Quarter 3, 2024

Global Equity Investment Outlook

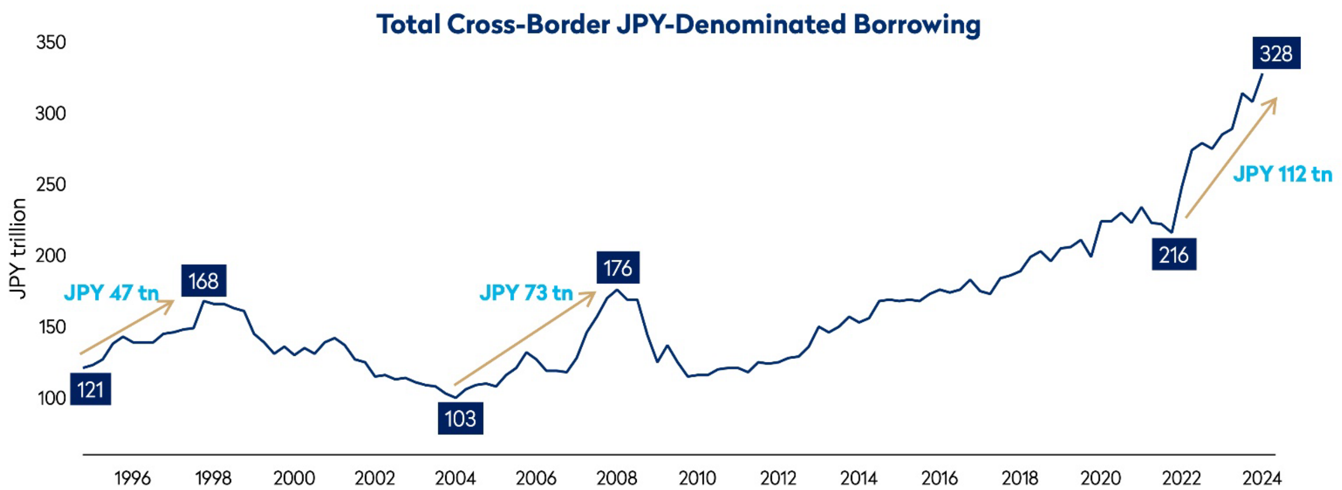
Mondrian portfolios have benefitted from positive stock selection in Japan over multiple time periods

Recent equity market volatility has led some to question the Japanese equity market renaissance. As such, we wanted to revisit the rationale for Mondrian's positioning in Japan and to consider what, if anything, has changed more recently.

Mondrian has a long-term track record stretching back almost 35 years of adding value through stock selection in the Japanese equity market. While we are proud of that track record, our experience has taught us that currency-led volatility can be very challenging for an externally-facing stock market such as Japan. While it is still early days in what could become a longer turbulent period, we are reassured that our portfolios produced characteristic returns consistent with our defensive value style during the yen-induced turbulence over the past couple of months. Mondrian's portfolios generated strong absolute returns and showed defensiveness during the periods of market weakness. Mondrian's global equity composite's Japanese stocks materially outperformed both MSCI Japan and MSCI World in the third quarter.

While the Japanese market ended the quarter up in US dollar terms and only just behind MSCI World in a very strong period, returns were driven by the yen, which appreciated more than 12%. The Bank of Japan's rate hike on July 31st, was accompanied by hawkish commentary, and coincided with weaker US labor market data which led to heightened expectations of US rate cuts. This looks to have triggered a sharp reduction in the yen carry trade leading to the currency's sharp appreciation against the US dollar, and all other major currencies.

Sourcing accurate and current data on the yen carry trade is notoriously difficult but Bank for International Settlements data does indicate that cross-border yen denominated borrowing had increased steadily since about 2010 and that it had accelerated sharply from 2022 to mid-2024. We may have more information when the next data points are published at the end of October.

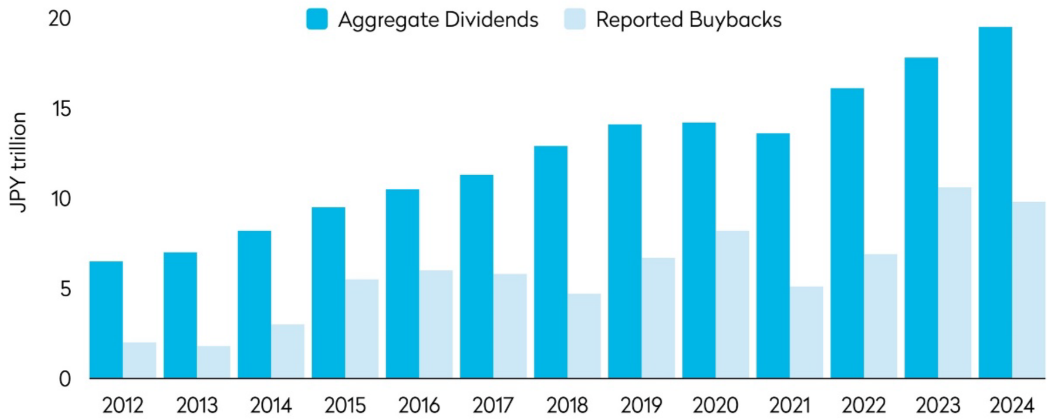


Source: BIS, Jefferies

Improving shareholder returns and corporate governance reforms continue to gather momentum

The longer-term positive from improving corporate governance in Japan remains in place and continues to translate into growing shareholder returns. Share buybacks announced so far in 2024 (calendar year) are already well above 2023 record highs, and dividends-per-share have grown at a strong 10% annual growth rate over the past 20 years.

Aggregate Dividends and Reported Buybacks since Fiscal Year 2012



	CAGR %
Aggregate dividends	9.6%
Reported buybacks	14.2%

Source: Jefferies, Mondrian Investment Partners

The latest push from the Tokyo Stock Exchange (TSE) for corporate governance reform continues to gather momentum. The TSE is now publishing a monthly list of companies which have complied with their request to explain their return on capital relative to cost of capital, to update this annually with improvement plans, and to facilitate better dialogue with shareholders. These TSE reforms are the latest in a more-than-decade-long process of domestic driven corporate governance reform in Japan, started by ex-Prime Minister Abe. Corporate governance standards in Japan still lag those in other developed markets, but we believe that Japan is now seeing the fastest governance improvement among peers and that it has the most value still to be unlocked from relatively straightforward improvements.

Management teams are very aware of the TSE requests; several portfolio companies have made positive changes including large share buybacks and dividend hikes, adding new independent directors, increasing alignment of management compensation with shareholders, selling legacy cross-shareholdings, and exiting non-core/low return businesses.

The sell-down of corporate cross-shareholdings, long a drag on ROE and a protection from shareholder scrutiny and from potential takeovers, continues to accelerate with an 86% YoY increase in the value of sales. The once reluctant Toyota Group is now taking a lead in unwinding cross-shareholdings including strategic holdings in group members, a symbolic move for corporate Japan. Portfolio holding Toyota Industries still has more than 100% of its market capitalization in cross-shareholdings but has recently made significant improvements in disclosure on capital allocation and in shareholder return policy, including a commitment to significantly reduce policy-held shares and its largest ever share buyback. We have long felt that the possible unwind of these substantial cross-shareholdings supported the skew of outcomes for the stock and have engaged with management on this topic for several years.

Next step: Barbarians at the Gate?

Will the next steps in Japan's evolving corporate reform include further corporate consolidation or even hostile M&A? In the fiercely independent auto sector, Honda's recently announced alliance with Nissan and Mitsubishi Motors would have been unthinkable only a few years ago. We expect it will likely lead to further industry consolidation.

Probably even more significant is the Canadian company Alimentation Couche-Tard's (ACT) unsolicited bid for the leading Japanese convenience store operator Seven & I. This is the largest foreign takeover attempt in Japanese history. While this transaction will face hurdles the conversation since the bid became public demonstrates an evolution relative to the past (when bids were privately dismissed). Seven & I's new independent Chairman stated:

> *"The proposal grossly undervalues our standalone path and the additional actionable avenues we see to realize and unlock shareholder value in the near- to medium-term... We are open to sincerely consider any proposal that is in the best interests of 7&I shareholders and other stakeholders. However, we will resist any proposal that deprives our shareholders of the company's intrinsic value".*

With the world watching, the bid should prove a useful test of Japan's Ministry of Economy, Trade and Industry's new Fair M&A guidelines released in August 2023 and further enhance scrutiny of Japan's market for corporate control. Even now OECD studies find the US is markedly more restrictive to FDI (foreign direct investment) than Japan.

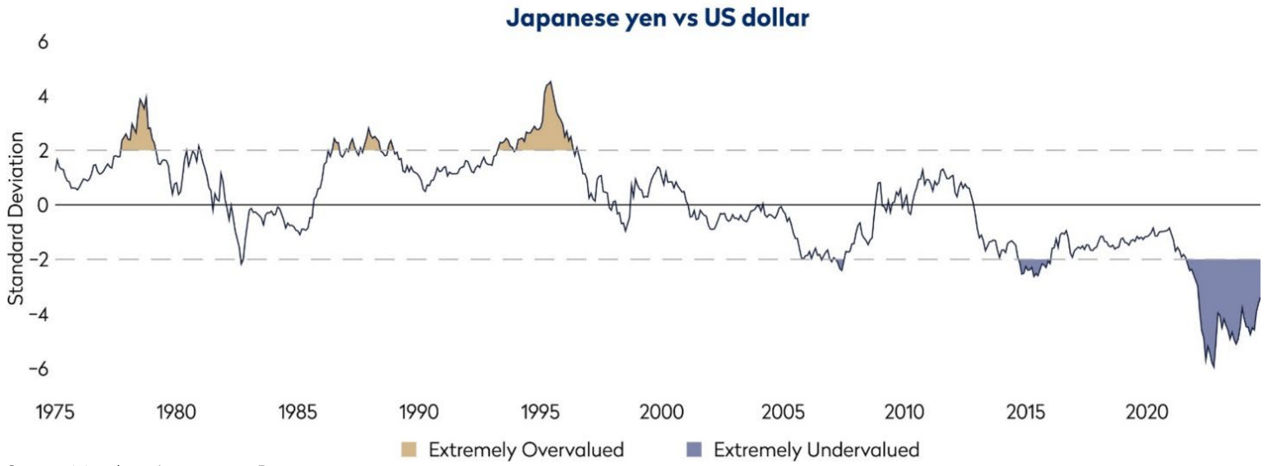
New Prime Minister and snap general election unlikely to be disruptive

Japan's ruling LDP party elected a new leader at the end of September. Mr Ishiba will automatically assume the post of prime minister following the resignation of the former party leader and Prime Minister, Mr. Kishida. Low approval ratings on the back of a party funding scandal and rising cost-of-living pressures, exacerbated by yen weakness, led Mr. Kishida to step down.

Mr. Ishiba is a veteran politician with extensive ministerial experience in portfolios such as defence and agriculture. He has also held senior LDP roles including secretary-general, the party's number two position. We expect broad continuity in existing economic policies under Mr. Ishiba, including the continued normalization of monetary policy. His first act as Prime Minister was to trigger a general election to be held in late October. Although the new leadership may lead to some policy shifts, it is important not to overstate the impact; post-war Japanese Prime Ministers have averaged eighteen months in office. The pro-business centre-right LDP party remain dominant, and Japan's relatively low political risk stands out in a global context. Importantly, there is now broad-based political support for corporate reform and to improve returns on domestic assets to offset demographic challenges.

The yen remains cheap even after recent appreciation

Mondrian's Purchasing Power Parity (PPP) analysis continues to indicate that the yen is materially undervalued even after the c.12% appreciation against the US dollar in the third quarter.



Source: Mondrian Investment Partners

Our Fixed Income and Currency team highlight that the Japanese yen remains extremely undervalued according to our PPP models. Alongside other major currencies, the yen has been depreciating against the US dollar since 2012. This depreciation accelerated from the start of 2022. To its recent lows in June 2024, the yen sold off by almost 30% against the US dollar, taking its nominal exchange rate to levels not seen for almost forty years. At the same time, domestic consumer prices have been relatively subdued and producer price inflation has been more controlled than in other major economies, underpinning the value of the theoretical real exchange rate. As a result, the yen's PPP undervaluation signal is still among the strongest we have ever seen from developed market currencies, and its real effective exchange rate (REER), which measures the currency against a basket of other currencies, is the lowest it has ever been since exchange rates started floating in 1973. Extreme valuations such as this are typically unsustainable and do not persist indefinitely.

There may now be reason for a reversal. The yen carry trade capitalized on the divergence of Japanese monetary policy from that in the rest of the world. Over the past two years, central banks outside Japan raised interest rates aggressively to fight inflation while the Bank of Japan left rates largely untouched. The wide gulf between interest rates in Japan and elsewhere has begun to narrow.

Despite the volatility in exchange rates this year, the yen/US dollar exchange rate ended the quarter at roughly the same level as at the start of 2024. The weak yen/strong US dollar trade has been at the center of financial markets for over a decade. It is reasonable to assume that a sharp reversal could cause some destabilization in either the financial economy, the real economy or both. In order to address this risk, we have incorporated currency adjustments in our top-down and bottom-up valuation models. Yen appreciation will impact the overall economy given that approximately 60% of Japan's corporate profits come from overseas, but will not impact all companies equally. Mondrian's process is well-suited to capturing the nuanced impact of a shift such as this on different companies. By incorporating currencies moving back to their inflation-adjusted fair value in our bottom-up models, our process can distinguish between transactional impacts, translational impacts, and domestic-only businesses. As a result, we have added recently to more domestic-oriented investments. Moreover, while Japanese corporate earnings can be cyclical, most of our Japanese investments have strong net cash balance sheets which can comfortably withstand a downturn while maintaining, or even continuing to grow, shareholder returns.

Japan continues to offer attractive opportunities for active managers

Our overweight position in Japan is based on attractive valuations and our expectations for future real returns. Mondrian's investments in Japan have performed well. Nevertheless, we think that the skew remains positive given strong corporate balance sheets and structural improvements in corporate governance. While we recently reduced some exposure to the more cyclical and semiconductor-related companies, we see a long way to go and remain confident in the portfolio's absolute exposure to Japan. Japan's equity market remains broad and deep, and heightened market volatility can provide opportunities for active managers such as Mondrian. Stock selection in Japan has contributed positively to Mondrian international and global equity portfolios' relative returns over all time periods. We will continue to focus on the skew of outcomes, underlying fundamentals, and valuations as we seek to identify further opportunities in mis-priced securities.

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Unless otherwise stated, all returns are in USD

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