

# Pelargos Japan Alpha Fund

## October 2016



### Fund Performance

The Pelargos Japan Alpha Fund Class B appreciated +2.38% in October. Since July 2008, inception-to-date (ITD), the fund is up +53.62% with a realized volatility of 7.3%, whilst the MSCI Japan is up +2.15% ITD with a realized volatility of 20.1%.

### Fund Performance

Share Class	NAV	MTD	YTD	ITD
Class A EUR	1,341.86	2.38%	0.40%	34.19%
Class B EUR	1,536.21	2.38%	0.79%	53.62%

### Market Environment

In October, the MSCI Japan advanced +5.1%. The Japanese Yen (JPY) provided a strong tailwind for equities. At the end of September the JPY re-tested 100 JPY/US dollar for the 4<sup>th</sup> time in 3 months and JPY buying finally exhausted itself. The JPY quickly depreciated towards 105. Global growth expectations improved and yields started to creep higher; a great backdrop for under-owned Japanese equities.

Perceived bond-like equities and low-volatility stocks with long duration assets continued to underperform. Financials, such as banks and insurance companies, as well as cheap real estate developers performed very well last month. The rotation into cheap cyclicals and business models benefitting from higher rates started late June / early July and continued into October. Value stocks performed well, again.

This type of market environment is rather supportive for our investment style and the long book performed nicely, appreciating 5.4% for the month. Whilst the short book underperformed and only delivered +2.3%. Of the 20 trading days, 14 trading days showed positive returns and only 6 negative returns.

Our factor analysis showed that the market behaved very systematic in terms of factor returns, which indicates a persistent top-down approach to risk allocation rather than rewarding single stock picking. Longer term price momentum (12-1 month) performed poorly again. Thus, cheap laggards with poor earnings revisions performed best last month.

### Top & Bottom Industry Movers

Industry Group	MTD	YTD	PB	PE
Real Estate	8.4%	-13.2%	1.2	15.0
Retailing	6.8%	3.5%	0.9	18.7
Div. Financials	5.2%	-17.5%	1.0	16.6
Industry Group	MTD	YTD	PB	PE
Food & Staples	-2.5%	14.7%	1.5	18.6
Software & Services	-0.5%	33.9%	1.9	19.4
Utilities	-0.4%	-12.4%	0.8	15.6

Source: Bloomberg

### General Statistics

% Return long book	5.4%
% Return short book	2.3%
# Long stocks	49
# Short stocks	12
% Long stocks ↑	76%
% Short stocks ↓	17%
# Up days / Down days	14 / 6
Daily Correlation with MSCI JP	0.56
Turnover as % NAV	37%

Source: Facts&figures

### Top 10 gross positions

Honda Motor	4.4%	Tokyo Ohka	2.9%
NBF	3.7%	Kikkoman	2.7%
Ichigo Group	3.4%	Mitsui Soko	2.7%
Takara Leben	3.1%	Metawater	2.5%
Hitachi High Tech	2.9%	Relia	2.5%

Source: BNY Mellon Fund Services

### Single Stock Activity

Largest Buy & Buy Cover*		Largest Sell & Short Sell**	
Honda Motor	B	Sumitomo Heavy	S
Sumco Corp	B	Kose Corp	SS
Shin-Etsu Chemical	B	Seven & I	S
Amada	B	Resona Holdings	S
Nishimatsu Const	B	NBF	S

\* B = Buy; BC = Buy Cover

Source: BNY Mellon Fund Services

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

### Investment Strategy

The core value book consists of 49 long positions and 12 short positions.

Honda remained the largest long position, a quality cyclical stock at depressed valuations. We continue to short expensive defensives and remain long undervalued cyclicals.

Last month we mentioned that we re-initiated a long position in Sumco. We have followed Sumco, and for that matter Shin-etsu, for more than 10 years and found the current demand/supply environment extremely favorable for long positions in both. Sumco as a pure play on wafer demand and enormous earnings leverage towards pricing, seems to have finally reached its most important inflection point in 10 years.

Seven & I dropped below our stop loss level and we exited the position. We will continue to monitor the company in order to assess whether the recent top management reshuffle can positively affect the stock price. We increased the short position in Kose, and we are still convinced Pola Orbis stock is a better proposition because Pola Orbis' earnings power is more attractive.

**Investment Strategy**

The fundamentals for Tokyo Ohka are very strong and the share price could no longer ignore all the positive news. The stock remains inexpensive and although the stock rallied from recent, depressed levels the company remains undervalued. Low price momentum, low price-to-book stocks performed very well last month. Honda Motor, Mitsui Fudosan and Murata definitely qualify as such and contributed 30bps each in October.

Long position Ichigo Hotel REIT was the top losing position last month with a -0.2% contribution. In the long term the demand growth outlook and pricing for domestic hotel rooms is very favorable. However, the stock continued to underperform because of its interest rate sensitivity and perceived slowdown in inbound tourism. Furthermore, the number of losers and the magnitude of single stock losses were rather limited.

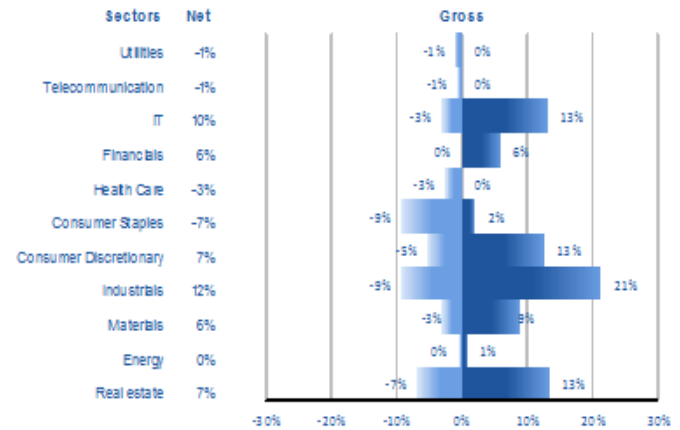
The Real Estate sector on a stand alone basis is a 7% net long position. The REIT exposure consisted of a blend of specialist situations such as Ichigo Hotel REIT, Ichigo Office, Kenedix Retail, Kenedix Office and Takara Leben Infrastructure Fund. The net long in Industrials and IT increased further and stood at 12% and 10% respectively.

**Top Gainers & Losers**

Gainers		CTR*	Losers		CTR*
Tokyo Ohka	L	0.6%	Ichigo Hotel REIT	L	-0.2%
Honda Motor	L	0.3%	Nippon Express	S	-0.1%
Mitsui Fudosan	L	0.3%	ANA	S	-0.1%
RELIA	L	0.3%	Aeon Mall	S	-0.1%
Murata Mfg	L	0.3%	Seven & I	L	-0.1%

\*CTR = Contribution

Source: Factset

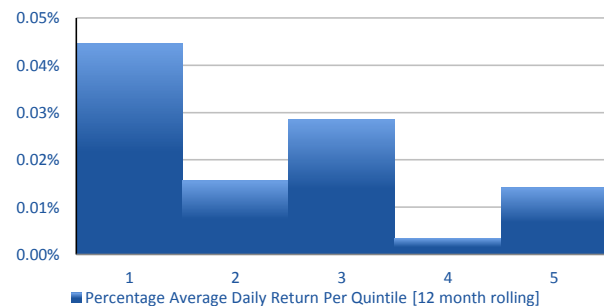
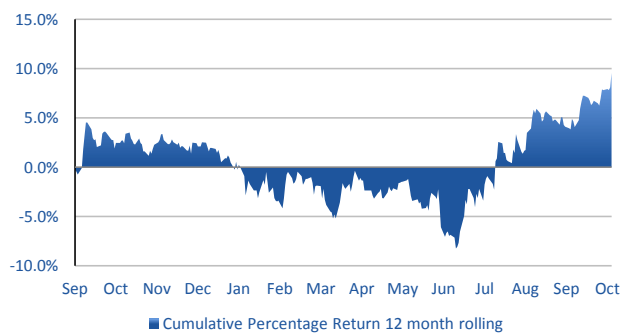


Source: UBS PAS

**Value Factor Performance\***

	P/E	EV/EBITDA	P/B	Div Yld	EV/IC	FCF
MoM	2.2%	4%	4%	2.0%	2.8%	2.1%
YoY	5.2%	3%	9%	8.7%	2.9%	9.1%

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.

The value factor continued to perform well. The performance of value was very consistent across different types of definitions and sectors. Even on a sector basis expensive sectors underperformed cheap sectors. In previous newsletters we have been writing extensively about the gross mispricing of cyclicals against defensives and the reversal of this misallocation is in full swing.

The P/E of the long book is 15.8x compared to 24x for the short book. The EV/EBITDA of the long book is 6.9x compared to 11.2x for the short book. The dividend yield of the long book is 2.3% compared to 1.7% in the short book.

The weighted average P/B of the long book is 1.4x compared to 1.9x for the short book. The cheapest P/B stocks can be found in the financials sector. However, because we restrict our investment universe to what we deem knowable and comprehensible we only follow a few banks and insurance companies.

Therefore, our own investment universe has a median P/B of 1.3x and average P/B of 1.7x, largely due to our limited interest in banks, which are currently very inexpensive stocks.

The price momentum exposure has increased even further. On a 9-month basis, the long book is up 7.1% and the short book down -5.2%.

# Pelargos Japan Alpha Fund

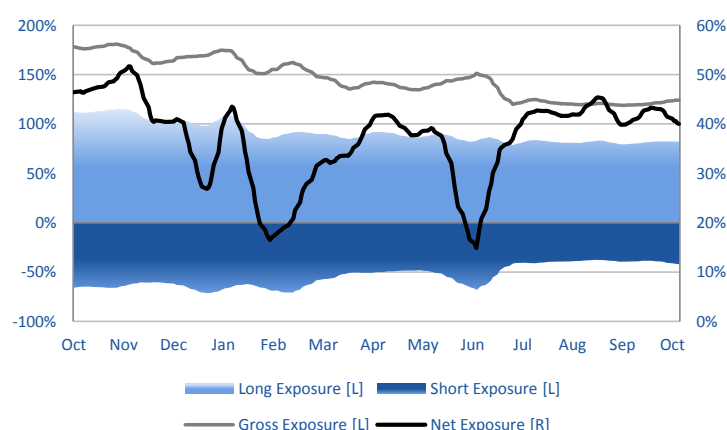
## October 2016



### 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. Little has changed in terms of net and gross exposure. At the end of October, the gross exposure stood at 122%, the delta adjusted gross exposure was 124%. The net exposure stood at 39% and including the long Nikkei 225 put option, the delta adjusted net exposure stood at 37%.

The ex-ante volatility based on daily data was 7.7% with an ex-ante beta of 0.38. In stark contrast to prior years, the beta of the long book is higher than the short book. As explained above we favor long positions in cheap, cyclical stocks and short expensive defensives.



Source: BNY Mellon Fund Services\*

### Fund Overview

	Long	Short
Price to Earnings (PE)	15.8	24.0
EV/EBITDA	6.9	11.2
Price to Book (PB)	1.4	1.9
Dividend Yield	2.3	1.7
EV/IC	0.9	1.6
1 month momentum	7.2	1.6
6 month momentum	8.4	0.5
9 month momentum	7.1	-5.2
Earnings momentum (1M)	5.0	14.0
Earnings momentum (3M)	0.2	22.6
CFROI	7.6%	9.1%
Cash/MarketValue	35.6%	17.3%

Source: Factset

### Style Exposure

	Long	Short
Beta	1.00	0.77
Volatility	14.7%	12.8%
Debt-to-equity	14%	56%

Source: UBS PAS

### Risk Statistics Delta Adjusted

Volatility (ex-ante; 3 months daily data)	7.7%
Volatility (ex-ante; 5yr monthly data)	8.2%
Var (99%, 5 days)	1.3%
Beta (ex-ante)	0.38

Source: GS and Nomura

### Outlook

#### Strategic Framework - Outlook 2nd half of 2016

During the first half of 2016 we operated under the assumption of a cyclical bear market. The three year bull run completed in August 2015. We argued for a cyclical bear market due to tightening conditions in global dollar liquidity. We correctly anticipated that the Fed would not be able to normalize interest rates, because it is built on the faulty assumption of a self-sustaining US economic growth cycle. This thesis has materialized to a large extent and Japanese equities had the deepest correction since the global financial crisis, correcting 30% peak-to-through. In June, we witnessed a full fledged panic with Japanese equities in free fall and broad based capitulation. Our strategy is contrarian in nature, thus buying cheap assets and shorting overpriced assets. Every once in a while 'mister market' is handing out gifts for those willing to go against the crowd and those who have the patience to hold them for a prolonged period. Easier said than done, the market is far from acting 'rationally' and although 80% of the time assets are efficiently priced, certainly at this moment in time, market participants are highly distracted by non-fundamental issues. Dislocation within the market is at multi-decade highs and the potential alpha source an obvious one. However, price action remains tightly correlated to currency moves and swings in liquidity conditions.

#### Tactical assessment - monthly outlook

Last month we concluded that it is time to get more constructive on Japanese equities from a long beta perspective. The best risk/reward opportunity lies in going long cheap cyclical assets and short expensive, defensive yield proxies, preferable stocks fitting the low volatility theme. This call was spot on. With rates in the US moving higher the increased interest rate differential mitigated the buying pressure on the JPY and JPY weakness might even accelerate as BOJ's Kuroda needs to intervene heavily to keep 10-year JGB rates at 0%. This could be the perfect storm for a rapid depreciation of the JPY against the US dollar and even the Euro. Market participants are certainly not positioned for such an outcome. In addition, higher Japanese equities would be inevitable. During 2016 we drastically increased the exposure towards low price-to-book specialty tech chemicals and cheap capital goods companies. On the other side, the short book remains exposed to the expensive defensives. Now that the low volatility theme and bond like equity proxies have suffered heavy losses it is only the beginning of the outflows to come and we remain convinced that value continues to perform well.

# Pelargos Japan Alpha Fund

## October 2016



### 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%	-4.52%	2.08%	-1.09%	-0.33%	2.38%		
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%	-4.33%	2.12%	-1.05%	-0.29%	2.38%		
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>	0.40%	5.81%	-6.99%	18.86%	10.24%	-4.96%	8.66%	0.36%	
<b>Class B EUR</b>	0.79%	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>	€ 220,762,973
<b>Firm AUM in USD</b>	\$242,508,126

#### 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>	€ 92,405,338
<b>Fund Size in USD</b>	\$101,507,263
<b>Participations Outstanding Class A</b>	236
<b>Participations Outstanding Class B</b>	59,945
<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

Contact Details

WTC The Hague, Tower E 7th floor  
Prinses Margrietplantsoen 43  
2595 AM, The Hague  
The Netherlands  
+31 (70) 7568030  
[www.pelargoscapital.com](http://www.pelargoscapital.com)

**Disclaimer**

Pelargos Capital B.V. has compiled this publication. Pelargos Capital B.V. is a management company and in that capacity avails of a license pursuant to section 2:65 of the Act on Financial Supervision of the Netherlands (Wft) as that section reads following the incorporation of the AIFM Directive in the Wft].

Although the information contained in this publication is composed with great care and although we always strive to ensure the accuracy, completeness and correctness of the information, imperfections due to human errors may occur, as a result of which presented data and calculations may vary. Therefore, no rights may be derived from the provided data and calculations. All information is provided "as is" and is subject to change without prior notice.

Pelargos Capital B.V. does not warrant the adequacy, accuracy or completeness of any information and expressly disclaims any liability for errors or omissions therein. The recipients of this publication are responsible for evaluating the accuracy, completeness or usefulness of this information.

The information contained in this publication does not constitute any recommendation, investment proposal, offer to provide a service, nor a solicitation to buy or sell any security or other investment product.

The publication of this information may be subject to restrictions imposed by law in some jurisdictions. Pelargos Capital B.V. requests any recipient of this publication to become acquainted with, and to observe, all restrictions. Pelargos Capital B.V. accepts no liability for infringement of such restrictions.

The recipient shall not distribute, forward or publish this information. No rights may be derived from the provided information, data and calculations. Also by risks inherent to this investment fund, the value of the investments may fluctuate. Past performance is no guarantee or guide to future performance.

