Stewart Investors
Sustainable Funds Group

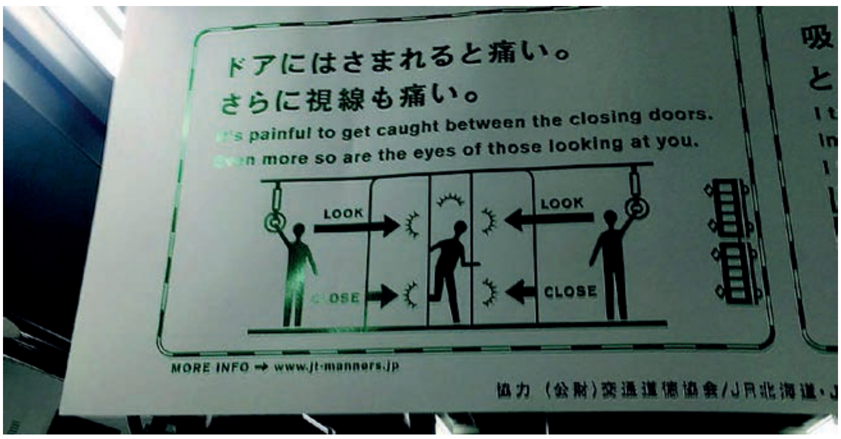
Japan

This document contains information which is no longer up to date. As such, it is maintained solely for information purposes to provide historical information. This document should not be relied upon, including for the purposes of making an investment decision. Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy and Stewart Investors does not necessarily maintain positions in such companies.

The below image is a sign from a packed subway line en route to the bullet train at Shinagawa Station. A sign that initially amused but then began to hold more power as a metaphor as the trip went on. In most other countries, a sign highlighting the pain that comes from getting trapped in a train door would be enough to deter passengers from trying their luck with some automatic doors. Why the second point and why the emphasis on that being the major deterrent to risky behaviour? After some internet searching we find a form of social phobia, one which occurs primarily in Japan. Called *Taijin Kyofusho* it translates as 'the disorder of fear' – a social paranoia characterised by a fear of harming or offending others. The potential consequence of a culture that emphasises conformity?

This fear looks to continue from the commute to the board room. Those management teams and corporate cultures that have managed to overcome the pressure of conformism and take assertive risks, stand out as companies that have and should continue to thrive both domestically and on a global scale. It has been in the best interests of management and shareholders for these companies to show some 'irresponsible responsibility' and break from the herd. As we know in many facets of life (including investing) and in every corner of the globe, it is far better for the reputation to fail conventionally than to succeed unconventionally.

We met a number of primarily domestically-focused companies on this trip who at some point in their history succeeded in thinking unconventionally and recognised early in their journey that they should not be constrained by the traditional means of operating their businesses. Choosing instead to follow their own path, whether that be in consolidating a market (Miraca), creating a new market (MonotaRO or Kakaku.com) or thinking with long enough time horizons to align their franchise with the government's inevitable aim of reducing the country's healthcare costs (Ain), all have proven to be vitally important endeavours since unlike India, Japan lacks a tidal wave of demand that many investors hope will raise all ships.



"It's painful to get caught between the closing doors. Even more so are the eyes of those looking at you."

Source: Stewart Investors investment team, June 2015

Then there are those companies who chose to take on a greater task and the greater risk of non-conformity by venturing overseas. This would have been an almighty decision at the time but for those who have fostered contrarian cultures and have a franchise to back up these ambitions, there remains vast potential to thrive on foreign soil. Unicharm, Nippon Paint, Hoya, Nidec and Kikkoman have been able to establish quality franchises in growing markets where they successfully go toe-to-toe with global multinationals.

It is no surprise then that it is these types of companies that lead the way on governance, diversity and meritocracy. They are, of course, not perfect but they have at least (very consciously) made early moves to break from toeing the line and think a little differently about the importance of the people within the business. This must be respected. All look to have realised the importance in hiring local management within their foreign operations and the more progressive have allowed this thinking to rise to senior management and the board. Hoya is a great example of a non-conformist steward with a relatively young, multinational management team and an independent board. They show few signs of the reactive moves to corporate governance box-ticking that exist among the lesser quality corporates we have met around the world over the last few years. Omron talked candidly of the challenges they face in fostering diversity of thought and the associated risks to the long-term survival of their franchise. Domestically, MonotaRO is a fascinating illustration of a company swimming against the tide with its 40-year-old CEO and independent board.

Sadly, as a result of Japan's inheritance tax laws, it's very difficult for families to preserve control over a number of generations. There are very few multi-generational Ayalas or Tatas here. This makes life a little harder for the long-term investor to find suitable stewards of our clients' capital. The best we can do in the absence of such stewards is to find those management teams and cultures that exhibit values similar to the long-term owners we admire: think like owners with long time horizons which allows them to continue to invest in the business, exhibit contrarianism and a respect for all stakeholders. A lack of such values, combined with cash-heavy balance sheets, sadly increases the likelihood of Robin Hood shareholders coming to rob from the long-term to give to the short-term, usually in the form of aggressive buybacks and a leveraged balance sheet.

Those companies that incorporate all stakeholders within their decision making stand out when it comes to understanding the long-term threats to their franchise. Companies such as Unicharm, Kikkoman, Omron, Hoya, and to some extent Nippon Paint, are well placed to benefit from and contribute to sustainable development. Kikkoman should benefit from the increasing consumption of plant-based proteins and naturally brewed soy sauce, while Unicharm is making a considered move to reduce the environmental impact of their supply chain and continue to invest in the holy grail of affordable recyclable diapers.

Many of the higher quality companies we met on this trip have strong brands built on technical competence and are guided by capable management teams with global attitudes. The next challenge many face is to continue this development and ensure success in new markets. Similar to conversations we have had with other companies within the region, China is where the majority complain of the almost impossible task of keeping pace with the demands of the growing middle class and the evolving distribution channels that feed these wants. Fortunately for many of the Japanese companies who have ventured abroad, the country's reputation for quality goods has afforded them a head start over many competitors. This is especially the case in industries where domestic brands have let down an increasingly informed consumer base (viz. adulterated milk or diapers). For consumer companies this has made brand-building a far easier exercise than it otherwise would have been. Unicharm for example can't simply follow the same strategy they applied in China and Indonesia in the Indian market as the Indian consumer doesn't hold Japanese products in similar levels of esteem. Bottom-up (no pun intended) brand-building is the only answer. Here Unicharm are saved both by their willingness to provide relative autonomy to local management and their ability to share and reflect upon mistakes made in other markets.

For these companies, new and growing markets offer the potential for greater sales, higher margins and healthier returns than what are commonly very competitive domestic markets. We mustn't overlook the fact that those companies that have managed to prosper through twenty years of deflation and zero interest rates will come to the global market armed with a cut throat mentality and should pose serious challenges to global competitors who have been fortunate to have an easier time finding growth, and have likely built up some fat in the process. This offers these companies the opportunity to invest cash flows in growing, profitable ventures that should ensure both the quality of their franchise and the quality of growth continue long into the future. This hopefully allows them to avoid the closing doors of the economic and political malaise that much of the world finds itself in today.

Japan's leaders have had the eyes of the world on them for a few years now. Their quivers must feel increasingly light as their arrows struggle to ignite the growth craved to pull the country out from under (the rising) mountain of debt. This is an increasingly difficult task in a world with a slowing China, low oil prices (Japan is a net energy importer) and where their shrinking population has offset any advances in productivity. Today, however, Japan no longer stands alone. Much of the developed world now shares the characteristics of low interest rates, low inflation and stacks of debt. Unconventional monetary policy no longer feels that unconventional. Companies don’t operate in a vacuum but thankfully those whose management teams have taken considered risks, managed to diversify the cash flows generated by globally competitive franchises and have exposure to growing markets, should continue to be attractive long-term investments and survive the fluctuations caused by economies and short-term investors. We were fortunate to meet a number of such franchises on this trip but as is the case with most other regions in our investible universe, quality isn’t cheap.

Source for company information: Stewart Investors investment team and company data. For illustrative purposes only. Reference to any companies mentioned in this communication is merely for explaining the investment strategy, and should not be construed as investment advice or investment recommendation of those companies. Companies mentioned herein may or may not form part of the holdings of Stewart Investors.

Investment terms

View our list of investment terms to help you understand the terminology within this document.

Important information

This document has been prepared for general information purposes only and is intended to provide a summary of the subject matter covered. It does not purport to be comprehensive or to give advice. The views expressed are the views of the writer at the time of issue and may change over time. This is not an offer document, and does not constitute an offer, invitation, investment recommendation or inducement to distribute or purchase securities, shares, units or other interests or to enter into an investment agreement. No person should rely on the content and/or act on the basis of any matter contained in this document.

This document is confidential and must not be copied, reproduced, circulated or transmitted, in whole or in part, and in any form or by any means without our prior written consent. The information contained within this document has been obtained from sources that we believe to be reliable and accurate at the time of issue but no representation or warranty, express or implied, is made as to the fairness, accuracy or completeness of the information. We do not accept any liability for any loss arising whether directly or indirectly from any use of this document.

References to "we" or "us" are references to Stewart Investors. Stewart Investors is a trading name of First Sentier Investors (UK) Funds Limited, First Sentier Investors International IM Limited and First Sentier Investors (Ireland) Limited. First Sentier Investors entities referred to in this document are part of First Sentier Investors, a member of MUFG, a global financial group. First Sentier Investors includes a number of entities in different jurisdictions. MUFG and its subsidiaries do not guarantee the performance of any investment or entity referred to in this document or the repayment of capital. Any investments referred to are not deposits or other liabilities of MUFG or its subsidiaries, and are subject to investment risk including loss of income and capital invested.

Past performance is not a reliable indicator of future results.

Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell. Reference to the names of any company is merely to explain the investment strategy and should not be construed as investment advice or a recommendation to invest in any of those companies.

Hong Kong and Singapore

In Hong Kong, this document is issued by First Sentier Investors (Hong Kong) Limited and has not been reviewed by the Securities & Futures Commission in Hong Kong. In Singapore, this document is issued by First Sentier Investors (Singapore) whose company registration number is 196900420D. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore. Stewart Investors is a business name of First Sentier Investors (Hong Kong) Limited. Stewart Investors (registration number 53310114W) is a business division of First Sentier Investors (Singapore).

Australia

In Australia, this document is issued by First Sentier Investors (Australia) IM Limited AFSL 289017 ABN 89 114 194 311 (FSI AIM). Stewart Investors is a trading name of FSI AIM.

United Kingdom

This document is not a financial promotion. In the United Kingdom, this document is issued by First Sentier Investors (UK) Funds Limited which is authorised and regulated in the UK by the Financial Conduct Authority (registration number 143359). Registered office: Finsbury Circus House, 15 Finsbury Circus, London, EC2M 7EB, number 2294743.

European Economic Area ("EEA")

In the EEA, this document is issued by First Sentier Investors (Ireland) Limited which is authorised and regulated in Ireland by the Central Bank of Ireland (registered number C182306) in connection with the activity of receiving and transmitting orders. Registered office: 70 Sir John Rogerson's Quay, Dublin 2, Ireland, number 629188.

Middle East

In certain jurisdictions the distribution of this material may be restricted. The recipient is required to inform themselves about any such restrictions and observe them. By having requested this document and by not deleting this email and attachment, you warrant and represent that you qualify under any applicable financial promotion rules that may be applicable to you to receive and consider this document, failing which you should return and delete this e-mail and all attachments pertaining thereto.

In the Middle East, this material is communicated by First Sentier Investors (Singapore).

Kuwait

If in doubt, you are recommended to consult a party licensed by the Capital Markets Authority ("CMA") pursuant to Law No. 7/2010 and the Executive Regulations to give you the appropriate advice. Neither this document nor any of the information contained herein is intended to and shall not lead to the conclusion of any contract whatsoever within Kuwait.

UAE - Dubai International Financial Centre (DIFC)

Within the DIFC this material is directed solely at Professional Clients as defined by the DFSA's COB Rulebook.

UAE (ex-DIFC)

By having requested this document and / or by not deleting this email and attachment, you warrant and represent that you qualify under the exemptions contained in Article 2 of the Emirates Securities and Commodities Authority Board Resolution No 37 of 2012, as amended by decision No 13 of 2012 (the "Mutual Fund Regulations"). By receiving this material you acknowledge and confirm that you fall within one or more of the exemptions contained in Article 2 of the Mutual Fund Regulations.

United States of America

In the United States, this document is issued by First Sentier Investors International IM Limited, as SEC registered investment adviser. Stewart Investors is the trading name of First Sentier Investors International IM Limited. This material is solely for the attention of institutional, professional, qualified or sophisticated investors and distributors who qualify as qualified purchasers under the Investment Company Act of 1940 (hereafter the "1940 Act"), as accredited investors under Rule 501 of SEC Regulation D under the US Securities Act of 1933 ("1933 Act), and as qualified eligible persons as defined under CFTC Regulation 4.7. It is not to be distributed to the general public, private customers or retail investors.

Other jurisdictions

In other jurisdictions where this document may lawfully be issued, this document is issued by First Sentier Investors International IM Limited which is authorised and regulated in the UK by the Financial Conduct Authority (registration number 122512). Registered office 23 St. Andrew Square, Edinburgh, EH2 1BB number SC079063.

Contact details

Edinburgh

23 St Andrew Square
Edinburgh EH2 1BB
United Kingdom
t. +44 (0) 131 473 2900

London

Finsbury Circus House
15 Finsbury Circus
London EC2M 7EB
United Kingdom
t. +44 (0) 207 332 6500

Singapore

58 Duxton Road
2nd & 3rd Floor
Singapore 089522
t. +65 680 59670

Sydney

Suite 10, Level 3
13 Hickson Road
Dawes Point
Sydney NSW
Australia 2000
t. +61 2 8274 8000

info@stewartinvestors.com
stewartinvestors.com