funds has a longstanding track record of proven performance and offers a broad range of mutual funds, with strategies that can play a role in nearly every investor's portfolio allocation. Our line-up includes traditional equity, specialty category and sector funds, as well as more conservative balanced products. Each of the Hennessy Funds employs a consistent and repeatable investment process, combining time-tested stock selection strategies with a highly disciplined, team-managed approach. Our goal is to provide products that investors can have confidence in, knowing their money is invested as promised, with their best interest in mind.

Hennessy offers two Japanese equity funds, the Hennessy Japan Fund (HJPNX/HJPIX) and the Hennessy Japan Small Cap Fund (HJPSX/HJSIX), both of which are sub-advised by SPARX Asset Management Co. Ltd. Located in Tokyo, SPARX is one of the largest and most experienced Asian-based asset management specialists.

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Net debt to profits ratio is a debt ratio used to measure a company's net financial leverage and is calculated by dividing a company's total net liabilities by its profits. **Return on equity** (ROE) is the amount of net income returned as a percentage of a shareholder's equity. **JPX-Nikkei Index 400** is composed of 400 companies with high appeal for investors, which meet requirements of global investment standards, such as efficient use of capital and investor-focused management perspectives. The index was jointly developed by Nikkei, Japan Exchange Group and Tokyo Stock Exchange. The **MSCI Japan Index** measures the performance of Japanese large- and mid-cap stocks. The **MSCI Europe Index** captures the large -and mid-cap representation across 15 developed markets countries in Europe. The **MSCI USA Index** measures the large- and mid-cap U.S. stocks. One cannot invest directly in an index. The **Tokyo Stock Price Index** (TOPIX) is a market capitalization-weighted index of all companies listed on the First Section of the Tokyo Stock Exchange.

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