BRANDES
INVESTMENT PARTNERS

Japan Equity Strategy Notes
Fourth Quarter 2024 (1 October – 31 December 2024)

The Brandes Japan Equity Strategy declined 3.93% (gross of fees), underperforming its benchmark, the MSCI Japan Index, which was down 3.60% in the quarter.

Positive Contributors
Positive contributors included holdings in communication services, notably entertainment company DeNA and media firm TV Asahi. DeNA rose significantly behind the success of its new Pokémon game.

Other contributors included Kissei Pharmaceutical and Kaken Pharmaceutical, as well as Hachijuni Bank and Hyakugo Bank. Nissan Motor also appreciated on news of its potential strategic alliance with Honda Motor.

Performance Detractors
Major detractors included food products companies Yakult Honsha and Meiji Holdings, as well as machinery firm Kubota. Health care holdings Astellas Pharma, H.U. Group, and Medipal Holdings also weighed on returns, along with chemical business Artience.

Select Activity in the Quarter
In comparison to the past few quarters, trading activity has normalised. We pared positions in well-performing holdings such as DeNA, Calbee and Mitsubishi UFJ, and divested the position in Dai Nippon Printing. We redeployed the capital to positions with healthy margins of safety, such as recent purchases Kyocera and Bridgestone, and other holdings for which we have re-evaluated and reconfirmed the intrinsic value estimates, including Sumitomo Mitsui Trust, Mitsubishi Shokuhin and Medipal Holdings. Additionally, we initiated a position in mobile game developer Akatsuki.

Full Sale

Dai Nippon Printing
Dai Nippon Printing (DNP) was one of the longest-held positions in the portfolio. Similar to many of our investments, DNP traded at a low cash-adjusted price/earnings ratio and a significant discount to book value. The company had an excessively capitalised balance sheet, with a large cash reserve and substantial equity investments, including privately held Recruit Holdings that later went public at a price well above its book value. While the domestic printing business was in secular decline, DNP had a portfolio of various printing technology-related businesses including integrated circuit cards, color and optical film for LCDs (liquid crystal displays), photomasks for semiconductors, and metal mask for OLEDs. We believed these businesses had attractive growth and profitability prospects.

Throughout our holding period, we actively engaged with DNP through letters, meetings with the board, and extensive discussions with management. Although it took time and effort, DNP did execute some of our suggestions, including reducing its board size from over 20 members initially, initiating buybacks and increasing dividends, and divesting non-core assets (e.g., the partial monetisation of its Recruit Holdings stake). Recently, a prominent activist investor appeared to have applied further pressure, leading the company to announce its plans to improve earnings and returns on capital through an aggressive buyback program (over 10% of shares outstanding) in order to achieve a market valuation of at least a 1x book value.

Amid this development, we updated our intrinsic value estimate for DNP, and we ultimately concluded that the market price reflected a reasonable degree of optimism. DNP was in a better position than when we first purchased the shares, given its growing electronics business and successful new products, such as battery packs for lithium-ion batteries that have gained significant market share. Acknowledging the potential for further upside, we gradually reduced the position over a period of time, with the final held shares sold at a price that was well above our estimate of intrinsic value for DNP.

New Buy:

Akatsuki
We initiated a position in Akatsuki, a mobile game developer and online comic creator and publisher. The company's core competency lies in forming strategic alliances with IP (intellectual property) owners to create mobile games.

Akatsuki has successfully launched four core titles through collaborations with Bandai Namco Entertainment, Square Enix, and Koei Techmo Games. While the company has focused mainly on the domestic Japanese market, it has recently decided to expand to larger-scale, global titles. Although this will lead to higher costs in the near term, Akatsuki's current business is cash-generative and its balance sheet has ample excess capital, alleviating any concerns about capital availability.

In December 2023, Akatsuki announced a new strategic alliance with Sony and Koei Techmo to collaborate in development of mobile games. This agreement entailed a capital tie-up where Akatsuki issued treasury shares to both companies, resulting in Sony now owning a 9.87% stake in Akatsuki and Koei a 7.97% stake.

Our investment thesis for Akatsuki is two-fold: 1) the potential for the operating business to return to growth once the investments for new content in mobile and comic businesses start gaining traction, and 2) the value of cash and investments, which currently accounts for a substantial portion of the market value. While we have some concerns with the new capital deployment strategy, earnings appear to be near trough and the current valuation (below book value) appears to not give much credit to the new investments or to the overall businesses.

Year in Review and 2025 Outlook

This past year marked an interesting period for the Japan Equity Portfolio as it exited nine positions that included some long-term holdings such as the two property and casualty insurance companies (MS&AD Insurance Group Holdings, Sompo Holdings), Dai Nippon Printing, Taisho Pharmaceutical, and Yodogawa Steel. Our investment period for these holdings extended for more than 15 years each, and these businesses went through similar cycles as the aforementioned DNP, with positive performance contributions overall—except for Taisho, which went private. While there could be an argument that we may have owned these positions "too early," our core competency and process are deeply engrained in purchasing assets when undervalued, as we acknowledge that forecasting market movements is fraught with difficulty and uncertainty. As long as we populate the portfolio in a diversified manner with companies trading at a discount to our estimated intrinsic values, we believe we can generate excess returns over the long run.

Of the eight positions initiated over the past year, seven are companies that we have never owned over the past 20 years. We believe these companies add diversification, with Kubota and Fuji Corporation bringing some economic and product cyclicality features (tractors, chip mounters), Bridgestone adding long-term global growth with its tire business, and Gungho and Akatsuki adding some research and development optionality with mobile game development. Compared to past investments, we have allocated larger positions to some of these names due to our optimistic view of their potential long-term returns.

From a performance perspective, the Japanese stock market continued to achieve positive returns in U.S. dollar terms—and even higher in local currency terms. Despite the market rise, the Brandes Japan Equity Fund was able to compete with the MSCI Japan Index (primary benchmark) and outperform TOPIX (secondary benchmark), although it underperformed the MSCI Japan Value Index. Factors contributing to our underperformance vs. the value index included our lack of holdings in companies that account for large positions in the index, our underweight to the large mega-banks (compared to our overweight to regional banks), high exposure to the underperforming health care sector, and the poor performance of some of our larger positions (e.g., Nissan, Astellas). As we pride ourselves in our tendency to outperform the value index during value-led periods, we are highly disappointed but not discouraged.

We remain optimistic with the long-term portfolio outlook. The recent announcement of Nissan potentially forming a strategic alliance with Honda could be a positive if materialised. Additionally, we have seen that some our small- and mid-cap names have started to perform better on the back of improved earnings and optimistic outlook. Our large position in Takeda should hopefully start to contribute positively when and if revenues revert to growth following the completion of the patent cliff. After two strong years of market performance, we believe investor focus will eventually shift to companies where the valuations look more attractive relative to those that have performed well.

From a portfolio perspective, we are excited about the current opportunity set. While positioned with more domestically oriented investments, we believe we have added more balance with the recent additions of companies with ex-Japan exposure, such as Kubota, Bridgestone, Kyocera, and Fuji Corp. Domestically, cost inflation pass-through is becoming a reality, leading to improved profitability relative to the past where companies tried to absorb such costs. The TSE (Tokyo Stock Exchange) directives also appear to be having some positive impact, although we believe the aggressive push by activists and private equity players is the stronger driver for corporate reform. Increased dividend and buyback activity is becoming a trend, while mergers and acquisitions as well as management buyout activities are becoming much more prevalent compared to the past. We believe our portfolio is populated with attractive assets whose potential hopefully can be realised through more aggressive corporate actions.

As bottom-up, fundamental research-based value investors, we do not employ a market view when managing the portfolio. Yet, we are cognisant there is a tendency for markets to correct following a period of strong performance. Thus, we believe whether the market goes up or down, being disciplined on price is imperative. 2025 may bring more uncertainty compared to other years with the new U.S. administration, the somewhat unstable hold of government control by the LDP (Liberal Democratic Party) in Japan, and overall geopolitics. Nonetheless, we believe the portfolio is well positioned with holdings that have what we consider strong balance sheets to manage both the micro and macro risks.

Conclusion

We would like to express our sincere appreciation to our clients who have continued to give us the opportunity to manage the Japan Equity portfolio on their behalf following disappointing performance relative to the value benchmark. We are honored to continue serving as stewards of your capital.

While there are numerous external factors beyond our control, such as inflation, unpredictable interest rate movements, global economic uncertainty, political instability across many countries, and geopolitical tension, our focus remains on what we can control, which is our process and belief in our estimates of intrinsic values based on bottom-up, fundamental analysis. We are also committed to optimising the portfolio through diversification of various risk factors with the goal of minimising capital impairment over the long term.

It is difficult to predict how the Japanese stock market or the Brandes Japan Equity portfolio will perform in 2025, but our commitment is steadfast: to remain consistent, transparent, and dedicated to achieving the best possible outcomes based on what we can control. In a world that is unpredictable, we are sure that 2025 will bring about more unforeseen events, but we strive to be prepared to manage the downside risk, while also capitalising on potential investment opportunities. Hopefully, we can continue to earn your trust and reward it with enhanced performance.

We always appreciate any dialogue regarding the portfolio, our process and philosophy, as well as the firm, so please do reach out anytime. Critical comments and observations are always welcome as well. We sincerely value the relationship over the years. It is truly a privilege to manage the portfolio on your behalf.

May 2025 bring peace, happiness, wellness, and prosperity to all.

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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