James Carthew: Japan trusts backing internet winners and streamlining cash sinners

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There has been more than one way tap value in Japan's strongly performing stock market.

Last summer I looked at JPMorgan Japanese (JFJ), which was the leading investment trust specialising in the country at the time, and it still is!

Fund managers Nicholas Weindling and Miyako Urabe have hit a sweet spot in performance terms. The trust just about doubled from the low point in the panicky markets of March 2020 to the end of December. Its share price is up 58% over the past 12 months.

There were good reasons why Japan did relatively well last year. In common with neighbours such as Korea and Taiwan, it managed to get Covid-19 under control, helped by being an island and having strict border controls – why didn't we think of that?

Its companies also tended to have a fair bit of cash on their balance sheets, which allowed them to ride out the storm – Japan still had a big economic hit in the second quarter of 2020.

Where JFJ got it right was being in exactly the sorts of stocks that were beneficiaries of the crisis. These included companies providing online medical consultations, online retail, video games, cloud security and robotics. The fund managers point out that Japan is behind many other countries in its adoption of things that we take for granted such as cashless payments.

Its top-performing companies include the company behind the Japanese equivalent of Adobe's DocuSign (it is still normal for companies to approve contracts with ink stamps known as hanko) and a boutique specialising in mergers and acquisitions.

That latter company, Nihon M&A Center, is a beneficiary of a rising tide of corporate activity in Japan. In part, this is driven by its ageing population. Business founders are often way past normal retirement age and looking for an exit. Another driver has been the trend of improving corporate governance, part of which involves unwinding cross-shareholdings. A corporate governance code was introduced in 2015 and strengthened in 2018.

We have a few trusts profiting from this trend of improving corporate governance. The first dedicated to this thesis was AVI Japan Opportunity (AJOT), which launched in October 2018. It was born out of the experience that AVI Global (AGT) had built up in the country. Profiting from cash/asset rich Japanese companies is still a key theme within that trust. The newer kid on the block is Nippon Active Value Fund (NAVF), which is approaching its first birthday.

It is fair to say that the dedicated corporate governance funds did not keep pace with the likes of JFJ over 2020. The sorts of companies that they target tend to be more towards the value rather than the growth end of the market.

There is another problem too, if you are trying to persuade a company that it is overcapitalized and then along comes an event like Covid-19, they can legitimately turn around and claim that hanging onto rainy day money was justified.

Nevertheless, there are still many situations where boards, managers and other investors know that the writing is on the wall and it is time to hand back cash to shareholders.

AVI's approach to activism is to keep it behind the scenes as much as possible. The hedge funds that go in all guns blazing often stir up resistance. It is better to achieve consensus where possible. That does not mean that they will never go public. In the past, AVI has published detailed analysis of companies it holds with the aim of highlighting inefficiencies and opportunities, and winning support from fellow shareholders.

AVI also says it targets cash-generative companies with robust underlying businesses. It can take time to achieve the desired result and they want to be able to take a long-term view.

One example that it cites is Fujitec, one of a narrow group of elevator manufacturers, competing with the likes of Otis, Kone and Schindler. AVI believed that the company was not sufficiently focused on the money that it could make servicing the lifts it had installed.

It also thought Fujitec was wasting its time trying to compete in too many markets. AVI published its research on the company, which included recommendations of ways to drive up margins and returns on invested capital. In December, Fujitec published the findings of a strategic review, promising a shift in the right direction and to shed its 'poison pill' arrangements that block any unsolicited takeover. The shares have risen by more than 20% since the announcement.

This is not the only success notched up by these corporate governance funds in recent months. NAVF has pulled off a successful exit from a stake it had built up in Sakai Ovex. This company creates fabrics from man-made polyester and nylon – weaving, knitting, dyeing, finishing and printing these. It is also developing a carbon fibre business, which would be used in fields such as aerospace, building, civil engineering, transportation and shipbuilding rather than apparel.

Last November, NAVF suggested that the Sakai Ovex board consider a management buyout priced at 2,350 yen per share. In the event, the president of the company used a special purpose vehicle to launch a tender offer for stock at 2,850 yen. NAVF's in-price was 2,059 yen.

These success stories illustrate the rewards available to these trusts if they can unlock the value trapped within these companies. There is still money to be made in Japan, whether you back the funds hunting out tomorrow's winners or those strealining established businesses.

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