UOB Asset Management

United Japan Small and Mid Cap Fund

April 2023

Why Invest?

- **Exposure to the underrepresented universe of Japanese small and mid-cap sectors:** Small and mid-cap companies represent more than 80 per cent of the Japanese universe but many are often under-researched. The Fund represents an attractive opportunity for investors to gain exposure to Japanese small and mid-cap equities.

- **Ride on Japan's equity market rally:** Japan's Nikkei 225 and Tokyo Stock Price Index (TOPIX) indices have recently surged to 33-year highs, making it one of the world's best performing markets. With drivers such as improved corporate governance and positive earnings, we believe that Japan's equity market will continue to have upside potential over the next few months.

- **Attractive valuations**: Japanese stocks have reached multi-decade highs but remains relatively inexpensive when compared to other markets. TOPIX price-to-book ratio of 1.3x is still well below the S&P 500 Index's 4x and STOXX Europe 600's 1.8x.

- **Focus on long-term capital growth:** To achieve its objective, the Fund focuses on companies that are 1) growing in developing business sectors; 2) with unique business models or superior technologies; 3) in mature markets that are still able to grow earnings through innovations.

Investment Objective

To achieve long term capital growth through investing in securities of small and medium capitalisation corporations listed, domiciled, or having substantial operations, in Japan.

Fund Information

Morningstar Rating

★★★★

Fund Size

SGD 106.82 mil

Base Currency

SGD

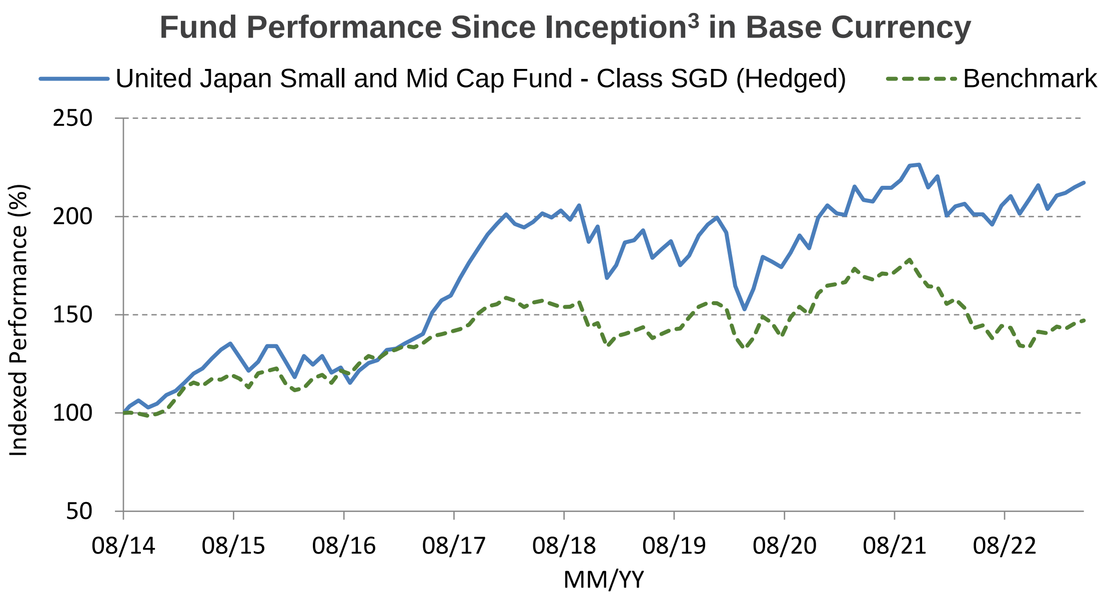
Fund Manager

Sumitomo Mitsui DS Asset Management

One Month Portfolio Review

For the month of April 2023, the United Japan Small and Mid Cap Fund – Class A SGD Acc (Hedged) (the "Fund") returned 1.06 per cent[1] in April 2023 in Singapore dollar (SGD) terms. Its benchmark, the MSCI Japan SMID Cap Index, similarly returned 1.06 per cent[2] in the same month.

Historical Performance



Past performance is not necessarily indicative of future performance.

Fund performance is calculated on a NAV to NAV basis.

Benchmark: MSCI Japan SMID Cap Index

Source: Morningstar. Performance as at 30 April 2023, SGD basis, with dividends and distributions reinvested, if any.

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[1] *Source: Morningstar, Performance from 31 March 2023 to 30 April 2023 in SGD terms, on a Net Asset Value ("NAV") basis, with dividends and distributions reinvested (if any).*
[2] *Source: Morningstar, Performance from 31 March 2023 to 30 April 2023 in SGD terms.*
[3] *The United Japan Small and Mid Cap Fund – Class A SGD Acc (Hedged) (ISIN Code: SG9999012033) was incepted on 11 August 2014.*

All statistics quoted in the write-up are sourced from Bloomberg as at 30 April 2023 unless otherwise stated.

Annualised and Cumulative Performance

Performance (Class A SGD Acc (Hedged))

	Cumulative Performance (%)	Annualised Performance (%)			
	1 month	1 Year	3 Years	5 Years	Since Inception
Fund NAV to NAV	1.06	7.98	9.99	1.95	9.30
Fund (Charges applied^)	-3.99	2.58	8.13	0.91	8.66
Benchmark	1.06	2.72	2.10	-1.20	4.53

Source: Morningstar. Performance as at 30 April 2023, SGD basis, with dividends and distributions reinvested, if any. Performance figures for 1 month till 1 year show the per cent change, while performance figures above 1 year show the average annual compounded returns. Benchmark: MSCI Japan SMID Cap Index. Past performance is not necessarily indicative of future performance. ^Includes the effect of the current subscription fee that is charged, which an investor might or might not pay.

Market Review

Foreign investors have taken the spotlight as the most prominent traders of Japanese equities, accounting for around 70 per cent of trading volume. Since the start of 2023, foreign investors have been net buyers of over 3.7 trillion JPY (USD28 billion) in Japanese cash equities and equities futures. Up until 19 May 2023, foreign investors have been net buyers for seven consecutive weeks, with approximately two-thirds of the amount in cash equities and one-third in futures. Notably, between 2020 and 2022, foreign investors sold 13 trillion JPY of Japanese equities, leaving ample room for expansion in their recent flows. It is worth noting that foreign investors predominantly focus on large-cap stocks, primarily through Nikkei 225 products and futures. This preference has led to a factor leadership bias towards large caps and liquidity over small caps. This is expected and typical in the early stages of a bull market in Japanese equities.

The swift rise of Japanese equities can be attributed to several factors. Firstly, the renewed interest from Warren Buffet has played a significant role. In April 2023, he mentioned he would add to his position in Japanese trading houses and during Berkshire's annual meeting, he indicated a preference for Japan over Taiwan. Additionally, the plausible prospects of sustained nominal GDP growth also contributed to the positive sentiment. Optimism for greater shareholder return through dividends and buybacks has also been fuelled by the Tokyo Stock Exchange's demand for action and improvement plans from companies trading below 1x price to book.

Furthermore, the ongoing accommodative monetary policy, supported by the reassurance against the "premature" tightening of monetary policy from Ueda, the new governor of the Bank of Japan, has bolstered market confidence. While the early phase of the rally may have been been driven by short term commodity trading advisors (CTAs), there are signs of longer-term capital shifts to Japan with the strong buying of cash equities in addition to futures. Considering these factors, we believe they present a persuasive and compelling case for global investors as they make their medium to long-term asset allocation decisions.

Another contributing factor to the upward momentum in Japanese equities is the relative strength of Japan's economic fundamentals relative to both its historical performance and global peers. Japan is experiencing multi-decade wage growth of 3.7 per cent during the 2023 Spring negotiations, a level not seen since the early 1990s. While real wages have contracted year-on-year (YoY) due to the cost-push inflation spike last year, the overall consumer outlook is robust.

The presence of pent-up demand and excess savings followed the delayed reopening from the pandemic has further bolstered the consumer's financial health. We see ongoing upward pressure on wages from import prices and structural labour shortage with real potential of starting a virtuous cycle in prices and wages as companies manage to pass through costs and consumers begin to shed their deflationary mindset.

Also, the Japanese yen has weakened (against the US Dollar) to the 138 level which we see as a net positive for the Japanese economy. Although immediate positive effects are clearer for exporters than domestic demand-driven sectors, a weak yen is a strong positive for inbound tourism.

Outlook and Positioning

Outlook

May 2023 saw the announcement of financial results of Japanese companies for the fiscal year ending in March 2023. Overall, earnings season was largely in line with our expectations, and we do not intend to make significant changes to the portfolio based on these results.

We are seeing an accelerating strong uptick in interest in Japanese equities, particularly small and mid-caps. Despite their underperformance compared to headline indices year-to-date (YTD), we have corroborated this observation with other industry contacts in Tokyo and heard that other fund houses have also reported similar observations.

In the near term, the market is likely to exhibit volatility in line with overall market risks, such as the resolution of the US debt ceiling and upcoming data releases.

Considering the uncertainty surrounding the trajectory of the global economy, we maintain a cautious stance on exporters. However, companies oriented towards domestic demand continue to perform extremely, well, and our portfolio exposure is centred around such companies.

As global uncertainty and higher interest rates impact exporters, especially of durable goods, the delayed reopening and inbound tourism will provide support to the domestic economy. Our portfolio is strategically positioned to benefit from this narrative.

Even without multiple expansion, which is quite plausible in the Japanese market with a forward earnings multiple of around 13x, we see potential for upside. This is supported by the potential for improvement in metrics such as the payout ratio and operating margins which currently stand at approximately half the levels of the US market.

The expectation of nominal GDP growth surpassing 2 per cent for the next few years is anticipated to raise earnings per share (EPS) and, consequently, create potential for further upside in the market. Moreover, we observe signs of the beginning of a virtuous cycle in wages and prices, which contribute to ending deflation in Japan.

Ongoing investments by Japanese companies in labour-saving measures and efficiency improvements, particularly in the filed of digital transformation, are notable. System development and systems integrator companies, many of which are included in the portfolio, have demonstrated strong performance. An example would be **JBCC Holdings** (previously known as Japan Business Computer Corporation), an Information Technology services company with strengths in rapid low code software development, cloud and security, and its stock has shown a YTD increase of 22 per cent. The firm has transitioned from selling International Business Machines (IBM) devices wholesale to adopting a more digital cloud and security-oriented stock-based business model. This shift has produced better earnings stability and margins. The company's guidance is also markedly conservative given brisk demand for digital transformation investments from the corporate sector.

In addition, as economic activity has normalised following the easing and removal of pandemic control restrictions, the performance of human resources-related companies, which are also heavily included in this portfolio, has been strong. An example is **Outsourcing Inc.**, a company which provides outsourcing services to a range of different industries. In addition to recovery from the manufacturing segment which suffered from cuts to auto sector production amid supply chain bottlenecks in the last fiscal year, we expect the company to capture demand for personnel at new semiconductor plants in Kyushu. Supply of technical personnel and engineers remains tight and unit costs are likely to increase. From this fiscal year, the number of foreign workers will increase as support for long-term visas is increased and the current visa system is overhauled. The increase in the number of tourists is attracting attention, but the increase in the number of workers coming to Japan is also accelerating. This stock is up 36 per cent YTD.

Going forward, human resource-related companies are likely to benefit from an influx of overseas workers. Recovery in the number of tourists, especially from China, will also provide a boost to the Japanese economy.

While the current situation has been positive for the portfolio's constituents, response from the market in less well-known and smaller cap names have been muted as foreign investors seem to be mainly buying the large cap-oriented Nikkei. However, we think that this is a result of a convergence of positive factors for Japanese equities, and foreign investors have finally realised the attractiveness of Japanese stocks. It is typical for large indices constituents to lead initially, and we think that interest will spread to small and medium-sized stocks.

The current share prices of the portfolio's constituents are significantly below price targets based on our analysis with our tried and tested economic value-added framework. This framework has consistently underpinned the long-term performance of the Fund and is utilised to measure the absolute value of companies. The expected rate of return is comparable to the level at which Abenomics began. Therefore, we believe that now is an opportune time to invest in small and medium-sized Japanese stocks.

Positioning

The Fund is well diversified with 92 names as at the end of April 2023.

Our focus is mostly domestic exposure companies that can achieve earning growth over a mid-to-long term, benefitting from unique structural changes in Japanese society.

Our sector allocation reflects this philosophy:

1) Industrials (portfolio weight: 34.10%): We are investing in IT-related companies such as software developers and system integrators, since we have been seeing promising growth of the industry, backed by the continuous demand for digital transformation in the Japanese society.

2) Information Technology (portfolio weight: 24.49%): We have invested in several staffing services companies in this sector which could provide great solutions to Japanese companies that are facing challenges in securing sufficient workforce in an aging society like Japan.

Despite an extremely uncertain market in 2022 driven by the US Federal Reserve's monetary tightening to control inflation, the Fund's focus has remained changed. This is because the external environment will have less impact on the corporate fundamental of domestic exposure companies we invest in. Additionally, it will not change the unique growth opportunities presented by the structural changes occurring in Japanese society.

As the market is gradually shifts its focus back to fundamentals, there is a growing preference for domestic demand stocks. In line with this trend, our focus on digitalisation and staffing services positions us well for the medium to long term, presenting favourable prospects for the Fund.

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