



Tatsuro NIGAURI, CMA
Senior Portfolio Manager

Views from the Japan Equities Small Cap Desk

COVID-19: Impact and considerations for Japan Small Cap Equities

What is your reaction to recent market events?

The short-term economic downturn caused by coronavirus appears to be substantial. However, the disease is not so serious as to severely restrict the activities of people in the long term and the cause is clear even if the economy deteriorates. Furthermore, we expect that governments are likely to implement political countermeasures to cope with the economic slowdown. On 10 March the Japanese government announced a set of emergency measures in response to the coronavirus outbreak. These measures include 119.2 billion yen to support business activities and employment, a 1.1 trillion yen additional loan package and 430.8 billion yen spending package to help medical professionals and those affected by school closures. There are expected to be additional measures announced next week.

Have you made any changes to your approach?

This is a strategy which focuses on fundamentals and accepts that there will be short-term market noise. We believe that a normally functioning market is one that ultimately recognises and realises the intrinsic value of companies. This is a belief based on three decades of investment experience in the Japanese small cap market through different market cycles. We believe that this approach holds true today. We will stick to our investment philosophy and approach, although we may make some adjustments to our current portfolio if any unexpected events happen.

Where do you see opportunities in the current market?

We invest in deeply undervalued companies with sustainable mid-to-long term earnings growth. In the current market, many companies in manufacturing sector are deeply undervalued. The rationale for our exposure to manufacturing names is very simple - the biggest reason is their attractive and low valuations. Our top holding as at the end of February is Nichias (5393) which has strengths in various fields, such as fire-resistance materials, sealing materials and parts for semiconductor production equipment. It has a 1 year expected PER of 7.86x (as at 13 March 2020). By comparison the PER of Russell/Nomura Small was 12.49x (as at the 13 March 2020). There are many companies that have excellent technologies in specific areas. We believe that the excellent technologies of our investee companies enable them to have tolerance to business performance deterioration, even during a severe economic downturn and to realize growth in the medium to long-term.

We are also interested in IPO names that were listed in the last six months and have sold-off excessively. These could present a buying opportunity.

Which sectors do you expect to be most affected?

We expect the service sector and good-related industries to be impacted due to the cancellation of events and as a result of restrictions imposed to curtail the further spread of the virus. These sectors are particularly sensitive due to the timing before the Olympic season. ‘In-bound’ names which depend on sales from foreign tourist such as from China and elsewhere would also be disproportionately affected by the current economic situation. We do not have much exposure to such names.

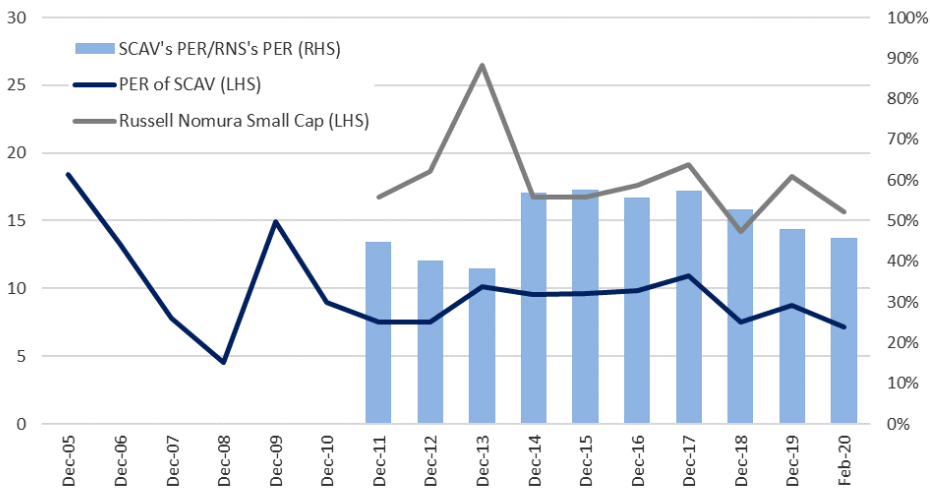
We expect “supply chain” problems to occur in various business areas like automobile and apparel. However, we consider that these problems to basically be a one-off. They can expect to benefit from pent-up demand later on.

How do you mitigate against risk in the portfolio?

We continue to see potential risk with companies that have extremely high valuations i.e. ‘unicorn’ companies and mature companies with excessive debt. We avoid these companies and favour steady but unexciting companies with good management who have carved out a niche in their sector and can deliver sustainable earnings growth.

We are careful to check whether an investee company’s real debt to equity ratio (adjusted for goodwill) is within an appropriate range for the risks inherent in the business. We consider discount forward EPS of companies with weak financial fundamentals when we make projections, resulting in a low weight for such companies.

PER at very low levels



- We have a disciplined focus on PER which we believe to be the most effective indicator for Japanese small cap market.
- Using PER as both a valuation metric and indicator of future earnings.
- The chart above demonstrates that the strategy is adhering to its philosophy which is to target undervalued companies in the Japanese small and micro-cap market.

Final thoughts

Whilst macro-economic events can have a large impact on investor sentiment, it is my belief that it is the fundamentals and earnings growth potential of the underlying securities that determines performance over the long-term. I have a long track record of managing small cap stocks through several market cycles (strategy inception date is 2004). Through my research and company meetings of this under-researched sector I seek to establish a company's true intrinsic value and catalyst for stock price change. I take a long-term view and believe that the true value will be recognised in time. The current environment presents opportunities for a stock-picker with experience in identifying undervalued companies with strong fundamentals.

Tatsuro NIGAURI, CMA
Senior Portfolio Manager, Japan Equity Small Cap Absolute Value

Tatsuro Nigauri is a Japanese small-cap equities manager with three decades of experience managing money based in Tokyo. He joined the firm in Oct 2002 and has managed the Japan Equity Small Cap Absolute Value strategy since its inception in 2004 and the UCITS funds since their launch in 2017. He started his career as a research analyst at the Daiwa Institute of Research in 1991. Nigauri is an award-winning manager and has received many accolades, including the Lipper Fund Awards Japan (2012, 2013 and 2016), the R&I (Rating and Investment Information) Fund Awards (consecutive years from 2012-2019) and the J Money Fund Awards (2016 and 2017).

He obtained a BA degree in economics from the University of Tokyo in Japan, and is a Certified Member Analyst of the Security Analysts Association of Japan.

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Contact Details

Business Development and Client Relations

Phone: +44 (0) 20 7507 6400

Email: smdukmarketing@smd-am.co.jp

Sumitomo Mitsui DS Asset Management (UK) Limited
5 King William Street, London, EC4N 7DA
United Kingdom
www.smd-am.co.uk

