U ACCESS – LONG/SHORT JAPAN CORPORATE GOVERNANCE

Quarterly Comment | Q4 2022

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

Market Comment

- TOPIX (TR) rose 3.3% in Q4. The Japanese equity market was lifted by investor opinion that US monetary tightening would slow but then fell on heightened concerns the European and US economies could fall into a recession. Japanese equity prices then continued to fall as alterations to the BoJ’s yield curve control strategy were seen as a de-facto rate hike.

- The Japanese market rose at the beginning of the quarter as investors came to expect a slowdown in US rate hikes and fears abated over US monetary tightening. Then entering into November, the Japanese market was pulled upwards by large-cap names on the back of US equity strength as US CPI undershot expectations and FOMC minutes suggested there would be a slowdown in rate hikes.

- The Japanese equity market then saw a downturn as we entered into December. Investors feared recessions in Europe and the US as more market participants started to believe monetary tightening would be here for the long run and US retail data came in weak. The BoJ then announced at a monetary policy meeting that it would tweak yield curve control, allowing for greater fluctuations around its long-term target rate. This betrayed market expectations for continued easy monetary policy. The market fell as investors saw the policy tweak as a de-facto rate hike. The overall market was then weighed down in particular by exporters as the yen strengthened against the US dollar.

- Global equities traded near the long-term average forward PE ratio at 15.0 at the end of December, with 2022 earnings growth expectations steady at +10.1%, up from +7% at the start of the year, while 2023 expectations were further reduced to +2.8%, down from +9% at the start of the year. In fact, significant margin pressure is expected for companies which do not have enough pricing power to offset the likely weakening consumer demand in 2023.

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 6.64% return for the fourth quarter (in USD for LU2187691956).
- 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 4Q2022 the short side again started to make a meaningful positive contribution to gross alpha. Since inception, the long and short sides have contributed +7.4% each to gross performance.
- Since inception, the tech & media sector has made the largest positive contribution to performance followed by automotive, machinery and utilities. Eight sectors made significant positive contributions to performance. Five sectors (transport, real estate, healthcare, electronics and consumer) made negative contributions since inception.
- In December, nine sectors contributed positively to performance, with consumer, real estate, machinery and chemicals responsible for much of the positive performance. The tech & media and financials were the negative contributors in December.

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 December we did a stop loss on one long position. This was in the healthcare sector, where we closed the position after previously reducing it to half the target weight. We therefore increased the original replacement stock to full weight, having previously only taking a position at half the target weight. We also reversed a previous stop loss trade on a long position in the consumer sector. The stock price of the original stock on which we had done the stop loss had recovered by more than 10%, thus indicating that the negative momentum had reversed. As there was no fundamental problem with the company, we re-instated the position.
- We took profit on two short positions in the automotive and chemicals sectors, replacing them with similar stocks with more attractive risk-reward. We also did a replacement trade on a short position in the electronics sector. The fundamentals of this company had shown improvement, so after revising our forecasts we no longer felt it was over-valued. We replaced it with another bad governance company in the electronics sector that we believe was meaningfully overvalued.
- We also entered into three additional new positions. These include a new long position in the chemicals sector and a short position each in the real estate and tech & media sectors. These positions were taken because these good / bad governance stocks had significant stock price moves which made their valuations attractive.

Outlook

- December saw the Japanese equity market fall on policy changes made by the BoJ but equity prices have remained in the boxed range seen since the beginning of the year. While the BoJ’s policy shift was unexpected, the market outlook is still that the equity market will continue to lack direction given concerns of a global recession.

- US long-term rates will remain an important metric to watch in 2023. We expect they will fall from their current 3.5%-4.0% range to 3.0%-3.5% given our expectations for a recession in the latter half of the year. We expect the fall in US long-term rates to boost the equity market by helping to raise valuations. We expect corporate earnings to fall at an increased pace but bottom out in 1H FY2023. We will keep watch of the level of deterioration of corporate earnings over the short term but expect all negatives to have played out after that. We believe the market factored in further negatives for monetary tightening by the BoJ given the drop in equities and bounce in the yen in December. While there are many obstacles to overcome in implementing further tightening, we will be keeping watch of movement by the BoJ as Haruhiko Kuroda approaches his term limit as governor in April.

- The pressure on the Bank of Japan (BoJ) to exit its extremely loose monetary policy continued to build. In a surprise move on 20th December, the BoJ eased its Yield Curve Control (YCC) policy by loosening the cap on 10-year government bond yield from 25bp to 50bp. The Japanese Yen had already been recovering steadily from its lows and in December rose sharply from 141 to 133 per dollar.

- We believe that the Japanese equity market will remain in its current trading range in the first half of 2023 and start to break out in the second half of the year. We believe there is room for a 10-20% increase in TOPIX versus its 2022 finish of 1,891.

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