Aberdeen Japan

AJIT will continue to pay a considerably increased dividend yield relative to history...

Update
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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. We discuss this process and recent trust activity under **Portfolio**.

This focus on seeking to identify high-quality and resilient businesses has proven beneficial in recent months given the highly uncertain macroeconomic framework businesses are currently operating in, as we discuss in the **Performance section**.

In 2019, AJIT introduced a new dividend policy which will see the trust offer a notably increased dividend in the future compared to what it has historically produced. This has led to the financial year (FY) 2020 dividend rising to 15p per share from 5.4p in FY 2019, paid from a mixture of revenue returns, revenue reserves and capital reserves, which amounts to a c. 2.5% yield.

Despite the improvement in relative returns seen in recent years and the significantly increased dividend policy, AJIT continues to trade on a wider discount than the rest of the sector. Having traded at an average discount of wider than 10% for the 90 days prior to the previous financial year end, the board was compelled to offer shareholders a continuation vote at the most recent EGM. The vote subsequently passed in favour of continuation, as we discuss under **Discount**.

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Analyst's View

The improvement in AJIT's performance has been welcome, and it was also reassuring to see the relative resilience in a downturn we anticipated from the emphasis on quality has played out in 2020's challenging market and economic environment. Whilst markets have recovered, the economic outlook remains very uncertain; liquidity pressures have been eased for now, but solvency risks globally certainly remain. In this context, and in the absence of an improbably rapid economic recovery, the continued focus on quality seems to us likely to remain in favour with the market in the nearer term. Looking further out, the managers have highlighted their expectation that many of AJIT's holdings can benefit from a general trend of corporate consolidation. We would agree that the Japanese market is one of the few developed markets globally where a sustained trend towards consolidation might reasonably be expected, and AJIT would seem well positioned in this regard.

The move to boost the dividend is welcome for income investors, and in returning some of the large capital reserves to shareholders AJIT's board and managers seem to be 'eating their own cooking' in regards to their general push for improved corporate governance in Japanese companies.

BULL
Thematic trends towards corporate consolidation seems to remain favourable
Dividend yield of c. 2.5%, supported by the board returning revenue reserves and capital to shareholders
Discount remains wide on an absolute and relative basis

BEAR
Could trail in the short term if we see a rapid economic recovery
Despite falling in recent years, OCF remains relatively high compared to the sector average
Gearing can exacerbate downside in a generalised market sell-off

Portfolio

Aberdeen Japan Investment Trust (AJIT) seeks to generate long-term capital growth from investment in a reasonably concentrated portfolio of c. 61 high-quality companies in the Japanese market. Chern-Yeh Kwok, Hisashi Arakawa and Flavia Cheong are the named lead managers on the trust, 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.

Portfolio construction and stock selection are very much driven by bottom-up stock analysis, with the team seeking to identify and buy high-quality businesses with the ability to consistently grow their earnings through the economic cycle. This focus on resilient business models meeting wider, relatively macro-insensitive demand has been re-emphasised in the fraught economic environment of 2020 thus far.

Typically, this bottom-up stock process with its emphasis on high-quality companies tends to emphasise companies with high barriers to entry and/or strong brand loyalty. Companies meeting the team's criteria will also tend to have strong balance sheets, and AJIT's management team seek to ensure company managements have exhibited strong capital discipline. With strong balance sheets and cash flows, the team anticipate that the companies held should be able to continue to generate and fund their own growth from internal cash flows. This could be done with limited need for debt or equity financing to drive expansion, except for in exceptional circumstances, such as where value-accretive mergers and acquisitions can be undertaken.

Considerations around capital discipline feed into a general desire to see companies and managements display strong corporate governance, with AJIT's team looking to ensure management and shareholder interests are aligned. Increasingly, this concern incorporates further ESG considerations, including the use of external analytical tools as well as internal assessments of ESG criteria. As we note in the **ESG section**, these factors have in some instances helped drive the performance of certain stocks in recent months.

The companies likely to interest the AJIT team are thus likely to display high levels of profitability and wide profit margins, with premium levels of returns on equity relative to the wider market. Valuation considerations are also important for the team, and they will look to ensure they are not overpaying for a quality company. We have detailed the stock-selection process more fully **in our previous note here**.

When we spoke recently with Hisashi, he noted that the indiscriminate nature of the recent market sell-off gave rise to a raft of significant buying opportunities in companies the team had long admired, but where they had felt hesitant to pay the valuation multiple previously seen. With the broader market sell-off encompassing even high-quality companies likely, in their opinion, to see relatively few operational impediments, they were able to add and build positions in companies such as Zuken, where previously they had regarded the valuation as prohibitive.

Having previously been held in the Japanese smaller-companies OEIC run by the same team, Zuken was added to the portfolio when its valuation dropped to a level the team regarded as a highly attractive entry point. As a global leader in developing software for designing electronic circuit boards, which are necessary for developing artificial intelligence as well as more near-term demand drivers such as use in cars, the company enjoys secular growth prospects from structural economic trends. Chern, Hisashi, Flavia and the team have a long-standing familiarity with the company and its management, and have observed the latter repeatedly implement corporate strategies successfully. The company continues to enjoy strong sales growth, and it is anticipated by the managers of AJIT that it should exhibit strong operational leverage as sales continue to grow, with management exhibiting cost discipline. This growing profitability should then enable greater returns of capital to shareholders whilst ensuring the company generates sufficient free cash flow to continue reinvesting in the business to maintain market leadership. Such secular growth opportunities are often widely appreciated, and thus tend to command a high valuation multiple. This was the case for Zuken, but having been sold off in line with the wider market the team were able to initiate a position at a multiple of under 20x P/E based on most recent earnings.

AJIT remains an all-cap strategy, and the managers note that they have been able to utilise the trust structure to add to or introduce positions in less liquid small-cap stocks during the sell-off. This included introducing positions in small-cap companies such as Advanced Media, where the stock price had been particularly acutely hit due to lower levels of liquidity (thus seeing relatively small sell orders having unusually and disproportionately negative impacts on the stock price). Whilst this stock would be too illiquid to hold in an open-ended structure, the closed-ended nature of AJIT meant the managers were comfortable initiating a position in this company with a long-term outlook, taking access to a market leader in speech-recognition solutions for a broad range of applications.

Hisashi notes that Japanese companies in general have been relatively resilient, and high-quality companies particularly so. This has reaffirmed the team's conviction in identifying high-quality market and industry leaders, and indeed prompted some selling activity within AJIT to rebalance towards companies better able, in their view, to meet future challenges. An example of this was the move to sell shares in Honda whilst retaining Toyota. Hisashi noted that in addition to being the existing market leader, Toyota had exhibited superior supply-chain management to the rest of the market, and is therefore better placed in the team's view to meet future regulatory and research & development costs. Although they believe that Honda remains a quality company, they believe it is less well positioned to meet these challenges, and anticipate an environment where Toyota can take further additional market share. This feeds into a generally observed trend towards greater corporate concentration in the Japanese market, which is often much more fragmented than global peers.

As well as some selling activity in companies such as Honda, where they anticipate increased competitive pressures, the team have also sold some companies on valuation grounds following strong recent rallies where they deem the strength in the share price to be in excess of the operational improvements. This drove their decision to reduce their exposure to Chugai Pharmaceutical, a company whose drug was tipped as a potential treatment for a symptom in severe cases of COVID-19, and where the share price accordingly rallied strongly. Whilst in the team's view the company maintains a strong pipeline, they have been trimming their exposure as the stock rallied to manage their relative and stock-specific risk. However, even as they have trimmed this position it has remained one of their top holdings.

Top Ten Holdings

HOLDING	%
KDDI	4.1
Chugai Pharmaceutical	4.0
Shin-Etsu Chemical	4.0
Toyota Motor	4.0
Tokio Marine	4.0
Daikin Industries	3.7
Keyence	3.5
Sony	3.2
NEC Networks & System Integration	2.7
AMADA	2.7
TOTAL	**35.9**

Source: Aberdeen Standard Investments, as at 30/06/2020

The managers of AJIT note that their focus on corporate governance is aligned with wider thematic shifts in the Japanese corporate landscape, which remain an ongoing focus of the authorities. Although ostensibly the COVID-19-related global economic shutdown may seem to justify the extremely conservative balance sheets of many Japanese corporates, the team have not noticed any retrenchment from company managements. The wider market was buoyed in part by indications that Japan was amongst the first nations to seemingly control the spread of the virus, and also by extremely extensive government stimulus programmes. Against this backdrop, company managements have remained constructive on continuing to improve corporate governance and demonstrate greater alignment with shareholder interests, and the managers of AJIT note that they continue to find managements working to improve shareholder returns and returns of capital to shareholders.

Although government stimulus support for the economy has been helpful to the corporate sector in the managers' view, they also believe that ultimately a reopening of the economy will be more important for determining the corporate winners and losers in a post-COVID world. Thematically, they continue to find interesting ideas in areas such as improving air quality, or in companies such as Keyence which stand to benefit from moves towards automation.

This latter theme is particularly likely to entail some overseas-revenue risks, given the world-leading status of many Japanese companies and global demand. Chern, Hisashi, Flavia and the team are cognisant of these potential risks, and continue to work to try to ensure that their portfolio risk is not inordinately skewed by global trade volumes or potential geopolitical tensions, though areas such as automation will entail exposure to the Chinese economy, for example.

A general stylistic tilt remains towards growth and quality factors, and less towards value factors, as we can see in the table below, which shows the R2 (a measure of correlation) of AJIT to different style weighted indices in the Japanese market.

R^2 To Different Japanese Style Indices

STYLE	12-MONTH R^2	TEN-YEAR AVERAGE R^2
Growth	0.76	0.77
Quality	0.70	0.56
Value	0.61	0.33

Source: Morningstar

Hisashi notes that the team remain cognisant of this, and that this is an output of their stock-selection process as opposed to a conscious input or portfolio strategy. The bottom-up stock selection, and the focus on quality and the ability to sustainably grow earnings will, for example, see the team typically eschew the largely moribund banking sector, a significant component of quantitatively generated value-style indices. However, they do retain some exposure to financials, holding insurance company Tokio Marine. Already a dominant player in the local property and casualty-insurance markets, the company is using these cash flows to drive overseas expansion, whilst any excess capital generated is typically returned to shareholders (with the company paying a special dividend in 2019).

FX exposure has been left unhedged since 11/07/2018, though the managers previously hedged c. 50% of the portfolio back to sterling.

Gearing

AJIT is presently c. 12% net geared as of 01/08/2020. The board typically expects a gearing range of between 5% and 15% depending on market conditions, with the expectation that gearing of c. 10% should ordinarily be appropriate to enhance shareholder returns. Gearing levels are ultimately determined by the management, who typically look to utilise additional gearing when they observe significant additional stock opportunities from their bottom-up stock analysis.

This was the case in recent months, with the managers increasing gearing slightly with the aim of taking advantage of market turbulence, initiating positions in new ideas which they believed had been indiscriminately sold off in line with the rest of the market. This lack of discrimination was particularly acute amongst small-cap companies with thin levels of liquidity, even though the fundamentals had, in the case of stocks AJIT's team purchased, remained very resilient in their opinion.

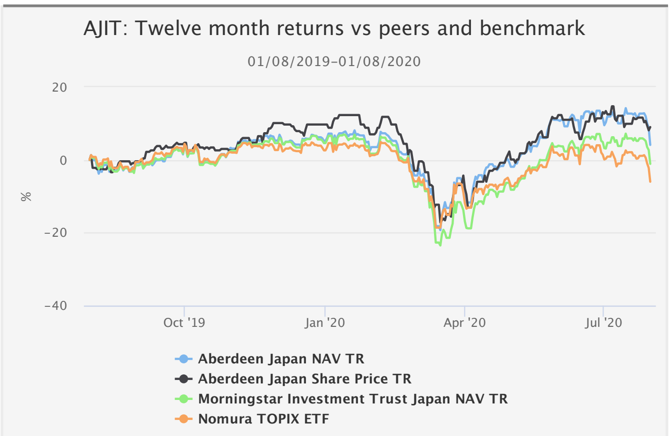
Borrowing is undertaken through two separate short-term facilities, both of which are due to expire in January 2021. These were themselves renewed in January 2020.

Performance

Despite the challenging circumstances of the 12 months to 01/08/2020, AJIT delivered both NAV and share-price gains of c. 4.1% and c. 9% respectively. As well as positive absolute returns, this also represents outperformance of the wider Morningstar Japan peer group, which saw average NAV and share-price returns of c. -1.1% and c. -0.9% respectively. It also represents outperformance of the benchmark TOPIX Index (as represented by a passive index-tracking product), which saw returns of c. -6% over the same period.

Share-price returns have benefitted from a narrowing in the discount over this period, though it unsurprisingly widened in Q1 2020 amidst the wider risk aversion seen in markets. The managers note that several of their stock holdings perceived as enjoying secular growth tailwinds – in areas such as technology – have benefitted from the perceived new environment. Meanwhile, the focus on high-quality companies with strong balance sheets and low insolvency risks proved beneficial relative to peers in the market drawdown of Q1 2020, but also in the immediate recovery. This was, in our opinion, because most redeployment of 'risk-on' capital following steps to ease a global liquidity crunch tended to prioritise companies with low perceived insolvency risks.

Fig.1: 12-Month Cumulative Performance Vs Peers And Benchmark

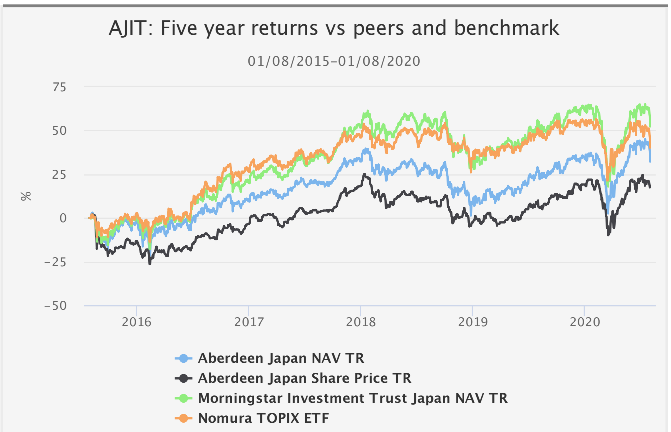


Source: Morningstar

Several stocks also proved beneficiaries of stock-specific factors, such as Chugai Pharmaceutical, where shares moved aggressively higher following suggestions the company was making progress in developing a treatment for COVID-19.

Over the five years to 01/08/2020, AJIT delivered NAV and share-price returns of c. 32.2% and c. 18.4% respectively. This has represented underperformance of the benchmark, which has delivered a return of c. 40.2% over the same period. At a sector level, AJIT also underperformed peers, which overall returned an average of c. 52.3% and c. 43.8% in NAV and share-price returns respectively.

Fig.2: Five-Year Returns Vs Peers And Benchmark

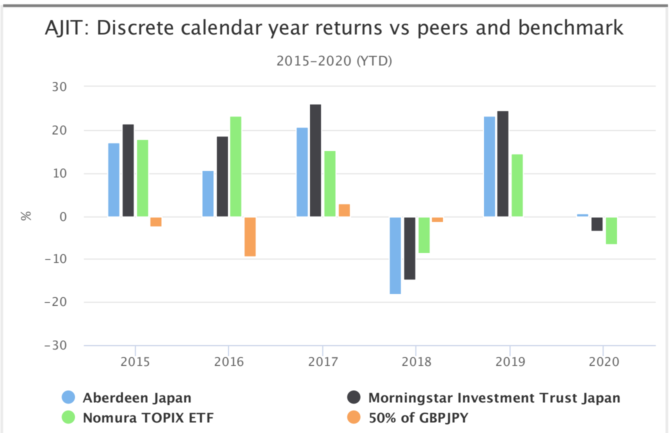


Source: Morningstar

As noted under the **Portfolio section**, until July 2018, 50% of AJIT's exposure to the Japanese yen was hedged back into sterling. From 01/08/2015–11/07/2018 (when the hedge was removed), the Japanese yen appreciated by c. 31% vs GBP (Source: FE Analytics). Thus, a 50% short exposure to the JPY (which the hedge effectively incurred) will have caused considerable performance drag for AJIT over this period. Since the hedge was removed on 11/07/2018, AJIT has outperformed the peer group on both a share-price and NAV basis, and has also outperformed the benchmark, delivering NAV and share-price returns of c. 5.7% and c. 7.3% respectively to 01/08/2020. Over this same period, the peer-group average NAV and share-price returns have been 0.9% and -1.8% respectively, whilst the benchmark has delivered c. -2%.

When we look at the relative returns of Japanese markets in GBP against in JPY over these time periods, it seems apparent to us that the previous decision to hedge the currency exposure is at least partially responsible for a significant proportion of the underperformance seen over the five-year period under review. We can see the discrete calendar-year returns for AJIT, the peer group and benchmark (including 2020 YTD) in the chart below. We have also shown the equivalent of 50% of the change in GBPJPY for the calendar years 2015, 2016 and 2017, and for the period 01/01/2018–11/07/2018 (when the 50% currency hedge in AJIT was removed). From this, we can see that GBP weakness in 2016 in particular was likely to be a significant detractor, whilst even the positive calendar-year returns in 2017 will have offered relatively little support.

Fig.3: Discrete Calendar-Year Returns Vs Peers And Benchmark



Source: Morningstar

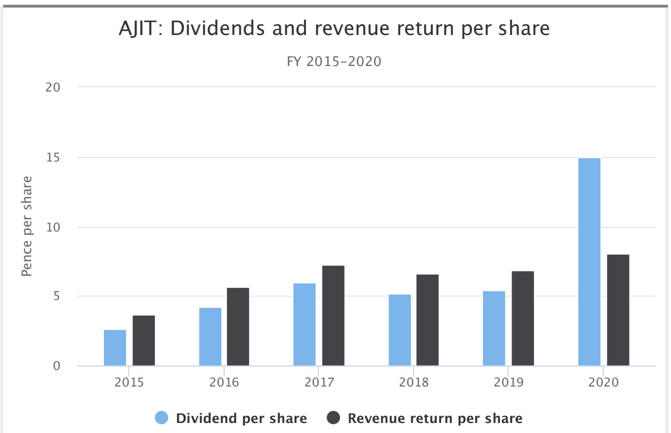
Dividend

AJIT currently yields c. 2.5% on a historic basis, as of 01/08/2020. There has been a substantial change in dividend policy in recent years, with the board having resolved to make a substantial increase in the level of distributions. This resulted in a move to introducing an interim dividend, where previously distributions were only made annually, and a sharp increase in the total dividend paid. This increased rate of dividend is to be paid from a mixture of income and capital.

In our previous research, we noted that "the board anticipates a minimum distribution for the financial year ending 31 March 2020 of 15p per share". This has been achieved with financial-year (FY) 2020 total distributions of 15p per share. Whilst the board and manager have noted that they expect some (relatively muted, compared to that of most global markets) dividend impairment from the underlying portfolio, the board has reiterated its belief that a regular and sustainable dividend is important to helping to broaden the shareholder base and maintain the discount at reasonable levels. Over time, the managers expect payout ratios to continue to rise across the Japanese market as a whole, improving dividend cover from underlying revenue returns.

The new dividend policy has been funded from a mixture of portfolio income, revenue reserves and capital reserves (with the 15p per share of dividends funded by 8p from revenue returns, 3p from revenue reserves and 4p from capital reserves). We estimate that AJIT retains c. 14p of revenue reserves per share, and capital reserves (after buybacks and distributions) of c. £5.22 per share. This would suggest there remains ample room for support of the dividend in the near term at least.

Fig.4: Dividend Per Share



Source: Aberdeen Standard Investment, the AIC

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 managements 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

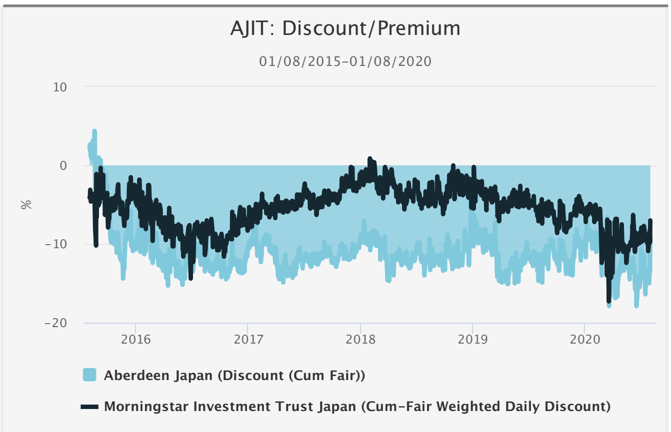
AJIT presently trades on a discount of c. 9% as at 01/08/2020. This is slightly wider than the AIC Japanese sector-average level of c. 7%, but this additional level of discount on a relative basis has been fairly typical in recent years and this is indeed slightly narrower than has been typical.

The board of AJIT has continued to try to prevent the discount trading at excessively wide levels through using tactical buybacks when deemed appropriate. This approach does not target a specific discount level, but is focussed on repurchasing shares when the board believes doing so will add value for investors.

In the current financial year (since 31/03/2020), the board has repurchased c. 146,000 shares, worth c. £858,000, at a weighted average discount of c. 14%. We estimate that shares held in treasury now amount to c. 13.7% of total shares in issuance.

AJIT is required to hold a continuation vote should 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. This occurred in the previous financial year ending 31/03/2020. Shareholders subsequently voted overwhelmingly in favour of continuation.

Fig.5: Discount/Premium



Source: Morningstar

Charges

AJIT presently has ongoing charges of 1.04%, compared to an average of 0.79% 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% on the lower of the trust's market capitalisation or net asset value, incentivising the manager to see the trust trade in excess of NAV, which is charged at 60% to capital and 40% to revenue. The KID RIY is 1.35% (which includes the cost of gearing), below the 1.38% average for the sector, although calculation 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 managements 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 managements to try to promote greater transparency in their own ESG efforts.

In the shorter term, the management team have noted that many companies which have previously prioritised employee safety have been able to adapt quicker to the new strictures required, further boosting their ability to take market share. This has been seen, for example, in Nippon Paint, already a leading participant in the decorative-paints business in China and other parts of Asia. The company was able to quickly adapt its workplace to account for social distancing and distribute suitable masks to workers, and was therefore able to reopen ahead of much of its competition.

The focus placed upon sustainability of earnings and growth, along with a preference for companies that generate sufficient free cash flow to finance inorganic expansion. A significant focus is also placed upon identifying companies which demonstrate superior corporate governance. These characteristics tend to lend themselves to the portfolio by naturally exhibiting ESG-friendly characteristics.

We understand that ensuring alignment with ESG functions has become increasingly formalised in recent years, with ESG considerations now embedded into the analytical process and into each analyst's formal company-research notes.

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