June 2015

# Japanese Engagement Strategy

## Discussion Paper: Environment, Valuations and Measuring Success

The Strategy aims to generate significant alpha by actively engaging with a concentrated number of Japanese listed companies. The investment team focusses on fundamentally sound companies where they see considerable upside potential by identifying factors that can be remedied through shareholder engagement.


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### Will new rules in Japan affect our corporate engagement strategy?

We expect that the new Japanese Corporate Governance Code - launched on the 1st June - will take some time to implement fully, with genuine change perhaps not being seen until even after the 31st December deadline, which is when firms will need to explain whether they have complied with the Code, and if not, why not.

The RWC Japanese engagement funds maintain their focus on quality companies that we believe will not only continue to do well in today's Japan but will also pull away from competitors who are poorly managed. The strong focus on governance and shareholder activity will, we believe, lead to a polarisation where stronger firms will do even better.

### Valuation

We are sometimes asked about the valuations of our portfolio stocks, which can look rich compared to those of activist funds, particularly non-Japanese funds. This is largely due to our cooperative, soft engagement approach and tendency to invest in quality stocks whose solid fundamentals provide a strong base for the returns we hope to achieve.

We believe that it is not only difficult, but potentially counterproductive to try to change top management in Japan. We therefore work with the management in place when we invest, and push for the changes we believe can generate value, remaining cognisant that if we do not fully succeed, we still need to be able to aim for a positive return.

We often see good engagement opportunities in younger companies with strong operational efficiency but with rudimentary development and enterprise management strategies. The managers of such companies, which typically trade on justifiably high valuations, often welcome our guidance.

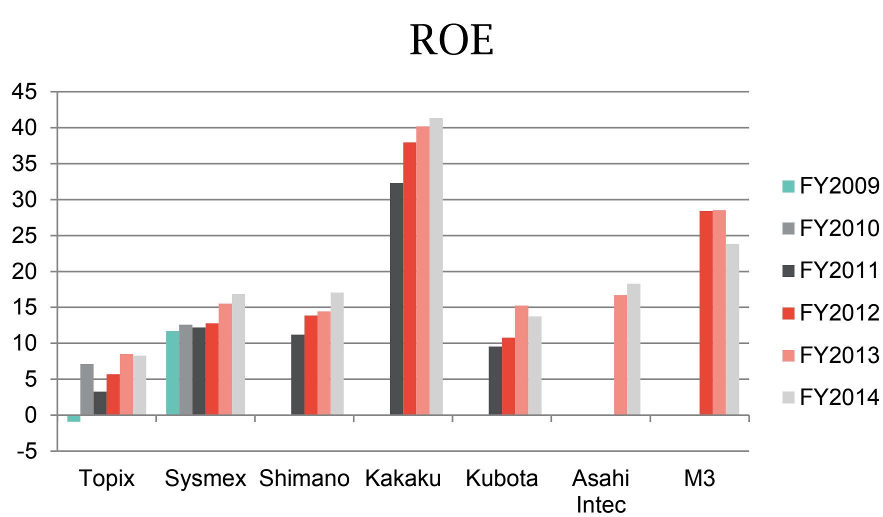
Several companies held by the funds, such as Sysmex, Shimano, Kubota and Asahi Intec, with their highly competitive product ranges, dynamic managements and strong growth are set to continue to outperform their peers. We believe the possible upside in these companies and the other 15 portfolio stocks could exceed 20%, and in some cases 75%.

### Measuring Success

With a soft engagement strategy like ours it can be difficult to pinpoint the exact moment within the process at which value is added. However, one can use certain metrics to assess success, to a degree.

ROE is a measure of how efficient a company is in managing the equity that shareholders have given to it and as such can be a useful metric when we engage in discussions with our portfolio companies. We treat it with some caution, as it will vary according to the level of profits a company attains and that will in turn be affected by numerous factors that we are quite willing to accept as reasons for a temporary dip in ROE as long as management is transparent about them and we don't feel they will impair the firm's long-term value.

In four of the funds' top five portfolio companies, Sysmex, Asahi Intec, Kakaku.com and Shimano, we have seen steady increases in ROE since we first invested in them, not least due to our discussions with their managements about shareholder value, as demonstrated below.




Source: Nissay Asset Management, as at 31 May 2015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With respect to the dividend payout ratio, another useful metric, but again one that needs to be treated with care, we have seen a more frustrating trend, but one that is not surprising given:

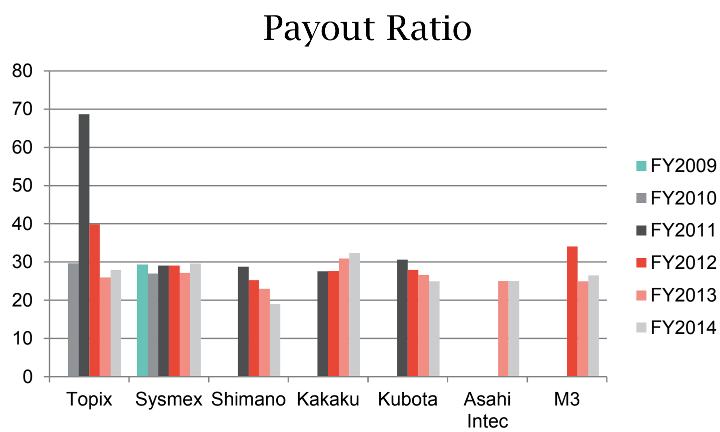
1. The growth bias of the funds' current portfolios
2. Japanese companies' predilection for steady dividends

This makes it quite difficult to use the dividend payout ratio as a measure of how earnings support dividend payments.

The tendency of high growth firms to make lower payouts, as earnings are not paid to investors but are instead put towards investments for future earnings growth, means that quite a few of the funds' portfolio companies have seen volatile payout patterns.

The firms displaying what appear to be a steady decrease in payouts show two different trends - in the cases of Shimano and Kubota, we see two mature firms with steady growth but also a stable dividend, while in the cases of M3, Asahi Intec, Kakaku.com and Sysmex we see growth firms whose on-going investments in new business areas drag down the payout ratio. Recent annual payout ratios of these companies are shown versus the Topix index below.

We continue to address appropriate payout levels with all portfolio companies and track this metric with some care.




Source: Nissay Asset Management, as at 31 May 2015

## Conclusion

Given the current, constantly evolving stewardship landscape in Japan and the convoluted nature of commonly used analytical metrics, we continue to conduct thorough and detailed analysis into those companies where we believe we can capture and generate significant outperformance.

Despite a short-term dilution of quality stocks on the assumption that all Japanese corporates will now improve due to the new Corporate Governance Code, we believe our strategy will continue to deliver.

We believe that the involvement of respected and engaged shareholders is fundamental in our process and so continue to develop relationships and work with management, particularly as companies begin to comply with the new Corporate Governance Code over the next six months.