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JAPAN: AN UNDERVALUED OPPORTUNITY?

With the Rugby World Cup starting next week and the 2020 Olympic Games on the horizon, Japan is set to be the focus for many around the world in the coming months.

For investors, long-term performance from investment companies focused on the region has been rewarding, with companies from the **Japan** and **Japanese Smaller Companies** sectors returning an average of **251%** and **195%** respectively over the past ten years*.

But the past 12 months have seen returns turn negative, and many investors believe Japanese shares continue to be undervalued. Could now be an attractive entry point? The **Association of Investment Companies (AIC)** has spoken to the managers of Japan-focused investment companies about their investment approach, where they are finding opportunities, the impact of the Rugby World Cup and Olympics, and their outlook for Japan.

Investment approach

Joe Bauernfreund, Manager of AVI Japan Opportunity Trust, said: “At AVI we look to invest in under-researched and misunderstood companies. This approach leads us in turn to small-cap Japanese companies, a segment of the market which is poorly covered. Of the 28 companies in our portfolio, only four are covered by more than one analyst and, as a result of investors’ general aversion to Japan, all are unloved. These factors have led to us finding abnormally low valuations in good-quality, highly cash-generative companies.”

Matthew Brett, Manager of Baillie Gifford Japan Trust, said: “We are bottom-up, growth-orientated investors with low turnover. Our aim is to identify businesses with attractive industry backgrounds, strong competitive positions, attractive financials and favourable attitudes towards shareholders. Once we develop conviction that we have a strongly different view about a company’s long-term prospects, we buy the shares and then hold them to benefit from the growth in the underlying business.”

Taeko Setaishi, Lead Adviser of Atlantis Japan Growth Fund, said: “The investment approach at Atlantis Japan Growth is based on the assumption that long-term earnings growth drives equity prices. The investment adviser, Atlantis Investment Research Corporation (AIRC), employs a growth-oriented, bottom-up stock picking investment style with decisions based on proprietary fundamental research. This style can, but does not necessarily, result in a portfolio bias toward small and medium capitalised companies."

Opportunities

Taeko Setaishi, Lead Adviser of Atlantis Japan Growth Fund, said: "Japan's economy is undergoing significant structural change, which in turn is creating numerous attractive investment opportunities in the healthcare, technology and the services sectors. In services, we believe one is spoiled for choice. Examples include Recruit Holdings, a global leader in recruitment and other HR functions, and Bengo4.com, a lawyer and accountant referral website. In the healthcare sector, our investments include elderly care provider Solasto and drug discovery enabler PeptiDream. In technology, we expect sustained earnings growth from the semiconductor production equipment assemblers Lasertec and Tokyo Electron."

Matthew Brett, Manager of Baillie Gifford Japan Trust, said: "The two major current areas of investment for the Baillie Gifford Japan Trust are internet and factory automation companies. In total, these comprise approximately 40% of the portfolio. For example, we are very enthusiastic about Softbank which we believe has world-class assets, including a large investment in Alibaba, ARM and many exciting venture companies, trades at nearly a 50% discount to the sum of these investments, and is managed by the extremely value-added Mr Son. Also, we like FANUC, which is a leading global robotics company that has the potential to see accelerating growth as robotics expands to new industries and applications and where management have begun to return much more cash to shareholders."

Nicholas Price, Manager of Fidelity Japan Trust, said: "While there have been no significant changes to the overall composition of the company's holdings, I have selectively increased positions in oversold semiconductor related companies and component makers. New investment ideas, for example in companies that are likely to be rerated as internal change leads to a period of renewed growth, have also been added. A prime example is endoscope maker Olympus, which has implemented a long-term restructuring plan 'Transform Olympus' to enhance profitability and improve capital efficiency. I also continue to search for opportunities to invest in innovative companies at the pre-IPO stage. Conversely, I have reduced exposure to machinery and chemicals stocks where the risk/reward balance had deteriorated, and near-term upside appeared limited. I have also actively taken profits in strong performers, in the retail and medtech sectors."

Nicholas Weindling, Manager of JPMorgan Japanese Investment Trust, said: "We currently find compelling investment opportunities in structural growth areas like e-commerce, automation and opportunities created by an aging population, as well as companies prioritising improving shareholder returns."

Joe Bauernfreund, Manager of AVI Japan Opportunity Trust, said: "Fujitec is a global lift manufacturer with sales in Japan, China, Southeast Asia, North America and Europe. The most appealing aspect of the business is the maintenance revenue that Fujitec receives after installation. These maintenance contracts can last for decades, producing steady, recurring profit, which explains why Fujitec's global peers trade on enterprise value to earnings before interest and tax multiples (EV/EBIT) approaching 20x. However, Fujitec, which operates the same business model, is on a multiple of just 5x. Fujitec's balance sheet is hugely overcapitalised, which means we are, in effect, investing 56% of our capital in cash and listed securities while gaining exposure to a high-quality, profitable operating business at a low valuation – all the while receiving a 4% dividend yield."

Impact of the Rugby World Cup and 2020 Olympics

Taeko Setaishi, Lead Adviser of Atlantis Japan Growth Fund, said: "The impact of the World Cup and Olympics will be at least twofold. Firstly, close to two trillion yen has been spent on associated infrastructure, such as stadiums and facilities. Estimates suggest this expenditure peaked in 2017-2019 and the impact has largely been delivered. Secondly, In-bound tourist flows have been on an uptrend for the past three to four years due to eased visa restrictions, low cost carriers and government promotion. However, Olympic arrivals will likely push visitor numbers well over the 40 million target set by the government. More importantly, this flow should maintain Japan's position as an attractive tourist destination for years to come."

Nicholas Price, Manager of Fidelity Japan Trust, said: "It's great to see big global sporting events here in Japan and I will be watching with interest. While the run-up and legacy effects of the two events are difficult to quantify, there should be economic benefits through inbound tourism and construction investment. However, it's not a material investment in the portfolio."

Nicholas Weindling, Manager of JPMorgan Japanese Investment Trust, said: "We see little long-term impact from the rugby and the Olympics. We're looking for investments with good duration. That said, stocks relating to tourism and Japanese brands, such as Shiseido and Fast Retailing, should be beneficiaries and offer long-term duration."

Outlook

Taeko Setaishi, Lead Adviser of Atlantis Japan Growth Fund, said: "Perhaps the major challenge Japan will encounter in the medium-term is an aging population slipping into depopulation. Rising productivity and greater workforce participation have offset, to a degree, the negative effects of depopulation. This development is already producing significant social change, particularly around public finances and welfare expenditure priorities.

“On the positive side of the ledger, Japan continues to run a significant current account surplus, is politically stable, and possesses a deep repository of patents available for monetisation. The stock market, on a 12x forward price-to-earnings ratio, appears undervalued, particularly in light of the improving corporate governance. However, Japan, unfortunately, is located in a politically unsettled corner of Northeast Asia which it shares with four nuclear powers, and relations are cool at best. Geopolitical risk is significant, and outside of Japan’s influence.”

Matthew Brett, Manager of Baillie Gifford Japan Trust, said: “We believe that the Japanese stock market contains a number of very attractive individual businesses and the prospects for the shares of those companies over the long-term are as good as quality businesses listed anywhere in the world.”

Nicholas Price, Manager of Fidelity Japan Trust, said: “Japanese stocks have lagged their global peers so far this year, as uncertainty over US-China trade frictions and the impact on the global economy have clouded the outlook for corporate earnings. While the analyst revision index has already reached its typical bottom and earnings trends should stabilise in the coming quarters, share prices are likely to remain volatile amid a steady stream of political news flow.

“While not immune to external headwinds, the Japanese economy remains stable. Confidence among Japanese manufacturers has clearly weakened, but sentiment in the non-manufacturing sector is holding up. Employment conditions remain tight, with the job-offers-to-applicants ratio at record levels. Capital expenditure plans are supported by non-cyclical factors such as investment in labour saving technology and research and development. The Bank of Japan remains highly accommodative and extensive counter measures will be deployed to mitigate the effects of the October 2019 consumption tax hike from 8% to 10%.

“From a valuation perspective, Japanese stocks priced in a significant level of risk in late 2018 and continue to look undervalued at around 12x forward earnings. With valuations testing historical lows in some parts of the market, there are opportunities to capitalise on disconnects between near-term sentiment and mid-term fundamentals.”

Nicholas Weindling, Manager of JPMorgan Japanese Investment Trust, said: “The outlook for Japan is increasingly mixed. Set against a backdrop of slowing global growth and sluggish earnings growth in Japan’s cyclical sectors, valuations of the TOPIX continue to be lower than its own history, as well as other major markets. On the policy front, Japan continues to make progress in tourism, free trade and corporate governance. The market is likely to reward companies with improving governance policies overall, including shareholder returns, internal controls and disclosure.”

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Notes to editors

1. * Performance is % share price total return to end August 2019. Source: AIC/Morningstar (ten years to end of August 2019).
2. The Association of Investment Companies (AIC) was founded in 1932 to represent the interests of the investment trust industry – the oldest form of collective investment. Today, the AIC represents a broad range of closed-ended investment companies, incorporating investment trusts and other closed-ended investment companies and VCTs. The AIC’s members believe that the industry is best served if it is united and speaks with one voice. The AIC’s mission statement is to help members add value for shareholders over the longer term. The AIC has 359 members and the industry has total assets of approximately £200.3 billion.
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