


Eastspring Investments – Japan Dynamic Fund



A Prudential plc company 

Market review

In October, the MSCI Japan Index declined in USD terms. The USD/JPY rate approached a three-month peak, influenced by political uncertainty following Japan's ruling coalition's loss of its parliamentary majority. The Bank of Japan maintained its key short-term interest rate in line with expectations. Japan's annual inflation decreased to 2.5% in September, with core inflation dipping to a five-month low of 2.4%, amid a slower increase in electricity and gas prices. The au Jibun Bank Japan Manufacturing Purchasing Managers' Index declined to 49.0 in October, marked by a contraction in output, new orders, and a sharper fall in export orders.

Key contributors

Month-to-date, East Japan Railway, Ricoh and Sumitomo Mitsui Financial Group were key absolute contributors to Fund performance.

East Japan Railway's share price again outperformed in October, as expectations are starting to rise for robust profits due to recovery in ridership and possible increase in transportation fare into next year. We have observed the company has remained focused on cost control in the rail business and increasing the value of its real estate assets. Our trend operating margin and capital expenditure assumptions for the rail business conservatively account for possible lower trend ridership level versus pre-pandemic level, as well as provisions for both large scale maintenance and CapEx programs. East Japan Railway plans to increase non-railway business profit share from 30% to 40% in five years' time. We have factored in higher capital expenditure as a result and our conservative return on asset assumptions are consistent with an asset-heavy business model for commercial property. East Japan Railway exhibits supportive trend valuation, and the Fund built a moderate position amid share price underperformance.

Ricoh also rose strongly over the month on an increase in expectations for improved earnings into next year on meaningful restructuring efforts in the printing business. The share price has also been supported in recent months as a well-known activist has been increasing its stake in Ricoh. Ricoh is beginning to benefit from efforts to transition its business portfolio to software services from printing hardware. It is restructuring in both domestic and overseas production and sales operations should support cashflow sustainability from its existing printing business. We continue to have a high conviction for Ricoh based on our conservative trend margin assumptions and significant trend valuation support.

Sumitomo Mitsui Financial Group has managed its balance sheet well by shedding non-core assets and creating room for elevated returns to shareholders and investments abroad. On top of capital management, the company has also showed stringent cost management. SMFG has a diversified income stream with meaningful exposure and leading positioning in consumer finance and credit card businesses. It has also been focused on improving the profitability of its loan book through mix improvement. The company is moving to the offence by investing in its businesses in Asia. The share price rose over the month along with the wider Financials sector.

Key detractors

Month-to-date, Daito Trust, Sumco and Sundrug were key absolute detractors from Fund performance.

Daito Trust is a house builder where growth has moderated, after decades of rapid expansion. Initially new construction orders were affected by Covid, and subsequently construction margins saw headwinds due to raw material and labour cost inflation. Being the homebuilding leader in the rental housing market, Daito Trust has reached a point where the market is cautious about its ability to continue to grow, however the company continues to generate positive cash flows and has a solid capital structure. There remains room for improvement in shareholders' returns as management reviews asset efficiency and capital structure, with our conservative valuation assumptions supporting the case for conviction. Investors digested the company's quarterly earnings during the month, with revenue and net income up year-on-year, as well as an increase in profit margin. However, buyback expectations did not materialize.

Sumco is principally engaged in the manufacture and sale of high-purity silicon wafers for semiconductor manufacturers. The company's share price continued to be under pressure along with the wider sector. Short-term profit outlook was weaker than expected on prolonged wafer inventory adjustments and increased depreciation cost guidance.

Sundrug operates and manages drug stores and dispensing pharmacies in Japan. As a result of our deep fundamental analysis and after applying conservative assumptions for labour cost pressures, the team has found that Sundrug trades at significant valuation discount to its fair value. The share price has been under pressure along with the broader sector, with declining consumer confidence in October further weighing on sentiment around the sector and the stock.

Fund activity

During the month, the Manager sold shares in companies where valuations look relatively less compelling and bought shares in companies where valuations look relatively attractive compared to other high conviction positions. Several positions were trimmed, including Ricoh and AEON Mall, whilst positions in Yamato Holdings and AGC were added to.

Strategy and outlook

We believe that the long-term structural drivers of deflation, reforms and reallocation remain in place and corporate earnings can continue to improve over the coming years. Firstly, inflation appears to be becoming more entrenched, changing management behaviour and allowing companies to increase their pricing, benefiting margins. The labour market is also tighter than it has been in many years placing upward pressure on wages, and thus supporting consumption. The capex environment appears to be improving, driven by the trends of re-shoring, friend-shoring and the green transition. These are key for a sustained move out of the deflationary era and we think this is the best chance Japan has had in a generation to do so. Secondly, the Tokyo Stock Exchange initiative and ongoing corporate governance reforms are positive for the value end of the Japanese equity market, where there is larger potential to improve Return-on-Equity and see a corresponding valuation re-rating. We expect the trend of share buybacks to continue in 2024 as more companies address the excess cash on their balance sheets and we are encouraged by corporate management teams' willingness to cut costs, restructure underperforming business units and unwind extensive cross shareholdings.

Top 10 absolute contributors (one month)

Holdings (%)	Average weights		Contribution to fund performance
	Fund	Benchmark	
EAST JAPAN RAILWAY COMPANY	5.1	0.5	0.38
RICOH COMPANY, LTD.	4.4	0.2	0.38
SUMITOMO MITSUI FINANCIAL GROUP, INC.	4.0	2.1	0.29
TAKEDA PHARMACEUTICAL CO. LTD.	5.6	1.2	0.21
MIZUHO FINANCIAL GROUP, INC.	2.1	1.3	0.18
SANKYU INC.	1.6	-	0.18
BROTHER INDUSTRIES, LTD.	1.6	0.1	0.13
KIRIN HOLDINGS CO. LTD.	3.4	0.3	0.10
TAISEI CORPORATION	2.7	0.2	0.09
NOMURA HOLDINGS, INC.	1.0	0.4	0.09
Total	31.5	6.2	2.02

Top 10 absolute detractors (one month)

Holdings (%)	Average weights		Contribution to fund performance
	Fund	Benchmark	
DAITO TRUST CONSTRUCTION CO., LTD.	4.2	0.2	-0.13
SUMCO CORPORATION	3.4	0.1	-0.11
SUNDRUG CO., LTD.	0.9	-	-0.11
IZUMI CO., LTD.	1.0	-	-0.10
AIR WATER INC.	2.1	-	-0.09
KUBOTA CORPORATION	2.6	0.4	-0.08
TEIJIN LIMITED	2.3	-	-0.07
ASAHI KASEI CORPORATION	2.7	0.2	-0.06
KANEKA CORPORATION	1.5	-	-0.05
YAMATO HOLDINGS CO., LTD.	2.9	-	-0.03
Total	23.7	0.9	-0.82

Top 10 absolute contributors (year to date)

Holdings (%)	Average weights		Contribution to fund performance
	Fund	Benchmark	
RICOH COMPANY, LTD.	5.6	0.1	2.64
SUMITOMO MITSUI FINANCIAL GROUP, INC.	4.6	2.0	1.78
FURUKAWA ELECTRIC CO., LTD.	1.6	-	1.41
NOMURA HOLDINGS, INC.	1.9	0.4	1.18
RESONA HOLDINGS, INC.	3.5	0.3	1.00
TAISEI CORPORATION	2.7	0.2	0.92
SUMITOMO CHEMICAL CO., LTD.	3.4	0.0	0.90
EAST JAPAN RAILWAY COMPANY	4.9	0.4	0.79
HONDA MOTOR CO., LTD.	2.7	1.3	0.72
BROTHER INDUSTRIES, LTD.	2.2	0.1	0.67
Total	33.1	5.0	12.02

Top 10 absolute detractors (year to date)

Holdings (%)	Average weights		Contribution to fund performance
	Fund	Benchmark	
NISSAN MOTOR CO., LTD.	3.0	0.2	-0.70
SUMCO CORPORATION	2.4	0.1	-0.57
PANASONIC CORPORATION	5.9	0.5	-0.44
NABTESCO CORPORATION	2.8	-	-0.35
AGC INC.	2.3	0.2	-0.20
KOITO MANUFACTURING CO., LTD.	1.1	0.1	-0.18
YAMATO HOLDINGS CO., LTD.	1.2	0.1	-0.18
KUBOTA CORPORATION	2.3	0.4	-0.12
SUNDRUG CO., LTD.	0.9	-	-0.10
IZUMI CO., LTD.	1.0	-	-0.10
Total	22.9	1.6	-2.94

Statistics

Characteristics	Fund	Benchmark
Number of holdings	41	198
Price to earnings (number of times)	14.5	16.5
Price to book (number of times)	0.9	1.5
Forward 12-month dividend yield (%)	3.4	2.5
Active share (%)	89.6	N/A
Tracking error (%)	7.9	N/A

Additional notes

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Representative Agent: First Independent Fund Services Ltd, Klausstrasse 33, 8008 Zurich

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United Kingdom - Facility Agent

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