UBAM – ANGEL JAPAN SMALL CAP EQUITY

Quarterly Comment | Q3 2023

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

Market Comment

- TOPIX (TR) was up 2.5% during the third quarter (in Japanese Yen). The market rose for the fourth consecutive quarter, albeit at a low rate. The corporate earnings outlook improved slightly given the post-covid pick-up in economic activities, the recovery in automobile production, and yen depreciation. However, share prices saw upward resistance as both domestic and overseas long-term rates rose following a rise in concern over prolonged tightening by major central banks and murmurings of potential monetary policy normalisation from the BoJ. The Japanese equity market managed to remain on an upward trajectory for the quarter because expectations for improvements to capital efficiency (following Tokyo Stock Exchange (TSE) pressure) remained high.
- In Q3, growth stocks were weak because of the rise in interest rates. However, value stocks rose on persistent expectations for Japanese companies to improve capital efficiency on the back of TSE pressure. Financial inflows from overseas investors slowed and medium- to undervalued small-cap stocks attracted investor interest. Financial stocks outperformed the market as many investors believed that the BoJ would normalise monetary policy soon. Low-P/B sectors such as Marine Transportation and Oil & Coal Products, which announced large-scale shareholder return programs, and Transportation Equipment, which experienced a recovery in automobile production, outperformed the market. However, overvalued sectors such as Electric Appliances and Precision Instruments underperformed.
- Domestic equities rose at the beginning of the September as investors became less suspicious of further rate hikes in the US given that inflation concerns, driven by the tight labour market, have receded on the back of employment data showing a growing unemployment rate. Market sentiment improved in August as fears of a Chinese economic slowdown receded on the back of growth in the China Caixin Manufacturing PMI to above 50, the boundary demarking positive and negative sentiment. BoJ governor Kazuo Ueda then suggested that all data needed to put an end to negative interest rate policy could be available by year-end. This led to growth in long-term rates and the purchase of financial names, especially banks. Through the end of the month investors came to more strongly believe monetary tightening will continue for longer than initially expected as the Fed raised its own rate expectations. The big increase in US long-term rates led to weakness in the US market and a fall in the Japanese market. Increasing crude oil prices and the risk of US government shutdowns also contributed to the decline.

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 -8.68% net of fees (Institutional share class in JPY, LU0306285197). Stock selection was the main driver of underperformance while sector allocation was also negative. Stock picking was very challenging in Information Consumer Discretionary and Industrials. Stock selection was strong in Information Technology.
- Portfolio characteristic haven’t change during the third quarter, average EPS growth is higher than benchmark. We continue to monitor companies earnings growth trajectory.
- One of the best performing stocks during Q3 and also one of our largest position and conviction is **Kotobuki Spirits**, a Consumer Staples name. The firm produces and sells sweets mainly for tourists. During Covid-19, kept aggressive strategy with strong balance sheet while competitors moved out. Sales and profit recovered rapidly exceeded before Covid-19 level in 2023. The Share price is at a high level, but given the growth potential, current valuation is still attractive. We will continue to hold at a high weight while confirming the situation through quarterly meetings
- Another good performing stock is **Japan Elevator Serrvice Holdings**. The company is the Largest Independent Elevator Maintenance Company in Japan. The firm enjoys a unique position as it is the only company which can provide all components of all companies. The maintenance and repair demand has been increasing rapidly.

Portfolio Activity

- During 3Q, we held 244 research meetings, and so far in 2023 we added 13 companies and sold out 15 companies.
- Year to date, we held 763 research meetings.
- We added **Azoom**. The firm provides matching services between users and unused car parking lots in offices or condominiums. Focusing on strong demand areas they are increasing human resources and parking lots. Recently, Azoom was successful in increasing users’ choices and to expand contracts. It is expected to growth fast, for this reason we added it into the portfolio.
- We sold out **Snow Peak Inc**. Snow Peak is an outdoor equipment brand that specializes in creating high-quality and highly original products. Although our view regarding their strength has not changed, the impact of inventory adjustments at wholesalers is prolonged, and it would take time to return to an accelerating growth phase. Therefore, we sold it out.

Outlook

- We expect Japanese companies to experience increased revenues and profits this financial year, thanks to the strong US economy, normalization of domestic economic activity, and yen depreciation. However, we refrain from too much optimism given the negative impact prolonged monetary tightening in the US and Europe will have on the global economy and the slowing economic recovery in China. We may see improved expectations for domestic economic policy measures to be decided on by October-end. However, valuations already reflect expectations for improved earnings and capital efficiency (following Tokyo Stock Exchange (TSE) pressure) among Japanese companies. We believe investor expectations are unlikely to continue rising unless we see more positive catalysts.

- For the Bank of Japan (BOJ), YCC (Yield Curve Control) worked well when inflation was low. However, it has become cumbersome against the backdrop of an unprecedented tightening cycle in the US and rising global inflation. In March 2021, the BOJ widened the band to 0.25% to breathe life back into the market. BOJ doubled that in December 2022 to 0.50% under a speculative attack from investors. We don’t exclude the possibility of another tweak to the YCC target. Specifically, the BOJ could widen the band (formally) by another 25 basis points to 1.00% in December. After all, 10Y JGBs have already started converging towards that level. For this to happen, the BOJ needs to see substantial cyclical pressures via an overshoot in cost-push inflation and higher US 10Y yields.

- In terms of markets, even in case Ueda outright cancels YCC in December, widening rate differentials with the US will continue to fuel depreciation. BOJ has intervened verbally, but material interference is not likely. Meanwhile, Japanese equities are negatively correlated with the exchange rate, as many listed companies are large conglomerates than earn USD and report back in JPY. Compounded with measures to boost corporate governance (buybacks for listed companies with P/B ratio < 1), this supported a 30% rally in Japanese equities YTD.

- It is difficult to envision a large correction to the Japanese market as valuations are not at expensive levels and large-scale share buybacks (on the back of TSE pressure) are creating a lot demand for stocks.

- 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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