U Access – long/short japan corporate governance

Quarterly Comment | Q1 2022

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Market Comment

- TOPIX (TR) growth during Q1 was -1.2% (JPY). The market opened the quarter on a downtrend because of expectations the US would quickly ramp up its monetary tightening program. Prices dropped further on the Russian invasion of Ukraine in February but then rose on improved market sentiment stemming from expectations surrounding ceasefire negotiations, finishing the quarter down 1.2%.

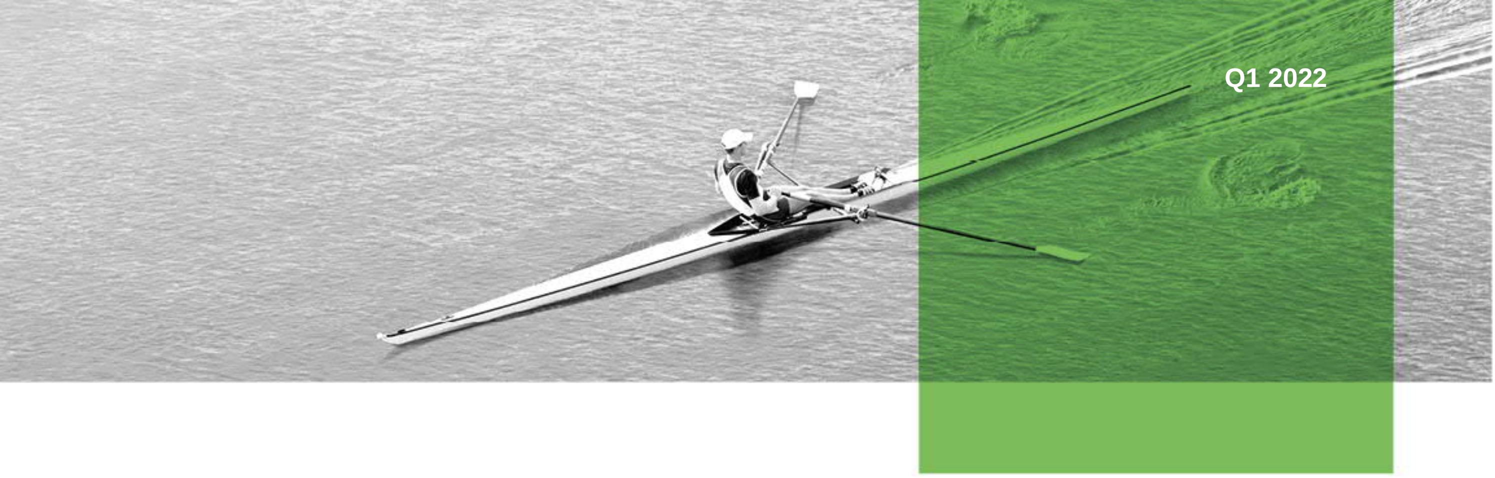
- The Japanese equity market opened the quarter on a decline because of the drop in valuation multiples, particularly those of overvalued names. This was likely a result of expectations for an acceleration to monetary policy normalization at the FRB following signals from FOMC notes of the possibility of strong rate hikes and a shrinking of the central bank's balance sheet. Strong corporate earnings helped support share prices from late-January through mid-February, but this was countered by the rapid increase in omicron infections in Japan and fears of escalation of the geopolitical situation in Ukraine. The market seesawed back and forth during this period. The market then declined in late-February when Russia crossed the Ukrainian border, pushing a shift to risk avoidance and pushing up resource prices. The market reclaimed some lost ground from mid-March as market sentiment improved on heightened expectations surrounding ceasefire negotiations.

- In early March, the Japanese equity market fell due to increased resource prices following Russia's invasion of Ukraine. However, prices then rose through the second half of the month as market sentiment improved on expectations surrounding ceasefire negotiations.

- The market rose during the middle of the month despite the Fed appearing more hawkish at its FOMC meeting, signaling rate hikes would be greater than the market expected. The market was supported by improved sentiment on expectations for progress in ceasefire negotiations between Russia and Ukraine as well as Chinese authorities stating they would aid in stabilizing the equity market and give support to Chinese companies listed overseas.

Sources: UBP, Bloomberg Finance LP.

Past performance is not indicative of future performance

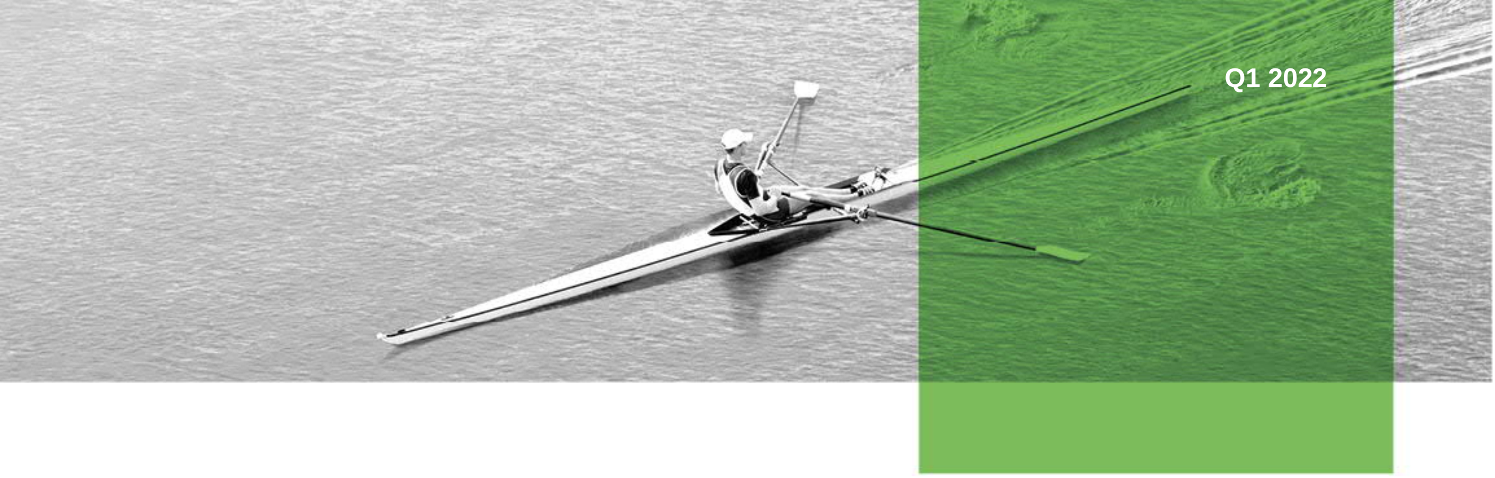


Performance Review

- The market had been in a downward trend from early January, falling by -8% up till the end of February. This downward trend continued in early March with the market falling a further -6%, due to the Russian invasion of Ukraine and resulting spike in oil prices. This resulted in a total YTD decline of -14% for the Japanese market. US government bond yields started to rise from the second week of March after another strong inflation number was reported, while oil prices fell. The Yen, which had been stable at around 115 to the dollar, started to fall, declining to 122 by month end. The weaker Yen, combined with a recovery in the global markets, resulted in the Japanese stock market recovering +13% from its lows in the second week of March.
- The strategy initially performed well while the market was falling, but then gave up the performance when the market bounced sharply, ending the month down -0.31. When the markets bounced sharply, the shorts rose in line with the market, whereas the longs failed to keep up. In aggregate over the month, the longs contributed negatively whereas the shorts contributed positively, but not quite enough to fully offset the long side.
- The cumulative return since inception is +9.0% (5.2% annualized return) with volatility of 5.1%. The maximum drawdown has been -5.6%, i.e. just over one standard deviation.
- Since inception, the tech & media sector has made the largest positive contribution to performance. Seven sectors made significant positive contributions to performance, namely utilities, machinery, materials, chemicals, staples, automotive, consumer and financials. Only three sectors (transport, electronics and healthcare) made meaningful negative contributions since inception. In March, the consumer and staples sectors gave up part of their inception to date returns, whereas real estate continued to contribute negatively. The tech & media, utilities, machinery and materials sectors made moderate positive contributions to largely offset the negative contribution of the three underperforming sectors.

Portfolio Activity

- In January we did profit taking with exit in 2 short positions. These shorts, in the tech & media and consumer sectors, underperformed by -43% and -30% since the positions were taken. They were replaced by other companies in the same sector, with appropriate governance and risk/reward characteristics. We did two replacement trades of long positions during the month. These were in the consumer and transport sectors.
- In February we did one replacement trade of a long position in the consumer sector. The governance and fundamentals of the company had not changed. However, a larger cap and more liquid company with a similar business and better governance had fallen sharply and had now become attractively valued. We therefore decided to switch into this more liquid and better governance name. We also made 11 small rebalancing adjustments to maintain both market and sector neutrality as well as to deploy cash inflows. There was no partial profit taking or cutting of position sizes for risk control purposes.
- In March we took profit on one short position in the materials sector that had underperformed the market by more than -20%. This was replaced by a similar bad governance company in the same sector that had outperformed the market by over +20% in the past 6 months. We also made 9 small rebalancing adjustments to maintain both market and sector neutrality as well as to deploy cash inflows. We cut one position size on the short side for risk control purposes.



Outlook

- Although COVID-19 concerns have eased since the start of the year, which has allowed for the global reopening of economies to continue, the Russia-Ukraine crisis has begun to reshape the geopolitical and economic outlook. Geopolitical tensions, persistent supply constraints and less accommodative monetary and fiscal policies will likely lead to a decline in global economic growth from 5.8% in 2021 to around 3% in 2022 and 2023

- The Japanese market looks to have bottomed. The fighting continues in Ukraine and short-term negatives seem to have played out with the recent FOMC meeting. The P/E for the Japanese equity market as a whole temporarily broke below 12x, a level reached in the past when investors feared a recession. While the recent rebound was likely a reaction to a short-term oversold position, the future remains uncertain.

- The market remains concerned about the situation in Ukraine and guidance risk given the coming results season beginning at the end of April. That said, the market P/E of below 13x likely indicates prices already reflect guidance risk. While guidance revisions will unlikely cause significant negatives, they will likely cap price growth. Quantitative tightening is expected to take root, with the Fed expected to raise rates 50bp at each of its May and June FOMC meetings. While the market looks to already be prepared for such an event, alarm over this sudden monetary tightening will likely not abate.

- While it is difficult to pinpoint the direction in which the market will move, we believe we will see earnings recoveries and improvement to sentiment in the second half of the year. The market fears inflation will slow economic growth, but we believe that with both the 10-year interest rate and expected inflation in the US below 3% a recession can likely be avoided. We expect the Japanese equity market to show gentle growth through the end of 2022.

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