Client Update
February 2021

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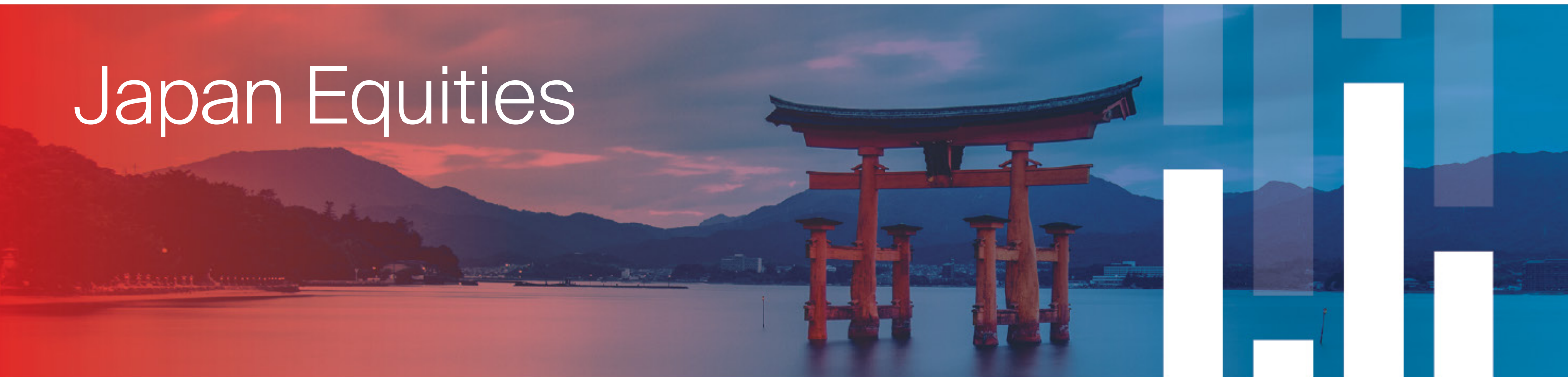
Japan Equities



Looking back over 2020, a challenging year for many reasons, there were two key investment decisions that helped the performance of the FSSA Japan Equity strategy. Firstly, in the early days of the pandemic we started to identify companies that might benefit from the acceleration of secular investment trends. The 2011 Tōhoku earthquake taught us that significant external events can change consumer behaviour– even against the backdrop of Japan's conservative society norms. The longer such catastrophes continue, the more structurally embedded the new behaviour becomes.

This led us to the principal businesses in the digital payments, e-commerce and Software-as-a-Service (SaaS) industries, as well as affordable private-label retailers that tapped into consumers' cost-consciousness. Interestingly, we already owned many of these types of companies, and we took the opportunity to add to them at lower prices amid the market sell-off earlier in the year. We have long believed that Japan's digitalisation efforts would eventually accelerate; and, as we touch upon later in this note, our investment approach is to seek out businesses that can perform well regardless of macro conditions.

Secondly, we continued to focus on the fundamental strength and quality of the businesses we own. We firmly believe that this, along with a strong management team, is what protects capital during a downturn. In our view, "quality" is what drives returns in the long run, rather than relative valuation metrics such as the price-to-earnings ratio (PER), which we believe to be flawed in its assumptions.

In this update, we also set forth our views on the quality vs. valuation debate in response to some common questions from our clients – notably, how we consider the valuation risks of quality companies (as they tend to be more expensively valued), and how they might perform in an environment of rising inflation and interest rates.

Digital transformation

There is a viral meme making the rounds on social media that asks, "Who led the digital transformation of your company?" A red circle drawn around the answer "Covid-19", rather than CEO or CTO, is intended to be a humorous response. While the meme is meant to be tongue-in-cheek, surveys conducted by consultants such as McKinsey, Boston Consulting Group and IBM have indeed noted the acceleration of digital disruption due to Covid-19.

In Japan, as an example of the changing times, a group of small and medium-sized information technology (IT) companies held a "memorial service" for *hanko* seals that are no longer used due to digitalisation[1]. A *hanko*, to put into context, is a physical stamp used in place of a signature to process official documents. During Japan's recent Covid-related state of emergency, workers had to commute into the office to "sign" documents – though the new Suga administration soon abolished the *hanko* requirement and determined that digital administrative procedures needed to improve.

To date, despite Japan boasting one of the largest annual IT expenditures globally, the pace of digital adoption there has been slow. There is still a strong attachment to methods from the "old days", with manual processes and offline business models. However, with tailwinds brought about by Covid, companies are now picking up the digital pace. According to the Information-technology Promotion Agency, 40% of Japanese companies have established a digital transformation (DX) project[2].

We believe this will benefit the internet services and SaaS companies owned in the FSSA Japan strategy, some of which we have owned for years. M3 is one such example. The company provides digital marketing services, connecting pharmaceutical companies to doctors on its

[1] Source: https://english.kyodonews.net/news/2020/10/985e53241486-memorial-held-for-hanko-seals-discarded-due-to-digitalization.html
[2] Source: https://www.ipa.go.jp/files/000082054.pdf (Japanese language)

web-based platform. More than 80% of Japanese doctors are active members on the M3.com website. As the leading marketing platform for the pharmaceutical industry, M3 saw orders for e-detailing surge 2.5x in 1H2020, as doctors avoided in-person meetings with medical representatives.

We expect this to continue post-Covid, as the industry increasingly embraces technology to deliver highly efficient yet low-cost marketing. Given online marketing expenditure is only 1 - 2% of pharmaceutical companies' marketing budgets, we believe the long-term growth potential for M3 is huge.

Amid the Covid environment, Rakus, which provides cloud-based services to small and medium-sized enterprises (SMEs), also delivered strong (40%+) year-on-year growth for its core expense management software, Raku Raku Seisan. One of the benefits of cloud services, particularly during a health pandemic where citizens are asked to stay home and keep a distance from others, is that it can be accessed anywhere and at any time. Rakus' suite of software helps its key target market – SMEs and their employees – save significant labour and time costs. With extremely low penetration (due to low IT literacy), we believe there should be a long runway of growth ahead.

Another company in this sector, Bengo4.com, operates the only online platform for Japanese consumers to seek legal advice from registered lawyers. It is also the largest provider of cloud-based contract software in Japan. Its e-signature service CloudSign has over 80% share of the market, with sales up 2.6x year-on-year due to the broad work-from-home environment across industries in 2020.

Covid-19 has served as the strongest push yet for corporate Japan to shift away from the deeply rooted *hanko* stamp culture. Bengo4.com has grown exponentially as more companies adopt e-signatures in their business, with future growth supported by the government's plans to accelerate digitalisation in Japan. The company estimates that only a small number (single digit) of Japanese businesses currently use e-signatures, with growth picking up significantly in the coming years.

Deflationary spending

The only retail format in Japan that has had much success over the past 20 years is the specialty private-label retailer. These retailers commit to high quality products at affordable prices, and transfer their cost benefits (from economies of scale) to consumers in the form of lower prices. Consumers reciprocate by purchasing more items, providing even greater scale for these companies who then pass on the additional savings in a virtuous cycle. We have invested in several of these types of retailers, from apparel companies to furniture stores and supermarkets.

In the midst of economic instability during Covid, a recurring theme we have noticed is the "quality value for money" trend. Demand for goods and services that stretch consumers' real disposable income have strengthened, and have been popularised all over the world.

In 2020, Gyomu Super, a leading discount grocery franchise operated by Kobe Bussan, enjoyed an exceptional 16% same-store sales growth, driven by stay-at-home demand and products sold cheaply in bulk. Kobe Bussan, a vertically-integrated retailer, can offer low cost products with its in-house production and global sourcing capabilities, which means it can sell its private-label goods at a 30-50% discount to those at a traditional grocery store (for example, 2kg of chicken thighs cost just USD 5). It has also consistently launched new products, such as frozen tapioca and desserts in milk cartons (you can buy a 1kg pudding for USD 2-3), which offers a unique "treasure hunting" shopping experience.

Similarly, Workman, a specialty retailer of private-label outdoors and athleisure clothing, recorded 18% same-store sales growth over the fiscal year (FY) 2020. Its functional wear is priced at a fraction of the big brands (a Workman winter jacket costs less than USD 30 and a suit is only USD 50). Demand has been so strong that its franchisees struggle to restock the shelves in a timely manner, while the improved decor of its "Workman Plus" stores has helped to bring in new customers and boost sales.

In Japan, "cheap" products used to be viewed with suspicion, though that perception has slowly changed as more customers in the middle-income bracket now visit the likes of Gyomu Super and Workman. Gyomu Super's products are actually quite decent, and Workman's clothing range ("every day low price") is seen as good value. Consumers actively identify and promote these quality labels through social media, and recipes made with Gyomu Super ingredients or outdoor styling with Workman clothes have been highly effective in raising awareness of these two brands. Given the performance of other discount retailers in Japan (such as Nitori and Uniqlo), we believe the discounting trend – particularly with Japan's sluggish economy and muted wage growth – is here to stay.

Macro and rotation

One of the biggest lessons from 2020 is that attempting to forecast the market is a fool's errand. We are quite sure that nobody forecasted a global pandemic, the worst recession since the Great Depression, and then a record year for equity prices. John Kenneth Galbraith, an economist, said, "There are two types of forecasters: those who don't know and those who don't know that they don't know." We know that we belong to the former group.

Over the past 20-30 years, investing in Japan based purely on macro views has been ruinous for some. One of the many examples of this is the popular bet against the Japanese yen. With Japan's rising public sector debt, investors believed that its currency would debase or that the country would face bankruptcy one day. Instead, the yen remains one of the most reliable safe haven assets during times of economic and geopolitical turmoil, or even a global pandemic. After large losses incurred by investors, betting on the yen's depreciation has come to be known as the "widow-maker trade".

We do not predict macro events, because our investment approach – as bottom-up stock selectors – seeks to identify companies that are in charge of their own destiny. While Japan consistently defies convention, we select only the companies that can thrive, regardless of the country's economic challenges. As we have mentioned in previous client letters, *economic growth is never a part of our growth assumptions*. This is true for virtually every company that we own in Japan.

Among the many questions that we are frequently asked are: Will we switch to lower quality cyclicals or banks when there is a style rotation? What is our view about the recovery post-Covid and where will interest rates be? Moreover, what do we think about the potential currency swing on Japanese equities or the cancellation of the Tokyo Olympics?

Firstly, we only invest in companies that we believe can maintain their return on invested capital (ROIC) and profit growth relatively independently of the macro environment and without leveraging. Because of this, we avoid stocks that are heavily cyclical or highly leveraged, those with outdated business models; and so forth. In a strong bull market, when a rising tide lifts all boats, we tend to lag behind. This is especially true after a downturn – our investee companies do not typically have strong recovery stories, because there is nothing to recover from.

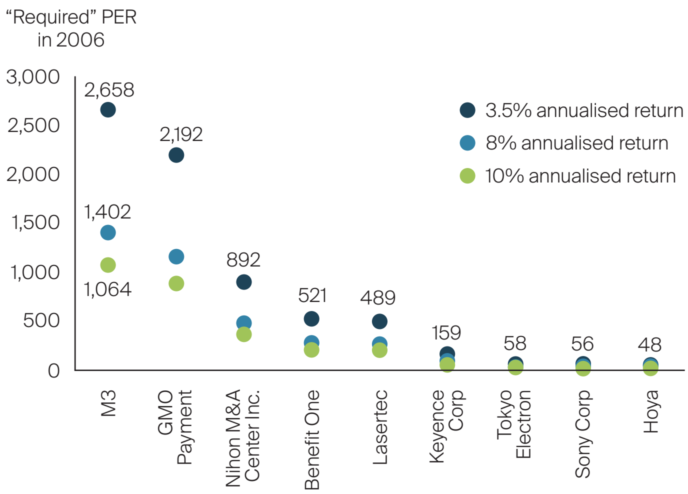
Secondly, it is fair to say that quality companies appear more expensive relative to the rest of the market; but when interest rates rise, both camps (quality companies and cheap ones) become expensive. Would our portfolio holdings still be able to deliver decent returns over the next 5-10 years or longer?

To attempt to answer this question, we looked at the nine largest holdings in the Japan strategy[3]. We calculated the maximum PER we could have paid in 2006 (a Japan equity market peak, right before 2008 Global Financial Crisis) for each company to go on and deliver annualised returns of 8% or 10% over the next 15 years (a reasonable target). We also looked at the Topix as a reference point – annualised returns for the benchmark was 3.5% over the 15-year period, so for comparison purposes we calculated the corresponding PERs in 2006 based on this return threshold as well.

The chart below shows that the lowest "required" PER to generate a 3.5% annualised return over 15 years (and therefore outperform the Topix) belongs to Hoya (48x), followed by Sony (56x) and Tokyo Electron (58x). They are overshadowed by the eye-watering 2,658x PER for M3. In other words, if we had bought these stocks at the beginning of 2006 – at these PER valuation levels or lower – and held them for 15 years, they would have performed at least as well as the Topix.

If we had theoretically bought M3 (which is currently trading on a forward PER of 128x) in 2006, we could have paid as much as 1,402x PER for an 8% annualised return over the next 15 years (or 1,064x PER for a 10% annualised return). This indicates that in the short-term, investors often undervalue a company that can generate sustainable growth for a prolonged period of time.

Theoretical valuations and returns of our largest company holdings in Japan



Source: FSSA Investment Managers, Bloomberg, as at 15 January 2021

[3] As at 15 January 2021. Of the Top 10 Holdings in the FSSA Japan Equity strategy, Recruit Holdings was listed in 2014 and therefore could not be included in this calculation.

Quality vs. Valuation

We have found that one of the biggest obsessions among market participants is "price" and we are often asked about the relative valuations of our company holdings – far more so than the quality of management, the business, corporate innovation, or other fundamental factors. Given the interest, we thought it might be useful to recap our investment philosophy in some detail.

At the core of our investment philosophy is ROIC, which we aim to be much higher than any feasible cost of capital. This approach is simple and proven over time. As at the end of 2020, the weighted average ROIC of the FSSA Japan strategy was 43%. To quote from Warren Buffett's 1979 annual letter:

> *The primary test of managerial economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and not the achievement of consistent gains in earnings per share.*

Interestingly, our investment approach contradicts one of the core principles of financial theory: that a higher return has to come with higher risks. Our investee companies share certain characteristics that indicate a superior franchise, such as a dominant market share in niche industries, strong pricing power, continual innovation (either in terms of product or business model), an asset-light business model, high recurring revenue (implying high customer satisfaction and a low churn rate), the rare ability to create new avenues of growth (often making them seem undervalued based on the available information), and a cash-rich balance sheet (as a result of high returns and cash generation). Most importantly, behind all of these factors is a strong corporate culture and team of people – which, in our experience is their ultimate source of lasting competitive advantages.

Many investors prefer to compare the near-term earnings per share (EPS) growth vs. the 12-month forward price-to-earnings ratio (PER), which is a quicker and lazier way. However, in our view, both EPS growth and the PER carry serious inherent flaws. First and foremost, they do not reflect the ROIC or quality of earnings. Not all earnings should be judged similarly – earnings that are mostly delivered in cash and from the sources mentioned above carry a different risk profile (more sustainable) compared to those earned in a cyclical recovery, or from reflationary trends, leverage and share buybacks, or those that require a greater amount of capital.

Moreover, short-term PER cannot capture a company's resilience during periods of turmoil (like in 2020), nor the visibility, magnitude and duration of its future growth, or its ability to defend against disruptive innovation – which, if not managed well could lead to long-term value destruction. As we discussed in past client letters, quality companies in a Japan context (which could reasonably apply to other regions too, as the world becomes more "Japan-ised") is best seen as those that can generate steady returns and sustainable growth regardless of macro factors.

The only exception to our focus on high ROIC companies are those in industries that are still at a nascent stage of development, but have a large addressable market and benign competition. In these instances, we would encourage companies to invest as much as they can, based on the view that the normalised return would be highly attractive and most of the revenue acquired would stay with the company over a sustained period of time. This should lead to a high Lifetime Value to Customer Acquisition Cost (LTV/CAC) ratio, a good indicator of returns.

The second important factor that we look at, after ROIC, is sustainability of growth. The companies we own are either leading businesses positioned in secular growth industries or companies that can take market share from incumbents through innovative means. If a company can demonstrate a track record of creating new avenues of growth (by adding products and services to its existing portfolio) without compromising their normalised returns, they are usually proven to be outstanding investments over time.

On a personal note, having spent seven years studying statistics in college and graduate school, I have been tempted from time to time to lean towards mean reversion theory, or the law of large numbers. These theories suggest that good companies attract competition, which should eventually reduce their returns to the average. Or, that relative near-term valuations (such as the 12-month PER) should revert to the long-term average over time. In other words, poor quality companies often have the chance to rerate, and vice versa.

Notwithstanding the above, our investment strategy is to look for and invest in a few companies that can diverge from the mean for as long as possible. The ability to identify such companies – and refrain from the temptation to follow "conventional wisdom" – is perhaps our biggest value-add to our clients.

When it comes to companies trading on valuations that do not provide enough of a "margin of safety", we conduct our in-depth research beforehand and then wait patiently for the right time to initiate a position. Our experience of past cycles and investor behaviour suggests that even good companies struggle periodically. The Japan market, which is still considered an "ATM" for global investors (meaning a source of cash) and a proxy for economic cycles, often experiences irrational sell-offs. These times create the best opportunities to buy high quality companies at attractive prices. Indeed, out of the top ten contributors to performance over the past three years[4], four companies were those that we had purchased after they had been sold off without any good fundamental reason.

Conversely, we have no interest in owning poor quality companies and believe that not everything has a price. Value investors sometimes fall into the trap of owning companies with low valuations because they consider it the most important part of the investment case. Some suggest that low valuations can protect against downside risk during a falling market, even if that business is highly cyclical, generates low returns or faces existential threat.

We would respectfully disagree; and reiterate that the fundamental strength of a business and the management behind it protects against downside risk, not relative valuation. In fact, we do not subscribe to the delineation of so-called "value" and "growth" investors. In our view, all investors should be value investors – that is, to invest in companies that trade below its intrinsic value. This depends on the company's ROIC and long-term growth vs. the cost of capital. A stock may have a low valuation, but an even lower intrinsic value.

Furthermore, investing in poor quality companies is not particularly within our circle of expertise. There are few reasons to buy such companies, none of which we are comfortable with. The first is believing that price is more important than the business you buy, as discussed above. The second is believing that "the worst is over" and the company can improve from here on. The problem with this approach, going by the old adage, is that only a rare leopard can change its spots. Quoting Mr Buffett, we believe "there is never just one cockroach in the kitchen". Meanwhile, an investor's capital could probably be invested elsewhere more productively rather than waiting for change to happen. When the share price of such a company falls sharply, say in a global pandemic, we know that we would not have the courage to try to catch a falling knife.

Some investors believe that results may soon pick up along with the economic cycle; and by being great at market timing, they will be able to sell the stock just before the cyclical peak. Others may believe that "it is already in the price", particularly for companies that face disruptive innovation in their industries. We make no claims on our ability to time the markets; and we have learnt from experience that potential losses from technological disruption are not only permanent but have tended to be under-appreciated, rather than incorporated into valuations. As a general rule of thumb, we prefer not to invest in such companies. Lastly, some investors talk about diversification benefits. To us, this is the most puzzling rationale of all. How can a portfolio possibly improve by diversifying across lower-quality businesses?

In conclusion

We believe that discussing the quality of the underlying business deserves far more of our time and effort than the optical valuation of a company. We believe one cannot possibly get a handle on the various assumptions needed to value a company appropriately without understanding the business in depth. We have made these mistakes in the past and inadvertently moved down the quality curve.

As stewards of our clients' capital, we believe quality should always outweigh price. First, we determine whether a company is of sufficiently high quality to own for the long term, then we aim to buy it at a reasonable or attractive price – perhaps during a temporary weakness or the indiscriminate market sell-off that happens from time to time. After we have purchased a company's stock, we consider ourselves as part owners of a business, rather than just a piece of paper. We hope that we will never need to sell, and that our investee companies will grow sustainably and over a long period. As we have learnt the hard way, divesting a high quality company because of high short-term optical valuations usually turns out to be a mistake in the long run. Selling for the sake of switching into a poorer quality business at a lower price usually compounds the error.

Lastly, I would like to express my gratitude to all of our investors, especially those who were willing to take a leap of faith with us in the early days of the FSSA Japan Equity strategy. Without your support and understanding, and your encouragement along the way, we would not have been able to get this far. Although the strategy is still relatively young, we believe our commitment to continuous learning and being open-minded are among our biggest competitive advantages. We have a supportive team structure, which allows us to admit our weaknesses and mistakes – so that we can learn from them and evolve our investment approach. We think it is important to reflect on our investment decisions, guarding against ego and denial; and while we may make mistakes from time to time, we believe every one of them is a learning opportunity that can ultimately lead to positive outcomes for our client portfolios.

[4] As at 31 December 2020

Source: Company data retrieved from company annual reports or other such investor reports. As at 31 December 2020 or otherwise noted.

Important Information