



U Access - Long/short Japan corporate governance

Quarterly Comment | Q3 2021

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Market Comment

- TOPIX (TR) growth for July to September was 5.3%. Increasing Covid-19 infections both in Japan and overseas as well as reports of reduced automobile production weighed on the market initially but entering into September growth was restored on the back of reassurance of domestic political stability and increased expectations of new economic stimulus.
- The market seesawed in July and August with catalysts coming in the form of strong corporate earnings announcements and better-than-expected macro data releases and negative catalysts coming in the form of increasing Covid-19 infections, the reinstatement of a state of emergency within Japan, news of Toyota global production units for September being 40% lower than planned, and stricter regulations on the education industry in China.
- The market rose on the reassurance of stable domestic politics and growing expectations for new economic stimulus as well as a drop in new Covid-19 infections. That said, concerns of a default at a large Chinese real estate developer and troubles in US budget discussions weighed on the market.
- The market showed strength at the beginning of September as Prime Minister Yoshihide Suga's announcement he would not be running in the LDP leadership contest led to an improved approval rating for the party and hopes of new economic stimulus.
- The market then faced upside resistance during the middle of the month as concerns arising of default at a large Chinese real estate developer tempered positive sentiment surrounding the clear peak-out and continued drop in Covid-19 infections.
- The market then fell towards the end of the month following a drop in the US market caused by rising long-term rates that resulted from signals from the FOMC that the Fed would begin hiking rates earlier than the market expected.

Sources: UBP, Bloomberg Finance LP.

Performance Review

- During the quarter, the fund performed well, retreating 0.12% in July followed by a very strong August (+ 1.34%), before a mild positive performance of 0.27% in September.
- The market ended the quarter up +8% for the month of September (TOPIX500 index). The election of Fumio Kishida as the new head of the LDP, and hence the new Prime Minister, was a slight disappointment as he is considered to represent the status quo and hence not expected to champion any radical reform. The market focus will be on the general elections expected in November.
- Despite the sharp moves in the market, the market neutral Long/Short Japan Corporate Governance strategy had a quiet month with relatively small moves, generating a positive return of +0.27% in September. This brings the year-to-date return to +6.29%.
- In total, the strategy generated positive returns during thirty-four of the sixty-two weeks since inception. There were only nine weeks with negative returns larger than -0.50% compared with twenty-three weeks with returns greater than +0.50%. The maximum drawdown was -2.51%. The cumulative return since inception is +14.08% with volatility of 5.1%.
- Since inception, four sectors made large positive contributions to performance, tech & media, consumer, chemicals and staples. Six sectors (automotive, materials, utilities, electronics, machinery and financials) made moderate positive contributions while the real estate sector made a neutral contribution. Only two sectors (healthcare and transport) made negative contributions since inception. We did a stop loss on a short position in the transport sector in August to stem the losses which had been caused by strong profit improvements driven by supply disruptions/shortages causing current rates to rise to unprecedented levels. In the healthcare sector while maintaining strict risk control of the individual position sizes, we remain confident in the governance characteristics, fundamentals and valuation mispricing of our positions in this sector.

Portfolio Activity

- Every year we update the governance scores of most companies in July-August. This is because they elect new boards at their AGMs at the end of June and then publish their Corporate Governance Reports in early July. We did a thorough review of the portfolio at the end of August, with a focus on changes in relative governance scores. This resulted in 11 trades, 6 longs and 5 shorts. On the long side, 1 of the trades was due to a deterioration in the relative governance score, 1 trade was a replacement with more attractive stock, whereas 4 of the trades were to take profit on outperformers. On the short side, 1 trade was a stop loss, 2 of the trades were due to governance improvements/relative attractiveness, and 2 trades were to take profit on large underperformers. We also made 26 small rebalancing adjustments to maintain both market and sector neutrality as well as to deploy cash inflows.
- In September, we did profit taking with exit in 2 short positions in the financial sector. The two companies had underperformed by -31% and -20% when we initiated positions at the inception of the fund. Each of the names was replaced by another company in the same sector, with appropriate governance and risk/reward characteristics. We also made 18 small rebalancing adjustments to maintain both market and sector neutrality as well as to deploy cash inflows. These included reducing the size of 4 short positions that had reached or were close to position sizes larger than -2.17%, i.e. 0.50% larger than the target weight of -1.67.

Outlook

- The Japanese equity market underwent a significant increase in the middle of September, with TOPIX even hitting a new high. However, it has recently undergone a big dip. We still believe that the Japanese market will rise through the end of the year on expectations for an economic reopening, growth in US long-term rates (which are highly correlated with Japanese equity), and expectations for upward revisions to corporate earnings guidance.
- The primary driver of the mid-month rise was a positive outlook on a new administration as Suga and his cabinet took their leave. With Fumio Kishida, also from the LDP, taking over as prime minister there has been no significant change to government policy. We expect the LDP will maintain its dominant position in government through the October general election and that it will push for further economic stimulus.
- Key drivers behind the recent drop in equity prices have been China, which has been subject to fears surrounding real estate prices and power outages, and the US, which is facing a debt ceiling problem. We do not believe the real estate or power problems in China will have a significant impact on the economy because the government can control both of them. The debt ceiling problem in the US is something we have seen time and again and we expect a political resolution soon enough.
- The risks present in both China and the US are controllable. Further vaccinations and news of Covid-19 treatments will likely give confidence to an economic reopening. We maintain our bullish stance on the Japanese equity market as we expect US long-term rates to go on a gentle uptrend and believe companies will revise corporate earnings guidance upwards from their initial conservative estimates during July to September earnings season.

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