U ACCESS – LONG/SHORT JAPAN CORPORATE GOVERNANCE

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 LP.

Past performance is not indicative of future performance

Performance Review

- The strategy generated positive returns over the quarter, resulting in 2.17% return for the second 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 1Q and 2Q 2023. In 3Q 2023 both the long and short sides contributed positively to alpha. Since inception, the long and short sides have contributed +7.0% and +15.4% respectively to gross performance.
- Since inception, the tech & media sector has made the largest positive contribution to performance followed by machinery, materials, chemicals, utilities, automotive, electronics and staples. Ten sectors made significant positive contributions to performance. Two sectors (consumer and transport) made significant negative contributions since inception.
- In September, five sectors made meaningful positive contributions to performance, namely materials, machinery, chemicals, tech & media and utilities. Unfortunately, this was partly offset by small negative contributions from the staples, automotive and financials sectors.

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 September we did a stop loss on one long and one short position in the automotive sector as well as a long position in the staples sector. Although the stop loss criteria had not been hit, in an abundance of caution, we also closed one long and one short position in the consumer sector as well as a short position in the tech & media sector.

- We took profit on two short positions in the staples sector that had underperformed the market by -20% and -27%. We replaced these names with two new, bad governance short positions in the staples sector.

- The above trades amounted to 4% turnover on the long side and 6% turnover on the short side.

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.

- 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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