JPMorgan Japan Small Cap Growth & Income

Kepler GROWTH RATING

JSGI offers the rare combination of small & mid-cap growth potential and a decent income...

Update
09 March 2021

Summary

JPMorgan Japan Small Cap Growth and Income (JSGI) offers exposure to the high growth potential in small and mid-cap Japanese equities as well as a significant income pay-out, in part from capital. The JSGI team is composed of three experienced managers based locally in Tokyo, with the broader Japan team making over 4,000 company visits a year.

The JSGI team uses a multi-faceted investment process to identify what the team believe are the highest quality companies within Japan's mid and small-cap space, with a distinct focus placed on companies which can best capitalise on the sectoral trends driving Japanese equity markets. We outline this further in our **portfolio section**.

JSGI has generated enviable **performance** over the last five years, with a NAV total return of 129.1% and a share price return of 140.0% over the last five years, compared to the 76.6% return of its benchmark. We note that a large part of this return can be attributed to the impact of COVID-19 on the Japanese economy, with the resulting change in consumer patterns disproportionately benefitting many of the names in JSGI's portfolio.

JSGI has recently changed its name, to better reflect its income generating potential. Since April 2018, JSGI pays a dividend each quarter equal to 1% of the NAV at the end of the previous quarter, meaning it can offer an income despite the relatively low yield of the small-cap growth sector. The historic yield is currently 3.7% (as at 10/02/2021). While JSGI trades at an 8.7% discount, this has been narrowing over recent years thanks, we think, to its superior performance and the introduction of a competitive dividend.

Analysts:
David Johnson

Analyst's View

JSGI offers a powerful combination of exposure to a high growth market with an illiquidity premium attached and a high regular income, using the flexibility of the closed-ended structure to the full – indeed its strategy would be impossible in an open-ended fund. Thanks to the change of dividend policy in April 2018, JSGI is now one of the few ways investment trust investors can simultaneously access the Japanese small and mid-cap market without having to sacrifice an income.

JSGI's portfolio is a clear beneficiary of many of the trends underpinning '**New Japan**' , while also being a beneficiary of the COVID-19 pandemic as the sudden change in consumer behaviour further accelerates many of the trends underpinning its holdings. Yet its outperformance is more than a short-term occurrence, with JSGI having outperformed over the majority of recent calendar years, evidencing the success of the team's investment process.

We believe that the recent narrowing of JSGI's discount is a reflection of its total return and income potential. While the broader Japanese equity market is seeing renewed interest from foreign investors, JSGI's income generation is relatively rare in the sector. We think so long as it continues to deliver outperformance (and strong income potential as a result) we could see a further narrowing of the discount.

BULL
Ability to provide competitive income despite its small-cap quality focus
Strong performance track record, reinforced by its outperformance during the recent pandemic
Well-resourced and locally based team, able to directly access the volume of companies needed for a smaller-cap strategy

BEAR
Gearing can amplify losses during downturn
Quality and growth focus may underperform during strong cyclical rallies
Dividend pay-outs from NAV cannot be guaranteed to be progressive

Disclosure – Non-Independent Marketing Communication. This is a non-independent marketing communication commissioned by JPMorgan Japan Small Cap Growth & Income. The report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on the dealing ahead of the dissemination of investment research.

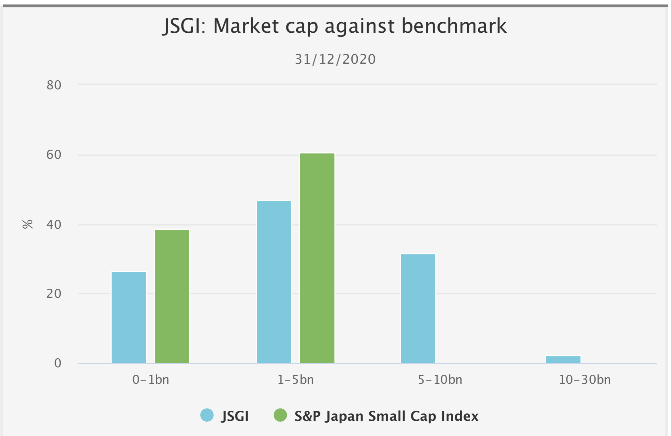
Portfolio

JPMorgan Japan Small Cap Growth and Income (JSGI) gives investors access to a portfolio of small and mid-cap Japanese equities, with a clear tilt towards growth focussed companies which are best able to capitalise on the sectoral trends driving much of Japan's equity markets. In December 2020, the trust changed its name from JPMorgan Japan Smaller Companies Trust, with a corresponding change in ticker (where it previously traded as JPS). The change was made in order to better reflect the trust's current investment objective and dividend policy. In April 2018, the board saw fit to introduce a new dividend policy of a pay-out based on 1% of NAV each quarter, with the new name reflecting the higher income the trust now offers investors. Despite the name change JSGI's overall investment objective remains the same: to produce long-term capital growth through investment in small and medium-sized Japanese companies.

JSGI is run by Eiji Saito, Naohiro Ozawa, and Michiko Sakai, all of whom sit within the broader JPMorgan Japan equity team. The managers, and broader JPMorgan Japan equity team, are all on-the-ground in Tokyo; and while the ability to meet managers face-to-face is considered important for any investment strategy, the team note that it is of far greater pertinence for small and mid-cap investors. Much of the analysis of small-cap companies in general requires substantial contact with company management, given the lack of general analyst coverage and comparatively little data available compared to their large-cap peers. We thus regard the JSGI team's local presence, combined with the inherent access afforded to them through JPMorgan's reputation, as a distinct advantage for the managers, and the JPMorgan Japan investment professionals conduct over 4,000 company meetings a year.

The team's investment process aims to produce a portfolio of high quality and high growth, opportunities with the intention to hold their positions for as long as possible, with some of the current holdings having been first purchased over a decade ago. Alongside their investment process, and views on the thematic factors driving equity returns, the team's definition of the small and mid-cap universe is a defining feature of the strategy. JSGI's maximum market cap is a c. USD10bn limit at time of investment, with their investable universe including all listed Japanese equities bar Japan's largest 200 companies. While they can let their winners run, and are able to hold onto a company as it passes the top 200 barrier, once a company is past the top 100 threshold it is considered to have firmly entered the large-cap space, and must be sold down as a result. One such example is their holding of GMO Payment Gateway, which has grown to an USD11bn market cap since they purchased it in 2012, when it was sub USD1bn. The team have recently been trimming this position with a view to eventually exiting it entirely, as they do with any company transitioning into the large-cap space. The current breakdown of the portfolio and its benchmark's (S&P Japan Small Cap Index) market cap can be seen below:

Fig.1: Market Capitalisation Breakdown



Source: JPMorgan

The team follow a three-step process when filtering down their universe, broken down into analysis of 'Economics', 'Duration', and 'Governance'. The team's analysis of economic factors determines if a company generates sufficient value for its shareholders. This is done through the team's assessment of a company's pricing power, balance sheet strength, identification of large and sustainable margins, and suitable cashflow generation. The team want to see long-term sustainability in these factors, preferring long-term market beating qualities rather than short term, exceptionally high, levels. This description allows the team to have confidence in their holdings' long-term value creation, and feeds into their second stake of analysis: duration.

Duration is the team's assessment of a company's ability to sustain its value creation, an important consideration as JSGI's holding period can run to over a decade. Companies which can sustain their economic fundamentals will often be those with good economic moats and competitive advantages, as well as operating in large markets in which they can continue to grow their market share. It is also within their analysis of the duration factor that the team incorporate much of the ESG analysis, through identifying which ESG risks may materially impede a company's long-term outlook. We cover JSGI's ESG integration in greater detail in our **ESG section**.

The final component of the team's analysis is Governance. They believe a misalignment of objectives between management and shareholders, or a general poor quality of governance and corporate oversight, will ultimately be conducive to poor shareholder returns, regardless of how well a company score in the economic and duration analysis. When analysing a company's corporate governance, the team look at factors like capital and ownership structure, management competence, and alignment with shareholder objectives.

Once companies of sufficient quality have been identified, a valuation must be assigned to ensure an appropriate price is paid, as JSGI is not a 'growth at any price' strategy. A company's valuation is assigned based on a five-year expected return. The expected return (ER) of a company is a combination of earnings per share growth, dividend growth, and the change in valuation; with a target P/E ratio assigned to a company to determine its valuation and exit price target. The resulting portfolio is one of relatively low turnover (averaging c. 21% p.a. turnover over the last 4 years), high active share, and position sizes which reflect the team's conviction. Yet due to inherent risks associated with small-cap investing and the resulting need for a large number of holdings to try and diversify away said risks, JSGI's portfolio is not as top heavy as its large-cap peers; a position will typically have a 1-2% weighting, with 24% of the portfolio in its top ten holdings. As positions enter and exit the portfolio, they often take on a much smaller weighting, as part of JSGI's risk controls. The current top ten can be seen below:

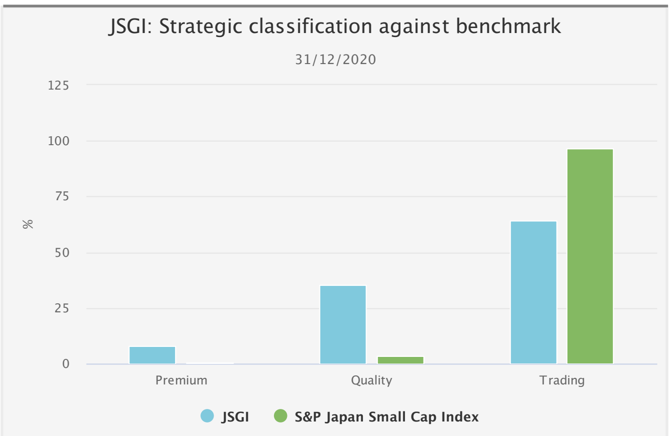
Top Ten

TOP 10	SECTOR	WEIGHT %
Taiyo Yuden	Information Technology	3.4
MIURA	Industrials	2.7
Benefit One	Industrials	2.5
Raito Kogyo	Industrials	2.5
Monogatari	Consumer Discretionary	2.1
CyberAgent	Communication Services	2.0
Nittoku	Industrials	2.0
MEC	Materials	1.9
Mercari	Consumer Discretionary	1.9
DTS	Information Technology	1.9
Total		**23.9**

Source: JPMorgan, as at 31/12/2020

The names which make up JSGI's portfolio are assigned to three different categories: Premium, Quality, and Trading. These categories are an ordinal ranking, with Premium representing the highest pedigree of companies (as determined by the team's economic, duration, and governance analysis) and Trading the lowest. So stringent are their requirements for a Premium rating that only 0.3% of the companies within their benchmark qualifies. At present, c. 43.3% of JSGI's portfolio is split between the premium and quality categories, compared to c. 3.6% of the benchmark. The team do remark that they have a slightly larger allocation to the trading rating than JPMorgan's larger capitalisation Japanese equity strategies, though they note that this is not due to inherently lower quality of their holdings but rather the shorter trading history of many of their names which prevents the sufficiently exhaustive analysis needed to be assigned a quality or premium rating. The full breakdown can be seen below:

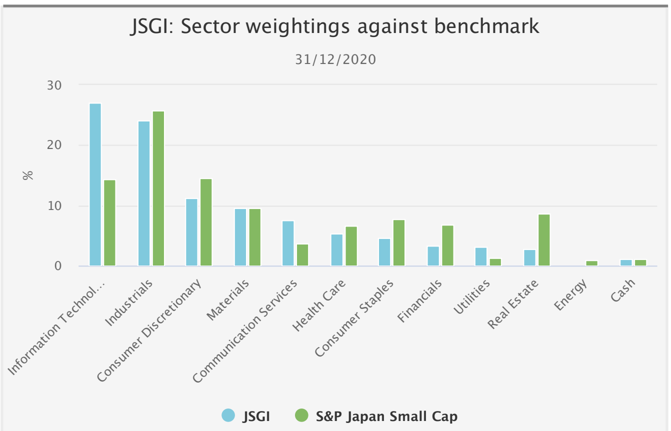
Fig.2: Strategic Classification



Source: JPMorgan

As we have mentioned in our previous notes, the JSGI team looks to make thorough use of the structural trends underpinning much of Japan's equity market, and in doing so help determine which companies have the greatest capacity to generate long term value. JSGI can be broadly categorised as focused on 'New Japan', which encapsulates the premier growth industries transforming the daily operations of Japan or providing new answers to the region's pressing demographic issues. We outline the nuances of 'New Japan' in our **recent editorial**. Many of the sectors associated with 'new Japan' focus on digitalisation, such as cashless payments, remote services, like online shopping and food delivery, or online medical consultations and education. As a result, JSGI has a clear overweight to the technological and consumer sectors (such as entertainment and consumer goods), with JSGI's sectoral weightings shown below:

Fig.3: Sectoral Weightings



Source: JPMorgan

The JSGI team believe that many of the above structural themes which underpinned the portfolio in early 2020 will continue to drive future returns, with COVID-19 having a minimal impact on the outlook of many companies. If anything, they believe the pandemic has improved the prospects of their holdings, by materialising much of their predicted future growth. Specific examples of themes at play within JSGI include: Hennge, a digital identification and access management service, a clear beneficiary of the work-from-home trend as the demand for remote logins increases. Arguably one of the biggest beneficiaries of COVID-19 is Bengo4.com. Bengo4.com has a c. 80% share of registered Japanese companies as users and provides digital certification services as part of its product suite, offering a solution to Japan's previously engrained practice of physically providing a personal stamp (a signature equivalent) to each document signed.

As the team take a long-term view to investing, there has been relatively little change to the portfolio over the last year (c. 21.6% turnover over 2020), despite the impact of COVID-19. Most of the changes to the portfolio have been due to names graduating into the large-cap space and having to be replaced as a result, or those which began to trade at an excessive premium due to the broader market piling into COVID-19 'winners'. There have been two new additions to the portfolio, Ascenteh, an information security and services provider, and Renova, a renewable energy provider. Renova, along with JSGI's increased allocation to companies like IRISO electronics and Nittoku, represents the managers' increasing belief in the potential of the sustainability trend within Japan. There have been two complete sales within the portfolio: Nihon M&A Center, which fully transitioned into a large-cap company, and Nishimatse Construction, a Japanese construction company which was sold due to superior investment opportunities being found elsewhere in the space. There have been a number of positions that have been trimmed over the same period, like Bengo4.com, Misumi, and Capcom, whose share prices continued to rise despite COVID-19 and were trimmed to either take profits or reduce their exposure as they transitioned into large-cap companies.

Gearing

JSGI's current net gearing is c. 8% of NAV (as at 10/02/2021). The trust's policy is to operate a gearing range of between 5% net cash and 15% net geared in normal market conditions, with the option of raising this to 10% net cash or 25% net geared, with the board's agreement, in 'extraordinary' circumstances. A three-year revolving floating-rate loan of ¥4bn is utilised tactically, and there is no structural gearing in place.

Whilst the trust's policy is reasonably flexible regarding gearing, in practice the managers prefer to maintain a relatively stable level of gearing of between 6% and 12% which reflects the managers' overall conviction in the market or individual stock names. However, this may increase in the face of sharp pullbacks if they regard the de-rating of stocks they like to be irrational. Gearing may also be used for buybacks.

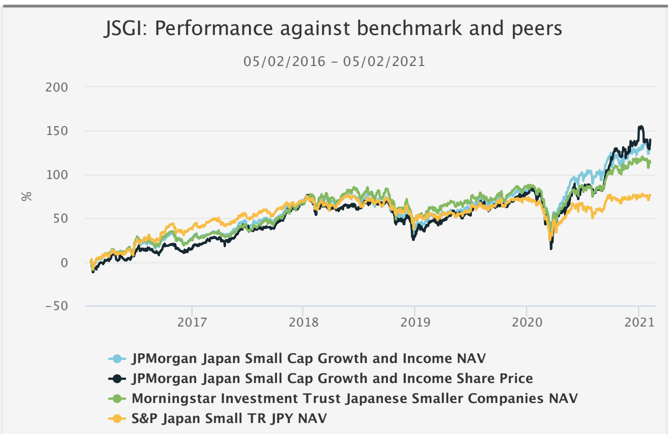
Fig.4: 1 Year Gearing

Source: Morningstar

Performance

JSGI has achieved an enviable amount of outperformance versus its benchmark, the S&P Japan Small Cap Index, over the last five years, having returned 129.1% in NAV total return terms, compared to the 76.6% return of its benchmark. It has also managed to outperform its peer group's 113.6% NAV total return. It is important to highlight that smaller capitalisation strategies are typically associated with higher risk, due to the increased perceived sensitivity of the sector to both economic data and the underlying company's respective corporate announcements. Over the last five years JGSI has generated a standard deviation of 16.5%, versus the TOPIX's 15.8% (with the TOPIX being the proxy for broader Japanese equities).

Fig.5: JSGI: Five-Year Performance

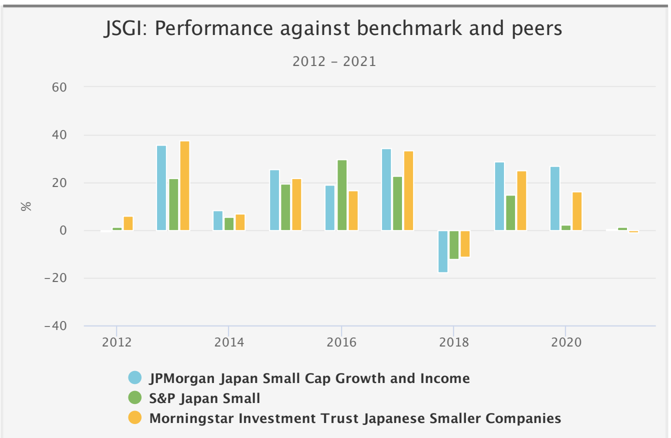


Source: Morningstar

Past performance is not a reliable indicator of future results.

JSGI's outperformance over its peers and benchmark has generally been consistent over recent memory, it having outperformed the sector in four of the last five years and its benchmark over the last three of five. JSGI's greatest periods of outperformance came in 2019 and 2020 when many of its sectoral trends began to accelerate, causing JSGI's portfolio companies to outperform as a result.

Fig.6: Discreet Annual Performance

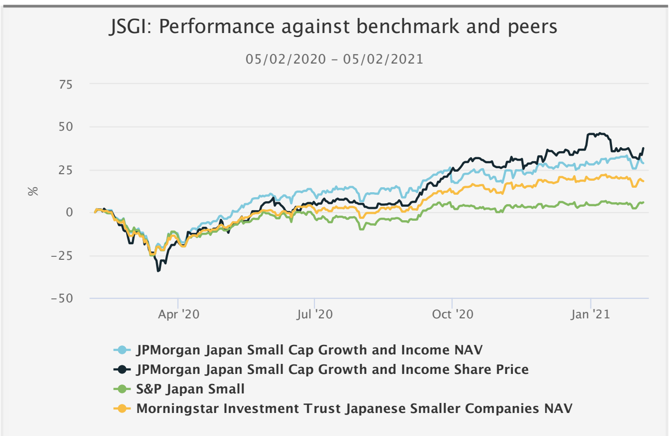


Source: Morningstar

Past performance is not a reliable indicator of future results.

We think the last 12 months have been demonstrative of JSGI's superior performance, with JSGI generating a NAV total return of 28.7% compared to its benchmark's 5.8% return, and its peer groups' average of 18.2%. COVID-19 has ultimately been a boon for many of JSGI's holdings, as it has accelerated the adoption of remote working, increased the demand for digital services (like computer games and online shopping) as well as remote services like education and online medical consultations.

Fig.7: One-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

At a sectoral level, the biggest individual contributors to performance included software and service companies, sectors which were clear beneficiaries of the work-from-home shift brought about by COVID-19. Specific names within this sector include Bengo4.com, Grace Technology, and Capcom; with Bengo4 and Capcom being sold down as a result of the rapid rise in the share price over the year. The largest sectoral contributors to JSGI's performance over 2020 were Capital Goods and Media & Entertainment; which contributed 10.16% to annual performance, the majority of which was pure stock selection.

Looking forward the team have a somewhat mixed view of Japan's short-term prospects. They believe that Japan will continue to face an economic downturn in the near term, thanks to the impact of COVID-19 on both the domestic economy and on global demand. They are seeing some signs that the impact of COVID-19 is bottoming out though, especially its impact on corporate earnings. They further think that there are a number of silver linings for Japanese equities, the first being that COVID-19 has accelerated many structural changes that were already taking place in Japan, with the team highlighting the gains made by automation and information technology industries over the period. They also believe that the ongoing improvements to corporate governance, as with the associated improvements to shareholder returns, will continue into the future. Japan's political leadership is likely to remain stable in their view, as there is no significant opposition to the ruling Liberal Democratic Party and thus little political resistance to its policies of governance reform as well as its recently announced commitment to net carbon zero emissions by 2050.

Dividend

JSGI shares have a historic yield of 3.7% and it is now the highest yielding trust in its sector, with a peer group average yield of 1.2% (as at 10/02/2021). Since April 2018, the board has operated a dividend policy which aims to subsequently pay out a regular quarterly dividend equivalent to 1% of the NAV on the last business day of each financial quarter. As well as provide a desirable income, the board has stated it hopes the policy will reduce the discount and discount volatility through widening the shareholder base. Since the policy was brought in, as we discuss in the **Discount** section, there is some evidence this has worked.

Despite this payout policy, the objective of JSGI remains focussed on long-term capital growth. As the dividend can be paid out of capital there is no pressure on the managers to provide a level of revenue return sufficient to cover the dividend. This allows the team to focus on companies with the best growth potential, rather than sacrifice growth potential for a higher dividend pay-out. However, the caveat of this is that it is possible that even under normal market conditions the dividend payout of JSGI could be volatile, as the NAV of a trust can fluctuate between a given financial year and thus the corresponding pay-out. Despite the volatility of the yield, we note that, given JSGI's ability to pay out from capital, it represents a rare opportunity for income investors to access growth focussed small and mid-cap companies, a sector rarely associated with high yielding companies.

Management

JSGI is managed by Eiji Saito, Naohiro Ozawa and Michiko Sakai, all of whom are based in Japan and function as portfolio managers and Japanese equity specialists. They all have extensive experience in Japanese equity market investing, and have been with JPMorgan since 2004, 2006 and 2013, respectively. As part of the JPMorgan Japan investment team, they are able to draw on the research of a team of 14 analysts who each specialise in different sectors. Including all the portfolio managers on the desk, JPMorgan has 27 professionals on the ground in Japan and conducts over 4,000 company meetings a year. The reach and resources of the Japanese equity team are a clear advantage when investing in small-caps, as there is little to no external analyst coverage for the majority of Japanese small-cap companies.

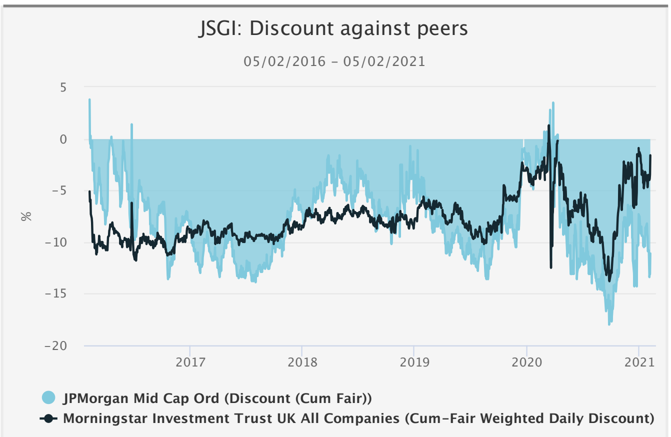
EiJi Saito has the longest track record with JSGI, having managed it for five years. Prior to joining JPMorgan, he worked at Nikko Asset Management Co. Ltd., where he spent eight years, initially responsible for managing Asian equities funds and latterly for Japanese mid to small-cap equity funds. Naohiro Ozawa and Michiko Sakai both have a three-year track record with JSGI. Ozawa has spent nearly his entire career within JPMorgan, and transferred to JPMorgan asset management in 2008. Michiko has been working as a portfolio manager within the Asia Pacific Regional team as well as a country specialist for Japan equities since she joined in 2013.

Discount

JSGI currently trades on an 8.7% discount, wider than its AIC peer groups 2.6% average discount (as at 05/02/2021). JSGI's current discount represents a gradual narrowing of the difference between it and its peers over the last three years, a trend which can be seen in the chart below (notwithstanding the brief period of volatility immediately following the COVID-19 crash). We believe that this is a result of the increasing outperformance of the strategy since 2019 and the change in dividend policy of the trust in 2018, with the provision of income leading to more resilient investor demand.

We foresee two factors which may lead to a further narrowing of JSGI's discount: the first being the recent uptick in demand for Japanese equities from foreign investors, with high profile names like Warren Buffett having publicly signalled their positive outlook for the region. This would, however, more likely drive a narrowing of the broader peer group and so less unique to JSGI. The second factor, and more unique to JSGI, is its development of a track record of strong dividend pay-outs. While the initiation of any dividend payout is often welcomed by investors, the combination of a dividend pay-out with small-cap growth investing is a far more unusual offering, especially as JSGI is now the highest yielding trust in the AIC Japan Smaller Companies sector despite its growth and quality bias.

Fig.8: 5 Year Discount



Source: Morningstar

Past performance is not a reliable indicator of future results.

The board has the authority to repurchase up to 14.99% of the shares in issues granted by shareholders at the 2019 Annual General Meeting, with the authority having been renewed at the most recent AGM in January 2021. The board acknowledges that a widening discount can disadvantage shareholders, and may use its ability to repurchase shares to address supply and demand imbalances, thus reducing the volatility and absolute level of discount. There have been no transactions made in its own shares over the last 12 months.

Charges

JSGI has an OCF of 1.14%, above the 1.00% weighted average of the AIC Japanese smaller-companies sector. This includes a tiered management fee and thus, as net assets grow, JSGI's overall OCF should fall further.

The management fee has recently been reduced on the upper tier of assets. Management fees are now charged at 1% on net assets up to £150m, and 0.75% on all assets above this level. Presently JSGI has c. £319m of net assets, giving a weighted average management fee of c. 0.87%, though clearly this will fluctuate in line with net assets. On the previous charging structure, the weighted average management fee would have been c. 0.9%.

The KID RIY figure is the lowest in the sector at 1.37%, below the sector weighted average of 1.46%, though we would caution that calculation methodologies can vary between trusts.

ESG

ESG is a clear consideration for both the risk management of JSGI and its alpha generation. Governance (the G in ESG) is the third pillar in the team assessment of a company's overall quality. While the team's assessment of governance covers all of the major facets of its analysis, such as ownership structure, alignment of shareholder interests, management competency, and transparency. What is arguably more important than how they analyse governance is how the team integrates it within their process, and how much weight they assign the factor. For the JSGI team, their assessment of governance is so onerous that even if a company ranks highly in the other aspects of their analysis (economic and duration specifically), the inability for the team to have confidence in a company's governance structure, and thus the reliability of a company to translate their high value creation into shareholder returns, will prevent its inclusion into JSGI's portfolio.

For broader ESG consideration the team use a proprietary 'red flag' system to help identify ESG risks their potential investments face, which is incorporated into JSGI's investment process during their duration analysis. The team uses a 98-question checklist when assessing a company's 'red flags', with three quarters of said questions being around ESG issues. Example questions include: Does the company have issues with labour relations? Has the company had issues with privacy or data security? Has the company changed key accounting policies?

It is important to highlight the issues small and mid-cap managers have when assessing the ESG credentials of their universe, especially around the use of third party ESG data vendors. Small and mid-cap companies often lack the resources to report on their ESG activities or provide the same volume of data to third party vendors, and as a result ESG analysis based solely on data will often under or misrepresent small and mid-cap companies. Issues of disclosure are also a concern for the JSGI team, with much of their engagement efforts with companies focussed around improving disclosure quality. Beyond their engagement over disclosure, the team will also address issues of board diversity and capital allocation, often voting against management at AGMs if they believe there is need for change. One recent example being their engagement over corporate diversity, where the team's initiatives with the Aica Kogyo Company saw the appointment of a senior female manager as a result.

Morningstar rates JGSC's sustainability as below average, based on its ranking within the broader Morningstar Japan's small and mid-cap peer group. This rating may reflect the lack of available ESG data for JSGI's holdings, especially as a number of them have relatively short track records. This rating will not take account of the corporate engagement performed by the team. ESG conscious investors may find the difficulty in monitoring the sustainability of JSGI off-putting, but we highlight the trust's evidence of positive social impacts (such as their drive for diversity) as a positive counterbalance. Hopefully their continuing adoption of the sustainability trend within the portfolio, and their active initiatives to improve corporate reporting, will improve their empirical sustainability ratings in the near term.

Disclaimer