

SPARX Japan Fund



Fact sheet as at 28 February 2022

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

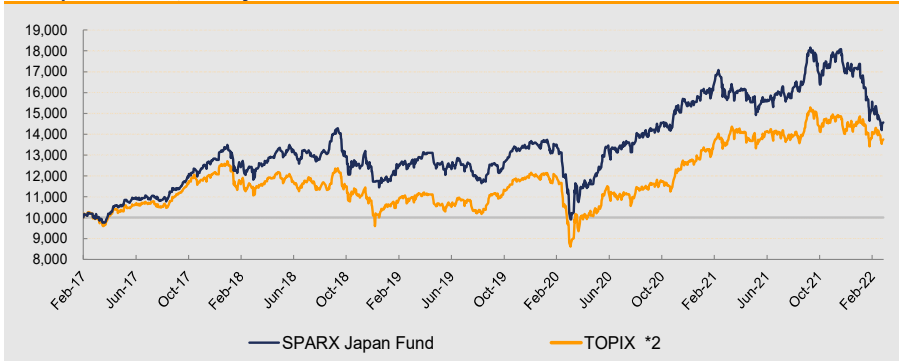
Portfolio manager	Masakazu Takeda
Portfolio manager since	November 2006
Strategy AUM (\$ million)*, ⁺⁶	4,955.73
Fund AUM (Net, \$ million)*, ⁺⁸	1,513.07
Fund inception	31 October 2003
Investment advisor	SPARX Asset Management
Fund domicile	Dublin
Legal structure	OEIC

* Exchange rate USD/JPY = 115.175, W/M Reuters Close. Strategy size is based on internal estimates.

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)

Fund performance, last 5 years⁺¹

28/2/2017=10,000



Fund performance (%)⁺⁸

Cumulative	Fund ⁺¹	TOPIX ⁺²
Month-to-date	-3.97	-0.43
3 months	-14.55	-1.97
Year-to-date	-14.93	-5.24
Since inception	191.70	155.53

Discrete	Fund ⁺¹	TOPIX ⁺²
2021	8.21	12.74
2020	16.98	7.39
2019	14.99	18.12
2018	-7.93	-15.97
2017	29.22	22.23

Top 10 holdings (% of NAV)^{+3,6}

Hitachi, Ltd.	7.51
Mitsubishi Corporation	7.43
SONY GROUP CORPORATION	7.37
KEYENCE CORPORATION	5.79
SoftBank Group Corp.	5.39
Recruit Holdings Co., Ltd.	5.02
MISUMI Group Inc.	4.60
Nissan Chemical Corporation	4.38
SHIMANO INC.	4.31
NIDEC CORPORATION	4.17
Total	55.97

GICS Sector weight (% of NAV)^{+3,6,11}

Industrials	35.56
Consumer Discretionary	19.51
Consumer Staples	11.67
Health Care	10.60
Information Technology	9.25
Communication Services	6.63
Materials	4.38
-	-
-	-
-	-
-	-
Total	97.60

Fund characteristics^{+3,6}

Active share (%) ^{+2,10}	83.75
Active risk (%) ^{+2,5}	6.03
Annualized turnover (%)	9.02
Number of holdings	27
Yield (%)	1.23

ESG & Climate change⁺¹³

	Fund ⁺¹	TOPIX ⁺²
ESG Risk Rating	23.01	24.30
Carbon Intensity (C/R) Scope 1+2	49.93	100.66
Carbon Intensity (C/R) Scope 3	185.85	175.53

Performance statistics^{+1,2,6,7}

	Fund	TOPIX
Alpha (%)	1.66	-
Beta	0.95	-
Standard deviation (%)	15.54	14.66
Sharpe ratio (Rf = 0%)	0.50	0.45

Market cap breakdown (% of NAV)^{+3,6}

Large cap (top 70%) ⁺⁴	81.75
Mid cap (bottom 15-30%) ⁺⁴	14.79
Small cap (bottom 15%) ⁺⁴	1.06
Cash	2.40
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
E ⁺¹⁵	IE00BNCB6582	0.75%	\$10,000,000	Acc
EUR A ⁺¹⁵	IE00BNCB6251	1.50%	€100,000	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 29, 2020 are as follows: USD Institutional E Class Shares 0.1928 USD per share; EUR Hedged Class C Shares 0.0353 EUR per share; GBP Institutional D Class Shares 0.2192 GBP per share; GBP Institutional F Class Shares 0.2736 GBP per share.

⁺¹³: ESG Rating score corresponds to the Sustainability ESG Risk Exposure Category of the Fund. This exposure is defined by Sustainability and considers a company's sensitivity or vulnerability to ESG risks. Source: Sustainability. C/R is Carbon Emission to Revenue. Source: Trucost, in Tonnes CO2e/USD mn.

⁺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

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Fund commentary

In February, the Fund decreased by -3.97% (net of fees; JPY Institutional Class A), underperforming its reference index, the TOPIX index with dividends of all shares traded on the first section of the Tokyo Stock Exchange (TSE), which decreased by -0.43%.

The month's positive performers among the Global Industry Classification Standard (GICS) sectors included shares of Industrials and Consumer Staples, Materials and Communication Services while Industrials, Consumer Discretionary and Information Technology detracting from the Fund's performance.

Among the best performers were my investments in ROHTO PHARMACEUTICAL CO.,LTD. (4527), a leading skincare cosmetics and OTC ophthalmic medicines producer, ASAHI INTECC CO.,LTD. (7747), the domestic market leader in circulatory organ-related PTCA guidewires, and Nissan Chemical Corporation (4021), a manufacturer of liquid crystal alignment films and pesticide.

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, Mercari, Inc. (4385), the operator of Japan's largest online flea market app "Mercari", and SONY GROUP CORPORATION (6758), a diversified consumer and professional electronics, gaming, entertainment and financial services conglomerate detracted from the Fund's performance.

In last month's commentary, I explained that the Fund had been well-positioned to withstand rising inflation and interest rates from a business fundamentals perspective. That is to say, the Fund's portfolio holdings have been carefully balanced between "high quality holdings whose competitive strengths are rooted in manufacturing excellence" (be it industrial, medical device, apparel, consumer products) and "businesses whose compelling economics reside in intangible assets such as proprietary software, algorithms, user data, network effects and intellectual properties". The former group is asset heavy and can be generalized as businesses that sell 'stuff' (physical goods) while the latter tends to be asset light in nature. It's worth noting that over the last several years, I have been making more new investments in the latter type than the former.

In the face of rising prices, the Fund's intangible asset driven businesses that provide software and online services are feeling minimal impact as these asset light / less labor intensive companies continue to report record high profits. Meanwhile, the Fund's investees in manufacturing businesses are currently under pressure citing higher raw material costs, chip shortages, supply chain disruptions, and lack of available labor. But they have excellent track records of masterfully navigating through past recessions / crises be it during the Asian currency crisis in the late 90s, the burst of dotcom bubble in the early 2000s or the 2008 global financial crisis thanks to competent management teams, strong pricing power, and cost competitiveness. Hence, I believe they have the ability to weather the current inflationary headwind. Better yet, should the inflation turn out to be short-lived, these manufacturing stocks will come back strongly for sure.

On the contrary, my portfolio was not so well-prepared to stay insulated from valuation multiple contraction caused by rising interest rates. The reason for this is partly by design as I have said in the 2020 November letter that I am generally averse to investing in value stocks (as defined by low PER or low PBR) due to their inherent subpar business nature.

This is why my portfolio remains exposed to de-rating risk in the current market environment even though I have been mindful of the risk and taken some corrective actions ahead of time. For example, in the last 24 months, I made large new investments in Sony Group (newly purchased at 13x P/E in 2019/2020) and Hitachi (newly purchased at 10x P/E in 2021), both of which were trading at below market average P/E at the time of purchase, and added meaningfully to Mitsubishi Corp (added at 7.5x P/E during 2021/2022). This effectively has helped to bring down the overall valuation of the portfolio, albeit insufficiently.

While I may have underestimated the impact of the recent rise in interest rates globally and an ensuing shift in market trends, I do believe the long-term gains from being patient will eventually outweigh the short-term pain. In other words, over time the businesses' strong fundamentals will drive the Fund's performance again. The Fund's investees are all promising global businesses that have grown their earnings 250% to 350% on average (CAGR 6.3% - 8.7%) over the last 15 years from their pre-2008 crisis peak profits. This compares to a meager 40% cumulative growth to no growth (CAGR 0.0% - 2.1%) for other large index constituents (financials, telecoms, utilities, traditional manufacturers) that the Fund doesn't own.

I should also point out that the Fund-level P/E ratio has declined as a result of the recent share price correction with the premium over the market average narrowing sharply. As shown in the November letter last year, the Fund's P/E was hovering around 50% above that of the TOPIX. Today it is only about 20% higher. Considering the quality advantages of our investees, the Fund's valuation is becoming increasingly attractive.

Below, I would like to further offer my thoughts on the difficult absolute as well as relative YTD Fund's performance.

Thoughts on the difficult YTD absolute performance and my expectations moving forward

In last month's commentary, I have warned that some of high growth / high PE stocks in the portfolio are admittedly at risk of de-rating, should domestic long-term rates rise. For instance, if I were to change the discount rate by 2% from 8% to 10%, the intrinsic value estimates would fall by as much as 30-40% keeping all the other growth rate assumptions constant. Our long-term holdings such as Keyence and NIDEC could be the biggest victims of this.

Why am I still holding these names? Below is an excerpt from last commentary to address this question.

"Over the last 14 years the Fund has been invested for, Keyence has increased its market cap tenfold (JPY 1.5 → 15 trillion), making it one of the most successful investment cases to date. This value appreciation can be broken down into the profit growth and multiple expansion. During our ownership, Keyence's net income grew 5-fold (forward looking Net Profit JPY 60 billion at the time of the initial purchase to FY2022 ending March 2023 estimated JPY 300bn) while the forward P/E went from 25 to 50 times. NIDEC has been held since 2013 in the Fund, during which time the market cap nearly quintupled (JPY 1.4tn → 6.8tn), which can be divided into profit growth of 2.9 times (forward looking NP JPY 60bn at the time of the initial purchase to FY2022 ending March 2023 estimated NP JPY 175bn) with the forward P/E advancing from 23 to 40 times (1.7x)."

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Of these two contributing factors, the profit growth factor should be relied upon more when thinking about the intrinsic value estimate moving forward. The reason being, the moats for Keyence and NIDEC continue to stay intact and robust in my assessment, and their earnings growth prospects will likely remain bright with abundant addressable markets. As such, the accumulation in intrinsic value due to profit growth from the past is unlikely to be lost, which in turn implies that the part of market cap appreciation brought about by this factor will likely stick around although the multiple contraction (de-rating) on the back of rising interest rates may continue to take a toll. I would also like to emphasize that as a price conscious stock picker, I pay great attention to valuations upon entry. Keyence and NIDEC were both first invested at near historical trough valuations.

It is extremely difficult (frankly I think it is impossible) to forecast how much the bond yields will rise over what timeframe and how long the phenomenon will persist. While the argument for the current inflationary trend being transitory has been largely dropped by the Fed, and some of today's inflationary trend could be structural in nature such as due to demographic changes and environmental factors, there are always counter-arguments that assert technologically enabled innovations can be a deflationary factor. Putting all of these things together, I come to the conclusion that long-term inflation and interest rates are too complex to predict ahead of time, hence I just leave this topic in the "too difficult pile" (as Warren Buffett often likes to stash away things that are too difficult for him to comprehend).

What I continue to focus solely on is the companies' businesses and their progress. When I invest in promising long-term capital compounders at historically attractive valuations, my approach is almost like "buy-and hold" (unless the business's moat suffers significant deterioration or the valuation becomes "irrationally" expensive). This mindset unfortunately hurt the Fund returns during the latest month but it is also true that such determination served well during the past interest hikes (by not selling too hastily). Even when I recognize that some of its holdings are disproportionately benefitting from multiple re-rating on top of rising profit levels, my de facto action is to just "let the winners run" with only occasional profit-taking (e.g. to meet Fund redemptions) but rarely exit the position completely."

So what is the outlook for these beaten-down stocks? Well, if the share price corrects by 30-40% from the peak (as of this writing, some of the holdings have already corrected by 20-30% YTD) due to de-rating, theoretically earnings would have to increase by 40-60% to fully offset the lost ground. Based on the historical 12-15% earnings compounding rate of Keyence and NIDEC, it would require 3-5 years to bring us back to the peak share price levels. Valuation multiple contraction can occur in a very short period of time as happened recently, but earnings growth can only materialize over several years. Hence, patience is required.

Of course, NIDEC and Keyence could overcome the de-rating headwind quicker if the earnings growth accelerates thanks to their own business efforts. One such potential scenario is NIDEC's traction motors business for electric vehicles. Though the company has yet to score a big win (such as winning a Tesla order etc.), NIDEC has been consistently revising their FY2025 order projections upwardly from 2.5 million to 3.5 million units over the past year. It is important to remember that NIDEC is the world's largest DC brushless motors of all types with over 3bn units in total annual production, giving them formidable scale advantage. As the EV traction motor production volume ramps up, management expects this business to breakeven in FY2023, which could potentially add JPY 30bn to their existing consolidated profit base of JPY 190bn. Once in the black, its profit contribution will accelerate thereafter, and combined with the continuous growth of other motor segments, their earnings momentum is poised to pick up significantly.

Keyence, the factory automation sensor developer, has masterfully navigated the turbulence so far. The company's unique direct sales channel strategy allowed management to respond quickly to secure enough parts supply, while most of its competitors rely on a sales agency model and hence were unable to effectively deal with the problem. As a result, Keyence, posted a 50% operating profit increase YoY in the last quarter, surpassing the previous record high in 2017 by 25%. The company's overseas revenue roughly accounts for half of the total. If the revenue breakdown was to mirror the global GDP distribution, I would not be surprised to see 5 years from now Keyence's foreign sales making up a far bigger portion than its domestic sales, which are still growing at a decent clip. As an aside, my export-oriented holdings are expected to benefit from JPY depreciation as well.

Meanwhile, I am excited about my recently purchased names. For instance, Hitachi should have limited de-rating risk as we entered at value stock-like valuation (10x P/E, low-teen ROE, healthy balance sheet), and I believe the firm has the potential to transform into a growth company from a manufacturing-driven hardware sales model to a scalable solution-based model built around their proprietary industrial IoT (Internet of Things) platform called Lumada. As the business portfolio shift progresses, their ROE should improve further accompanied by above average earnings growth, increases in free cash flow and continued strengthening of the balance sheet. I suspect the stock remains considerably undervalued due to the market's "anchoring bias" from the times when the company was a lethargic, low margin, troubled hardware manufacturer. If my investment view is correct, I expect both earnings growth and multiple expansion to drive up the share price. On the other hand, if I am proven wrong, Hitachi will just remain as a cheap manufacturing stock with not much downside risk. Hitachi is still in the early stages of the transition, however restructuring efforts over the past 10 years has helped the company already achieve mid-teen ROEs on a reasonably healthy balance sheet. As such, there remains downside risk to the current year's profit guidance but given a far bigger future upside potential, the odds are in our favor.

It is probably debatable but I would classify SoftBank Group under the "value" bucket with a good margin of safety due to its heavily discounted valuation. The firm's NAV, which consists of attributable market values of its publicly traded investees as well as fair value assigned to pre-IPO investees. I can see some of the Fund's investors frowning upon such "value" designation. But it is worth mentioning that over 70% of its investment securities are publicly traded, which allows any outside people to objectively measure the aggregate value of its investment portfolio based on quoted security prices. True, these investees are concentrated in loss-making tech start-ups but when SoftBank Group's shares are trading 50% below the objectively measured aggregate NAV, I cannot help but think of it as an undervalued security. Management is also on our side as they are acting on yet another big share buyback program (worth JPY 1tn this time or equivalent to over 10% of its current market cap).

Then, there are investment cases, where, even with contracting multiples, it is entirely possible that long-term profit growth can outweigh the valuation de-rating factor. As a historical case study, the US internet giant Google is a case in point. As shown in the table below, Google shares experienced a multiple contraction from 52x in 2007 to 29x at the end of last year. During this period, however, its EPS increased from \$6.6 to \$100.5, giving the stock an 8-fold increase (\$346 at the end of 2007 to \$2,897 at the end of 2021). It is also noteworthy that Google's stock price tumbled during 2008 by 60% amid the Great Financial Crisis but still achieved this great performance. Conversely, Coca Cola also went through a similar phase where its P/E ratio contracted from 47x in 1997 to 18x in 2011, during which time the EPS growth only managed to bring the share price back up to where it was 14 years earlier.

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What these case studies tell us is that it's the business performance that matters and my belief is that, in this modern digital age, proven intangible asset-based businesses (internet, software, platform businesses), which I often term in my letters as "non-linear" businesses is the best way to achieve this. I would like to highlight Mercari and Recruit, two of my internet stocks with successful business track records. I am very much looking forward to them driving the Fund's performance over the mid-to-long term.

<Coca Cola share price performance breakdown>

(1)	FY2007 end share price	FY2007 earnings per share	P/E Ratio
	\$33.3	\$0.71	47x
(2)	FY2021 end share price	FY2021 earnings per share	P/E Ratio
	\$35.0	\$1.93	18x
Growth	+4.9%	+171.7%	-61.4%

<Google share price performance breakdown>

(1)	FY2007 end share price	FY2007 earnings per share	P/E Ratio
	\$346	\$6.6	52x
(2)	FY2021 end share price	FY2021 earnings per share	P/E Ratio
	\$2,897	\$101	29x
Growth	+737.9%	+1,412.6%	-44.6%

(Source: Bloomberg)

YTD relative performance vs the benchmark

I should also be forthcoming with the Fund's poor relative performance. The Fund has not only suffered in absolute terms but also significantly underperformed the index thus far this year. While the Fund holdings remained under selling pressure as the growth-to-value market rotation took a toll, the value stocks marched higher despite their lack of growth appeal. In theory, higher interest rates should result in price correction of all equities regardless of whether they are long-duration stocks (growth names) or short-duration stocks (value names). But in reality it is completely reasonable that some stocks get re-rated, perhaps driven by mean-reversion effect. After many years of anemic growth, the P/E ratios of these companies were depressed, so for their valuation levels to moderately recover is not surprising. So far, we have seen this take place with Japanese's banks' P/B ratios rising to 0.5x from 0.3x recently. For Toyota, the largest index constituent, its P/E ratio has climbed to 11x from 9x. When such polarization of the market occurs, the difference between the Fund return and the market return becomes quite vivid especially when the last few months is looked at in isolation. With the Fund's active share of over 80%, it is inevitable that the Fund behaves very differently from the broader market. I cherish this as an active manager.

In conclusion

Lastly, while the equity markets continue to be spooked by the prospect of rising inflation and the resulting higher interest rates, I attempt to look beyond and focus on when the inflation is brought under control. No matter how steep the pace of inflation may be, things will eventually settle down. I am mindful that the majority of market participants today have lived in a disinflationary world all their lives and are navigating uncharted waters at present. I have no clue whether the world will witness the return of a Volcker era but I will make certain that our investees maintain their competitive moats to survive and thrive during this challenging period, which should eventually lead to superior Fund's performance in the future.

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Europe

This document should be considered a marketing document.

A copy of the English version of the prospectus of the Fund and the Key Investor Information Document (KIID) relating to the Fund may be obtained online from www.fundinfo.com or alternatively received via email upon request by contacting tateam@mjhudson.com. Where required under national rules, the KIID will also be available in the local language of the relevant EEA Member State.

A summary of investor rights associated with an investment in the Fund is available online in English at www.fundinfo.com or it may be received upon request via email by contacting tateam@mjhudson.com.

A decision may be taken at any time to terminate the arrangements made for the marketing of the Fund in any EEA Member State in which it is currently marketed. In such circumstances, Shareholders in the affected EEA Member State will be notified of this decision and will be provided with the opportunity to redeem their shareholding in the Fund free of any charges or deductions for at least 30 working days from the date of such notification.

Contact

Investment advisor	SPARX Asset Management Co., Ltd.
Email	investor.report@sparxgroup.com