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Views from the Japan Equities Small Cap Desk

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Quarterly results disclosure is the most appropriate frequency

The new Prime Minister, Fumio Kishida, is proposing a review of quarterly disclosure requirements, and of course I am opposed to it. In the first place, I cannot comprehend how reducing the frequency of financial results reporting could be beneficial for non-shareholding stakeholders. If business management was being distorted to achieve short-term profits it would be a different story, but I don't think that most Japanese business managers, for better or for worse, put shareholders first to begin with.

In most cases, I think quarterly is the most appropriate frequency for external investors to check business conditions (that's why the corporate quarterly report has been around for over 80 years). I was an analyst during the half-year accounting era, and the basic rule was to conduct a review three months after the announcement of results. The disclosure of information was discretionary and based on a relationship of trust, which I felt was problematic in terms of fairness and accuracy. The best approach would be to publish and make widely available a minimum set of figures, and when you want to convey more nuanced details to communicate these as well.

Second quarter results not as uplifting as first quarter

The results for the July to September period, which were announced amidst the debate about the review, were as expected not as uplifting as those for the January to March and April to June periods, although they were still strong overall. In addition to the recovery of domestic demand being setback due to the fifth wave of COVID-19, the constraints on supply and high costs caused by lockdowns in South-East Asia, power shortages in China and semiconductor and container shortages led to significantly varied results, particularly in the manufacturing sector.

The upstream materials industry is still performing well. Demand for products is generally strong and price increases are possible, which means that the benefit of sales can outweigh the impact of high raw material prices. Based on the current context, I feel that even if a high carbon tax were introduced, it will be very difficult to curb carbon dioxide emissions during a boom period.

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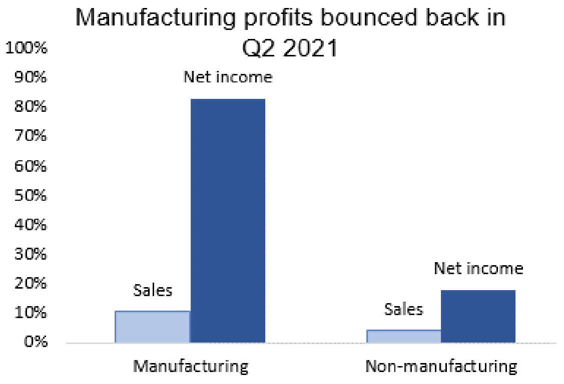

Note: Percentage change is compared to the same period in the previous year.

Source: Data from Quick and SMBC Nikko Securities.

Raw materials prices increased, assembly profits fell in Jul-Sep 2021

Company (code)	Net income (bn yen)	YOY Change (bn yen)	Company (code)	Net income (bn yen)	YOY Change (bn yen)
Nippon Steel (5401)	136.5	285.6	SBG (9984)	-397.9	-1025.4
Nippon Yusen (9101)	260.2	249.7	Sony (6758)	213.1	-245.4
Hitachi (6501)	200.2	172.7	JAPEX (1662)	-126.7	-129.3
Mitsui & Co. (8031)	213.3	165.8	Honda (7267)	166.6	-74.2
Toyota (7203)	626.6	156.1	Chubu Electric Power (9502)	8.8	-71.9
Sumitomo Corp. (8053)	133.7	152.8	Nomura (8604)	3.2	-64.4
Mitsui OSK Lines (9104)	170.7	145.9	Suzuki (7269)	15.7	-36.7
JFE (5411)	78.7	145.2	Sekisui (4204)	-16.4	-29.8
Kawasaki Kisen Kaisha (9107	144	133.4	Nintendo (7974)	79	-27.5
Mitsubishi Corp. (8058)	172.9	122.9	TEPCO (9501)	91.6	-27.1

Note: Red denotes raw materials, green denotes assembly.

Source: Data from Bloomberg.

However, we should not take these good conditions for granted. In addition to the long-term issue of carbon emissions, the current level of demand has been inflated by both monetary and fiscal measures in response to the pandemic in developed countries, and as I will touch upon later, there is a considerable amount of investment in inventory. In light of this, I think it is important to make investment decisions based on the assumption that stocks will fall at some point (in fact, that seems to be the way prices have been formed).

On the other hand, in the downstream processing and assembly industry, there were many examples of the negative impact of the aforementioned factors. Even in the buoyant electronic components industry, which has remained largely unaffected by the coronavirus pandemic, we have heard countless stories of production being restricted by lockdowns in South East Asia for products that rely heavily on time-consuming assembly and inspection processes.

The negative impact of this is even more pronounced when it comes to final products. In many sectors, supply constraints have resulted in delays to the sales period and missing out on sales altogether, because if even one component is missing production is impossible. This problem is even more acute in modern industrial products, where the complexity of design and the rigour of quality assurance make it hard to change component manufacturers.

In the automotive sector, where the impact of the crisis has been most apparent, Toyota Motor Corporation continued steady production in the period from April to June thanks to a careful procurement strategy while other companies were struggling with the shortage of semiconductors. However, from September they were forced to scale back production due to a shortage of wiring harnesses caused by lockdowns in South East Asia, which had a knock-on effect on a number of related companies. Further, in the July to September period, the impact of supply constraints started to manifest for a wide range of companies, including sectors such as general machinery and electrical machinery that had not yet been affected.

Inventory levels are rising

As I solely invest in medium-sized companies, my coverage of the manufacturing sector is mainly processing and component manufacturers, but my general impression is that inventory levels are rising strongly. This is partly because of an intentional accumulation of inventories in response to the economic situation, and partly because inventories of other materials have built up due to supply constraints that halted planned production. In any case, at each stage of manufacturing and further downstream in the distribution industry, inventories are certainly increasing.

In contrast, on the sales side, we have noticed that the decline in production of screws and other automotive parts, which are relatively easily acquired, has been smaller than the decline in production of finished cars. Presumably, this is because customers are building up inventories, either to level out their operations or to prepare for a deterioration of current conditions.

In this context, it is difficult to know which companies to invest in. If you want to bet on fourth-quarter or full-year results, you should aim for companies whose performance has been affected by temporary factors, but, with the exception of a few companies, there is no clear exit in sight. I am buying more shares in companies that show good results, with a good outlook, that are undervalued, as well as extremely undervalued companies that are expected to recover to some extent in the coming quarter.

At any rate, in order to invest with an eye on a company's medium to long-term prospects, it is necessary to keep a close eye on their current figures. As well as calling for a calm response from governing authorities, investors need to take a longer-term view and not be swayed by short-term wins and losses.

Source: Based on an article by Tatsuro NIGAURI, published in The Nikkei Online Edition on 7 December 2021.

About Tatsuro NIGAURI, CMA

Mr Tatsuro Nigauri is a highly experienced Japanese small-cap equities specialist based in Tokyo. He joined the firm in October 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.

Mr 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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NOTES:
† Source: SMDAM, as at 31 March 2021.
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