SPARX Funds plc.

SPARX Japan Fund

SPARX

Fact sheet as at 30 September 2023

Fund description

The objective of the Fund is to provide long-term capital growth by identifying and acquiring undervalued Japanese equities by capitalizing on the Investment Manager's intensive in-house research expertise and extensive information network established through independent investment experience in Japan since 1989. The Fund will normally invest at least 80% of its assets in equity securities of Japanese companies.

Fund facts

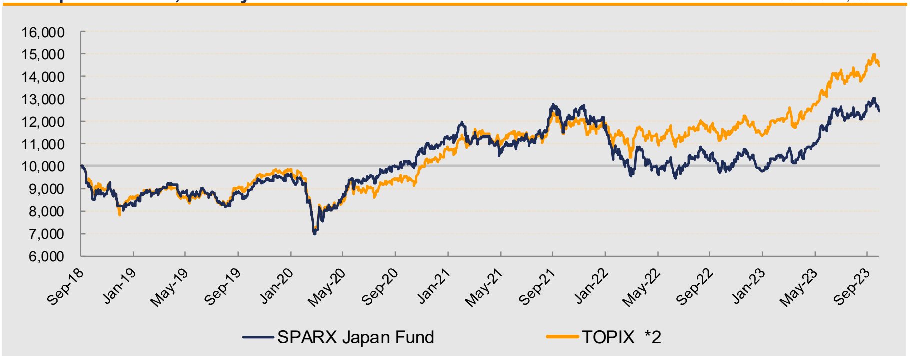
Portfolio manager	Masakazu Takeda
Portfolio manager since	November 2006
Strategy AUM ($ million)*, *[6]	4,196.08
Fund AUM (Net, $ million)*, *[8]	1,024.83
Fund inception	31 October 2003
Investment advisor	SPARX Asset Management
Fund domicile	Dublin
Legal structure	OEIC

Regulatory structure	UCITS
SFDR classification*[14]	Article 8
Dealing frequency	Daily
Dealing cut-off time	17:00 (Ireland)
Administrator	HSBC
Share classes available	JPY, GBP, USD, EUR, CHF
Investment style	All Cap, Quality Growth
Reference index	TOPIX (Total Return)

** Exchange rate USD/JPY= 149.225, W/M Reuters Close. Strategy size is based on internal estimates.*

Fund performance, last 5 years*[1]

28/9/2018=10,000



Fund performance (%)*[8]

Cumulative	Fund*[1]	TOPIX*[2]
Month-to-date	-1.09	0.51
3 months	-0.03	2.45
Year-to-date	25.86	25.70
Since inception	255.03	230.66

Discrete	Fund*[1]	TOPIX*[2]
2022	-17.74	-2.45
2021	8.21	12.74
2020	16.98	7.39
2019	14.99	18.12
2018	-7.93	-15.97

Top 10 holdings (% of NAV)*[3,6]

Hitachi, Ltd.	7.87
Mitsubishi Corporation	7.36
Seven & i Holdings Co., Ltd.	6.78
SONY GROUP CORPORATION	6.52
Mitsubishi UFJ Financial Group,Inc.	5.40
ORIX CORPORATION	5.04
ROHTO PHARMACEUTICAL CO.,LTD.	4.96
Tokio Marine Holdings, Inc.	4.60
Tokyo Electron Limited	4.35
Shin-Etsu Chemical Co.,Ltd.	4.35
Total	**57.22**

GICS Sector weight (% of NAV) *[3,6,11]

Industrials	22.50
Financials	21.45
Consumer Staples	13.99
Consumer Discretionary	11.90
Information Technology	11.34
Health Care	7.41
Materials	6.66
Communication Services	2.82
-	-
-	-
Total	**98.08**

Fund characteristics*[3,6]

Active share (%)*[2,10]	77.82
Active risk (%)*[2,5]	4.41
Annualized turnover (%)	18.11
Number of holdings	30
Yield (%)	1.83

ESG & Climate change*[13]	Fund*[1]	TOPIX*[2]
ESG Risk Score	21.94	23.70
Carbon Intensity (C/R) Scope 1+2	53.31	93.35
Carbon Intensity (C/R) Scope 3	126.63	152.23

Performance statistics*[1,2,6,7]

	Fund	TOPIX
Alpha (%)	-2.81	-
Beta	1.01	-
Standard deviation (%)	16.85	15.19
Sharpe ratio (Rf = 0%)	0.27	0.50

Market cap breakdown (% of NAV) *[3,6]

Large cap (top 70%)*[4]	84.07
Mid cap (bottom 15-30%)*[4]	13.98
Small cap (bottom 15%)*[4]	0.03
Other*[4]	0.00
Cash	1.92
Total	**100.00**

Share classes*[9]

Class	ISIN	AMC	Min investment	Acc/Inc
JPY A	IE0067168280	1.50%	¥10,000,000	Acc
C	IE00BNGY0956	0.90%	¥100,000,000	Acc
E	IE00BF29SZ08	0.75%	¥5,000,000,000	Acc
G	IE00BD6HM324	0.65%	¥20,000,000,000	Acc
USD A*[15]	IE00BNCB6475	1.50%	$100,000	Acc
C*[15]	IE00BNCB6699	0.90%	$1,000,000	Acc
D	IE00BGRX6380	0.90%	$1,000,000	Inc *[12]
EUR A*[15]	IE00BNCB6251	1.50%	€ 100,000	Acc
C	IE000JEGIGP6	0.90%	€ 1,000,000	Acc
C*[15]	IE00BNCB6368	0.90%	€ 1,000,000	Acc
E	IE00BMDKDC31	0.75%	€ 35,000,000	Acc
F*[15]	IE00BZ7MN936	0.75%	€ 35,000,000	Inc *[12]
GBP C	IE00BYVLF156	0.90%	£1,000,000	Acc
C*[15]	IE00BD4F5K64	0.90%	£1,000,000	Acc
D	IE00BGPFC725	0.90%	£1,000,000	Inc *[12]
E	IE00BJDQWX40	0.75%	£30,000,000	Acc
E*[15]	IE00BNC0LD80	0.75%	£30,000,000	Acc
F	IE00BK749L82	0.75%	£30,000,000	Inc *[12]
F*[15]	IE00BNC0LF05	0.75%	£30,000,000	Inc *[12]

*1: *JPY Institutional A Class Shares. The performance shown is net of fees. Inception date is October 31, 2003.*
*2: *TOPIX Total Return Index is used as the Reference Index.*
*3: *The figures are calculated in Japanese Yen.*
*4: *SPARX defines market size as follows: Small-Cap is defined as the bottom 15% of the total market cap of the Japanese Market, Mid-Cap is defined as the next 15% of the total market cap and Large-Cap is defined as the top 70% of the total market cap. Other may include, but not limited to: ETFs, J-REITs and CBs .*
*5: *The calculation excludes cash. Ex-ante tracking error. Annualized Standard deviation. Data source is Barra.*
*6: *Source: SPARX Asset Management Co. Ltd. (Tokyo, Japan)*
*7: *Annualized figures. Last 5-year period.*
*8: *Source: HSBC Securities Services (Ireland) Limited*
*9: *Active share classes only.*
*10: *Data source is Barra.*
*11: *Sector data is based on MSCI's revised Global Industry Classification Standards. For more details, visit www.msci.com. Source: MSCI INC.*
*12: *The latest dividend-paying share class distributions made on May 9, 2023 are as follows: EUR Hedged Class F Shares 0.6306 EUR per share ; GBP Institutional Class D Shares 0.4633 GBP per share; GBP Institutional Class F Shares 0.6566 GBP per share.*
*13: *ESG Rating score corresponds to the Sustainalytics ESG Risk Exposure Category of the Fund. This exposure is defined by Sustainalytics and considers a company's sensitivity or vulnerability to ESG risks. Source: Sustainalytics. C/R is Carbon Emission to Revenue. Source: Trucost, in Tonnes CO2e/USD mn. These data providers may retroactively correct their data.*
*14: *Sustainable Finance Disclosure Regulation ("SFDR") is part of the EU financial policy framework of regulatory measures aimed at providing consistent disclosure requirements in relation to sustainability.*
*15: : *Hedged Shareclass*

SPARX Japan Fund

Fact sheet as at 30 September 2023

Fund commentary

In September, the Fund returned -1.09% (net of fees; JPY Institutional Class A), underperforming its reference index, the TOPIX index with dividends, which rose by 0.51%.

The month's positive performers among the Global Industry Classification Standard (GICS) sectors included shares of Financials and Communication Services while Industrials, Information Technology and Materials detracted from the Fund's performance. Among the best performers were my investments in Mitsubishi UFJ Financial Group,Inc. (8306), one of Japan's largest financial groups, Tokio Marine Holdings, Inc. (8766), the general insurance company with the best underwriting track record in Japan, and ROHTO PHARMACEUTICAL CO.,LTD. (4527), a leading skincare cosmetics and OTC ophthalmic medicines producer. As for the laggards, Recruit Holdings Co., Ltd. (6098), Japan's unique print & online media giant specializing in classified ads as well as providing HR services, Hitachi, Ltd. (6501), one of Japan's oldest electric equipment & heavy industrial machinery manufacturers, and Shin-Etsu Chemical Co.,Ltd. (4063), Japan's largest chemical company negatively impacted the fund's performance.

In this month's letter, I will uncharacteristically share my perspective on the current trends of Japan's macro-economy and what I believe needs to be done for sustained growth going forward.

Over the past two years, emerging signs of much-awaited inflation have been drawing attention in Japan, a country that had been plagued by deflation for over two decades. Based on our experience, deflation accompanied by ultra-low interest rates (or negative rates) can give rise to various problems and many side effects. When prices of goods and services are continuously falling, consumers hold off their purchases in anticipation of further price drops. This leads to deterioration in corporate profits, which in turn squeezes workers' wages, reducing their purchasing power, and businesses suffer more. A vicious cycle. In an environment where interest rates are near or below zero, the economy encourages consumers' discretionary spending such as houses and cars and boosts corporate capex. However, at the same time, many investment projects are executed with poor IRRs. It allows many zombie companies to stay in business, resulting in the misallocation of capital within the economic system. Furthermore, the lack of industry consolidation brings endless futile price competition, prolonging deflation as we know it.

The recent inflationary trend and the expectation for interest rate hikes in Japan can be seen as positive developments for the economy, which has been stagnant since the 1989 collapse of the bubble. But the prospects are not “definitive positive" yet as it remains to be seen whether the current inflation becomes "good inflation" or "bad inflation". Good inflation refers to moderate inflation creating virtuous cycles whereby inflation stimulates private consumption, prosperous businesses can increase wages, leading to more consumer spending. On the contrary, bad inflation is essentially stagflation, where households struggle to make ends meet under ever-rising prices. Looking at the recent economic trends, though I am cautiously optimistic, Japan is at a crossroads today. There is a persistent view that Japan could always fall back into deflation if a recession hits, but I see the possibility of unexpectedly high and sticky inflation. We learned last year that overseas inflation could spread to Japan when a sharp rise in US treasury yields triggered a rapid depreciation of the yen fuelling domestic inflation through soaring import prices.

As listed below, there are many structural factors behind the current global inflation:

•The globalization that continued for more than 20 years has reached a turning point due to the US-China trade tensions. Companies are being forced to diversify global supply chain networks. The Russia-Ukraine conflict is also accelerating this trend. These events inevitably raise the cost of doing business for companies.

•Since the 2008 global financial crisis, there have been under-investments in natural resources development around the world, causing commodity prices to stay elevated, pushing raw material and energy costs higher. Due to its capital-intensive nature, new supply takes years to come online. Environmental restrictions also make it increasingly difficult to develop and consume hard commodities.

•Labor shortages are also a global phenomenon. For example, in the US, we are seeing an ageing labour population, more stringent immigration policies, and workers choosing early retirement due to changes in people's social values, etc. Similarly in Japan, over the past 10 years, the increasing female and elderly labour participation is reaching its limit and is no longer able to offset the overall working-age population decline. Unfortunately, the inflow of foreign workers into Japan has been minimal owing to language and cultural barriers as well as the weak yen. All of these are contributing to a short supply of new labour and wage inflation.

•ESG investment is the global new norm. Companies are required to monitor the impact they have on the environment as well as corporate governance. Associated costs are increasing to comply with regulations. This also results in the inflation of costs for companies to do business.

All the above eventually get passed on to consumers. So, what do we need to usher in "good inflation"? The positive news is that Japanese consumers have become tolerant of price increases over the past two years. According to a 2021 survey conducted by Professor Tsutomu Watanabe of the University of Tokyo, as much as 60% of respondents had answered that they would avoid buying products after a price increase and only 40% of them had opined that price hikes were acceptable. A year later, this ratio reversed with nearly 60% of consumers being accommodative of this trend, a level like the US, the UK and Germany, where inflation has been the norm for many years. When people begin to expect prices to rise, real wage growth is what matters. Since the early nineties, real wage growth has been essentially flat in Japan. Even after this year's unprecedented victory by labour unions in the spring wage negotiation season (achieving an average base salary increase of 3.6%, highest since the early 90s), consumers' purchasing power is still under pressure. The quickest way to achieve positive real wage growth is to raise the labour share of corporate profits, but that would deteriorate the profitability of the business. Consumers' purchasing power can also be increased by taking on household debt. But that too is not an ideal solution. History is rife with examples of severe backlashes ensuing many years of debt-fuelled consumption as seen in the post-bubble Japanese economy in the nineties and the global economy during the 2008 financial crisis. For these reasons, income growth should be brought about by productivity gains.

SPARX Japan Fund

Fact sheet as at 30 September 2023

Fund commentary

According to the OECD, Japan's labour productivity is among the lowest in the world (27th out of 38 countries in 2021[1]), and worse yet, is ranked at the bottom among the G7 countries for fifty straight years[2]. This is a shocking revelation. Fixing the perennially low labour productivity is therefore vital for companies to continuously give wage increases. Consequently, households will become confident in future income growth. Japanese companies can tackle this issue by investing more in DX (the country is widely known for its slow adoption of innovative technologies), breaking away from excessive customer services that do not necessarily translate into sales revenue, and introducing more meritocracy into the compensation system. Among these solutions, I am particularly keen to discuss my thoughts on the last point.

It is a well-known fact that many Japanese companies still adopt a seniority-based wage system, in which employees are implicitly guaranteed a small but steady pay raise every year. This cultivates staff's loyalty to their employer; hence the Japanese labour practice is referred to as “lifetime employment.”
In my view, merit-based compensation should do a better job of boosting employee morale and motivation, whereby productivity gains can also be made. Japanese companies significantly lag their foreign counterparts in this regard. For instance, the remuneration of directors at large Japanese companies is said to be about one-fifth of that in the UK and less than one-twentieth of that in the US[3]. Such uncompetitive remuneration de-motivates C-suite executives and discourages them from taking appropriate risks to grow the business. Even more egregious is that there are often significant differences in compensation between Japanese and non-Japanese executives within the same company. Earning only a fraction of the fellow non-Japanese directors just because you are a Japanese national seems utterly absurd to me. This situation needs to be rectified by establishing a more equitable compensation structure.

Raising profitability by implementing price hikes is another approach worth considering as improving labour productivity is not only about maximizing the physical volume of production per unit of labour but also about increasing value per unit of labour[4]. The latter measure focuses on maximizing the dollar amount and can be addressed by proper pricing of goods and services, which have been priced too low compared to global standards. In other words, it is imperative to proactively raise prices such that businesses will have more capacity to raise wages. Once the path to sustainable salary increases is established through better productivity, new consumer demand will be created, leading to "good inflation". Incidentally, these same measures for good inflation should also be effective in correcting the "PBR less than 1x" that the Tokyo Stock Exchange requested of listed companies earlier this year. Labour productivity betterment and capital efficiency improvement are two sides of the same coin. Nearly 40% of the listed companies on the Tokyo Stock Exchange fall into the “PBR less than 1x” group. In most cases, a stock price below book value indicates that management has been a poor steward of shareholders' capital. Since PBR is calculated by multiplying PER and ROE, the management of publicly listed companies should strive to increase ROE.

In Japan, the awareness of capital efficiency such as ROE was almost non-existent a decade ago. Indeed, this was one of the main reasons for the prolonged under-performance of Japanese equities post-1989 bubble burst. However, in recent years, I have begun to observe that things are slowly changing. Since the start of the corporate governance reforms in 2014-2015 under Abenomics, corporate management has come to embrace the basic concept of "returns on equity" (ROE) or "returns on capital" (ROC) as a key determinant of financial performance. This is evident from the fact that these terms are now frequently used in Investor Relations (IR) materials and annual reports today. I even feel that there is a sense of embarrassment among corporate directors if their stock price is languishing at less than PBR 1x.

To keep up the positive momentum, management needs to install a capitalistic mindset not just at the board level but throughout the organization. My research confirms that growth companies with a strong focus on capital efficiency are more highly valued in the stock market. To this end, operational metrics such as ROC should be linked to the employees' compensation system, and employers should reward them accordingly. I firmly believe that continued efforts by Japan Inc will eventually pay off in a way that will bring about a favourable inflationary environment and at the same time achieve the Tokyo Stock Exchange's market reforms.

Lastly, regardless of how the macroeconomy may play out, the portfolio is positioned well. It continues to remain concentrated around select attractive mid-to-large cap Japanese companies with global operations yet sufficiently diversified to weather unexpected adverse macro-economic events be it higher-than-expected inflation, interest rates or forex movements. Some of the Fund holdings are genuinely fast-growing companies with valuation premiums (e.g., Tokyo Electron, Fast Retailing, Recruit, Keyence, Daikin, SocioNext etc.), while others are growth companies trading at value stock-like multiples with significant ability to buy back shares and high dividend yields (ex. Mitsubishi Corp, Tokio Marine, Mitsubishi UFJ Financial Group, Orix, MS&AD, Sompo, etc). The overarching characteristics of all these names are that they have strong durable competitive advantages and huge addressable markets.

1 - source: https://japannews.yomiuri.co.jp/business/economy/20221220-78590/
2 - source: https://www.nippon.com/en/japan-data/h01196/
3 - source: https://www.nikkei.com/article/DGXZQOUC045XN0U3A700C2000000/
4 - source: https://toyokeizai.net/articles/-/622627?page=4

SPARX Japan Fund

Fact sheet as at 30 September 2023

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Europe
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