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Investing in Japan: A High Conviction Approach

Nomura Asset Management U.K. Ltd.

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Slow economic growth in Japan has coexisted for several years with strong corporate profit growth, accompanied by some interesting structural changes - such as population aging and improvements in corporate governance.

In the following interview Yuichi Murao, CFA, Head of Investment for Japanese Equities at Nomura Asset Management discusses how Nomura's Japan High Conviction Fund is positioned to take advantage of these and other investment trends by identifying truly competitive companies that are growing in both global and domestic industries.

It's the sixth year of 'Abenomics' in Japan, so what's the situation at the moment?

Prime Minister Abe was reappointed as leader of the Liberal Democratic Party, securing a third term as PM, this continuity is clearly positive for the market. The reforms he has championed since 2012 have helped to boost corporate profits, lift confidence, and drive away a pervasive deflationary mind-set that has long been holding the economy back.

Looking at the Bank of Japan's policies for example, we have seen aggressive monetary easing policies that have had a positive impact, mainly through the depreciation of the currency. Another example has been the introduction of the Corporate Governance Code, which has helped to boost the return on equity of Japanese corporations.

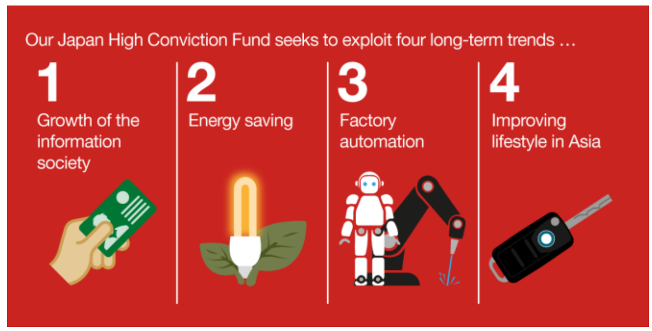
With economic growth still relatively slow, why should we focus on Japan?

While it is true that Japanese GDP growth rates are still low at around 1.0% (yoy), we are now seeing quite notable changes in the structure of the economy.

There's one very clear long-term investment theme, which is the improvement in corporate returns; and this is going to be played out very much at a stock level. Some companies are driving change in a new corporate environment of advancing technology, corporate governance reforms and a new trade environment.

Some Japanese companies will be operating at the forefront of these new market trends. We think it's important to focus on companies that are embracing these new opportunities, especially those that are also generating consistent returns for investors.

We have noticed some clear secular trends that we can exploit, such as economic integration with Asia, the Aging Society in Japan and elsewhere, factory automation; and other trends that are more specific to the Japan domestic market. We think these investment themes should be fertile ground for active managers.



There has been a clear trend for investors to move to passive vehicles as they look to cut costs. Do you think your fund has a sensible approach to Japanese equities?

We think Japan is one of the few developed markets where there is a clear case for active investment.

The TOPIX index contains more than 2000 stocks, with a long "tail" of small and microcap names of variable quality. We believe an active approach is needed to have access to, or gain exposure to, good quality companies.

Our investment philosophy for the Japan High Conviction strategy defines quality as a sustainable level of high ROE that will lead to growth in shareholder's equity, which in turn leads to stock price appreciation.

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Also, since ROE and Book Value are positively correlated, it follows that rising ROE will benefit the stock price performance. As long as the profitability - or the high level of ROE - is sustainable, there is no reason to believe that the valuation will decrease.

Here is the crucial point though – anyone can invest in companies based simply on their current level of ROE. However, we don't believe this would be a successful strategy. Even if the current ROE is high, the P/BV will decrease if a company's ROE starts to trend downwards.

So, identifying sustainability – by which we mean stocks that can continue to generate high or improving ROE – is where our experience and expertise can add value.

The other side of the research and investment process is avoiding stocks with high but potentially falling ROE. Having a strong understanding of the companies we invest in is critical for avoiding stocks that could potentially suffer a fall in ROE. Since the fund is benchmark agnostic, we can add value by effectively avoiding stocks that might weigh on the performance of a more benchmark constrained or passive portfolio.

What do you think makes you unique, or sets you apart from other managers?

The Japan High Conviction Fund is a concentrated portfolio of our highest conviction ideas in Japan. The portfolio is composed of around 30 stocks, which allows us to represent our best ideas. It still gives us enough diversification against unexpected downside risk.

It is basically our best ideas portfolio in the Japanese Equity market. Our managers and analysts are highly motivated and recognised experts in Japanese equities. With an on-the-ground team of over 20 analysts focused on Japan, we live and breathe this asset class.

For the Japan High Conviction Fund, why does conviction matter?

With fewer stocks, the Portfolio Managers are better able to develop a deeper understanding of the companies we invest in.

Many active managers possess good stock selection skills, but their funds often do not reflect this skill because managers are reluctant to construct high-conviction portfolios that might appear to be at odds with investor perceptions of risk.

Having a concentrated portfolio allows us to demonstrate our expertise and be selective, instead of owning stocks just because they have large index weightings.

The Japan High Conviction Fund has performed well over the years. In what kind of market do you tend to outperform?

The fund can perform well in a range of market conditions. Despite the funds' quality growth bias, there are instances where we have outperformed even when growth was out of favour.

In essence, this is a concentrated 'best ideas' strategy that focuses on stock picking. It aims to deliver long-term outperformance by focusing on stocks with strong and sustainable growth characteristics, most notably return on equity (ROE).

Good companies can generate superior returns in a wide range of conditions, and these are the stocks we are looking for every day.

Nomura's Japan High Conviction Strategy

Our Japan High Conviction strategy is a concentrated portfolio of our highest conviction ideas. We look for profitable companies that can increase their shareholders' equity regardless of macroeconomic conditions. There are a wealth of investment opportunities within this "quality growth" space as long as you have the resources and experience to find them.

At Nomura, we have one of the largest on-the-ground research teams dedicated to Japan. The fund has a five-year track record and a five-star Morningstar rating under Lead Portfolio Manager, Shintaro Harada, who has over 25 years' experience.

The team currently manage over $5bn in growth strategies, including $300m in the Japan High Conviction strategy and $135m in the dedicated UCITS fund.

For more information please contact info@nomura-asset.co.uk

A focused equity portfolio of around 30 high conviction Japanese stocks. Our approach is 100% stock-selection driven, benchmark agnostic with no sector constraints

1st

quartile returns

Our UCITS fund has achieved 1st quartile peer group returns over the last 5 years, delivering 3.65% annualised excess return since inception*

25

years' experience

Chief Portfolio Manager, Shintaro Harada, CMA, has been with Nomura since 1993 and has extensive experience in managing Japanese equities

The strategy operates off our extensive buy side research platform in Tokyo, one of the largest in Japan

*Source: Morningstar as at 30/09/2018 in JPY net of fees annualised. Benchmark: TOPIX. Since Inception Date: August 2013. Universe Parameters: Open-End Funds; Morningstar category: Europe/Africa/ Asia: Japan Large-Cap Equity; Oldest Share Class. AUM data as at 30th September 2018