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A postcard from Japan: enabling the sustainable transition

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Simon Clements and Chris Foster travelled to Japan for a week-long trip, meeting 21 Japanese companies from across the economy. Japanese companies play an important role in the transition to a more sustainable global economy and, by extension, in the global and managed funds for the Sustainable Future process.

Japanese companies have long led the world in technological advancements, driving the shift to a more resource efficient global economy. Unlike many other countries, it has never been able to rely on abundant natural resources to power its economy. However, its reliance on imported fossil fuels and nuclear energy has incentivised the efficient use of energy. The Japanese prowess in engineering and industrial technology, combined with their focus on investing for the long term, has delivered important technological breakthroughs.

Japanese corporate culture has traditionally been mired in secrecy, poor governance and a lack of openness to more advanced western corporate norms. Much of this has changed, as corporate Japan is in the midst of a push to make the stock market more open in order to encourage western investors. This really began in 2013, under the now late prime minister Shinzo Abe, but the desire to change and improve from both an investor perspective through good governance and improved returns on capital has continued.

We experienced this first hand, as we were surprised to find 11 of the 21 meetings were conducted in English. The first time I went to Japan in 2007, we were lucky if any meetings were conducted in English. From a gender perspective, more than half of the corporate representatives were female, again an important step forward for Japan and Japanese corporate culture. There were references made throughout the meeting to "modern Japan", as opposed to "traditional Japan". After nearly 20 years of visiting, you could feel the change that's underway.

Amid the jet lag and oppressive heat, we met some really interesting companies. A big area of interest currently is, of course, AI. Japan plays an important role in the semi-conductor industry's supply chain, and it is clear AI is a beneficiary to the entire supply chain. We met Tokyo Electron, a company that helps prepare the chip before it is put through a lithography machine. We also met **Advantest,** a global leader that helps test semi-conductor chips for faults, improving yields and reducing defective products. These are examples of companies that are benefiting from both an upturn in the semi-conductor cycle and the super cycle related to AI investment in the industry.

We also visited a number of companies with exposure to electric vehicles (EVs) and industrial automation, both of which have been areas of weakness globally. EV manufacturers have disappointed investors, as weak demand in Europe and the US has combined with substantial supply from manufacturers across the world. **Nidec** is a company that partners with a European original equipment manufacturer (OEM) and has been experiencing both demand issues and also issues around profitability, and its EV division has been an area of disappointment. We also met **Rohm**, a semi-conductor manufacturer which sells into both the EV market and the industrial automation end market. Both companies had experienced significant cyclical weakness, and the message was clear – longer term they remain confident in the end demand, but the exact timing of the cyclical upturn is not clear. It has been a difficult period for these sectors, but patience is required from investors as the structural tailwinds will eventually drive growth.

We visited **Keyence**, which has been a core holding in the Sustainable Future Global and Managed strategies for over a decade. Keyence dominates the global market for machine vision and sensor technologies, and its technology is crucial for detecting faulty products in cutting-edge manufacturing processes used in end markets such as smart phones and EVs. We have been engaging with Keyence over the full decade we have invested in the business, and we again pushed the management team on issues. Specifically, we have asked for improved disclosure around its product impact, requesting metrics related to the number of faulty products it helps to detect. We also requested further improvements on governance structure, as well as pushing the company on what it plans to do with the huge pile of cash it has on its balance sheet.

Our final meeting in Osaka was with another long-term holding: **Daikin**. We sold the world's leading manufacturer of energy efficient air conditioners out of the global and managed strategies in December, after an engagement which failed to lead to the divestment of its contract with the Japanese Ministry of Defence (MoD). While the products the company produces for the MoD are purely smoke bombs which are used for training purposes, and the business is very small, we decided in consultation with our advisory committee to sell the position. On meeting Daikin management, we were told (post our sale of the stock), that it had decided in January to exit the business it had with the Japanese MoD. We had been a shareholder for more than 10 years, and we were pleased that our decision to exit the position had influenced management to exit this business and focus on the core air conditioner business.

We left Osaka and returned on the impressive bullet train, or Shinkasen, back to Tokyo, where we met a host of impressive technology companies focused on the application of technology across the Japanese economy. These included **GMO Payments**, which is driving the adoption of payments in a country far behind its western counterparts in the shift from cash to digital payments. We also met the founder of **Rakus**, a Software-as-a-Service (SAAS) platform that helps Japanese SMEs become more efficient.

Overall, we left with the sense that Japanese companies are determined to make themselves more open to overseas investors. The era of mistrust of foreign investment and ownership is fast being replaced with a need to improve disclosure, governance and importantly target improvements in quality metrics such as return on equity and return on capital.

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

All investments will be expected to conform to our social and environmental criteria.

Overseas investments may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of the Fund.

This Fund may have a concentrated portfolio, i.e. hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the Fund's value than if it held a larger number of investments.

The Fund may encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings.

Outside of normal conditions, the Fund may hold higher levels of cash which may be deposited with several credit counterparties (e.g. international banks). A credit risk arises should one or more of these counterparties be unable to return the deposited cash.

Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

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