LWM Consultants Ltd

Meeting the fund manager

Neptune Japan Opportunities

Last year we reduced exposure to Japan as we simply didn't know where the country was headed. One of the fund managers we really respect when it comes to investing in Japan is Chris Taylor of Neptune. He is somewhat a maverick in the investment world but you know that his knowledge of the region and the opportunities tend to be second to none.

He joined Neptune in 2004 as a fund manager alongside his role of Head of Research. Prior to that he was the Managing Director of Fuji Investment Management Company Ltd which gives him a great insight as to how the Japanese think and work.

The fund is different to other funds in the sector because he uses hedging as part of the investment strategy. This is important because there are factors occurring in Japan which make this strategy potentially deliver higher returns than other funds in the sector.

Last year we had a one-to-one meeting with Chris; this update was conducted via a telephone conference. We believe that what he said was interesting and as a result of this we possible will increase our weighting to Japan in July.

Overview

The catalyst for change in Japan is the election of the LDP party with its leader Shinzō Abe. Japan has suffered from a lack of leadership for years with the average term for a prime minister being around 12 months. This election has shifted the political landscape because the party has a supermajority which means it can force through legislation in the upper house which is something that could not be done previously.

The seats in the upper house are up for election in 2013 and it is expected that the LDP will take a majority in the upper house as well.

The objectives are very simple the idea is to weaken the Yen to boast corporate profits in Yen terms. This in turn will increase government tax revenues. The strength of the Yen has masked a lot of what is happening to corporates in Japan.

As an example since 2007 a Japanese firm operating in the UK would have to double its profits just to keep it in line with the Yen. So if the Yen is weakened then there are more tax revenues which can fund spending programmes.

This in turn reflates the economy which leads to higher wages and boasts consumption.

Another important change is the replacement of the Bank of Japan Governor, Masaaki Shirakawa, seen by many as a negative influence to change. Other key members of the committee have gone or are going, making it much more favourable to the government and its policies. The first two changes are that the self-imposed bond issuing of Yen 44^{tn} p.a. will be scrapped and there is likely to be more QE.

These political factors are risky and particularly the weakening of the Yen. It is felt the next six months are crucial to this but if it works then the key is the boast in tax revenue. Shinzō Abe unlike many of his predecessors has the backing of the people and he has made it clear that he will do anything to turn the country around. He will spend on aging infrastructure, defence, investment in innovation and encourage more children.

These measures should bring inflation where the country has had twenty years of deflation. In Yen Sterling terms, Chris expects the Yen to hit the 160 mark in March / April and then possible 200 by the end of the year. To achieve everything he believes it needs to go as high as 700. Turning this to returns an increase to 160 Yen could see a return of around 10% and 200 could see 50%. Of course there are a lot of factors that could derail this.

He is keen to stress that although political change is important so are the corporates. A lot of what these companies have done is screened by the strength of the Yen. Many good companies are global multinationals with a 50 / 50 split of business between domestic and global. They have above average exposure to emerging and developed markets.

All the valuations show these companies as too cheap. If you look at the likes of Toyota they have much larger sales outside of the domestic market whereas the likes of other brands like VW and Ford rely heavily on the domestic market. These companies have low P / E ratios, cash on the books, good balance sheets and often better credit ratings than the banks as well as an average dividend yield in now 3.78%.

These companies have had to control their own fate rather than turn to the banks for help. The weakening Yen will boast profits significantly.

Domestically there is a feeling that slowly there will be a shift away from bonds to equities. To put this in perspective currently for every ten dollars in bonds 1 dollar is in equities, in the US it is 5 to 5 and the Euro zone 4 to 1. This change will boast the markets.

So there is a shift happening in Japan and this fund is positioned to benefit from this. However, although Chris is very optimistic for the future and there could be potential high returns the risk should not be ignored as the next six months are clearly important. Having said all of that the BoJ Governor has said he will step down early in March which is an important factor.

Conclusion

Japan is a difficult market to call and last year we reduced the holding and spread the risk over a few funds. Certainly Chris paints a very optimistic picture and possible one that has not been seen before. We do feel confident to increase the exposure up on the back of this. However, a lot can happen and sometimes does in Japan but all the signs are positive.