RBC BlueBay
Asset Management

Celebrating 10 years of the RBC Japan Equity Strategy

For professional investors only | Marketing communication

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"A strong track record supported by the Asian Equity team's robust and consistent investment philosophy and process."

The RBC Japan Equity Strategy ("the Strategy") has marked 10 years since its inception in April 2014. Over this time, the Strategy has outperformed both its primary benchmark, the MSCI Japan Index, and its secondary benchmark, the Topix Index, demonstrating a strong track record supported by the Asian Equity team's robust and consistent investment philosophy and process.

Fertile hunting ground for active managers

Over the past few decades, Japan's backdrop has made the economy less appealing to investors than its developed market counterparts. Challenges such as unfavourable demographics, a heavily indebted economy and a state of deflation since the bubble of the 1980s, amongst other things, have caused headwinds for the economy and we feel that investors have overlooked the asset class as a result.

The region's structural challenges have resulted in the asset class being under-researched in a global context; as of June 2024, close to 50% of Topix-listed companies had zero analyst coverage[1]. More recently, global equity allocations to Japan have been improving, but investors remain underweight the asset class versus global benchmarks, a trend that has persisted over the past couple of decades[2].

Despite a challenging backdrop, we have long regarded Japan as a fertile hunting ground for stock pickers, and we feel our approach as an active manager has a strong edge when it comes to capturing alpha. Unlike passive strategies, active managers can provide selective exposure to best-in-class, structurally-winning companies. Over the past ten years, and across varied market environments, the Strategy has delivered consistent performance, achieving an annualised return of 11.4% (an outperformance of 2.7% relative to its primary benchmark)[3].

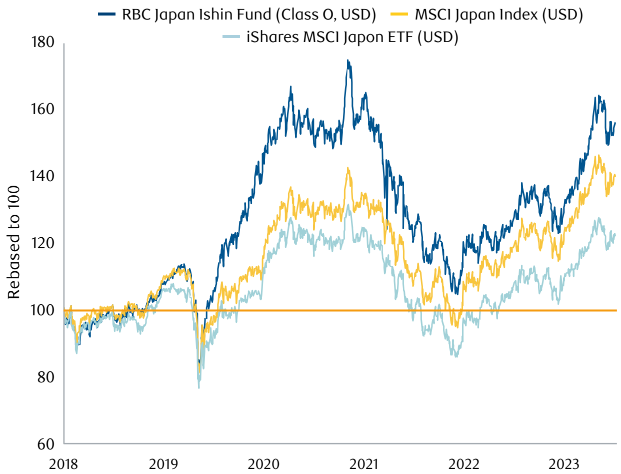
[1] CLSA Research.
[2] IMF, MSCI, Bloomberg Finance L.P., JPMorgan, as at June 2024.
[3] RBC GAM, as at 30 April 2024.

More recently, both exogenous shocks and endogenous reforms have helped to reignite the economy, and subsequently investor interest in the region. As the country takes centre stage, dedicated Japan managers can help to reduce investor underweights, provide select exposure to compelling opportunities that are arising from key structural changes, and generate alpha that passive funds often miss out on (Figure 1).

> **"More recently, both exogenous shocks and endogenous reforms have helped to reignite the economy."**

We explore the opportunities for active managers in the region in more detail in our note, Japan: on the rise.

Figure 1: Passive solutions lag the index over time and risk leaving alpha on the table



Source: Bloomberg , from 7 November 2018 to 22 May 2024.

Tangible improvements to corporate governance

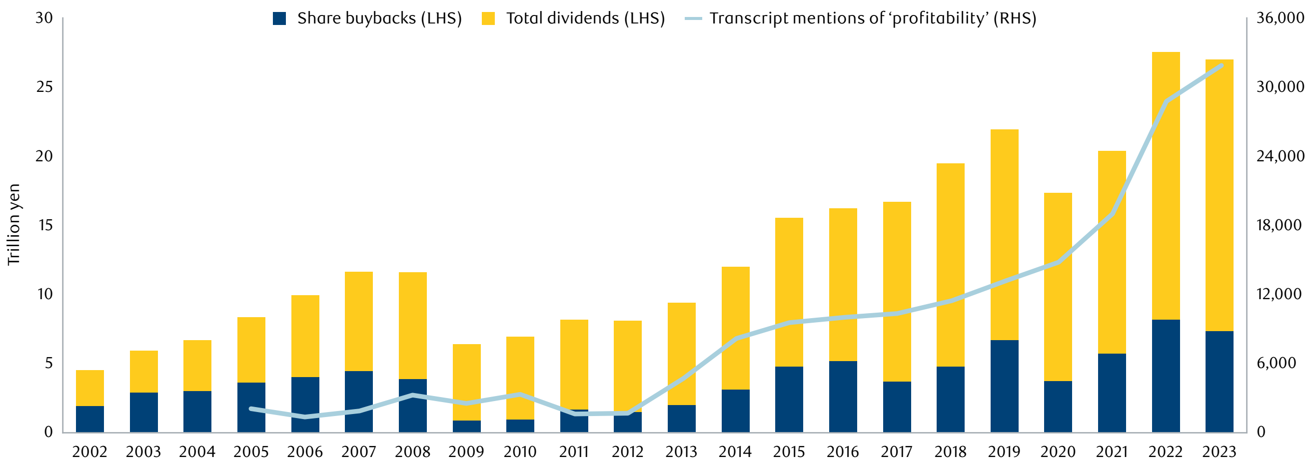
Against a global peer group, Japanese companies have historically lagged when it comes to corporate governance practices. Issues such as the keiretsu system, a network of interlocking businesses involved in messy crossholdings, have caused issues for corporate Japan and acted as a deterrent for global investors.

However, over the past decade, Japanese companies have been on a journey of self-help (something which we examined in our past note The quiet revolution), working to improve corporate cultures and best practices. More recently, government support efforts and revived plans from the Tokyo Stock Exchange (TSE) are helping to fast track these improvements and bring corporate Japan's efforts into the spotlight.

In 2023, TSE unveiled new plans to reform Japan's equity market, focusing on improvements to corporate governance and profitability. Along with the formation of the PRIME market, specifically designed to highlight the top value-creating Japanese companies and defined by the TSE as companies which constructively communicate with global investors, the exchange called on all listed companies to take action and improve disclosures surrounding plans to improve shareholder value.

Since then, a growing number of companies have committed to governance reform targets, and corporate mindsets are showing signs of change (Figure 2). Meetings with company management are newly focused on these efforts to improve profitability, divest from non-core businesses, and become more competitive in a global context.

Figure 2: Corporate mindset finally focusing on shareholder returns and 'profitability'



Source: Morgan Stanley, AlphaSense, TSE, Nikkei NEEDs, FactSet, Bloomberg, as at 1 March 2024. Share buybacks and total dividends data relates to the Topix. Profitability screening is conducted by AlphaSense using Japan as the country filter (includes a total of 3,835 listed companies). Multiple mentions of 'profitability' in the same document are counted as one mention. Documents include global filings, event transcripts, press releases, 40F/40FA - annual filings, and other company publications.

This is a notable shift within Japan's corporate landscape, and we are encouraged by the changes here; as bottom-up investors, we welcome the improvements being made at an individual company level.

> **"We seek to build a high conviction portfolio of best ideas based on our rigorous company analysis, and we approach portfolio construction with a high awareness of risk."**

ESG analysis has been integrated into our bottom-up stock selection process since the team's inception, and is a responsibility that is shared by each team member with research responsibilities. The analysis and understanding of ESG risks and opportunities help us to form a more holistic view of a company, providing a broader, long-term outlook. The assessment of corporate governance forms a key part of this analysis, and is often a topic of focus in our meetings with company management. Recent market developments have helped to create a more constructive environment for these dialogues, and a genuine sense that Japanese companies are working towards improvements that are sustainable over the long term. Our [Asian Equity ESG Report 2024] looks at our approach to ESG in more detail, as well as delving deeper into the TSE's reform efforts and the market's reaction to these.

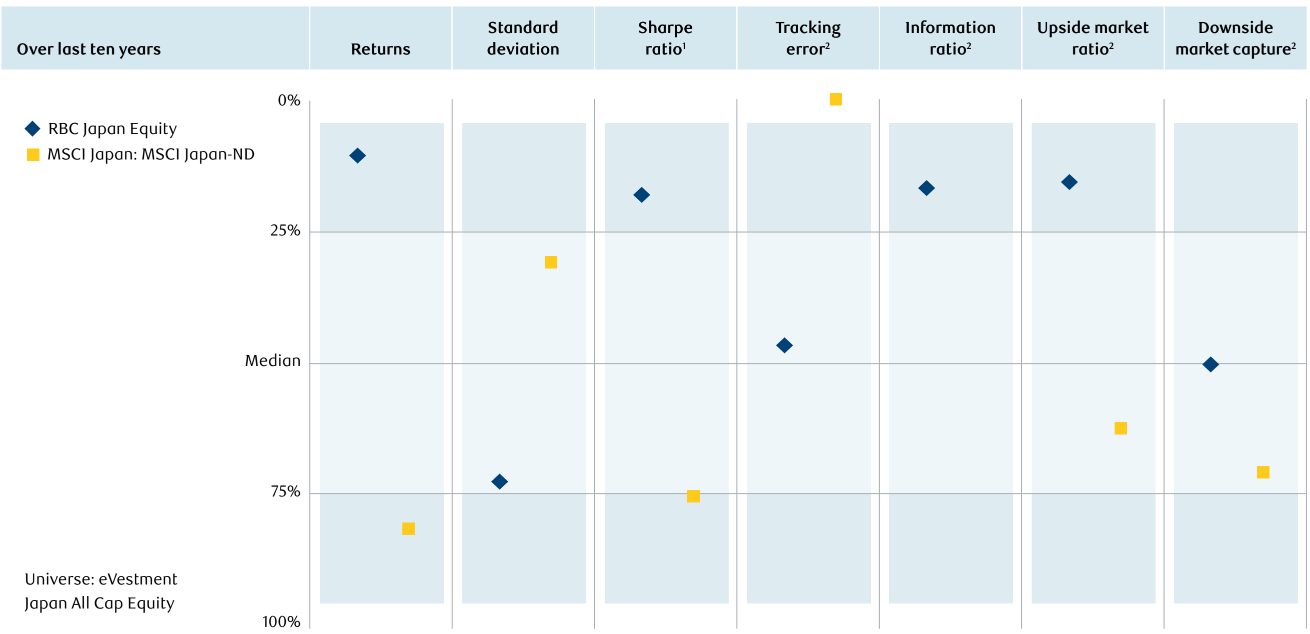
Disciplined investment approach and industry expertise

The Strategy has exhibited strong relative performance over the past ten years, including against periods of challenging macroeconomic backdrops (Figure 3). Navigating these market environments can be a complex process, but we believe our fundamentals-driven, high conviction approach lends itself to long-term success.

In-depth, first hand research is comprised of holistic due diligence, supported by regular trips, in person meetings and site visits, as well as speaking with customers, suppliers, competitors, employees and conducting channel checks. This research agenda is set and led by our Japan manager but also conducted by our regional sector specialists who bring a broader, industry-focused pan Asia perspective. We believe this approach of harnessing the broader context of Asia Pacific, while considering the Japanese market in its own right, gives us a competitive edge.

We seek to build a high conviction portfolio of best ideas based on our rigorous company analysis, and we approach portfolio construction with a high awareness of risk. Our dedicated portfolio engineer supports this process, looking to diversify active risk systematically across stock specific risks, whilst minimising unintended factor risk and style bias, helping to build an all-weather core portfolio.

Figure 3: Our disciplined approach to risk management and strong returns stand out against peers



	Returns	Rank	Standard deviation	Rank	Sharpe ratio[1]	Rank	Tracking error[2]	Rank	Information ratio[2]	Rank	Upside market ratio[2]	Rank	Downside market capture[2]	Rank
RBC Japan Equity	9.49	12	15.63	73	0.51	19	5.34	47	0.57	17	111.79	15	96.18	50
MSCI Japan-ND	6.43	82	14.08	32	0.35	76	0.00	1	–	–	100.00	63	100.00	71

Source: RBC GAM, eVestment. Past performance is not indicative of future results and is calculated in USD. Returns may increase or decrease as a result of currency fluctuations. Data shows last 10 years through to 30.04.2024. Created on 23.05.2024 from a universe of 176. [1]FTSE 3-Month T-Bill; [2]MSCI Japan-ND. Returns are presented gross of management fees and include the reinvestment of all income.

It isn't too late – more change and more upside to come

Japan's stock market has exhibited blockbuster performance over the past 18 months, surpassing all-time highs in March of this year. Whilst this undoubtedly sparks comparisons to the country's 1989 asset price bubble, the mood this time around feels very different, and we feel there is still significant upside potential. Two key structural changes are contributing to this improved outlook: **1)** the country's emergence from a persistent state of deflation, and **2)** the meaningful developments when it comes to corporate governance reform.

Inflation has remained above the BoJ's target of 2%, and this year's Shunto (Japan's spring wage offensive) provided comfort that this trend could be sustainable over the long term. The negotiations led to the biggest wage hikes the country has seen in 33 years, with an increase of 5.28%, and we would expect this to further increase in 2025 if the country's CPI stabilises around current levels[4]. Companies have responded positively to this move, aware of the importance of wage growth in order to attract skilled workers and boost productivity against the backdrop of an ageing population. Real wage growth still needs to follow suit, but we expect this to happen over the next few months, at which point we should start to see a recovery in domestic consumption as well.

Looking ahead, there is still plenty of scope for improvement when it comes to corporate governance reform, and the next phase of TSE's plans focuses on passing responsibility to shareholders. The exchange has set the stage, and will continue to publicly list companies that have met disclosure requirements regarding 'Action to Implement Management that is Conscious of Cost of Capital and Stock Price', but it is now over to investors like ourselves to drive future change.

In our recent Asian Takeaways note, Donburi Despatch, we explore the next stage of these plans and how investors can help to continue the progress that has already been made.

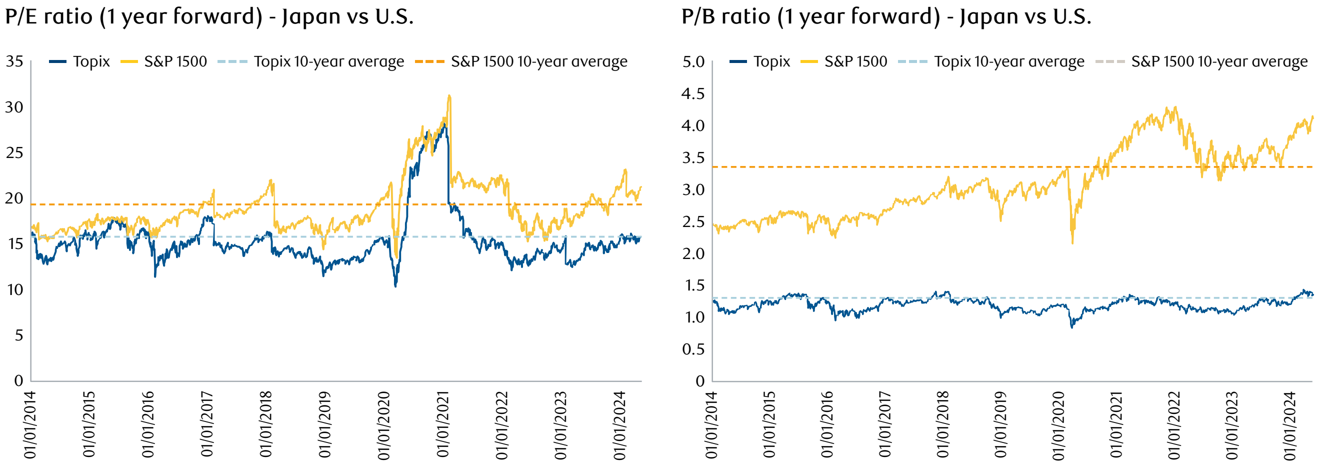
It is encouraging that such reform measures have been taken seriously by the market, and we see renewed interest in the region from foreign investors on the back of these changes. The government has been offering additional support, working to reduce regulatory bottlenecks and improve market access for overseas investors, with the aim of promoting Japan's attractiveness as a destination for foreign capital.

Domestic investors are also starting to take note, previously deterred by the realities of inflation and limited progress when it came to governance reform. The introduction of the NISA programme (Japan's tax-free savings scheme) should help to drive further inflows into equities from retail investors.

The scheme increases the existing account limit and should incentivise a redeployment of cash into equities; at present, household savings represent a huge untapped pool of capital with over 50% held in currency and deposits[5].

Looking at market performance to date, the recent rally has been broad based and predominantly supported by earnings. Whilst valuations have expanded over this period, on both an absolute and relative basis, the market remains inexpensive (Figure 4); as at the end of 2023, close to 50% of the Topix was trading below book value, compared with just over 10% for the S&P 1500[6].

Figure 4: Despite market strength, valuations remain inexpensive



Source: Bloomberg.

[4] Reuters, Japan union group announces biggest wage hikes in 33 years, presaging shift at central bank, as at 15 March 2024.
[5] CLSA, BoJ, FRB.
[6] CLSA, Bloomberg.

Conclusion

We believe there is still plenty of upside for investors considering the asset class; the current market environment creates compelling opportunities and we expect to see continued improvement in Japanese corporates when it comes to governance reform, adding to the market's long-term appeal.

Across all sectors of the market we are focused on unearthing high quality businesses that can benefit from the enormous changes we are witnessing in Japan. Those with high levels of cash or cross shareholdings, but with adaptive management teams focused on improving shareholder value, offer strong investment potential.

> "Across all sectors of the market we are focused on unearthing high quality businesses."

As active investors in this market with 10 years of experience, we are enthusiastic about the changes we are seeing, and believe our investment approach positions us well to capture future growth. Our focus on active engagement, the strength of relationships with company management, and corporate Japan's evolving attitude towards foreign investors equips us with a solid backdrop to benefit from these changes and generate sustainable alpha over the long term.

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