

Views from the Japan Equities Small Cap Desk

Author



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“A once in a decade opportunity”

Until the middle of 2020, we saw a fear driven market where value stocks were out of favour due to concerns about the impact of the pandemic on the real economy. This sentiment subsided in the last quarter of 2020 and this year we have seen improved sentiment towards companies that will benefit from the opening of economies.

Despite the rotation into large cap value orientated stocks this year, Mr Nigari believes that there is still a lot of hidden value in the small cap sector that is yet to be fully recognised. His belief is that current valuations of some companies are at “once in a decade lows”. When these fundamental strengths are recognised the subsequent increase in valuations should be strong.

How have interactions with companies changed due to COVID-19?

Up until June last year the number of meetings declined. But they have increased since then, but they are all now all conducted over video conference.

There are two reasons why meetings have increased again:

1. People have got used to conducting meetings remotely
2. Earnings visibility is clearer so companies are keener to speak with investors

Can you tell us more about the impact on the quality of meetings?

The quality of meetings is good where there has been previous contact. But it's true that virtual meetings are not as good when compared to meeting face to face, especially when there has been no prior contact and this is the first meeting with company management. However one advantage of technology is that the frequency of meetings can be increased to compensate and improve the quality of information obtained.

What have you changed in the portfolio over the past 6 months?

My portfolio turnover in 2020 was around 31%¹. This is in line with historical levels. I've not made many changes to the portfolio over the last 6 months. Just some transactions to meet investors flows.

Can you tell us some more about your highest conviction stock?

G-TEKT has been one of the largest portfolio weights (4.72% as at 31 Jan 2021²) They are a specialist manufacturer of autobody components and to a lesser extent transmission parts. They use specialist technology to optimise the design of parts for both safety and environmental requirements. They mainly supply Honda. Auto parts are very profitable and have maintained profitability throughout 2020. I believe they can increase their share of business over the medium term and that they can make the transition to electric vehicles.

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Your largest sector weight is Construction & Materials. Please explain why you favour this sector?

Constructions and materials were the largest sectors at 27% as at the end January 2021³. This is an output of my bottom-up stock-picking approach and I do not make top-down sector bets. Bear in mind that sector classifications can be somewhat misleading and do not reflect the diverse nature of companies within a sector. For example, G-TEKT which is an auto parts maker falls into this category rather than Automobiles & Transportation equipment.

How do you look at price to book ratios (PBR) and how reliable is it?

In my investment process I utilise price to earnings ratio (PER) when analysing stocks. I believe PER to be the most effective indicator for Japanese small caps. However during the pandemic when earnings visibility has not been so good, PBR is the next best thing.

PBR has been very low for small caps over last few years and has diverged from large caps in this respect. The balance sheets of companies in my portfolio are very solid and I do not worry about stranded assets. The companies I hold are very cheap when compared to the Russell Nomura Small Cap Index, with a PBR of 0.6 for the fund vs 1.0 for the index². Mispricing is based on small caps being out of favour and not based on the company fundamentals.

Who are the buyers of Japanese small and micro-caps?

It is fair to say that year to date significant flows have gone to Japanese large caps and we've not yet seen that to the same extent with Japanese small caps. I can't predict who the significant buyers will be. It could be foreign investors, institutional or domestic high net worth investors. One thing is clear, because there is not much supply (of these small cap companies), an increase in buyers will push the price up. The change in sentiment can happen very rapidly, as it has done in previous cycles when valuations have been depressed as in 2008-09 and 2001. We just cannot be sure of the exact timing.

How compelling is the current environment for your strategy versus other markets historically?

In 2008-09 markets were very cheap and again in 2001. Valuations gaps were large both times and then they re-priced. I see a similar opportunity this time in terms of the valuation gap. So in my opinion, this is a once in a decade opportunity.

Sources:

1. Sumitomo Mitsui DS Asset Management (SMDAM), Dec 2020
2. SMDAM, Jan 2021
3. SMDAM, Jan 2021. Sector classification is TOPIX-17 Series.

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About the Japan Equity Small Cap Absolute Value Fund – Fund philosophy and investment approach

❑ Find the hidden gems

Pure bottom-up, research-driven, stock picking approach that seeks to uncover attractive small and micro-cap companies at deep discounts from their intrinsic value. Aims to deliver strong returns in the medium to long term by focusing on company fundamentals specifically PER which we believe to be the most effective indicator for Japanese small caps.

❑ Deep knowledge of the local market

This research driven approach sees the portfolio manager visit many hundreds of companies each year. By maintaining this value investment approach backed by extensive research, we are able to uncover companies with true earnings potential and exploit opportunities that existing within the Japan small cap market.

❑ Time is our ally

We typically hold a stock until the market notices and corrects the undervaluation. We can be patient and take a long-term view due to our extensive proprietary company research and the fundamentals of the companies in which we invest.

About Tatsuro NIGARI, CMA

Mr Tatsuro Nigari 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. M Nigari 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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We are an active investment management company headquartered in Tokyo, Japan with regional offices in London, New York, Hong Kong, Singapore and Shanghai. We currently manage assets in excess of USD143 billion globally †. With nearly five decades of experience in managing assets on behalf of institutional investors, we take advantage of our regional investment presence and in-depth research-driven approach to deliver a competitive edge for investors. For more information please visit our website at www.smd-am.co.uk.

NOTE: Daiwa SB Investments Ltd. (DSBI) merged with Sumitomo Mitsui Asset Management Company, Limited (SMAM) on 1 April 2019.

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