WOLFGANG FICKUS, CFA

JAPAN EQUITIES

STRONG YEN: A FALSE POSITIVE FOR INVESTORS IN COMGEST'S JAPAN STRATEGY

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Member of the Investment Committee

Viewing Japan as a short-term currency play might be right for short-term investors. Below we provide an in-depth analysis showing that this misleading 'macro call' for investors in Comgest's Japan Strategy could cut them off from potentially significant long-term growth opportunities. Our fund's stable 20%-25% earnings growth over the past five years has been insensitive to currency swings. This analysis also counters misconceptions that Japan's domestic conditions are ex-growth due to factors such as weak demographics and low inflation. We provide several examples of strong domestic growth themes found in our Japan Strategy. While investors may be plagued with doubts about the effectiveness of Abenomics, we have observed good progress on many fronts. Japan's much improved capital returns over the past three years – at odds with weakening returns around the globe – are a tangible sign that reforms in Japan are heading in the right direction. Our plea to investors is to stay as confident on Japan as we are and to exploit some ample stock-picking opportunities.

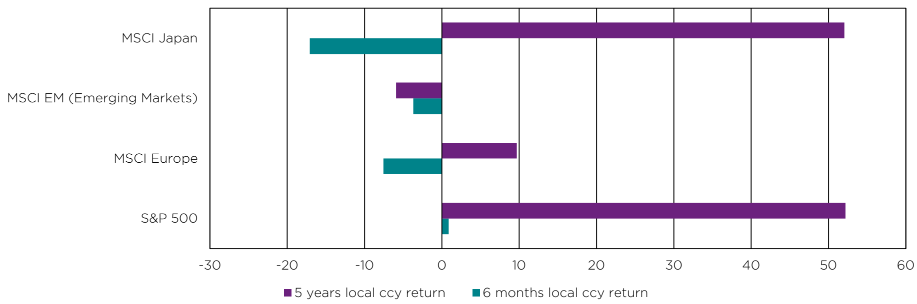
Is the yen a real concern?

Since the beginning of the year investors have shown signs of concern about the yen's renewed strength and the effectiveness of Abenomics. Undoubtedly short-term currency fluctuations guide investor behaviour, as insinuated by the Financial Times front page article, 'Soaring yen defies Tokyo's effort to spur growth and heads off deflation' (8 April 2016). A myriad of recent strategy reports suggests that it is better to 'escape from the land of the rising yen' as one piece I came across recently headlined.

— **Short-term currency fluctuations guide investor behaviour**

For investors, currency swings are an important driver of investment returns. The MSCI Japan lost 17% in yen terms and 6% in US dollar terms over the past six months (as of 12 May 2016). Over the last five years the index gained 52% in local currency, however only 13% in US dollars. In order to protect EUR- and GBP-based investors from these potentially significant yen swings, Comgest will launch hedged Japanese equity share classes in Q3 2016.

Figure 1. Japan: From Star Performer to Underdog?



Source: Factset, 12 May 2016

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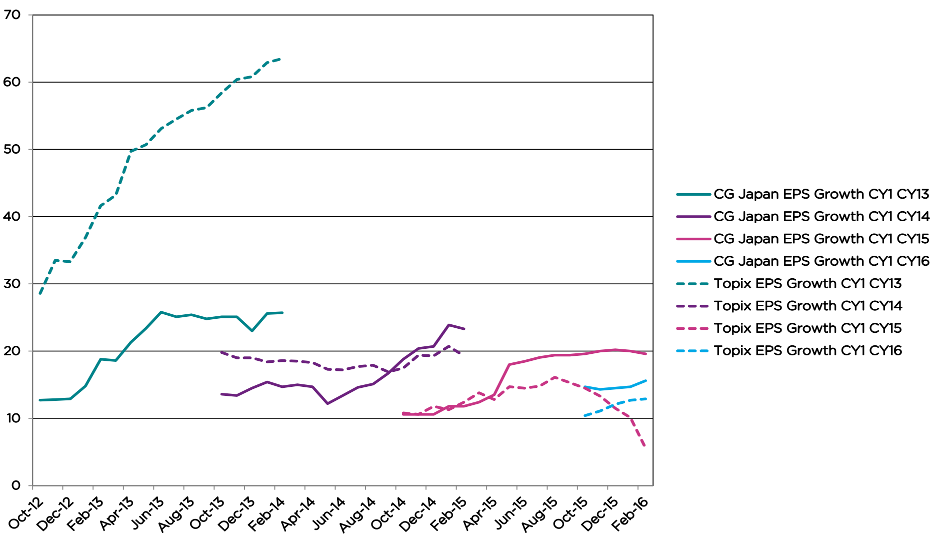
— Japan can be perceived as a market in which investors cannot make money with a "buy and hold" long-term strategy

How do currency swings impact our stock picking and portfolio holdings? Our strategy is to find companies that deliver solid performance to investors over time by focusing on a select number of companies that are able to generate strong and sustainable earnings growth. The volatility of the yen did not prevent us from finding quality growth companies that delivered very stable 20-25% EPS growth for the Japan Strategy over the past five years, unlike the broader TOPIX index where currency fluctuations rendered earnings trends quite volatile (see *Figure* 2). But how does it work?

Figure 2. EPS Growth CG Japan vs. Topix 1st Section



Source: Factset; 31 March 2016

As long-term quality growth equity investors, the real question for us is whether currency swings have a sustainable impact on our franchises and their growth prospects. In general terms, the question is whether capital returns and/or the growth of a company can substantially change due to currency fluctuations. While a persistent change of these parameters can affect a company's long-term cash generation, upon which its valuation is based, it is important when examining this question to distinguish between translation risk and transaction risk.

The Comgest Japan Strategy – no concern about swings in yen exchange rates

The majority of our portfolio holdings are exposed only to translation risk, where sales and costs in different currencies are closely matched, and the impact on the exchange rate risk is minimal. In the case of transaction risk, on the other hand, companies produce in one currency and sell in another, possibly risking not only their profitability, but also their market competitiveness. At Comgest, we place great emphasis on the visibility of earnings growth. We therefore try not to be exposed

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to companies where unpredictable currency swings greatly impact reported profits and cash flows.

A common misconception about Japan is that all manufacturers have remained textbook exporters of Japanese products including large caps such as Denso, Mazda, Kyocera, Casio, or Yamaha. The reality of corporate Japan is multifaceted. This is where Comgest's quality growth approach comes into play.

— Currency strength has led many companies to develop lean cost structures and energy efficient production, e.g. revolutionary production techniques in Japan during the '90s

— Japanese companies lead the pack when comparing the environmental (ESG) scores of manufacturers held in Comgest regional portfolios

In comparison to Japan, Germany and Switzerland are known to have the most competitive and successful manufacturing sectors in the world. A common factor in these countries is that their currencies have appreciated over decades. This contradicts common wisdom that exporters are in trouble once domestic currencies appreciate. In reality, a lot of companies adapt over time. Currency strength has led to the innovation of lean cost structures and energy efficient production, such as the revolutionary 'just-in-time' production techniques created in Japan during '90s. When we compare the environmental scores of the manufacturers held in our various regional portfolios from an ESG perspective, Japanese companies emerge at the head of the pack. Similarly, outbound M&A, based on a strong domestic currency, has significantly strengthened competitive positions over time. For many niche market leaders with well-diversified global cost and revenue footprints, this strategy has helped them build up strong market share and, thus, pricing power. This is what interests us as quality growth investors.

Given the strength and breadth of Japanese manufacturing franchises (e.g. automotive, industrial, medical), we find a number of quality growth companies in this segment of the market. Our Comgest Growth Japan fund holds a significant number of manufacturers including Nidec, Hamamatsu Photonics, Sysmex, Fanuc, Keyence, Amada, OSG, Murata, Daifuku, Daikin, Murata and Shimano. 40% of the holdings in the Comgest Growth Japan fund are manufacturers in mainly niche markets and a majority of these companies boast global market shares in excess of 50%. As market-dominating suppliers for many industrial, consumer and medical high tech engineering applications, pricing power is in their favour. While economic cycles drive volume and operating leverage, pricing power and recurring revenues (e.g. software, maintenance or services) have substantially limited profit margin volatility over the past 20 years. This is particularly true for our largest holdings – Sysmex, Keyence and Hamamatsu – as seen in *Figure 3* showing the very low volatility of their gross profit margins, 2%-4%, over the same period.

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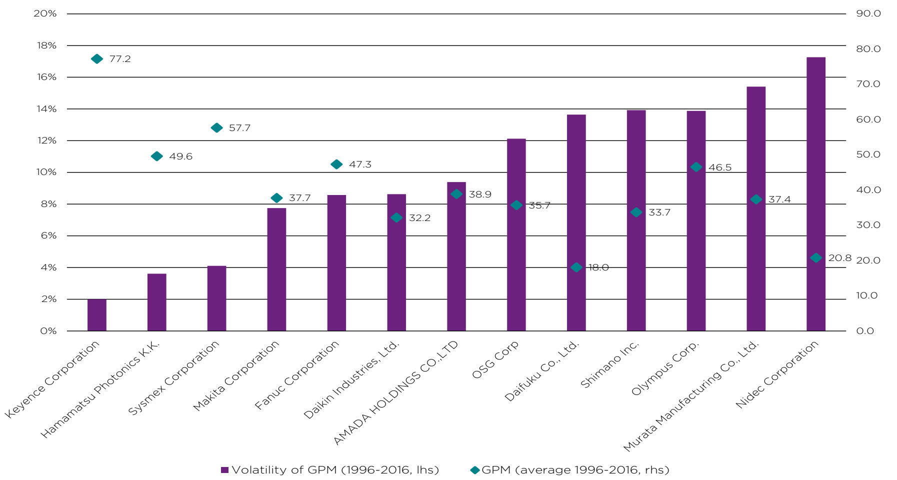
— **Comgest's quality growth approach takes advantage of Japan's multifacted corporate reality, e.g. manufacturers that have grown profitably and largely independent of currency swings**

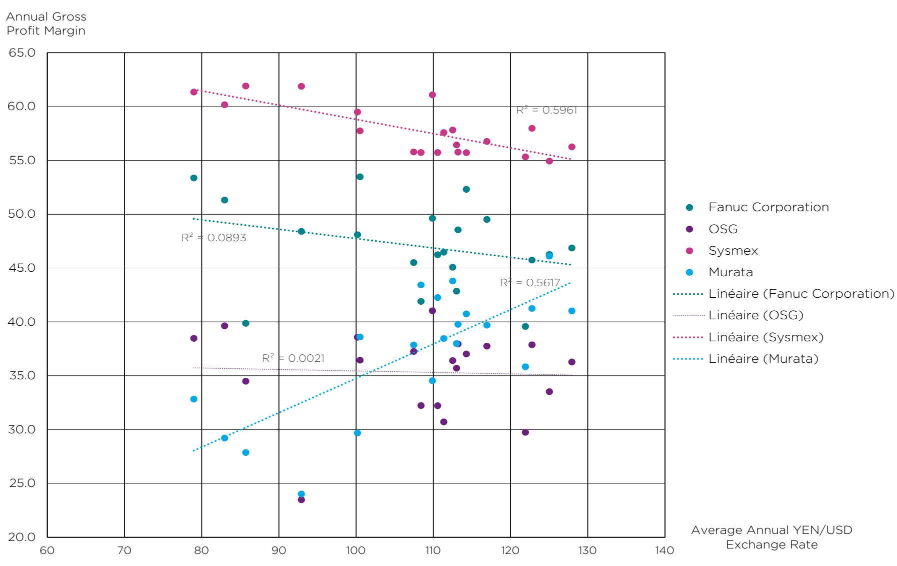
Figure 3. Manufacturers in CG Japan Fund*: Stable Profit Margins Over Past 20 Years



*Comgest Growth Japan fund; Source: Comgest & Factset; 31 March 2016

In analysing our proprietary database, which has a 20-year track record, our conclusion is that only Murata's profitability boasts a statistically significant positive correlation with a weaker yen (see *Figure 4*). That is not surprising given its strong asset base in Japan and high export orientation. In our top three holdings, Sysmex's currency sensitivity works the opposite way given its significant cost base outside of Japan. Therefore, we consider it wrong to have the manufacturers of our Japanese strategy in the same basket as textbook Japanese exporters, which still exist.

Figure 4. Manufacturers in CG Japan Fund*: Only Sysmex & Murata Correlate to YEN/USD



*Comgest Growth Japan fund; Source: Comgest & Factset; 31 March 2016

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Comgest's Japan Strategy delivers high – and highly visible – earnings growth

As a result of our quality growth focus, the Comgest Japan Strategy has delivered stable earnings growth, largely independent of currency swings. This is particularly true in comparison to the TOPIX benchmark. *Figure 2 (on page 2)* outlines earnings growth for the years 2013-2015, which were very stable at 20%-25%. FY2013 was the last year with a significant currency tailwind for Japanese companies caused by a weaker yen. This resulted in strong EPS growth of around 60% for the TOPIX 1st section. However, in FY2015, earnings growth suffered substantially towards the end of the fiscal year in March 2016. That was clearly driven by the recent appreciation of the yen. In contrast, the earnings growth of our Japan Strategy during this period has been remarkably stable at 20%, which underpins the quality of the manufacturing franchises in our portfolio.

In our opinion, considering the Japanese market a simple 'currency play' could be a mistake for long-term active investors. Contrary to short-term investors who would like to make shorter-term currency bets, we believe that Japan's large export exposure and open economy could be a misleading 'macro call' for long-term investors as it could prevent active investors from realising potentially significant long-term growth opportunities.

Comgest Japan Strategy exposed to domestic growth trends

— **A common misconception about corporate Japan is that domestically oriented companies are necessarily ex-growth due to weak demographics and a low-inflation environment**

A misunderstanding that we hear about corporate Japan is an assumption that domestic-oriented companies are necessarily ex-growth due to weak demographics and a low-inflation environment. On the contrary, we find numerous examples of Japanese companies that benefit from these statistics, which are particular to Japan and offer powerful structural trends for long-term investors.

We consider Pola Orbis, our top holding in the fund, to be such an example. It is the fourth largest cosmetics company in Japan with a focus on skincare in the Japanese market, the second largest cosmetics market in the world. Pola Orbis exploits two attractive demographics: mature income-earning consumers and younger cost-conscious adults. It has two main brands: Pola, accounting for roughly 60% of sales, is premium-positioned and marketed to the brand's core clients — older, wealthy women – using direct sales channels (Pola 'Ladies'). This premium brand is consistently growing. In comparison, the value-priced Orbis brand accounts for roughly 25% of sales and is sold via internet/mail order to young women. Orbis mail order has repeatedly been voted the number one online shop in Japan since 2010. By avoiding the middle market, which continues to shrink, Pola Orbis sales grew by more than 5%, EBIT by 13% and net profit by 15% over the past five years.

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Other examples include Don Quijote, a Japanese-styled ALDI specialising in discount food and general merchandise retailing with consistent sales growth in a burgeoning niche market; Sugi Holdings, which has been successful in consolidating the pharmacy and drugstore market in Japan; and Nihon M&A, a consultant specialising in succession planning for small- and mid-sized companies — an attractive growth market in view of the high number of companies without a natural successor. All of these companies have effectively tilted their strategies towards the demographic and corporate particularities in Japan. These domestic Japanese growth trends represent around 30% of our Comgest Growth Japan fund.

— We view online companies as strongly growing domestic franchises

As is the case in many other countries, the internet is revolutionizing many sectors in Japan such as online procurement (Monotaro), eCommerce (Kakaku.com, Start Today and Rakuten) and drug development (M3). We see these online companies as strongly growing domestic franchises and they represent around 20% of our Comgest Growth Japan fund holdings.

The effectiveness of Abenomics

While there is a lot of uncertainty about the effectiveness of Abenomics, including the recent appreciation of the yen and weaker-than-expected inflation, we have a number of domestic-oriented consumer discretionary stocks in our portfolio that all meet robust demand. Many companies are raising salaries again, e.g. most recently, Toyota targeted a 2.6% wage increase for 2016. Statistically the most relevant figure is inflation excluding fresh food, oil and the disruptive impact of the 2014 VAT increase. This inflation measure rose 1.1% in February 2016. Last, but not least, our experience on the ground tells us that the Japanese are no longer waiting for prices to fall, as per the past decade. The deflationary spiral disappeared, a success of Abenomics.

— Key points of Abenomics include sweeping tax reform (raising VAT and reducing corporate income tax) and corporate governance reform

— This will render Japanese corporate taxes more competitive internationally and should hinder "hidden" profits

The most important point of Abenomics is the third pillar, which includes sweeping tax reform (raising VAT and reducing corporate income tax) and corporate governance reform. Corporate income tax rates are down, as evidenced by the FY2016 corporate tax rate, which was cut from 34.6% to 32.1% in the previous year, a 7.3% reduction. The next cut of three percentage points occurred recently, in April 2016. The main goal of the reform is to reach an average corporate income tax of below 30%, a favourable comparison to the 41% rate applied until 2012. In an international context, this will render Japanese corporate taxes more competitive and should stop a tendency to "hide" profits. Our conclusion: Abenomics is not dead.

We have seen numerous companies in our Comgest Growth Japan portfolio change their behaviour by improving capital allocation via share buybacks or raised dividend pay-outs. Such is the case for Fanuc, which announced a 60% pay-out ratio over the next five years – up from

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30% in the previous nine years. Amada set a pay-out ratio target from 30%-50% to 50% and used the remaining 50% of profits to buy back 3.5% of shares, then eliminating most of them in order to return 100% to investors in FY3/2015. As noted in the Asia Nikkei Review, the "Amada shock" surprised the market. Pola Orbis, meanwhile, likewise raised its pay-out ratio target level from 41% in FY2012 and 2013 to over 50% from FY2014, and it actually paid out 100%, including special dividends in FY2014 and 59% in FY12/2015. Kakaku.com similarly repurchased shares worth 1.61% in FY3/2015 and 1.27% in FY3/2016, and eliminated most of them.

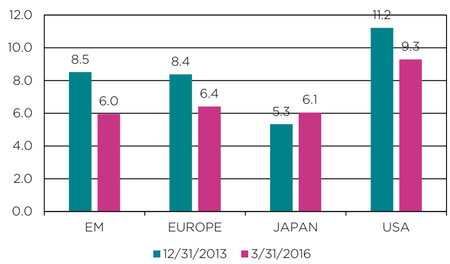
In our view, a lot more must be done to improve the supervisory boardrooms of corporate Japan, which often consists of company insiders nodding off as decisions are made by the management board. As an engaged ESG investor, Comgest has frequent company contacts on the topic of corporate governance in Japan and is a member of the Corporate Stewardship Code in Japan. The improvements of corporate governance in Japan, as well as the lowering of corporate taxes, should be a long-term positive driver for earnings growth and, crucially, improvement of capital returns.

Investors and companies have increasingly paid attention to the constituents of a very sought after index: JPX Nikkei 400. This index offers exposure to companies with a higher shareholder focus. Among the criteria used for inclusion, a three-year average ROE is a key metric. In a country known for its specific sociology, this inclusion can be a status symbol, nudging other companies to strive for index inclusion.

Figure 5 shows that Japan has already made progress in improving its chronically weak capital returns. Japan is the only region where ROIC has improved over the past three years, with the ROIC of the MSCI Japan ex-financials catching up to those in emerging markets and Europe. A lot remains to be done, but the trend is clearly encouraging and we believe that investors should have no doubts about the effectiveness of Abenomics.

General sources: Comgest, Factset (index and corporate growth and profitability measures, portfolio data), Company data, MSCI, EPFR Global, BCA Research, Asia Nikkei, Credit Suisse, NPR. Data as of 31 Mar 2016, unless otherwise stated.

Figure 5. ROIC: Japan Catches Up with the Rest of the World*



*Comparison of MSCI Indices ex-financials
Source: Factset, 31 March 2016

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Wolfgang Fickus is a graduate of the University of Cologne (Germany) with a degree in business administration (Diplom-Kaufmann) and studied at the London Business School. He also holds a CEMS Master's in international management and is a CFA® charterholder. Wolfgang began his career in 1995 at Paribas Asset Management Paris as a European-equity fund manager. In 2000, he moved to WestLB where he worked as an analyst for European technology stocks before becoming the Head of Mid- and Small Cap Research in 2005. Wolfgang joined Comgest in September 2012 and is a Member of the Investment Committee.

At a glance: Comgest Growth Japan*

Performance:

	1 Year	3 Years annualised	5 Years annualised	Since 01/07/2009 annualised
Fund	0.22	20.43	17.70	13.17
Index	-10.79	11.37	11.46	7.90

Top 5 Holdings:

Pola Orbis Holdings Inc.	Consumer Staples	4.3
M3, Inc.	Health Care	3.9
Sysmex Corporation	Health Care	3.6
Keyence Corporation	Information Technology	3.5
MonotaRO Co., Ltd.	Industrials	3.4

Portfolio Profile:

Asset Class	Japan Equity
Number of holdings	37
Weight of top 10 stocks	34.1%
Dividend yield next 12 months	1.1%
Index* *used for comparative purposes	Topix – Net Return

Sector Allocation:

		+/- Index
Industrials	27.5%	+6.4
Consumer Discretionary	21.2%	+0.8
Consumer Staples	15.4%	+5.8
Information Technology	13.5%	+3.0
Health Care	11.1%	+3.6
Financials	6.2%	-9.7
[Cash]	5.0%	+5.0
Energy	0.0%	-0.8
Materials	0.0%	-6.2
Telecommunication	0.0%	-5.9
Utilities	0.0%	-2.1

*Data as of 31 March 2016. Current team commenced managment of the fund as of 1 July 2009. Past performance is no guarantee of future results. Indices are used for comparison of past performance only. Performance calculation based on NAV to NAV variation expressed in Japanese yen. Fund volatility is calculated using weekly performance data. Data on holdings is provided for information purposes only and is not a recommendation to buy or sell the securities shown. Data on holdings is subject to change and excludes cash and cash equivalents.