FUND COMMENTARY SICAV

Eastspring Investments - Japan Dynamic Fund

February 2022

INVESTMENT OBJECTIVE

The Fund seeks to generate superior long-term, risk-adjusted performance by investing in a fundamentally driven, concentrated portfolio of Japanese common equities. Employs a relative valuation, priced focused approach to identify and exploit behavioral mispricing and market inefficiencies.

FUND DETAILS

Reference Index
MSCI Japan Index

Portfolio Manager
Dean Cashman

MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. With 323 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan. Returns are MSCI Index total returns for the specific country or region mentioned, in US dollar terms, unless otherwise stated.

Market review

The MSCI Japan Index returned -1.2% in JPY terms in February. The market continued to respond to a number issues, most notably the escalating conflict between Russia and Ukraine, with a full scale Russian military campaign on Ukrainian territory beginning towards the end of February. The conflict further supported the heightened global inflationary pressures, with Brent crude prices closing the month at over US$100, and related policy response that continues to challenge what have been very entrenched market views. This has been particularly notable in the challenge it has presented for the expensively valued companies in the market.

We continue to observe improving trend fundamental health among many Japanese companies. This is evident from surprising resilience and improving quality of earnings we observe across a range of companies. Notwithstanding near-term uncertainty, the macro data also remains largely supportive, with the unemployment rate remaining low at 2.8% and jobs-to-applicants ratio remaining stable at 1.20x in January. The latest Economy Watchers survey indicated a decline for the first time in five months as the new COVID wave has impacted consumer activity, although activity is expected to recover once recent restrictions are lifted. A combination of supportive trend fundamentals at a company level, and attractive valuations compared to other major markets are pre-conditions for the longer-term re-rating for Japan equities.

Japan's direct trade exposure to Russia and the Ukraine is low and we have been reviewing our individual stock holdings to assess any material direct business exposures. While direct exposure seems small for the companies, second order effects on the overall economy from higher inflationary pressure, consumer confidence and knock-on effects on economic growth are possible scenarios. Although these periods inevitably see heightened uncertainty, we continue to engage closely with our investee companies and have not seen a need to change our trend assumptions.

Our focus on sustainable earnings differentiates us from a market that obsesses over recently reported earnings. The market's myopic view on recently reported earnings is the source of the local representativeness bias that drives the extrapolation of trends, and ultimately gives rise to herding behaviour.

Key Contributors

Month-to-date, the key absolute contributors to the Fund's performance were Nippon Steel, Mitsubishi Heavy Industries and Dentsu Group.

The market has grown increasingly negative on overcapacity within the steel industry and has been extrapolating cyclical risk into the future. On top of this, investors remain anchored around Nippon Steel's reputation historically for over-investment and mis-allocation of capital and continue to ignore efforts by the company to consolidate its domestic production facilities to increase efficiency and improve competitiveness. While the market has been pricing a very negative outlook for Nippon Steel, we have observed significant adjustments to capacity and a focus on mix and pricing which demonstrate changing behaviour within the

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company. Capital expenditures are now focused on increasing efficiency at existing plants. The company has also been more proactively managing its balance sheet efficiency by re-focusing its alliances and addressing cross-shareholdings. Furthermore, we find that the company appears well placed in an industry that will increasingly need to address environment issues such as carbon dioxide emissions. Our conservative trend assumptions, which also take into account any material environmental-related risks, suggest there is strong valuation support to warrant a high conviction position.

Mitsubishi Heavy Industries ("MHI") is a conglomerate with four core businesses that include Energy and Environment; Machinery, Equipment and Infrastructure; Commercial Aviation and Transport Systems; and Integrated Defence and Space Systems. MHI's profitability has been under pressure from heavy losses and development costs in its regional jet MRJ project. In recent years, profit has further deteriorated due to the pandemic's impact on its civil aircraft parts business and challenges in its coal-fired power business. In response to the above, management has frozen the development of the MRJ project. In the gas turbine equipment market the company has managed to increase its share, leveraging its strong position in Asia. MHI has also undergone restructuring to exit uncompetitive and sub-scale businesses. Further business portfolio optimization, as well as cost restructuring efforts are expected to be supportive for longer term trend returns. The company's focus on technology in hydrogen and nuclear supply chain could provide long-term opportunities in energy transition. Strong valuation support and management's self-help efforts are supportive of our strong conviction in the stock.

Dentsu is the leading advertising agency in Japan, which grew to become one of the larger agencies globally as a result of acquisitions abroad. Shorter term margin pressure and weakening organic growth due to the Covid outbreak negatively impacted market sentiment and share price performance. Dentsu responded by aggressive cost restructuring efforts both domestically and abroad to withstand the pressure on revenue. As revenue has been recovering more recently, this improved operational leverage has helped stronger improvement in profits. The company also reviewed its investments and disposed of non-core assets, which has in turn freed capital for improved returns to shareholders. Strategically the company continues to focus its resources on improving its digital advertising and data offerings both in Japan and overseas, shifting the mix of its business to solutions provision to clients. We continue to test our trend valuation assumptions and conviction levels with the evidence of progress to Dentsu's strategy, and manage our position size accordingly.

Key Detractors

Month-to-date, the key absolute detractors from the Fund's performance were Nissan Motor, Mitsubishi Motors and Panasonic.

Market sentiment for Nissan Motor has deteriorated amid an increasingly competitive US auto environment, which has implications for the earnings Nissan may generate from its US business. The majority of its sales in the US are supported by an in-house financing business, which under competitive pressure

may require greater sales incentives to capture sales volumes. Additionally, there are market concerns for a possible deterioration of the residual value of its vehicles, which reflect a rise in the number of used vehicles entering the secondary market at the end of a significant leasing cycle of the past five years. Our conservative trend valuation assumptions take these issues into account and we find there is material valuation support. The negative market sentiment has more than priced the shorter term cyclical concerns that are currently being extrapolated. More recently Nissan's management has made significant efforts to cut fixed costs and lower the break-even point of its manufacturing operations. It is in the middle of increasing its geographical focus which should consolidate resources for better product and efficient brand investments. Whilst Nissan Motor currently has significant valuation support, the position size is smaller than implied by the valuation alone as a result of a number of material risks and concerns identified during our due diligence that we continue to monitor, including uncertainty around the future direction of the Renault-Nissan Alliance and the company's corporate governance policies.

Mitsubishi Motors has been struggling due to sub-scale operations and aggressive growth ambitions under previous management, which had contributed to fragile and volatile business foundations. The company has changed its strategy to focus on regions and products of strength, by right-sizing and de-risking operations in Europe and Americas, while concentrating resources in South East Asia, where it is well positioned for profitable growth. The company has made good progress in cost restructure and it is working to further improve its product pipeline and business structure in South East Asia. Its collaboration with Nissan on technology is also a supporting factor for long term profits sustainability. Current valuation support is strong and justifies a moderate position in the stock.

Panasonic, a technology related company, had struggled to operate in fiercely competitive industry segments and has been generating low margins for the past decade, to the detriment of shareholder returns. More recently, the market has been concerned about the deterioration of the profitability of its Auto and Avionics businesses. Raw material cost increases and uncertainty of the degree to which they will be passed through also seem to be a concern for the market. Panasonic has focused on exiting from non-core loss-making businesses or collaborating with other companies in capital intensive businesses, such as its partnership with Toyota in battery and housing businesses. Whilst the restructuring process is well under way, share price performance has been volatile amid market uncertainty around potential weakness in end market volumes. The shorter-term focus is factoring in little restructuring benefit. We have tested our valuation for sensitivity to a range of potential outcomes, and find strong valuation support.

Fund Activity

During the month, the portfolio manager sold shares in companies where valuations look relatively less compelling compared to other high conviction positions. Notable trades included topping up positions in JGC Holdings and Teijin, and trimming positions in Seven & I Holdings and Dentsu Group.

Strategy and Outlook

The market's shorter-term focus on thematic macroeconomic news flow can drive significant share price anomalies for the Fund to exploit. There remains a tail of stocks, which are often ignored by the market and as a result may be mispriced by the market. This market dynamic presents opportunities for our valuation discipline to exploit.

However, we note that there are many companies in strong financial health and observe that companies' restructuring efforts are continuing and, in some cases, have accelerated. With continuing pressure on governance, it is likely that the focus on improved profitability will continue to be a stronger imperative for some companies to improve capital efficiency by encouraging shareholder-oriented behaviour. We continue to observe supportive trend fundamentals at a company level, and this is a significant driving factor in the longer-term re-rating for Japan.

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