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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

# Stable Japanese Companies for the Long Term

**MASAKAZU TAKEDA, CMA**, has been Portfolio Manager of the Hennessy Japan Fund since 2006, and has been an Analyst and Fund Manager with SPARX Asset Management since 1999. Prior to joining SPARX Asset Management, he was employed by the Long Term Credit Bank of Japan, currently Shinsei Bank, and LTCB Warburg, now UBS Securities. Mr. Takeda received a bachelor's degree in liberal arts from the International Christian University.

**SECTOR — GENERAL INVESTING**

**TWST: Can you give us an idea of your role in your firm and the fund that you'd like to talk about today?**

**Mr. Takeda:** I am a Portfolio Manager at SPARX, and I run the Japan equity strategies at Hennessy including the Hennessy Japan Fund.

**TWST: What are the assets under management?**

**Mr. Takeda:** SPARX manages $9 billion worldwide. We manage $3 billion in this strategy, which is called Japan Focus All Cap Strategy. The Hennessy Japan Fund, which is available only to U.S. investors, comprises $179 million.

**TWST: Give us an overview of the characteristics of the strategies and the investment philosophy.**

**Mr. Takeda:** In industry parlance, we are growth investors, but quality growth. Our approach is to invest in great businesses with exceptional managements at attractive prices. We look for several things in our investment candidates. The three most important qualities are: 1) high returns on capital or high returns on equity; 2) sustainable and predictable above-average, long-term earnings growth rates; and 3) strong cash flow generation. Basically, we want to invest in companies with a proven track record and time-tested business model.

**TWST: Are you open to different sizes of companies in terms of market cap?**

**Mr. Takeda:** Yes, the fund is an all-cap strategy but currently skews primarily mid-to-large cap.

**TWST: Can you describe how current holdings are chosen or sold, and then also about some of your top holdings?**

**Mr. Takeda:** We have seven investment criteria. We begin with a simple and intelligible business model because, as an investor myself, I have to understand the target company's business, right? Then basically our investment strategy is long-term, low turnover and very, very concentrated. We want to own stocks over the long term through economic cycles, so we want to invest in a business that is considered stable like consumer goods, stable growing companies, etc. Then we look for a strong balance sheet.

In many cases, we don't like companies with a lot of debt. A company has to have a durable competitive advantage or, in Warren Buffett's term, an economic moat. We are talking about a high-entry-barrier business, whether it is consumer brand identity or scale of economy. We look for high returns on equity as well as above-average earnings growth rates, which is commensurate with high ROE. We seek companies with strong cash flow, so we are not looking for just accounting profit but actual cash flows coming through the business. Finally, we want to invest in companies run by smart management that understands how to create value for shareholders.

**TWST: Looking at the Hennessy Japan Fund, it does seem now that it has very, very strong sector ratings in, say, consumer both staples and discretionary as well as industrials. Can you give us a sense of whether that is due to rules or weightings that you might apply to the fund?**

**Mr. Takeda:** No, there is no sector allocation element. We just pick stocks one by one to build the portfolio and then keep an eye on them.

**TWST: Do you have a ceiling on how many holdings you'll have?**

**Mr. Takeda:** I like to keep the portfolio concentrated. Given the environment, I believe that to meaningfully beat the market, you have to have a highly concentrated portfolio. So the portfolio typically contains about 20-plus holdings. Based on conventional classification, it may look a bit tilted toward certain sectors, but in my mind, we are running a concentrated yet diversified portfolio. What I mean by that is the underlying businesses in the portfolio are highly diversified.

Just to give you a few examples, we have businesses ranging from personal care goods, telecom, medical devices, factory automation and running shoes, etc., and I don't think these companies' businesses have high correlations to one another in terms of earnings trend or earnings cyclicality. As much as the portfolio is concentrated, because I believe that's the only way to produce market-beating returns, we are mindful of keeping the portfolio highly diversified so as not to take any unintended risk.

**TWST: OK, yes, which also is going to impact your criteria that you use because in order to hold them for a while you have to have a certain understanding or confidence in certain elements of the company?**

**Mr. Takeda:** Exactly. We are highly selective. Obviously, there are not that many companies out there that fit the bill.

**TWST: Can you give us a sense of some of the holdings, say in the top 10 that you have now, and why you've chosen some of them and kind of drill down a little bit?**

**Mr. Takeda:** The easiest example will be a company called **Unicharm** (TYO:8113), which produces sanitary napkins and adult and children's diapers, much like **Kimberly-Clark** (NYSE:KMB). **Unicharm** is Asia's largest diaper maker. In China, they are number two. They have number one market share in Thailand and Indonesia, which is 60% market share. India, which is growing rapidly right now, also is a big presence for them. So they are all over Asia, not to mention in Japan, obviously.

**Highlights**

*Masakazu Takeda discusses managing his firm's Japan Fund. His approach is to invest in great businesses with exceptional managements at attractive prices. Mr. Takeda aims to invest in companies with proven track records and time-tested business models. He gives examples of his current holdings and also talks about the current economic environment in Japan.*

*Companies discussed: Unicharm Corp (TYO:8113); Kimberly Clark Corp (NYSE:KMB) and KEYENCE CORPORATION (TYO:6861).*

Then, if you think about the business, if you're a young mother raising a newborn baby, you don't want to sacrifice quality for lower price, which means that if you have a very successful brand image, you tend to have pretty strong pricing power. That is the kind of business that we think is very attractive and why we've been holding this name since 2007. Their growth engines include the volume growth across Asia for the baby diaper business and, obviously, as countries age, the aging demographics. The adult diaper market will be another driver. So it has a strong brand image backed up by the superior quality, and we believe there is a long runway for growth based upon population sizes in different countries. China, for example, has 17 million newborns, which is 17 times bigger than Japan. India is 23 times bigger. We are talking about an enormous opportunity to grow.

**TWST: Can you mention a few others as well?**

**Mr. Takeda:** Another one that is more uniquely Japanese is a company called **KEYENCE** (TYO:6861). This is an industrial company specializing in factory automation sensors, a developer as well as marketer. Factory automation is where Japan has been a global leader and will continue to be, in our opinion. What **KEYENCE** produces are customized factory automation sensors for customers to be used in their factories. Japan is a country that has been experiencing an aging labor population and a rising labor cost since as early as the 1960s and 1970s. That is why we have this industry that is leading the world in robotics and factory automation. **KEYENCE** is at the forefront.

Now, one of the great things about this company is they have a direct sales channel that caters to factories and corporate industrial customers. This is a hard-to-replicate business model, because factories don't normally want any outsiders walking around their premises. This direct sales channel strategy is very difficult to replicate in our view, and because of this they have extremely high margins with historical operating margins of more than 50%. They are very, very global and very cash-flow generative with a strong track record and strong balance sheet. In a nutshell, we believe it is a great business.

***"As much as the portfolio is concentrated, because I believe that's the only way to produce market-beating returns, we are mindful of keeping the portfolio highly diversified so as not to take any unintended risk."***

The reason why I like that company is we want to invest in companies that can grow regardless of economic conditions. Japan, at the end of the day, has been in a very difficult environment politically and economically for so many years. We have been forced to think of how to invest in companies that can grow over time independent of the external environment. We believe that the diaper business is, first of all, easy to understand, and a consumer staple, so no matter what happens tomorrow whether there is a financial crisis or whatnot, there will be demand for fresh diapers. If you are raising a baby, you have to keep buying fresh diapers for your precious baby.

**TWST: How does your assessment of the Japanese stock market as well as just some of the market drivers going on there, including tourism associated with the future Olympics, impacting your stewardship of this fund?**

**Mr. Takeda:** We are not thematic investors. We keep our focus on the attractiveness of the business model of each company. Then hopefully we will fit a certain theme, but that is not a requirement. The way I see it right now, Japan is getting more attractive from a valuation standpoint.

Just to give you some numbers, the last few years since Abenomics, the Japanese stock market, as represented by TOPIX, an index kind of like the S&P 500 in the U.S., increased twofold roughly. Corporate earnings doubled roughly. We are talking about a stock market roughly keeping pace with corporate earnings up to now. If you look at some valuation metrics, Japan trades at about 14.5 times this year's projected earnings. That compares favorably to other world major indices like the S&P 500, which I think is about 17.9 times. Europe is probably in the high teens.

On the basis of P?E multiple, Japan is not expensive. Year to date Japan has been a laggard, and it is because of rising uncertainties, such as geopolitical tensions, with the yen strengthening and the rising populism movement, etc. But that's all the more reason why we are getting more and more positive on the near-term market outlook.

**1-Year Daily Chart of Unicharm Corp**

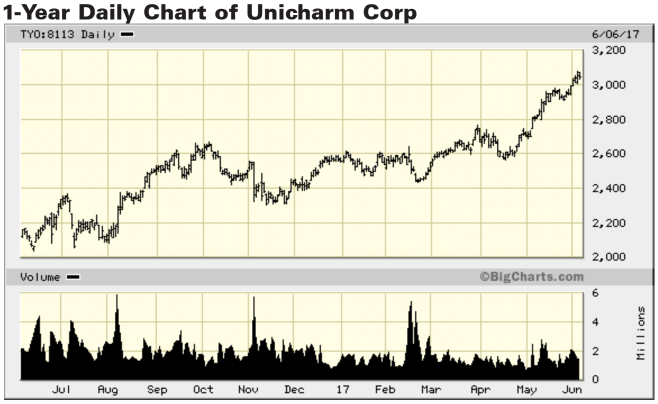


**Chart provided by www.BigCharts.com**

Then, the corporate earnings are expected to grow by around 10% to the low teens this year, which is the Street consensus. We don't provide any macro forecast as a company, but that low-teens growth rate is, I think, considered a reasonable expectation for the year. Again, I think it is getting attractive. It is not expensive. We are happy with our current portfolio. It is filled with what we believe are great companies at reasonable valuations, and we are happy with where we are now.

**TWST: Can you give us a sense, for those people who don't know much about Japan or Japanese companies, to what do you attribute success factors? You're talking about the corporate earnings rate and other things that are quite positive.**

**Mr. Takeda:** One of the key drivers over the last few years has been the Bank of Japan's monetary easing policy. That resulted in currency depreciation. Japan is primarily an export-driven economy in terms of incremental growth. There is a deep domestic market, but a lot of large caps are predominantly exporters. The currency is a big swing factor always. Corporate Japan has come a long way since the financial crisis, when the yen shot up to 70 to 80 yen to the dollar range. That was an extremely difficult environment for corporate Japan, but that is when they aggressively streamlined their cost structures to stay viable and profitable, even at those extreme currency levels.

Fast-forward seven years and we are seeing the currency exchange rate now around 110. Even though we saw moderate strengthening last year versus the dollar and year-over-year decline in corporate earnings in aggregate compared to seven or eight years ago, Japanese companies are very lean and comfortably profitable. What that means is that they are generating lots and lots of cash flows, and reinvesting in corporate activities and the main business activities, whether that be overseas capacity expansion, upgrading domestic production facilities or beefing up R&D spending, etc. That creates a sort of virtuous cycle and bodes well for future sustainable growth for the Japanese economy. Then hopefully that will spill over to more domestic-oriented industries over the course of time. That is the short-term outlook.

Longer term, it is still a mixed picture. Japan is changing for the better, albeit slowly, and that is because we are looking at structural reforms. I talked about monetary easing, but that has largely played its role. We need, going forward, for government to step in and implement structural reforms to keep the momentum going. But structural reforms take time to deliver results.

We believe that the government is still in good shape. Prime Minister Abe has very high approval ratings by historical standards. The Parliament and ruling parties are firmly controlling both the upper and lower houses, so it makes it a lot easier for the Prime Minister to push through a reform agenda. There are a lot of reforms being hammered out. I am not saying all of them will succeed, but in aggregate, we believe it is going to move the needle. As far as the long-term picture, there are a lot of negative arguments about the fate of Japan, but we say that things are moving in the right direction thus far.

**TWST: When you mention the structural reforms, can you point to something there so that somebody looking to invest in Japan might think it is a good indicator? What might be a structural reform that you feel is a positive sign for Japan's economy going forward?**

**Mr. Takeda:** There are a lot of reforms being contemplated and actually being implemented. In the last few years as well we have seen some positive measurable impacts with the corporate income tax rate reduction as one example. It went from, just three years ago, 38%, and now it is below 30%. That definitely helped corporate profits.

The so-called Stewardship Code and Corporate Governance Code signed by institutional investors and also the publicly listed companies has allowed for better and more efficient uses of capital. Because of this, return on equity for corporate Japan increased from about 5% a few years ago to 9% today. Going forward, there are still a lot of things in the pipeline, like more tax reforms and labor market reforms.

More recently, the focus has been on labor market reform, where Japan has been notoriously known for low labor productivity. We need to change that, and government is, for example, urging companies to introduce more meritocracy and performance-based compensation, and to remove labor inequality between part-time and full-time employees. That should bring in more senior/retired workers, housewives and full-time mothers back into the work force. There are a lot of things going on.

**TWST: In closing, can you explain why someone should look at this fund or set of funds on Japan over your peers, including funds that are focused on Asia or Japan only? What differentiates your fund in this regard?**

**Mr. Takeda:** That is a tough question. We don't really look at our competitors, but we believe in terms of our holdings that we invest as though we were private equity investors. We look at stocks, first and foremost, as owning a piece of business. That, we think, differentiates us from the competition. If you look at our portfolio, it is highly concentrated with low turnover, with names that we believe we can own for a very long time. We do take profits from time to time, but in our mind, we want to hold these companies forever.

The long-term performance speaks for itself. We have been outperforming the benchmark and also our peers. We are quality-focused, but we are not blindly investing in quality companies. Obviously for quality companies, everyone knows they are high-quality, and under most circumstances they are either fully valued or sometimes expensive. So we are very patient investors. Once we identify what we consider to be a great company in Japan after we go through our checklist, we just patiently wait for the right opportunity.

Our mindset is that we are basically contrarian, so we just wait patiently for a once-in-a-lifetime buying opportunity. Even the highest-quality company can sometimes run into a short-term hiccup, whether it is a macro-driven reason like the financial crisis in 2008 or the 2011 Great Earthquake in Japan, or sometimes even due to company-specific reasons, as in a stock price can go into free fall. So as much as we are quality focused, we are also very disciplined around valuations.

**TWST: Thank you. (KJL)**

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Top ten holdings for the Hennessy Japan Fund can be found here. Fund holdings and sector allocations are subject to change at any time and should not be considered a recommendation to buy or sell any security.

**Mutual fund investing involves risk; Principal loss is possible. The Fund invests in small and medium capitalized companies, which may have more limited liquidity and greater price volatility than large capitalization companies. The Fund invests in the stock of companies operating in Japan; single country funds may be subject to a higher degree of risk. The Fund may experience higher fees due to investments in pooled investment vehicles (including ETFs).**

The Tokyo Stock Price Index (TOPIX) is a market capitalization-weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. The TOPIX index is presented in U.S. Dollar terms. S&P 500 Index is an unmanaged index commonly used to measure the performance of U.S. stocks. One cannot invest directly in an index. **Diversification does not assure a profit nor protect against loss in a declining market**.

Return on capital (ROC) is a ratio which is estimated by dividing the after-tax operating income by the book value of invested capital. Return on equity (ROE) is the amount of net income returned as a percentage of a shareholder's equity. Cash flow measures the cash generating capability of a company by adding noncash charges (e.g. depreciation) and interest expense to pretax income. Portfolio turnover is a measure of how frequently assets within a fund are bought and sold by the managers. Correlation is a statistical measure of how two securities move in relation to each other. Price/earnings ratio is the market price per share divided by earnings per share. **Earnings Growth is not a measure of the Fund's future performance**.

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