# Fidelity Japan

**FJV looks for undiscovered growth stories in Japan...**

Update
28 February 2024

## Overview

Nicholas Price has managed the Fidelity Japan Trust (FJV) since September 2015, consistently employing a GARP (growth at a reasonable price) approach. He targets companies with steady earnings growth, but whose shares can be bought at a lower price than the earnings potential suggests they should be, essentially aiming to capitalise when the market is mispricing growth (see **Portfolio**).

A key aspect of Nicholas' strategy is focusing on small and mid-cap growth businesses, which he believes are often overlooked and under-researched. He targets those which have the potential for significant growth over time, favouring businesses in which he can see material change that has not yet been incorporated into the stock price, such as a shift in the company's operating environment or general market sentiment. Over FJV's latest financial year ending December 2023, several mid-cap names, such as Harmonic Drive Systems and Taiyo Yuden, were added to the portfolio due to attractive valuations on a trough-to-peak view and strong mid-term growth prospects. Additionally, Nicholas invests in unlisted companies, accounting for roughly 6% of the portfolio, with notable changes over the year including Innophys, which was redeemed via a share repurchase, and a new investment in taxi app company GO Inc.

FJV's allocation to small and mid-cap growth businesses hindered performance at times, particularly during periods of significant outperformance of value over growth stocks. However, Nicholas argues these businesses offer stronger alpha potential compared to their larger counterparts and have proven integral to FJV's long-term outperformance of the TOPIX under his tenure (see **Performance**). Moving forward, he sees several potential catalysts for a pickup in performance over 2024, including the governance reforms spreading out through the small and mid-cap companies he invests in.

FJV's **Discount** is currently wider than its own five-year average, trading at 11.3%.

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## Analyst's View

A distinct part of Nicholas' strategy is exposure to small and mid-cap growth businesses. He points out that only a fraction of the c. 3,800 Japanese companies are well covered by sell-side analysts meaning there are plenty of lesser-known businesses that hold significant long-term growth potential. Being locally based and fluent in Japanese, along with the support from a team of dedicated analysts in Japan (see **Management**), provides Nicholas valuable insight into company management and the domestic market, an advantage in stock selection in our view. We also think this bolsters his expertise in unlisted companies. Whilst only a small portion of the trust, we think exposure to this part of the market gives the team a greater view of emerging trends and competitors than other peers in the Japan sector, bringing high return potential and a differentiated source of returns to the table (see **Portfolio**).

Whilst these exposures have driven strong returns versus the index at times, they also entail risks, including heightened sensitivity to domestic factors, style rotations, and the nature of some unlisted businesses which have higher failure rates. That said, the reverse is also true and when in vogue contribute well to returns, as evidenced by Osaka Soda's recent run of **Performance**.

We think this is a higher-risk, higher-reward strategy that benefits from the steady hand of a longstanding manager who has been tested through multiple market cycles. The outlook for Japan moving forward is one of optimism driven by the emergence from a deflationary environment and the positive impact of corporate governance reforms. We believe Nicholas' focus on small- and mid-cap growth stocks, exposure to unlisted companies, and consistent levels of **Gearing**, position the trust to capitalise on these changes. Combined with a double-digit **Discount** which is wider than its own five-year average, we think this also presents a compelling opportunity for investors seeking exposure to the under-researched world of Japanese equities.

| BULL |
|---|
| On-the-ground research team is an advantage in stock selection |
| Expertise in the under-researched Japanese SMID space offers greater potential for uncovered opportunities |
| Exposure to unlisted companies offers a differentiated source of returns |

| BEAR |
|---|
| While offering a greater return potential, having a bias towards small and mid-caps can increase risk, which we saw particularly in 2022 |
| Trust may underperform during value-stock rallies |
| Use of gearing can magnify the losses in a market downturn |

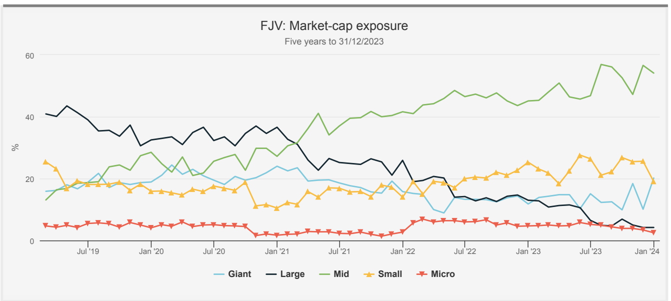
# Portfolio

Nicholas Price has over three decades of investment experience and became the lead manager of the Fidelity Japan Trust (FJV) in September 2015. Over this time, he has consistently employed a GARP approach to investing, otherwise known as growth at a reasonable price, which has helped lead to long-term outperformance of the TOPIX Index (see **Performance**). Nicholas' strategy is to seek out companies that he believes can grow their earnings steadily, but whose shares can be bought at a lower price than the earnings potential suggests they should be. Ultimately, the strategy is about taking advantage of opportunities where the market is under-pricing growth.

In Nicholas' opinion, the greatest opportunities in the Japanese equities market are further down the market-cap scale. While he invests in companies of all sizes, and approaches the index in an agnostic fashion, he has a particular affinity with small- and mid-cap growth stocks. He points out that only a fraction of the c. 3,800 Japanese companies are well covered by sell-side analysts, so there are plenty of under-researched and under-covered names waiting to be found. In our view, this represents a great opening for bottom-up managers like Nicholas, who are willing to do the legwork and identify the most attractive business cases. A crucial tool in the exploration of this part of the market is having an on-the-ground presence. Aside from the fact Nicholas has lived in Japan for many years, building a good reputation and strong relationships with companies over time, he also has access to a strong roster of dedicated analysts based on the ground in Japan (see **Management**). We think that having a local presence brings regular access to company management, as well as a close connection with the domestic Japanese market, allowing the team to see first-hand a lot of the new ideas and business models that are emerging.

We've included a chart below illustrating the market-cap breakdown of FJV's portfolio. Over the last five years, exposure to mid-cap stocks has steadily increased, largely down to the volume of opportunities that Nicholas and his team are seeing, but also the impact of market movements driven by the US rate hike cycle. Over the trust's latest financial year, ending December 2023, there have also been a number of additions to the portfolio, including Harmonic Drive Systems and Taiyo Yuden, both of which fall into the electric appliances sector. Given that factory automation and electronic component-related companies have had to deal with a prolonged inventory correction, exacerbated by the weak recovery in China, Nicholas argues that the valuations for these types of companies have become much more attractive. Harmonic Drive Systems in particular fits this statement given its price-to-earnings ratios are much lower than its three-year average, despite the potential for a strong earnings recovery into next year. Nicholas believes that given leading indicators such as machine tool orders are bottoming out there are signs of a gradual pickup in demand meaning the upside potential is there.

### Fig.1: Market-Cap Exposure Over Time




Source: Morningstar

Nicholas takes a disciplined approach to trimming positions of strength and coming out of stocks when he sees greater opportunities elsewhere. The turnover of the portfolio typically sits in a range of 70-100% which demonstrates his active portfolio management style. Following a strong run of performance, Nicholas took some profits from Tokyo Electron and Socionext, recycling the proceeds into other areas of opportunity, and sold out of Rinnai, a producer of high-quality home gas appliances that is experiencing headwinds from housing and real estate markets overseas.

Another tool that Nicholas uses is the ability to invest in unlisted companies, also known as private companies. The board has permitted the manager to invest up to 20% of the portfolio in unlisted investments and as of the end of December 2023, the portfolio had around 6% invested across seven companies. Over the year there were only two notable movements in the unlisted portion of the portfolio—Innophys which was redeemed via a share repurchase, and a new investment in taxi app company GO Inc. Investing in unlisted companies brings high return potential and a greater view of emerging trends and competitors. It does bring some risks though: early-stage companies are sensitive to funding costs, have a higher failure rate, and the track records are normally only three to five years versus ten years or more for many listed companies. As a result, the process is very selective. The team take a very disciplined approach in terms of financials and valuations, conducting multiple meetings with management. By building detailed research around the company the team can sort out carefully the most likely winners, as, unlike a listed company which can be exited if their thesis weakens, with unlisted companies their exit point will most likely be after an IPO, meaning the requirements for a new position are much higher. Typically, they will invest in the latter stages when a company is c.12-24 months away from listing.

Nicholas points out that many of the Japanese companies he identifies are trading at a discount versus their overseas peers. He thinks that there are a lot of examples where corporate governance improvements are driving higher returns on equity, mainly in the larger businesses, but with clear signs of these improvements trickling down the market-cap scale. Furthermore, Nicholas argues that growth stocks are trading on sub-market multiples despite higher rates of earnings growth and higher returns. We've included a table below showcasing some of the portfolio's characteristics. One characteristic to note is that FJV's portfolio's forward price-to-earnings ratio (PER) is now at a comparable level to the index. Nicholas points out that this is unusual, as the portfolio typically trades at a premium to the market given the higher growth rates and RoEs of the underlying companies. Therefore, Nicholas argues that this could be indicative of a level of potential upside to come.

### Portfolio Characteristics

#### Current calendar year estimates for 2024 and 2025

| | 2024 | | 2025 | |
|---|---|---|---|---|
| | FJV | TOPIX | FJV | TOPIX |
| Operating profit growth (%) | 22.4 | 12.8 | 18.2 | 9.9 |
| PER (x) | 16.2 | 15.6 | 14.7 | 14.1 |

Source:Fidelity

Moving forward we would argue the optimism around Japan's economy is painting an interesting picture for 2024. Japan is emerging from its decades-long deflationary spiral, with workers last year seeing their biggest wage increases since the early 1990s, and recent corporate governance reforms, driven by the Tokyo Stock Exchange, leading to Japanese companies focusing more on capital efficiency and increasing shareholder returns through share buybacks and higher dividend payouts. Given the area of the market Nicholas targets, we think the improving outlook could be conducive to a strong performance profile as we move further into the year. Furthermore, FJV's **Discount** is 11.3% at the time of writing, which is wider than its own five-year average, and in our view, could suggest an attractive entry point for investors looking for differentiated exposure to Japanese equities.

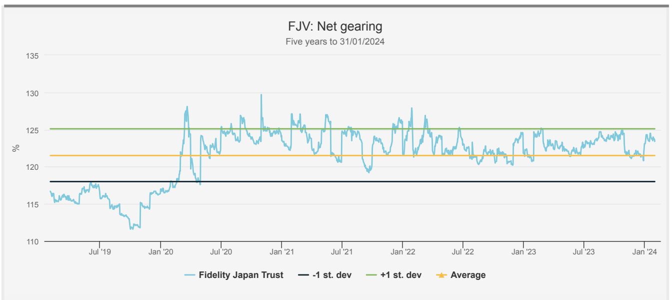
## Gearing

FJV uses derivative contracts for difference (CFDs) rather than a borrowing facility to provide its gearing, given their low cost and flexibility. CFDs allow Nicholas to increase exposure to individual stocks at a fraction of the cost of buying them outright, something he's been able to do with semiconductor production equipment maker Tokyo Electron and speciality retailer Ryohin Keikaku. Over the course of 2023, the aggregate gearing position had a positive impact on returns, notably through the exposure to these two companies.

At the time of writing, net gearing sits at around 23%, which is slightly above the five-year average, given attractive Japanese equity valuations. Nicholas is happy with where market valuations currently stand and feels comfortable with the leverage deployed in more stable growth companies rather than the high beta names. However, he is very strict when it comes to trimming positions into strength or when stocks approach their target prices, pointing out that if there is a sustained uptrend in individual names, he will have no issue with reducing the level of gearing employed and reassessing opportunities elsewhere.

Nicholas has been granted the discretion to be up to 25% geared should he choose, though anything over 25% requires prior board approval. In the first half of 2020, Nicholas was granted approval to increase the level of gearing above 25% given the COVID-19 driven market corrections were creating significant opportunities to add or increase positions in high-conviction growth stocks across the communications, technology, and healthcare sectors. As the chart below illustrates, gearing has declined since, partly down to Nicholas sticking to the process and selling stocks that approached their target prices.

### Fig.2: Gearing




Source: Morningstar

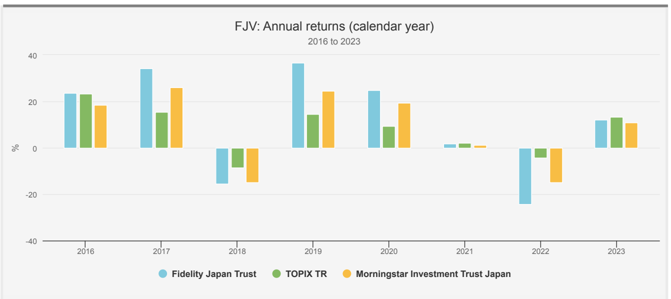
The aggregate exposure to Japanese equities, whether held directly or through CFDs, is limited to 30% of shareholder funds at the time any CFD is entered into, or a security is acquired. The board also intends that the exposure will not exceed shareholders' funds by more than 40% at any other time unless exceptional circumstances exist.

## Performance

As we note in the **Management section**, Nicholas Price has been managing FJV since 2015. Over this time, he has employed the same GARP investment approach to stock-picking, seeking out companies with growth prospects that are undervalued or haven't been fully recognised by the market yet (see **Portfolio**). This approach has helped deliver outperformance of the index, with NAV total returns of 113.7%, under Nicholas' tenure to 22/02/2024, which compares favourably to the 106.6% return from the TOPIX, though it has lagged the peer group over this period.

Nicholas' investment approach has meant that there have been distinct periods of both out and underperformance versus the index, something we illustrate in the chart below. While being index agnostic, the portfolio has a tilt towards small- and mid-cap growth stocks which meant that 2017, 2019, and 2020, periods where growth investing was in vogue, were years FJV outperformed the index and sector comfortably. However, since then, performance has tailed off, especially during 2022 when FJV underperformed the benchmark by 20.2%. The change in the global interest rate environment and the accompanying rise in long-term rates and weakening of the yen (given the policy divergence between the Bank of Japan and other major central banks) acted as catalysts for the comeback in value stocks. This put significant pressure on the trust as Nicholas has very little exposure in this part of the market, leading to the greater exposure in growth stocks, especially small and midcap growth stocks, becoming significant drivers behind FJV's underperformance.

## Fig.3: Annual Returns




Source: Morningstar

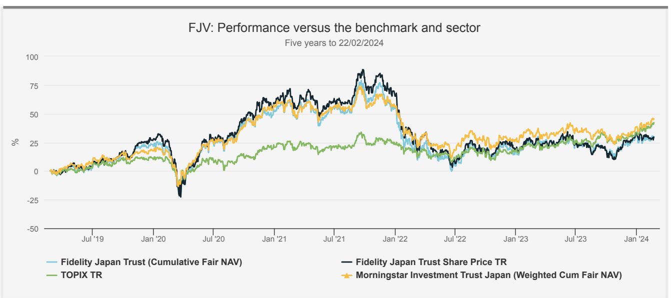
***Past performance is not a reliable indicator of future results.***

Looking over FJV's latest financial year, ending December 2023, NAV total returns were 12.2% which put it marginally ahead of the sector's return of 11% but just shy of the 13.3% return from the TOPIX. Nicholas points out that key Japanese indices registered their strongest annual returns since 2013, with overseas investors playing a key role in the market's ascent. Despite this, there were a number of headwinds for the strategy. Firstly, 2023 was a year of significant style divergence. The US bond yield cycle and accompanying currency trends exerted a sizeable impact on style returns, with strong gains in large-cap value stocks contrasting with the far more muted performance of medium and small-cap growth names. Given that FJV has a greater allocation to these stocks, compared to both the index and peers, it hurt performance in the first half of the year. Another factor was the slow recovery in China which weighed heavily on certain factory-automated names, most notably MISUMI Group. Its share price fell as adverse business conditions and a delayed recovery in the order cycle produced a slew of near-term earnings downgrades, leading to it being the biggest stock detractor from performance over the year.

Given the nature of Nicholas' investment process, though, he invests in a wide range of stocks that have multiple drivers of returns. This includes stocks that are trading at or close to market multiples despite offering consistent mid-term growth as well as contrarian growth names which are stocks that are disliked or overlooked by the market but where he sees catalysts for change. As a result, there were a number of companies that performed well over the year despite the headwinds, including Osaka Soda, a basic chemicals company that is transforming into a niche, value-added functional materials player. It generated 25% growth in operating profits over its fiscal year ending March 2023 and subsequently reported above-consensus quarterly results. These results were largely spurred by favourable pricing and strong sales of silica gel, a material used in the purification of pharmaceuticals, including Novo Nordisk's GLP-1 diabetes and obesity drugs. Other notable performers were fabless chip designer Socionext and semiconductor production equipment maker Tokyo Electron. The former reported strong full-year results that exceeded expectations, driven by automotive-related orders in the US and data centre/network sales in China. The latter was supported by sustained semiconductor demand, technological advances in chip making, and government support amid rising geopolitical tensions.

Nicholas and his team are optimistic moving forward and see a number of potential catalysts that could lead to a stronger performance profile as we move further into 2024. That said, in the short term small and mid-caps have continued to face style headwinds amid narrow market moves. While foreign investor interest was reignited in early 2023 most of their attention and efforts were steered towards the more liquid and easily traded large companies. Nicholas argues that the Tokyo Stock Exchange reforms are now spreading further down the market-cap scale which could increase the appeal to overseas investors. This part of the market is vast and not well covered by analysts, making it a good hunting ground for bottom-up managers like Nicholas to identify the most attractive business cases. Additionally, he thinks that there will be a marked pickup in factory automation-related names as leading indicators, such as machine tool orders, are highlighting that we passed a trough in the order cycle. In their view, given the potential pent-up demand release from China later this year, could see earnings recover quickly.

## Fig.4: Five Year Performance



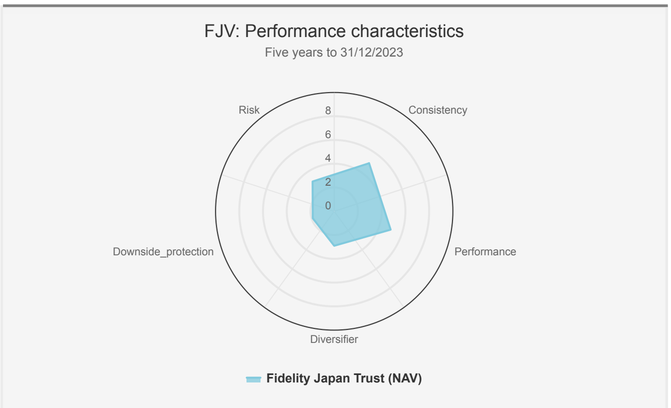

Source: Morningstar

***Past performance is not a reliable indicator of future results.***

For the sake of roundedness, we've also looked at FJV's NAV performance over five years. The underperformance in 2022 has impacted FJV's long-term performance numbers, meaning it is now lagging both the TOPIX and the sector.

Below is our proprietary KTI Spider Chart. It shows how FJV has performed versus a wider peer group of Japan and Japan smaller companies' investment trusts over the past five years. A selection of key characteristics is considered, with ten being the maximum score, and a higher score indicating superior performance in that characteristic. FJV has generated fair alpha over the past five years, reflected in its average score for performance. However, it had a difficult 2022 which has brought the score for performance down compared to previous years. For the reasons above, a sell-off in growth stocks globally, an area of the market that the trust is well represented, also had a negative impact on the risk and downside protection scores. Looking at each characteristic, we would argue that FJV is a higher-risk strategy, but with that comes greater return potential.

### Fig.5: KTI Spider Chart




Source: Morningstar, Kepler calculations

***Past performance is not a reliable indicator of future results.***

## Dividend

Nicholas is asked to focus on capital growth so doesn't actively seek out income opportunities. Additionally, the board does not aim to pay a dividend to investors and hasn't since 1996. All charges are made to the revenue reserve which is in deficit.

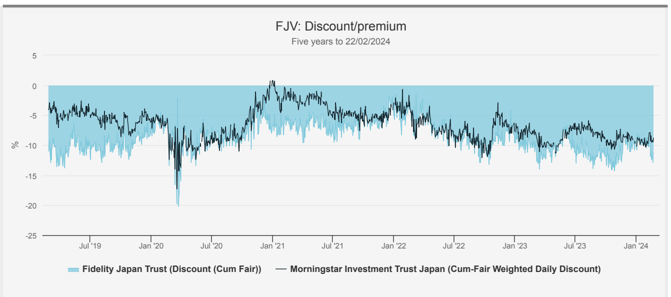
## Management

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 as a portfolio manager from 1999. He was appointed manager of Fidelity Japan Trust (or Fidelity Japanese Values as it was then) in September 2015. In total, Fidelity has 12 company analysts and three sustainable investment specialists based in Japan, meaning they have extensive on-the-ground research capabilities. Having a local presence brings regular access to company management, as well as a close connection with the domestic Japanese market. Nicholas is a fluent Japanese speaker and spends much of his time meeting companies himself, which has helped him build up contacts and a good reputation in Japan. His longstanding relationships in Japan have also helped better his access and understanding in the unlisted space which over the years has led to Fidelity investing in early-stage, pre-IPO companies. Nicholas can find himself being recommended by founders and CEOs of those unlisted companies to others who are looking to raise capital, reaffirming his expertise in the region.

## Discount

The chart below shows the movements in FJV's discount over the last five years, versus the sector. If we put the abnormally wide discount in March 2020 to one side for a moment, given it was the case for most trusts in the Japan and Japan smaller companies' sector, FJVs discount hasn't tended to widen out past 10% that often. A reason for this is the board's active discount management policy. It uses buybacks to reduce discount volatility, aiming to ensure it remains in high single digits at the most in normal market conditions. The board bought back 587,834 shares over the first half of 2023, to the end of July, and bought back a further 4,764,212 or 3.8% shares since then, to 22/02/2024. This helped bring the discount back in, which at the time of writing, now trades at 11.3%.

### Fig.6: Discount




Source: Morningstar

There have been a few periods where FJVs discount has widened out past 10%, most notably over parts of 2022 and 2023. The former was an incredibly difficult year for FJV in performance terms as a sell-off in global equities led to growth stocks, the preferred investments for Nicholas' strategy (see **Portfolio**), derate significantly which contributed to the discount widening. As we moved into the first half of 2023, Nicholas' preference for investing in small- and mid-cap companies posed as a headwind too. While the macroeconomic outlook for Japan was improving, most foreign investors' attentions were steered towards the more liquid and easily traded large companies. The strong gains in large-cap stocks, value stocks in particular, led to a more muted performance of mid- and small-cap growth names and aided the widening discount. However, since the end of October, a bounce back in growth stocks and a pickup of performance from Japanese mid-caps indices, such as the TOPIX Mid 400, saw the discount come in. Having greater exposure versus most peers in the small- and mid-cap space can at times present headwinds, but the manager believes that the greater return potential of these companies will shine through over time (see **Performance**).

If interest from foreign investors continues to increase, buoyed by long-term structural changes such as the improvements to corporate governance and the welcome return of modest inflation, then we think the discount could continue to narrow. Furthermore, FJVs current discount is wider than the AIC Japan peer group's weighted average of 9.1%, according to JPMorgan Cazenove. In our view, this could indicate a potentially attractive entry point for investors looking for differentiated exposure to Japan.

FJV has a three-yearly continuation vote which will be put to investors in the 2025 annual general meeting.

## Charges

FJV's latest ongoing charges figure (OCF), including its variable element, is 0.96%, compared to the average OCF of 0.80% for the AIC Japan sector, according to JPMorgan Cazenove. 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 will vary up to 0.2% in either direction depending on whether the trust's NAV outperforms or underperforms the TOPIX, over a three-year rolling period. 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. As such the maximum management fee charged could be 0.9% and the minimum 0.5%. The management fee is also chargeable at 80% to capital. The performance-related element incentivises the manager to continue to outperform as the fund grows, in our view.

The most recent KID RIY figure is 1.58% which is higher than the weighted average of the sector of 1.25%, although we would caution that calculation methodologies can vary.

## ESG

Nicholas Price argues that while Japanese companies generally have lower sustainability scores than their European counterparts, it's not because of any significant fundamental differences in strategy, but more to do with cultural reasons around disclosure practices and language. By utilising on-the-ground resources in Japan, alongside Fidelity's sustainable investing team, Nicholas believes the team are well equipped to identify companies implementing real change and moving up the governance scale. Over time, as these companies improve disclosure, their ESG ratings should catch up and the market should adjust valuations accordingly, which, in the manager's eyes, creates an opportunity for investors to benefit from the adjustment.

A recent example of this is SWCC, a wire and cable producer. The team engaged with management regarding its efforts to increase shareholder value and improve capital efficiency. SWCC's management were receptive to feedback and suggestions and have already presented specific measures to improve its price-to-book ratio. It has also announced a share buyback as proof of their confidence in their ability to improve profitability, which led to a significant rise in the company's share price.

Currently, Morningstar marks FJV one out of five globes on its sustainability scoring system, which is scored across open- and closed-ended funds in the Japan sector. However, only 87% of the portfolio is covered by Morningstar analysts, so we would not place too much emphasis on this. We think ESG is well integrated into the investment process and, given that Japanese companies generally have lower sustainability scores than some Western peers, there is plenty of opportunity for Nicholas and his team to engage with companies on the ground.

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