

Brandes Investment Partners

Japan Equity Strategy Notes

Third Quarter 2024 (July 1 – September 30, 2024)

The Brandes Japan Equity Strategy rose 8.82% (gross of fees), outperforming its benchmark, the MSCI Japan Index, which was up 5.72% in the quarter.

Positive Contributors

Notable contributors included holdings in health care, led by H.U. Group and Astellas Pharma, and in consumer staples, led by food product companies Yakult Honsha and Kewpie. Additionally, entertainment firms DeNA and Gungho Online Entertainment helped performance.

Performance Detractors

Detractors included bank holdings Hachijuni Bank, Hyakugo Bank, and Shizuoka Financial Group. Auto-related holdings Nippon Seiki and Nissan Motor also hurt returns, as did printing company Komori.

Select Activity in the Quarter

While the Japanese equity market (MSCI Japan) closed the quarter higher, it experienced significant volatility in the period, declining at one point by over 15% in a span of five days. As such, trading activity was relatively high for the portfolio, both in terms of buying and selling.

We initiated a position in ceramics and electronics manufacturer Kyocera, while increasing allocations in some underperformers in which we have strong conviction, such as Komatsu, Mitsubishi Shokuhin, and Nihon Parkerizing. Additionally, we reduced allocations to some outperformers, including Artience, Calbee, Chudenko, and divested three positions, namely Sankyo, Yodogawa Steel, and Kewpie. We also built out positions in some of the recently added holdings, such as Fuji Corp, Bridgestone, and Kubota.

Full Sales

Sankyo

Sankyo is one of the largest manufacturers of pachinko and pachislot machines in Japan, with an estimated 25% and 8% market share in these categories, respectively.

When we first purchased Sankyo, we were attracted to its appealing valuation—it was trading below 1x book value and had low multiples of earnings and cash flow—as well as its robust net-cash balance sheet and its capital-light, cash-generative business. We also saw potential for Sankyo to improve its margins and grow revenues and earnings through successful product development. At the time of our purchase, we believed that the company was experiencing a cyclical product downturn, and that research and development would eventually lead to earnings recovery. Similar to online and console games, the success of pachinko and pachislot machines is highly hit-driven.

Throughout our long holding period, Sankyo executed several value-enhancing share buybacks, purchasing what we viewed as undervalued shares from its family owners and subsequently canceling the treasury shares. Revenues and earnings also recovered materially, especially in recent years as the company benefited from successful new product launches and well-implemented initiatives focused on improving efficiency.

We raised our estimate of Sankyo's intrinsic value on numerous occasions given the company's continued improvement in business operations and shareholder returns. However, with excess capital still accounting for a large portion of the intrinsic value (cash has lower expected return than operating business), and the market valuation reflecting substantial optimism, we decided to deploy the capital invested in Sankyo to other opportunities.

Yodogawa Steel Works

Yodogawa Steel Works is a non-integrated producer of rolled, surface-treated steel products. The company sources hot or cold rolled coils from third parties and adds value by galvanising or painting the steel sheet, as well as producing a wide range of fabricated products, such as prefabricated construction materials and exterior storage units.

Our investment case for Yodogawa Steel Works was very similar to that for Sankyo. The company traded at low valuation levels (below 1x book value and low multiple of earnings and cash flow), partly due to its small market cap and lack of sell-side coverage. It also had a solid—albeit inefficient—balance sheet with large cash and investments and had historically generated healthy cash flow and reasonable returns on capital for a domestic oriented company. Furthermore, we appreciated the company’s experience of navigating the cyclical peaks and troughs of its markets.

During our long investment period, the company returned significant amount of capital to shareholders through dividends and buybacks, while also improving operations. Most recently, an activist fund made numerous shareholder proposals aimed at pressuring the company to formulate a plan to increase its market valuation to 1x book value.

As was the case with Sankyo, we raised the estimate of the company’s intrinsic value several times. However, with the company valuation exceeding our estimate, and with cash and investments accounting for a large portion of the intrinsic value, we decided to divest the position.

Kewpie

Kewpie is a branded packaged food company well known for its egg-based products, particularly its mayonnaise. We initiated our position in 2Q 2023, attracted by its favorable attributes that included a strong domestic franchise, expanding—though still in early stage—international presence, and a solid balance sheet. At the time, Kewpie was dealing with some near-term challenges such as cost inflation and COVID-related demand impact, which had negatively affected its share price. While the margin of safety was not the highest within the portfolio, we believed the company offered an appealing risk/return tradeoff given its balance sheet and brand strength, as well as the diversification benefit it provided to the overall portfolio. We also liked the upside optionality through the potential of domestic and international sales growth via inflation passthrough, new product launches, and increased demand in a more normalised environment.

Although Kewpie had a somewhat different investment profile compared to Sankyo and Yodogawa Steel Works, it was a typical “value” stock that we appreciate. The company presented interesting growth opportunities but also had near-term issues that may have dampened investor sentiment, thus resulting in what we considered undemanding valuation. During our relatively short holding period, we increased our estimate of Kewpie’s intrinsic value, but the stock appreciated even more. Consequently, we decided to sell our position as the shares reached our updated intrinsic value estimate.

New Buys

Kyocera

Founded in 1959 as a producer of ceramic parts for electronic equipment, Kyocera has since expanded its offerings to include various ceramic-based products such as cutting and drilling tools, consumer knives, and components for medical and dental implant systems. We view Kyocera as a low-growth materials and technology conglomerate with diverse end-market exposures. In addition to its core operating businesses, Kyocera has a considerable amount of excess capital and owns an approximately 15% stake in the Japanese telecom services provider KDDI.

Our investment thesis for Kyocera is based on the following:

- Prospects for slight topline growth and decent margin improvement over the long term, driven potentially by new product launches and demand expansion
- Large cash and investment portfolio (mostly in KDDI) representing a meaningful portion of its market valuation
- Low market valuations (below 1x book value and low earnings and cash flow multiples)

Key risks for the investment include potential of poor capital deployment, value impairment in KDDI (which accounts for a notable portion of our estimate of Kyocera’s intrinsic value), and deterioration of the core ceramics business. On the positive side, potential benefits include strengthened business operations, proactive measures to improve the inefficient balance sheet, and higher returns on capital through both revenue and earnings growth, as well as a right-sized capital structure. We believe the risk/reward tradeoff offered by Kyocera is skewed to the upside and we are excited to have added the company to the portfolio.

Current Thoughts

For this quarter, we would like to dedicate this section to explaining how we construct the portfolio.

While clients evaluate the portfolio's performance relative to a benchmark (e.g., MSCI Japan, TOPIX), the premise of our investment process is being benchmark-agnostic, with the portfolio construction centered mostly on a bottom-up, fundamental-based approach. There are certain restrictions for risk management purposes, such as no industry can be the higher of 20% of the portfolio or 1.5x the benchmark, and no position can be more than 5% of the portfolio at the time of purchase. However, there is no minimum investment criteria based on the benchmark, leading to instances where we have zero exposure to certain factors of the benchmark.

Our main goal is to populate the portfolio with what we believe are the most attractive investment opportunities based on our view of risk/reward tradeoff. While we consider many factors within this process (e.g., correlation risk, economic or cyclical risk, balance sheet risk, benefits of diversification), we do not take benchmark risk into consideration due to our benchmark-agnostic approach. Our investment philosophy is based on the belief that proper stock picking (correctly estimating the intrinsic value) and populating a portfolio with investments that have a margin of safety will lead to long-term excess returns, regardless of the benchmark adopted.

As a result of this process, our portfolios, including the Japan Equity portfolio, often look different from the benchmark. This is not due to our decisions to intentionally overweight or underweight a certain market cap or sector/industry relative to the benchmark; rather, it's a reflection of where we find value opportunities based on our bottom-up, fundamental analysis.

On occasion, the portfolio's differences from the benchmark can lead to sustained periods of positive or negative relative performance. During periods of poor performance, we frequently receive inquiries about the risk of being so overweight or underweight specific factors. We acknowledge that by being very different from the benchmark at times, we are positioning the portfolio as well as the clients at risk of underperformance for a potentially extended period. While this poses a business risk for us as a firm, as clients may not afford us the opportunity or time frame needed for our investment thesis, we do not see it as a risk to clients' capital as we wholeheartedly believe in this fundamental-based, benchmark-agnostic investment process. In an ideal world, we would prefer to consistently generate excess returns, but unfortunately, there may be periods of significant volatility in performance.

Over the past few years, the Japan Equity portfolio has experienced some difficult performance periods attributed to our "overweight" in small-cap companies and financials, as well as our "underweight" in large-cap names with international and technology exposure. The portfolio was not constructed to intentionally overweight specific market caps or sectors but was built based on our view that these investments in small-cap companies and businesses in certain sectors represented attractive long-term value opportunities. We believe the reason for the underperformance has been that these idiosyncratic risks (stock picking) have not paid off during this time frame.

As such, during our weekly meetings, our discussions have long revolved around the question of "are we valuing these companies correctly?" rather than "should we reduce certain positions and add positions in certain sectors to align better with benchmark performance?" We are stock pickers and fundamental research analysts. Our core competency is to estimate the intrinsic value of companies. There will be times where we are wrong, and we acknowledge that certain investments have a wider range of intrinsic values than others. The key drivers of our investment process are humility (acknowledging that we could be wrong), experience (across various economic cycles), diversity of knowledge and personalities, a long-term thought process, patience, and the mental wherewithal to withstand long periods of underperformance. While we do not know when or if the portfolio will outperform, we truly believe that over the long term, our fundamental, bottom-up approach to both valuing companies and constructing portfolios is the best way in which we can pursue excess returns for our clients.

Conclusion

We sincerely regret the portfolio's performance over the past few years and assure you that our belief in the value investment philosophy and our dedication to construct and manage the portfolio for the best interest of our clients remain unwavering. The third quarter provided a glimpse of the portfolio's potential as it was able to significantly close the gap in performance relative to the MSCI Japan Value Index. We remain genuinely excited for the long-term prospects of the Brandes Japan Equity Strategy, especially after these tough few years. Although we cannot predict the timing, we are confident that the tide will turn, as we have seen with many previous value cycles.

We are always open to dialogue regarding the portfolio, our process, philosophy, and the firm, so please feel free to 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.

The MSCI Japan Value Index captures large and mid cap Japanese securities exhibiting overall value style characteristics, defined using book value to price, 12-month forward earnings to price and dividend yield.

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

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