Brandes Investment Partners
Japan Equity Strategy Notes
Second Quarter 2023 (April 1 – June 30, 2023)

The Brandes Japan Equity Strategy rose 2.43% net of fees and 2.49% gross of fees, underperforming its benchmark, the MSCI Japan Index, which increased 6.42% in the quarter.

Annualized total return as of June 30, 2023	1-year	5-year	10-year
Brandes Japan Equity Composite (net)	17.93%	0.45%	5.66%
Brandes Japan Equity Composite (gross)	18.22%	0.88%	6.32%
MSCI Japan Index	18.14%	3.13%	5.22%

Past performance is not a guarantee of future results. One cannot invest directly in an index. Returns include reinvestment of all dividends and are reduced by any applicable foreign withholding taxes, without provisions for income taxes, if any.

Positive Contributors

Leading contributors included media firm **Fuji Media**, machinery company **Sintokogio**, household products business **JVCKenwood**, and insurer **MS&AD Insurance**. Several of our auto-related holdings also helped performance, including components company **Tachi-S** and automaker **Honda Motor**.

Performance Detractors

Several of our pharmaceutical holdings weighed on returns as the industry underperformed the broader market (MSCI Japan). Notable detractors included **Taisho Pharmaceutical**, **Takeda Pharmaceutical**, and **Kaken Pharmaceutical**.

Other poor performers included machinery company **Komori**, food products manufacturer **Calbee**, and health care services provider **H.U. Group**. Additionally, our underweights to two of the best performing industries, semiconductors and trading companies, hurt relative performance.

Select Activity in the Quarter

Amid a rising Japanese equity market, the investment committee divested two holdings that benefited from the upswing, JVCKenwood and **Nippon Beet Sugar**, and pared several large positions such as MS&AD Insurance, Honda Motor, and **Mitsubishi UFJ**. The committee also added two new names, **Ezaki Glico** and **Kewpie**, and topped up existing positions for which we have favorable views on the margins of safety, including **Fukuda Denshi**, H.U. Group, and Kaken Pharmaceutical. (The margin of safety is the discount of market price to our estimate of a security's intrinsic value.)

Additionally, the investment committee performed a "blank sheet" exercise in the quarter, in which each member reconstructed the portfolio from scratch. The purpose of this exercise is to enable the committee to think about the portfolio from a fresh perspective without existing bias. As a committee, we are always cognizant about the potential biases that we may have toward certain holdings or new names, and overall "action bias" (want to sell or buy). While we discuss these issues regularly in our weekly meetings, the blank sheet exercise can, at times, help with adjusting allocations and lead to a more holistic view of each committee member's thoughts on the portfolio. It can also help highlight names for which the committee members may have differing opinions. In such cases, the committee may make a portfolio change or request the respective analysts for more insight on the companies.

<u>Full Sales: JVCKenwood and Nippon Beet Sugar</u>

JVCKenwood was one of the portfolio's longest-held positions. Our initial investment started with the standalone company Kenwood, a manufacturer of after-market car electronics, communication equipment, and home electronics. Our original investment thesis was based on the margin recovery potential of Kenwood's home electronics segment, which was loss-making at the time. However, Kenwood's merger with JVC to form JVCKenwood in 2008 dramatically changed this investment case. The new company had significantly higher financial leverage, owned more underperforming assets including more loss-making home electronics, and was exposed to increased economic cyclicality through the car electronics segment during the most inopportune time of the global financial crisis.

This investment had long been deemed as the prototypical "value trap" as the share-price performance was quite disappointing for a long time despite the low earnings and valuation multiples. The investment committee was very cognizant of the price performance but was also diligent with our analysis. We did lower our estimate of the company's intrinsic value post-merger as the turnaround required more time than expected, and there was capital dilution as well as poor execution due to management mishaps. Additionally, we performed annual reviews of the investment, scrutinizing many factors to see where we could be wrong. Throughout, the investment committee believed that the market was more punitive than what we thought justified. We managed the downside risk through a controlled allocation. While patience, both ours and that of our clients', understandably grew thinner at times, the stock finally started to improve over the past few years. As the shares approached our estimate of intrinsic value, the investment committee decided to sell the position to reinvest in other opportunities.

The other full sale was that of Nippon Beet Sugar, a position that we initiated in 2018. The company is Japan's largest beet sugar manufacturer that also produces animal feed (beet pulp and compound), biodegradable paper planters, seeds, raffinose and other oligosaccharides. When we first purchased the shares, Nippon Beet was trading below book value and its net cash and investments. The investment committee decided to divest the position at a price slightly below our estimate of intrinsic value as more attractive investment opportunities such as Ezaki Glico and Kewpie (see below) came into play. While certainly not made lightly, our decision to exit the investment was based on factors that included low liquidity, smaller margin of safety relative to other small and illiquid names, and low contribution to diversification of the portfolio (e.g., it did not add much diversification benefit compared to other similar small, low price-to-book, heavily net-cash names).

<u>New Buys: Ezaki Glico and Kewpie</u>
Ezaki Glico is the leading manufacturer of confectionery products in Japan, with many popular brand names such as Pocky and Pretz. The company derives about two-thirds of its revenue from confections, ice cream and dairy products sales in Japan, with food ingredients and overseas sales making up the rest.

Kewpie is a branded packaged food company well known for its egg-based products, particularly its mayonnaise.

Glico and Kewpie share what we consider favorable attributes, including a strong domestic franchise, expanding—yet still in early stage—international presence, and a solid balance sheet. Both companies have also been facing similar near-term issues, such as cost inflation and COVID-related demand impact. In our view, Glico and Kewpie represent attractive opportunities to invest in solid franchises trading at undemanding valuations. While their margins of safety are not the highest within the portfolio, we believe these two companies offer an appealing risk/return tradeoff given their strong balance sheets and brands, as well as the diversification they provide for the overall portfolio. We also appreciate the upside optionality through the potential of sales growth domestically and internationally via inflation passthrough, new product launches, and increased demand in a more normalized environment. At their current prices, we are excited to add these new positions to the portfolio.

Current Thoughts
The second quarter was a difficult period for the portfolio, and we sincerely apologize for the disappointing performance. The sudden and increased popularity of Japanese equities has been a welcomed sight; however, it appears a lot of the capital flowed into mutual funds and exchange-traded funds (ETFs) composed of large-cap names. Our overweight to small-cap stocks and exposure to health care names were major detractors from relative performance, as was our underweight to trading companies, which received significant attention in the quarter. As bottom-up, fundamental-based value investors, we continue to believe that valuations matter and that the current Japan Equity portfolio is well positioned with what we consider undervalued companies with solid franchises.

While it is natural to be reactionary during a period of major underperformance, the investment committee remains disciplined to its approach of buying undervalued companies and selling companies trading above the estimated intrinsic values. As reflected in the portfolio's higher cash position, this quarter was mainly about reducing overallocated and well performing names to take advantage of the suddenly bullish market movement. The two new names were a product of our bottom-up research where we believe there is ample margin of safety that can potentially provide positive long-term results.

The investment committee reviews the portfolio allocations on a weekly basis. When sudden market movements such as the upswing we saw in the quarter occur, the investment committee attempts to take a step back to review and consider the impact on the portfolio. While there have been no wholesale changes to the portfolio positioning this year, we did make numerous tweaks, including selling names that have meaningfully appreciated, reallocating capital from illiquid names to more liquid names based on margins of safety, and reviewing new investments that could be potentially added. We do not look to chase the market movement, nor do we look to change the process. Our goal has been and always will be to optimize the portfolio to position it where long-term excess returns can be generated.

Conclusion

It is always interesting to see how the market momentum changes so abruptly. This year, to our dismay, has been a challenging period for performance. However, amid the recent market performance, we are excited about the potential of the Japan Equity portfolio, which remains overweight to small- and mid-cap companies. With large-cap valuations having risen significantly, we believe that at some point, investors will turn their attention to the largely ignored but potentially undervalued small- and mid-cap value stocks.

With regards to the Japanese equity market in general, we have seen many positive—albeit slow-moving—changes in corporate governance. For example, a recent directive by the Tokyo Stock Exchange asks listed companies trading below 1.0x book value to disclose initiatives to increase shareholder value. Additionally, there has been a growing wave of shareholder activism where we saw numerous shareholder proposals being put up for voting at companies' Annual General Meetings. While not many passed, it was a message sent to management, and we are beginning to see a noticeable shift in corporate behavior regarding excess capital. These are changes that we have long desired, but for which we have been tempering our expectations. Changes in Japan occur slowly, but we believe a small change is better than none. We have not adjusted our outlook for the companies we own, but we believe these developments should have an incremental positive impact over the long term.

We remain committed to our process, our belief in the value investment philosophy, and our dedication to construct and manage the portfolio for the best interest of our clients. In an environment full of unknowns as markets globally deal with inflation, increasing interest rates, economic uncertainty, and political tension, we strive to be prepared to manage the downside risk, while also seeking to capitalize on potential investment opportunities. We believe that a value philosophy-based portfolio can provide excess returns relative to the broader market (MSCI Japan) over the long run, and we aim to provide these benefits to our clients.

We are always open for any dialogue regarding the portfolio, our process and philosophy, as well as the firm, so please do reach out anytime. Critical comments and observations are always welcome as well.

Lastly, we sincerely appreciate the relationship over the years, and hope we can maintain and reward the trust given to us. It is truly a privilege to manage the portfolio on your behalf.

Book Value: Assets minus liabilities. Also known as shareholders' equity.

Net Cash: Total cash minus total debt.

Operating Margin: Operating income divided by net sales; used to measure a company's operating efficiency.

Price/Book: Price per share divided by book value per share.

The MSCI Japan Index with net dividends is designed to measure the performance of large and mid cap segments of the Japan market.