

Japan Equity Strategy Notes

First Quarter 2024 (1 January – 31 March 2024)

The Brandes Japan Equity Strategy rose 8.09% (gross of fees), underperforming its benchmark, the MSCI Japan Index, which increased 11.01% in the quarter.

Positive Contributors

Several holdings in financials, led by insurers MS&AD Insurance Group and Sompo Holdings, as well as Hachijuni Bank, appreciated as market optimism grew with the Bank of Japan's decision to raise interest rates, ending the negative interest rate era.

Communication services companies TV Asahi and Softbank also aided returns, along with auto component manufacturer Nippon Seiki.

Performance Detractors

Major detractors included several holdings in health care and consumer staples, which represented the two worst-performing sectors in the benchmark. Within health care, medical equipment business Fukuda Denshi and health care services companies H.U Group and Medipal Holdings declined, as did pharmaceutical firms Astellas Pharma, Takeda Pharmaceutical, and Kaken Pharmaceutical. Meanwhile, in consumer staples, food products companies Ezaki Glico and Meiji Holdings hurt performance.

Additionally, our underweight to automobiles weighed on relative returns as the industry was one of the best performers in the benchmark, up almost 30% in the quarter.

Select Activity in the Quarter

The Japanese equity market sustained its robust performance from 2023, with the TOPIX Index rising over 15% (in Japanese yen) in the quarter. Consequently, it was a busy period as we revisited the investment thesis and valuations of numerous holdings trading well above our estimates of their intrinsic values, while also scouring the market for new opportunities. With the Bank of Japan officially ending the negative interest rate policy, we also reviewed and discussed the positioning of our financials investments, which include mega-banks, regional banks, trust bank, and P&C (property and casualty) companies.

Furthermore, given the solid market performance and the meaningful impacts on the margins of safety for some of the portfolio holdings, we deemed it opportune to execute the *blank-sheet exercise*, in which we constructed the portfolio from a blank slate. We find this process valuable as the discussions that arise from comparing each other's thoughts on individual stocks, industry exposure, diversification, and target allocations can, at times, yield new ideas and suggestions.

From a trading and repositioning standpoint, this quarter was notably active compared to previous years. We divested three holdings, namely Softbank Group, Taisho Pharmaceutical, and Maezawa Kasei. Additionally, we pared positions that have become outsized due to share-price appreciation, including Fukuda Denshi, C. Uyemura, MS&AD, and Sompo. While we also pared some of our bank holdings, such as Mitsubishi UFJ, the overall allocation at quarter end remained higher than the last quarter due to their notable performance.

We redeployed the cash proceeds by adding four new positions to the portfolio, namely GungHo Online Entertainment, Paltac, Yakult, and Kubota. We also increased allocations to holdings that we believe provide an attractive risk/reward trade-off, such as Astellas Pharma, H.U. Group, and Kissei Pharmaceutical.

Full Sales

Maezawa Kasei

During the quarter, we completed the divestment of the remaining small position in Maezawa Kasei, a domestic manufacturer of water-related products used primarily for connecting PVC pipes in residential homes. Amid Maezawa Kasei's share-price appreciation, driven by improving margins, we opted to exit the position in favour of other opportunities that we deem could enhance portfolio diversification. While the stock and its valuation remain quite appealing, we concluded that redeploying the capital to other names offering more ample trading liquidity and better

long-term growth prospects would be beneficial to the portfolio. Our investment thesis for Maezawa Kasei centered around its large cash and investment holdings, a trait we believe can be replicated with other portfolio positions that have net-cash balance sheets.

Taisho Pharmaceutical Holdings

As noted in previous quarter's notes, we intended to exit our position in Taisho Pharmaceutical through the tender offer made by the founding Uehara family. While the offer price was below book value, it is important to note that the company has significant intangible assets, including goodwill, which raises concerns about impairment risk in the long run, especially given that the company has, in our opinion, overpaid for foreign assets. Ideally, we would have preferred a scenario in which a management team with a stronger profit orientation drove share-price performance. However, we acknowledge that this is unlikely given the majority ownership of the Uehara family. As such, we believe the take-out offer, which surpassed our estimate of Taisho's intrinsic value, was fair.

Softbank

Softbank is a holding company with large investment stakes in various entities, including Softbank Corp (top three telecom carrier in Japan), ARM (a semiconductor design firm), T-Mobile, and Vision Fund 1 and 2 (venture capital-like funds). Softbank also used to own a sizeable stake in Alibaba, and our initial investment thesis was based on our view that this stake would be a key value driver over the long term.

Since we added the company to the portfolio in early 2022, there have been two major changes at Softbank, one negative and one positive to our estimate of its intrinsic value. The negative aspect was the sale of its stake in Alibaba at a price we deemed significantly below its true worth. On the positive note, the recent IPO (initial public offering) of ARM, which we had conservatively priced at its 2016 acquisition cost of U.S.\$32bn, brought in U.S.\$4.8bn in cash, with Softbank retaining nearly a 90% stake after the IPO. The largest impact on the holding's margin of safety, though, came from ARM's current market valuation, which stands at approximately U.S.\$128bn.

Following a review of Softbank's various investment stakes and a long discussion regarding the potential intrinsic value of ARM, we decided to exit the position. Our sale rationale stemmed from the belief that ARM's current valuation may be closer to its peak than its trough. We acknowledge that we could be underestimating the value of ARM, given its valuable technology and tremendous growth prospects. However, ultimately, we could not come to the conclusion that ARM or Softbank was materially undervalued. Additionally, with ARM becoming a material cash source for a company with a somewhat constrained balance sheet, the risk of capital deployment into unknown assets, such as the Vision Funds, has become higher. Consequently, we determined that redeploying the capital into other opportunities would be better for the portfolio over the long term.

New Buys

GungHo Online Entertainment

GungHo Online Entertainment is a domestic mobile game developer with a 59% stake in publicly traded Korean game developer and publisher Gravity. The company has a history of steady cash-flow generation and possesses a solid balance sheet. We appreciate that GungHo has a franchise in Japan, and through its majority stake in Gravity, also in other Asian countries. Potential expansion of user base through game upgrades and new developments presents a key long-term growth prospect for GungHo, while product concentration—two major titles account for over 90% of revenues—presents an investment risk. Over the long term, we believe that investing in companies that are deploying capital into new product development can be fruitful, although research and development (R&D) often takes time. In our view, GungHo has the balance sheet to withstand some tough times, as well as the ability to deploy capital in potentially value-generating investments. Trading at only a slight premium to net cash and at 1x book value, GungHo represents an attractive risk/reward trade-off to us.

Yakult Honsha

Yakult Honsha manufactures and sells food and beverage products in 40 countries, with Japan accounting for approximately 55% of total sales. Its core Yakult brand, a probiotic beverage that promotes gastrointestinal health, is estimated to represent over 80% of sales and over 90% of profits. Our investment thesis is based on the view that Yakult's current earnings in Japan and internationally (especially in China) are depressed, and that margins could improve through increased capacity, new product development, and cost reductions. Potential top-line growth, especially outside Japan, could further boost profits due to the company's operating leverage. We believe Yakult's current valuation represents an attractive entry point to invest in a company with a solid balance sheet and healthy returns on capital, a potential to improve margins, and a brand that is increasingly popular globally.

Kubota

Kubota is a manufacturer of agricultural and construction equipment, with the former accounting for a major portion of revenues and earnings. The company holds a dominant position in the small tractors segment, boasting leading market shares in Thailand, Japan, and North America. Recently, Kubota has struggled with weak margins due to high input costs, logistical/shipping expenses, and R&D. However, we believe Kubota is well positioned to improve its margins, especially given its profitability-oriented management team. Our view is that the current valuation is undemanding and that an investment in Kubota adds to the diversification of the portfolio from an industry perspective.

Paltac

Paltac is one of the largest wholesalers/distributors of cosmetics and general products in Japan, a market dominated by the top three players. Supplying a wide range of cosmetics, daily necessities, over-the-counter pharmaceuticals, and health/sanitary products, Paltac interacts with over 1,000 manufacturers and delivers to more than 50,000 retail stores. Through acquisitions and organic investments, the company has become one of the largest players in the non-food wholesale/distribution market for consumer goods. Medipal Holdings, another position in the portfolio, owns an over 50% stake in Paltac, but the board is majority independent. Our investment thesis is based on the view that the company will be a beneficiary of consumption volume growth in various retail chains (including from tourism), e-commerce expansion, and potential consolidation within the industry. As it trades at a discount to book value and has a healthy balance sheet, we believe there is an attractive risk/reward proposition in Paltac.

Current Thoughts

The Japanese stock market (the TOPIX Index) continued to generate remarkable returns in local currency terms so far this year. There are several factors that seem to have contributed to this market excitement: 1) valuation discrepancy compared to many other developed markets, 2) capital flowing from the Chinese stock market, 3) some domestic retail investor interest stemming from the expansion of NISA (Nippon Individual Savings Account) benefits, and 4) optimism toward potential improvement in Japanese corporate governance and shareholder returns based on the directives from the Tokyo Stock Exchange (TSE).

As a bottom-up, fundamental investor, we acknowledge that there have been some positive shifts that have rightfully led to higher valuations, such as many Japanese corporates becoming more proactive in addressing excess capital and placing greater emphasis on returns on equity. However, we are also cognizant that there may be other, non-fundamentally driven factors that have elevated market prices. Therefore, we remain committed to evaluating our intrinsic value estimates as needed and to making portfolio decisions solely based on risk/reward assessment of individual investments, while focusing on the portfolio's overall margin of safety and diversification.

In terms of portfolio positioning, we continue to observe compelling pockets of value in the small- to mid-cap space, which has lagged the overall market. While this has been one of the key drivers of the portfolio's underperformance over the past few years, we truly believe there are many undervalued companies with fundamentally sound business profiles in this space.

Another negative contributor to relative performance in recent years has been our overweight in financials. However, this has begun to change with the prospects of rising interest rates in Japan following the end of the negative interest rate policy. Market valuations for several of our bank and other financials holdings have increased and are approaching our intrinsic value estimates. As such, if the trend persists, it is more likely that we reduce our allocation to the sector rather than increase.

Lastly, if the Japan market continues to rise at this pace, the expectation should be that there may be more trading activity as we look to reduce overweight positions and sell companies that have valuations exceeding our estimates of intrinsic value. We continue to scour for new investment opportunities that may offer attractive margins of safety and add more diversification, with the objective of improving the overall long-term return profile of the portfolio.

Conclusion

While the year has changed, 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 have not. We remain excited about the prospects of the Brandes Japan Equity Strategy. 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 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.

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.

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

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