UBAM – ANGEL JAPAN SMALL CAP EQUITY

Quarterly Comment | Q2 2023

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

Market Comment

- TOPIX (TR) rose 14.4% in April–June. The corporate earnings outlook remained robust as expectations for the BoJ to revise its monetary policy abated and the yen depreciated against the US dollar as investors became more acutely aware of differences in monetary policies between Japan and Europe and the US. Foreign capital flowed into the Japanese equity market due to expectations for improvements to capital efficiency at Japanese companies (following TSE pressure) and a recovery in demand driven by Japan's economic reopening. The domestic equity market rose significantly as stocks, particularly large-cap names, were bought on outlooks for earnings improvements driven by economic recovery against a backdrop of foreign investors being net-purchasers of Japanese equities.
- During the second quarter, large-cap stocks outperformed the market and drove it up on the back of substantial net buying by overseas investors. Outperforming sectors were Wholesale Trade and Transportation Equipment's, which benefitted from expectations for an earnings recovery on the back of the yen's depreciation and a recovery in automobile production. However, materials-related sectors, such as Oil, Iron & Steel, and Nonferrous Metals, underperformed because of China's slow economic recovery and weaker materials and energy prices. Value names outperformed growth names as large-cap names such as Toyota Motor and low-PBR names such as trading houses attracted investor interests.
- In June, the Japanese market rose for the sixth month in a row as fears over a downturn in the economy driven by excessive monetary tightening by the Fed faded following the halt to rate hikes and foreign investors remained net buyers of Japanese stocks. In addition, Transportation Equipment's and Iron & Steel drove up the market as expectations for economic recoveries in the sectors rose due to the People's Bank of China's cut in loan prime rates.
- At the beginning of June, the Japanese market rose as US Congress agreed to suspend the debt ceiling until January 2025 and investors projected the Fed will pause rate hikes. From the middle of the month, stock prices were steady as net buying by foreign investors continued and the Fed decided at its June FOMC meeting to leave the federal funds rate target rate unchanged given weaker concerns of inflation following a lower-than-expected US consumer price index. The market also found support from further yen depreciation versus the US dollar as expectations for the BoJ to revise its monetary policy at an early stage faded following the central bank's decision to leave policy unchanged at its June meeting.

Sources: UBP, Bloomberg Finance L.P.
Past performance is not indicative of future performance

Performance Review

- The portfolio underperformed the MSCI Japan Small Cap index by -6.97% net of fees (Institutional share class in JPY, LU0306285197). Stock selection was the main driver of underperformance while sector allocation was slightly positive. Stock picking was very challenging in Information Technology and Industrials. Stock selection was strong in Consumer Staples.
- Portfolio characteristic haven’t change during the second quarter, average EPS growth is higher than benchmark. As most of the companies are now entering in the new fiscal year, we will revise earning forecast accordingly.
- One of the best performing stocks during Q1 was **MEC**, a Materials name. MEC is a chemical manufacturer used in semiconductor. It has well-known for its advanced technology, mainly copper surface treatment agents. In addition to the strength of its technology, future demand for semiconductors will be strong from consumer goods to 5G and in-vehicle use.
- Another good performing stock is **ROUND ONE**. The company is a major entertainment service provider operating complexes with bowling alleys, game centers and karaoke rooms. Though the company suffered from Covid-19, the strong position hasn’t change. Its current performance shows that existing store sales in Japan continued to increase strongly.

Portfolio Activity

- During 2Q, we held 259 research meetings, added 3 companies and sold out 4 companies.
- During the first half of the year, we held 519 research meetings, added 8 names and sold out 10.
- We added **INSOURCE**. The firm provides training services and E-learning materials for companies. One of its strengths is the development ability to create programs tailor made for clients’ various needs. Its know-how lies in providing services that closely meet customer needs. Customers can choose to take training online or offline. The strengthening of the sales system has been successful in generating new services.
- We sold out **SHIN NIPPON BIOMEDICAL LABORATORIES (SNBL)**. The company provides wide services from Contract Research Organization (CRO) Business to Translational Research Business. SNBL is particularly strong in supporting services for pre-clinical tests for medicine development. Though tight supply and demand for experimental NHPs (Non-Human Primates) is a tailwind for SNBL. It is also getting harder to assess the future growth of the business since political decisions are affecting it.

Outlook

- As experienced in May, US base rates continued increasing in June on the back of US strong activity indicators especially in the services sector. We continue being of the view that we are at the end of FED's hiking cycle, and the main part of US base rates adjustment is behind us. Consequently, US base rates should be supportive of hard currency fixed income returns during the rest of the year.

- Positive factors for corporate earnings exist in the market. These include the domestic economy progressing toward pre-covid normality, a recovery in automobile production, and the yen depreciation. However, we believe the current outlook is unlikely to improve significantly given potential negative impacts on the economy, driven by major overseas central banks' hawkish policies. Valuations already reflect expectations, especially amongst foreign investors, for improved business sentiment and capital efficiency (following TSE pressure) among Japanese companies. Hence, we believe investor expectations are unlikely to continue rising as long as no more positive factors appear.

- It is difficult to envision a large correction to the Japanese market as valuations are not at expensive levels and record levels of share buybacks (on the back of TSE pressure) are creating a lot of demand for stocks. However, it will likely take some time before we see serious growth driven by earnings improvements.

- As active managers, such an environment should very much play to the team's strengths, as innovative fast-growing companies are increasingly sought after, and the valuation sensitivity is less rewarded by way of outperformance. The investment team remains very optimistic that their investment approach will be rewarded in the current environment.

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