U ACCESS – LONG/SHORT JAPAN CORPORATE GOVERNANCE

Quarterly Comment | Q1 2023

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Market Comment

- TOPIX (TR) rose 7.2% in January–March period. In the first half of the quarter, the Japanese equity market went up. This is because concern over excessive monetary tightening by central banks abated as inflation rates had peaked, and expectation of an economic boost rose given the lifting of China's zero-covid policy. In the middle of March, the equity market and interest rates plummeted as the BoJ left its monetary policy unchanged and risk-off sentiment, driven by bankruptcies of US banks, worsened. However, the market then rebounded as fears over a financial crisis faded due to swift actions by the Fed and central banks in Europe. These same central banks continued to hike rates despite financial system turmoil.

- Outperforming sectors were Iron & Steel and Wholesale, benefiting from expectations of favorable earnings, and the cyclical sectors of Electric Appliances and Machinery. Underperforming sectors were Banks and Insurance, suffering because of concern over financial system turmoil and the sharp drop in interest rates following the collapse of some US banks. Value names underperformed against growth names given the fall in financials. However, small-cap value names outperformed as those with low PBRs attracted investor attention after an announcement that TSE will request sub-1x PBR companies to disclose their improvement measures.

- The Japanese market was strong at the beginning of March, benefiting from Chinese PMI overshooting expectations and yen depreciating. However, share prices, especially for financials, then fell in the middle of the month because of bankruptcies at Silicon Valley Bank and Signature Bank and heightened concerns over the financial system in Europe and the US after Credit Suisse acknowledged "material weakness" in its internal controls over financial reporting. Stocks then rebounded because excessive fears over the financial system were alleviated as the US Treasury announced protections for deposits at smaller banks, the FRB demonstrated support for the banking system by making available additional funding through a new Bank Term Funding Program, and UBS announced an acquisition bid for Credit Suisse.

- US 10-year government bond yields dipped 50bp in mid-March, from 3.9% to 3.4% as several mid-sized US banks and Credit Suisse ran into financial difficulties. Global stock markets, which had risen between 2-4% early in the month, reacted negatively to these events and fell by over 4%. The pressure on the Bank of Japan (BoJ) to exit its extremely loose monetary policy decreased as 10-year Japanese government bond yields eased from their 50bp cap to about 30bp. The Japanese Yen, which had been weakening steadily since January to hit 137, suddenly strengthened to 131 per dollar. The Japanese market initially rose +4% in the first half of the month, but then sharply fell by -6%, before recovering again and ending the month up 0.78%.

Sources: UBP, Bloomberg Finance LP.

Past performance is not indicative of future performance

Performance Review

- The strategy generated positive returns over the quarter, resulting in 1.36% return for the first quarter (in USD for LU2187695437).
- The short side contributed more to gross alpha than the long side in 2020 and 2021. However, in 2022 the short side detracted from gross alpha in each of the first three quarters. In 1Q 2023 the short side made again a positive contribution to gross alpha. Since inception, the long and short sides have contributed +6.9% and +9.2% respectively to gross performance.
- Since inception, the tech & media sector has made the largest positive contribution to performance followed by automotive, utilities, machinery, chemicals, staples and materials. Seven sectors made significant positive contributions to performance. Two sectors (consumer and transport) made significant negative contributions since inception, while four sectors made small or zero contributions to performance.
- In March, six sectors contributed positively to performance, with automotive, utilities, machinery, electronics and real estate responsible for much of the positive performance. The consumer sector was the main negative contributor in March as a short position in a bad governance company recovered sharply after announcing strong quarterly results and limited impact of accounting irregularities that had resulted in a one-month delay in reporting earnings.

Portfolio Activity

- Since September we adopted a tighter stop loss rule. Previously we had a soft stop loss for 20% adverse stock price moves. This meant that the decision was a discretionary one and was based on whether there was a thesis violation. Once we executed the stop loss, we did not easily re-enter into the same position as it was based on a thesis violation. This kept portfolio turnover low, however it could leave us vulnerable to adverse momentum. We therefore adopted a hard stop loss rule. The new rule is based on a 15% adverse stock price move on both an absolute and market relative basis. By basing the rule on both absolute and relative performance, the rule is not triggered simply by stocks moving up or down with the market. The rule also protects the portfolio against sustained adverse momentum in particular stocks. As the stop loss is not based on a thesis violation, we have therefore also adopted the process of re-entering the position once we feel that the adverse momentum has abated. This new process has increased portfolio turnover, however, as we only invest in liquid stocks the market impact of our trading is small.
- Based on the hard stop loss rule, in March we did stop losses on three short positions and one long position. Two of the short positions were in the consumer sector, whereas one was in the materials sector. The long position was in the machinery sector. One of the consumer-sector stop losses was on a short position that had potential accounting irregularities that resulted in a one-month delay in reporting quarterly earnings. When the earnings were reported in mid-March, with a strong beat of expectations, the stock went limit up. We did a stop loss on this position, but it nonetheless hurt performance.
- We reversed two previous stop loss trades on short positions in the consumer and financials sectors. The stock price of the original stock on which we had done the stop loss had declined by more than 10%, thus indicating that the upward momentum had reversed. As there was no fundamental improvement in the company, we re-instated the short positions.
- We took profit on two short positions in the automotive and healthcare sectors as well as one long position in the chemicals sector. We replaced each of them with stocks in the same sectors with more attractive risk-reward.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

Outlook

- Equity markets will be quite turbulent for the course of 2023, as the side effects of low interest rates continue to come to the surface. As far as earnings estimates are concerned – notwithstanding downgrades in recent months, the team still feels like there is no downside to earnings estimates in 2023. Investors shall arguably be attracted to companies with innovative profiles, strong balance sheets and pricing power, while shunning those with vulnerable balance sheets and no growth. The team suspects 2023 will see ‘Growth’ mean revert and quite possibly outperform for a prolonged period.

- We believe the market will benefit from an increase in the number of companies working to improve capital efficiency on the back of the TSE urging those with sub-1x PBRs to disclose how they intend to improve. However, we also believe that weak corporate earnings will drag on share performance and create momentum for good governance companies. While the recovery in automobile production and Chinese economic recovery will no doubt act as a positive, we do expect to see good performance in good governance market participants' earnings expectations given strong worries over how continued monetary tightening at central banks around the world will impact the economy.

- It is difficult to envision a large correction to the Japanese market given valuations are not at expensive levels and record levels of share buybacks are creating a lot of demand for good quality stocks. However, we see serious downgrade pressure for poorly governed companies driven by earnings downgrades.

- As active managers, such an environment should very much play to our strengths, as good governance companies are increasingly sought after, and the valuation sensitivity is less rewarded by way of outperformance. The investment team remains very optimistic that their investment approach will be rewarded in the current environment.

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