"The Japanese Exception"

Dear Investors,

We began our Autour du Monde investments with you in 2005. Japan came late to the party, around 2012-2013, but has never stopped growing since. Our recent trip to Japan, during which we met more than 40 companies over 2 weeks, is a good opportunity to review this joint history.

We took our time addressing Japan, even though it is a particularly mature stock market, because its valuations took a long time to steady down after the bubble burst at the end of the 1980s. Also because most Japanese businesses only gradually started making their margin and dividends a priority, having for a long time been unaccountably irrational in how they allocated capital. The current mediocre level of margins is not just due to being indifferent to finance, it also reflects a concern for social cohesion. In Japan, corporate social responsibility is evident and stretches all the way to guaranteed jobs-for-life, for instance. This was the case at Showa Aircraft: at the time of our visit in 2013, it still had 300 employees with no work to do, 8 years after losing a subcontracting agreement! Similarly, capital allocation is restricted by local practices, which companies find hard to circumvent. For example, the habit of exchanging often-substantial cross-shareholdings with suppliers, customers and other partners, which still affects over 60% of Japanese businesses.

Nevertheless, starting in 2012, we found relevant investments in high-quality, low-valuation growth companies, such as Keyence - the global leader in consulting and sales of sensors for product line robotisation - and cosmetics business Mandom, which is growing significantly in South-east Asia, especially in Indonesia. Both these cases are interesting, in that it is the irrational capital allocation, leading to large amounts of cash on the balance sheet, which led to these stocks being undervalued, since the market did not take the cash into account, whereas it is easier to show more patience with companies in a zero-rate environment.

Since 2012, Japan's position in the Sextant Autour du Monde and Grand Large funds has grown, specifically because of the progress made in the financial culture of Japanese businesses. In the last few years we have invested in Shiseido and Fanuc, two ideas that provide a good illustration of the changes in the ways Japanese companies consider both their margin and capital allocation. Shiseido has always been passionate about developing new products and therefore has kept good marks. However, the company's profitability was low, even reaching zero abroad. The marketing teams were totally detached from actual sales. There was significant inefficiency in the organisation, which would be unacceptable in the rest of the world for a business of this size, such as having no purchasing function in the overheads. The arrival of a new CEO who had experience of both Japanese and US cultures, and was a first-ever outside appointment, started a profound cultural revolution, including a review of the entire internal organisation and a potentially multi-year boost to the business activity and margins. For Fanuc, it was the arrival of activist investor Daniel Loeb that gave the company the opportunity to review its entire shareholder returns policy, which had always been meagre despite the huge amounts of cash on hand. The company has now undertaken to return its entire annual cash generation to its shareholders through regular dividends and opportunistic share buybacks. This progress is remarkable, but in our opinion has not properly been taken into account in the current valuation of this stock, even though the question of the cash war-chest already in the balance sheet remains unanswered.

There is still progress to be made, therefore. To measure this more accurately, we went back to meet with over forty businesses in Tokyo, Yokohama, Nagoya, Osaka and Kyoto, and with local sector analysts and investors who share our investment philosophy. This also reflects our opportunistic approach to overseas investments, with ten years of experience that have given us a thorough knowledge of the major stock markets. To find out where we need to concentrate our efforts at any given time, we avoid macroeconomic scenarios, preferring to take a contrarian attitude. We bet on the fact that acting systematically when problems become obvious gives us the best chances, since the macroeconomic risks have already occurred - at least in part -, valuations have already fallen, and there is widespread scepticism. At such times, we activate our local networks, set up a programme of visits and look for ideas that will remain relevant over the long term, whatever changes there may be in the short and medium terms. Following on from India in 2010-2012, Brazil in 2014 and Russia in 2015, Japan became a must this year, after a significant stock market fall related to the rising Yen since June 2015, at a time when the other developed countries offer ever fewer possibilities.

Weather-wise, August is not the best time: heat and humidity are high, there are typhoons and we even witnessed the impressive experience of an earthquake right in the middle of a meeting. There are also the linguistic difficulties that require an interpreter to be almost always in attendance. Fortunately, we could always count on the general civility of the Japanese, their sense of hospitality and comfort, their obsession with hygiene, illustrated by the heated toilet seats and immaculate antimacassars on taxi seats, and of course the military-style cleaning of the bullet trains (the famous "7-minute clean" - see http://m.youtube.com/watch?v=kt92-ZDm-HM or search Google or YouTube for "7 minute miracle" to find the video, or scan the QR code at the end of this newsletter). Just like extreme discipline and efficiency, their obsessive - often minimalistic - attraction to perfection remains fascinating, despite its dark side. Steve Jobs was inspired by it, for which the Japanese show their gratitude: Japan has the highest market share in the world for iPhones - close to 100% between users of the Tokyo Subway - with the latest models being very highly represented. This also has an influence on business culture and explains the colossal global market shares - often above 30% and sometimes 50% - achieved by many of the manufacturing and electronics companies we met, from Murata's Wi-Fi connectors to SMC's automated production line compressed-air equipment.

One consequence of this is that Japanese companies' financial practices certainly change very slowly, but also very deliberately, just like a steamroller. So, dividend payout ratios are increasing regularly and share buybacks, which were almost forbidden until 2001, now account for one-quarter of the sums returned to shareholders, growing regularly and above all independently from the orientation of the stock market, whereas in the rest of the world, they are almost perfectly correlated with the level of stock markets. This movement has been encouraged by the government in recent years, for example by creating a new index that includes the best companies in terms of return on equity, which is a very good approximation of the quality of a company's financial management. Today, more and more Japanese businesses are paying attention to their ROE level because of this. They have defined targets for this and communicate on a regular basis. Qualitatively, the government is also encouraging progress in terms of good governance, leading to a strong increase in the number of independent directors on company boards. This progress is all the more attractive because Japanese companies have halved their debt since 2010, whereas the other Asian companies doubled theirs over the same period, and American did practically the same since 2007. In United States companies, this debt is used in an unhealthy fashion to remunerate shareholders, since it now exceeds the cash they generate - clearly an unsustainable aberration at the top of the cycle.

Of course, this would be of no use if the Japanese market valuations built this into their stock prices. To the contrary, by simply looking at the year's P/E ratio, Japanese stocks are on average 15% cheaper than European stocks and 25% cheaper than US stocks. Japan's particularly unfavourable demographics could explain this in part. But this constraint has been fully taken into account by Japanese companies: in industry, they are at the leading edge in terms of automation, while in consumption, they are turning more aggressively to overseas markets, especially in the rest of Asia. In addition, the under-valuation is no lower at mainly export-focused companies. Consequently, it was quite logical that we found new ideas in Japan, such as Meitec, which we talked about in the Sextant Autour du Monde fund's monthly report. Others are being examined, but already, Japanese stocks represent respectively 9% and 13% of the assets invested in shares for the Sextant Autour du Monde and Sextant Grand Large funds.

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