RWC

RWC Japan Active Engagement

1st May 2020 Update

Although we consider ourselves fundamental stock-pickers, our process at our regular meetings and calls also involves touching upon the macro environment and I thought I would share how we are assessing the current situation. As I am sure you are aware, Japan has declared a state of emergency, but have not enforced a lockdown like many other countries. Many restaurants, offices, shops and services like beauty salons remain open, although naturally, foot traffic has fallen considerably. As of today, the number of infections is around 15,000 and the number of dead is around 500. Like many market observers, we envisage three main possible scenarios on how the effects of Covid-19 could play out.

Scenario 1 “V-shaped”:

The Japanese emergency declaration will be successful, and the number of new patients will decrease after the May Golden Week holiday. As forecast by the government, emergency restrictions will be lifted soon after and coronavirus will be terminated without causing major medical disruption (single-digit new patients per day in Tokyo). From the consumer's point of view, Coronavirus-related fear will gradually fade, and some people will begin traveling during their summer holidays. From the October-December period onwards, Corona-related behaviour is minimal, and in this respect it follows a pattern similar to SARS and MERS in the past.

Globally, stringent lockdown measures have been successful. The number of deaths in the United States is about 50,000, which is significantly lower than Trump's initial forecast. Expectations for the development of therapeutic drugs and vaccines will increase from the latter half of the year.

The global economy is expected to recover in a V-shape, and stock prices will recover in anticipation. Stock prices will recover to the level before concerns about the new coronavirus. Long-term interest rates will similarly recover.

Scenario 2 “U-shaped”:

Japan's declaration of an emergency was too late, and it will be impossible to lift the restrictions until well after the May holidays. The number of new infected people in Tokyo jumps up to 400-500 per day and remains at an elevated level until the Autumn when it drops to around 100 per day. Corona fatigue becomes a problem and it is widely acknowledged that it will take a considerable amount of time to recede. However, the collapse of the Japanese medical system is avoided and the death toll remains ones of the lowest globally. It is also widely recognized among consumers that the new coronavirus is different from SARS and MERS, and a lifestyle consciousness of how to live with the virus is established. There are a certain number of people who cancel overseas travel, and working from home spreads mainly among large companies. Although the Tokyo Olympics have to be scaled down, it will be held.

Globally, the effect of lockdowns are muted and prolonged. The number of deaths in the United States exceeds 100,000, and the collapse of medical care will be clear. The number of new patients increases again from China, where they said it was over, and remains constant thereafter. Vaccine development is not going well.

The world economy becomes more depressed. After employment adjustments and negative growth, we enter an era of low growth. Although not as bad as the Great Depression, it is firmly established that returning to pre-coronavirus economic growth is difficult. The stock market turns down again and remains low thereafter. The US 10-year bond interest rate barely remains in a positive range.

Scenario 3 “L-shaped”:

An explosion of infections also occurs in Japan, and the number of deaths will increase rapidly due to the tightness (collapse) of medical sites. Additional lockdowns will be considered, but policy will fall behind due to lack of government leadership. Life in Tokyo is constrained like life in NY today, and that situation will continue even after the Autumn. The Tokyo Olympics will be cancelled. Although people's dissatisfaction reaches its peak and riots are avoided, the Abe administration will change.

The world is aware of how difficult it is to control this virus, and it will cause major restrictions and changes in personal and corporate behaviour over the long term. International passenger restrictions will not be lifted in 2021 and airlines will be forced into bankruptcy or nationalization. The economy and employment will be comparable to those during the Great Depression, causing riots and

looting around the world. President Trump will take advantage of his current strength to control the presidential election. The US criticizes China, and the US-China conflict increases.
The stock market falls sharply worldwide, and flight to quality continues. US 10-year bond interest rates have remained negative, and a world without positive interest rates arrives.

In summary, we as a team believe that Scenario 2 is the most likely outcome and we see signs that the market sentiment in Japan is implicitly leaning from Scenario 1 to Scenario 2 as well. Even so, valuations are still at elevated levels, partly because some investors are still assuming a V-shaped recovery, and partly because companies have yet to revise their forecasts.
Having said that, we do feel that Japanese companies are relatively well-positioned against their global peers. Meaningfully, they have more experience than most in weathering a protracted, low-growth environment. Some of the much-criticised characteristics of corporate Japan may now prove to serve them well. Cash-richness, job security/lifetime employment, strong corporate relationships and well-worn disaster management playbooks. In particular, corporate Japan's strong balance sheets should ensure that most full-time employees will keep their jobs and this, combined with various Government policies (including gifting Y100,000 per person) should help keep consumption relatively well-supported versus other markets.

With the current environment being in such stark contrast to the buoyant conditions experienced last year, perhaps underperformance of the portfolio would have been expected, but instead our companies are faring relatively well. There are a number of reasons for this, which we have explored. We believe that over 60% of the portfolio by weight is benefitting either directly or indirectly from changes in behaviour triggered by or enhanced by Covid-19. Companies like large-scale retailer Cosmos Pharmaceutical, and Yakult are in the “direct” bucket. Cosmos' size and scale have enabled them to be reliable stockists of limited products like masks, hand sanitizer etc and they have enjoyed free marketing by word-of-mouth. Yakult provides an everyday, low-cost health drink believed to help boost the immune system through improved gut health. They are also one of a number of our companies which have a China-related growth story and are well-positioned to benefit from the early Chinese recovery.

The “indirect” bucket is much larger and we feel, more important. These companies are beneficiaries of changing patterns of behaviour which were already in motion, but Covid-19 has served to expedite the transition from for example, physical to virtual or manual to electronic. We have numerous companies that feed into these themes of innovative technology or medtech and one example of this includes M3, who remove the need for physical visits between doctors, patients and pharmaceutical representatives. Another is JustSystems, a company that provides online resources and learning software for schools and companies. In a clear example of the expediting process, the Governments' goal of providing every publicly educated schoolchild (98% of children) with a tablet by 2023 has now been moved to 2021.

In terms of the portfolio as a whole, we often refer to our focus on “quality” companies and this, in turn, reflects the resilience imbedded in companies with high margins, dominant market share, customer loyalty, brand recognition, high barriers to entry, strong cash positions and management open to engagement. Our focus on ESG is inextricably linked to assessing both risk and resilience, and it is encouraging to see those building blocks form a strong foundation for the portfolio in different market conditions.

Finally, what is happening to engagement? Clearly, all or most companies will incur some damage from the inevitable slowdown in the world economy and many have been stunned by both market moves and disruption to their supply chains and/or end-demand. Although all interaction is now via phone or video call, we continue our regular dialogue with portfolio companies. Our long-term and deep relationships with company management have come through, as has Nissay's position in corporate Japan as a long-term and highly respected institution. We are providing our advice and experience to our companies and continue to encourage them to improve for the benefit of all stakeholders. If anything, the Coronavirus crisis has galvanised our arguments and highlighted the need for companies to strengthen themselves and build better, more sustainable businesses.

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