

UBAM – angel japan small cap equity

Quarterly Comment | Q3 2020

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Market Comment

- TOPIX (TR) growth for the period from July to September was 5.2%. The domestic equity market showed a strong performance during the period as a bottom-out in corporate earnings was seen in Apr–Jun and more investors came to the opinion that new prime minister Yoshihide Suga will see through a continuation of Abenomics. That said, we did see periods of temporary decline on growth in new Covid-19 infections and uncertainty caused by former prime minister Shinzo Abe's resignation announcement.
- While valuations are increasing on the support unprecedented monetary easing has provided for the market, strong doubts remain over an economic recovery in Europe and the US as new Covid-19 case numbers have started to grow again.
- Growth stocks were preferred to value stocks. Value factors like low PER and low PBR gave way as quality names with high ROE and low credit risk were favored by investors. By sector, Machinery, Appliances, Info & Comm, and Services drove growth. Machinery and Appliances rebounded from their fall in Jan–Mar, while Info & Comm and Services have earnings that are relatively unaffected by Covid-19. Defensive sectors, such as Elec Power & Gas and Transportation lagged and underperformed.
- Shinzo Abe stepped down as prime minister, because of a relapse of the ulcerative colitis that forced him to abandon his first time as prime minister 13 years ago. There will not be another general election for the lower house until September 2021. Since the election of Suga the ruling Liberal Democratic Party (LDP) will remain in power, Abenomics will continue on its current trajectory. We believe it is highly likely the LDP will remain in power in 2021 as approval ratings for other parties are low in comparison. Japan will remain politically stable in comparison to the US, which will have a presidential election in November.

Sources: UBP, Bloomberg Finance LP.

Performance Review

- The portfolio outperformed the MSCI Japan Small Cap index by 7% gross of fees. Stock selection was the main driver of performance while sector allocation was also positive. Portfolio overweighting in Health Care was one of the most important sector contributors. Portfolio's underweight position in Materials did also bring positive sector effect as this sector was the worst performing during the quarter.
- For individual stock picks, overweighting in Media Do, M3 and Elan contributed positively while overweighting in Lasertec, Japan Material and Rorze contributed negatively.
- The team has not drastically changed its medium-term forecast. Even if some companies' short-term results will be affected by the pandemic, the team believes that those firms can catch up by the next fiscal year if their company's strengths do not alter. In this case, the upside potential for those stocks given the market sell-off could be huge. The team anticipates the consequence of deep undervaluation will lead to a significant price recovery in the next 12–18 months.

Portfolio Activity

- No specific activity throughout the quarter. We added Grace Technology, a company which provides manual creation service for industrial machine operation (MOR=Manual Order made Service), and consulting service for planning, producing and management of web manual for domestic and overseas manufacturers (MMR=Manual Management System). Many companies are introducing web manuals from the perspective of cost reduction, and the demand for MMR is rapidly increasing. The company is also aggressive in expanding overseas and entered a new growth phase.
- We also added Pola Orbis Holdings. The company is a major cosmetic manufacture. "POLA" is known as a high-end cosmetic with home-visit counselling. The company is also expanding and enhancing cosmetic shops with aesthetic salons attached. "ORBIS" is a brand offering lower-medium priced products via mail order. The company is also developing several brands. Tough affected by Covid-19, sales of POLA is on a recovery trend, e-commerce sales are increasing steadily, and restructuring of overseas brand that had been struggling progressed, the company is entering a quick recovery phase. On the other hand, the share price is extremely undervalued, so we judged it should be an opportunity for new purchase

Outlook

- In September, the US market underwent a correction, mainly in IT names, while Japanese equities stood firm. One reason for this difference is that the Japanese market does not contain many IT-related growth names. In comparison to other countries, it was favoured because of low valuations and halts to downward revisions. While not unexpected, Suga taking over from Abe as prime minister made clear that Abenomics would continue and was a sense of relief mainly for overseas investors.
- Our focus going forward will be on results season, which will get into full swing in the second half of October. Many companies will likely see earnings exceed initial guidance, which was set at a conservative level because of Covid-19. The equity market has already rebounded somewhat, and we will soon likely see a strong recovery in earnings. That said, this will not succeed in lifting share prices further.
- We believe Suga will pursue monetary and fiscal policies in line with Abenomics. In addition, we believe he will reinvigorate the reform efforts that had lost momentum during the last few years of Abe's tenure. We see a continued shift of power from ministry bureaucrats to the politicians as a positive. A key initiative of Suga's is to break down the silos between ministries and to increase transparency and information sharing through the digitization of government functions. He is a fervent supporter of deregulation, market reform and increased competition. As Suga will face both an LDP leadership election and a general election within the next 12 months, we expect him to move quickly with his reform agenda in order to have early wins before the next elections.

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