MARTIN CURRIE
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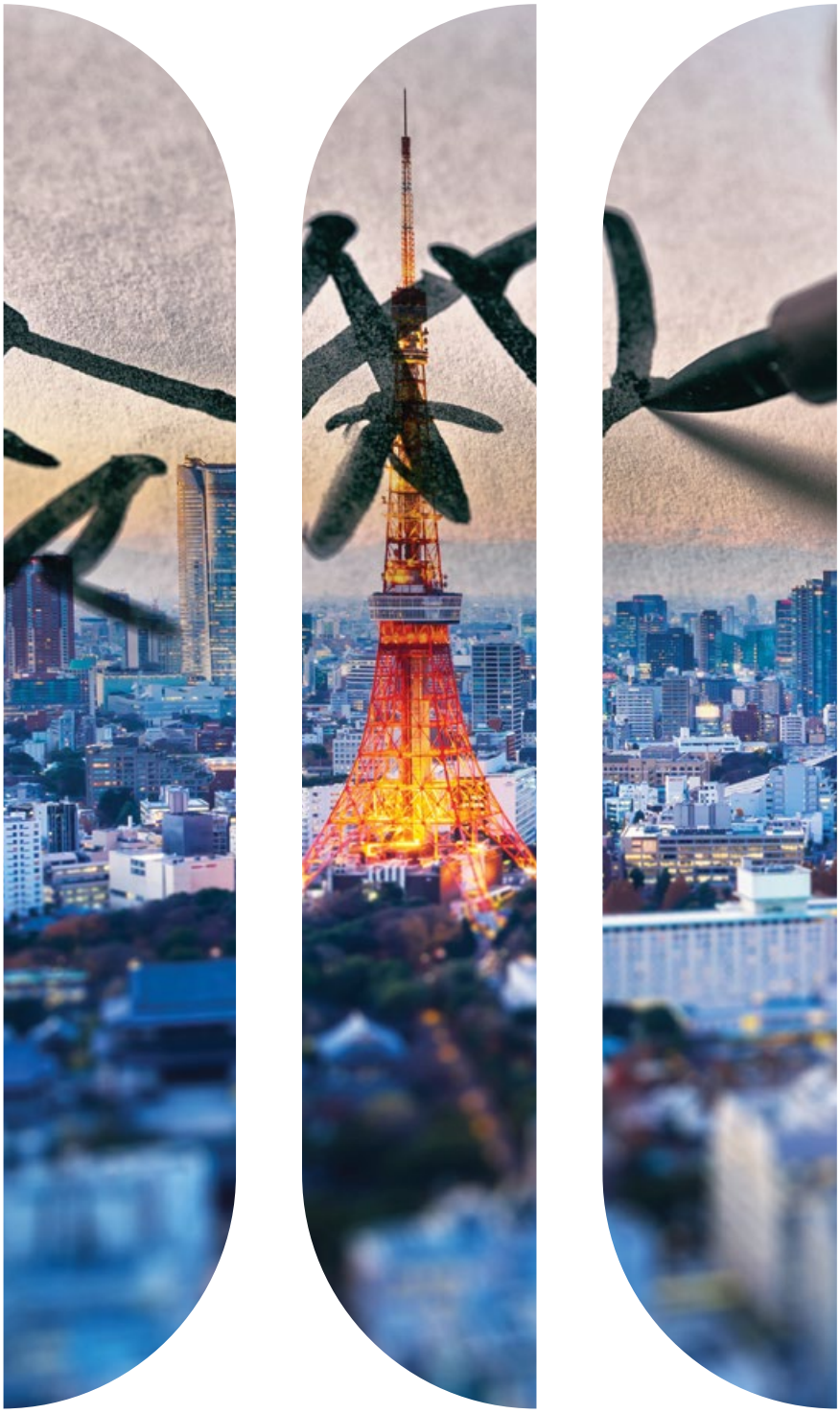
JAPAN EQUITY

THE STORY SO FAR...

JANUARY 2023

For professional investors only



As the new investment team enter their second quarter overseeing the portfolio, Reiko Mito and Paul Danes talk us through the Japan equity story so far...

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Market review

The fourth quarter of a challenging 2022 saw the TOPIX index up 3.3% in local terms and 5.1% when translated to GBP.

Earlier in the quarter markets were strong on the back of a more dovish view of Fed policy which arose from evidence that inflation was reducing somewhat. However, markets retreated as fears turned to the risk of a global recession in 2023. Late in December the Bank of Japan surprised markets by tweaking their Yield Curve Control Policy, in what was taken as a de facto rate hike.

With rate rises to the fore, Value outperformed Growth by some margin, continuing the trend clearly in place over the past 18 months. Sectors wise the best performers were Marine Transport, Banks, Insurance and commodity related sectors. This also meant that large caps outperformed mid and small over the quarter.

The Yield Curve Control policy change is potentially very significant and explains the Banks outperformance, as well as a stronger Yen, as the ultra-loose monetary policy of many years begins to change ahead of a change in Bank of Japan Governor. Nevertheless, there is not yet wage inflation in Japan, a key criteria before inflation is likely to sustainably return to Japan after decades of deflationary pressure.

On the fiscal side the Government announced a significant Y29 trillion packages in November aimed directly at the impact of rising costs, in particular energy prices. The Government also reemphasised their desire for wage growth which could help the economy grow and change cost push to demand led inflationary pressures, something which hasn't existed in Japan for decades.

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Portfolio review

We took over management responsibility for the portfolio at the beginning of this quarter.

There have been no significant changes to the portfolio in terms of aims, themes or style. The portfolio is exposed to stocks benefitting from long term structural growth themes, namely digitalisation, aging population related, including medical innovation and the shortage of labour in Japan. There is a bias to small and mid-cap stocks, reflecting the companies in these sectors and a definite growth tilt. Stylistically these stocks have been out of favour in the rising rate environment resulting in significant underperformance over 2022.

However, in the vast majority of cases the underlying businesses are performing as expected. October and November saw the announcement of most quarterly results, the Q2 for many. Not unusually, surprises were reflected in share prices and overall, we were generally pleased with the results for the portfolio holdings.

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Contributors

Top contributor over the quarter was Baycurrent Consulting, the largest holding in the strategy. Strong Q2 results, with operating profits up 34.6% reflected strong demand from DX (Digitalisation) projects, as well as strong recruitment of new consultants. We have used the share price strength to reduce this position by 2%, although it is still the largest holding.

Medley, a provider of doctor recruitment and telemedicine system services, rose a remarkable 60% (JPY) over the quarter. The company reported solid quarterly results and made an upward revision for the full year. Both the HR platform (placement of medical care personnel) and Medical platform (online consulting system and electronic record) businesses are trending better than expected. In mid-October, the government has announced a preliminary plan to urge medical records to be standardised and to penetrate nationwide (currently roughly 50%), which should benefit Medley's business. Details are likely to be unveiled by March 2023.

SMS, an infrastructure provider related to nursing, medical and health care services rose 16% over the quarter. Quarterly results were better than expected on the back of recovery from Covid in the career business, in which SMS offers recruiting agent services for care managers, care givers, and nurses. Recruitment involving face-to-face interviews has gradually been normalised in Japan. In addition, SaaS sold to nursing care facilities has continued its solid trend as small and medium-sized nursing care operators appreciate SMS's comprehensive management support services to pursue efficiency.

Although it wasn't the results which moved the share price it is worth mentioning Peptidream, a biotech company whose shares rose 30.5%. During December, Peptidream announced two deals with an upfront payment of over Y12 billion in total. The deals are with Merck and Eli Lilly in relation to a new peptide drug conjugate (PDC) research and discovery deals. Merck and Lilly have been working with Peptidream for years. Peptidream holds a technology of a wide variety of peptides called Peptide Discovery Platform System. This includes non-natural amino acids and constrained peptide, which are different from conventional small and large molecules and are expected to better target the disease with less side effect. These two deals illustrate the possibility of more PDC collaborations with other pharmaceutical companies.

Detractors

The worst contributor in the portfolio was JMDC, down 19%. Quarterly results were moderately softer than expected as the acquisition of loss-making "Real World Data" (RWD) conducted in July is a burden in the short-term. Long term however we believe that it offers opportunities. RWD holds a database of medical information at large-sized hospitals covering 24.4 million patients in Japan, which is meaningful for JMDC to generate revenue by combining with its existing database and by providing the analysis and consulting services to pharmaceutical makers and insurance companies.

M3 was the largest holding when we took over management and fell 10% over the quarter. Results were better than expected; however, the management guidance on the coming quarters was not upbeat, particularly regarding the orders from non-Japanese pharmaceutical companies that seem to have reduced their marketing budget. We believe the issue is short-lived and the long-term trend to shift marketing budget from conventional sales activities to online promotion is intact. The markets have continued to penalise the medtech sector based on its 'growth' categorisation. We have reduced the position size in M3 by about 1/3 over the quarter, mostly before the results, as we seek to somewhat reduce the concentration in the top few holdings.

Outsourcing is another stock we have reduced in size. It is one of the few holdings in the portfolio with significant debt. Whilst it is well covered by a cash flow generating, low asset business, it is nevertheless an extra risk when the company is going through a cyclically weak period.

As an outsourced labour provider, the company has particularly suffered from the weakness of domestic auto manufacturing and its failure to recover even as component shortages ease. This saw the company revise down current year expectation at their result meeting in November and the stock fell by 10%. The shares offer very good value, and short-term management plans should help, but ultimately, we need to see a recovery of demand.

Two new positions have been added to the portfolio during the quarter. M&A Research Institute is a M&A broker. The company is engaged in M&A broking and benefits as numerous SMEs in Japan, with aged management, lack successors to the business. The company has a highly data-centric approach at the front office and combines systematic sales and efficient workflow to overwhelm its peers. We think they offer solid growth with 90% of the deals being concluded through direct marketing. Its compelling fee structure of not charging the seller anything until completion enhances attractiveness versus competitors and makes them a clear disruptor.

Visional is an online direct recruiting services provider. The company operates a direct recruiting internet platform, called BizReach, which has good growth prospects. Instead of using headhunters, corporates increasingly use the BizReach platform which is more reasonably priced and efficient than conventional physical headhunters. The company has also a SaaS for ATS (applicant tracking software) and talent management as their second pillar. Although this second part of the business is not profitable currently, the client base of BizReach is well-suited to tap and to construct a wider HR ecosystem.

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Outlook

Whilst a global recession is clearly a real risk, Japan is still on a recovery track as the post covid re-opening is only just beginning.

The aggregate same-store-sales of restaurants have exceeded the pre-Covid level for the first time only in October for example. China's reopening this month can have a further positive impact on Japan, both through supply chain availability and the likely influx of tourists. More generally 24% of Japanese exports are destined for China, so any boost there will be beneficial.

In his New Year speech Prime Minister Kishida highlighted 3 policies. An economic cycle leading to higher wages, responding to the demographic decline and effective leadership of the G7. The first two of these are very supportive of the industries into which the strategy is invested and to the companies owned. In particular the HR solution and outsourcing companies are both ready made solutions and beneficiaries of rising wages.

Additionally, if the economic package of the Japanese government launched in early November begins to help households, wages rise and the Yen weakening halts. As it has for now, this bodes well for domestic consumption and could create a long awaiting virtuous cycle in the domestic economy. Despite concerns on monetary policy, it is unlikely to be severely restrictive until a demand led recovery takes place.

If Japan can finally break the entrenched deflation, companies can pass on costs and wages rise, there is real scope for a sea change in the Japanese domestic economy just as significant as the global monetary policy change, we have seen over the past year.

Of course, this worldwide change in the monetary environment since 2021 has resulted in a dramatic downturn in the share prices of growth stocks. At the same time, we have had the outperformance of commodity and interest rate sensitive stocks. We are now 2 years into this process and are likely going to see at the least a significant economic slowdown globally. This alone should see investor attention shift from cyclical value to longer term growth and quality characteristics, as investors will want companies which can outgrow a slowing economy and have the balance sheet and market position to survive. The Martin Currie Japan Equity strategy continues to invest in companies that benefit from long term structural changes in the Japanese society and economy. We believe valuations of these companies have become more attractive and we see plenty of opportunities to invest capital in high quality growing businesses without overpaying.

*Source: Bloomberg, 31 December 2022 unless otherwise stated

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