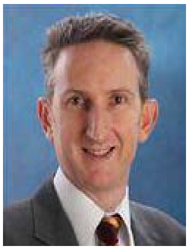
INSIGHTS

December 2013

Japan Equity 2014 Outlook

Valuation Anomalies Offer Ample Opportunities



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What a difference a year makes! The Abe government's aggressive reflationary policies brought Japan's extremely under-valued market into focus which surged in late 2012 and into 2013.

Few would have predicted such stellar performance – many ignored the market's significant upside potential. The Nikkei rose nearly 80%[1] from its November 2012 low to mid-November 2013.

I believe this unexpected performance highlights an important facet that is central to the way we think about markets and how we make investment decisions within the team. I would argue that regardless of geography, industry or asset class, future market outcomes are inherently ambiguous.

I believe it is almost impossible to consistently get shorter term forecasts right and often fruitless to base decisions around them. In my opinion, shorter term forecasts are no more successful than "predicting" a coin toss. One thing we did know was that Japan was cheap!

Armed with this philosophy, how are we looking to improve the odds of success in 2014 and beyond?

There is one vital element common amongst all stocks we hold. It is the significant gap between the price of the stock and the fundamental value of the underlying company. This vital element is not dependent on the nature of the business or macroeconomic themes or government policy that the market perceives to be important.

I have no doubt that holding only the most attractively priced bargains delivered our strong performance in 2013. Where extreme valuation gaps exist, the greatest opportunities will likely be found.

Source : [1]Bloomberg, Nov 2013

A quick look at how we positioned ourselves over the last couple of years should clarify our investment philosophy in practice. In doing so, please bear in mind that our investment decisions often take the opposite stance to what the broader market is focused on and loves.

Profit opportunities grew as the valuation gap between the compelling bargains and expensive names widened

Throughout 2012, the gap continued to widen between the compelling bargains and the expensive names. We therefore had an ideal opportunity to take profit on a number of domestic names that were becoming more expensive. The proceeds were invested in a number bargains we had identified, such as in financials and technology related stocks.

Ultimately this “repositioning” served us very well in 2013.

Towards the end of 2012 and into 2013, market sentiment improved rapidly on the Abe government’s reflationary policies. The unloved and extremely cheap names were rediscovered by the market and began to do well. We were very well placed to benefit from this change in market behavior as financials and companies related to the global economic cycle, delivered some of our funds’ greatest returns.

Valuation upside exists in a number of major Japanese banks.

Perhaps financials are a good example of how cheap many stocks had become in recent years. Whilst rising share prices have enabled us to take profits, there is still good valuation upside in a number of major banks, which remain well capitalised. Many are well placed to cherry pick international business and expand their overseas loans. In fact, some Japanese banks are already taking the lead in unexpected areas such as global project financing. With European banks expected to remain cautious about major financing projects, Japanese banks are becoming a major presence in the field.

Offshore growth is also helping boost overall loan growth and profits. Overseas loans[2] have now reached 20-22% of total across the megabanks, with 40-50% of these loans in Asia, and the remainder split roughly equally between the Americas and Europe.

On top of all this, the banks we like have good asset quality and some of the lowest market value to deposit ratios globally.

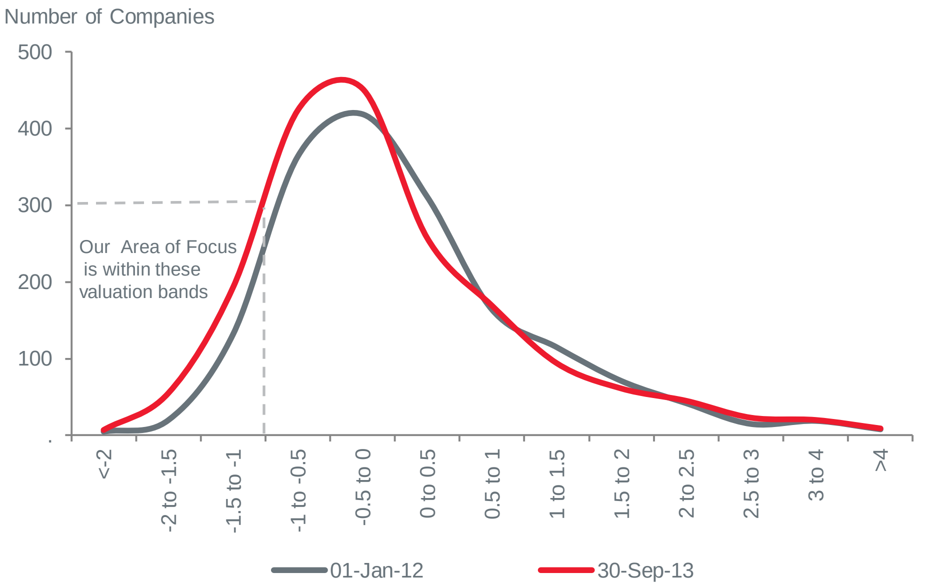
Source : [2] Eastspring Investments Singapore, Nov 2013

Given the renewed interest in Japan equities, a common question many clients have been asking, “What investment opportunities exist today?”

We exploit valuation anomalies by stock – and we can see ample opportunities in 2014.

Reassuringly, our analysis suggests that there is a wider spread of valuation today, which means there are more cheap valuation outliers now than in 2012. This means we can identify a long tail of out-of-favour bargains that offer new sources of potential outperformance to replace those stocks that have already outperformed.

Chart 1 : 2013’s wider valuation dispersion suggests ample investment opportunities



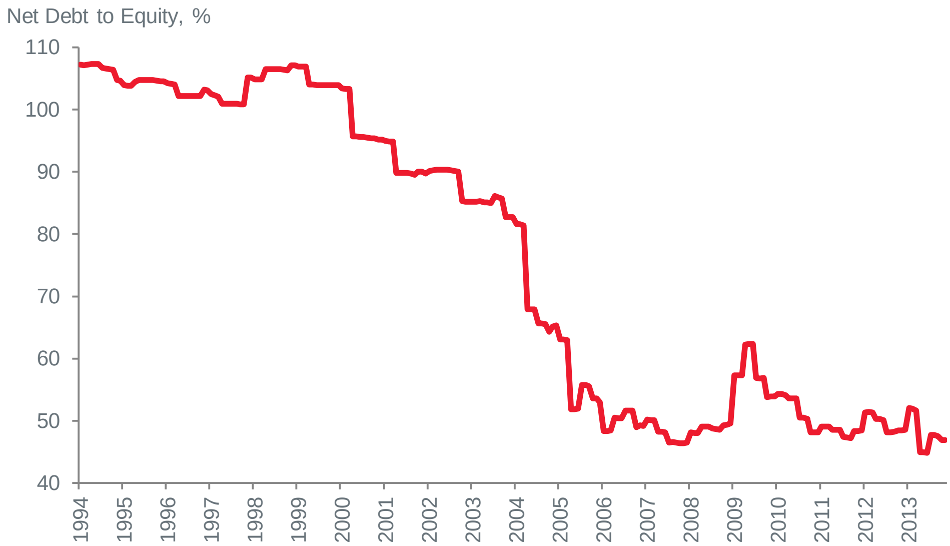
Source: Eastspring Investments Singapore as at 30 September 2013. The valuation bands on the x-axis are based on Price to book ratio relative to the investible universe

“What makes this investment opportunity sustainable?” is another question we commonly receive. My observation is that many crucial changes at the company level have not been fully recognized (or indeed recognized at all) by the broader market. Whilst opportunities exist now, we also believe these crucial changes are likely to drive future market performance over the medium term.

Firstly, strong balance sheet health points to sustainability with significant levels of free cash flow being generated and used to invest in new businesses, repay debt, and return value to shareholders via dividends and buy-backs.

Second is the meaningful change we have observed in corporate attitudes. This change points to a competitive edge that can drive profitability for such companies. Many companies have refocused on core businesses; are moving to higher margin business models; and are using their strong balance sheets to pursue sensible merger and acquisition opportunities to gain overseas market access and to diversify into complimentary products.

Chart 2 : Strong balance sheets suggest that Japan's corporates possess the competitive edge to drive profitability



Source: Thomson Reuters Datastream as at 1 Nov 2013

Abenomics has triggered a renewed focus on Japanese equities.

Our clients are also very interested in "Abenomics" and the policy impact for 2014. In our opinion, Mr. Abe's coordinated monetary and fiscal policies have already rapidly changed expectations for inflation in Japan. They have also brought an undervalued and under-owned equity market quickly back into focus.

Meaningful policy outcomes, however, are difficult to predict in the shorter term and any impact on the real economy should take place over a number of years. The initiatives have ultimately given investors a rationale to reassess their long held negative views on Japan.

Abe has a window of opportunity. Today's environment differs from any point in the last decade as some of the big headwinds to sustainable growth, such as the long process of corporate balance sheet repair and debt deflation are now coming to an end.

This environment is conducive to companies positively responding to changes in policy. This we believe can contribute to rising corporate profitability, and underpin a sustainable rerating of the Japanese share market.

At the policy forefront is Japan's participation in the Trans Pacific Partnership (TPP) which will create a foundation for further microeconomic reform. The TPP is a free trade area for the Asia-Pacific region. It aims to include Asia-Pacific countries covering a region that represents more than half of global output and over 40 percent of world trade. The TPP will bring competition into Japan and drive further changes in domestic corporate behaviour. We believe improved corporate efficiency gained from ongoing restructure is vital and is a strong signal for investors who are looking for evidence of sustainable corporate performance in Japan.

In a nutshell.

This year, investors have chased the macro themes, but we think Japan will present itself as a market for stock pickers (again) in 2014. The policy environment appears to be changing towards growth and the starting point is also different - valuations are now very attractive for very competitive companies which are operating in rude financial health.

In short, we believe there continues to be ample opportunities for our approach which only focuses on the extremes of valuation. Bring on 2014!

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