

Sumitomo Mitsui DS Asset Management

Why Small Cap Value in Japan?

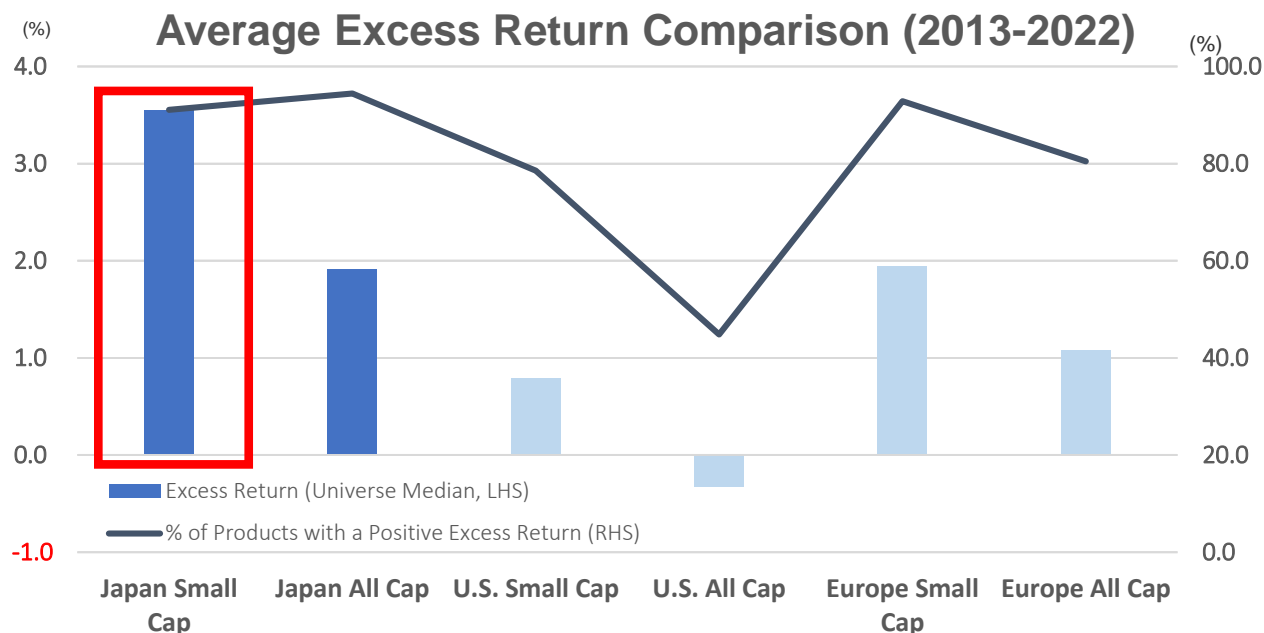
September 2023

Executive Summary

- Most global investors take exposure to Japan through indices or well-known large-caps. Many investors do not know that Japan has a long tail of smaller listed companies as they are difficult to access through off the shelf and passive products.
- The highest returns have been found in the long tail. **Outperformance of value small caps has been even more significant.** What is more, whilst many investors think of small caps as higher risk, **annualised volatility for small cap value has been lower than that of the all cap TOPIX index.**
- Higher levels of information asymmetry due to insufficient analyst coverage create convex opportunities in the small cap segment of the market. **Especially in undervalued names neglected by the market** – with limited risk of ownership.
- Small cap stocks' valuations are attractive compared to history and larger stocks.
- Higher retail investors' participation can lead to **sentiment and behavioural factors dictating volatility**, fundamental analysis is consistently rewarded.
- Lower correlation to other global equities **improves risk return profile of an investor's portfolio more than an allocation to Japanese large caps.**
- Major structural change in Japan is likely to benefit small caps which are more nimble in terms of structure and decision making, and less diversified in terms of business exposure.

Japanese Active Small Cap Equity Managers Consistently Deliver Alpha

- Amongst developed market equities, whilst **passive investing may be more suitable in the US market**, analysis using eVestment on active managers shows that **Japanese small cap managers consistently deliver alpha**.
- We attribute this to Japan being a more **relatively inefficient market**. This paper will explain several key reasons why investors should **approach Japan through small caps and particularly Small Cap Value**.

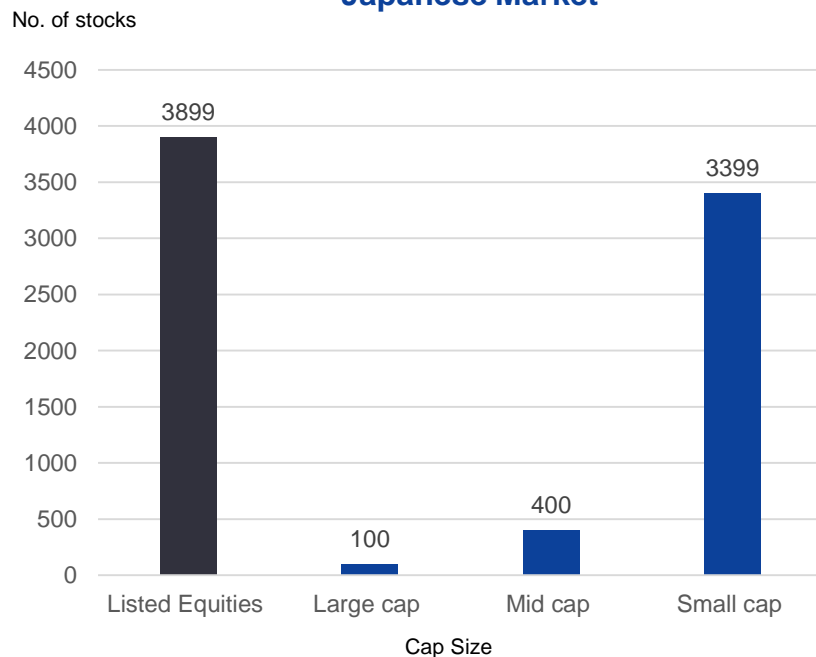


Source: eVestment, data for the period from January 2013 to December 2022
 Universe: eVestment Universe (MSCI relevant benchmark for all comparison)

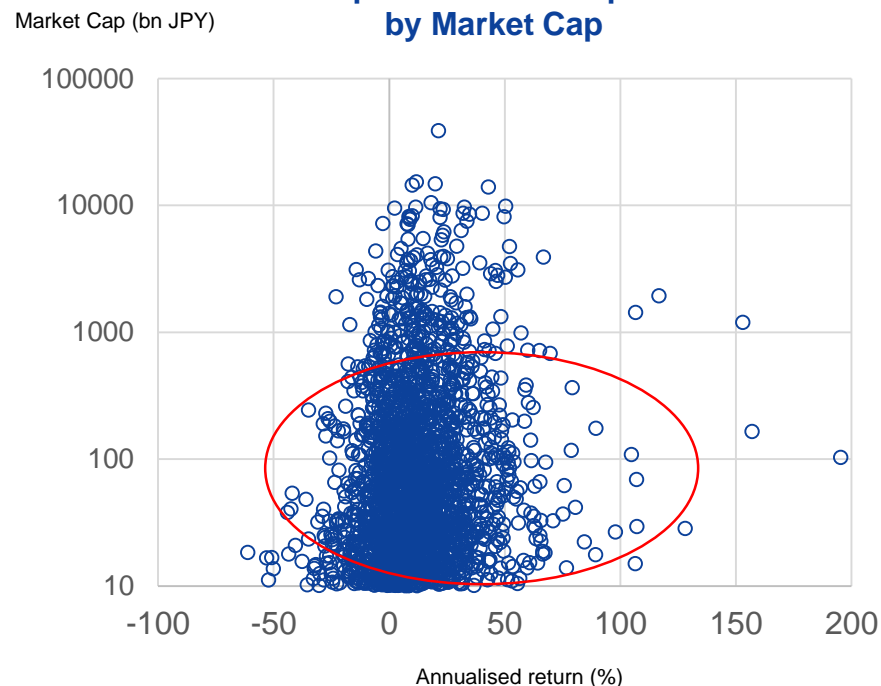
1. Vast Opportunity Set Under the Radar

- Combination of an extremely large universe, wider dispersion in return among smaller companies creates attractive opportunity set in Japanese Small Caps for fundamentally driven stock pickers.

Market Cap Classification of Japanese Market



3 Year Annualised Return Dispersion in Japanese Listed Equities by Market Cap

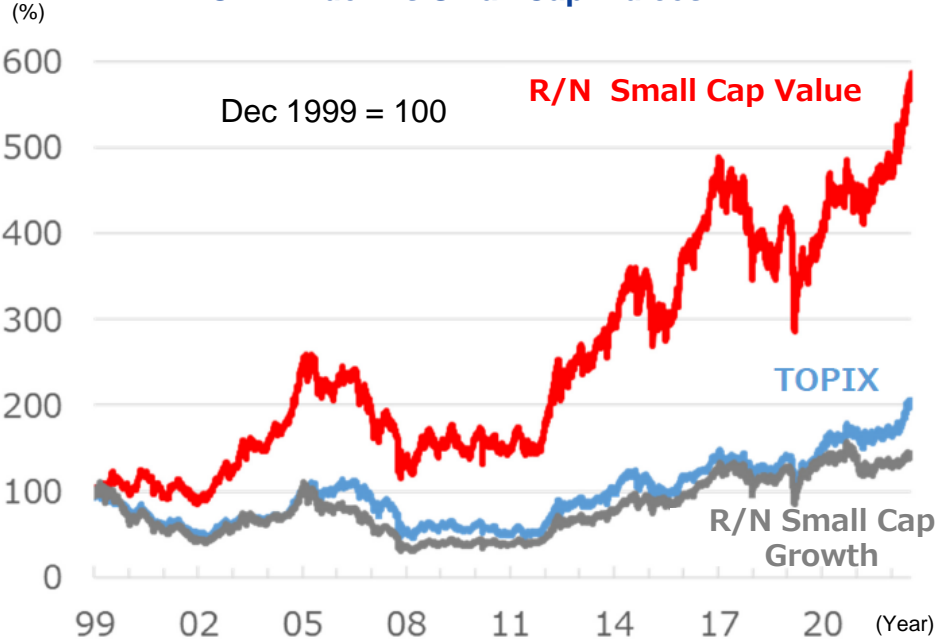


Source: Bloomberg as at 31 July 2023
Definition: Small cap includes all of the listed companies which are not members of TOPIX Core 30, Large 70, or Mid 400

2. Highest Returns have been in Small Caps

- Highest returns have been found in the long tail of smaller companies as small cap index outperforms over time.
- Undervalued and under covered small caps have consistently been the strongest performing segment with lower volatility.

TOPIX Index vs Small Cap Indices



Source: Bloomberg, compiled by SMDAM
 As at 31 July 2023, Russell Nomura Small Cap Value Data December 1999 – July 2023
 Indices: TOPIX Total Return, Russell Nomura Small Cap Value Total Return, Russell Nomura Small Cap Growth Total Return

Annualised Risk/Return

























	TOPIX	Russell Nomura Small cap Value	Russell Nomura Small Cap Growth
Return	3.1%	7.8%	1.6%
Risk	20.9%	19.4%	20.4%

Source: Bloomberg, compiled by SMDAM
 As at 31 July 2023, Russell Nomura Small Cap Value Data December 1999 – July 2023
 Return: Cumulative return annualised, Risk: Standard deviation of daily return annualised

Risk warnings: Performance is shown in JPY, the return may increase or decrease as a result of currency fluctuations, and is gross of fees (after trading expenses). Past performance is not a reliable indicator of future performance and may not be repeated. An investment's value and the income deriving from it may fall, as well as rise, due to market fluctuations. Investors may not get back the amount originally invested.

3. Information Asymmetry in Small caps

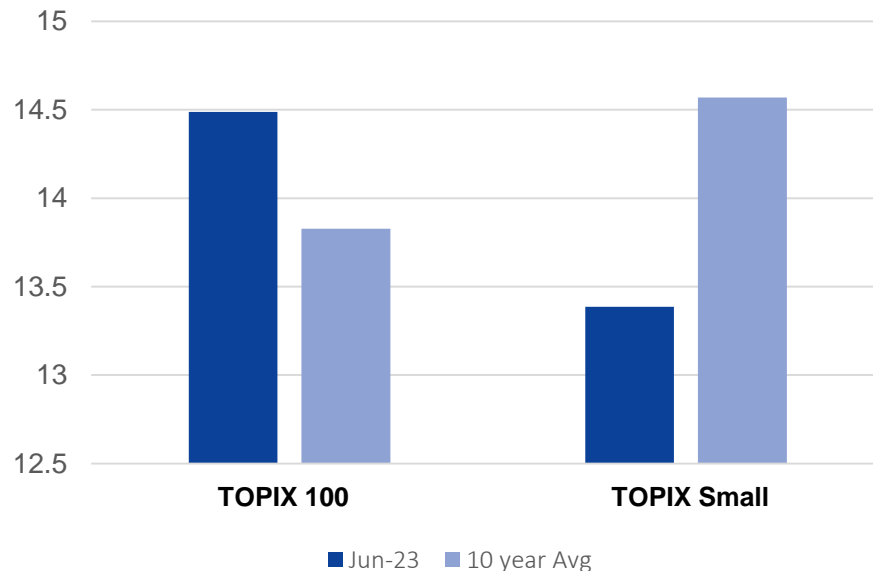
- Analyst coverage ratio is low relative to large cap Japanese stocks, contributing to mispricing.

The Average Number of Sell-side Analyst Coverage per Company																	
No	Index	Average Number															
1	TOPIX 100 Index (Large Cap)	15.5															
2	TOPIX 400 Index (Mid Cap)	7.9															
3	TOPIX Small Index (Small Cap)	1.0															

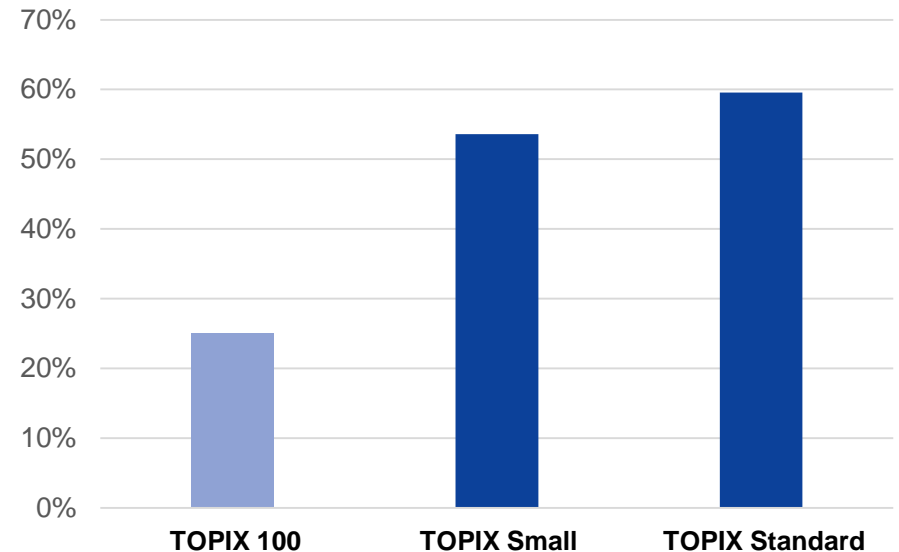
4. Undemanding Valuations

- Small Caps are currently cheap in terms of both price to earnings and price to book in absolute terms and relative to history.

Price to Earnings of TOPIX Large & TOPIX Small and 10 year Average



Percentage of Companies Trading at Below 1x Price to Book



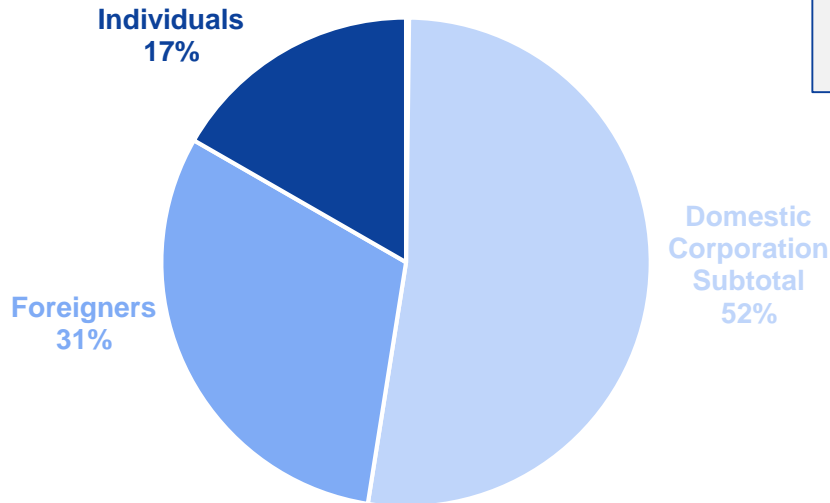
Source: Bloomberg, data as at 30 June 2023

TOPIX 100 represent 100 largest stocks by Market caps; TOPIX Small represent all stocks whose Market caps are below top 500 on the Tokyo Stock Exchange. TOPIX Standard: The TOPIX Standard segment of the Tokyo Stock Exchange

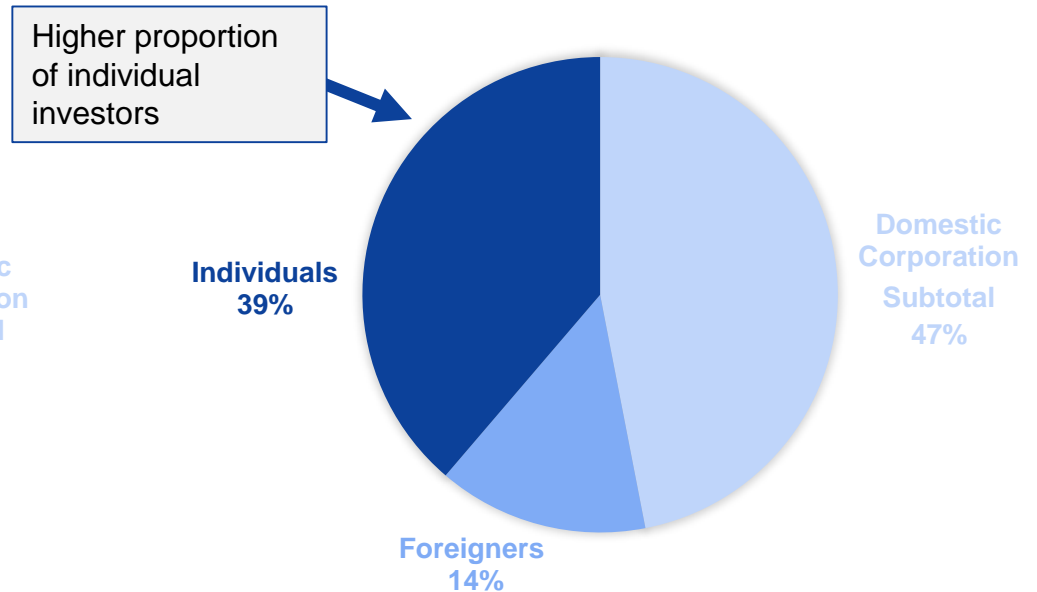
5. Equity Ownership Base Contributes to Opportunities

- Higher participation of retail investors In Japanese small cap markets. Equity ownership structure is different to US small cap markets.

Equity Ownership by Market Cap of Prime Market
(Larger stocks)



EQUITY OWNERSHIP BY MARKET CAP OF NON-PRIME MARKETS (SMALLER STOCKS)



6. Low Correlation with Global Equities

- Our Fund (Japan Equity Small Cap Absolute value) has lower correlation with commonly held global equities compared to Japan all-caps, improving risk/return profile outcome.

5 Year Monthly Correlation Analysis

The Fund	1.00						
Russell 2000	0.64	1.00					
S&P 500	0.59	0.90	1.00				
Nikkei 225	0.78	0.82	0.77	1.00			
MSCI Japan	0.85	0.81	0.77	0.97	1.00		
Nasdaq	0.46	0.80	0.93	0.70	0.69	1.00	
Stoxx Europe 600	0.66	0.86	0.89	0.74	0.78	0.76	1.00

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