



Japanese Equities—An Asset Class Familiar With Volatility

While unsettling, uncertainty can help to affirm investment conviction.

March 2020

Much has been written about recent market events, but the past month has been defined by a near perfect storm of negative and unpredictable news flow. Set against a backdrop of raised expectations that 2020 would be defined by stability and improvement, the subsequent emergence of the coronavirus, the economic impact of control measures to delay its spread, and a very untimely oil price war have combined to shock equity markets lower.

Recent market volatility is certainly understandable, given that investors are fearful of the unknown—in this case, the scale and longevity of the coronavirus impact being the definition of “unknown.” However, while times like these are challenging for investors, we believe that volatility and uncertainty can also help to affirm conviction in certain investments, especially those that can emerge sustainably from periods of duress.

Maintaining Calm

March 11, 2020, marked the nine-year anniversary of the Tohoku earthquake, and the subsequent Fukushima nuclear disaster—a disaster that caused the TOPIX, on March 15, 2011, to fall more than 12%¹ in a single day as investors struggled to price risk or gauge the potential duration of the risks that



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emerged in that period. Coming on the heels of the global financial crisis in 2008, the earthquake and its market impact led to an extreme level of skepticism that even Japanese equities have rarely seen—and Japanese equities is an asset class used to investor skepticism.

Today’s environment is very different from either of the events mentioned above, but there are parallels with respect to investment success during worrying and uncertain times. And it is this previous experience that we are drawing on to help guide us in the management of the Japanese Equity Strategy during the current challenging period.

This includes the fundamental truth that, ultimately, the quality, durability, and cash flow generation of a business matter greatly over the medium and long term when considering returns. In addition, we retain a strong belief that

“...Japanese equities is an asset class used to investor skepticism.”

¹ Source: TOPIX—Tokyo Stock Exchange, Inc.

“While challenging for investors, we believe that periods of volatility and uncertainty can help to affirm conviction in certain investments...”

periods of crisis and volatility are not usually opportune moments to rotate aggressively toward a more risk-averse portfolio. Instead, maintaining conviction and investing through a cycle, including periods of volatility, can lead to better outcomes over the longer term.

In our ongoing search for assets that fit the characteristics noted above, we are utilizing the full extent of our local and global resources. We are also leaning on our deep experience in the Japanese equity market in order to manage emerging risks while also being awake to new opportunities to invest in what we believe are exceptional businesses that are now trading at much lower valuations.

The core of our investment process is built around a long-term investment horizon and measured, unemotional, fundamental research. We are maintaining these principles through the current market environment.

Remaining Constructive

With respect to the coronavirus, we believe that we will work through the issues currently dominating society and markets and see better times, both in terms of the health and social impact, as well as the economic impact. While the global backdrop could potentially worsen in the very near term, markets have re-priced a sharp economic and earnings impact with speed, assuming a recessionary outlook for the first half of 2020. We think this is a fair and realistic assessment.

However, with policymakers active in providing liquidity, and with potential fiscal policy stimulus at the ready should the situation deteriorate, any

further action is likely to be a globally coordinated one. The oil price collapse has only accelerated the convergence of central bank interest rate expectations and long-end bond yields. The U.S. Federal Reserve has already responded with emergency action to support the economy, cutting interest rates to a target range of 0%–0.25%. With monetary policy reaching its limits, we could see renewed and coordinated fiscal response to help support economies as we deal with the near-term decline in economic activity levels.

While stimulus alone in no way guarantees the improvement we expect in the second half of 2020, we do see a likely path to a better backdrop, and we retain conviction in our portfolio of holdings given the strength of business models, balance sheets, and management quality that we naturally look for in our investments. Japan continues to progress along a path of structural improvement in terms of governance, engagement, and shareholder returns, and corporate Japan delivered record stock buybacks in 2019 (amid a profits recession) in demonstration of this point. As and when we see stability return to the economic environment, improvement and growth will no doubt be fertile themes for investors, and we believe Japan typifies these kinds of opportunities.

It is times like these when quality matters, and we believe we have a significant bias to quality, both within our strategy and within the research resources directed toward the management of our clients' assets during these periods of concern.

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