U ACCESS – LONG/SHORT JAPAN CORPORATE GOVERNANCE

Quarterly Comment | Q1 2024

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

Market Comment

- TOPIX (TR) was up 18.14% during the January-March period. The rise in large-cap equities was particularly striking as capital flowed into Japanese stocks from foreign investors against a backdrop of US equity market record-highs following robust US corporate earnings and expectations for early rate cuts by the Fed. Expectations for Japanese corporate earnings also grew as JPY depreciated versus USD. The BoJ lifted negative interest rate policy and ended yield curve control (YCC) at its March monetary policy meeting following salary increases seen at the annual spring union salary negotiations. The Japanese equity market rose substantially on heightened expectations for deflation to end.

- In Q1, Japanese large-cap stocks led the market on foreign inflows driven by expectations for the end of deflation, while small- and mid-cap stocks underperformed. Overvalued names were avoided because of the slight rise in long-term rates in and out of the country. The Transportation Equipment sector was popular because the market was bullish on JPY depreciation versus USD. Names in the Financials and Real Estate sectors also outperformed on the BoJ’s normalization of monetary policy and expectations for deflation to end. Domestic-focused sectors, for which the market was concerned because of prolonged high inflation, and sectors with high valuations, such as Services and Precision Instruments, underperformed.

- The Japanese market was weighted down at the beginning of March as expectations for the BoJ to put an end to negative interest rate policy at its March monetary policy meeting led to JPY appreciation versus USD. That said, sectors that rose were led by financials. The market then rallied as despite the BoJ putting an end to negative rates and abandoning yield curve control on prospects of the country having escaped deflation and seeing spring union wage negotiations lead to high raises, investors still believed monetary policy will remain accommodative for the time being. The market then gained support through the end of the month as JPY depreciated versus USD and on comments from Fed chair Jerome Powell after leaving monetary policy unchanged (much in line with market expectations) that there is a high chance the Fed will begin cutting rates before the end of 2024.

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 2.92% return for the first quarter (in USD for LU2187695437).
- 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 4Q 2022 the short side again started to make a meaningful positive contribution to gross alpha. This trend continued in 2023, with the short side contributing positively to alpha in all four quarters as well as 2024. Long side performance was mixed, making small positive or negative contributions in each quarter of 2023. Since inception, the long and short sides have contributed +3.8% and +22.8% respectively to gross performance.
- Since inception, the machinery sector has made the largest positive contribution to performance followed by materials, staples, tech & media, electronics, utilities, chemicals, automotive and real estate. Nine sectors made significant positive contributions to performance. Only two sectors (consumer and transport) made significant negative contributions since inception.
- In March, the machinery and healthcare sectors made large positive contributions to performance. Unfortunately, this was offset by moderate negative contributions from the tech & media, real estate, automotive and chemicals sectors. The strategy performance was quite stable over the month, rising or falling by small amounts. The longs and shorts both rose almost in line with the market. Performance for the month ended at -0.14%. The cumulative return since inception is +23.80%, with volatility of 5.6%.

Portfolio Activity

- Since September 2022, 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 March we did stop losses on three long and two short positions. The long positions were in the automotive, consumer and financials sectors, while the short positions were in the chemicals and consumer sectors. We re-entered one long and three short positions on which we had previously done stop losses. These were in the machinery sector on the long side and in the healthcare, tech & media and transport sectors on the short side. Each of these names had peaked out and started to move in our favour by 10% or more.
- We took profit on five long and six short positions. The long positions were in the machinery, consumer, electronics, staples and real estate sectors. These stocks had outperformed the market by +28%, +26%, +23%, +17% and +11% respectively. The short positions were in the machinery, electronics (2 names), transport and tech & media sectors. These stocks had underperformed the market by -53%, -45%, -23% and -18% and -18% respectively.

Outlook

- We expect corporate profits could likely increase in FY24 given expectations for inventories at manufacturers to bottom out and domestic real wages to grow and capital efficiency improvement policies to be enacted on the back of pressure from the Tokyo Stock Exchange (TSE). However, it is also highly likely that profit growth momentum will slow given little room for further domestic economic normalization and JPY depreciation.

- Valuations are not at expensive levels despite haven risen at a fast pace since the beginning of the year on capital flows from foreign investors. While we believe that the market could readily respond to a new negative catalyst given that earnings improvements expectations are already baked into prices, it is difficult to envision a large correction to the Japanese market given expectations for capital efficiency improvements on TSE pressure and support for equity demand from the high level of large scale share buybacks seen recently.

- The probability of a 10 bp rate hike in October increased. We can’t exclude the possibility of this taking place sooner in July, although the data remains inconclusive. Investors should examine BOJ’s statement for cues on when that could be. A weaker yen and higher oil prices may also exert upside pressures on BOJ’s inflation forecast. We are watching for signs that a virtuous wage-price cycle has started to take hold.

- As active managers, such an environment should very much play to our strengths, as good governance 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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