PORTFOLIO MANAGER Q&A | NOVEMBER 2022

FINDING ATTRACTIVE VALUATIONS: RESEARCH NOTES FROM JAPAN

Equity Portfolio Manager Reid Galas recently returned from his first post-Covid investment research trip to Japan. We sat down with him to hear about companies' improving shareholder focus, robust balance sheets, and optimistic management teams. Learn more about why he feels Japan might be the most attractive market globally today.

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Q: It's been a while since you traveled to Japan to meet with company management teams there, thanks to Covid. Did anything surprise you during your trip?

Reid: I've been making annual or semi-annual investment research trips to Japan every year, barring Covid, for the last 15 years. This trip was the first time I recall Japanese companies being more upbeat about their prospects than their peers. I believe this was at least partially related to Japan just emerging from a series of Covid related restrictions, a year or more after the US and EU. This shift to non-synchronized economic cycles, for the first time since the financial crisis, is one reason I'm bullish on Japan.

Somewhat related, I was in Japan before it opened up to tourists. So my hotel was very empty, although Tokyo was just as dynamic as usual. The exchange rate though! I knew that the US dollar was strong, but having grown up with the view that Japan is expensive, it was quite a surprise to see how affordable it has become to visitors. The economy has had little inflation in the last 30 years and now the currency is weak too. It's a great time to be using US dollars to buy things priced in yen.

Q: Do you feel like anything has meaningfully changed since you were last there?

Reid: The prices for one. The other difference is the continued move towards a shareholder focus at many Japanese companies. We still do not get all the actions or responses we'd like, but when we talk to management teams about shareholder returns with a focus on profitability and capital allocation, I now hear at least a recognition that these principles matter.

FINDING ATTRACTIVE VALUATIONS: RESEARCH NOTES FROM JAPAN *continued*

Q: What else came through in your meetings with company management teams?

Reid: Given that I hadn't visited Japan since 2019, I spent most of my time with existing portfolio companies and I'm pleased to report that there were not any large surprises. The sense of improving business was palpable and our view on the value of labor seemed to be borne out as well, with almost every company saying their biggest business constraint was finding qualified workers. We have invested heavily behind this theme so it was positive to see it playing out as expected.

Q: What can you learn by visiting companies versus talking to management teams via video conference or phone call?

Reid: Generally I think we can get about 80% of the value from a video meeting. Building relationships, which is important in Japan if you want to have frank and meaningful discussions, really needs to happen in person though. I also get a lot of value from the informal discussions that take place outside the context of the meeting. It can be talking as we walk through the office, the ability to ask about visual cues, a better sense of tone, as well as the ability to talk with people outside of the core investor relations and senior management ranks.

In addition, when we do investment research trips we are normally seeing four to five companies a day, every day, for one to two weeks. There is a good deal of insight that comes from being able to compare and contrast answers and themes among even unrelated businesses.

Q: What's the most encouraging thing you're seeing in Tokyo, from a markets/investing perspective?

Reid: We focus on investing in individual companies but also pay attention to macroeconomic factors — combined, Japan is probably the most attractive market globally. The currency gives us the ability to pick up world-class companies on the cheap. Decades of deflation are finally ending. Shareholder returns are in focus. Valuations, even in local currency are extremely attractive. Balance sheets are incredibly robust, which means that rising interest rates are probably going to help, not hurt, our investments. The Japanese economy is emerging from Covid just as many other developed markets are slowing down, providing us investment opportunities out of synch with other market cycles.

Q: What's the most discouraging?

Reid: The macro concerns around Bank of Japan policy and what it will mean when its yield curve control policy, implemented in 2016 with the aim of bringing inflation in Japan to a 2% target, finally ends is a big uncertainty. The 10-year yield has not been market determined since yield curve control started, so there is risk on where it will go once the policy ends, and what problems such a sudden move in yields would trigger. Also, the continued supply chain disruptions, hopefully now ending — especially in the important auto industry — have kept some businesses from being able to capitalize on strong demand. And while it is improving, it can still be frustrating to see so many over-capitalized, "lazy," balance sheets.

Q: Has anything you've seen or experienced reshaped what you consider to be your opportunity set?

Reid: I did have several meetings that caused us to make changes in our portfolio. They were generally around margin opportunities not being as positive as I had expected. Given the huge number of attractive companies on offer we decided to exit a few positions to free up space in the portfolio.

FINDING ATTRACTIVE VALUATIONS: RESEARCH NOTES FROM JAPAN *continued*

Q: What are the biggest challenges Japan is facing now?

Reid: There are no real secrets here and the challenges are pretty well understood. There is a major shortage of skilled labor. The Bank of Japan policy has future crisis written all over it. Japanese companies are more exposed to China than what we see in the US. Given the proximity of the two countries this is to be expected, but is worrisome given my view of China's economic outlook. After a long period of stability in Japan under former Prime Minister Shinzo Abe, it appears to me that we might be back in the revolving door of unpopular and short-lived governments. Finally, if the rest of the world goes into recession, Japan won't be immune.

Q: Are you seeing any unexpected generational differences?

Reid: There has been a big improvement, from my perspective, in the current generation of company management.

Q: Are businesses embracing change and staying competitive?

Reid: Japanese companies have long been some of the best in the world. In order to remain profitable and competitive after decades of deflation, the survivors are constantly looking to improve efficiency and reduce costs. My experience, however, has been that they can be a bit slow to embrace new technology. The structure of companies plays a big role in this — for example, most Japanese companies outsource much of their core tech functions. I often see a gap of several years between key trends in the US and Japan. This has provided us with some attractive investment opportunities, as we're essentially able to see how things turn out in one market and leverage that in another.

Q: How is urban life — have things returned to pre-Covid levels?

Reid: Japan is a pleasure to visit. This time there were no tourists, which I enjoyed. Many offices are employing a hybrid approach to work post-Covid. But the people and cities were just as welcoming as ever. I'd encourage everyone to take advantage of the exchange rate and visit.