Fidelity Japan

FJV's wider-than-average discount could present an attractive entry point as economic pressures ease...

Update
09 December 2024

Overview

Nicholas Price has been at the helm of the Fidelity Japan Trust (FJV) since September 2015, consistently applying a growth-at-a-reasonable-price (GARP) investment philosophy. His strategy focusses on identifying companies with solid growth potential that are undervalued relative to their projected earnings and capitalising on market inefficiencies in pricing future growth.

It's been a busy 12 months, with market turbulence prompting Nicholas to make some adjustments to FJV's portfolio. Several companies, despite maintaining strong fundamentals, have seen their valuations fall to more attractive levels – an opportunity Nicholas has seized. This is exemplified by his decision to increase the trust's stake in Miura. More broadly, he has added opportunities in typical large-cap sectors, where companies are moving from value to growth. Nicholas has also taken profits from several of FJV's strongest performers, including semiconductor equipment maker Tokyo Electron, reallocating the proceeds to more attractive opportunities elsewhere in the market.

Whilst Nicholas remains underweight in financials overall, he has selectively added to individual names in the sector over the last 12 months (see **Portfolio**), including increased allocations to mega bank Mizuho Financial Group and consumer finance company Credit Saison, and a new position in insurer Sompo Holdings. These moves are designed to capture the upside potential offered by a supportive backdrop for the sector and company-specific drivers, whilst also helping to mitigate some of the impact from value style headwinds.

Despite strong results from several stocks over the past 12 months, a combination of stock-specific detractors and a challenging market environment resulted in weaker relative **Performance**. One area under pressure has been FJV's allocation to small- and mid-cap growth stocks, which have underperformed their value-oriented counterparts further up the market-cap scale. However, Nicholas maintains that they offer greater alpha potential, especially compared to larger firms, and could rebound quickly given the right catalysts.

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Analyst's View

Japanese equities had a strong start to the year, driven primarily by central bank policy expectations surrounding both the Bank of Japan (BoJ) and the Federal Reserve, along with strong gains in semiconductor-related stocks. However, as expectations of Fed rate cuts waned and geopolitical risks heightened, the upward momentum was capped, with key indices peaking in late March in sterling terms. Since then, markets have struggled to replicate the impressive returns seen earlier in 2024. Despite this, we continue to argue that a combination of low valuations, long-term structural changes – such as corporate governance reforms and the return of modest inflation – paints an encouraging outlook and a potentially exciting environment to invest in.

FJV has had a tough run over the past three years, which we attribute primarily to its positioning, stylistically speaking. Unlike other markets globally, Japan continues to see value-oriented businesses outperform their growth counterparts, a trend that has persisted for much of the last three years. Consequently, growth-focussed investment trusts in the sector have been hit hard. FJV, with its tilt toward small- and mid-cap growth opportunities, has been one of the most impacted. However, these types of companies have a proven track record of rebounding swiftly in favourable conditions, meaning FJV's wider-than-average **Discount** could present a compelling entry point for investors seeking exposure to this part of the market.

Additionally, FJV's small allocation to unlisted companies offers investors access to sources of differentiated returns compared to other trusts in the Japan sector. Overall, we believe FJV serves a specific role within a portfolio: it's a higher-risk, higher-reward strategy providing balance to global portfolios more heavily weighted toward value-oriented strategies or those lacking exposure to high-growth Japanese businesses.

BULL
All-cap exposure, with expertise in the under-researched Japanese small- and mid-cap space, offers greater upside potential
Current discount may present an attractive long-term entry point for investors
Exposure to unlisted companies offers a differentiated source of returns

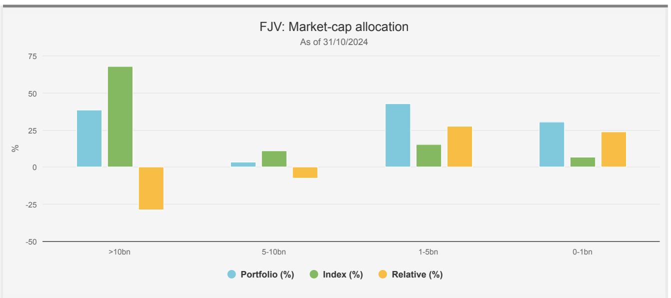
BEAR
Whilst offering a greater return potential, having a greater exposure towards small- and mid-caps can increase risk
Given its 'growth-tilted' nature, the trust may underperform during value-driven markets
Gearing can magnify the losses in a market downturn

Portfolio

Fidelity Japan Trust's (FJV) lead manager, Nicholas Price, employs a growth-at-a-reasonable-price (GARP) approach to investing. He seeks companies with the potential for steady earnings growth, but whose shares are undervalued relative to that earnings potential. Ultimately, the strategy is about taking advantage of opportunities where the market is underpricing future growth. The portfolio consists of high-quality, high-growth Japanese businesses situated across the market cap, though Nicholas has a particular affinity for under-researched small- and mid-cap stocks (see **previous note**).

These small- and mid-cap businesses are trading at steep price-to-book discounts compared to large-caps, and Nicholas believes that as the US Federal Reserve cuts interest rates and they catch up in terms of governance reforms, the outlook for this segment should start to improve. Moreover, the Bank of Japan's (BoJ) stance on rate hikes is expected to gradually drive a trend towards yen strength. This currency shift could benefit more domestically oriented companies, many of which are mid-caps, where the portfolio is overweight relative to the index, shown below.

Fig.1: Market Cap Allocation



Source: Fidelity

At the same time, Nicholas has been capturing opportunities towards the upper end of the market-cap scale, with HR technology company Recruit, mega bank Mizuho Financial and sensor maker Keyence among the portfolio's key active positions. Overall, the absolute exposure to >10bn market-cap companies has increased by c. 12% YTD.

Given the strategy, many of the underlying holdings are growth-oriented businesses, resulting in a portfolio typically exhibiting higher growth rates and return on equity relative to the index. Despite this, the price-to-earnings ratio of FJV's portfolio is at a more comparable level to the index than in previous years, which Nicholas finds unusual, considering the higher growth potential on offer. He believes that this could signal potential upside and has, over the past 12 months, taken advantage of market volatility by adding high-quality businesses to the portfolio amid periods of share price weakness.

Portfolio Characteristics

	CY2025 FJV	CY2025 TOPIX	CY2026 FJV	CY2026 TOPIX
Operating profit growth (%)	17.4	10.5	14.3	8.9
P/E (x)	16.6	14.1	14.7	13.3
P/B (x)	1.9	1.5	1.8	1.5
RoE (%)	11.9	10.8	12.4	11
ROIC (%)	16.1	10.3	17.6	10.9

Source: Fidelity, as of 31/10/2024

Portfolio turnover usually ranges from 70 to 100%, reflecting Nicholas's active portfolio management style. However, over the last 12 months, market turbulence has pushed turnover slightly above this range to around 103%. Nicholas attributes this to the number of opportunities arising in the market, driven by excessive recession fears in the US and at times severe short-term market adjustments, which led to a rapid (albeit temporary) appreciation of the yen and a sharp decline in stock prices. He maintains that corporate fundamentals remain relatively unchanged and views these movements as a temporary unwinding of positions.

Nicholas has capitalised on these opportunities by increasing exposure to businesses he believes remain fundamentally strong but have experienced share price weakness. For example, he raised his stake in Miura, a global leader in once-through boilers, which offer superior energy efficiency. He argues that the company has an excellent business model based on the provision of contract-based maintenance services, which are conducive to recurring and stable profits. He has also been impressed with the strategic changes that the company has implemented, particularly its efforts to reduce its dependence on the Chinese market and to broaden its product lineup, evidenced by its recent acquisition of US-based Cleaver-Brooks, which will provide a new growth driver for the business. Whilst the outcome of the US election has somewhat reduced the level of uncertainty, the issue of tariffs is likely to dominate headlines for months to come and Nicholas argues that it's therefore appropriate to hold reshoring beneficiaries such as Miura that can deliver stable earnings.

Alongside attractively valued opportunities, several portfolio holdings approached their price targets over the period, allowing Nicholas to take some profits from stronger performers like Tokyo Electron, a leading global supplier of semiconductor production equipment. He also exited positions in theme park operator Oriental Land and chemicals company Kansai Paint, reallocating the proceeds into more attractive investments elsewhere.

Portfolio adjustments are driven by bottom-up research, meaning sector weightings are a by-product of the investment process. However, given the current market backdrop, Nicholas has focussed on reducing the impact from ongoing style headwinds by increasing the portfolio's exposure in certain parts of the financial sector. Whilst FJV remains underweight in financials overall, Nicholas has selectively added to banks, insurance and consumer finance. Additionally, he believes the sector is likely to benefit from favourable fundamentals, supportive policy developments, and stronger commitments to capital efficiency and shareholder returns, prompting him to focus on companies such as Mizuho Financial Group, consumer finance company Credit Saison, and insurer Sompo Holdings. More broadly, he has added positions in large-to-mega-caps in growth areas such as services and electric appliances.

Sector Allocations

	PORTFOLIO (%)	INDEX (%)	RELATIVE (%)
Electric appliances	19.9	17.6	2.3
Chemicals	13.5	5.6	7.9
Services	9.7	5.0	4.6
Information & Communication	8.8	7.5	1.2
Wholesale trade	8.6	7.0	1.6
Precision instruments	8.5	2.5	6.0
Transportation equipment	6.5	7.4	-0.9
Retail trade	6.3	4.4	1.9
Machinery	6.0	5.6	0.4
Other products	5.0	2.5	2.5
Other sectors	21.7	34.7	-13.1

Source: Fidelity, as of 31/10/2024

Whilst there have been no changes to this part of the portfolio YTD, we think it's important to highlight one of FJV's key differentiators compared to its peers in the sector. Nicholas has the flexibility to allocate up to 20% of the portfolio in unlisted (private) companies. He notes an increase in entrepreneurial activity in Japan compared to five to ten years ago, with many new growth companies emerging and creating opportunities in the pre-IPO market.

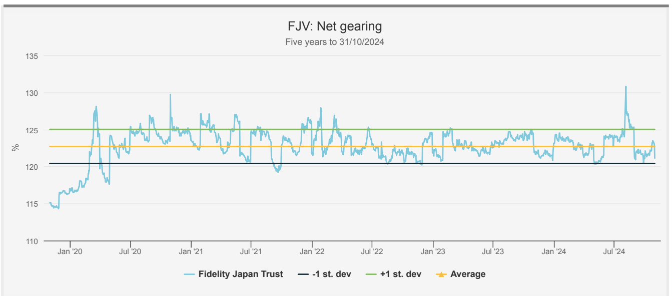
We believe that investing in unlisted companies brings high return potential and provides valuable insights into emerging trends and competitors. However, it also carries certain risks: early-stage companies are sensitive to funding costs, have higher failure rates, and typically have shorter track records – often three to five years compared to the decade or more seen with many listed companies. The process is very selective, typically focussed on late-stage companies, and the team apply a disciplined approach to these opportunities, scrutinising financials and valuations whilst also conducting multiple meetings with management to ensure thorough due diligence. At the time of writing, FJV has approximately 6% of its portfolio invested in unlisted companies, offering investors a differentiated source of returns.

Moving forward, Nicholas views Japan as being at a pivotal moment, with monetary policy normalising and structural shifts driving long-term opportunities. Wage increases and domestic reflation are supporting consumption, whilst corporate governance reforms and pressure from the Tokyo Stock Exchange are improving capital efficiency and sparking activity like share buybacks and M&A. Mid-cap companies, particularly those focussed on sustainable growth and less reliant on external factors, offer significant potential as valuations remain low. Meanwhile, speciality retailers and industrials are benefitting from rising consumption and reshoring trends. Despite risks from geopolitical fragmentation, the outlook for corporate earnings is improving, and sectors like factory automation, which have lagged their semiconductor-related peers, and mega banks stand out as attractive opportunities.

Gearing

The board has granted Nicholas the discretion to be up to 25% geared should he choose, with any increase beyond that requiring prior approval. In early 2020, Nicholas sought and received approval to raise gearing above 25% due to the COVID-19-induced market corrections, which presented significant opportunities. This allowed him to increase positions in some of his highest conviction holdings.

Fig.2: Gearing



Source: Morningstar

The board views gearing as a distinct advantage of the investment trust structure and believes it will enhance the trust's performance as markets recover. It remains comfortable with the current limits in place and the decision to employ gearing primarily through derivative contracts for difference (CFDs), given their greater flexibility and lower costs compared to traditional bank debt. According to FJV's latest factsheet, net gearing is 21.1%, having decreased slightly since the half-year results, largely due to Nicholas sticking to his process of selling stocks approaching their target prices. Moreover, Nicholas cites that when you exclude his allocation to unlisted companies, which stands around 6% at the time of writing, net gearing falls to roughly 15%.

Performance

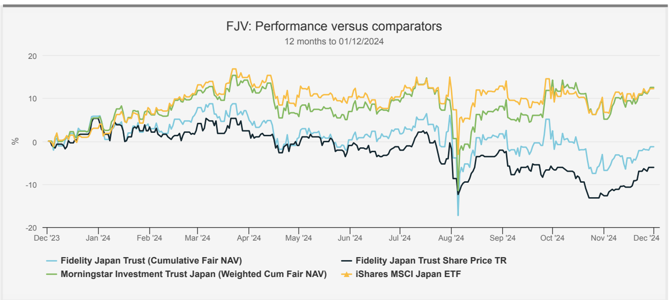
Japanese equities had a strong start to the year, driven primarily by central bank policy expectations surrounding both the BoJ and the US Federal Reserve, as well as strong gains in semiconductor-related stocks. As a result, FJV performed well in the early months, buoyed in particular by its exposure to high-quality growth businesses such as Tokyo Electron, a leading semiconductor manufacturer. However, a delayed recovery in the factory automation space, waning expectations of US Fed rate cuts, combined with heightened geopolitical risks, capped this upward momentum with key indices peaking in late March in sterling terms.

These challenges have also been amplified by the style divergence within the Japanese equity market. Value stocks have continued to outperform growth, a trend that's been ongoing for the past three years, creating particularly fierce headwinds for trusts like FJV, which focus on growth stocks. Japan's corporate governance reforms aimed to raise the standards of listed Japanese companies, meaning those considered 'value' are forced to improve their profitability and growth prospects. These headwinds have contributed heavily to FJV's underperformance over the past 12 months. It delivered NAV total returns of -1.3%, underperforming both its benchmark and the Morningstar Investment Trust Japan sector's total return of 12.5% and 12.5%, respectively.

During this period, performance has been shaped by a mix of key detractors and contributors. Mitsui High-tec, a leading producer of xEV motor cores, was the largest detractor, having lost ground after its fiscal 2024 earnings guidance fell below market expectations due to higher capital expenditure and depreciation costs. Harmonic Drive Systems, a leading manufacturer of mechatronic drive systems and precision gears, was another notable decliner primarily due to a delayed recovery in the factory automation sector amid inventory overhang.

On the positive side, semiconductor-related holdings such as Tokyo Electron and Rorze were among the trust's best performers over the past 12 months. Both businesses have benefitted from the growing demand for generative artificial intelligence, which has led to a boost in their respective share prices. Additionally, Tokyo Electron has climbed further due to its growing support from the government amid rising geopolitical tensions, whilst Rorze announced stronger-than-expected earnings guidance for the fiscal year to February 2025.

Fig.3: One-Year Total Performance

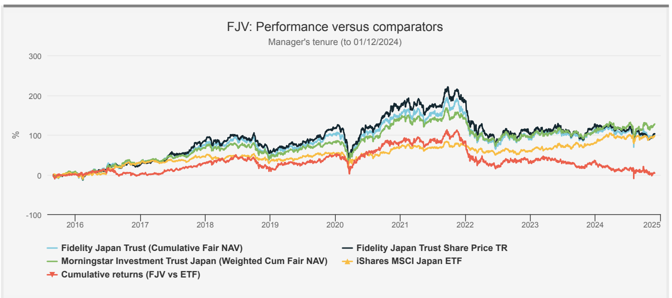


Source: Morningstar

Past performance is not a reliable indicator of future results.

Recent performance has been particularly challenging; however, Nicholas's investment process (see **Portfolio**) has proven it can outperform in certain market environments. In the chart below, we've included a red line that shows the cumulative returns of FJV versus an ETF tracking the MSCI Japan Index. It highlights periods of underperformance, denoted by a downwards sloping, and periods of outperformance, highlighted by an upwards line. Whilst the portfolio is index agnostic, it leans towards small- and mid-cap growth stocks, which led to strong returns in 2017, 2019, and 2020, when growth investing was in vogue. These were years FJV outperformed the index and sector comfortably. One area under pressure has been FJV's allocation to small- and mid-cap growth stocks, which have underperformed their value-oriented counterparts further up the market-cap scale.

Fig.4: Performance Under Manager's Tenure



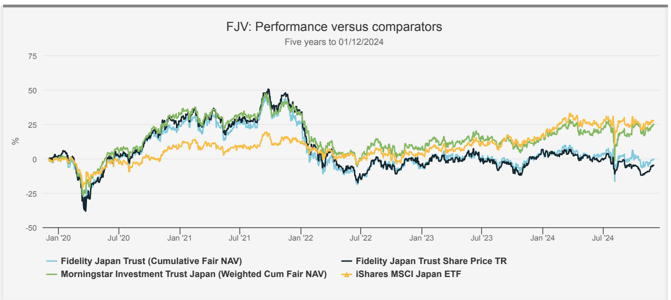
Source: Morningstar

Past performance is not a reliable indicator of future results.

A risk worth bearing in mind, though, is that the trust will not outperform in every scenario. In particular, periods of extreme value dominance, such as we've seen since the beginning of 2022, will likely lead to the trust underperforming. We think this reinforces the idea that FJV serves a specific role in a portfolio: it's a higher-risk, higher-reward strategy that can offer balance to a global portfolio weighted more heavily towards value-oriented strategies or portfolio's lacking exposure to high-growth Japanese businesses.

For the sake of completeness, we've highlighted FJV's performance over the last five years, in which it delivered NAV total returns of -0.5% compared to its benchmark and the Morningstar Japan sector total returns of 30.3% and 24.9%, respectively. Since early 2022, Nicholas's strategy has faced headwinds as growth stocks, especially in the small- and mid-cap space, have been out of favour and detracted from performance. Consequently, FJV has underperformed both its benchmark and sector returns over this period. For comparison, an ETF tracking the MSCI Japan Index is also shown below.

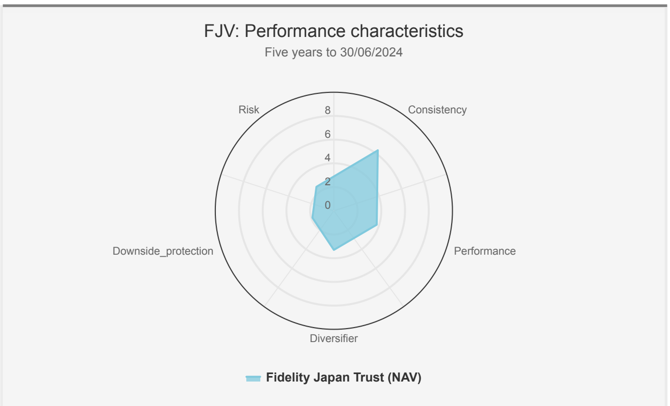
Fig.5: Five-Year Performance



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

Our proprietary KTI Spider Chart shows how FJV has performed versus a peer group of all Japanese and Japanese small-cap trusts over the past five years, in some key categories. A selection of key characteristics is considered, with ten being the maximum score, and a higher score indicating superior performance in that characteristic.

Fig.6: KTI Spider Chart



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

FJV has generated average alpha over the past five years, including the number of months it has outperformed its benchmark, reflected in its average score for both performance and consistency. However, it had a difficult 2022. A sell-off in growth stocks globally, an area of the market that the trust is well represented in, has brought its performance score down compared to previous years and had a negative impact on the risk and downside protection scores.

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. As the revenue reserve is in deficit, the board does not recommend the payment of a dividend.

Management

FJV is managed by Nicholas Price, having worked for the company in Tokyo since 1993, first as a stock analyst and later as a portfolio manager, from 1999. He was appointed manager of Fidelity Japan Trust (formally Fidelity Japanese Values) in September 2015. Nicholas, a fluent Japanese speaker, spends much of his time meeting companies himself, which has helped him build a broad network and a good reputation in Japan. His long-standing relationships in Japan have also enhanced his access to 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 these companies to others seeking to raise capital, reaffirming his expertise in the region.

Nicholas also benefits from the large, well-resourced team at Fidelity. In total, Fidelity has 12 company analysts and three sustainable investment specialists based in Japan, meaning they have extensive on-the-ground research capabilities. We believe that having a local presence brings regular access to company management, as well as a close connection with the domestic Japanese market.

Discount

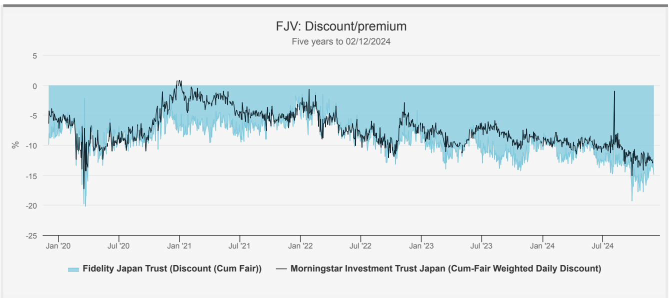
Towards the end of 2021, FJV's discount began to widen steadily, reflecting an unfavourable market backdrop for Nicholas's preferred investment style. The market rally at the time favoured more cyclical, lower-quality stocks, which gained traction and outperformed their growth-oriented counterparts amid the reflationary rally. The trend persisted into 2022 and 2023 as rapidly rising interest rates boosted value-oriented sectors like financials, where FJV has less exposure. Additionally, the global equity sell-off led to a significant derating of growth stocks, the preferred investments for Nicholas's strategy (see **Portfolio**), which contributed materially to the trust's underperformance relative to its benchmark.

Beyond performance issues, broader market factors have further pressured FJV's discount, in our opinion. Investor concerns about Japan's economic direction, the yen's weakness, future actions of the BoJ and the potential impact of a US recession have all weighed heavily on both investor sentiment and FJV's discount. At the time of writing, the trust trades at a discount of 14.9%, wider than both its five-year average of 9.0% and the AIC Japan sector's weighted average of 7.4%, according to Morningstar.

The board has remained active in trying to manage the discount through share buy backs, aiming to reduce overall volatility. In its latest half-year report, the board noted it bought back 3,615,644 shares, representing 2.7% of the issued share capital. Since then, to 02/12/2024, an additional 3,277,967 shares (2.8% of the shares in issue) have been bought back to help manage the discount. Despite these efforts, the board acknowledges that a sustained reduction in the discount will require renewed investor interest in Japan and a material pick up in performance, a sentiment we share.

Whilst Japan's stock market performed well in the first few months of this year, Nicholas's investment approach has been out of favour, hindering performance and contributing to the discount widening. Additionally, investor concerns, amplified by Japan's history of 'false starts', continues to weigh on sentiment. For the situation to improve, we need to see an easing of these concerns, which may see Nicholas's investment style return to favour and a subsequent pickup in performance, alongside continued progress in Japan's corporate governance reforms, which could reassure investors that this time is different. Should these changes materialise, FJV's diversified portfolio of high-quality, growth-oriented Japanese companies could become more appealing and, with its current discount, present a potential buying opportunity for investors seeking exposure to Japan.

Fig.7: Discount



Source: Morningstar

Charges

At the end of FJV's 2023 financial year its ongoing charges figure (OCF), including its variable element, was 0.84%, compared to the AIC Japan sector average of 0.81%. FJV's fees have an unusual structure, incorporating a performance-related component into the management fee. The standard management fee is 0.7% but it can 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. Specifically, the variable element of the fee increases or decreases by 0.033% for each percentage point of outperformance or underperformance against the TOPIX during this rolling three-year period and is calculated daily. This means the maximum management fee could be 0.9%, whilst the minimum could be as low as 0.5%.

Whilst performance fees are not uncommon, this structure is, as Fidelity are willing to give up some of the fee if the trust underperforms. The structure allows for a partial refund of charges in the event of underperformance on a rolling three-year basis, and in FJV's latest results it highlighted there was a credit of £244,000 in the variable element of the management fee for the six months to 30/06/2024. The management fee is also chargeable at 80% to capital. In our view, the performance-related element incentivises the manager to deliver outperformance as the fund grows.

The board has revised its KID in light of the FCA's statement on forbearance in relation to investment company disclosure requirements. The KID now states an ongoing charges figure of 0.99% (0.84% including the variable element of the management fee), which represents the total of investment management fees and other expenses of the trust (excluding transaction costs, interest payments, tax and non-recurring expenses) expressed as a percentage of the average net asset value throughout the financial year.

ESG

Nicholas Price argues that whilst Japanese companies generally have lower sustainability scores than their European counterparts, this stems more from cultural factors related to disclosure practices and language differences rather than any significant divergence in strategy. By leveraging Fidelity's sustainable investing team alongside on-the-ground resources in Japan, Nicholas believes the team are well equipped to identify companies implementing real change and moving up the governance scale.

As these companies improve their disclosures over time, their ESG ratings are likely to improve, which could lead to valuation adjustments by the market. In the manager's view, this creates an opportunity for investors to benefit from these adjustments. Nicholas also emphasises the importance of active engagement with company management, helping elevate corporate standards and strengthening relationships between companies and shareholders. In the first half of 2024 the engagement team based in Tokyo conducted 59 meetings, in addition to the research meetings, covering each part of ESG in detail.

Morningstar awards FJV one out of five globes for sustainability when looking across open- and closed-ended funds in the Japan equity sector. However, we wouldn't place too much emphasis on this score, as only 85% of the portfolio is covered by Morningstar analysts, some of which will be FJV's unlisted businesses.

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