Daiwa SB Investments

PERSPECTIVES

VALUE + ALPHA GROUP

1 April 2019

Author: Takuya KAMIISHI
Portfolio Manager, Value + Alpha

The Need to Invest in Growth Companies

All-rounders are indispensable in a world of winners and losers to engage the audience and rouse excitement. All-rounders such as Yoshiharu Habu in Japanese chess, Takaharu Ohi in mah-jongg and Peter Lynch in the world of investment have a wide variety of talents, making good in everything they do. We all feel thrilled and admiration for their strength.

Peter Lynch classified equities into six categories as below, delivering good results in each category. According to his view on portfolio building, the weightings in low-growth stocks and cyclical stocks are lower, while the weightings of high-growth stocks, income stocks and turnaround stocks (stocks with earnings recovery) are higher than those of standard Japanese equity funds.

Six categories by Peter Lynch

Name	Characteristics	Sector	Investment policy by Peter Lynch
Low growth stocks	・EPS is growing at 1-3% per annum. ・There are many big and old-style companies. ・Payout ratios are mostly high.	Financaials, Pharmaceutical, Electric Power & Gas	・Don't invest in this category in prnciple as their stock prices are unlikely to climb. ・Pay attention to past records of their dividends (dividend yield, whether they cut or passed dividends before, potential of dividend increase)
Blue chips	・EPS is growing at 5-10% per annum. ・Performances are stable even in recessions.	Info & comm, Medical device, Foods/Retail trade, Toiletary	・This category generally accounts for 10-20% of the portfolio. ・Lock in profit when issues rise by 30-50%.. ・P/E ratio is the most important factor, followed by the growth potential.
Rapidly growing stocks	・EPS is growing at 15-25% per annum. ・There are many aggressive small/mid-sized companies ・Many belong to low growth rather than rapidly growing industry.	Services, Other Produsts	・This category generally accounts for 30-40% of the portfolio. ・Keep an eye on growth rates to find out when the growth slows down. ・Sell the issues when the P/E ratio hits 40-50.

Name	Characteristics	Sector	Investment policy by Peter Lynch
Cyclical stocks	・Revenues and profits cyclically rise and fall. ・You tend to misinterpret these stocks as safe ones, leading to a loss. ・Success depends on whether you can seize a turning point of their performances. ・Stock prices can jump tenfold but decline to one-tenth.	Automobiles, Construction/ Machinery, Marine/Air transportation, Steel/Chemicals	・This category generally accounts for 10-20% of the portfolio. ・Sink capital at the cyclical bottom. ・Low P/E ratio often heralds the peak of profits. ・Sell the issues in case of market downturns, inventory growth and increased competition.
Asset stocks	・Companies with some sort of assets although investors haven't noticed them. (e.g.: Cash, Equity, Land, Patent, Brand, Loss carried forward)	Railway, Warehousing, TV station	・Invest as you think proper. ・Consider hidden asset values and chances of being acquired. ・Sell the issues when the takeover by other companies is announced.
Turnaround stocks	・Companies who have the potential to emerge from bankruptcy risks.(e.g.: government bailout, comeback from accidents) ・Selection and concentration by diversified companies belong to this category. ・Stock price fluctuations which buck the market trend.	Electric Appliances, Congromerate	・Allocate the rest to this category. ・Keep an eye on the amount of debts, the debt structure, passtion for cost reduction/ downsizing of unprofitable divisions and a progress of their restructuring plans ・Sell the issues when they succeed in earnings recovery.

Source: The book "Beeting the Street" by Peter Lynch (2001)
* Characteristics and sectors were derived from interpretations on Japanese equities by the author, as premises are different from the then USA and today's Japan.

Composition ratio based on analysis by Peter Lynch

Name	Estimated ratio of each stock
Low-growth stocks	5%
Blue chips	15%
Rapidly growing stocks	35%
Cyclical stocks	15%
Asset stocks	15%
Turnaround stocks	15%

*Figures above were calculated by the author.

The ratios of low-growth/ cyclical stocks in Japanese stock price indexes were low from the beginning. In addition, if you continue investing in value stocks with low P/E ratios (absolute value), ratios of low-growth/ cyclical stocks would tend to become high. We have an impression that low-growth/ cyclical stocks were weak amid the economic slowdown in 2018, as Peter Lynch predicted. Peter said “We don’t invest in low-growth stocks in principle because there are few possibilities for their rallies,” and “Cyclical stocks will be volatile. They can jump tenfold but decline to one-tenth as well, depending upon the market.” Furthermore, a series of high-growth stocks and turnaround stocks lost their status and were regarded as low-growth stocks.

We strongly believe in the importance of investing in growing companies when we consider future investment policies. Peter Lynch achieved excellent performance by investing in rapidly growing companies with P/E ratios less than 15 times. When we look at the relationship between earnings and stock prices in the long-term, the former moves in tandem with the latter. Peter said, “The best place to begin looking for the 10-bagger is close to home -- if not in the back yard, then down at the shopping mall, and especially wherever you happen to work.” From now on, we will pay attention to our surroundings to find undervalued high-growth companies.

With regard to growing companies, we also believe it is important to reduce the weights in companies which temporarily suffer sluggish performances, promptly and accurately. We tend to maintain the current ownership ratio or the applied P/E ratio, justifying it by using excuses such as “The company will enjoy a long-term growth,” or “The corporate earnings will turn up soon.” However, stock prices are unlikely to bounce back when earnings are declining, and a slump in earnings is a prior warning of downgrades from high-growth stocks to low-growth ones. Stock prices of companies with long-term growth prospects will inevitably recover through the momentum of performance, so we can buy back the issues then.

I maintain my views in my previous commentaries, namely “The Asset Plays and Turnarounds Stories That Benefit from ESG Factors” in August 2018 and “Attention On Asset Stocks as Investment Destination in Light of Q Ratio in the 1980s” in January 2019, and I continue to focus on asset stocks and turnaround stocks. We aim to acquire a myriad of skills to invest in equities such as rapidly growing stocks and asset stocks turnaround stocks, to become fund managers who can inspire awe and excitement in investors like all-rounders, while maintaining our core philosophy of being value stock pickers.

Daiwa SB Investments

Takuya KAMIISHI, CMA, Portfolio Manager, Value + Alpha Group, Equity Management Department

Mr Kamiishi joined Daiwa SB Investments in 2009 and covered US & European equities as a strategist from 2010 to 2013. He moved to Hong Kong in 2013 as an analyst for the auto & industrials sector in Asia Pacific ex-Japan equity. In 2015, he returned to Japan and covered the IT & services sector as a Japan equity analyst. In 2016, he became a portfolio manager in the Value + Alpha group.

Mr Kamiishi obtained a BA degree in Economics from Keio University (2009) in Japan.

Contact Details

Arnaud GÉRARD, CFA
Head of Business Development
& Client Relations
Phone: +44 (0) 20 7597 7035
Email: arnaud.gerard@daiwasbi.co.uk

Daiwa SB Investments (UK) Ltd.
5 King William Street
London EC4N 7DA, United Kingdom

www.daiwasbi.co.uk

Disclosures

Issued by Daiwa SB Investments (UK) Ltd. Registered in England and Wales

Registered office 5 King William Street, London, EC4N 7JA; registered number 1660184. Authorised and regulated by the Financial Conduct Authority.

Past performance is not a reliable indicator of future performance and may not be repeated. An investment's value and the income deriving from it may fall, as well as rise, due to market fluctuations. Investors may not get back the amount originally invested.

The data contained in this document is for information purposes only. It is correct to the best of our knowledge at the date of issue and may be subject to change. The client legal agreement will take precedence over this document. This document is not legally binding and no party shall have any right of action against Daiwa SB Investments Ltd., in relation to the accuracy or completeness of the information contained in it or any other written or oral information made available in connection with it. Nothing in this document or any related presentation shall be deemed to constitute investment advice, nor shall we be deemed to be an investment advisor unless formally appointed as such, or as discretionary investment manager, by way of written agreement.

The information contained in this presentation is to be used by the professional client that this document is issued to only.

On 1 April 2019, Sumitomo Mitsui Asset Management and Daiwa SB Investments merged to form **Sumitomo Mitsui DS Asset Management.**