Japan Update 2023

July 2023

In June and July 2023, our Japan team (Masa Hosomizu and Ilhwa Lee) travelled to Japan to attend company meetings and network locally. Compared to our visit last year, the improvements in Japan's macro economy were noticeable, as the country has been emerging out of COVID restrictions since earlier in the year. We confirmed our long-term thesis and investment case in Japan based on our positive findings during the trip.

Seeing is believing – Strong reopening demand is driving the economy

While we were in Japan, we observed strong traffic in retail stores, restaurants, and shopping malls. People are spending more money even though inflation was inching up in the country where deflationary economy had been the norm for so long. Reportedly, wages were increasing due to the labor shortage under the post-COVID demand, while the savings households have kept during COVID support consumer spending. Just as we observed in the U.S. and Europe, Japan was experiencing the positive impact of the economy re-opening almost a year after its peer countries because of the belated lifting of COVID restrictions this spring. Consumer spending is expected to be even stronger during this summer, as workers receive their summer bonus at the end of June, which was at the highest level of payout in the recent past.

In addition to the domestic consumption, in-bound tourist traffic from Asia, Europe, and North America was leading the demand-side of the economy under the weak Japanese yen, which boosts tourists' purchasing power. The spending frenzy by these tourists was driving retail sales across large and small boxes and dining scenes. In the meantime, current in-bound traffic does not include tourists from mainland China, due to China's strict restriction on international travel. Once China reopens its border and allows their citizens to travel abroad, Japan will certainly be the one of the most popular destinations for them, as it was pre-COVID, and even stronger tourist-driven consumption is expected to support Japan's macro economy.

Our investment case of Japan remains intact:
Abenomics is upgrading Japan's economy and businesses

We were one of the first advocates of Japan's equity market recovery as we identified the initial changes in the country in 2013, when the Liberal Democratic Party (LDP) of Japan regained power under Prime Minister Shinzo Abe and launched Abenomics economic reform initiatives. While all his reform policies, the so called three arrows (monetary easing, budgetary stimulus, and economic reform) are important, we believed the third arrow, economic reform, would be transformational for the country, which had been suffering from a decades-long economic slump. We had been particularly interested in the impact and consequence of the corporate governance reform that we believed to be a critical driver for the publicly traded companies in Japan to transform themselves and improve their capital efficiency, shareholder return, and eventually stock prices in the long-term. Ten years have passed, and we are only more confident about our investment case in Japan to see the positive changes in the country.

2023 is an inflection point for Japan to break its 30+ years of deflation

Post-COVID reopening resulted in an inflationary economy in Japan, which is an historic event for the country, which had been in deflation so long. Prices are increasing, wages are increasing, and corporate profits are increasing – a virtuous cycle started to break Japan's 30+ years of stagnant economy. Though the end of the COVID pandemic and the economy reopening were the triggers for this inflationary shift in the country, we should be mindful that there were more long-term changes in the global macro background. Japan's decades-long deflation coincided with China's economic growth, where China effectively exported its cheap labor forces outside, especially to neighboring countries such as Japan. Japan's wages and consumer prices have been under downward pressure, as the country offshored its labor costs to China. However, as China achieved strong economic growth and its wage levels increased significantly, such deflationary pressure to Japan eased, resulting in the upward push for Japan's wage and price levels. Further, the aging society in Japan was inflationary for the country. Labor forces became scarce resources as there are fewer in the working age population with more senior citizens retiring and exiting the labor market. The aging population became pure consumers, contributing to the net increase in demand, further adding to inflationary pressure in the country.

Japan's corporate culture is changing toward true capitalism-mindset to pursue profit and efficiency

During our trip, we met with management teams of dozens of companies, from large to small. After years of corporate governance reform under Abenomics, we observed that even companies that had been regarded as old and slow-to-change, such as Hitachi Ltd. (6501 JP), NEC Corp. (6701 JP), and Fujitsu Ltd. (6702 JP), have been dramatically shifting their corporate culture under their new and strong leaderships to pursue profit and capital efficiency. These changes went on somewhat unnoticed because, in general, these structural reforms take time and are hard to result in immediate improvements in hard numbers for the first few years of the reform initiatives. However, the leadership of these companies kept their own reform efforts patiently for the past several years and are finally seeing improvements in profit levels and capital efficiency, though only to be discovered by the stock market recently.

Tokyo Stock Exchange made a timely call for price-to-book ratio to be above one time

With the change in corporate culture of Japanese companies in the background, it was a timely call by the Tokyo Stock Exchange (TSE) to demand Japanese listed companies to target above one-time price-to-book ratio (PBR). PBR of one time is regarded as a threshold for companies if their operations are generating wealth for shareholders or not. Theoretically, companies that trade below one time book value would be better off by dissolving themselves and returning their assets to shareholders. In Tokyo, more than 60% of the publicly listed companies are traded below this key threshold, and their weak capital efficiency came under scrutiny by the shareholders when the TSE requested all listed companies to aim to achieve one time or above book value in January this year. We believe this goal is not necessarily hard to achieve for most of the companies, because key issues at these low capital efficiency businesses are not their profitability but their capital structure, or over-capitalized balance sheets in a form of excess cash, unnecessary real estate properties, or cross shareholdings. These companies can improve their capital efficiency relatively easily by investing excess capital in profitable operations, or simply returning excess capital to shareholders, and can expect their valuation multiples to be revalued above book value. In June this year, when most companies wrap up their fiscal year and announce full year results, we observed that many companies beefed up their dividend payouts or initiated share buyback programs in their efforts to lift their book value multiples. This trend should provide a great hunting ground for investors – more than 60% of the listed companies in Japan, or more than two thousand publicly listed companies, are all suddenly rushing to take positive corporate actions so that their valuations are lifted upward.

More changes in Japan's corporate culture: Recent spin-off and hostile takeover cases

Changes in Japan's corporate culture and reform mindsets do not stop at simple corporate actions, such as dividends or share repurchase. Recently, we observed more aggressive corporate actions, such as spin-offs of non-core operations and hostile takeover cases, to achieve better operational structure, capital efficiency, and wealth creation for shareholders. Behind the scenes, Ministry of Economy, Trade, and Industry (METI) has been actively launching new tax rules and best-practice guidelines to encourage such corporate actions among Japanese businesses.

In May, Sony Group Corp. (6758 JP) announced its plan to spin-off Sony Financial, its financial business subsidiary, a corporate action Sony's management had refused to take approximately ten years ago when U.S.-based activist Third Point demanded such a spin-off. As METI recently added a tax incentive ruling for spin-off transactions, Sony's management may have decided a more rational action to improve shareholders' value. In July, Nidec Corp. (6594 JP), a major motor manufacturer for electronics, industrial machineries, and automobiles, launched a hostile takeover bid for a publicly listed small machinery company with approximately 100% premium over the pre-announcement stock price. Though hostile takeover has been a sort of taboo in Japan, recent mergers and acquisitions (M&A) guidelines updated by METI demanded potential target companies to sincerely consider acquisition offers, even hostile ones, for the sake of general shareholders' benefit. This guideline, as well as the recent changes in social acceptance of more capitalism-mindset actions in Japan, may have encouraged Nidec's management to initiate the hostile bid. We expect that these cases would be followed by more similar cases by other companies that pursue better corporate value for shareholders.

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Japan's political stability supports our investment case

Since Russia's invasion of Ukraine in February 2022, geopolitical issues have been among key concerns of investors and weighing on the real economy across the regions. In Asia, China's aggression over Taiwan has been a concern among investors. Consequently, Japan came under a spotlight as an alternative to Asia exposure for global investors because Japan enjoys political stability under the democratic system, the same value shared by western countries. Further, Japan is benefiting from the changes in the regional geopolitics, as the businesses are reversing the decades-long off-shoring trend and building domestic production capacities in Japan. For example, the semiconductor and electronics industry is strategically building new capacity in the Kyushu Island of Japan with the support of government incentives to make the island a new technology center in Asia. Coincidentally, Kyushu is approximately the same size as Taiwan Island, which is known as a technology center in Asia. Domestic reversion of capex, along with jobs, should help the Japanese economy in the long-term, further supporting the investment case of Japan as a proxy for Asia investing.

Market's appetite in Japan is back and became stronger since 2022

Since 2022, global investors became bullish on Japan, and started to recognize how Japanese equities are undervalued. Since last year, prominent investors, including Warren Buffett, are aggressively adding their bet in Japan. As a result, money is flowing into Japanese equities with the Nikkei Index reaching a 40+ years' high.

FX is mean-reverting - We expect that the weak yen is a temporary phenomenon as history shows

Lastly, we would like to touch on the foreign currency (FX) discussion, a frequently asked question from our clients. In general, FX rates are decided by interest rate differentials. Currently, the Japanese yen is weak against the U.S. dollar because the Fed is raising the interest rates in its fight against inflation, while the Bank of Japan (BoJ) maintains zero-interest rate policy as Japan gets out of deflation. The difference of the central banks' policy directions is explained by the timing of COVID reopening as well – the U.S. got out of COVID restrictions more than a year ago and inflation kicked in since then. In a mean time, Japan had a longer period of COVID pandemic than its peer countries and has just lifted its COVID restriction in the spring of 2023. Though inflation is kicking in in the country, the level of inflation is much lower than other countries, barely exceeding the BoJ's inflation target of 2% and not resulting in a BoJ rate hike yet. Once the inflationary trend continues with deflation in the rearview mirror however, we expect BoJ to update its policy, and the value of the Japanese yen to eventually revert to its parity level.

Sincerely yours,

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Investment Terms:

Price-to-Book (P/B) ratio *measures the market's valuation of a company relative to its book value. P/B ratios under 1 are typically considered solid investments.*

The ***price-earnings ratio*** *(P/E ratio) relates a company's share price to its earnings per share. A high P/E ratio could mean that a company's stock is over-valued, or else that investors are expecting high growth rates in the future.*

Capex - *Capital expenditure or capital expense (abbreviated capex, CAPEX, or CapEx) is the money an organization or corporate entity spends to buy, maintain, or improve its fixed assets, such as buildings, vehicles, equipment, or land.*

Top 10 Holdings	Weighting
Mitsubishi UFJ Financial Group Inc.	7.99%
ITOCHU Corp.	7.57%
Sanyo Shokai Ltd.	5.40%
Subaru Corp.	4.10%
Hitachi Ltd.	3.98%
Murata Manufacturing Co. Ltd.	3.59%
Takuma Co. Ltd.	3.47%
Mitsui Fudosan Co. Ltd.	3.20%
Nintendo Co. Ltd.	3.07%
Kao Corp.	2.89%

Holdings are subject to change. The above is a list of all securities that composed 45.25% of holdings managed as of 6/30/2023 under the RMB Japan Fund ("Fund") of RMB Capital Management, LLC ("RMB Capital") based on the aggregate dollar value. This list is provided for informational purposes only and may or may not represent the current securities managed. It does not represent all of the securities purchased, sold, or recommended for advisory clients (under the Fund or otherwise) during the calendar quarter ending 6/30/2023. The reader should not assume that investments in the securities identified and discussed were or will be profitable. For a complete list of historical recommendation for the Fund, please contact RMB Investors Trust at 855-280-6423.

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All investing involves risk including the possible loss of principal. The Fund invests in foreign securities which may be less liquid, subject to currency-rate fluctuations, be in areas with political and economic instability and be subject to less strict regulation of the securities markets.

An investment cannot be made directly in an index. The index data assumes reinvestment of all income and does not bear fees, taxes, or transaction costs. The investment strategy and types of securities held by the comparison index may be substantially different from the investment strategy and types of securities held by the Fund. The MSCI Japan Index is designed to measure the performance of the large- and mid-cap segments of the Japanese market. With approximately 320 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

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