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Brandes Investment Partners
Japan Equity Strategy Notes
Fourth Quarter 2023 (October 1 – December 31, 2023)

The Brandes Japan Equity Strategy rose 7.04% net of fees and 7.11% gross of fees, underperforming its benchmark, the MSCI Japan Index, which increased 8.19% in the quarter.

Annualized total return as of December 31, 2023	1-year	5-year	10-year
Brandes Japan Equity Composite (net)	20.81%	5.24%	6.05%
Brandes Japan Equity Composite (gross)	21.10%	5.64%	6.69%
MSCI Japan Index	20.32%	6.91%	4.97%

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 holdings in health care, particularly **Taisho Pharmaceutical** and health care equipment company **Fukuda Denshi**. Chemical companies **C. Uyemura** and **Koatsu Gas Kogyo** also boosted performance, along with food distributor **Mitsubishi Shokuhin**.

Performance Detractors
Significant detractors included automakers **Nissan** and **Honda Motor**. Several pharmaceutical firms also declined, notably **Takeda Pharmaceutical**, **Astellas Pharmaceutical**, and **Kissei Pharmaceutical**.

Technology was the strongest performing sector in the benchmark; as such, our significant underweight hurt relative returns.

Select Activity in the Quarter
The investment committee took advantage of the continued strength of the Japanese equity market (as represented by MSCI Japan) by divesting two positions, **Daiichi Jitsugyo** and **Kyushu Financial Group**. With the prospects of further U.S. interest rate increases fading, growth-oriented sectors such as information technology, where the portfolio currently has little exposure, drove the market's rise. In contrast, more defensive sectors such as health care lagged. Following extensive discussions regarding the portfolio positioning, the investment committee proceeded to add to select health care positions such as Takeda, Astellas, Kissei, **Kaken Pharmaceuticals**, and **Medipal Holdings**. In our opinion, these holdings offer appealing long-term upside optionality based on their reasonable valuations, healthy balance sheets, and solid free-cash-flow generation. Moreover, we believe they are well positioned for growth opportunities from innovation and the aging population.

One surprising but positive event during the quarter was the announcement by Taisho Pharmaceutical Holdings of its intent to take itself private at a 50% premium to the six-month average trading price. While the offer price is below book value, the company has significant intangible assets, including goodwill, which could face impairment risk in the long run, especially given that the company has, in our opinion, overpaid for foreign assets. Taisho was one of the large holdings in the portfolio, and as the shares surpassed the management buyout price, we decided to reduce our position by more than half. After we completed this sale, which took time due to liquidity and trading opportunities, the share price adjusted closer to the buyout price (very slight premium). We plan to tender the remaining shares as the tender price is above our estimate of Taisho's intrinsic value.

Full Sales:
Daiichi Jitsugyo
After significantly reducing our allocation in the third quarter, we completed the full sale of Daiichi Jitsugyo, a machinery trading and service provider that generates over 50% of revenues outside Japan.

We initially purchased Daiichi in 2017 and divested that position in 2021. In late 2022, we re-initiated a position in the company. To counter potential biases—such as familiarity and success bias—the investment committee scrutinized the investment rationale before repurchasing. Among our discussion topics were: what changed since we had last owned the company; what could have caused the stock-price underperformance post our exit; and whether the investment thesis was intact. This process helped ensure that our decision was based on objective analysis rather than solely past experiences.
The committee concluded that Daiichi Jitsugyo was an attractive opportunity due to its robust balance sheet, healthy returns on capital, and asset-light business model. We also appreciated Daiichi's global presence and its growth prospects from exposure to Japanese companies expanding internationally. Importantly, the company was trading below book value and at a low price/earnings multiple adjusted for cash, making it an appealing risk/reward tradeoff, in our opinion.

Post-pandemic, the company continued to execute well, with margins and returns on capital improving above what we believed was a normalized rate. We increased our intrinsic value estimates following numerous reviews of the business, but ultimately decided to exit the position as the share price surpassed our assessment of its fair value. Our view that Daiichi Jitsugyo is a good company with solid fundamentals remains unchanged, and we are open to repurchasing the shares if the price movement aligns favorably with our buying criteria again.

Kyushu Financial Group
The investment in Kyushu Financial Group originated from the merger of Higo Bank and Kagoshima Bank in October 2015, combining two regional banks where separate positions were previously held. Our initial investment thesis for these banks was based on their strong capital positions and low valuations, offset by a dim view of interest rates in Japan. Following the merger, we anticipated there would be potential synergies in revenue and cost structures. We understood, however, that realizing these benefits would take time given the merger's friendly (vs. hostile) nature and the slow pace of integration in Japan.

While it took longer than expected, the company has succeeded in reducing costs and has started to see positive developments, including the expansion of the Kyushu economy buoyed by investments from the semiconductor industry. With the market valuation increasing and considering the portfolio's high overall allocation to banks, the investment committee decided to exit the position as the share price exceeded our estimated intrinsic value.

Year in Review
In 2023, the Japanese stock market saw remarkable returns in local currency terms. While difficult to ascertain the reasons for the positive performance, many have cited the weakening of the yen, the valuation discrepancy compared to other developed markets, capital flowing from the Chinese stock market, and optimism toward potential improvement in Japanese corporate governance and shareholder returns based on the directives from the Tokyo Stock Exchange.

Despite the significant market rise, Brandes Japan Equity was able to compete with the MSCI Japan Index (primary benchmark) and outperform TOPIX (Tokyo Stock Price Index; secondary benchmark). However, it unfortunately underperformed the MSCI Japan Value Index. Factors contributing to our underperformance vs. the value index included our lack of holdings in companies that account for large positions in the index, low exposure to trading companies that outperformed the index—driven partly by news that Warren Buffet added to his holdings of Japanese trading firms (the so-called "Buffett effect"), high exposure to the underperforming health care sector, and an overweight to the small- and mid-cap companies.

Our tendency has been to outperform the value index during "value-led" periods (when MSCI Japan Value outperforms the benchmark), but there are times when this is not the case. This is mostly because our investment philosophy is based on a benchmark-agnostic process. The Japan Equity portfolio has maintained an average active share of over 80% for over a decade, and the portfolio allocation process never involves discussions regarding the benchmark weights. The only benchmark-related factor that the investment committee considers when making investment decisions is to maintain a maximum industry allocation that is either 1.5 times the benchmark weight or 20% of the portfolio at the time of purchase, whichever is greater.

Although the underperformance versus the MSCI Japan Value Index was disappointing, we remain optimistic about the portfolio outlook. We truly believe that valuation matters, and thus being benchmark-agnostic gives us the flexibility to pursue value opportunities that may provide long-term positive risk/reward profiles.

2024 Outlook

As a bottom-up, fundamental-based investment manager, we do not employ a top-down view of the direction of the economy, currency, industries, commodity prices, or the stock market. While we do consider both macro and micro risk factors, our investment process focuses mainly on estimating intrinsic values of businesses and optimizing the portfolio for long-term return potential by balancing the margin-of-safety consideration with factors such as diversification of industries, market cap, and liquidity.

Based on our bottom-up fundamental analysis and the current opportunity set, we believe there is still upside in a market that saw positive performance of nearly 30% (MSCI Japan; in Japanese yen) in 2023, especially in the small- and mid-cap space. We also believe there are pockets of opportunities in the health care sector, as well as auto and auto components, and food products industries. However, we are also cognizant that there is a tendency for markets to correct following a period of strong performance and thus believe that being disciplined on price, focused on strong balance sheets, and managing the micro/macro risks from an overall portfolio perspective is important for capital preservation.

We have received numerous inquiries from clients and consultants about the directives by the Tokyo Stock Exchange (TSE) and whether the change in corporate behavior to become more favorable for shareholders is “real” or merely superficial. Our response is nuanced. We acknowledge that the TSE has exhibited stronger influence than at any time in the past, thus increasing the pressure for corporates to adapt. So far, this has led some companies to announce more proactive measures, highlighting their efforts to improve share-price performance, increase returns on equity through share buybacks, higher dividends, and to focus on capital deployment (e.g., mergers and acquisitions). The recent string of management buyout announcements may have also stemmed from the TSE pressure. The Brandes Japan Equity Strategy has seen some positive impact from these changes, although there could be greater benefit if the trend continues and spreads to more companies.

That said, we believe these movements tend to gain traction when the economy and stock market are on the rise. Conversely, in periods of stock market downturns or heightened economic uncertainty, the TSE and companies are likely to become more cautious, which is not unreasonable—albeit not ideal for shareholders. This is not just a Japan phenomenon, but rather a global pattern where corporate actions such as share buybacks and dividend increases usually occur in times of high confidence in outlook, while less favorable prospects typically result in corporates holding back or hesitating to implement changes.

If the TSE directive continues to lead to improved corporate governance, more efficient capital management, higher returns on equity, and more aggressive measures from companies to increase their market valuations above 1x book value, the Brandes Japan Equity Portfolio should be well positioned. As of December 31, 2023, the portfolio’s price/book value is well below 1x and lower than that of the MSCI Japan Index. Note that our intrinsic value estimates do not explicitly incorporate any positive development of this trend as we have long accounted for this possibility as just an upside optionality with little value assigned. The take-private of Taisho Pharmaceutical Holdings was something that we saw as a possibility and discussed during company reviews, but we assigned no probability to it actually happening considering past precedent. Maybe this is a new Japan, but we continue to be conservative. We would happily welcome the change, but our focus remains on the risk/reward tradeoff and downside protection, while considering structural or secular changes more as upside optionality.

Conclusion

First and foremost, we would like to express our sincere appreciation to our clients who have continued to give us the opportunity to manage the Japan Equity portfolio on their behalf following disappointing performance relative to the value benchmark. We are honored to continue serving as stewards of your capital.

While there are numerous external factors beyond our control, such as inflation, increasing interest rates (not yet in Japan), global economic uncertainty, and geopolitical tension, our focus remains on what we can control, which is our

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process and belief in our estimates of intrinsic values based on bottom-up, fundamental analysis. The investment committee is also committed to optimizing the portfolio through diversification of various risk factors with the goal of minimizing capital impairment over the long term.

It is difficult to predict how the Japanese stock market or the Brandes Japan Equity portfolio will perform in 2024, but we remain optimistic and confident that the portfolio is positioned well. Our commitment is steadfast: to remain consistent, transparent, and dedicated to achieving the best possible outcomes based on what we can control. In a world that is unpredictable, we are sure that 2024 will bring about more unforeseen events, but we strive to be prepared to manage the downside risk, while also seeking to capitalize on potential investment opportunities. Hopefully, we can continue to earn your trust and reward it with enhanced performance.

Lastly, we always appreciate 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. We sincerely value the relationship over the years. It is truly a privilege to manage the portfolio on your behalf.

May 2024 bring happiness, wellness, and prosperity to all.

Personal Message

Our thoughts and prayers go out to all those that have been impacted by ongoing conflicts worldwide. It is our sincere hope that there will soon be a peaceful resolution and an end to the violence. Also, we would like to express our sincere condolences and sympathy to the people in Noto Peninsula and those that have been impacted by the massive earthquake on January 1, 2024. It is truly devasting to hear news of such suffering.

Term definitions: https://www.brandes.com/termdefinitions

The margin of safety for any security is the discount of its market price to our estimate of its intrinsic value.

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

The MSCI Japan Value Index captures large and mid cap Japanese securities exhibiting overall value style characteristics, defined using book value to price, 12-month forward earnings to price and dividend yield.

TOPIX with gross dividends measures performance of all domestic common stocks listed on the Tokyo Stock Exchange First Section.

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