



MARKET COMMENTS

In February, the MSCI Japan declined -9.6%. Up until January, the global economy was stabilizing at low levels from a two years lasting growth slowdown. Leading indicators pointed towards reacceleration, but the Corona virus breakout quickly put an end to this scenario. Global markets were instantly hit by risk-off, as such this low frequency, high impact event is impossible to price. In January, the market declined -1.6% and the fund appreciated +1.7%. However, in February we recorded the worst monthly performance since inception in July 2008. Despite the low-beta long exposure to almost exclusively domestic business models and fortress like balance sheets, the market decline had a drastic impact on our performance. In a full-fledged panic, correlations converge to one, as investors do not differentiate between assets at risk and relative safe assets. The question which market participants are under distress and which stocks are owned by forced sellers, is more important than underlying business fundamentals. We have seen panic attacks many times before (more often than we wished), however the current one is of extraordinary proportion. The game plan in such situations remains one of getting risk off the books until the daily losses stabilized. Prior to the virus outbreak, we had the highest net and gross exposure in the 12 years since our inception, as the corporate governance revolution in Japan was gathering pace. This catalyst in combination with extremely attractive valuations and an improving economic outlook has been the rationale behind our positioning. Upon the change in the outlook, we aggressively hedged the net exposure through futures hedging. We already had put options in place prior to the outbreak as an ongoing hedging program 'to protect the left tail' in case of unforeseen events. Unfortunately, the corporate governance related names were hit hardest as those had performed enormously.

SINGLE STOCK OBSERVATIONS

The best performing position last month was the short position in Dentsu, contributing +0.75%. We had a long-standing short position in Japan's number 1 ad-agency. Dentsu is an old-fashioned TV campaign reliant advertising agency and has bought its way into global and digital advertising through M&A. Domestically, Dentsu has a bloated cost base and revenues are structurally under pressure because of the shift towards online. All the sell side analysts' hopes were on the Tokyo Olympics, which are increasingly unlikely to take place (at least this summer). Besides Dentsu, we have several transportation shorts in place, such as Japan Airlines (contributing +0.3%), Central Japan Railway (contributing +0.6%) and East Japan Railway (contributing +0.5%). These business models carry high cost bases and are heavily dependent on load factors/utilization rates. Obviously, as social distancing is the

new normal, those businesses have been suffering tremendously and their stock prices declined accordingly. The single biggest loser last month was Maeda Road (MR), its stock price declined 14% and hit the fund by -1.3%. As explained in prior newsletters, Maeda Corp. (MC) made a tender offer for MR at a significant premium and the deal turned hostile pretty quickly. MR Board of Directors (BoD) quickly figured out that in order to protect themselves they needed to pay out the biggest chunk of its cash holding to all existing shareholders. As such, MR announced a special dividend equivalent to 20% of market cap and the stock collapsed. Such an event might be considered a break clause and might make MC reconsider its pursuit of MR. The stock indeed reacted harshly, whilst writing this newsletter, MC confirmed that the deal would go ahead. As it stands now, we will not only receive a significant premium on our tendered shares, but additionally a 20% special dividend (which needs to be confirmed at the extraordinary shareholder meeting in April). There are several other long positions suffering big declines, most of them are small capitalization stocks. The MSCI Japan Small Cap index declined -12% in February after having declined -3.4% in January. Historically, Japanese small caps are the most sensitive to marginal changes in global liquidity and this time is no different.

OUTLOOK

At this point traditional modelling of financial scenarios has turned into a rather meaningless exercise. The global economy faces unprecedented risks to the downside and every business is either directly or through second and third order effects impacted by the worst healthcare crisis since the Spanish flu in 1918. We have spent plenty of time reviewing scenarios and listening to specialists modelling impact scenarios. The conclusion remains, too many unknown unknowns. Therefore when shedding risk during February, we first decided to neutralize market exposure. Secondly, we reduced the number of names and focus (even more so) on purely domestic business as we are confident Japan will get its act together, whilst the rest of the planet will continue to deteriorate. Thirdly, cash is king; the positions left in the long book are either (undervalued) asset rich to an extent that its collateral value is unquestioned or have a tremendous portion of its market value as cash on the balance sheet. Unfortunately, the current crisis is of such an existential nature that corporate governance reforms are being put on the back burner. BoDs are busy with assessing risks and executing business continuity plans, rather than listening to shareholder demands. Contrarian indicators are flashing green, valuations are getting absurdly cheap (again!), sentiment is dismal, but liquidity is a disaster. With no-one willing to take the other side, assets can reprice to irrational levels, we will take advantage of that ... but in a gradual manner with plenty of patience, because the global financial system is under a level of stress that needs to be addressed first, before



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