

Small firms, big potential

Aberdeen Asset Management's Kwok Chern-Yeh shares his views on the investment universe of Japanese smaller companies

JAPAN equities have enjoyed a resurgence in investor interest, thanks to quantitative easing and asset purchases by the Bank of Japan, pension reallocations into equities and a positive earnings momentum. This round, we speak to Aberdeen Asset Management's Kwok Chern-Yeh, Head of Investment Management, Japan, Equities – Asia, about the investment universe of Japanese smaller companies.

The firm's Japanese Smaller Companies Fund invests in companies with a market capitalisation of less than US\$2.5 billion.

Q: Small cap stocks are notoriously high risk. Please tell us – what is the investment case for Japanese smaller companies? (why Japan, and why smaller companies)

Yes you're right. Smaller companies can be riskier because they may have a shorter track record, and they can be more vulnerable to sudden changes in business conditions. But investors should assess each company on its own merits.

Broadly speaking, smaller companies are generally under-researched, but in Japan, these differences are magnified. Research coverage is often thin, which benefits active managers like us who do our own due diligence. And these companies aren't only focused on the domestic market; in fact, a number of them have significant operations outside Japan.

Look hard enough, and you can find smaller companies that are just as well run as their larger counterparts. Many boast robust balance sheets, and some are global leaders in their specialist fields. Headline growth rates may also be stronger.

Q: What is the buy and sell discipline towards stocks for the portfolio, and how do you mitigate risk, particularly the underlying stocks/companies' operational risk?

What we do is to look for good quality companies that trade at sensible valuations, and to invest in these companies for the long term.

We define quality in terms of transparency, balance sheet strength, management openness and fair treatment of minority shareholders, and we always visit companies before we invest in them. And we will continue meeting with the management teams to monitor their progress. On average, we have held the companies in our Japan smaller companies portfolio for about six years, with some holdings having been in the fund for more than 10.

On occasion, something does happen that will lead to us to exit an investment, such as a deterioration in quality. Examples include a loss of business focus, a loss of competitiveness, or a controversial change in

management – or if a company's valuation outpaces its growth potential. We may also sell out of a holding following corporate activity, such as a takeover or a merger.

Q: How would you describe the quality of corporate governance among Japanese smaller companies in general? What governance red flags would you look for that may tell you to avoid or sell a stock?

Corporate governance in Japan has long been a source of anguish for foreign investors. Companies have been run as much to ensure social harmony as to maximise profits, with shareholders often finding themselves at the tail end of a long list of stakeholders.

This is a problem across the corporate landscape in Japan, so it isn't limited to smaller companies. But the attitude to shareholders can vary, and what we've found is that some companies are much more progressive than others in their treatment of shareholders.

A new corporate governance code that came into force in June is a further sign of progress – this has led to a rush of companies trying to meet these new guidelines – but we've found that some Japanese companies have already exceeded these guidelines.

That said, corporate governance in Japan still has room to improve, and there are still numerous corporate decisions at some companies that we disagree with. These decisions may include equity issuance with no clear use of proceeds, dilutive convertible bond issuance, or attempts to sell a company at a price that does not reflect its true value.

Q: What major themes run through the portfolio today, and why do you like these themes?

We are buy-and-hold stock-pickers, guided by the belief that over the long term, share prices reflect underlying business fundamentals. Therefore, companies are assessed on their individual merits. Some have found ways to grow within Japan, either by taking market share from rivals or expanding into new businesses, while others have taken their businesses abroad, including that of successfully tapping fast-growing emerging markets.

As an example, we like snack food-maker Calbee because of its strong brand portfolio, its innovation in launching new products, its improvement in cost management, and its sturdy balance sheet. The firm enjoys tremendous potential to expand further across both developed and emerging markets, and an alliance with PepsiCo offers opportunities for joint product development.

Meanwhile, Pigeon, a provider of baby and child-care products, is a key beneficiary of China's rising affluence, and the company's progressive expansion into other emerging markets should bolster medium-term earnings growth. **W**

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