

SHINING A LIGHT ON..... BAILLIE GIFFORD SHIN NIPPON INVESTMENT TRUST

At a glance

Investing in Japan over the last 25 years has been a roller coaster ride with many false dawns. Over the last 18 months we have heard the quote “this time is different”. This may be true because if Japan does nothing it will be bankrupt.

Part of the strategy is to weaken the Yen which will help boost corporate profits; this in turn will improve employment and deliver higher salaries. In theory if investors believe this time is different then there are sound reasons to invest in Japan.

There is however a cautionary note, although corporate profits increase because the Yen is weaker investors who do not hedge the Yen see the returns reduced. As an example in the second half of 2013 the Yen weakened significantly. The Neptune Japan Opportunities Fund which hedges the Yen was up 22.05% but others which didn't were flat despite gains in the market.

Conversely in the first quarter of 2014 the Yen has been flat and the currency hedge has meant the falls on Neptune have been greater than on the non-hedged funds.

Understanding this is really important when considering investing in Japan and the fund you choose. We recently met the manager of Baillie Gifford Shin Nippon Investment Trust. The stated aim of the trust is to invest in 'new' Japan with a focus on small cap companies. Assuming an investor believes in the long term outlook for Japan, there are many reasons why an investor would lean towards this fund compared to other funds which tend to invest in 'old' Japan.

The performance over the last five years is exceptional; it doesn't use a hedge strategy although the managers can adopt this if they believe it is right to do so.

In this review we will unpick this further.

Who are the team behind the fund?

The lead manager is John MacDougall. He joined Baillie Gifford in 2000 and also contributes ideas to the Global Discovery Team. He has an exceptional track record and his focus is on Japanese smaller companies.

What is the story behind the investment?

Japan has faced many false dawns and this could be seen as another, however I believe this time there is a difference. The main reason is the political landscape. The new Prime Minister has a majority government which over the next three years means he has the ability to drive through change. In the first 12 months of Prime Minister Abe's administration Japanese economic growth was one of the strongest in the developed world.

The aim of Abenomics is to; remove inflation and reduce government debt - but like many developed economies they have an aging society and a reducing workforce. Most western economies are ignoring this and Japan is recognised as the first to face facts.

LWM Consultants Ltd

There are three arrows to the strategy – aggressive monetary policy, flexible fiscal policy and structural change.

Over the last 12 months we have seen a lot of activity around the first two arrows and now we are starting to see action with the third. 30 bills are going through parliament and although these are not startling they pave the way for dynamic changes. The areas they are keen to tackle are promotion of investment, better utilisation of human resource which includes immigration, creation of new markets and better global economic integration.

If Japan does nothing the economy will go bankrupt, we shouldn't underestimate the extent of the challenge facing the government however the building blocks are there and perhaps this time it won't be a false dawn, if it is it may be the last.

Fund highlights?

The Nikkei was up 56% in 2013, the best year since 1972. The Topex Index was up 51% the 3rd best since the 1950's. The fund itself returned 55.51%. (Source: Morningstar).

The trust stands out from the crowd with its focus on new Japan. It is best described as a high octane fund which will deliver significant upside when these businesses are in favour; however the opposite is also true. Over the last five years it has returned 258.15% compared to the tracker option which has returned 24.20%.

The fund manager believes there has been a significant shift in attitude in Japan. Where gloom has followed them, this is changing – base salaries are going up and the outside world is recognising them again what with being awarded the Olympics. This combined with a 'secure' government he believes signifies a catalyst for change.

This change is filtering down to the increasing number of entrepreneurs especially in areas like biotech, stem cell technology, nano technology and green technology. Many of these individuals are young, overseas educated and with links to Silicon Valley.

Many of the good businesses that the fund focuses on have higher than average growth in earnings, higher than average return on equity and stronger balance sheets than old Japanese businesses.

The manager describes himself as somewhat 'geeky' attending trade fairs to seek out new entrepreneurs and ideas. The trust at the moment can only invest in listed companies but it may consider widening its remit to unlisted companies in the future as the manager believes there are many opportunities which can't currently be accessed by the trust.

Japan has always focused on the past and this shift is significant. 3 out of the 5 richest people in Japan are from new money. Abe has elevated the status of entrepreneurs so that now they are an acceptable part of society and many are involved with policy shaping committees.

The fund has a focus on Consumer Discretionary (25%), Information Technology (23.5%), Industrials (16.4%) and Health Care (12.4%). In 2013 it benefited from e-commerce, online platforms and gearing (2.24% RBS Y1,150 to 08/08/2014).

It has a high number of holdings (around 70) and the top ten includes internet and health care businesses like F@N Communications, MonotaRO, CyberAgent, M3 and Start Today. It also has businesses like Nihon M&A Center which acts as an introducing agency when business founders are

LWM Consultants Ltd

looking to secure the future of their business with another company and Don Quijote who are a discount store chain.

This approach has been the driver for the returns over the past five years and investors may be attracted to the fund for this reason. However, one of the strategies of Abenomics is the weakening Yen. If this strategy is the driver over the next five years then this will reduce returns for the trust.

In 2013 the trust posted a return of 55.51%, however as the Yen weakened in the last six months of 2013 the return for those six months was just over 6% meaning that most of the returns were secured when the Yen was stronger. We have seen the same this year as the Yen has remained subdued the returns have been stronger than hedged funds but this could reverse.

The challenge for an investor is where they feel the Yen will be in the future, will it 'Yo Yo' in which case this fund will likely do the same posting strong or weak returns in congruence with the Yen. As it demonstrated in 2013 if the headwind is strong enough this can still deliver significant upside. However, it is invested in high octane business which can fall out of favour so there could be a double negative whammy!

A hedge fund could suffer this as well but it depends on its investment strategy which may protect from the double whammy.

The trust can (and has in the past) adopt a hedge strategy and the board discuss this on a regular basis.

In conclusion for investors the story is appealing; 'new Japan' is clearly a growth area and the managers have significant experience in this. However, although the performance has been strong over the last five years with a weakening Yen, it is not clear if this fund can continue to deliver these types of returns in the future.

Fund performance

Performance for the past five years vs GLG, Japan CoreAlpha Fund, Neptune Japan Opportunities Fund and db x-trackers MSCI Japan Fund is shown below:

	2009	2010	2011	2012	2013	2014
Baillie Gifford Shin Nippon Investment Trust	24.19%	38.53%	0.47%	24.11%	55.51%	-6.20%
GLG Japan CoreAlpha Fund	9.35%	24.28%	-16.64%	0.48%	31.61%	-7.86%
Neptune Japan Opportunities Fund	5.25%	-0.11%	-21.57%	17.15%	50.74%	-14.20%
Db x-trackers MSCI Japan ETF	-7.12%	17.46%	-14.46%	3.73%	24.61%	-10.23%

You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced.

Conclusion

For individuals who believe this time is different then this fund stands out from the crowd with its focus on new Japan. However, although the performance over the last five years has been exceptional with a weakening Yen it is unclear how the trust can respond to this and whether a Yen hedged option may be better. It is also worth remembering that the board can adopt a Yen hedge and they have in the past.

The source of information in this note has been provided by Baillie Gifford and is correct as at April 2014. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase any fund mentioned. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well rise.