

U Access - long/short japan corporate governance

Quarterly Comment | Q4 2020

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Market Comment

- TOPIX (TR) growth for the period from October to December was 11.2%. After a good third quarter, the fourth quarter of 2020 saw a slow start in October followed by rapid appreciation for Japanese equities particularly in November. The domestic equity market was strong as investors were hopeful for an economic recovery following the successful development of a Covid-19 vaccine. That said, the global increase in case numbers and the new Covid variant weighed on prices in late December.
- In October, the market was pulled up and down by news flow concerning the US presidential election and potential additional stimulus in the US. A risk-off mood then took over because of increasing Covid-19 case numbers in both Europe and the US, leading the market to finish the month down slightly. Successful development of a Covid vaccine was announced in November, pushing up hopes for the economy to return to normal and boosting share prices significantly from mid-month. While December market movements were weighed on by increasing Covid-19 cases in Japan and the discovery of a new strain of the virus in Europe, the market finished the month up on the rollout of vaccinations, agreement in the US on additional stimulus, and the signing of a trade agreement between the UK and the EU.
- In December, the market rose at the beginning of the month because of expectations for a quick rollout of vaccines and better-than-expected machinery orders data. That said, there were moments of weakness because of concern over the global increase in Covid-19 case numbers and short-term overheating in prices.
- Prices largely moved sideways as continued fears of damage to the economy on increasing Covid-19 cases were offset by increased hopes for a recovery on vaccine rollouts in Europe and the US and a sense of relief in the market following the FRB's announcement that it will continue with monetary easing over the long term.

Sources: UBP, Bloomberg Finance LP.

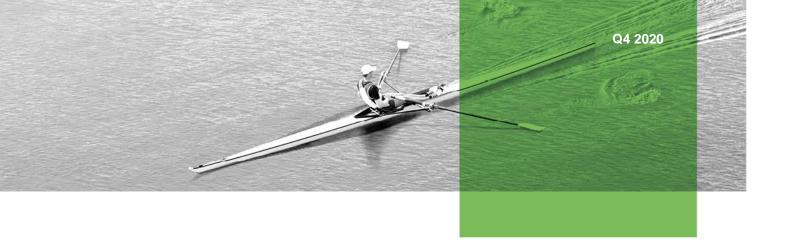


Performance Review

- During the quarter, the fund performed well, gaining 1.4% in October and 4% in November, before giving up -1.5% in December.
- The long-side of the portfolio outperformed the market in October-November, producing positive alpha. During this period the short side significantly underperformed the rising market, making an even larger positive contribution to alpha. In December the long-side did not keep up with the continuing rise in the market, while the short-side rose in line with the market. This resulted in the 1.5% return in December.
- In terms of sectors, 8 sectors contributed positively to alpha, 2 were neutral and three were negative. Staples, Tech & Media and Chemicals were the biggest positive contributors, with both the longs and shorts contributing significantly to alpha. The detractors were the Transport, Healthcare and Electronics sectors, where the longs did not rise in line with the market.

Portfolio Activity

- During the quarter we took profit on 7 long positions, replacing them with other good governance companies with better remaining upside potential. We similarly took profit on 4 short positions where the stocks fell despite the sharply rising market. We replaced these with bad governance companies that had bounced sharply with the rising market. We also did 3 stop-losses and replaced 2 other stocks as there were better alternatives in those sectors after the market moves. The total turnover during the quarter was approximately 25% on the long side and 15% on the short side.
- After the market rose 15% in November-December, we did a thorough review of the portfolio at the end of December. This resulted in 10 trades, 4 longs and 6 shorts. On the long side, 3 of the trades were to take profit on large outperformers. Similarly, 4 of the trades on the short side were to take profit on large underperformers. One of the short trades was a stop loss. The remaining two trades, 1 long and 1 short were to switch to more attractive companies after large relative stock price moves. We also made 3 small rebalancing adjustments to maintain both market and sector neutrality.
- The profit taking with exit was in three long positions in the following sectors: chemicals (stock up +36%), machinery (+27%) and automotive (+26%). On the short side we took profit on four short positions in the following sectors: materials (stock down -18%), chemicals (-10% and -6%) and machinery (-3%). Each of the names was replaced by another company in the same sector, with appropriate governance and risk/reward characteristics.
- We replaced a long position in the healthcare sector with a different good governance company with greater upside potential. This was driven both by a downward reassessment of the upside potential of our existing holding and the significant recent underperformance of the replacement stock. We replaced a short position in the materials sector with a different bad governance company with greater downside potential. Our trade was similarly driven by a reassessment of the downside potential of the existing holding combined with the large recent outperformance of the replacement stock.
- We did a stop loss in the automotive sector. Since September, the sell-side had started to raise earnings estimates for this company. The company had also recently adopted a performance-based stock compensation plan. Based on improving fundamentals and governance we decided to close the short position. We replaced this with a poor-governance automotive stock that jumped over 40% in the recent stock market rally.



Outlook

- The Japanese equity market continued to grow in December. The market has been desensitized to increasing Covid-19 case numbers and has aggressively factored in a return to normal around the globe on the back of the development of a vaccine.
- The current economic recession is unlike those of the past caused by financial crises and popped asset bubbles. This time, it is highly likely the economy will see a rapid rebound, largely pushed by the release of pent-up demand once the vaccine is able to lift restrictions on movement.
- Suga needs to face 2 elections in 2021. The LDP leadership election must be held by the end of Sept. The second is a general election, which must be held by 21 October. Either or both elections could be held early, however the probability of them being held early is not very high. There are several reasons for this. The first is to avoid holding the election early if Covid-19 is not under control. The second is the Olympics. Despite a challenging start in 2021 for many countries affected by the pandemic we do not see other major headwinds for the LDP in the coming months.
- We expect the market to fluctuate around its current level over the short term as stocks no longer look undervalued and macroeconomic indicators are expected to be weak, given increasing Covid-19 case numbers. Over the longer term, we expect market movements to remain strong as global monetary easing leaves ample cash to enter the equity market and investors are basing forecasts on profit levels for FY22, when the Covid-19 situation is expected to be behind us.
- Despite growing concerns surrounding Covid-19 and the market sector rotation towards value and large dispersion in stock returns, our performance has proved steady. This shows how effective our process is in a context of improving corporate governance in Japan.

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