Aberdeen Japan

Update
04 December 2018

Summary

Aberdeen Japan aims to generate long-term capital growth from a concentrated portfolio of Japanese stocks.

The trust is managed by the Aberdeen Asian Equities Team, who look for stocks with high quality management and good or improving corporate governance as well as strong financial characteristics which believe means they will be able to generate above-market growth over the long run.

The trust's style has been out of favour in recent years, and this has resulted in it sinking to a discount of 12.5%, significantly wider than the peer group average and at a level the board have been active with buybacks.

Key themes in the portfolio are automation and robotics as well as pharmaceutical innovation, areas in which Japanese companies are among the world's leaders.

The trust is also benefitting from increasing corporate governance reform in Japan supported by a drive by the government, which is hoping to thereby boost economic productivity and growth.

The trust only pays out the minimum dividends necessary to retain investment trust status which means payouts are low and volatile; the yield is currently 1%.

Portfolio

Aberdeen Japan owns a concentrated portfolio of Japanese equities, aiming to generate long-term capital growth. The trust has historically held around 40 stocks, although this has risen to 48 in recent months as the managers have reinvested some of their profits in smaller and mid-sized companies.

The trust is team-managed with a concentration on bottom-up stock analysis. The Aberdeen Asian Equities team based in Singapore and with a team on the ground in Tokyo aims to identify high quality companies with the potential to grow faster than the market consistently over the longer run. This focus on "quality" means the team looks for strong management teams with interests in alignment with those of shareholders and good corporate governance records and policies as well as strong financial fundamentals.

As for the latter, the team looks for high and sustainable return on equity, strong balance sheets with low or easily manageable levels of debt and then for good valuations. An attractively valued entry point is important, and the team will look at a company's valuation relative to its history as well as to its peers to be sure that they are not paying over the odds. However, "quality" is very much the priority rather than "value", and it is the strength of a company's financial, business and management positions which is critical to it being bought.

The aim is to buy and hold for the long term in order to take advantage of the best companies' ability to consistently generate above market returns. Over the past three

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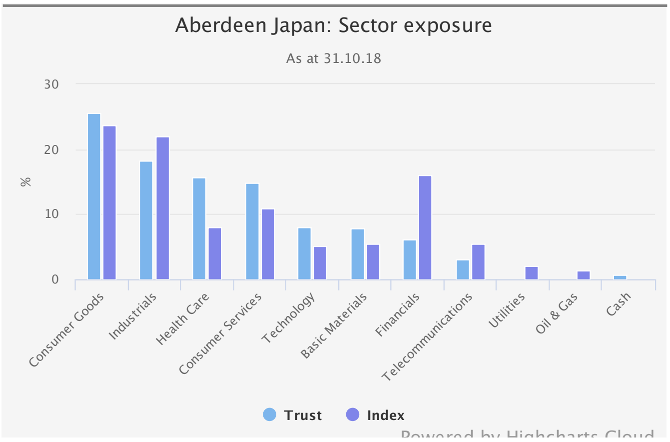
calendar years the turnover ratio has averaged 15.5%, according to Morningstar data, consistent with a holding period of over six years. However, the turnover has been a little higher in 2018 thanks to the shift into more small cap stocks.

The team have been finding more opportunities in mid and small cap companies over the past year. More of these companies meet their quality requirements than in the past, while the valuations are a little more attractive than the large caps after the strong run in Japan in 2016 and 2017. There is very little analyst coverage of small and mid-sized companies in Japan, which the team think makes it easier to generate alpha.

The trust is managed with a benchmark-agnostic approach which means that all stocks are selected because the manager thinks they are the best individual investments in the market rather than to meet a quota or ensure that a particular sector or industry is represented. This approach means that the trust has a very significant underweight to the financials sector and a very high overweight to the healthcare sector.

Fig.1: Sector Allocation



Source: Aberdeen Standard Investments

The latter position has been a source of some of the best-performing stock ideas in 2018, as a number of pharmaceutical companies have made strong returns. The trust has a 3.8% position in Shionogi, which saw its share price rise 26% in the year to 31 October. Shionogi has FDA approval for a successor to flu treatment Tamiflu called Xofluza, which has demonstrated superior effects to Tamiflu. The company has an agreement with Roche whereby the latter will distribute it through its subsidiary Genentech. Shionogi also has market-leading drugs in HIV treatment through a tie-up with Glaxo.

Aberdeen Japan also has a 3.4% position in Chugai Pharmaceutical, which generates roughly 50% of its revenues from oncology treatments and rose 30% in the period. It also owns Asahi Intecc, a medical device manufacturer which builds the wires used in heart surgery and other serious operations.

Another theme in the portfolio aside from medical innovation is automation and “smart” factories. Japan has the world’s leading companies in this area, and Aberdeen Japan owns both Fanuc and Keyence. Robot-maker Fanuc’s shares have suffered this year as China’s economy has slowed and concerns about tariffs have weighed on markets. However, sales have picked up to other geographies, and the company has a diverse portfolio of products which should make it more resilient over the longer run. Keyence, by contrast, has held up relatively well in a falling market, buoyed by rising operating profits in its Q2 update. Keyence also has a diverse range of products, focussing on using technology to make factory systems more efficient. It also has a huge pile of cash on the balance sheet. It is the second-largest position in the portfolio.

The largest position in the trust also has a technology angle, although it sits in the materials sector: Shin-Etsu is a chemicals company which generates 30% of its operating profit from silicon used in computer chips. As we discuss in the performance section, the company has sold off this year despite barnstorming results which saw a 34% uptick in operating profit in the half to September.

Top Ten

	FUND (%)	INDEX (%)	DIFFERENCE (%)	# OF YEARS HELD BY ABERDEEN
Shin-Etsu	4.4	0.7	3.7	11
Keyence	4.3	1.2	3.1	11
Sysmex	3.9	0.3	3.6	10
Shionogi	3.8	0.4	3.4	1
Daikin	3.6	0.8	2.8	4
Seven & i	3.5	0.9	2.6	14
Pigeon	3.4	0.1	3.3	8
Chugai	3.4	0.3	3.1	8
Shiseido	3.1	0.6	2.5	1
KDDI	3.1	1	2.1	5

Source: Aberdeen Standard Investments

Another theme in the portfolio is corporate reform. Aberdeen have a company-wide focus on corporate governance and are strong believers in engaging with company management to improve governance in the interests of shareholders. The government of Shinzo Abe, in power since 2013, has made improving corporate governance a key aim as it tries to increase productivity in the Japanese economy, which has suffered low growth for decades.

At Seven & i Holdings, Aberdeen has pushed for a restructuring of the non-performing operations and acceleration of the medium-term management plan. At The Coatings Expert, they have achieved a change on the board, and are pushing for stronger recognition of minority shareholders' rights. Being a long-term shareholder is crucial to being listened to by company boards, who are usually in their posts for a very long time, and often former employees.

One of the new positions this year, Yamaha, has a strong reform angle. The company is unwinding the cross-shareholdings of the motorbike and musical instruments business, which is creating a more efficient company. The team believe that companies are being encouraged to be more open to reform due to the labour shortage in Japan which is a result of their poor demographics and which is requiring a greater focus on efficiencies. Capex in Japan is at record levels thanks to this pressure on human resources.

Payout ratios and share buybacks are rising in Japan as companies engage more with minority shareholders, making long-term investments in the country more attractive to some investors. Balance sheets are still generally very inefficient, which means they should be more resilient at least and have the potential to unlock value should companies continue to reform.

Before the 11 July 2018 the trust was 50% hedged back into sterling, but this has now been completely removed, eliminating a cost to the fund but leaving it exposed to movements in the pound / yen exchange rate. During the period that the hedge was in place, it had a net neutral effect on shareholder returns but cost £1m, making it uneconomical.

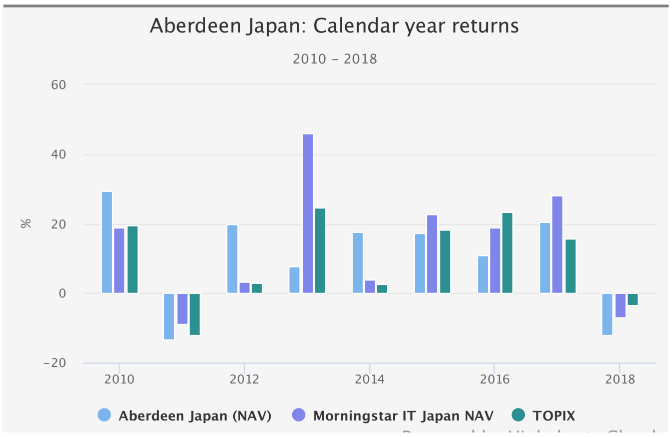
Gearing

The board monitors the levels of gearing and expects it to vary between 5% and 15% over the course of a cycle, although the level at any one time is up to the manager. The managers have tended to keep gearing stable around 10% over the long run. The gearing is taken through two short-term facilities with ING, one of two years' duration and the other of one year's duration, which will be renewed in January.

Returns

Aberdeen Japan's strong quality tilt has been out of fashion in recent years. The quality exposure helped the trust outperform the index in 2014, but in 2016 and 2017 the world economy saw a growth and momentum-led rally which the trust lagged in its market. During this period the high-growth, tech-focussed trusts outperformed.

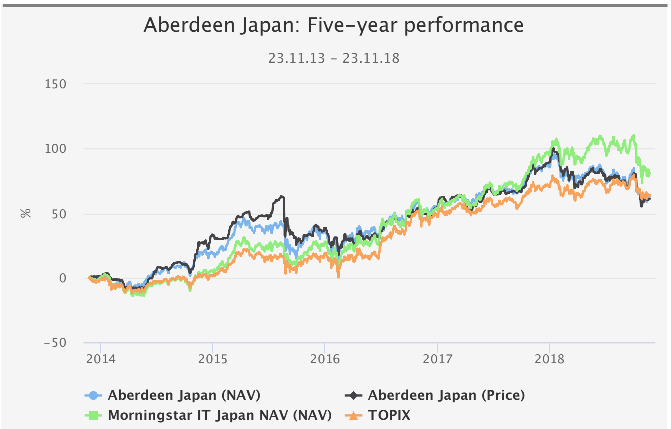
Fig.2: Annual Returns



Source: Morningstar

Overall, the trust has therefore performed in line with the index over five years but has lagged the peer group thanks to the latter's greater exposure to growth and technology in 2016 and 2017.

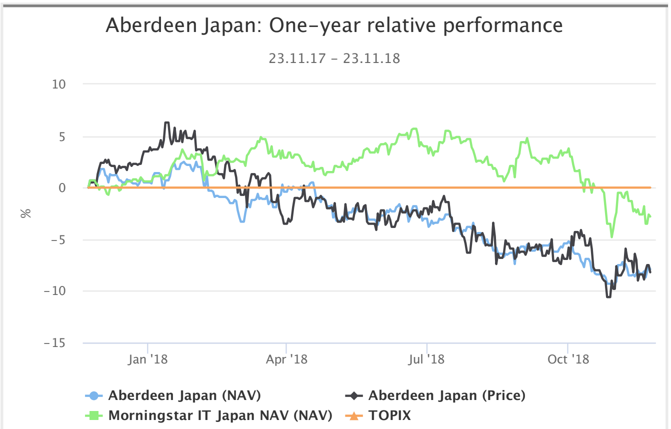
Fig.3: Five-Year Performance



Source: Morningstar

The outperformance of the peer group versus the index has started to reverse in the second half of this year, however, as the winners of the 2016/ 2017 rally, largely in

Fig.4: One-Year Relative Performance



Source: Morningstar

the tech sectors, have sold off. Whilst this means a stylistic headwind for the trust has been removed, relative returns over the past year have been hit by some of the trust's major holdings in China-exposed and technology-related industries being punished in an indiscriminate sell-off which has gathered pace in the autumn.

Stocks with greater exposure to China have done poorly as the market has worried about the effects of the confrontation between Trump and the Chinese Communist Party over trade. This has particularly hurt the trust's holdings in the industrials sector. The managers tell us that the companies themselves are still doing well, and the sell-off has not been justified by fundamentals.

There have also been relative losses in the technology sector and related stocks in other industries. For example, chemicals company Shin-Etsu has sold off dramatically; 30% of the company's operating profits are derived from selling silicon wafers used in computing. The stock has done poorly despite sales and profits rising and the company hiking its dividend and discussing a share buyback.

Given the strong fundamentals of the stock-level detractors, the team hasn't been selling them down but has remained cautious about adding given the strong downward momentum in markets.

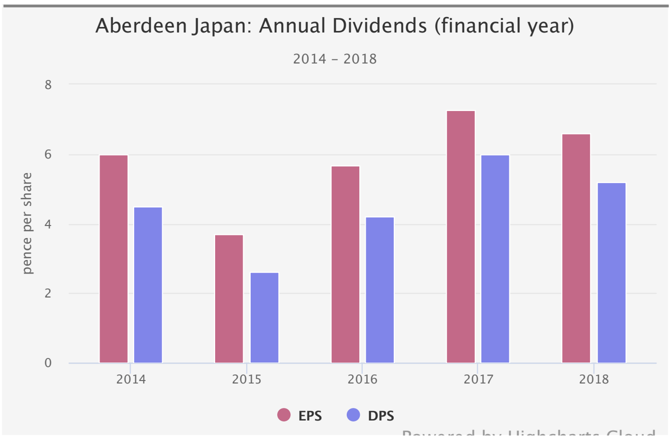
There have also been some stock-specific issues at holdings which have added to the underperformance. For example, the holding in Suruga Bank was sold after fraud emerged in some of its real estate dealings. Renesas Technologies, which was hit by the poor sentiment to tech stocks, is also dealing with an inventory build-up following over-enthusiastic re-stocking after the 2016 earthquake; the team continue to hold this one and believe in its long-term attractiveness.

The Japanese market has been punished by foreign investors in 2018; as US and Europeans take risk off the table they have taken it from Emerging Markets and Japan in particular – foreign outflows from Japan are at multi-decade highs despite the economy motoring along well. This has disproportionately hit the most bought stocks in the past few years, which includes many of the most interesting companies in the world. Japan suffers from being a market very open to the global economy, which means that it suffers contagion from a slowdown elsewhere.

Dividend

The trust aims for capital growth rather than to pay an income, and the payout policy merely specifies that the trust will seek to maintain its investment trust status, which requires a payout of at least 85% of its income. Because sterling income per share can be quite volatile, thanks to movements in the pound / yen exchange rate, dividend payouts have been volatile too. The current dividend yield is 1%.

Fig.5: Dividends



Source: Morningstar

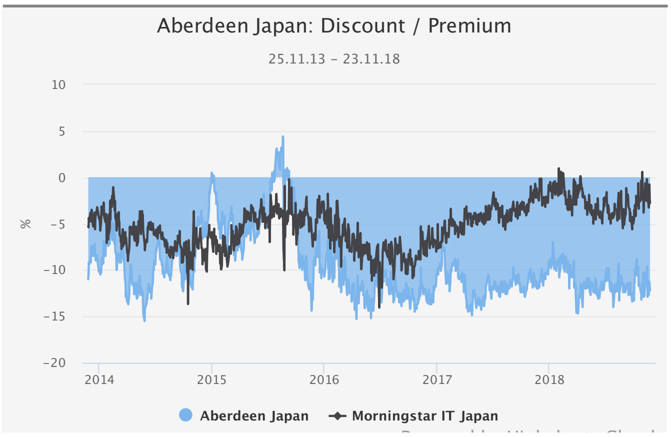
Management

The trust is managed from Asia by the Aberdeen Asian 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 Asia Pacific Equities team is now led by Flavia Cheong from Singapore, with her Deputy Kwok Chern-Yeh being based in Tokyo. There are seven team members in Japan, with two new additions this year at a junior level. The collegiate approach and consistency of strategy is one of the key selling points of the Aberdeen approach. The team seek consensus on stock picks, and don't rush to invest before the proper due diligence has been done. 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 as the Japanese government is making improving governance in Japanese companies a priority in a bid to boost productivity and growth in an economy which has been sluggish for decades.

Discount

The trust has tended to trade on a discount between 10% and 15% over the past two years. At the time of writing it is at 12%, in the middle of that range. During this period investors have favoured trusts with a higher growth factor exposure which have generally outperformed. Aberdeen's "slow and steady", quality approach has been less in favour. The board have supported the share price with a buyback programme, although there is no specific figure they have defended.

Fig.6: Discount



Source: Morningstar

Whilst the gap between the trust and the sector's discounts has widened, this is mainly due to two trusts moving onto significant premiums, one with a strong growth bias and one with an income mandate.

The trust will hold a continuation vote if the trust trades on a discount of more than 10% over the 90 days prior to the end of the financial year in March, which reduces discount risk by either keeping the discount under control or giving investors the chance to vote on continuation. A negative vote would provide investors with the option to exit at close to NAV.

Charges

The management fee was cut in April 2018 which has not yet been factored into the OCF figures recorded by the AIC and other aggregators. It is now 0.75% on all assets, having been 0.95% on assets below % £50m last year. This is a saving of £100,000 to shareholders and means the OCF will come down to 1.07% from 1.18%, all other things remaining equal. This makes the trust more competitive relative to its peers on cost, putting it close to the average 1.01% OCF of the AIC Japan sector.

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