SHINING A LIGHT ON……
NEPTUNE JAPAN OPPORTUNITIES FUND

At a glance

Investing in Japan is like marmite; you either love it or hate it. For many investors Japan is full of many false dawns, and very few remember the growth in the market from the fifties through to the end of the eighties.

It is a complex region and many investors consider that the risk of investing in the area against the potential returns doesn't match. However, some are arguing that this time is different. This phrase worries me because many will say that and then nothing happens.

However, perhaps there is some truth in this with Japan. A new government came into power in 2012 and where they are different is twofold firstly they have an overall majority in government and secondly of their party. This gives them the freedom to push through reform and we are starting to see the benefits of this.

One fund we have followed for some time is the Neptune Japan Opportunities Fund; this is a high conviction portfolio of 46 holdings and is different to most funds out in the market. The key differences are twofold, firstly the manager uses a Yen hedge and secondly, he focuses on Japanese companies where the majority of their earnings are delivered outside of Japan. His argument is that Japan is all about the companies and not the country and we will cover that further in the update.

The Yen is also important for two reasons, he believes that as a consequence of the reforms the Yen will weaken and therefore if investors don't hedge then any returns will be reduced. As an example against the GLG Fund; GLG made all of its returns for 2013 in the first six months, when the Yen weakened in the last six months the returns were flat. Over the same period Neptune was flat in the first six months but significantly outperformed both the index and GLG for the year based on the last six months performance.

The manager has never wavered from his belief and strategy and investors need to understand that this fund is different to others in the sector and the key is that outperformance has been driven not only through stock selection, but also by hedging the Yen. This makes the fund significantly more volatile than both the sector and GLG Fund.

In this update we will outline some of the current thoughts from the fund manager.

Who are the team behind the fund?

The fund is managed by Chris Taylor.

Chris graduated from Oxford University in 1980 with a BA in Physiological Sciences and The City University Business School in 1981 with an MBA in Finance. He then joined County Bank International Investments, a part of NatWest, as European Equity Manager. Subsequently, he has worked at Enskilda Securities as Head of Scandinavian Equities and in New York as Global Equity Fund Manager for Swiss American Asset Management, part of the Credit Suisse group. Latterly he returned to the UK to join Fuji Investment Management, where he progressed to Managing Director during his fifteen year tenure. Chris joined Neptune as Head of Research in June 2004.

The fund is about Chris and that is an additional consideration for potential investors. If he left then the question is could the performance be repeated with a different manager and would they follow his style of management.

Fund highlights?

Chris started by outlining the companies he likes. He believes many analysts are missing the change in corporate Japan. Many strong companies have moved from export only models to global multinationals. By this he means the majority of the earnings are delivered outside of Japan. A weakening yen therefore boasts the value of overseas earnings for these businesses (and importantly tax revenue for the government).

Effectively, the majority of the fund is invested in global multinationals rather than domestic focused companies. Of course this only works if the political environment is favourable and the new government is supportive of change. The policies currently being used are no different to the past but the tools used to deliver them are. A consequence of the changes which is to ultimately reduce the deficit is to weaken the yen.

Chris touched on this further because this is the thesis for investing in his fund and investors have to believe in this otherwise they could invest in any Japanese Fund. Increased tax revenues are the only way to reduce the deficit however many companies and individuals do not earn enough to pay tax and in fact perhaps only around 150 companies are big enough to make a difference.

If their profits increase then they will pay more tax, it will generate more employment and increases wages. It will also feed down to the smaller suppliers who tend to be based in Japan and have been squeezed by the larger corporates.

This touches on Chris' argument that those companies which will do well are those which invest outside of Japan, and are not restricted to the domestic market. He used an example of the Auto industry where 63% of production is outside of Japan, and exports have fallen to 17.3%. He explained this is across the industry.

Many of these companies are cash rich and in comparison to the global market are cheap because of the perceived risk. He used an example which showed the global index had increased by 2662.63% since 1982, in comparison the Topix is up just 267.64%. The point is that if there is just a slight correction in values the Topix has a considerable amount of potential to deliver positively in an upward direction. Added to this if the Yen weakens further then the only way to gain exposure to that growth is through hedging the Yen because what you gain you will lose if you don't hedge. This can be seen in the last six months of 2013.

It is a concentrated portfolio of 46 holdings and we touched on the volatility, the index has a volatility of 12.35% whereas this fund is 19.53%. The GLG Fund is at 15.71%. Therefore investing in the fund will not be smooth. Clearly the point of difference is the investment in global multinationals and hedging the Yen and investors in the fund have to believe in this to understand at what time the fund will do well and when it won't.

Some investors who think the idea of hedging is good but are worried that if the strategy fails they will lose may consider blending the fund with a non-hedged fund. Or others may consider that this time isn't different and are prepared to wait and see if anything changes.

One thing for investors to consider is what Japanese investors are doing. There are two significant changes – firstly the largest pension fund has been negative equities for years, they have just started to increase their weighting to domestic and overseas equities and secondly the Nippon ISA enables investors to hold shares in the Japanese market for five years and take the proceeds tax free at the end of that period. One of the additional weaknesses in the Japanese market is the lack of domestic investors, this will take time to reverse but these signs are important.

In conclusion there are two things for investors to consider. Firstly do they believe this time is different and therefore are they prepared to hold for the long term to gain the benefit of this, and secondly if they do, do they believe the thesis of Chris that the only way to get maximum benefit from this is via hedging the Yen in which case this is where his fund will work to deliver the strongest returns.

Over 1, 3 and 5 years he has significantly outperformed the index but at significant more volatility and there is no guarantee that this will continue. For those who believe in the Japanese story but not sure on the hedge, a blended approach is an alternative option to consider.

Fund performance

Performance for the past five year's vs GLG Japan CoreAlpha Fund and db x-trackers MSCI Japan Fund is shown below:

	2009	**2010**	**2011**	**2012**	**2013**	**2014**
Neptune Japan Opportunities Fund	5.25%	-0.11%	-21.57%	17.15%	50.74%	1.30%
GLG Japan CoreAlpha Fund	9.35%	24.28%	-16.64%	0.48%	31.61%	0.03%
Db x-trackers MSCI Japan ETF	-7.12%	17.46%	-14.46%	3.73%	24.61%	-0.52%

	12 months	**3 years**	**5 years**
Neptune Japan Opportunities Fund	11.07%	69.93%	40.51%
GLG Japan CoreAlpha Fund	1.46%	25.50%	27.85%
Db x-trackers MSCI Japan ETF	0.12%	24.98%	27.29%

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

Many investors in Japan have seen short periods of outperformance followed by prolonged periods of underperformance. There is an argument that this time is different but there is no guarantee that this is the case. If investors believe this to be the case then now could be a good time to invest. This fund is worthy of consideration if investors believe the yen weakness will play a significant part in the overall reforms. The manager has demonstrated a good track record and a consistent investment style.