U ACCESS – LONG/SHORT JAPAN CORPORATE GOVERNANCE

Quarterly Comment | Q4 2023

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

Market Comment

- TOPIX (TR) was up 2.0% during the October-December period. The market rose for the fifth consecutive quarter, albeit at a low rate. Domestic and overseas long-term rates rose in October on concerns over prolonged monetary tightening in the US and the BoJ's adoption of a more flexible approach to the 10-year JGB yield ceiling. The market sagged as investors became more risk-averse following the escalation of geopolitical risk in Israel. However, Japanese equities then showed strength as US equities rose following a significant drop in US long-term rates stemming from expectations for the Fed to cut rates soon, which was in turn driven by weaker-than-expected jobs data and CPI.

- In Q4, Japanese large-cap growth stocks were bought up as the US equity market grew sharply on the back of slowed inflation and the consequent abated concerns of excessive monetary tightening. Names in sectors with high valuations, such as Electric Appliances, Precision Instruments, and Services rose given lower interest rates. Stocks in Marine Transportation also outperformed due to expectations for freight charges to soar given rising geopolitical tensions in the Middle East. However, banking stocks were sluggish because of diminished expectations for normalisation in monetary policy and names in Transportation Equipment underperformed given the yen's appreciation versus the US dollar, which stemmed from narrower interest rate differentials between Japan and the US, driven by the drop in US long-term rates.

- The drop at the beginning of December was largely focused on export-related names because of the rapid appreciation of JPY versus USD. This appreciation was the result of the interest rate gap between the US and Japan shrinking following hints from BoJ governor Kazuo Ueda that changes could be made to monetary policy and heightened expectations for the Fed to cut rates soon because of the continued slow in inflation. From the middle of the month onward the market seesawed. The drop in long-term rates in the US (November employment data while strong was not enough to warrant a rate hike) and Japan (maintained easy monetary policy) was positive for the market but growth was tempered by the rapid appreciation of JPY versus USD. Across the whole month, the market was down slightly.

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 1.27% 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 2023, with the short side contributing positively to alpha in all four quarters. 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 +1.0% and +16.4% respectively to gross performance.
- Since inception, the tech & media sector has made the largest positive contribution to performance followed by staples, materials, machinery, chemicals, utilities, automotive and electronics. Ten sectors made significant positive contributions to performance. Only two sectors (consumer and transport) made significant negative contributions since inception.
- For the full year 2023, the largest positive contributors were the electronics, real estate, staples and machinery sectors. Tech & media, chemicals, financials and transport also performed well. Two sectors performed poorly, consumer and automotive.

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 December 2023 we did a stop loss on one long and three short positions. The long position was in the healthcare sector, while the short positions were in the automotive, chemicals and tech & media sectors. We re-entered two long and five short positions on which we had previously done stop losses. These were in the consumer and financials sectors on the long side and in the automotive, consumer (2 names), electronics 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 three long positions in the materials, staples and consumer sectors that had outperformed the sharply rising market by +29%, +12% and +9% respectively. We took profit on seven short positions in the utilities, materials, real estate, transport, machinery (2 names) and staples sectors. These stocks had underperformed the market by -108%, -54%, -37%, -35%, -31%, -8% and -13% respectively.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

Outlook

- At the end of July, the Bank of Japan announced a tweak to its yield curve control policy, allowing interest rates to rise a bit more freely. This resulted in rising Japanese government bond yields since July in expectation of further policy changes by the BoJ. A healthy job market and slightly higher than expected headline inflation in the US since July has resulted in the market expecting US interest rates remaining higher for longer. In November, expectations of the Fed cutting rates sometime in 2024 picked up. This resulted in US and Japanese government bond yields falling slowly, but steadily. Since October, US and Japanese 10-year yields fell by 100bp and 35bp respectively. The Japanese Yen recovered significantly from 151 to 141 to the dollar over these two months. Global stock markets, which had risen nearly 20% year-to-date by the end of November, continued rising in December. They ended the year up nearly 25%. The upward trajectory of the Japanese market, which had risen nearly +30% year-to-date by mid-November, could not maintain the upward momentum in December, falling -2.5% in the first two weeks, before recovering slightly to end the month down -0.84%.

- Value beat growth in 2023 due to continual expectations for capital efficiency improvements at low-efficiency companies on the back of TSE pressure. Outperforming sectors included Iron & Steel, Marine Transportation, and Wholesale Trade given expectations for shareholder returns on strong short-term earnings. Underperforming sectors included Pharmaceutical, which was overvalued, and Land Transportation, Services, and Retail Trade, which saw weak domestic demand and costs increases.

- Corporate profits and sales will likely increase this fiscal year thanks to the strong US economy, normalization of domestic economic activity, and yen depreciation. We predict profits will continue to grow next fiscal year on rising expectations for a soft landing for the US economy, outlooks for inventories bottoming out, and a recovery in domestic real wages. However, the earnings growth momentum will highly likely decelerate because of the negative impact monetary tightening in the US and Europe will have on the global economy. We believe market expectations will unlikely improve given the slowing economic recovery in China and heightened geopolitical risks.

- 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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