

# Pelargos Japan Alpha Fund

## May 2016



### Fund Performance

The Pelargos Japan Alpha Fund Class B declined -1.06% in May. Since July 2008, inception-to-date (ITD), the fund is up +55.66% with a realized volatility of 7.2%, whilst the MSCI Japan is down -3.74% ITD with a realized volatility of 20.2%.

### Fund Performance

Share Class	NAV	MTD	YTD	ITD
Class A EUR	1,364.14	-1.03%	2.07%	36.41%
Class B EUR	1,556.61	-1.06%	2.12%	55.66%

### Market Environment

In May, the MSCI Japan appreciated +2.6%. May was a rather calm month compared to the preceding four months. After an initial sell-off in early May, the market steadily recovered throughout the month. The broader market continued to be strongly correlated with the Japanese yen (JPY). In May the JPY had a countertrend move and declined 4%, which was a major support for risk-on sentiment in Tokyo.

Nevertheless, the overall investor sentiment remained dreadful, which is reflected in current market valuations. The entire market trades at close to replacement value of 1x price-to-book. Earnings season turned out to be rather disappointing. This year's JPY strength started to impact company guidance. In general most companies issued conservative guidance as the global economy remained weak and the perceived stronghold, the US economy, continued to bump along at an underwhelming growth rate.

The long book lagged the market by 100bps and unfortunately the short book greatly outperformed last month. The month of May is always a tricky month due to earnings season. We do not have an event driven approach and do not adjust position sizes prior to earnings announcements. Because of the binary macro environment investors struggled to shift attention from macro to company specific news and at the same time trade off current earnings announcement compared to full year earnings guidance. The daily correlation with market returns had been negative for the past few months and in May turned out to be positive 0.4. Turnover remained low at 22% of NAV. The long book consisted of 46 positions and the short book had 13 positions.

### Top & Bottom Industry Movers

Industry Group	MTD	YTD	PB	PE
Health Care Equip.	7.5%	23.1%	1.2	16.4
Semiconductors	7.3%	-16.4%	0.7	14.3
Software & Services	5.3%	18.5%	1.6	15.2
Industry Group	MTD	YTD	PB	PE
Energy	-2.5%	-17.4%	0.7	11.7
Utilities	-2.5%	-9.2%	0.8	9.0
Tech Hardware	-2.4%	-12.2%	0.7	14.3

Source: Bloomberg

### General Statistics

% Return long book	1.6%
% Return short book	4.4%
# Long stocks	46
# Short stocks	13
% Long stocks ↑	50%
% Short stocks ↓	15%
# Up days / Down days	9 / 12
Daily Correlation with MSCI JP	0.40
Turnover as % NAV	22%

Source: Factsset

### Largest Long & Short Holdings

Longs	Shorts
Honda Motor	Oriental Land
Acom	Nippon Express
Takara Leben	Kose
Relia	Hino Motors
Fuji Media	All Nippon Airways

Source: BNY Mellon Fund Services

### Single Stock Activity

Largest Buy & Buy Cover*		Largest Sell & Short Sell**	
Honda Motor	B	Oriental Land	SS
Amada	B	Tokyu Corp	S
Megmilk Snow	BC	Murata Mfg	S
Resona Holdings	B	THK	SS
Fuji Media	B	Itochu Corp	SS

\* B = Buy; BC = Buy Cover

Source: BNY Mellon Fund Services

\*\* S = Sell; SS = Short Sell

### Investment Strategy

Compared to last month we added to long positions Honda and Fuji Media, these stocks trade at all-time-low price-to-book levels. Ichigo dropped out of the top 5 long holdings. We are long term believers in Ichigo, but everything has its price and we tactically took profits; same goes for Tokyu.

With regards to the short positions, we significantly increased the short position in Oriental Land and Kose. We initiated the short position in Oriental Land in the April and substantially added to it. This perceived defensive stocks trades at 28x price-to-earnings with little to no earnings growth. Undoubtedly, it is a high margin, high return-on-investment business, but it is already priced for perfection. At current valuation the risk/reward is skewed to the downside. We manage the position with tight stop loss levels and put a maximum short in place. In addition, we re-entered a short position in THK.

**Investment Strategy**

Toshiba Plant System (TPS) has gotten little attention in our newsletter over the past two years. However, in May it was the best contributing stock. We have owned TPS for many years and visit the company on a regular basis. TPS is a specialist engineering company with exposure to power generation, be it nuclear, solar or thermal. It is an asset light business model with good margins (8-9%) and decent return-on-equity (9-10%), trading at 1.3x price-to-book and 12x price-to-earnings. Not extremely cheap based on multiples, but once cash and cash proxies are taken into account, which amounts to 2/3 of market cap, the stock is a steal. Nomura resumed coverage with a punchy price target which pushed the stock price higher. Takara Leben and Acom continued to perform well and added a combined 50bps.

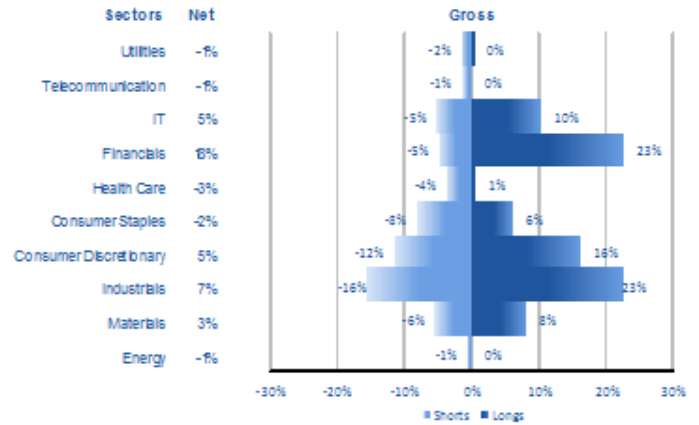
With regards to the negative contributors, the Megmilk Snowbrand rallied 37% in May and despite it being a small position we lost 20bps. This outrageously expensive stock had decent earnings upgrades due to the fashionable, high growth Yogurt drinks product. These drinks are considered functional food and everything in this category enjoys strong growth with good margins.

**Top Gainers & Losers**

Gainers		CTR*	Losers		CTR*
Toshiba Plant	L	0.3%	Megmilk Snow	S	-0.2%
Takara Leben	L	0.3%	Murata	L	-0.2%
Ichigo Hotel REIT I L		0.3%	Tokyo Ohka	L	-0.1%
Acom	L	0.2%	Kikkoman	S	-0.1%
Maruichi ST	L	0.2%	Yamada Denki	L	-0.1%

\*CTR = Contribution

Source: Factset

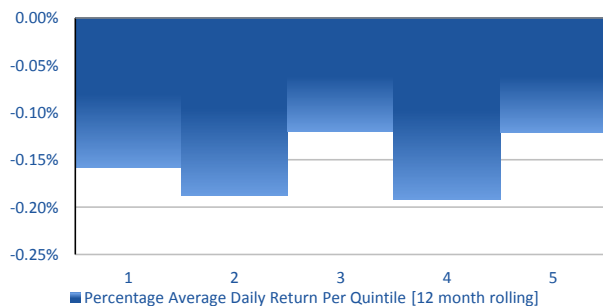
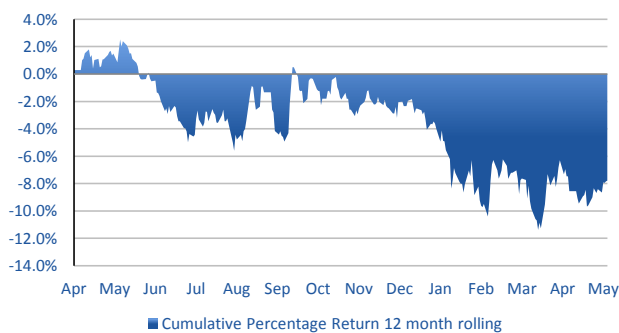


Source: UBS PAS

**Value Factor Performance\***

	P/E	EV/EBITDA	P/B	Div Yld	EV/IC	FCF
MoM	1.3%	0%	0%	-4.1%	-0.6%	0.5%
YoY	-8.0%	-8%	-6%	-1.2%	-5.5%	0.1%

Source: Factset\*



Source: Factset\*

**Style Performance**

On a daily basis we track a number of style factors based on our proprietary quant model. This helps us to detect dislocation within the market. In addition, it helps our understanding of style trends and investor's behavior in Japan.

In May, the value factor continued to show rather mixed results. Price-to-Book was just flat month-on-month and down substantially on a 12-month basis. Low Enterprise Value-to-Earnings Before Interest Tax Depreciation and Amortization (EV/EBITDA) was flat as well. Only low Price-to-Earnings (P/E) stocks performed well last month, although on a year-on-year basis the factor is still very poor.

The EV/EBITDA of the long book is 8.3x compared to 10.8x for the short book. The dividend yield of the long book is 2.4% compared to 1.7% in the short book.

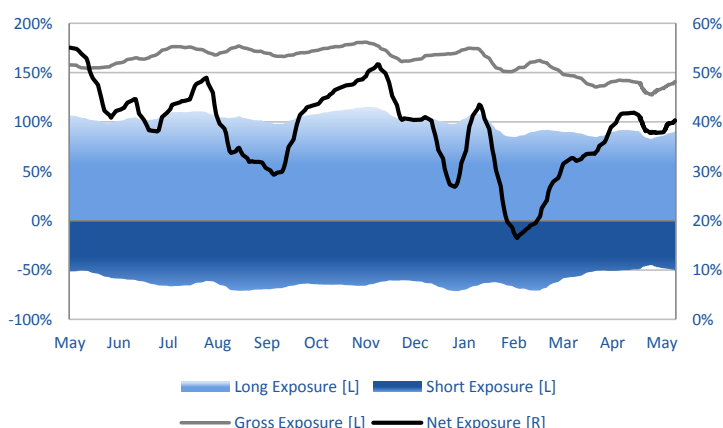
The price-to-book (P/B) spread remained similar to last month with the long book's P/B of 1.5x compared to 2.1x for the short book. Given our value approach we have a strong preference for cash rich companies. The overall market trades at a price-to-book of 1.1x. Our circle of competence, our fundamentally restricted investment universe, includes only few financials. Our own investment universe has a median PB of 1.3x and average PB of 1.7x, largely due to our limited interest in, currently very inexpensive, banks.

As of end of April the momentum exposure (spread between long and short book) is significantly higher. On a 9-month basis the long book is up 4.4% and the short book down-4.7%.

### Risk Measurement and Management

The chart below shows the rolling 12-month net and gross exposure for the fund. The exposures are shown as 10 (trading) days moving averages. At the end of May the gross exposure stood at 143%, the delta adjusted gross exposure was 153%, somewhat lower compared to the prior month. The net exposure stood at 40%. Including the long Nikkei225 put option strike 17000, the delta adjusted net exposure stood at 29%. The REIT exposure, consisting of Ichigo Hotel, Ichigo Office, Kenedix Office and Kenedix Retail, amounted to 8% in total.

The ex-ante volatility based on daily data over the past 1 year was just 5.5% with an ex-ante beta of just 0.1. Partly because of the REIT exposure, and the fund's lack of bank exposure, the beta of the long book was 0.78. Historically, we have had a preference for being long low beta stocks.



Source: BNY Mellon Fund Services\*

### Fund Overview

	Long	Short
Price to Earnings (PE)	14.8	20.1
EV/EBITDA	8.3	10.8
Price to Book (PB)	1.5	2.1
Dividend Yield	2.4	1.7
EV/IC	1.0	2.0
1 month momentum	2.7	0.4
6 month momentum	-1.9	-8.8
9 month momentum	4.4	-4.7
Earnings momentum (1M)	1.4	-7.7
Earnings momentum (3M)	-11.3	-6.8
CFROI	6.9%	9.3%
Cash/MarketValue	33.7%	22.7%

Source: Factset

### Style Exposure

	Long	Short
Beta	0.78	0.87
Volatility	17.7%	19.2%
Debt-to-equity	7%	37%

Source: UBS PAS

### Risk Statistics Delta Adjusted

Volatility (ex-ante; 3 months daily data)	5.5%
Volatility (ex-ante; 5yr monthly data)	6.1%
Var (99%, 5 days)	1.3%
Beta (ex-ante)	0.11

Source: GS and UBS PAS

### Outlook

#### Strategic Framework - Outlook 1st half of 2016

In our opinion, the six year bull cycle in global equities is over. Last year's correction was the initial leg down in a cyclical bear market. The FED induced policy divergence resulted in universal US dollar strength and a substantial drain on global US dollar liquidity. With such drastic tightening, commodity prices collapsed and related credit suffered. We think, this cycle is only mid-way and it will end with a major liquidity event. Investors across asset classes are in the process of re-pricing risk, not only economic risk but also liquidity risk. The period of central banks suppressing risk premia through monetary activism has come to a halt and the price we pay for ultra low interest rates is capital mis-allocation. In our opinion, the US FED's 'normalization' of interest rates is built on the faulty assumption that the US economy can stand on its own feet. Due to central banks' intervention it is impossible to distinguish noise from signal. For us, it seems that the US recovery is asset price led and therefore a phony construct, which easily unravels once asset prices revert. 2016 has all the hallmarks of a proper cyclical bear market.

#### Tactical assessment

Admittedly equity markets globally performed much better than we had anticipated. Within our base case of a cyclical bear market in mind, we did not expect risk assets to bounce so far for so long. Capital markets remain in a precarious situation with liquidity mismatches and central banks masking the fault lines. The Abenomics trade is no more and policy markets are back to square one. In order to prop up asset prices once more, policy makers will have to come up with even a bigger bazooka, too bad a bazooka can only be fired once. Maybe our dear central bankers wish to deploy the heavy artillery and start dropping confetti from helicopters. Undoubtedly, risk aversion will return at some point and the kneejerk reaction will be more confetti for everybody. The only sustainable rock bottom will be a level of cheapness at which investors refuse to sell and strong hands regain control. The Japanese market trading at replacement value is an excellent starting point as we find quality stocks trading at multiples below 2008 levels.

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### Historic Fund Performance (Monthly)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
<b>Class A EUR</b>												
2016	1.35%	0.88%	1.08%	-0.20%	-1.03%							
2015	-1.28%	4.85%	-0.32%	3.21%	2.54%	-1.63%	-3.07%	-3.05%	2.42%	1.83%	2.16%	-1.62%
2014	-3.21%	-0.64%	-0.59%	-1.03%	-2.28%	1.40%	0.19%	-0.64%	2.01%	-1.94%	-1.28%	0.92%
2013	4.99%	-0.58%	6.55%	6.10%	-1.05%	-0.78%	0.26%	-0.91%	1.08%	-0.79%	1.35%	1.61%
2012	-1.43%	3.77%	1.31%	-1.26%	-3.88%	1.72%	0.79%	0.89%	1.28%	0.54%	2.53%	3.78%
2011	0.84%	-0.06%	-1.56%	0.10%	-0.19%	0.38%	-0.01%	-3.68%	0.64%	-0.41%	-2.64%	1.64%
2010	0.65%	-0.25%	3.27%	3.16%	-2.71%	-1.27%	1.12%	-0.39%	0.82%	1.03%	1.28%	1.75%
2009	0.35%	1.62%	-0.76%	-0.71%	0.98%	1.03%	-1.84%	2.07%	-1.61%	-0.40%	-3.37%	3.19%

### Class B EUR

2016	1.27%	0.92%	1.18%	-0.19%	-1.06%							
2015	-1.24%	4.89%	-0.27%	3.25%	2.57%	-1.67%	-2.94%	-3.01%	2.46%	1.88%	2.06%	-1.42%
2014	-3.16%	-0.60%	-0.56%	-0.99%	-2.24%	1.44%	0.23%	-0.60%	2.06%	-1.89%	-1.24%	0.96%
2013	5.35%	-0.58%	6.98%	6.48%	-1.07%	-0.78%	0.31%	-0.92%	1.18%	-0.80%	1.46%	1.73%
2012	-1.38%	3.81%	1.35%	-1.21%	-3.83%	1.76%	0.84%	0.93%	1.32%	0.58%	2.50%	4.06%
2011	0.93%	-0.03%	-1.55%	0.14%	-0.14%	0.42%	0.03%	-3.63%	0.69%	-0.38%	-2.60%	1.68%
2010	0.73%	-0.23%	3.52%	3.39%	-2.83%	-1.31%	1.23%	-0.37%	0.91%	1.13%	1.40%	1.89%
2009	2.07%	1.67%	-0.73%	-0.67%	1.34%	1.13%	-1.93%	2.24%	-1.68%	-0.39%	-2.99%	2.84%
2008							0.96%	-1.35%	1.40%	3.44%	0.52%	1.39%

### Historic Fund Performance (Yearly)

	2016	2015	2014	2013	2012	2011	2010	2009	2008
<b>Class A EUR</b>	2.07%	5.81%	-6.99%	18.86%	10.24%	-4.96%	8.66%	0.36%	
<b>Class B EUR</b>	2.12%	6.36%	-6.52%	20.57%	10.95%	-4.48%	9.67%	2.75%	6.46%

#### Fund Facts

<b>Investment Manager</b>	Pelargos Capital
<b>Legal Status</b>	FGR (fund for joint account)
<b>Fiscal Status</b>	VBI (tax exempt)
<b>Dividend Policy</b>	Reinvestment
<b>Base Currency</b>	EUR
<b>ISIN Class A EUR</b>	NL0009051887
<b>ISIN Class B EUR</b>	NL0001118015
<b>Inception Date Class A EUR</b>	January 2009
<b>Inception Date Class B EUR</b>	July 2008

#### Company Facts

<b>Firm AUM in EUR</b>	€ 1,501,457,581
<b>Firm AUM in USD</b>	\$1,672,473,600

#### Portfolio Managers

Richard Dingemans  
Michael Kretschmer

#### Fund Description

<b>Investment Strategy</b>	Equity Long/Short
<b>Investment Style</b>	Value with a twist
<b>Investment Objective</b>	Capital appreciation through investing in long/short positions in Japanese securities

#### Fund Facts

<b>Fund Size in EUR</b>	€ 90,294,457
<b>Fund Size in USD</b>	\$100,578,995
<b>Participations Outstanding Class A</b>	236
<b>Participations Outstanding Class B</b>	57,800
<b>Minimum Subscription Class A</b>	EUR 10,000
<b>Minimum Subscription Class B</b>	EUR 10,000
<b>Dealing Day</b>	First business day of each month
<b>Subscription</b>	Any dealing day, 5 business days notice
<b>Redemption</b>	15 business days notice
<b>Management Fee Class A</b>	1.5%
<b>Management Fee Class B</b>	1.0%
<b>Performance Fee Class A</b>	20% subject to High Watermark
<b>Performance Fee Class B</b>	15% subject to High Watermark
<b>Early Redemption Fee</b>	max 1% (accrued to Fund)
<b>Lock-up Class B</b>	1 year

#### Service Providers

<b>Prime Brokers</b>	UBS AG, Goldman Sachs International
<b>Administrator</b>	BNY Mellon Fund Services
<b>Accountant</b>	PricewaterhouseCoopers
<b>Legal</b>	De Brauw Blackstone Westbroek N.V.
<b>Title Holder</b>	SGG Netherlands N.V.
<b>Depository</b>	Bank of New York Mellon

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