Fidelity Japan

FJV is a committed growth vehicle available on a wide discount...

Update
04 July 2022

Overview

Fidelity Japan Trust (FJV) uses all the flexibility of the investment trust structure to maximise long-term capital growth potential. Manager Nicholas Price aims to identify companies whose growth prospects are undervalued or overlooked by the market. Nicholas is a Japanese speaker who has lived in Japan for many years, running portfolios since 2000. He personally, alongside Fidelity's team of specialist analysts based in Tokyo, conducts hundreds of company meetings a year to root out undiscovered growth companies. The Japanese small and mid-cap space is vast and little covered by analysts, making this a good hunting ground for stockpickers.

Nicholas is index agnostic, though the portfolio has a mid-/small-cap growth tilt. Nicholas can also invest in unlisted companies, typically shortly before an expected IPO, currently representing 7% of the portfolio. The team has invested in this space for eight years and has built up a network which sees them presented with dozens of prospective unlisted companies each year. Additionally, Nicholas has run the portfolio with consistent levels of **Gearing**.

These factors have contributed to the trust seeing periods of strong outperformance, while it has also underperformed in falling markets (see **Performance**). Notably, 2022 was a tough year, as growth significantly underperformed value in a falling market, and gearing exacerbated FJV's losses. However, 2023 has seen somewhat of a recovery, particularly in Japan, and Nicholas and the team think Japan looks set to perform well, while their portfolio is attractively valued versus history.

FJV's shares have slipped onto a 10.6% **Discount** at the time of writing, wider than their own five-year average and the current Japan sector average too.

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Analyst's View

FJV offers a really powerful set of features which could deliver exceptional returns in the right circumstances – and have done so in the past. The small and mid-cap bias, the use of gearing, and investment in unlisted companies all bring risks, but they also increase the potential for alpha generation and long-term absolute returns. Last year saw everything work against the strategy, from value massively outperforming growth to small and mid-caps underperforming and the Japanese Yen even managing to underperform the out-of-favour pound sterling. We think the trust looks more attractive after this sell-off, with portfolio valuations lower and a significant share price discount opened up.

Of course, there can be no guarantee that we will not see another leg down in global equity markets this year, and that is presumably why investors are not rushing in to buy and the shares have slipped to a 10.6% discount. In our view, this is likely to be a good long-term entry point, although we acknowledge the possibility that the short term could see further weakness. In Japan, we think the balance of probabilities tilts in a more optimistic fashion than it does elsewhere. The domestic economy is seeing impetus from the late ending of COVID-related restrictions and a return of inbound tourists, while its terms of trade have improved and domestic price/wage inflation is more favourable than in many other developed countries. Perhaps more significantly, Japanese corporate governance reforms continue to gather pace, with buybacks and dividends hitting record highs and management teams open to actions that can unlock corporate value. This is a unique growth driver in Japan which looks likely to have years to run.

BULL
A highly experienced manager, locally based and well-resourced
A flexible mandate with many ways to add alpha
Strong performance delivered in the past when its style was in favour

BEAR
Gearing and SMID focus brings sensitivity to falling markets too
Global economy remains weak which could see a risky assets sell-off again this cycle
While Japan may currently look more stable than some peers, as a single country fund FJV is exposed to the health of its economy and politics

Portfolio

Fidelity Japan Trust's (FJV) portfolio is managed by Nicholas Price, a highly experienced, long-term resident of Japan. Nicholas speaks Japanese, and does a lot of the leg work himself, meeting company after company in Japan and digging out under-appreciated companies with huge growth potential. Japan is a relatively under-researched market, and Nicholas focusses on the mid and small-cap space where many companies receive no regular analyst coverage at all. His basic strategy is to look for those where markets are mispricing growth, i.e. a growth-at-a-reasonable-price (GARP) approach in the industry jargon. Nicholas focusses on looking for situations in which change has not been incorporated in stock prices, whether that be a company's operating environment, internal operations, or market sentiment. This way he aims to identify a disconnect between sentiment – and therefore valuations – and long-term growth prospects.

Typically, FJV's portfolio could be expected to be more expensive than the market but with higher growth metrics. In the table below this is illustrated through return on equity (RoE) and return on invested capital metrics, as well as higher expected operating profit growth. Nicholas targets companies with an RoE of over 10% and a three- to five-year runway of growth, with management committed to increasing shareholder returns. This last commitment is a source of great opportunity in the Japanese market given a generational shift in corporate governance that is underway thanks to significant and sustained reforms. As we have discussed in past **strategy notes**, Japanese corporates are being pushed into improving balance sheet management and increasing growth investment and shareholder returns as a way to increase growth in the economy. This is an interesting dynamic which could boost returns in Japanese equities over the medium term, and the Fidelity team note that share buybacks and dividends both hit record highs in 2022.

Portfolio Characteristics

	2023		2024	
	FJV	Topix	FJV	Topix
Operating profit growth (%)	13.9	10.4	21.0	8.6
P/E (x)	17.9	14.8	16.1	13.7
PB (x)	2.4	1.5	2.2	1.4
Return on Equity (%)	14.2	10.2	14.4	10.3
Return on invested capital (%)	14.6	11.9	16.3	12.3

Source: Fidelity, FactSet, MSCI Barra as at 30/04/2023

Notably, the persistent adherence to this focus on growth has led to the trust having the greatest exposure to what Morningstar classifies as growth stocks in the AIC Japan sector.

Style Allocation

	EQUITY STYLE VALUE (%)	EQUITY STYLE CORE (%)	EQUITY STYLE GROWTH (%)
Fidelity Japan Trust	5.3	28.3	66.4
JPMorgan Japanese	7.3	33.9	58.7
abrdn Japan Investment Trust	14.6	33.6	51.8
Baillie Gifford Japan	18.9	32.1	49.0
CC Japan Income & Growth	32.4	40.1	27.5
Schroder Japan Trust	37.6	41.0	21.4

Source: Morningstar

Nicholas has been running portfolios of Japanese equities since 2000, following a consistent approach ever since. As noted, he takes a hands-on approach to stock selection, and historically the team estimate he has generated around 20% of the ideas for his portfolios himself – although the current number is a little lower thanks to the team expansion. The bulk of the ideas come from the research analysts who work alongside him in Japan. Fidelity has three analysts devoted to small and mid-caps, along with a team focussed on various sectors. Nicholas encourages them to seek out new ideas off the beaten track. The beauty of the Japanese market for stockpickers is that the small and mid-cap sectors are typically overlooked by research analysts, meaning there is the opportunity to find hidden gems. While he has an all-cap mandate, there is a persistent tilt to the mid- and small-cap areas of the market which stands out amongst the peer group.

Market Cap Weighting

	MARKET CAP GIANT %	MARKET CAP LARGE %	MARKET CAP MID %	MARKET CAP SMALL %
Fidelity Japan Trust	19.1	12.7	52.3	26.3
Schroder Japan Trust	36.6	29.1	30.2	15.4
CC Japan Income & Growth	44.2	18.7	28.9	7.1
Baillie Gifford Japan	29.0	30.3	27.6	12.2
abrdn Japan Investment Trust	44.8	33.7	27.2	12.2
JPMorgan Japanese	57.9	30.9	18.8	5.8

Source: Morningstar

A good example of a little-covered small cap that has a long-standing position in the portfolio is JustSystems, a software company that provides tablet-based B2C e-learning systems for school children. Japanese government policy is for all children to have access to a tablet in schools, so they have a huge addressable market.

An additional tool is the ability to invest in private companies. The board has permitted the manager to invest up to 20% of the portfolio in unlisted companies. At the time of writing the weighting is just 7%, made up of six positions, and the team is actively looking for opportunities to add to them. The focus is on companies which are at a late stage, one or two years away from IPO, where the team finds few potential investors competing. Past successes include Raksul, a July 2016 investment, which IPO-ed in May 2018 delivering a 78% annualised rate of return. Investing in unlisted companies brings high return potential and a greater view of emerging trends and competitors. It does bring some risks though: fewer investors are covering a company and thrashing out its value, while early-stage companies are sensitive to funding costs and have a higher failure rate. They also bring a lag to the portfolio's NAV as they are not priced daily, although, at 7% of the portfolio, this is limited. Nicholas has built up a network over the years which means he is often approached by companies looking for investors. Fidelity benefits from its relationship with VC investor Eight Roads, a one-time Fidelity spin-off. The team estimate they see around 100 unlisted companies a year.

The total portfolio is expected to have between 90-100 stocks. Adding to the manager's flexibility, Nicholas can also invest via contracts for difference (CFDs) which allow gearing. This tends to be used for more stable names where it can reduce the cost of trading. The use of gearing contributes to quite a high turnover. This was 67% for the 12 months to April 2023. CFDs cut the cost of this frequent trading. While Nicholas looks to hold companies for the long term, he does trim positions actively as their valuation rises, which also adds to the turnover. Notably unlike some of the other Fidelity trusts which use CFDs, Nicholas does not use them to short companies (and therefore doesn't short at all).

It should be clear from the foregoing that the portfolio is fundamentally a collection of companies picked for their attractive bottom-up characteristics. Many have idiosyncratic sources of growth which in theory provides diversification. One example is Kosaido Holdings, which has a monopoly on the cremation business in Tokyo. The company is delivering strong free cash flow growth and has deployed that cash in buybacks and dividends. Another is socionext, a specialist microchip manufacturer which looks set to have doubled 2020's free cash flow by 2024 and pays out 50% of earnings.

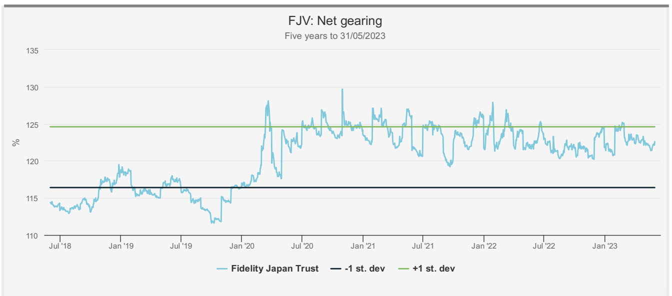
Elsewhere, the team highlight some common themes, one of which is companies that are global industry leaders, expanding overseas with strong pricing power. There are also a group of stable growth companies, in which the gearing tends to be invested. The portfolio also includes a number of companies which are benefitting from the reopening of the Japanese economy post-pandemic, which was only completed in late 2022 and is releasing a burst of economic activity through more consumer-related names. Similarly, there are several companies which look likely to benefit from a rebound in Chinese tourism after the dropping of its zero covid commitment. As discussed in the **Performance section**, these factors have contributed to Japan becoming a consensus pick amongst global investors for 2023.

Gearing

To make full advantage of the investment trust structure, the board and manager have agreed to use gearing, and derivative contracts called contracts for difference (CFDs) which are used due to their low cost and flexibility. These contracts can be bought on individual companies, allowing the manager to take exposure to a stock while putting down a fraction of the value of the position.

Nicholas doesn't take a strong market view but instead focuses on the availability of attractive investment opportunities. This means there is some counter-cyclicality to the gearing position, as the below chart suggests. However, having raised gearing in late 2020 into the global recovery, in 2021 and particularly 2022 it was a detractor as growth equities sold off. However, the team note that Nicholas tends to gear up the steadier, more stable companies in the portfolio, and so while the gearing was a detractor from the performance last year, the geared-up positions themselves did relatively well.

Fig.1: Net Gearing



Source: Morningstar

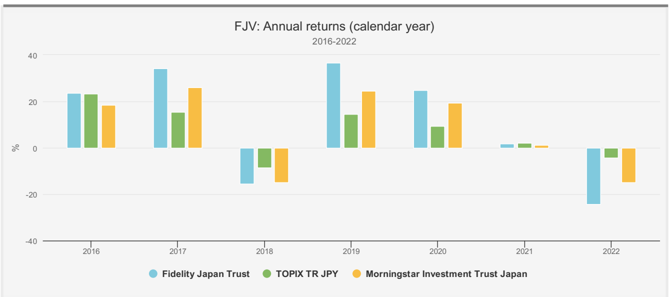
The total exposure to Japanese equities, whether held directly or through CFDs, is limited to 30% at the time any CFD is entered into or a security is acquired and 40% at any other time unless exceptional circumstances exist. That said, currently, Nicholas has been given the discretion to be up to 25% geared should he choose, with the limits and approach to gearing regularly discussed by the board.

Performance

The key attributes Nicholas looks for are earnings growth potential, reasonable valuations, and quality – with quality meaning strong balance sheets and repeatability of earnings. On occasion these factors come into favour however, at times the market looks for other things. The philosophy is that over the long run, these factors will lead to outperformance, even if this is not always true over the short term. The other critical factors affecting FJV's relative performance are the mid- and small-cap bias and the tendency to run gearing. Both of these bring more sensitivity to falling markets as well as outperformance potential in rising markets.

FJV delivered strong outperformance of the index in 2017, 2019, and 2020 when growth outperformed. In 2021 and 2022, value outperformed growth as the global interest rate environment changed, and FJV underperformed. Gearing was a factor as the market fell as well as style. In 2018, the market sold off towards the end of the year, and both factors worked against the trust.

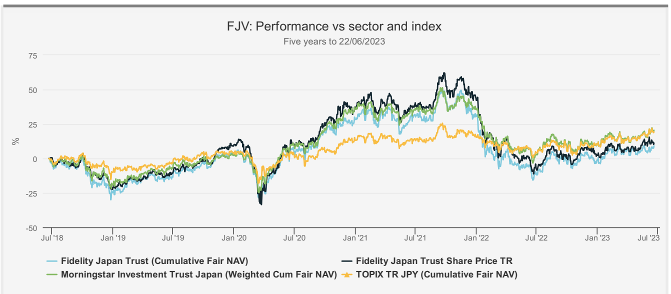
Fig.2: Returns



Source: Morningstar
Past performance is not a reliable indicator of future results.

Just eyeballing the chart above gives an impression of how bad 2022 was. Japanese markets have staged somewhat of a recovery in 2023, with FJV up 5.3% at the end of May

Fig.3: Five-Year Performance

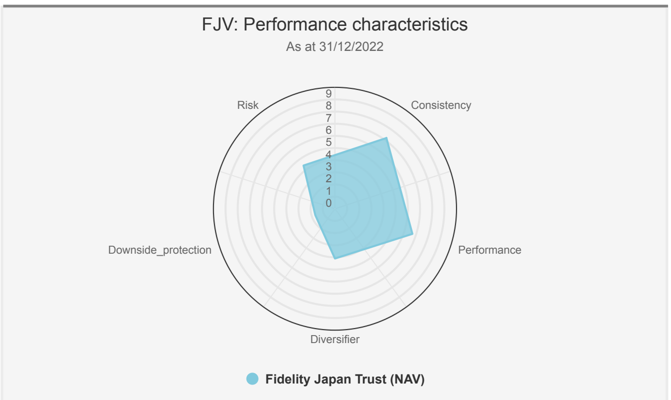


Source: Morningstar
Past performance is not a reliable indicator of future results.

in NAV total returns compared to 4.6% gains on the Topix. However, the loss of 24.3% in 2022 has dragged down FJV's absolute and relative returns over the long run. Over five years, as the below chart shows, the trust has delivered 9.2% (to 20/06/2023) versus 19.3% for the Topix and 20.5% for the weighted Japan sector average.

Our proprietary KTI Spider Chart is shown below. This shows how FJV has performed versus a wider peer group of Japan and Japan smaller companies investment trusts over the past five years, in some key categories. Each category is scored out of ten and scores are normalised to the peer group, with a higher score indicating a superior characteristic. The trust has actually performed better than average once the small caps are considered too, looking at a risk-adjusted measure of performance. The risk and downside protection scores are low reflecting the sharp sell-off seen in growth equities over the period and additionally the use of gearing. To us, this underlines the fact that FJV is a higher-risk strategy, which is the price to be paid for higher return potential.

Fig.4: KTI Spider Chart



Source: Morningstar, Kepler calculations
Past performance is not a reliable indicator of future results.

Japan was caught up in a global meltdown last year. However, in 2023 it looks in a strong position versus its peers. A weak currency and improving terms of trade have improved the competitive position of its exporters, while the domestic economy is relatively strong. Japan has dropped the last of its pandemic restrictions which has led to a burst of economic activity, and inbound tourism, with visitors from China starting to recover now since that country has also dropped travel limits. The strength of the domestic economy means the BoJ is in a position to be considering tightening monetary policy which could potentially be seen as normalisation from emergency levels leading to growing confidence in the economy. While Japanese equities are typically very exposed to the global economy, this growing domestic strength could potentially weaken its susceptibility to swings in global growth. It is no surprise that the country has become a consensus pick amongst global fund managers this year.

As regards Nicholas' style, the team note that the valuation premium FJV's portfolio typically trades at, versus the index, came down last year. While the portfolio is still more expensive, the margin is much lower, and the portfolio is expected to deliver much higher levels of growth. They note that historically the portfolio has bounced back strongly from periods of underperformance.

Dividend

Nicholas is asked to focus on capital growth and the board does not aim to pay a dividend. In fact, the trust has not paid one since 1996.

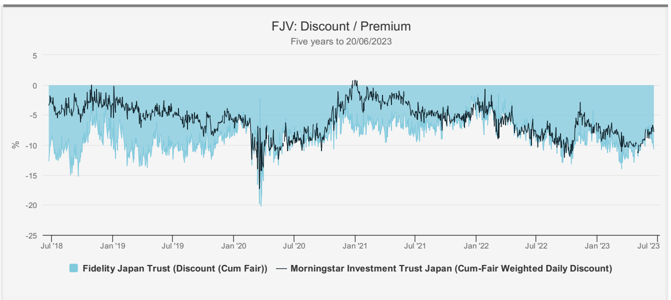
Management

FJV is managed by Nicholas Price, a career Fidelity man who has worked for the company in Tokyo since 1993, first as a stock analyst and then from 1999 as a portfolio manager. He was appointed manager of Fidelity Japan Trust (or Fidelity Japanese Values as it was then) in September 2015. He is supported by assistant PM Cenk Simsek. In total, Fidelity has five portfolio managers focussing on Japan along with 12 company analysts and three sustainable investment specialists. Nicholas is a fluent Japanese speaker and spends much of his time meeting companies himself. We understand around 20% of the portfolio has historically been made up of ideas Nicholas has uncovered himself, while three analysts specialising in small caps seek to find ideas to pitch to him. Over the years Nicholas has built up contacts and a reputation in Japan, and in particular, his access to the unlisted space is helped by this, as over the years he has led Fidelity to invest in early-stage, pre-IPO companies and as such can find himself being recommended by founders and CEOs of those companies to others who are looking to raise capital.

Discount

FJV's shares trade on a 10.6% discount at the time of writing compared to their five-year average of 8.5% and a weighted average for the Morningstar Japan sector of 7.8%. The shares traded close to par around the end of 2021 and the beginning of 2022, before a sell-off in global equities which hit growth stocks hardest seems to have led to the discount widening out substantially. We think it is notable that Japan has been widely picked by many investors to outperform this year, and if it comes into favour this could see FJV's discount narrow. That said, one factor keeping discounts wide is the high interest rate available on cash for UK-based investors which looks likely to persist for some time.

Fig.5: Discount



Source: Morningstar

The board uses buybacks to reduce discount volatility and to ensure it remains in high single digits at the most in normal market conditions. In the year ending 31/12/2022, the shares traded on an average discount of 7.6% (according to Morningstar) and only 0.1% of the share capital was bought back. In 2023, the discount has tended to be wider and 0.4% of the shares had been bought back at the time of writing. Buybacks were halted in mid-May when the discount fell below 10% for a period of time.

Charges

FJV's latest ongoing charges figure is 0.96%. The average for the AIC Japan sector is 0.91%. FJV's fees have an unusual structure which brings a performance-related element into the management fee. The standard management fee is 0.7%, but it will vary up to 0.2% in either direction depending on whether the trust's NAV outperforms or underperforms the Topix. As such the maximum management fee charged could be 0.9% and the minimum 0.5%. The variable element of the fee increases or decreases by 0.033% for each percentage point of the three-year NAV per ordinary share outperformance or underperformance over the Topix Index, and is calculated daily. We like this performance-related element which we think strongly incentivises the manager to continue to outperform as the fund grows. The latest KID RIY is 1.58% which compares to an average of 1.43% for the sector, according to JPM Cazenove.

ESG

ESG considerations are embedded in the research process, primarily through the implementation of the Fidelity Proprietary Sustainability Rating by the team of analysts. This is a forward-looking and holistic assessment of a company's ESG risks and opportunities, based on specific indicators appropriate for companies depending on the sub-sector they are located in. Additionally, analysts produce a Climate Rating, which captures their assessment of which companies are in the best position to transition to net zero, or which have a positive trajectory towards transition. The responsibility falls first on the analysts working on the business fundamentals, but they are supported by a Sustainable Investing Team responsible for consolidating the approach to ESG firm-wide and assisting with ongoing engagement. Managers can also consider external ratings before internal ratings are available, but internal ratings are ultimately relied upon. Nicholas is not prohibited from investing in companies which score poorly, but he does have to justify the ESG ratings and carbon footprint of the portfolio in the quarterly fund reviews with Fidelity's Head of Investments in Tokyo, alongside investment risks such as beta, tracking error, and any concentrated positions.

FJV gets one out of five globes in Morningstar's sustainability rating, although only 64% of the portfolio is covered by Morningstar analysts, so we would not place too much emphasis on this. Nicholas points out that the Japanese business culture is not naturally conducive to high ESG ratings, with management typically not keen to boast about achievements and information often presented only in Japanese, which limits the understanding of overseas ESG rating analysts. This provides opportunities for the team to encourage companies to improve disclosures and thereby generate share price re-ratings. Fidelity has three engagement specialists in Japan who work on this. A good example of this in practice is the engagement with the Misumi Group over the past two years. Fidelity asked the company to increase disclosures on a number of matters, and this contributed to the rerating by MSCI in June 2022.

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