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A different perspective on Japan

The Quilter Investors Japanese Equity Fund, managed by M&G, is a key holding within our Portfolios. We look at what differentiates M&G's approach to Japanese equities, while Carl Vine, the manager of the fund, discusses some recent success stories and the broader outlook for Japan.

1 *A differentiated approach*

M&G's long-standing research team takes a style-agnostic approach when it comes to researching Japanese companies. This enables the fund manager, Carl Vine, to take a different approach to portfolio construction compared to his peers.

The strategy aims to identify dislocations between the price of Japanese stocks and what his team considers to be the risk of ownership. The essence of this approach is to exploit these dislocations through the superior pricing of such risks, something which is enabled by the decades of differentiated research into local stocks undertaken by the team.

While M&G rejects the label of 'activist investor' it does actively engage with the companies in which it invests. It aims to position itself as a 'cultural insider' but with insight from outside of the local investment community. This unique perspective uncovers many hidden investment opportunities.

2 *Pan-Asian mindset*

Carl Vine is also co-head of the M&G Asia Pacific Equity team, which has been generating consistently differentiated research on stocks in the region since 2001.

The team's research is grouped around economic exposures, rather than geography, and spans the entire market-cap spectrum. The focus and breadth of this research universe is such that unintended 'factor biases' don't creep in. This allows the fund manager to construct a style-agnostic, factor-neutral portfolio that's driven by bottom-up stock selection.

The team is able to manage the idiosyncratic stock risks that come with this thanks to the unique perspective afforded by its research. This inherent focus on navigating risk means the fund should deliver a baseline of returns that are in line with the local market, but with the added boost that comes from the 'alpha' generated by the team's stock picking.

3 *Becoming 'shareholders of choice'*

The quality of M&G's hand-picked Japanese research universe has helped to drive M&G's ambition to become a 'shareholder of choice' for Japanese companies – a concept that encapsulates M&G's unique approach to value-added share ownership.

It derives from the concept of 'servant leadership' – a philosophy developed in the 1970s based on the notion that in order to lead, you have to serve. In M&G's case this boils down to earning a place at the corporate table through the quality of its company and sector research and its insight into the pricing of the risk of company ownership.

M&G's aim, as stewards of capital, is to help Japanese companies become better versions of themselves. The idea is that companies want to see M&G on their share register as it has a track record of adding value beyond the capital it invests.

Helping create a 'fat cat'

"A good example of an investment idea that demonstrates our 'servant-leadership' mindset, is the Japanese company Sanrio, which owns the Hello Kitty brand." comments Carl Vine, Fund Manager of the M&G Japan Fund.

"We've engaged extensively with the company since our research first identified the opportunity three years ago and we became a shareholder.

"Despite Hello Kitty having sold more branded merchandise than *Mickey Mouse*, the company's market capitalisation was only around US$1bn when we bought in. We engaged with the company on how it could improve its board structure and its advisers, and we introduced the company to Tencent; more recently we contributed some ideas to its emerging NFT strategy.

"Recent corporate disclosures from Sanrio show enormous levels of both honesty and corporate change, incorporating many suggestions from us. Meanwhile, the company's earnings and revenues are growing in line with a corporate transformation story that's revitalising a lucrative portfolio of globally recognised merchandising characters."

Carl Vine, Fund Manager, M&G Japan Fund

Seven up...

"Seven & I, a diversified Japanese retail group, is another core holding. We are bullish on the stock's prospects for long-term profit growth from its global portfolio of convenience stores.

"In 2021 the company, which is best known for its 7-Eleven convenience stores in North America and Japan, bought Marathon Petroleum's Speedway gas stations for around $21bn. The acquisition increased the number of 7-Eleven stores in the US and Canada by some 40% to around 14,000.

"The move was driven by a desire to shift the company's growth focus beyond Japan, due to its anaemic economic growth and ageing population. While much bigger in size, the US market is still fragmented; it has yet to experience the consolidation seen in Japan, largely thanks to the efforts of 7-Eleven. With the highest margins in its sector and the best unit economics, Seven & I has become the 'buyer of choice' in a US sector poised for rapid consolidation."

A season of low-hanging fruit

"We continue to be optimistic about the structural outlook for company earnings growth in Japan and believe the market offers an unrivalled investment opportunity over the coming decade. Our optimism derives from the ongoing process of 'self-help' underway across corporate Japan where companies of every hue are taking advantage of 'low-hanging fruit' to increase corporate margins while optimising their corporate structures and strategies.

"The 'self-help' story is especially compelling because it doesn't require a strong macroeconomic tailwind.

"In general, while economies elsewhere are trying to contain wage-price spiral dynamics, Japan is encouraging them. Higher real wages, real growth, and modest inflation trending back toward 2% by the end of the year are all in evidence, as is higher productivity, which should be sufficient to protect, or even improve, corporate margins.

"Even so, the nature of the 'self-help' dynamic makes it more important than ever not to lean on rotations in style factors. It will require detailed, bottom-up, stock selection to prosper in Japan over the coming years."

Key takeaways

- M&G takes a style-agnostic approach to portfolio construction based upon its differentiated research process that identifies dislocations between the price of Japanese stocks and the risk of ownership.
- M&G aims to become a 'shareholder of choice'. Its approach derives from the concept of 'servant leadership' – a philosophy based on the notion that in order to lead, you have to serve.
- Carl Vine expects Japanese stocks to produce a mid-teen compound annual return over the next decade, driven by the powerful 'self-help' story in evidence among Japanese companies.

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