UBAM - SNAM Japan Equity sustainable

Quarterly Comment | Q1 2021

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

Market Comment

- TOPIX (TR) growth for Jan–Mar was 9.3%. The domestic equity market was strong because of improved earnings guidance for Japanese companies and additional economic stimulus in the US. That said, the market experienced a drag effect from concerns that share prices were too high as well as the rapid growth in US long-term rates.

- The market seesawed in January because of fears that prices were too high and increasing volatility. The market then turned upwards in February as domestic companies had a strong results season and revised guidance upward overall. Faster-than-expected approval of additional stimulus in the US also played a part. The market then fell temporarily on corrections to valuations for high-priced names and technology companies as well as the BoJ’s decision to no longer purchase Nikkei225 ETFs. However, it ended the period on a growth trajectory thanks to the approval of additional economic stimulus in the US and expectations for further progress on the vaccine rollout.

- TOPIX seesawed in early March. Technology stocks were sold off because of the rise in long-term rates caused by expectations for an economic recovery in the US. This was offset by the rise in share prices for cyclicals and defensive sectors.

- In late March, the Japanese equity market fell. Investors were negative on the sell-off of high-priced Nikkei225 names following the BoJ’s decision to no longer purchase Nikkei225 ETFs and the spread of a highly contagious Covid-19 variant in Europe. The decision to not allow spectators from overseas for the Tokyo Olympics also dragged on prices.

Sources: UBP, Bloomberg Finance LP.

Performance Review

- The portfolio outperformed TOPIX (TR).
- Sector allocation detracted from performance while stock selection contributed.
- Portfolio overweighting of Consumer Staples and of Health Care detracted from performance. For individual stock picks, overweighting of J Front Retailing, Sumitomo Mitsui Trust and underweighting of Keyence contributed, while overweighting of Kirin Holdings, Nomura Research Institute, and Ajinomoto detracted from performance.
- In stock selection in March, our underweight in SoftBank Group and overweight in Sumitomo Mitsui Trust and Sawai Pharmaceutical contributed, while our underweight in Toyota and overweight in East Japan Railway and Kirin Holdings detracted. Overall, stock selection had a positive impact.

Portfolio Activity

- The portfolio manager constructs the portfolio according to Sompo AM's expected alpha ranking (expected alpha = intrinsic value / market price), a reflection of the team's fundamental analysis, forecasting, and valuation methodology, as well as ESG scores.
- Names we reduced our portfolio weighting in include Sysmex, Hitachi Capital, Nippon Soda. Names we increased our weighting in include Ushio, Sumitomo Heavy Industries, and Sumitomo Misui Financial Group.
- The portfolio was constructed in such a way to be neutrally weighted against our ESG classified sectors (Manufacturing, Consumer/Service, Finance, Public/Infrastructure). As of the end of the quarter, the sectors (GICS 11) the portfolio was overweight in were Information Technology and Consumer Staples. Underweight sectors were Communication Services and Consumer Discretionary.
- Our incorporation strategy will continue to focus on ESG scores and undervalued names, as determined by our alpha rank measure. We will continue to construct a portfolio with ESG sector neutral weightings and an effective risk/return balance.

Outlook

- Japanese equity market movements were dictated by US long-term rates in March. The increase in US rates is a result of the recovery to the US economy and is a phenomenon that has been seen during past recoveries. The increase in long-term rates will lead to corrections to valuation multiples, especially for growth names. However, given that rates are only in the 1.5%-2% range, we do not expect them to have a negative impact on the recovery to corporate earnings. It is unlikely long-term rates will increase to above 2% in the short term, given that we are still during an economic recovery and it will take some time for the unemployment rate to recover to pre-Covid levels. Once valuations adjust to be in line with new interest rates, we believe equity market growth will go back to being in line with EPS growth. However, interest rate growth could gain traction now that the US economy is implementing fewer restrictions on activity because of the vaccine rollout and the Biden administration is pumping out large-scale economic stimulus. We will be keeping watch of further changes in interest rates, including in expected inflation.
- We believe corporate earnings forecasts will continue to be revised upwards because of a better-than-expected recovery to the real economy, in particular in the US. As the Japanese equity market has already undergone a significant recovery, it is hard to envision any further rapid increase in prices. However, we believe we will continue to see gentle growth as the market factors in an end to the pandemic by FY22.

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