FSSA Investment Managers

Fund Manager Q&A

Riding out volatility with quality companies

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Sophia Li
Portfolio Manager

Sophia joined the team in 2009 as a graduate analyst and has built an extensive coverage of companies in North Asia. She became lead manager of the FSSA Japan Equity strategy at its launch in 2015.

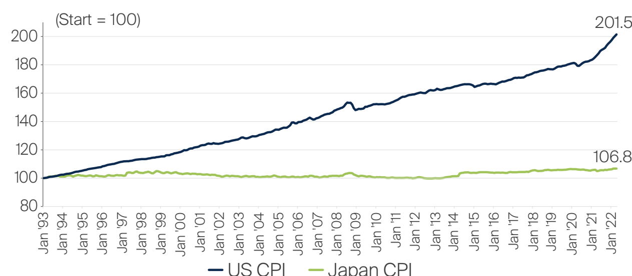
Given inflation levels are picking up around the world, why is this not a problem in Japan?

There are fundamental differences in Japan's economy to explain this. First, underlying consumption has stood still in the past decade or so. From 2015 until pre-Covid, consumption growth in Japan was close to zero when excluding VAT[1] hikes. Secondly, there has been virtually no wage growth in Japan. Over the past 30 years, wages grew by just 3% — much lower than the OECD[2] average — while the latest data shows that Japan's base wage grew by less than 1%. Generally speaking, without rising household income, you cannot expect inflation to accelerate.

Although Japan's CPI[3] has picked up in the recent month, this is mainly due to the reopening of the economy after the state of emergency earlier this year. Core CPI in previous months was still only 0.7%, which again is much lower than in other developed markets. Moreover, the CPI pick-up is being driven by cost-push effects, rather than increased demand. Although the market is worried that inflation in Japan will eventually surge and interest rates will need to rise, we don't agree — Japan CPI has grown by only 0.2% per year over the past 25 years (see chart below). And if we exclude the impact from the consumption tax hike, Japan CPI has in fact been negative.

Japan has had little experience of inflation since the 1990s

Japan CPI has grown by 0.2% p.a. vs. 2.4% in the US



Source: MIAC, BLS and CLSA

Another key difference in Japan is the extremely conservative attitude of householders. More than half of Japan's household assets are held in bank deposits, with only limited amounts in the stock market. As a result, the "wealth effect" in Japan has been subdued compared to

[1] Value-added tax

[2] Organisation for Economic Co-operation and Development

[3] Consumer Price Index

the likes of the US — the majority of Japanese people have not benefited from the surging stock market post-Covid, which is another reason that inflation has been quite mild.

On the bright side, this conservative mind-set means that Japanese companies have large cash reserves on their balance sheet and their attitude towards shareholder returns has improved significantly in the past decade — share buybacks hit a record high level in 2021 and we expect more to come. Notably over the past few months, a number of our portfolio companies announced increased dividend pay-out ratios as well as share buybacks, with the intention of protecting shareholder returns in this volatile market.

To conclude, we believe that inflation will stay relatively mild in Japan and interest rates should remain low. We expect both monetary and fiscal policies to continue to be supportive in the foreseeable future.

Given the widening interest rate differential between the US and Japan and that the USD/JPY rate slid to 20-year lows recently, would this put pressure on energy and food prices and lead to greater inflation in Japan? Any impact of a weaker yen on companies in the FSSA Japan Equity portfolio?

If we look at the actual numbers, it suggests the opposite of what global investors and the media are worried about. Energy CPI in Japan has risen by just 45% since the beginning of 1996, whereas in the US and Europe it is up by more than 150%. From a historical context, the price of crude oil has risen by more than 1,000% from trough to peak while energy prices in Japan have risen by just 30%. Mathematically, given that energy is only 7% of Japan's overall CPI budget, even if the crude oil price doubles in yen terms, the impact on CPI is only 0.4%, which is negligible. Similarly, if we compare Japan's food CPI with global food prices, there is absolutely no correlation. Meaning that the impact from a weaker yen on inflation in Japan is very, very limited.

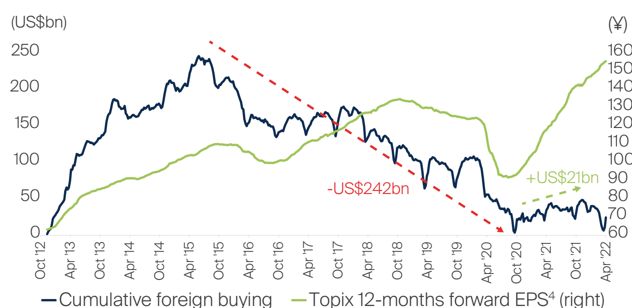
As for the impact on companies in the FSSA Japan Equity portfolio, we would argue that a weaker yen actually works in favour of the companies we own. The country will soon reopen to foreign tourists, which should benefit consumer services and staples companies in Japan. Meanwhile, for Japanese companies that compete on the global stage but have most of their operations in Japan, they should become more cost-competitive and should actually benefit from a weaker yen.

Japan is often written off by foreign investors on concerns about growth, but you seem to have a different perspective. Tell us more about that.

For any investor who invests based on the macro outlook, the question is usually, "Why should I bother with Japan?" Investment flows data show that foreign investors have sold virtually all their Japan equity holdings accumulated from the beginning of the Abenomics story in 2012 (see the chart below). Meanwhile, Japan's corporate profits have continued to grow to record-high levels, driven by global expansion, innovative products and the development of new technologies. Corporate restructurings and an increasing focus on return on invested capital (ROIC) have also contributed to higher profits; and in each sector, the gap between the winners and the losers is widening. As a result, we believe that an active and bottom-up investment strategy would work well in the Japan market.

Heavily under-owned despite continuous earnings growth

Topix earnings vs. foreign buying trend



Source: MoF and Bloomberg, as at April 2022.

In the FSSA Japan Equity strategy, we are not seeking to capture Japan's GDP[5] growth (or lack thereof) — just a slice of this growing profit pool. And we have found plenty of investment opportunities (hidden gems) in Japan. There are a large number of global companies with dominant market share in industries with secular growth — such as online recruitment services, factory automation, medical recruitment and premium consumer goods. Secondly, we invest in the leading companies in under-penetrated service industries. These companies are run by capable management who are highly motivated and think outside of the box. They are taking calculated risks to displace outdated business practices and complacent incumbents. In Japan, services like e-commerce, cashless payments and cloud services are still under-penetrated (see charts below) — whereas they are already proven business models in other developed markets. Our meetings with

[4] EPS is Earnings Per Share

[5] Gross domestic product

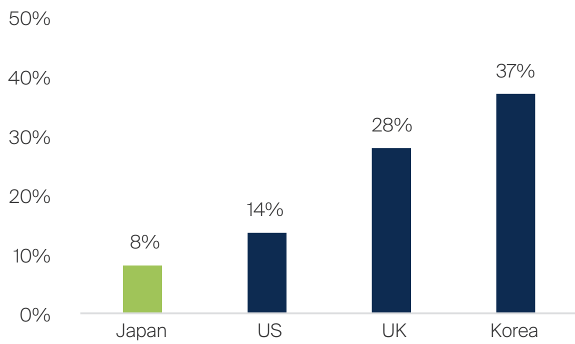
management suggest that Japanese companies are slowly changing their attitude towards digitalisation, which implies huge potential for these types of companies. They are not only growing at a relatively high pace, but they also have high growth visibility due to the lack of competition in Japan — which is again something quite different to the US or China.

Meanwhile, Japan is still one of the least efficient markets in the world. More than 75% of listed companies have only one sell-side analyst covering them or have no coverage at all. That presents an attractive opportunity for long-term investors. Having said that, the relatively lower market efficiency also brings more short-term volatility to share prices, which is something investors should keep in mind.

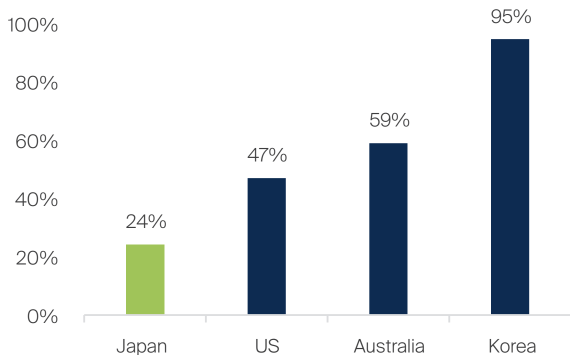
Structural growth sectors at a glance

Low penetration implies good growth opportunities for portfolio companies

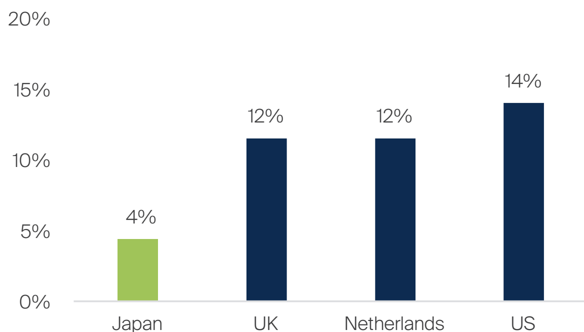
E-commerce (2021)



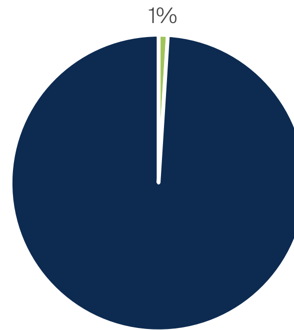
Cashless payments (2018)



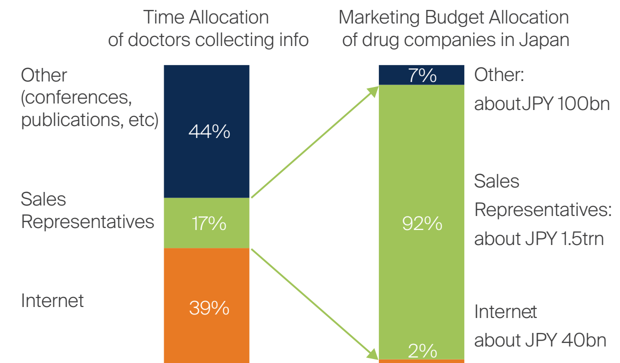
Public cloud as % IT spending (2022)



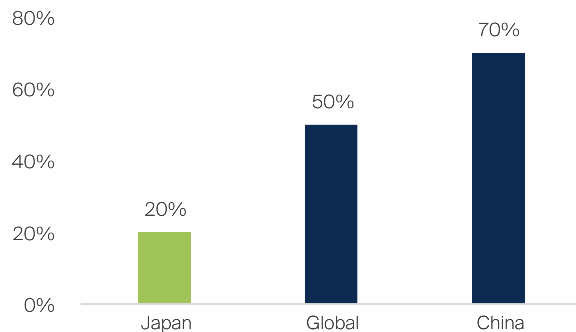
Software test outsourcing



Pharmaceutical digital marketing



Independent elevator maintenance



Source: GMO Payment Gateway (as at Feb 2022), Goldman Sachs (as at March 2022), Payments Japan (as at March 2021), Gartner (as at Aug 2019), Shift (as at May 2022), M3 (as at Jan 2020), Japan Elevator Service (as at May 2021), HSBC (as at March 2021).

https://www.gartner.com/smarterwithgartner/cloud-adoption-where-does-your-country-rank

With the "growth to value" rotation, some of these companies have suffered a massive pullback. Are you still convinced in their long-term investment cases?

In the short term, it is hard to understand price performance from a fundamentals perspective, as it is often driven by market sentiment and headline news. Stocks that corrected significantly year-to-date were

companies that actually performed well over the past few years when the Japanese economy was struggling through the Covid lockdowns. Although some companies in the portfolio have pulled back meaningfully, we believe their fundamental outlook remains solid.

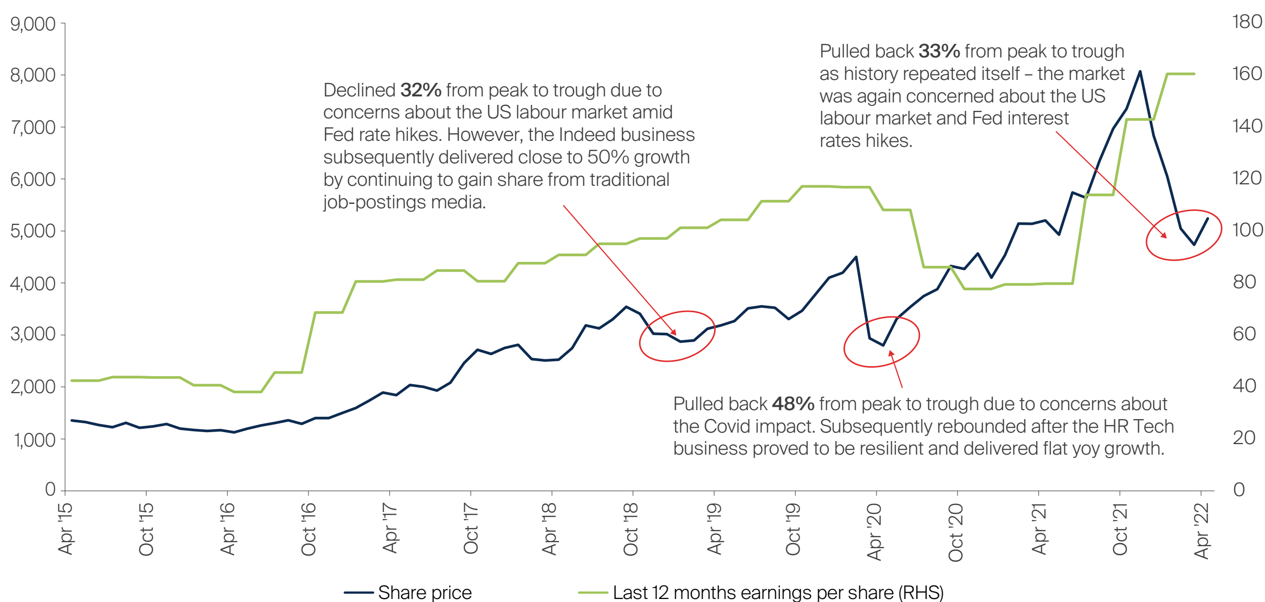
One such example, a company we have been researching since its IPO[6] in 2014, is well known for being a "cradle of entrepreneurship" in Japan, thanks to its success in developing new businesses. Its business portfolio is extremely diversified – it is one of the largest staffing companies in the world and it runs the top two marketing media portals covering travel, mining, real estate and others. It also owns the largest job search engine in the world, which was acquired in 2012 and has delivered more than 50% CAGR[7] growth since then.

If we look at this company's share price history, past drawdowns were mainly driven by market sentiment and concerns about rising interest rates in the US (which did not materialise). However, despite share price weakness, its operations continued to deliver resilient performance. In 2018, despite concerns about the US job market, the job search portal business rebounded by more than 50 percent; and in 2020, when the world was locked down due to Covid, growth was actually flattish for the year. This proves the quality of the management, in our view.

Some investors have argued that "this time is different", given the US Federal Reserve raised interest rates recently, and the market expectation is that Indeed's growth will actually slow this time. We do not have a crystal ball to forecast what might happen in the next two quarters. However, our investment philosophy is to identify and hold on to the best investment opportunities in Japan. Eventually, share prices tend to follow earnings and although Indeed's operations might slow, we believe the rest of Recruit's business – which accounts for about 70% of its revenue – should start to recover as Japan's economy gradually reopens.

Share price vs. earnings trends

Conviction to "buy the dips"



Source: FactSet, as at April 2022.

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Another company in which we have been long-term investors is attractive because it has more than 50% market share in the niche industry of corporate fringe benefits. It has a resilient business model, most of its revenue is generated on a recurring basis and the blue chip companies in Japan buying these services have a very low customer churn rate.

This company's historical drawdowns have been driven by the bearish sentiment on the Japan economy. But despite market concerns, the company continued to deliver resilient profit growth through these periods and we believe each dip proved to be a good opportunity to top up our position. More recently, the company guided for more than 20% revenue growth, although profits may fall by 10% due to investments into long-term opportunities.

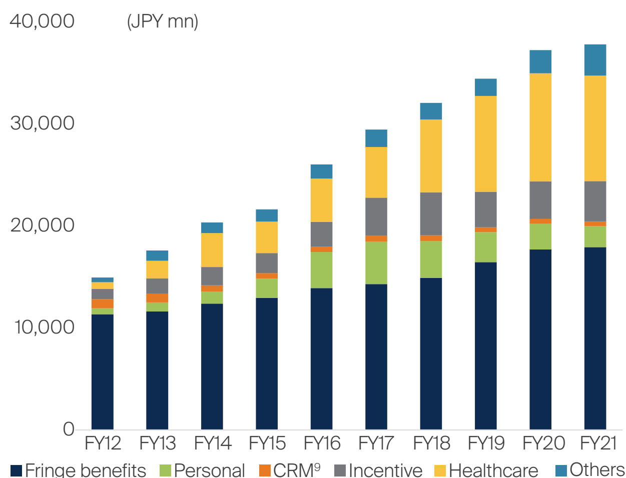
[6] Initial public offering

[7] Compound annual growth rate

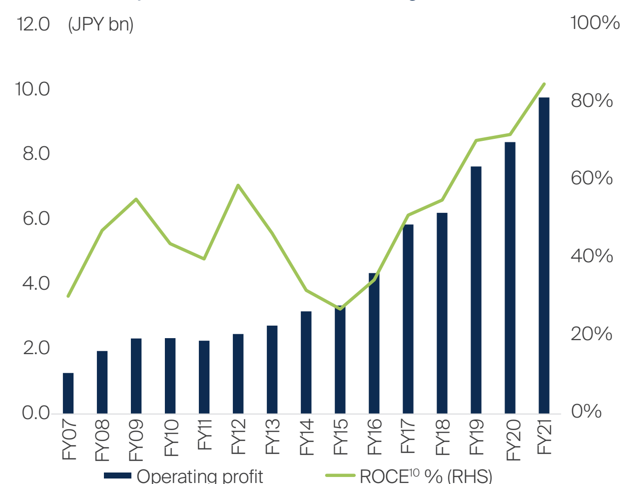
Return on capital employed (ROCE) is extremely high as the company doesn't need to invest in working capital. And the company has a good track record of launching innovative services and cross-selling to their existing customers. While the core fringe benefits business used to account for about 80% of total revenue, that has now dropped to below 50% with the launch of its new services.

Continuously evolving BPO[8] services provider

New business pillars driven by entrepreneurial management



Defensive compounder with robust cash flow generation



Source: Bloomberg, Company data, as of March 2021.

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What is the valuation of the portfolio today? How much has it de-rated from the recent peak?

Our view is that the year-to-date drawdown of the portfolio has been driven by a contraction in the multiples, rather than a deteriorating earnings outlook. Based on our recent management meetings with portfolio companies, we think that the long-term fundamental outlook has not changed that much. The price-to-earnings ratio (PER) of the portfolio today is about 32x and the 3-yr CAGR earnings growth is about 18%. The portfolio's weighted average ROCE is about 38%, which means that the companies we own require only limited capital to generate extra returns.

Meanwhile, our short-term relative performance has been weak for two main reasons. First, the portfolio has virtually no exposure to certain sectors like financials, telecom operators and commodity companies — and these sectors have performed very well. Secondly, a number of high-quality companies in Japan have corrected significantly year-to-date, driven by concerns about inflation and interest rate hikes. But, as mentioned above, we believe that both inflation and interest rates in Japan will remain at very low levels.

There are also concerns about a possible recession and a slowdown in earnings growth for Japanese companies. But for the FSSA Japan Equity strategy, we believe our portfolio companies provide more visibility and are better positioned than peers in terms of margin certainty and revenue growth. That is why we believe that market volatility is not a "risk" but rather an opportunity for us to buy on weakness.

Which companies have you added to and which have you sold? Are there any new positions added to the portfolio recently?

We have been adding to our existing holdings across the board, but mainly to the top holdings and especially those that have corrected more significantly. Given that they were the top holdings in the portfolio, that implies we have a higher level of conviction in their investment cases.

There was only one major disposal in the last quarter, a consumer staples company. We were disappointed in the management's strategy after the CEO changed two years ago. As a consumer staples company, we believe they will struggle to pass through cost inflation. They also planned to diversify into non-core businesses and as a result, incur more investment. We sold our position as the company's outlook is now more uncertain than before.

[8] BPO is Business Process Outsourcing;

[9] CRM is Customer Relationship Management;

[10] ROCE is Return on Capital Employed.

In the meantime, we initiated a few new positions that had been our watch-list for some time. Given the correction in the market, the lower valuations presented us with a good opportunity to buy a toehold. One of the most interesting companies we bought is the second-largest music copyright management company in Japan. They have only one major competitor, which is a non-profit organisation (NPO). The business seems to be high quality with limited competition, high margins, negative working capital and revenues are mostly recurring. We believe the company's mid-term plan is encouraging, though the performance of such a small company may not always be smooth sailing.

The FSSA Japan Equity portfolio has high weightings to companies in the Information Technology (IT) and Industrials sectors. Although the team's investment approach is bottom up, can you comment on these allocations and do you think the portfolio is sufficiently diversified?

The sector allocation in the FSSA Japan Equity strategy has been fairly consistent since inception. We have very low exposure to financials, banks, telecom operators and so forth, because we struggle to identify differentiated franchises that can deliver sustainable returns and earnings growth without riding on the overall micro environment. Exposure to the Information Technology and Industrials sectors seems optically high, but in reality covers a wide range of companies.

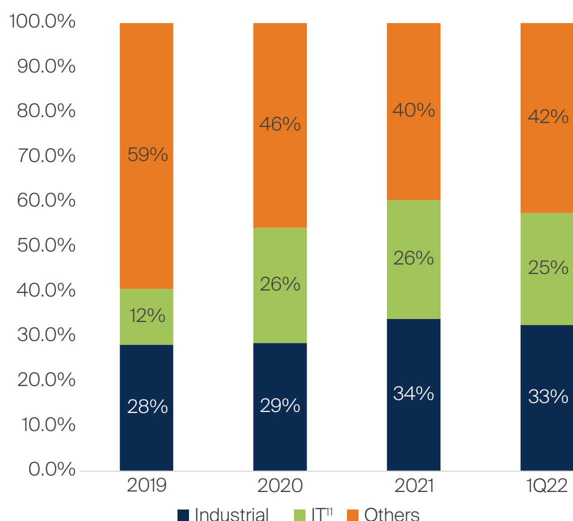
MSCI defines Industrials as all companies that sell services or products to business customers rather than individual consumers. As a result, it includes our portfolio holdings in Human Resources (HR) companies, commercial service providers, like elevator maintenance services, fringe benefits and other types of corporate services. It also includes the portfolio's e-commerce companies that sell industrial goods online. So our actual underlying exposure in the Industrials sector is quite diversified.

In the Information Technology sector, we have invested in the largest machine vision systems provider in the world, which is a factory automation company, and leading semiconductor equipment companies. We also own leading domestic IT services and software companies – these are typically more resilient, especially when compared to factory automation cycles and semiconductor companies.

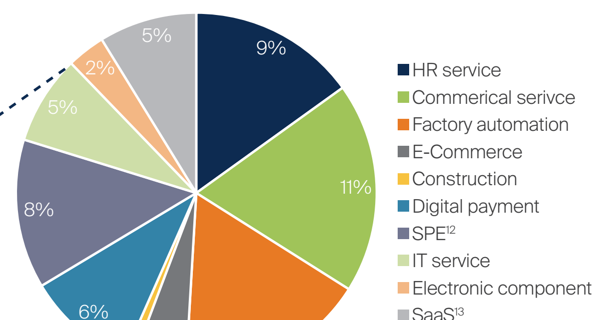
Since inception, the FSSA Japan Equity portfolio has maintained an active share of between 80 and 90%. It is constructed on a purely bottom-up investment approach and is a relatively concentrated, high-conviction portfolio. In the short term, our performance versus the benchmark will inevitably be quite different, but to quote American investor Benjamin Graham, we believe that "in the short run, the market is a voting machine, but in the long run, it is a weighing machine." And our goal is to deliver absolute and active returns for our clients in the very long run.

Diversified exposure to sub-sectors in portfolio

Portfolio weight trend



Subsector exposure in Industrial and IT



Source: First Sentier Investors, as of March 2022. Numbers may not add up to 100% due to rounding.

[11] IT is Information Technology;

[12] SPE is Semiconductor Production Equipment;

[13] SaaS is Software-as-a-Service

Despite Japan's low levels of inflation, many of its companies are competing on a global scale. How is the portfolio positioned to weather rising global inflation?

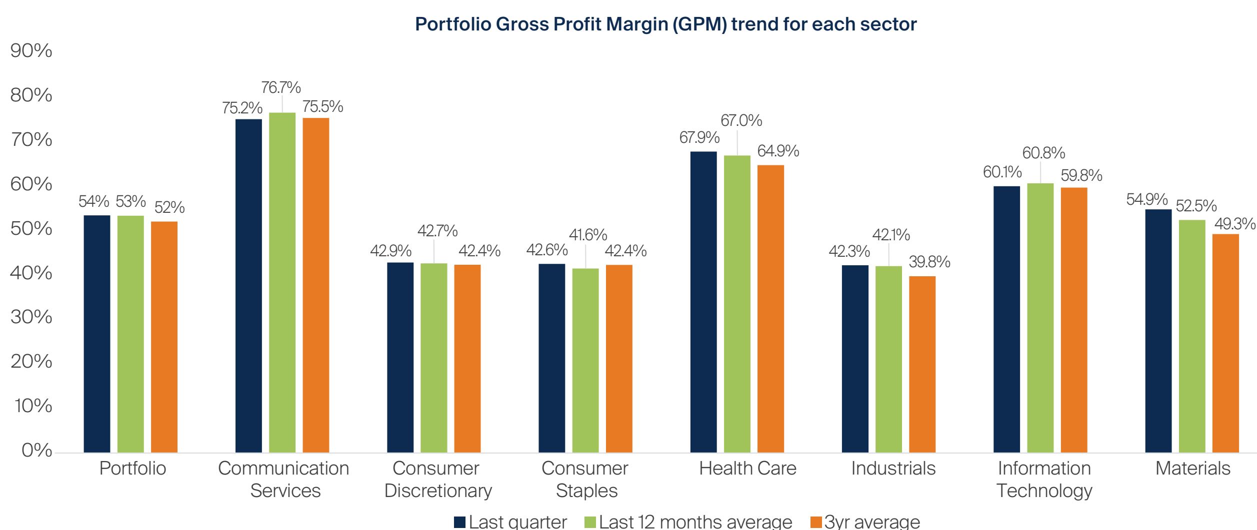
There are two qualities we look for in a company: the first is pricing power and second is the track record of the management in terms of handling past challenges and adversities. Based on our analysis, we are reasonably confident that the companies we own should be inflation-proof.

Japanese companies have learned a key lesson from the past 25 years. Because of Japan's stagnant economy, they have learnt to adapt their business models and strategies in order to grow regardless of the macro environment. As a result, the best companies do not base their growth on inflation or economic growth – they would launch new services and innovative products and so forth.

The companies in our portfolio that compete on the global stage usually have high gross margins, which speaks for itself in terms of pricing power. These companies do not pass through costs to their customers in a direct way – they will launch value-added products and charge more so that they can protect their margin. For example, one of our factory automation companies generates more than 80% of gross margin. A premium helmet manufacturing company in Japan we own generates more than 40% gross margin. Even at a chemicals company where one of its businesses is a highly commoditised PVC[14] manufacturer, the operating margin for this segment is over 30%, which is really quite respectable, in our view.

Meanwhile, 40% of the portfolio is invested in domestic services companies. Intuitively, cost inflation on materials does not affect them as they provide services, not manufactured goods – in other words, they are also inflation-proof. In the chart below, we compare the portfolio's average gross margin in the past quarter versus the last one and three years and it has been resilient. For many sectors, it has even increased in the past three years.

Profitability of our portfolio companies have been firm vs. the past



Source: First Sentier Investors, as at March 2022.

Environmental, social and governance (ESG) analysis has always been embedded in FSSA's investment process. Could you elaborate on that?

Assessing ESG – or environmental, social and governance issues – has always been an integrated part of our research and analysis. We don't invest in businesses or sectors that pose direct harm to the environment or to society, which means zero exposure to the gambling, defence and tobacco industries. For companies in which we have invested, we host annual ESG engagement meetings to discuss the key material issues and to encourage increased disclosures. This is one of the main challenges in Japan, as disclosure lags significantly behind global peers – especially in the small-to-mid-cap space.

We look at a comprehensive matrix of ESG factors as well as specific factors based on each industry. For example, given that the FSSA Japan Equity portfolio has high exposure to the services industry, we focus particularly on the "S" – for example, how do companies attract and retain talent? How do they deal with the potential risk of

[14] Polyvinyl chloride, a type of plastic

power dynamics and sexual harassment? Japan has a strong "working overtime" culture and given that Japanese companies in general lack an internal controls system, we would also engage with the management on this and discuss ways to strengthen their governance systems.

For manufacturing companies, we would focus on their supply chain management system and check whether they engage with their suppliers or impose certain ESG standards when selecting potential suppliers. We would also ask about their long-term plans on carbon neutrality.

Similar to many investors, we use ESG databases such as Sustainalytics, MSCI and RepRisk. However, we don't think ESG databases help much in our research, because the overall disclosure level in Japan is extremely low. In many cases, the first step is to convince these companies to disclose more. And a common problem with these database providers is that they usually give a zero mark to a company if they fail to disclose certain things. We don't think that is particularly fair. As a stakeholder in a company, we believe we should be helping companies to improve rather than stop investing in them just because of a lack of disclosure.

Moreover, this doesn't mean that Japanese companies have not progressed from an ESG perspective. They have progressed well on both the environmental and social side. But in terms of governance, the main improvement is based on shareholders' return — and this still has room to improve.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 30 April 2022 or otherwise noted.

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