- The Fund invests primarily in equity and equity related securities which are established or have significant operations in Japan and which are listed, traded or dealt in on regulated markets worldwide.
- The Fund's investments may be concentrated in Japan or a single sector which may have higher volatility or greater loss of capital than more diversified portfolios.
- Investing in small /mid-capitalisation securities may have lower liquidity and their prices are more volatile to adverse economic developments.
- The Fund may use FDIs for hedging and efficient portfolio management purposes, which may subject the Fund to additional liquidity, valuation, counterparty and over the counter transaction risks.
- It is possible that a part or entire value of your investment could be lost. You should not base your investment decision solely on this document. Please read the offering document including risk factors for details.

First State Stewart Asia
– Japan Equities
Client Update
March 2019

FIRST STATE STEWART ASIA – JAPAN EQUITIES

Looking past the market volatility

2018 was a challenging year for Japanese equities. While we usually prefer to talk about the companies we own rather than comment on the market or the economy, it was interesting to note that 85% of trades last year was on auto-pilot, controlled by machines, CTAs[1] and quant funds.

The TOPIX fell to around 12x forward PE[2] (close to where it was during the 2008 and 2012 downturn) and foreign capital flows amplified the level of volatility in the market – with a record JPY12.5trn (gross market value) of Japanese cash equities and futures contracts sold down over the year.

In our Japan strategies, around a quarter of stocks saw trading volumes spike by more than 40% in the fourth quarter (despite little change in fundamentals), and more than a third of the portfolio's holdings experienced trading volumes that were more than two-times the number of free-float shares.

During these periods of market dislocation, we believe it is important to look past the volatility and adhere to our investment philosophy, rather than react to short-term market conditions. Thus, we continued to take a bottom-up, benchmark-agnostic approach to portfolio construction and maintained a high active share ratio.

Most importantly, we remained focused on seeking high quality companies that we can hold for the long term. As we have experienced in the past, companies that have quality management, a dominant franchise and conservative financials usually rebound quickly once fundamentals reassert. Our mission remains to preserve capital and generate better returns for clients in the long run – by which we mean on at least a three-to-five year basis.

Adding to quality at more reasonable valuations

Over the course of the year, members of the team travelled to Japan on almost a bimonthly basis to evaluate new investment ideas, revisit existing portfolio holdings and reassess watch-list companies where valuations had become more attractive.

Most of our holdings continued to report solid earnings and in many cases our conviction increased after meeting with them. Last year's volatility provided us with numerous opportunities to buy companies with attractive economics at more reasonable prices. Some examples of the largest additions to the Japan strategies last year are given below.

Valuations for M3, the dominant online marketing and media company for the medical industry, had dropped to 7-year lows, which created an opportunity for long-term investors to accumulate. We added and it is now among our top five portfolio positions.

We believe M3's online services could transform the sales process of pharmaceutical and medical products. Currently, Japanese drug companies spend the majority of their annual marketing budgets on sales representatives and related commissions, while just 2% is allocated to online marketing. Conversely, doctors spend twice as much time on the internet collecting information than they do talking to pharma reps and, with the growing trend of digitalisation, this should only increase.

Pharma companies have been taking note and are increasingly turning to more efficient marketing methods to preserve margins. By using 'pay-for-performance' services to promote their products directly to doctors on M3's medical platform, the costs of hiring traditional medical representatives could be significantly reduced.

Over the past 15 years, M3 has built a huge following among doctors and its services have expanded. M3's platform dominates this niche market segment and now has more than 4mn doctor subscribers globally. Importantly, it has also monetised this relationship – it is highly cash flow generative with a conversion ratio of 90%[3].

We believe M3's entrepreneurial culture and innovative mind-set should ensure continued growth as it invests into new business areas and acquisitions in overseas markets. The management team are humble and down-to-earth (the founder and CEO, Itaru Tanimura, sits in a cubicle on the office floor just like any other employee); and their prudence – as reflected in the company's high ROCE[4] and ROE[5], and healthy cash generation – should help steer the company in a sustainable manner.

1 Commodity Trading Advisors – or futures traders
2 Price-to-earnings
3 Calculated as net income/free cash flow
4 Returnon capital employed
5 Return on equity

Last year, a profit slowdown combined with the generally-volatile market led to weakness in the share price. As mentioned above, we added to our position – taking advantage of what we considered to be a short-term pricing anomaly. We believe M3 is on the right side of disruption and could become a much larger company in the next 5-10 years.

Another company we bought on weakness was Pigeon, having sold previously due to concerns about its reliance on the China market. We have followed Pigeon for many years. It has a great franchise with a trusted brand and its baby-related and breastfeeding products are ranked highly in their categories.

Pigeon's products are staples for mothers, who care greatly about providing 'the best' for their children, therefore demand should be relatively sheltered from global macro concerns. The company has well-diversified revenue streams, with around 50% generated outside of Japan.

China remains its largest overseas market and is expected to grow at around 10% per year. Its Indonesian subsidiary (consolidated in 2017) has grown by around 20% year-on-year, while Malaysia, Thailand and Singapore (equally large businesses of around JPY 1bn) continue to grow strongly. Much of its average selling price (ASP) gain is through the introduction of new and premium products to the market.

In the US, where it acquired the Lansinoh Laboratories business in 2004, there is still room for margins to expand, as it focuses on developing sales from the DME[6] channel. Currently, the majority of US sales are generated from Walmart, Target and Amazon – large retailers with significant pricing power.

Run by a professional and shareholder-friendly management team, Pigeon has a strong financial track record and has consistently improved ROE and shareholder returns (there has been only one instance of profit decline over the last decade; and the dividend pay-out ratio has increased to a healthy 60%). Our meetings with management are refreshingly frank, with discussions about mistakes made and challenges faced, quite uncommon in a Japan context.

As might be expected for a high quality company, even after last year's correction Pigeon is not cheap. However, we believe it is among the best consumer companies to own, with limited competition and multiple growth drivers. Operating margin should continue to rise, as expansion into Southeast Asia and growth of its secondary brand Lansinoh become increasingly important growth drivers.

Another top-up was Relo Group, one of the largest fringe benefits and corporate housing management service providers in Japan. Due to structural labour shortages and government guidelines around "equal work, equal pay", fringe benefit services are forecast to grow at around 15-20% per annum, as corporates look for alternative ways to retain their employees.

There are mandatory and optional fringe benefit services, with the latter usually outsourced to third parties such as Relo, given the scalability of the business. The business model is straightforward: the client company pays Relo a fixed fee per employee each month and in exchange, their employees can make use of various services (such as hotel bookings and gym membership) at discounted prices.

The fringe benefits business is boring but steady – and highly profitable. It requires little capital expenditure and income is largely recurring, therefore generating high ROCE. It is growing faster than Relo's other services, but the remaining portfolio of businesses is extremely defensive too – the group's operating profit fell by just 5% during the 2008 global financial crisis.

We like the company's dynamic culture and its growth mentality. In a recent meeting, CEO Kenichi Nakamura reportedly said: "Double-digit growth is our company's motto; and we can't be innovative without aiming for ambitious targets." Stewardship of the company is overseen by the founder and chairman, Masanori Sasada, who remains the largest shareholder.

Relo's addressable market has huge potential: two-thirds of Japanese employees work for SMEs[7], where the penetration of fringe benefit services is less than 10% and, despite relatively low entry barriers, Relo has few competitors (we also own Benefit One, which is similarly focused on fringe benefits, but is much more expensive). Testament to the company's strategy and management's execution, recent results showed record profits and solid sales growth. This, along with its improving product mix should drive a re-rating in valuations.

Management catalyst; turnaround seems afoot?

Last year we bought Shiseido, a new position in the portfolio, on signs of a turnaround. Despite being one of the oldest and largest globally-distributed Japanese cosmetics brands in the world, it has a chequered financial history, having been mismanaged in the past. Until recent years, the domestic business was in decline; and overseas profitability was erratic as costs were shuffled back and forth between the headquarters and regional offices.

We believe that the company's changing fortunes can be traced to the 2014 appointment of Masahiko Uotani, who previously worked for large consumer groups such as Kraft Foods and Coca-Cola Japan, as the group's first outsider CEO (endorsed by the chairman).

6 In the US, 'Durable Medical Equipment' has a legal definition as customers are able to claim back the costs on insurance/Medicare. Lansinoh's breast pumps are covered under this.
7 Small and medium-sized enterprises

As a self-confessed 'people's person', Uotani likes to talk to everyone in the company – from the beauty consultant all the way up to executive officers. He believes that listening to the most junior employees in a company is the best way to identify issues and, a few months after becoming CEO, he visited every sales branch, Research & Development centre and manufacturing plant in the company – a good sign of hands-on and effective leadership.

Corporate governance has improved in the years since and the company is now more aligned with shareholders. Salaries and incentives are driven by performance rather than seniority and its employee KPIs are among the most transparent in Japan. It has one of the highest female leadership ratios in Japan too, with the edict straight from the top to improve diversity.

Over time, Uotani transformed the culture and the management. Underperforming or complacent managers were demoted or reshuffled to other areas, and new external mid-hires were brought in. Leadership was devolved from the Japanese headquarters to regional centres around the world.

Meanwhile, heavy investment into branding and marketing has rejuvenated the company's image. A third of its marketing expense is allocated to digital to cultivate a strong online presence and develop e-commerce sales. It has cut the number of brands and low-value SKUs[8] in favour of prestigious products, and has launched a series of new, innovative products to supplement its product range.

Shiseido now manages a well-balanced portfolio of best-in-class global skincare and makeup brands. Around 54% of total revenue is derived from high-end brands which has superior profitability, better immunity from competition and fast growth in China.

Last year's results were much improved; however the stock corrected on concerns that reseller regulations in China would lead to a fall in its business. We thought that the impact on Shiseido would be limited due to its extensive distribution channel and added to the position. We believe that Uotani and his management team are well-placed to lead the company through what should be relatively short-term challenges.

In closing

Our investment process focuses on seeking out quality companies with either secular growth drivers or high visibility on earnings. Most of our portfolio companies generate strong cash flows and have robust balance sheets that should help them survive (and potentially become stronger) in the event of a recession. Valuations in our universe are becoming more reasonable; and earnings growth for domestic demand-oriented companies should remain steady.

In addition, corporate governance and shareholder returns should continue to improve. Japanese companies have maintained extremely strong balance sheets (unlike US companies which geared up on low interest rates, Japanese companies rarely did so). In the short year-to-date, buybacks are already off to a record start and ROE is close to pre-crisis highs.

As always, our portfolio strategy is to identify a select number of companies that we believe can be much bigger in the next five to ten years, while ignoring short-term noise. Despite the ongoing volatility and the inevitable blips in sentiment, we continue to focus on identifying companies that can deliver sustainable and predictable returns over the long term.

On the macro, growth may well decelerate as widely expected, but whether or not a global recession appears this year is anyone's guess. Extreme events are inherently unpredictable, despite what market pundits say. As Paul Samuelson (a Nobel prize-winning economist) said: "*The stock market predicted nine out of the past five recessions*."

8 Stock keeping unit – or an individual item for sale

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Top 10 Company Holdings (%)

Stock name	%	Stock name	%
Keyence Corporation	5.5	Pigeon Corporation	4.2
Recruit Holdings Co Ltd	5.2	Tsuruha Holdings Inc.	4.1
Relo Holdings Inc	4.6	Trust Tech Inc	3.4
Unicharm Corporation	4.2	Kao Corp.	3.3
M3, Inc.	4.2	Shin-Etsu Chemical Co., Ltd.	3.1

Source: First State Investments as at 28 February 2019.

Cumulative Performance in USD (%)

	3 mths	YTD	1 yr	Since inception
First State Japan Equity Fund (I USD Acc)	-0.8	8.8	-11.7	28.5
MSCI Japan Index	-1.0	6.1	-10.3	13.0

Calendar Year Performance in USD (%)

	2018	2017	2016^
First State Japan Equity Fund (I USD Acc)	-15.0	42.9	-2.7
MSCI Japan Index	-12.9	24.0	-1.3

Source: First State Investments, Nav-Nav (USD total return), as at 28 February 2019. The fund above refers to First State Japan Equity Fund Class I (USD Acc) which is the non-dividend distributing class of the fund, the performance quoted are based on USD total return (non-dividend distributing).
^ Performance from inception date to 31 December 2016. Inception date: 6 September 2016. Past performance is not indicative of future returns.

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