Q2 2023

U ACCESS – LONG/SHORT JAPAN CORPORATE GOVERNANCE

Quarterly Comment | Q2 2023

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

Market Comment

- TOPIX (TR) rose 14.4% in April–June. The corporate earnings outlook remained robust as expectations for the BoJ to revise its monetary policy abated and the yen depreciated against the US dollar as investors became more acutely aware of differences in monetary policies between Japan and Europe and the US. Foreign capital flowed into the Japanese equity market due to expectations for improvements to capital efficiency at Japanese companies (following TSE pressure) and a recovery in demand driven by Japan's economic reopening. The domestic equity market rose significantly as stocks, particularly large-cap names, were bought on outlooks for earnings improvements driven by economic recovery against a backdrop of foreign investors being net-purchasers of Japanese equities.

- During the second quarter, large-cap stocks outperformed the market and drove it up on the back of substantial net buying by overseas investors. Outperforming sectors were Wholesale Trade and Transportation Equipment's, which benefitted from expectations for an earnings recovery on the back of the yen's depreciation and a recovery in automobile production. However, materials-related sectors, such as Oil, Iron & Steel, and Nonferrous Metals, underperformed because of China's slow economic recovery and weaker materials and energy prices. Value names outperformed growth names as large-cap names such as Toyota Motor and low-PBR names such as trading houses attracted investor interests.

- In June, the Japanese market rose for the sixth month in a row as fears over a downturn in the economy driven by excessive monetary tightening by the Fed faded following the halt to rate hikes and foreign investors remained net buyers of Japanese stocks. In addition, Transportation Equipment's and Iron & Steel drove up the market as expectations for economic recoveries in the sectors rose due to the People's Bank of China's cut in loan prime rates.

- At the beginning of June, the Japanese market rose as US Congress agreed to suspend the debt ceiling until January 2025 and investors projected the Fed will pause rate hikes. From the middle of the month, stock prices were steady as net buying by foreign investors continued and the Fed decided at its June FOMC meeting to leave the federal funds rate target rate unchanged given weaker concerns of inflation following a lower-than-expected US consumer price index. The market also found support from further yen depreciation versus the US dollar as expectations for the BoJ to revise its monetary policy at an early stage faded following the central bank's decision to leave policy unchanged at its June meeting.

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 4.13% return for the second 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 4Q 2022 the short side again started to make a meaningful positive contribution to gross alpha. This trend continued in both 1Q and 2Q 2023. Since inception, the long and short sides have contributed +5.7% and +14.8% respectively to gross performance.
- Since inception, the tech & media sector has made the largest positive contribution to performance followed by automotive, materials, utilities, machinery, chemicals and staples. Ten sectors made significant positive contributions to performance. Two sectors (consumer and transport) made significant negative contributions since inception.
- In June, three sectors made meaningful positive contributions to performance, with tech & media, machinery and staples responsible for much of the positive performance. Unfortunately, this was more than offset by large negative contributions from the healthcare and consumer sectors.

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 June we did stop losses on three long and two short positions. These stop losses were in the healthcare, staples, electronics, machinery and consumer sectors.
- We reversed four previous stop loss trades on short positions in the chemicals, consumer, staples and tech & media sectors. The stock price of these companies had declined by more than 10% from recent highs, thus indicating that the upward momentum had reversed. As there were no fundamental improvements in these companies, we re-instated the short positions.
- The market moves created some new opportunities. We took five new, long position in the consumer, electronics, materials and staples sectors. On the short side, we took eleven new, short positions in the consumer, electronics, financials, machinery, materials, staples, tech & media, transport and utilities sectors. To balance the portfolio, we closed one long position in the chemicals sector and three short positions in the electronics, staples and transport sectors
- We took profit on nine short positions in the automotive, financials, healthcare, materials, real estate, staples and tech & media sectors. These companies had underperformed the market by an average of -18%.

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

- As experienced in May, US base rates continued increasing in June on the back of US strong activity indicators especially in the services sector. We continue being of the view that we are at the end of FED's hiking cycle, and the main part of US base rates adjustment is behind us. Consequently, US base rates should be supportive of hard currency fixed income returns during the rest of the year.

- Positive factors for corporate earnings exist in the market. These include the domestic economy progressing toward pre-covid normality, a recovery in automobile production, and the yen depreciation. However, we believe the current outlook is unlikely to improve significantly given potential negative impacts on the economy, driven by major overseas central banks' hawkish policies. Valuations already reflect expectations, especially amongst foreign investors, for improved business sentiment and capital efficiency (following TSE pressure) among Japanese companies. Hence, we believe investor expectations are unlikely to continue rising as long as no more positive factors appear.

- 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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