Aberdeen Japan

Update
12 February 2020

AJIT's dividend will be significantly higher going forward...

Summary

Aberdeen Japan Investment Trust (AJIT) aims to generate long-term capital growth through investment in a concentrated portfolio of Japanese equities.

Managed by the Aberdeen Standard Japan equities team, the investment process places a strong emphasis on seeking high-quality companies with strong management and good or improving corporate governance. The team also seek to hold positions in companies with strong balance sheets, and whose earnings are resilient to fluctuations in the global and domestic Japanese economies.

The trust continues to overweight sectors such as healthcare and technology, where the manager believes there are thematic structural underpinnings that can drive growth going forward.

In mid-2019 a new dividend policy was endorsed by shareholders, which will see AJIT offer a notably increased dividend in the future compared to what it has historically produced. On the current share price, the minimum expected total distribution of 15p per share would equate to a yield of c. 2.4% (as of 31/01/2020). **We have covered the new policy in more detail in the Dividend section.**

The managers of AJIT have largely maintained gearing levels at around 12% (as of 31/01/2020). We understand from the manager that gearing at around these levels is likely to remain a structural feature of the trust. Presently trading on a discount of c. 8.1% (as of 31/01/2020), the board has been active in buying back shares.

Performance was notably improved in 2019, after a period where the trust had struggled somewhat. Five-year returns had been negatively impacted by a previous decision to partially hedge exposure to the Japanese yen (although in totality throughout its longer-term existence the contribution of this hedge was reasonably flat). This policy was reversed in July 2018.

Analyst's View

We think AJIT's portfolio's tilt towards overseas revenues could prove supportive if the global economy sees improved growth, and if trade war fears continue to recede. In a less rosy environment, the financial strength of the underlying companies (through significant excess capital on balance sheets) should provide resilience. With the ongoing corporate governance reform tailwind, the trust could well see an increasing number of companies choose to return an increasing amount of capital to shareholders in the near future.

With AJIT now having explicitly outlined an enhanced dividend aimed at increasing investor's appetite for the shares, as well as the board remaining actively engaged in buying back shares to reduce discount volatility, we think the improved performance seen in 2019 could serve as a further prompt for investors to revisit AJIT.

Key Information:

As at	11/02/2020
Price (p)	615
Discount (%)	-8.6
OCF (%)	1.10
Turnover Ratio	30.8
Yield (%)	0.8
Gearing (%)	11
Ticker	AJIT
Shares (£)	13,998,470
Market cap (£)	89,940,170

Analysts:

William Heathcoat Amory
+44 (0)203 384 8795

Pascal Dowling
+44 (0)203 384 8869

Thomas McMahon, CFA
+44 (0)203 795 0070

William Sobczak
+44 (0)203 598 6449

Callum Stokeld
+ 44 (0) 203 795 9719

Analyst's View

BULL	BEAR
Exposure to cash-generative businesses offers potential for return of excess capital in a supportive environment	Japanese exporters likely to display above-average vulnerability to the global market cycle
Increased dividend could attract marginal buyers to AJIT	Small size of trust means OCF is higher than average for sector
Discount to NAV is seeing some support from share buybacks	Gearing can exacerbate the existing tendency to underperform in falling markets

Portfolio

Aberdeen Japan Investment Trust (AJIT) invests in a reasonably concentrated portfolio (presently containing 58 holdings), with the aim of generating long-term capital growth from Japanese equities. The named lead managers on the portfolio are Chern-Yeh Kwok and Hisashi Arakawa, but the investment process places emphasis on ensuring that management of the portfolio is undertaken on a team basis, looking to gain consensus amongst the team members on any portfolio activity.

The team's stock-selection process is very much driven by bottom-up stock analysis, where they seek to identify and buy high-quality businesses which have the ability to grow their earnings steadily and reliably through the economic cycle.

This emphasis on identifying high-quality companies tends to lend itself to a preference for companies operating in industries with high barriers to entry and/or strong brand loyalty. Typically, companies held within AJIT will exhibit strong balance sheets, whilst good-quality management who have demonstrated good capital discipline are considered important. This is a facet of a wider focus on high-quality corporate governance, with the alignment of management's and shareholders' interests considered key, along with ongoing governance policies. The investment process at Aberdeen Standard Investments is increasingly inclusive of ESG considerations, with the manager having started the process of using MSCI to further enhance ESG analysis and ESG credentials at the fund level.

Companies likely to interest the team for inclusion in AJIT will generally be operating with high levels of profit margins, be generating superior levels of dividend growth to the wider market, and demonstrate superior returns on equity (ROE) to the wider market. The trust's investment policy allows for an all-cap approach such that the manager is able to select from across the range of listed Japanese companies.

If a company meets the qualitative 'quality' criteria, a valuation assessment will be made, with a focus primarily on ensuring the team are not overpaying for a company. The team do not look for heavily discounted 'deep value' opportunities, where the reason for the valuation discount could be that the business or industry is undergoing cyclical or structural (possibly existential) pressures.

Valuation assessments are made relative to the company's own history, as well as on a relative basis to industry peers. This latter assessment is not to necessarily identify the lowest-valued company within an industry, but to aid the team in making a qualitative assessment of how the market is pricing the relative merits of a company compared to its peers.

The management team believe that companies with strong balance sheets and leading market shares are best able to drive their own growth and sustain dividend payments. These companies can also capitalise on historically low interest rates to push through growth-enhancing mergers and acquisitions.

For instance, non-life insurer Tokio Marine is in the process of buying a US-based insurer to tap into the market for wealthy clients; air-conditioning specialist Daikin has bought a European freezer manufacturer; and Nippon Paint Holdings has acquired the leading decorative paint business in Australia.

Historically, AJIT has mostly comprised larger companies, primarily because the emphasis the investment approach places upon strong corporate governance and businesses' structural competitive advantages tended to lead to greater idea generation in the large-cap space. However, Chern-Yeh notes that he and the team are increasingly finding greater opportunities in small- and mid-cap companies, against a backdrop of reforms to the Japanese corporate governance code. **We debated the opportunities presented by this change in a recent analyst head to head**.

Increasingly the team are noting that smaller companies are in a stronger position to enact reforms to their corporate governance structure, with a simpler and easier follow-through possible once reforms are agreed upon. Additionally, these companies are increasingly open to outside engagement with shareholders to identify attractive ways to generate shareholder value.

Increasing opportunities amongst smaller companies include the position the trust now holds in NEC Networks & System Integration Corp (NESIC). With a c. $1.9bn market cap, this is not a micro-cap stock, but nonetheless is notably smaller than many of the other constituents of AJIT's portfolio. With limited competition, and a very experienced management team, NESIC is able to generate good profit margins on its existing business, whilst Chern-Yeh and the team believe its sales growth enjoys strong structural tailwinds.

Although developments in the Japanese corporate landscape are resulting in the team seeing increased opportunities in the small- and mid-cap space, they are cognisant of liquidity constraints in particular, and will generally introduce these positions at a smaller size. However, the closed-ended structure of AJIT and the relatively small size of assets means it is able to access these smaller-cap opportunities when they present themselves.

Top Ten Holdings

HOLDING	%
Shin-Etsu Chemical	4.1
Tokio Marine	4.0
Chugai Pharmaceutical	3.6
KDDI	3.6
Amada	3.4
Toyota Motor	3.4
Daikin Industrial	3.4
Keyence	3.1
Asahi Intecc	3.0
Elecom	2.9
TOTAL	**34.5**

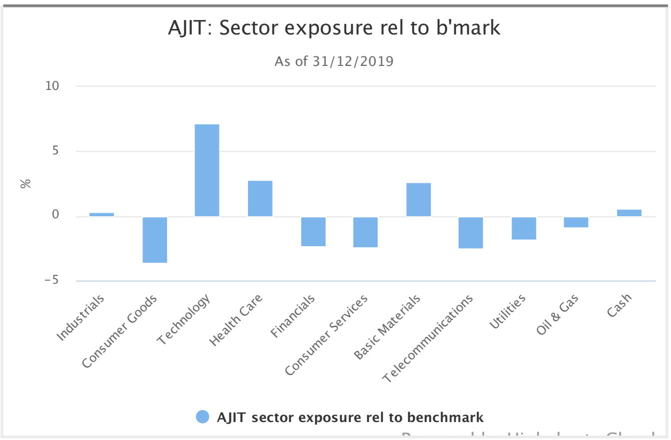
Source: Aberdeen Standard Investments, as at 31/12/2019

The managers believe that a buy-and-hold strategy offers the trust exposure to a compounding effect from consistently superior operational performance by the 'quality' companies they seek to identify and hold. They believe that, even if for periods in the interim markets are driven by other considerations, share prices will ultimately follow the company-specific fundamental performance. This can lead to long holding periods in companies where the team believe they have identified very strong fundamentals, such as the position in Asahi Intecc which the trust has had exposure to for over ten years.

Wholesale disinvestments are likely to be either a result of a fundamental reassessment of a business or because the team believes they have identified a superior opportunity elsewhere and do not wish to dilute other ideas by reducing their relative weightings to fund the new introduction.

AJIT is managed with a benchmark-agnostic approach, with all stocks selected because the managers think they are the best individual investments in the market, rather than to try and ensure that a particular sector or industry is represented. Accordingly, the team do not have to include any exposure to areas where they do not perceive there to be companies which meet their investment criteria, such as utilities or oil & gas.

Fig.1: Sector Allocation



Source: Aberdeen Standard Investments

Thematically, the managers continue to identify several industries which enjoy structural tailwinds, such as technology and healthcare, which helps them to build positivity on the underlying stock positions in these areas. Ageing demographics and increasing tightness in labour markets are also significant thematic considerations, and the necessity for increased automation and healthcare requirements in the future help underpin the growth trajectories for many companies.

Similarly, the team remain bullish that the ongoing reforms to corporate governance can continue to boost shareholder returns, noting that the pace of change is accelerating and that this is reflected in increasing buybacks and dividend growth across the market. The team note that shareholders are becoming more engaged with management as a result of the change in the Stewardship Code, and the team are even observing some hostile takeover bids (previously anathema within the Japanese market).

The portfolio tilts slightly in favour of overseas earnings growth ahead of domestic earnings growth; however, this is an output of the team's observations that overseas earnings growth tends to be of superior quality, as opposed to a targeted outcome.

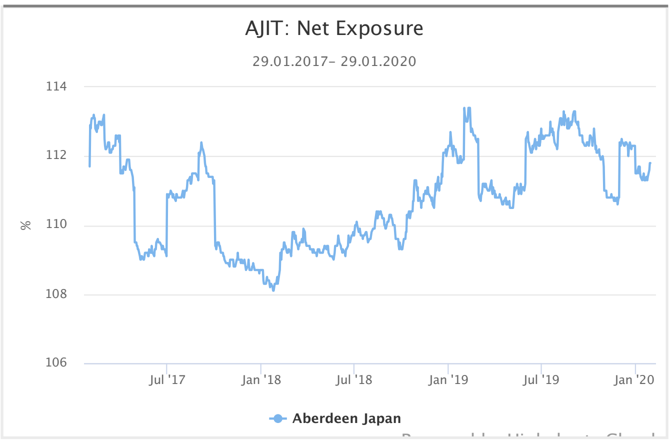
In terms of currency exposure, previously c. 50% of AJIT's NAV was hedged back to sterling; this ceased on 11 July 2018, and will save shareholders considerable hedging costs going forward.

Gearing

AJIT is presently c. 12% net geared as of 30/01/2020. The board monitors the level of gearing, with the expectation that a level of around 10% will ordinarily be appropriate to enhance shareholder returns, though levels are expected to range between 5% and 15%, depending on stock-market conditions. Ultimately, decisions on the application of gearing sit with the management team; they have tended to view the current level of gearing as broadly appropriate, having slightly increased it in Q4 2018 as valuations became more attractive.

As with the buying opportunity in late 2018, minor variations in the gearing level (as can be seen throughout 2019) are ordinarily more likely to be a result of the perceived bottom-up stock opportunities, or through realising a position.

Fig.2: Net Gearing

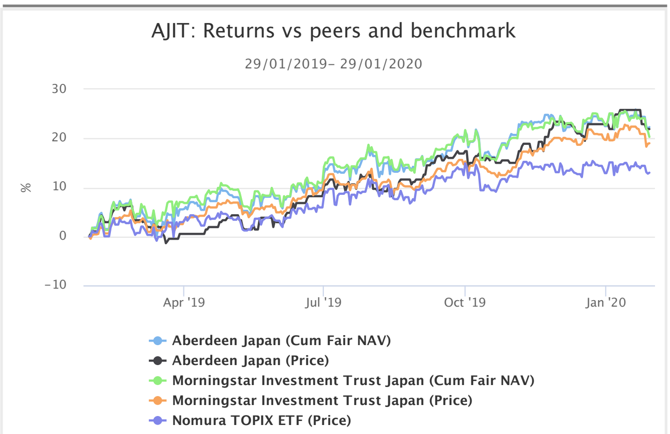


Source: Morningstar

Performance

AJIT's performance has improved markedly. Whilst the trust has underperformed over the previous five years, it outperformed the benchmark and the peer group over the 12 months to 29/01/2020. Share price and NAV returns of c. 22% each were ahead of the sector average share price and NAV returns of c. 20% and c. 19% respectively, and significantly ahead of the benchmark TOPIX Index

Fig.3: 12-Month Returns Vs Peers And Benchmark

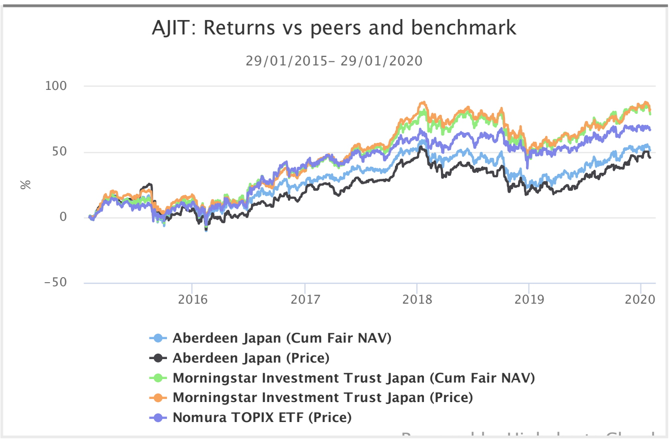


Source: Morningstar

(represented in the graph below by a passive investment vehicle), which returned c. 13%.

Returns over the previous five years have undoubtedly been disappointing, with AJIT lagging the peer group and the benchmark index. Over the five years to 29/01/2020, AJIT generated share price and NAV returns of c. 46% and c. 51% respectively, against a peer group share price and NAV average of c. 83% and c. 79% respectively, and benchmark returns of c. 67%. Part of the reason for this underperformance was the historic decision to hedge 50% of the FX exposure to the Japanese yen, a policy which was in place until July 2018.

Fig.4: Five-Year Returns Vs Peers And Benchmark



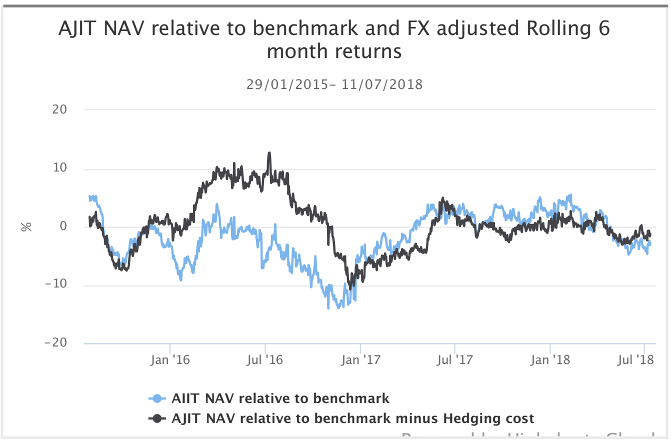
Source: Morningstar

In periods where the yen was rising, the yen/GBP hedge would be deleterious to performance (and vice versa), aside from the cost incurred of hedging. In the graph below we illustrate the effect of the hedging on performance. We compare AJIT NAV returns relative to the benchmark index over a rolling six-month period, and also show the same data series but minus 50% of the move in GBPJPY (an approximation for the performance impact of the hedging policy).

We can see a period of substantial and consistent outperformance through much of 2016 for the performance index without the hedge. Over the period 29/01/2015 to 11/07/2018 (at which point the hedge was removed), sterling declined by about 21% relative to the Japanese yen; this will have proven a severe headwind to relative returns for AJIT.

Since the hedge was removed in July 2018, NAV and share price total returns of c. 6.5% and c. 7.1% respectively have been broadly in line with the wider index returns of c. 7.2%, and superior to peer-group average NAV and share price returns of c. 4.7% and c. 4.5% respectively.

Fig.5: Rolling Six-Month Ajit Nav Relative Returns Vs Fx Adjusted Nav Relative Returns



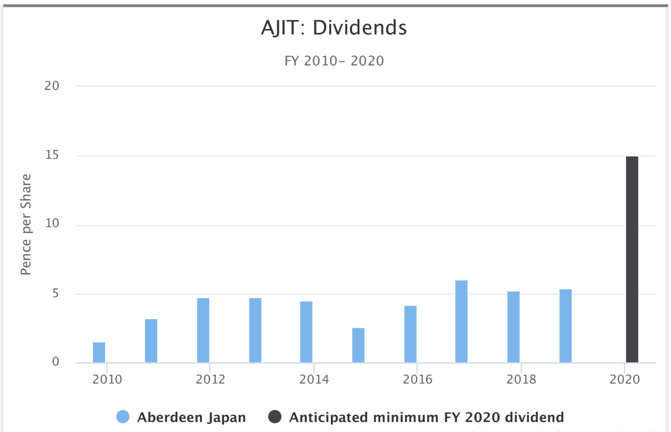
Source: Morningstar

Dividend

AJIT currently yields c. 0.9% on a historic basis, as of 31/01/2020. However, this does not reflect the reality of the new dividend policy which was enacted by the trust in mid-2019. The board have resolved to make a substantial increase in the level of distributions, and moved to introduce an interim dividend where previously distributions were only made annually; accordingly, the first-ever interim of 6p per share was paid to shareholders on 20 December 2019. The increase in dividend is to be funded through a mixture of revenue and capital reserves. We understand that there will be no change to the investment policy or management approach.

The board anticipates a minimum distribution for the financial year ending 31 March 2020 of 15p per share; 6p of this has already been distributed. On the current share price of 615p (as of 31/01/2020), a full-year dividend of 15p per share would equate to a yield of c. 2.4%.

Fig.6: Dividends Per Share



Source: Morningstar

Management

The trust is managed from Asia by the Japan equities team at Aberdeen Standard Investments. The team structure has not changed with the merger with Standard Life, although some senior personnel have been promoted upwards. The Japan equities team is led by Chern-Yeh Kwok, who is based in Tokyo, and there are six team members in Japan. The team seek consensus on stock picks, and don't rush to invest before the proper due diligence has been undertaken. They place a great emphasis on engagement with management to improve corporate governance, which we think has a great chance to boost returns in the coming years. This is because the Japanese government is making a priority of improving governance in Japanese companies in a bid to boost productivity and growth in an economy which has been sluggish for decades.

Discount

AJIT trades on a discount of c. 8.1% as of 30/01/2020. This has narrowed somewhat in recent months, in line with what can be observed across the sector as a whole as risk sentiment has improved. However, as the graph below shows, AJIT has consistently traded on a wider discount than the peer group.

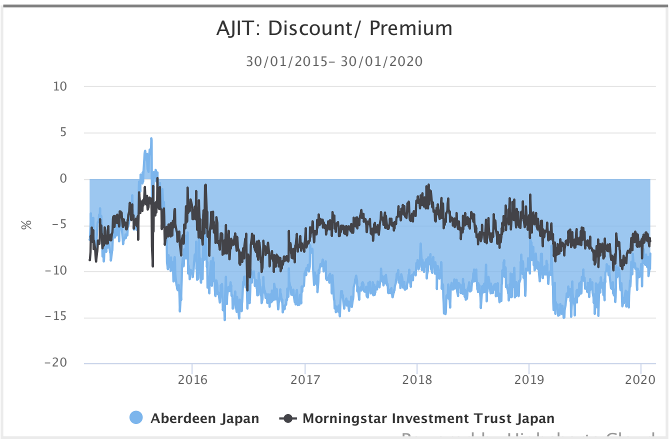
Back in 2015, AJIT traded on a premium to NAV. However, the widening in the discount at the start of 2016 was generally replicated across the sector. The initial period of discount widening in late 2015 and early 2016 was associated with a market drawdown and deteriorating investor confidence. On average, trust share prices across the Japan sector subsequently failed to keep pace with NAV recoveries as global markets started rebounding from February 2016 onwards. For much of 2016, this was likely a reflection of global market conditions, which initially favoured 'reflationary' assets such as commodities.

AJIT has tended to trade on a discount of between 10% and 15% since this period. The board has been active over this period, attempting to support the share price with a buy-back programme. It does not target a specific discount level as appropriate for intervention, but we understand it aims to repurchase shares when it believes that doing so will add value for investors. In the six months to the last interim report (31/03/2019–30/09/2019), the board repurchased 210,000 shares.

Since then, the board has repurchased a further 240,312 shares at a weighted average discount of c. 11.7%, with repurchases taking place on a range between discounts of c. 8.7% and c. 13.4% (as of 29/01/2020). The trust now holds c. 1.8m shares in treasury, representing c. 11% of shares currently in issuance.

AJIT will hold a continuation vote if the shares trade on an average discount of more than 10% over the 90 days prior to the end of the financial year in March. In our view, this should somewhat lessen discount risk by either keeping the discount under control or by giving investors the chance to vote on continuation.

Fig.7: Discount/Premium



Source: Morningstar

Charges

AJIT presently has ongoing charges of 1.1%, compared to an average of 0.82% in the AIC Japan sector. The small size of the trust, at c. £107m in net assets, clearly impacts upon the charges by reducing any benefits of significant scale. The OCF includes a management fee of 0.75%, which is charged at 60% to capital and 40% to revenue. From 1 June 2019, this has been charged on the lower of NAV or market cap, which clearly provides an incentive for the manager to close the discount. The KID RIY is 1.35% (which includes the cost of gearing), below the 1.48% average for the sector, although methodologies can vary.

ESG

Corporate governance reform is very much an ongoing facet of the Japanese economy and stock market, with companies being encouraged by the Japanese government to adopt more shareholder-friendly governance models. AJIT's team are actively engaged with the management of companies they hold, often encouraging them to return capital to shareholders from inefficient and overcapitalised balance sheets. Furthermore, the team have continued to engage with company management to try and promote greater transparency in their own ESG efforts.

The team's approach to stock analysis inherently lends itself to certain ESG considerations, with a strong qualitative preference for sustainable growth and superior corporate governance. This has been increasingly formalised in recent years, and we understand ESG analysis is now an embedded part of the analytical process and is being included in each analyst's company notes.

There are dedicated ESG analysts across every investment team within Aberdeen Standard, seeking to input wider considerations into investment decisions. Ongoing meetings with company management are used as an opportunity to better understand how these underlying companies perceive environmental and social risks to their business, and the team take the view that companies best able to manage these risks are likely to be best placed to ensure they can continue to grow their business over the long term.

ESG factors are financially material and impact corporate performance. Aberdeen Standard believes that informed and constructive engagement helps foster better companies, protecting and enhancing the value of investments.

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