Brandes Investment Partners
Japan Equity Strategy Notes
Fourth Quarter 2022 (October 1 – December 31, 2022)

The Brandes Japan Equity Strategy rose 17.65% net of fees and 17.74% gross of fees, outperforming its benchmark, the MSCI Japan Index, which was up 13.23% in the fourth quarter.

Annualized total return as of December 31, 2022	1-year	5-year	10-year
Brandes Japan Equity Composite (net)	-1.16%	-1.36%	6.27%
Brandes Japan Equity Composite (gross)	-0.91%	-0.88%	6.96%
MSCI Japan Index	-16.65%	0.23%	5.55%

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. Please refer to the GIPS® Report for additional information.

Positive Contributors

Value outperformance provided a tailwind for the strategy. At the stock level, the strongest performers included several financial holdings that benefitted from the rise in interest rates, such as **Sumitomo Mitsui Financial Group, Mitsubishi UFJ Financial Group**, and **Sumitomo Mitsui Trust**.

Medical device company **Fukuda Denshi** and consumer company **JVCKenwood** also appreciated notably**.**

Performance Detractors

Amid a rising overall market, detractors were mostly companies which were either flat or up less than the benchmark. These included auto related holdings **Nissan Motor** and **Honda Motor,** as well food products company **Calbee** and media business **TV Asahi**. Materials company **Maruichi Steel Tube** and electrical equipment firm **Futaba Corporation** also detracted from relative returns.

Select Activity in the Quarter

We took advantage of the market recovery in the quarter to reduce allocations in some of the solid performers (e.g., **Japan Petroleum**, **Sankyo**, JVCKenwood) and divest our positions in **K&O Energy Group** and **TSI Holdings**. Using the sales proceeds, we topped off our allocation to **Daiichi Jitsugyo**, which we first purchased last quarter, and added to our positions in **Astellas** and **H.U Group**. We also increased our exposure to names that underperformed the overall portfolio, such as **Shikoku Chemical** and **Toyo Ink**. Furthermore, we initiated a position in **Makita**, a global supplier of power tools.

<u>Full Sells – K&O Energy and TSI Holdings</u>

We initially purchased K&O Energy, a holding company with primary operations in the domestic production and distribution of natural gas and iodine, in 2016. At the time, the company was trading at a low earnings multiple and approximately 50% of book value, with significant excess cash and investments. We appreciated K&O Energy's solid business model and fair returns on capital, and the fact that it had some growth potential despite being mostly domestically oriented. Due to the low trading liquidity, we were not able to build a sizeable position, but were happy to own it as part of the portfolio. Recently, the shares outperformed the broader market (MSCI Japan) due to the buoyant demand for iodine. After reviewing our estimate of intrinsic value and considering the options for redeployment in higher liquidity opportunities, the investment committee decided to exit the position.

TSI Holdings (originally named Tokyo Style when we initiated the position) is a holding we owned in the portfolio for over a decade. The company is a major domestic apparel retailer formed through the merger between Sanei and Tokyo Style. As is the case for many of our small-cap investments, our investment thesis was based on low earnings and book value multiples, with the upside potential coming from the likelihood of value creation through improved earnings and deployment of excess capital. Through persistent shareholder engagement with management, TSI Holdings indeed increased capital returns to shareholders, raising dividends and buybacks. However, the business environment continued to deteriorate due to deflation, lower consumer spending, and intensifying competition from Japanese and non-Japanese retailers, as well as online platforms. Poor mergers and acquisitions, struggles with integration of acquired assets, and slow restructuring progress further weighed on the company's appeal. Following a thorough review, the investment committee reduced our estimate of TSI Holdings' intrinsic value significantly but decided to not sell the position immediately as the margin of safety was still sufficiently attractive. During the past six months, TSI Holdings' shares recovered greatly thanks to improved earnings and continued management share buybacks. Given the wide range of intrinsic value possibilities due to the volatile retail business, long-term secular challenges, and the negative margin of safety following the share price rebound, we decided to divest the position.

New Buy – Makita
Makita is a global supplier of power tools with a focus on the professional segment. Europe represents Makita's biggest market, accounting for nearly 50% of sales, followed by Japan, North America, and Asia ex-Japan. About one third of the company's revenue comes from emerging markets.

Makita's shares have lagged the broader market this year as its margins have declined due to higher input costs, heavy depreciation, and bloated inventory. Sales have been hurt by the relatively weak euro and the strong U.S. dollar, as well as the wind down of its Russian operations. Additionally, free cash flow has been hampered by the recent large capital expenditure (capex) program that should be nearing completion. While these issues negatively impact the company's near-term results, the investment committee believes that over the long term, Makita is well positioned to strengthen its margins through continued increase of sales volume, higher pricing to reflect the input costs, improved inventory management, and reduced capex. We believe the stock offers a great opportunity to invest in a solid global franchise with a strong balance sheet, healthy historical returns on capital, and a structurally growing market. Acknowledging there may be operational hiccups along the way and demand may decrease amid a global economic slowdown, our initial investment allocation is on the conservative end with the intent to increase over time.

Current Thoughts
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 a disappointing 2021 performance. We are honored to continue serving as a manager of your capital and pleased that we were able to provide improved returns for 2022.

The portfolio's robust relative performance this year, which was helped by the value tailwind, did not make us feel contented. The past few years have been rough for the portfolio and there is more room to make up for. Although the poor performance did weigh heavily on us due to the negative impact to our clients, we did not panic, change our process, or act in haste. We continued to believe in the process, refine or improve whenever possible, and remained steadfast in our belief that buying potentially undervalued assets would generate returns over the long run. The past year provided a glimpse of what we hope is a longer and favorable value cycle.

How do we view the portfolio following 2022? We continue to have confidence that we have built a portfolio with long-term value appreciation potential. The surprise interest rate hike by the Bank of Japan helped our holdings in the financials sector, in which we have long maintained an overweight relative to the benchmark. Although we do not have a crystal ball for whether and how much more Japan's interest rates may go up, any increase should continue to be beneficial for the financials we own, especially for the regional and megabanks. We also continue to believe that some of our larger positions in pharmaceuticals and the auto-related industries remain compelling investments due to the low valuations and various upside opportunities. Additionally, our holdings with net cash may become more competitive with more opportunities to invest compared to the higher financially leveraged companies.

In our year-end conversations with clients and consultants, we were commonly asked two questions: how do we see the market going forward and what will change with our positioning? We do not have any insight to what the market will bring, nor do we attempt to surmise what could potentially happen. Our focus strongly lies on deriving the intrinsic values correctly, and what our intrinsic value estimates tell us. Based on this, we believe there is still upside for the Japan Equity portfolio as we are encouraged by its attractive average margin of safety.

As far as portfolio positioning is concerned, our sector allocations did not materially change this year. However, we have started to observe some potential new investment opportunities in areas that we have not had exposure recently, such as technology, food products, and services. Our analysts are getting excited as they are starting to see more attractive valuations in the large-cap space, something we have not encountered over the past few years. The investment committee is also scouring the universe to find potential opportunities, leveraging what we are seeing in the international space and applying it to the Japanese universe.

Conclusion

With inflation, increasing interest rates, global economic uncertainty, and political tension worldwide among the many sources of worry, we remain dedicated to focusing on what we can have comfort with, and that is our 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.

While 2022 thankfully brought better results for our clients and we wish that 2023 will continue to be positive for value investors, we acknowledge that this is out of our control. Our only promise is that we will remain consistent, open, honest, and committed to achieving the best outcome we possibly can based on what we can control. In a world that is unpredictable, we are sure that 2023 will bring about more unforeseen events, but we strive to be prepared to manage the downside risk, while also capitalizing on potential investment opportunities. Hopefully, we can continue to receive your trust and reward that trust with improved 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.

Our thoughts and prayers continue to go out to those that have been impacted by the ongoing tragedy in Ukraine. It is our sincere hope that there will soon be a peaceful resolution and an end to the violence.

May 2023 be a prosperous year!

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

Free Cash Flow: Total cash flow from operations less capital expenditures.

Margin of Safety: The discount of a security's market price to what the firm believes is the intrinsic value of that security.

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.

Price/Earnings: Price per share divided by earnings per share.

Return on Capital: Net income minus dividends divided by total capital; used to assess a company's efficiency at allocating the capital under its control to profitable investments.

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

BRANDES
INVESTMENT PARTNERS