

Fidelity Japan Trust

Established, on-the-ground expertise in Japan

Fidelity Japan Trust (FJV) has a bottom-up, research-intensive investment process, a flexible approach to gearing and a focus on stocks across the market cap spectrum that offer growth at a reasonable price (GARP). Lead manager, Nicholas Price, has just notched up three years in charge, but has been with Fidelity in Japan for 25 years, first as part of the well-resourced analyst team and later as a portfolio manager across a range of mandates. FJV was known as Fidelity Japanese Values until May 2018, but changed its name as one of a number of administrative changes designed to align with the trust's all-cap, growth-focused strategy. Short- and longer-term performance have been strong, both in absolute terms and relative to indices; the discount widened over the summer while NAV performance remained positive, supporting near-term re-rating potential.

12 months ending	Share price (%)	NAV (%)	Blended benchmark (%)	TOPIX (%)	R/Nomura Mid & Small Cap Japan (%)	FTSE All-Share (%)
31/08/14	7.7	10.2	8.0	3.7	8.0	10.3
31/08/15	10.7	13.0	15.2	13.4	15.2	(2.3)
31/08/16	22.6	15.0	22.0	21.5	22.0	11.7
31/08/17	26.3	32.0	22.9	18.8	22.9	14.3
31/08/18	21.4	21.9	8.3	7.8	6.9	4.7

Source: Thomson Datastream. Note: All % on a total return basis in pounds sterling. Blended benchmark is mid- and small-cap Japan index until 22 May 2018 and TOPIX index thereafter.

Investment strategy: Research-intensive GARP

Fidelity's large, on-the-ground presence in Japan, with 13 dedicated analysts, allows it to unearth opportunities in a market where less than 10% of companies are well covered by the sell side. FJV manager Nicholas Price uses the analysts' research, as well as his own ideas, to build a portfolio of 80-110 companies where valuations do not reflect medium-term growth potential. He invests across the size spectrum, with a bias towards mid/small-caps and a preference for well-managed companies with strong brands, and growing revenues and profitability. Gearing is actively managed in a range of +/-25% of net assets, averaging 17.6% in the year to 31 July 2018.

Market outlook: Growth picked up in Q2

Japanese equity markets have responded well to Abenomics and the sustained growth in corporate earnings since 2013, significantly outperforming the UK market in sterling terms. Real GDP grew at an annualised 3.0% in Q218 after contracting for the first time in two years in Q1. Meanwhile, equity valuations remain reasonable versus history and relative to other global markets.

Valuation: Wider-than-average discount to NAV

At 17 September 2018, FJV's shares traded at a 12.2% discount to cum-income NAV. This was wider than the 10.3% average over one year, but narrower than the 12-month high of 17.1% seen in April 2018 and the averages over three, five and 10 years (range of 12.4% to 13.6%). FJV's board recently bought back shares for the first time since March 2017, repurchasing 325,500 shares. As the recent discount widening was largely a result of the share price falling while the NAV rose, there is scope for it to narrow again if sentiment improves.

Initiation of coverage

Investment trusts

18 September 2018

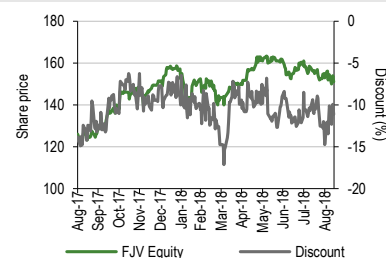
Price 151.0p
Market cap £204.3m
AUM £273.9m

NAV* 172.2p
Discount to NAV 12.3%

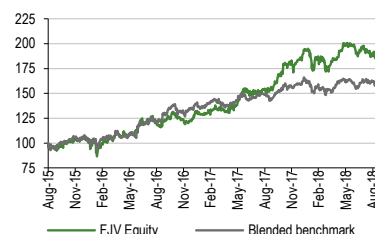
*Including income. As at 17 September 2018.

Yield 0.0%
Ordinary shares in issue 135.3m
Code FJV
Primary exchange LSE
AIC sector Japan
Benchmark TOPIX

Share price/discount performance



Three-year performance vs index



52-week high/low 163.5p 124.5p
NAV** high/low 184.4p 140.9p

**Including income.

Gearing

Gross market gearing* 13.7%
Net market gearing* 13.7%

*As at 31 July 2018.

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[Edison profile page](#)

Fidelity Japan Trust is a research client of Edison Investment Research Limited

Exhibit 1: Trust at a glance
Investment objective and fund background

Fidelity Japan Trust (formerly Fidelity Japanese Values) aims to achieve long-term capital growth by investing predominantly in equities and related securities of Japanese companies. Although its investment approach remains unchanged, it has recently changed its benchmark from a mid- and small-cap Japan index to the TOPIX index (total return, in sterling terms), and its AIC sector from Japanese Smaller Companies to Japan.

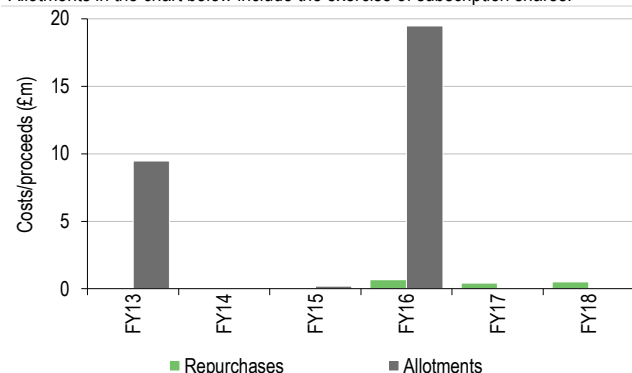
Recent developments

- 31 July 2018: Results for the half-year ended 30 June 2018. NAV TR +8.3% and share price TR +6.8%, compared with +0.5% for the reference index (Russell/Nomura Mid & Small Cap Japan including dividends until 22 May and TOPIX Total Return thereafter), all in sterling terms.
- 23 May 2018: Change of name from Fidelity Japanese Values to Fidelity Japan Trust following approval of changes to name, AIC sector and benchmark at FY17 AGM on 22 May.

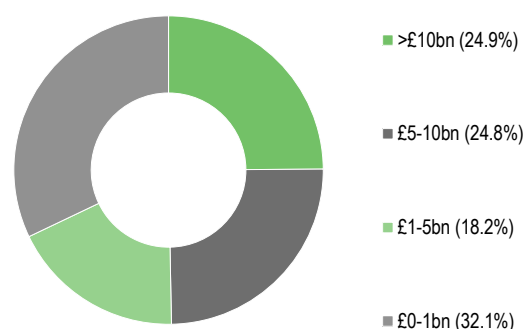
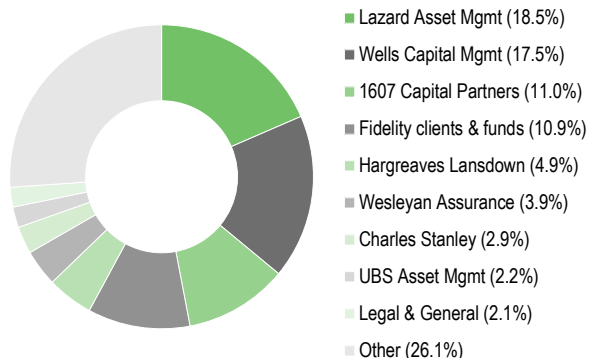
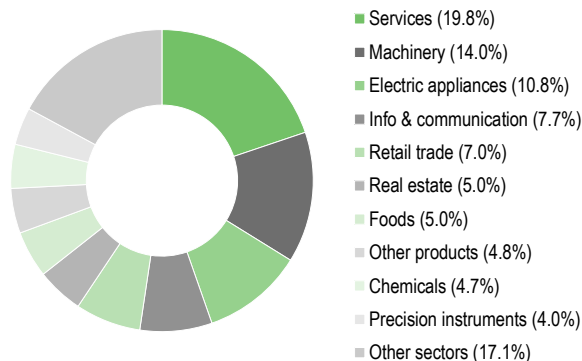
Forthcoming		Capital structure		Fund details	
AGM	May 2019	Ongoing charges	0.95% (prospective)	Group	FIL Investments International
Annual results	March 2019	Net gearing	13.7%	Manager	Nicholas Price
Year end	31 December	Annual mgmt fee	Variable (see page 10)	Address	Beech Gate, Millfield Lane, Lower Kingswood, Tadworth, Surrey, KT20 6RP
Dividend paid	None	Performance fee	None (see page 10)	Phone	0800 41 41 10 or 0800 41 41 81 (IFAs)
Launch date	15 March 1994	Trust life	Indefinite, subject to vote	Website	www.fidelityinvestmenttrusts.com
Continuation vote	Three-yearly, next 2019	Loan facilities	None (see page 10)		

Share buyback policy and history (financial years)

Renewed annually, FJV has the authority to repurchase up to 14.99% of shares and allot shares up to the equivalent of 5% of the issued share capital. Allotments in the chart below include the exercise of subscription shares.


Market capitalisation breakdown (in sterling, as at 31 July 2018)

Figures adjusted for gearing. FJV is heavily overweight small and mid-cap growth stocks, has broadly neutral exposure to large-cap growth and small-cap value stocks, and is very underweight large and mid-cap value stocks.


Shareholder base (as at 31 July 2018)

Portfolio exposure by sector (adjusted for gearing, as at 31 July 2018)

Top 10 holdings by net long position (as at 31 July 2018)

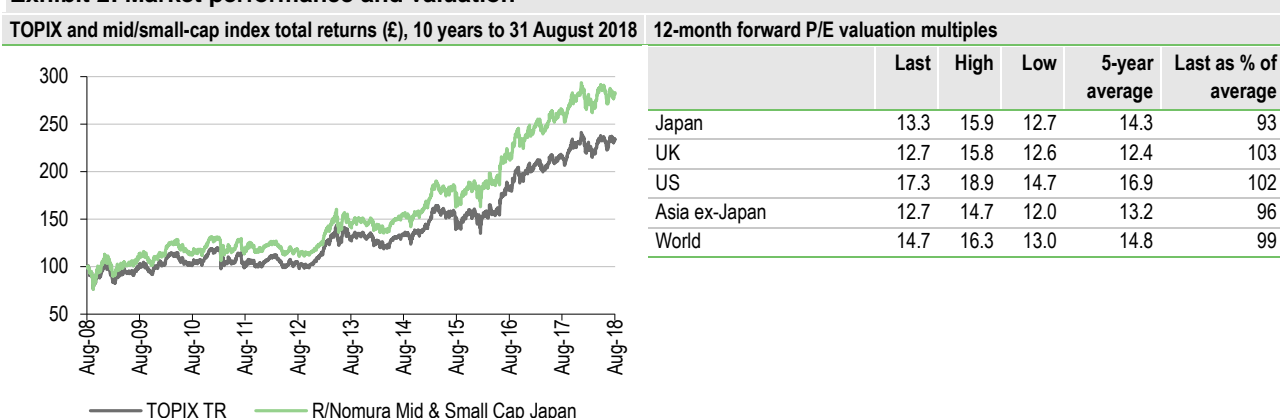
Company	Sector	% of NAV	
		31 July 2018	31 July 2017*
Makita Corp	Machinery	6.3	4.5
Recruit Holdings	Services	6.1	5.6
M3 Inc	Services	4.9	4.8
Daikin Industries	Machinery	4.3	5.1
Yamaha Corp	Other products	4.2	4.7
Sysmex Corporation	Electric appliances	4.0	N/A
Japan Tobacco	Foods	3.6	N/A
Misumi Group	Wholesale trade	2.9	N/A
Ryohin Keikaku	Retail trade	2.8	4.6
Asahi Intecc	Precision instruments	2.6	N/A
Top 10 (% of portfolio)		41.7	47.7

Source: Fidelity Japan Trust, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in July 2017 top 10.

Market outlook: Value and growth still available

Japan is arguably not on the radar of many UK retail investors. As one of the economic miracles of the post-Second World War era, Japan's economy was second only to the US in size until the early 2000s, when it was overtaken by China. But the rapid expansion caused a huge bubble in asset prices (including stocks and real estate) that burst in the late 1980s, from which normalisation has been painfully slow. Having reached an all-time high of 38,916 points in 1989, the blue-chip Nikkei 225 index sank during the country's long years of deflation, reaching a low of 7,055 points in March 2009. While the UK's blue-chip FTSE 100 index has roughly doubled since then, the Nikkei has trebled, and now stands at c 23,500 points. However, while Japan remains the world's second largest stock market, at 7.5% of the MSCI AC World index, at 31 July 2018 it made up only a little over 2% of UK investors' equity portfolios, according to figures from the Investment Association and the Association of Investment Companies, covering open-ended and closed-ended funds respectively.

Exhibit 2: Market performance and valuation



Source: Thomson Datastream, Edison Investment Research. Note: Valuation data at 17 September 2018, using Datastream indices.

As shown in Exhibit 2 (left-hand side), after four years of largely flat returns, Japanese equities have performed well in sterling terms since 2013, with the broad TOPIX index producing total returns of 83.1% and the mid and small-cap index returning 99.4%, compared with 44.1% for the FTSE All-Share index. The market has been buoyed by the 'Abenomics' programme under prime minister Shinzo Abe, which combines fiscal expansion, monetary easing and structural reform. While Japan may be some way off its target of 2% inflation (the 10-year government bond still yields close to zero, with short-term interest rates negative), GDP growth picked up to an annualised 3.0% in Q218, although a mild slowdown appears likely for the balance of the year, given the recent spate of natural disasters in Japan, and the risk of slower growth in capex amid a slowdown in the global economy and weaker exports. Meanwhile, as shown in the table, Japan's equity valuations remain reasonable versus the rest of the world, with the market's 12-month forward P/E ratio below its five-year average.

Part of the reason for UK investors' lack of exposure could be the memory of the extended market decline following the late-1980s bubble, although arguably unfamiliarity with the current generation of fast-growing Japanese companies could be a more significant factor. In such a case, investors may favour a fund managed by a locally based team with the research capability to uncover hidden gems.

Fund profile: Seeking growth at a reasonable price

Fidelity Japan Trust (FJV) was launched in March 1994 as Fidelity Japanese Values, changing its name in May 2018 as one of a number of refinements (see Recent developments below). Since 1 September 2015, it has been managed by Nicholas Price, a Tokyo-based member of Fidelity's Japanese equities team, who has been with the firm since 1993. Price also manages the open-

ended FIJ Japan Growth, FF Japan Aggressive and FIJ Japan Aggressive Growth funds, as well as a number of segregated mandates. All the funds are run on broadly similar lines, although FJV's closed-ended structure gives it the ability to gear, which allows the manager to run a higher-conviction portfolio with larger percentage positions in favoured stocks.

FJV aims to achieve long-term capital growth by investing in Japanese companies whose growth prospects are not fully recognised by the market. It has a flexible, all-cap approach, with a bias to less well-researched mid-cap and smaller companies, where Fidelity's considerable analyst resources can uncover potential growth opportunities. Following recent changes to its benchmark and peer group, FJV now measures its performance with reference to the Tokyo Stock Exchange TOPIX Total Return index (in sterling terms), and is a member of the Association of Investment Companies' Japan sector. Gearing is obtained through contracts for differences (CFDs), within a normal working limit of up to 25% of net assets without prior board approval.

Recent developments

FJV has recently undergone a number of changes, including to its name, peer group, benchmark, objective, investment policy and fee structure. Rather than signifying any changes in strategy, however, these developments were designed to reflect how the trust is managed in practice.

- **Change of name to Fidelity Japan Trust from Fidelity Japanese Values**, because the investment style of the trust is 'growth at a reasonable price', rather than value investing. This was effective from 24 May 2018.
- **Change of peer group from AIC Japanese Smaller Companies to AIC Japan**. Although FJV has a bias towards mid-caps, the investment strategy is all-cap and the trust holds a number of large-cap stocks as well as mid- and small-caps. This was effective from 28 May 2018.
- **Change of benchmark** from a mid- and small-cap Japan index (with dividends, in sterling) to the TOPIX Total Return index (in sterling), again to reflect the flexible, all-cap approach, with effect from 23 May 2018.
- **Change to investment objective**. The objective was amended to remove reference to a 'portfolio of securities primarily of small and medium-sized Japanese companies listed or traded on Japanese stock markets'. With effect from 22 May 2018, FJV's new objective is to achieve long-term capital growth by investing in equities and their related securities of Japanese companies.
- **Changes to investment policy** to codify the manager's investment approach, with minor amendments to the policies on cash and gearing. With effect from 22 May 2018, the investment policy is summarised as follows: 'The company will primarily invest in companies which are listed on Japanese stock exchanges. The portfolio is selected by the investment manager on the basis of its assessment of the fundamental value available in individual situations and with a typical focus on those companies whose growth prospects are not fully recognised by the market ("growth at a reasonable price"). Whilst the company's overall exposure to individual companies and industry sectors is monitored, the portfolio is not restricted in terms of size and industry, although certain investment restrictions apply in an attempt to diversify risk.' These guidelines or restrictions are largely unchanged and are detailed on page 6 under 'Investment process'. The new policy states that gearing will be obtained through CFDs, and that cash and cash equivalents, including money market instruments, will not exceed 25% of gross assets, not including amounts required as collateral to cover unrealised losses on derivatives.
- **Changes to fee structure**: with effect from 1 July 2018, the base management fee was revised from 0.85% of gross assets to 0.70% of net assets, with a variable element under which it could be reduced to a minimum of 0.50% if FJV underperforms its benchmark or increased to a maximum of 0.90% if the trust outperforms. See Capital structure and fees on pages 10-11 for an assessment of the likely impact of the change.

The fund manager: Nicholas Price

Investment opportunities: Demographic change and automation

Japan's demographic problems, with a low birth rate and an ageing population leading to a shrinking workforce, have been well documented over many years. With 98% of Japan's recent graduates gaining employment in the most recent hiring season, and a high jobs-to-applicants ratio in lower-skilled areas such as factory work and social care, Price says that higher wage inflation should gradually emerge (increasing workers' disposable incomes); it has been running at 1.5-2.0%, but even this is significant in a country where deflation had become a way of life.

Price argues that the responses to the demographic challenges are feeding investment opportunities in many areas. A shortage of factory labour has driven significant advances in factory automation, with key Japanese players such as Keyence and Misumi Group expanding into other tight labour markets like China (where wage growth has been significant, putting pressure on manufacturers to cut costs) and the US. A change in the law requiring Japanese employers to give temporary workers full employment rights has made the outsourcing of non-permanent staff, through companies such as UT Group, more appealing. Meanwhile, conditions are becoming easier for overseas workers, with a new visa scheme from 2019 set to tackle acute labour shortages in five areas: nursing, agriculture, shipping, hospitality and construction. This is positive for global recruitment portals such as Recruit Holdings (the owner of Indeed and Glassdoor), currently FJV's second-largest position.

Price sometimes buys into unlisted companies, such as online printing and logistics firm Raksul, which came to market in May 2018; the value of FJV's original investment in the company quadrupled following the IPO. Price comments that IPOs themselves can be relatively unattractive from a long-term investment perspective, with small parcels of stock coming to market that may then double in price on the first day of trading, propelling P/E valuations to as much as 70-80x, before declining over the immediate post-IPO period. He argues that a better time to buy a relatively new listed company is a year down the line, when initial lockups have expired and there is often still no analyst coverage. Stocks bought on this basis include Kamakura Shinsho (currently with a market cap of c £300m), a funeral services company with an online burial plot-finding service. Price says that Japanese people typically spend much more on funerals and graves than their peers in the UK or US (perhaps up to £16,000 compared with an average of c £5,000 in the UK), and as people in their 50s and 60s are now more internet-savvy, they are more likely to turn to an online service when thinking about their options.

Exhibit 3: FJV portfolio characteristics versus TOPIX Total Return index

	FJV	TOPIX
Median market cap (£bn)	5.8	13.5
12m estimated earnings growth (%)	17.0	9.7
Price/earnings ratio (x)	19.2	13.3
Price/book ratio (x)	2.7	1.3
Return on equity (%)	12.2	9.5

Source: Fidelity Japan Trust, Edison Investment Research, as at 30 June 2018

As shown in Exhibit 3, FJV's portfolio has a higher average P/E than the market, but also a much higher rate of earnings growth to justify the ratings. Three of the largest sectors in the TOPIX index are also among the cheapest, but Price comments that they are all cheap for a reason: banks are lowly rated because of financial repression; car makers are cheap because of elevated capex requirements and the potential impact of Donald Trump's global trade war; and telecoms are out of favour because Japan's ageing population means there are fewer data-hungry young consumers driving revenues.

Asset allocation

Investment process: Finding hidden gems across the market

FJV is an actively managed fund with a bottom-up investment process that draws heavily on Fidelity's proprietary research capabilities. Fidelity has had a presence in Japan – its first office outside its native US – since 1969, and there are 13 equity analysts in the firm's Tokyo office as part of a global research network of c 140 analysts. FJV manager Nicholas Price was a member of the analyst team for seven years before becoming a portfolio manager in 2000.

The investment style is growth at a reasonable price, with the aim of achieving capital growth in excess of the reference index (now the TOPIX Total Return index). The investment universe of more than 2,000 stocks includes those listed on a range of Tokyo and regional exchanges, as well as unlisted companies (where up to 10% of the portfolio can be invested). Typically, c 70% of the names in the portfolio are ideas identified by the analyst team, with c 30% coming directly from the manager, who is fluent in Japanese and draws on a range of information sources, such as industry conferences, the media and academics, to identify promising new business models.

The multi-cap portfolio typically contains 80-110 holdings, with a reasonably high level of conviction in the largest holdings (at end-H118, the top 10 positions accounted for c 42% of NAV, and the top 20 made up c 63%). The investment horizon is typically one to three years, and there are strong buy and sell disciplines.

While the approach is largely unconstrained, the investment policy sets out certain guidelines, and there are also informal limits on exposures. A single company or group of companies (including any CFD exposure) may make up no more than 12% of the portfolio at the time of investment, and positions are typically a maximum of 6pp over or under their benchmark weighting. (As the largest stock in the TOPIX, Toyota Motor Corporation, is only c 3.6% of the index, a 6pp underweight is purely notional.) Furthermore, FJV cannot own more than 7.5% of the shares of a single company, or 10% for a group of companies. The maximum that can be held in unlisted companies is 10% of NAV (increased from 5% in May 2018) at the time of investment. Unlisted investments are typically only held where there is a reasonable expectation that they will come to market within a year or two. Sector positions (based on TOPIX sectors, of which there are 33) are a result of bottom-up stock picking, but will typically not exceed 10pp above or below the index weighting. (At 31 July 2018, only one sector, electric appliances, made up more than 10% of the TOPIX, so FJV is effectively free to zero-weight almost any sector.)

Price explains that there is far less analyst coverage of Japanese stocks than in other markets. Fewer than 10% of the TOPIX constituents are covered by more than five sell-side analysts, with more than half the index having no coverage at all. This means fund management groups with locally based analysts are well placed to capitalise on under-researched opportunities. Fidelity's Tokyo-based analyst team typically has c 400-500 stocks under coverage, and the team can also draw on the firm's wider team of analysts around the world, who may assess Japanese stocks with international business models. Price typically conducts c 400 company meetings each year, both public and private, across the size spectrum.

The manager looks closely at businesses to assess sustainability and barriers to entry, valuations, liquidity and upside versus downside potential. He looks for a three- to five-year runway of growth, returns on equity (ROE) in excess of 10% a year, shareholder-friendly management, and reasonable valuations. This naturally leads to a bias towards mid/small-cap growth companies, which Price says tend to have better business models and ROEs, and management teams that are more incentivised in terms of shareholder returns. Valuations are assessed versus the medium-term earnings outlook as well as relative to historical ranges and industry peers, both domestically and internationally. The manager has a preference for companies with strong domestic brands and

competitive positions, that are starting to expand within Asia and globally. To be considered for selection, stocks should have growth prospects that are above average for their industry and are supported by secular trends, as well as top-line growth with improving profitability, and earnings that surprise on the upside rather than the downside. A smaller part of the portfolio focuses on turnaround situations that have underperformed on a 12- to 24-month basis and are trading on historically low valuations. Fidelity's analysts continue to cover stocks actively after their initial research, producing a fundamental research report at least every 120 days, and assigning all stocks a rating of between 1 and 5. The fund manager monitors the valuations of portfolio holdings on a daily basis.

FJV's portfolio construction is disciplined, with position sizes driven by the manager's conviction in a company's growth prospects, liquidity (particularly important for smaller companies) and potential upside. Long CFDs may be used to add gearing to individual holdings. Positions are managed dynamically, with the manager trimming positions to lock in gains as stocks approach their target price, and recycling proceeds into new names. Correlations between stocks are regularly assessed.

Central to the process in terms of both buy and sell disciplines is a focus on identifying signs of change. There may be a change in fundamentals, such as a company moving into a new product segment or market; a change in industry environment, such as consolidation among rivals or a new regulatory framework; a change in sentiment, such as where a disconnect occurs between short-term investor perceptions and medium-term fundamentals; or a change in the market's valuation methodology, such as a move from valuing a company based on its future earnings to focusing on its book value. Positive changes can result in a re-rating – giving an advantage to those investors who can spot the signs of change before others do – while negative changes in sentiment offer the opportunity to buy good companies while their share prices are depressed.

Holdings may be sold completely when they have achieved their target price, or where a change in the earnings outlook means a stock starts to look overvalued at its current share price. A change in fundamentals may also result in a position being exited, as may the identification of a potential new holding with better growth prospects. The active approach to managing individual positions means portfolio turnover is typically c 80-100% a year.

Current portfolio positioning

At end-H118 (30 June) there were 96 companies in the FJV portfolio, in the middle of the 80-110 stock range. At 31 July 2018, the top 10 holdings by net long position (including CFDs) accounted for 41.7% of NAV, a decrease in concentration from 47.7% a year earlier. The top 10 holdings (see Exhibit 1) also accounted for the 10 largest overweight positions versus the index.

Exhibit 4: Portfolio sector exposure vs TOPIX index (% unless stated)

	Portfolio end- July 2018	Portfolio end- July 2017	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Services	19.1	16.1	2.9	4.5	14.6	4.2
Machinery	13.5	11.6	1.8	5.2	8.3	2.6
Electric appliances	10.4	12.6	(2.2)	13.6	(3.2)	0.8
Info & communication	7.5	8.1	(0.6)	7.8	(0.3)	1.0
Retail trade	6.8	8.8	(2.0)	4.8	2.0	1.4
Real estate	4.8	3.5	1.4	2.4	2.4	2.0
Foods	4.8	N/S	N/A	4.2	0.6	1.1
Other products	4.6	8.2	(3.6)	2.0	2.6	2.3
Chemicals	4.5	N/S	N/A	7.5	(3.0)	0.6
Precision instruments	3.9	N/S	N/A	1.8	2.1	2.2
Pharmaceuticals	N/S	6.6	N/A	4.8	N/A	N/A
Transportation equipment	3.8	5.0	N/A	8.7	(4.9)	0.4
Rubber products	N/S	3.2	N/A	0.8	N/A	N/A
Banks	0.0	N/S	N/A	6.9	(6.9)	0.0
Other sectors	16.4	16.3	0.1	25.0	(8.6)	0.7
Total	100.0	100.0		100.0		

Source: Fidelity Japan Trust, Edison Investment Research. Note: Adjusted for gearing. N/S = not separately stated; may be included in 'other sectors'.

While the portfolio is constructed on a bottom-up basis (as shown in Exhibits 4 and 5, sector and market cap weightings diverge dramatically from those of the index), the manager has identified a number of themes at play in the portfolio. Internet-based job portals such as Recruit Holdings, which are helping to address demographically driven labour shortages in areas like elderly and nursing care, form part of a more general e-commerce/internet services theme, also expressed in holdings such as professional healthcare portal M3, and Just Eat equivalent Yume no Machi Souzou linkai. Speciality retail is a theme linked to growing consumption across Asia, and includes such stocks as Muji store owner Ryohin Keikaku; Start Today, a domestic Japanese company whose Zozotown app offers easy access to made-to-measure clothing; and Kotobuki Spirits, whose focus on souvenir food items allows it to capitalise on the growth of intra-regional tourism. Other themes include environmental technology/energy efficiency (including tool manufacturer Makita, expanding into cordless garden tools as a result of improvements in battery efficiency; and global air conditioning brand Daikin), and secular growth stocks with strong global positions, such as diagnostic equipment and medical device makers Sysmex and Asahi Intecc.

Exhibit 5: Portfolio market cap exposure vs TOPIX index (% unless stated)

	Portfolio end- July 2018	Portfolio end- July 2017	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
>£10bn	24.9	24.9	0.0	55.5	(30.6)	0.4
£5-10bn	24.8	20.7	4.1	15.7	9.1	1.6
£1-5bn	18.2	21.6	-3.4	20.4	(2.2)	0.9
£0-1bn	32.1	32.7	-0.6	8.5	23.6	3.8
Other index/unclassified	0.0	0.4	(0.4)	0.0	0.0	N/A
Total	100.0	100.0		100.0		

Source: Fidelity Japan Trust, Edison Investment Research. Note: Adjusted for gearing.

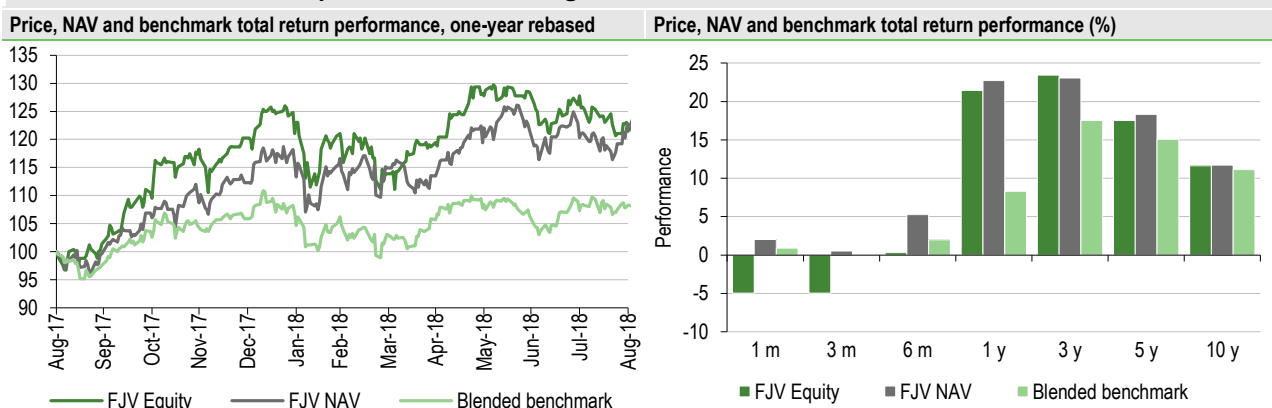
As shown in Exhibit 4, on a sector basis, FJV is overweight in services, machinery, retail, and 'other products', where musical instrument maker Yamaha (benefiting from strong sales growth for its digital pianos in China) is a key holding. The biggest underweight areas include banks (c 7% of the TOPIX index at 31 July 2018 but absent from the FJV portfolio) and transportation equipment, where FJV's only significant exposure is to cycle parts maker Shimano and Suzuki Motor, given the capex requirements on major car makers as they transition from internal combustion engines towards electric vehicles.

In terms of investment style and market capitalisation versus the index, FJV is heavily overweight small and mid-cap growth stocks, has broadly neutral exposure to large-cap growth and small-cap value stocks, and is very underweight large and mid-cap value stocks.

At 13.7%, gearing is currently close to its lowest level in the past year, having been reduced in response to a continued period of strong market performance, which has led to the manager finding fewer compelling opportunities with the right balance of undervalued growth potential.

Performance: Strong medium-term outperformance

After more than two decades of lacklustre performance versus the rest of the world, the Japanese stock market has recovered strongly since the election of Shinzo Abe as prime minister in 2012 and the subsequent introduction of the Abenomics package of structural reforms. FJV has outperformed both its old and its new benchmarks in share price and NAV total return terms over one, three, five and 10 years (Exhibit 6), with annualised returns of between c 12% and c 23%. The picture over the six months to 31 August 2018 was less positive in absolute terms; FJV's NAV rose 5%, but share price returns were affected by a 5% decline during August. NAV outperformance of the benchmark has been sustained over this shorter period too, however.

Exhibit 6: Investment trust performance to 31 August 2018


Source: Thomson Datastream, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised. Blended benchmark is the R/Nomura Mid & Small Cap Japan index (£) until 22 May 2018 and the TOPIX index (£) thereafter.

Exhibit 7: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to TOPIX TR	(5.8)	(4.9)	(1.0)	12.6	20.8	22.5	28.2
NAV relative to TOPIX TR	1.1	0.7	3.9	13.8	19.7	26.8	29.2
Price rel to R/Nomura Mid & Small Cap Japan	(5.4)	(3.3)	(0.3)	13.6	17.4	12.5	6.0
NAV rel to R/Nomura Mid & Small Cap Japan	1.5	2.3	4.6	14.8	16.3	16.4	6.8
Price relative to FTSE All-Share	(2.3)	(3.3)	(5.0)	16.0	40.6	55.6	46.0
NAV relative to FTSE All-Share	4.9	2.3	(0.3)	17.2	39.3	61.1	47.2

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-August 2018. Geometric calculation.

Having taken over management of FJV on 1 September 2015, the three-year performance figures to 31 August 2018 reflect the whole of Nicholas Price's tenure on the trust to date, with NAV and share price total returns of 86.3% and 88.0% respectively, compared with 62.3% for the blended benchmark. Price's track record on FJV versus the benchmark is graphically illustrated in Exhibit 8.

In the 12 months to 30 June 2018, stock selection in the services sector and an almost complete lack of exposure to banks (averaging 0.4%) were among the biggest positive contributors to relative performance, while positions in chemicals stocks detracted from relative returns. At a stock level, the top relative contributors included Recruit Holdings, medical portal M3, Yamaha (musical instruments), temporary staff outsourcing company UT Group and haematology equipment maker Sysmex. With the exception of UT Group, all these positions included long CFD exposure, which boosted returns. The biggest relative detractor was Yonex, a global market leader in badminton equipment, which suffered disappointing sales after a poor roll-out in China. Not holding Toyota Motor, the largest stock in the TOPIX index, also detracted from relative performance.

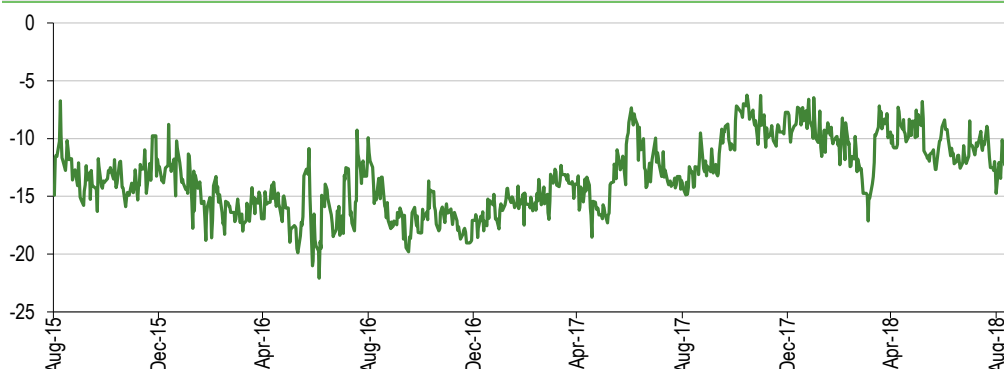
Exhibit 8: NAV total return performance relative to blended benchmark over three years


Source: Thomson Datastream, Edison Investment Research

Discount: Scope to narrow from current level

At 17 September 2018, FJV's shares traded at a 12.2% discount to net asset value. This was wider than the one-year average discount of 10.4%, but narrower than the 12-month high of 17.1% seen in April 2018, and narrower than the average discounts over three, five and 10 years (13.3%, 12.4% and 13.6%, respectively). The discount widened over the summer as a result of the NAV increasing while the share price fell (NAV TR +1.3% in August and share price TR -5.0%), meaning that a pick-up in sentiment could see the discount continue to narrow to a level more in line with the short-term average. FJV's board has authority to buy back shares in order to manage a discount, but in practice does so infrequently; buybacks occurred most recently in September 2018 at a discount of c 12%, in March 2017 at a discount of c 15%, and in October 2016 at a discount of c 17%.

Exhibit 9: Share price discount to NAV (including income) over three years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

FJV is a conventional investment trust, with one class of share since the final exercise of subscription shares in FY16. There are currently 135.3m ordinary shares in issue. The board has the authority, renewed annually, to buy back up to 14.99% of shares or allot shares up to 5% of the issued share capital, in order to manage a discount or a premium. There is no specific level of discount or premium at which buybacks or issuance would be triggered, and in the 12 months to 17 September 2018, 325,500 shares were bought back at a cost of £512,500. A continuation vote takes place every three years, with the next due at the May 2019 AGM. At the last vote in 2016, 99.5% of shareholders voted in favour of continuation.

Gearing is permitted up to a limit of 40% of net assets, with the fund manager having discretion to gear up to 25% without prior board approval. Rather than borrowing money, FJV gears using CFDs, derivative instruments that allow the manager to increase exposure to individual stocks at a fraction of the cost of buying the underlying shares. As with any form of gearing, the use of long CFDs boosts returns from holdings if share prices rise, but will magnify losses in a falling market. Between 31 July 2017 and 31 July 2018, FJV's gross market exposure (equivalent to net gearing) ranged from 13.1% (June 2018) to 23.8% (July 2017), averaging 17.6%. Gearing was 13.7% at 31 July 2018.

Fidelity Investment Services (UK) acts as FJV's Alternative Investment Fund Manager (AIFM) under the AIFM Directive, and delegates management and the role of company secretary to FIL Investments International. Until the end of H118, Fidelity was paid a management fee of 0.85% of gross assets, with no performance fee. Under new fee arrangements in place with effect from 1 July 2018, the calculation basis has been changed from gross to net assets, and the base fee has been reduced to 0.70%, paid quarterly in arrears. Under a new variable fee arrangement, the base

management fee may be increased to a maximum of 0.90% if FJV outperforms its new benchmark, the TOPIX index (total return, in sterling), or reduced to a minimum of 0.50% if the trust underperforms. Given that FJV's gearing averaged 13.4% from 30 June to 31 July 2018, we calculate an immediate positive impact from the change to the calculation basis from gross to net assets, even at the maximum variable fee of 0.90%. Ongoing charges for FY17 were 1.3%; we calculate that if the new base management fee of 0.70% of net assets were applied to the same period (assuming all fixed costs remained the same), the figure would be c 26% lower at 0.96%. This would bring FJV in line with the average for its peer group.

Dividend policy and record

In line with its objective of investing for long-term capital growth, FJV has not paid a dividend for more than 20 years. Japan has not historically been a high-yielding equity market, and although corporate governance reforms are encouraging companies to pay higher dividends, FJV receives a very small amount of revenue return from its portfolio companies (1.2p per share in H118, 1.9p per share in FY17 and 1.9p per share in FY16). This has historically been largely or completely offset by costs charged to the revenue account, which include the management fee and running costs of the investment trust.

Peer group comparison

Exhibit 10: AIC Japan and Japanese Smaller Companies sectors as at 17 September 2018*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (ex-par)	Net gearing	Dividend yield
AIC Japan										
Fidelity Japan Trust	204.3	20.3	95.1	114.8	212.6	1.3	No	(12.2)	115	0.0
Aberdeen Japan	84.3	4.3	43.6	84.5	209.7	1.2	No	(12.4)	111	0.9
Baillie Gifford Japan	761.8	19.2	97.0	135.3	379.3	0.8	No	5.4	112	0.0
CC Japan Income & Growth	196.6	14.6	--	--	--	1.2	No	3.1	120	2.3
JPMorgan Japanese	720.8	19.6	78.9	99.4	212.6	0.7	No	(9.2)	106	1.1
Schroder Japan Growth	253.8	7.4	55.0	80.1	171.9	1.0	No	(8.5)	113	1.7
Sector average	403.5	13.0	68.6	99.8	243.4	1.0		(4.3)	112	1.2
FJV rank in sector	4	1	2	2	2=	1		5	2	5=

AIC Japanese Smaller Companies

Atlantis Japan Growth	108.6	13.7	71.1	97.1	235.9	1.6	No	(6.8)	104	0.0
Baillie Gifford Shin Nippon	514.1	32.3	151.2	220.1	678.0	0.9	No	5.2	109	0.0
JPMorgan Japan Smaller Cos	234.7	11.5	79.3	112.3	196.7	1.1	No	(7.3)	109	0.0
Sector average	285.8	19.1	100.5	143.2	370.2	1.2		(3.0)	107	0.0

Source: Morningstar, Edison Investment Research. Note: *Performance to 14 September 2018. TR = total return, in sterling terms. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

FJV is one of a relatively small number of Japan-focused, closed-end investment companies, which the AIC organises into two sectors, Japan and Japanese Smaller Companies. Having previously been part of the Japanese Smaller Companies peer group, FJV moved into the AIC Japan sector at the same time as changing its name and benchmark, and amending its investment policy, in May 2018. In Exhibit 10 above, we show the constituents of both sectors, although we rank FJV only in comparison to its current peer group. FJV's market capitalisation is below average for the two sectors in aggregate, although it is one of four peers broadly in the range of c £200-300m. Its NAV total return performance is above the average for the AIC Japan sector over one, three and five years, ranking first, second, and second respectively (out of six, five and five funds). Over 10 years, FJV has the equal second-highest NAV total return in the sector, but is below average owing to the outsize returns from Baillie Gifford Japan. Compared with the AIC Japanese Smaller Companies sector, FJV's NAV total performance is above average over one year, but below average over three, five and 10 years; however, the average is again skewed by a Baillie Gifford fund, with FJV's

returns stacking up well against the remaining peers over all periods. Ongoing charges for FY17 are at the higher end of the range, with none of the funds in either AIC sector charging a performance fee. The introduction of the new fee structure (see Capital structure and fees, pages 10-11) should see FJV's ongoing charges reduce to a more competitive level. FJV's discount is the second-widest across the two groups, with three funds currently trading at a premium to NAV. Gearing is broadly average for the AIC Japan funds and above average compared with the Japanese Smaller Companies funds. In common with all its former peers in the small-cap sector, but in contrast to most of the AIC Japan sector, FJV does not pay a dividend.

The board

FJV has six directors, all non-executive and independent of the manager. David Robins joined the board in 2011 and was appointed chairman in 2012. He spent his professional career in economics and banking, latterly as chairman and chief executive of ING Barings, following 18 years with UBS; his previous roles included Japanese economist at the Bank of England. Philip Kay was appointed to the board in 2004 and became the senior independent director in 2016. He is a director of three Asian hedge funds and a fellow of Wolfson College, Oxford, with previous roles including director of the global Japanese cash equities business at Credit Suisse First Boston. Sir Laurence Magnus became a director of FJV in 2010 and chairman of the audit committee in 2011. He has spent his professional career in corporate finance, including roles in South-East Asia, and is currently a senior adviser to Evercore Partners, a US corporate finance adviser, and chairman of Historic England. Dominic Ziegler, who joined the board in 2014, is Asia columnist and senior Asia writer at The Economist in Hong Kong. Mami Mizutori, who had also been a director since 2014, stood down in February 2018 following her appointment as assistant secretary-general at the United Nations Office for Disaster Risk Reduction. Two new directors were appointed with effect from 22 May 2018. Sarah MacAulay is a former Asian equity fund manager and holds a number of directorships on Asia-Pacific investment companies. David Graham trained as a chartered accountant and has also spent his career in Asian investment management, both as a fund manager and on the business side. The whole board undertakes an annual due diligence visit to Hong Kong and Tokyo.

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