Stockdale

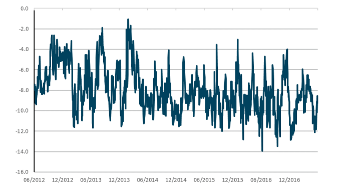
21 June 2017

# Investment Funds

## Withdrawing the punchbowl, buy Japan

**Fund in the spotlight:**
Atlantis Japan Growth (AJG)

**AJG discount**



**Source: Morningstar**

**We believe that the Federal Reserve is being forced to withdraw liquidity as the US economy is now at or near full employment. Going forward, either the US economic expansion is likely to falter or interest rates in the US will rise further. We believe that stock selection rather than index returns will be key in driving returns in the next phase of the bull market we are witnessing and favour mid and smaller companies worldwide. We recommend the Atlantis Japan Growth Fund (AJG), now advised by Taeko Setaishi, who has a strong long-term performance record. The annual subscription right programme and share redemption facility that AJG has, should gradually help increase liquidity and allow the fund to grow over time while controlling the discount.**

### A withdrawal of liquidity is on the cards

Central banks around the world have pumped enormous quantities of liquidity into markets since the onset of the global financial crisis. While this has been key to preventing a massive slowdown in the global economy, growth in developed markets has been lacklustre. The fundamental problem is the rise in inequality, particularly in developed markets. While unemployment in the US has dropped substantially, inflation remains stubbornly low. In the belief that higher wages will result in inflation rising to its desired level of c.2%, the Fed continues to raise rates and is looking at reducing the size of its balance sheet. The European Central Bank (ECB) is also looking at how it can withdraw from its programme of quantitative easing even as inflation seems to have peaked.

**Figure 1: Rising interest rates in the US**

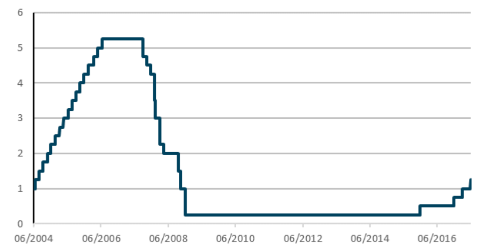



**Figure 2: Wage inflation in the US**


**Source: Federal Reserve, Bloomberg**

### Atlantis Japan Growth Fund

While we remain positive on the prospects for the US economy, we believe that broader US equity markets will struggle to achieve further gains between now and the end of the year. While economic growth in the rest of the world also looks promising, the withdrawal of liquidity from the US and Europe could pose significant headwinds for European equity markets as well. With the Bank of Japan remaining focused on achieving its 2% rate of inflation, we recommend that investors underweight US equity markets and buy Japanese trusts such as Atlantis Japan Growth Fund (AJG) for exposure to small and mid-cap companies in Japan. The redemption and subscription mechanisms adopted by the board, coupled with the long-term performance record of Taeko Setaishi in our view makes AJG an interesting vehicle for investors.

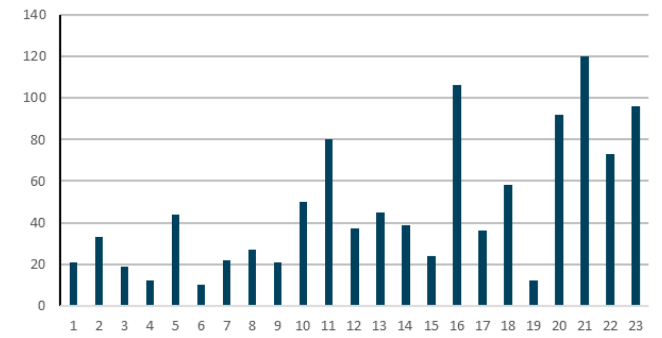
Priced at close
19 June 2017


Analyst
Saumya Banerjee
020 7601 6629
saumya.banerjee@stockdalesecurities.com

## Buy Atlantis Japan Growth Fund (AJG)

Expansions, which the National Bureau of Economic Research in the US defines as trough to peak, have lasted for an average of 46 months since 1900. In comparison, the current economic expansion has now lasted for over 96 months. So far, the US economy shows little sign of the excesses that normally trigger sharp recessions. While the Fed is withdrawing liquidity, it is doing so gradually and is likely to pause if either wage growth or inflation fail to materialise as predicted. Given its lacklustre nature, one should expect the duration of the current expansion to be longer than average and the risk of a recession in the US is not significantly higher than normal, simply because of the length of the expansion.

**Figure 3: Length of US expansions post 1900 in months (Y)**




Source: National Bureau of Economic Research

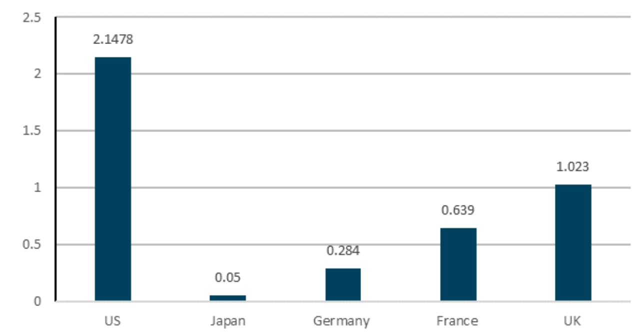
**Figure 4: S&P 500 adjusted positive P/E ratio**


Source: Bloomberg

While we do not expect the economic expansion to falter in the next 12 months, we believe that the US equity market is facing short-term valuation headwinds. Markets have rallied significantly and have incorporated a significant amount of the good news that could be expected if the Trump tax reform plans materialise. Given the relatively moderate growth outlook for the US economy, we would expect stock selection to be a key driver of equity returns going forward.

As Figure 5 shows, US ten-year government bond yields are already at significantly higher levels than countries like Japan, the UK, France and Germany. As the Fed begins to taper its balance sheet we think long-term rates in the US might rise even further. Simultaneously, the Bank of Japan (BoJ) is likely to continue to expand its balance sheet until it is confident that the Japanese economy has escaped the deflationary situation it has found itself in over the last couple of decades. We therefore favour the Japanese equity market, relative to the US and recommend that investors buy Atlantis Japan Growth Fund (AJG).

**Figure 5: Current ten-year government bond yields**




Source: Bloomberg

**Figure 6: Japan CPI ex-food and energy**


Source: Ministry of Internal Affairs and Communications

Atlantis Japan Growth Fund (AJG) is advised by Atlantis Investment Research Corporation (AIRC) which was established in 1996 and is an independent boutique fund adviser based in Tokyo. Taeko Setaishi took over as lead adviser to Atlantis Japan Growth Fund effective 1 May 2016, having been deputy fund adviser to Ed Merner since 1996. AIRC believes in a team approach and has a four-person investment team of portfolio advisers and analysts based in their office in Tokyo; the team has an average 30+ years' Japanese investment experience.

The AIRC team believes that fundamentals drive long-term performance and it follows a bottom-up, company visit driven approach to stock selection:

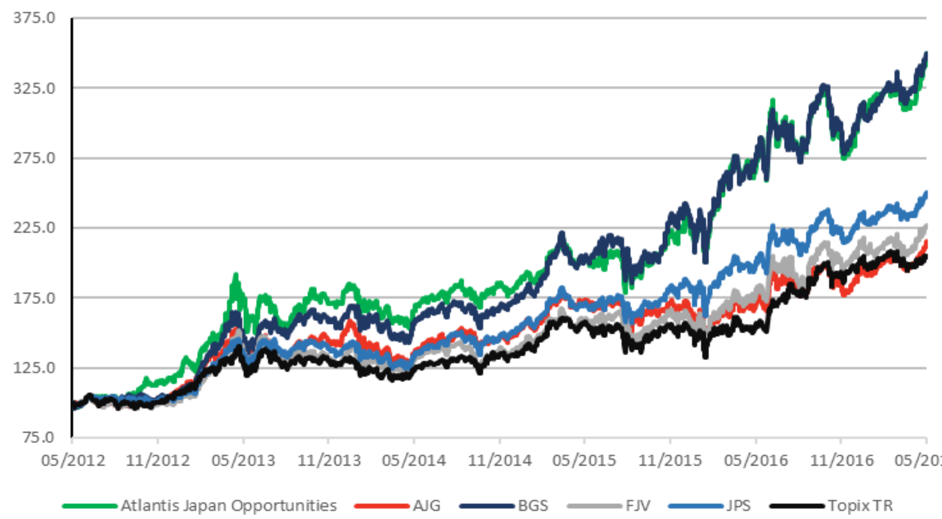
- Targets undervalued growth companies
- Takes bottom-up fundamental approach
- Company visits are AIRC's key source of added value
- Stock selection drives the asset allocation
- Small to mid-cap bias

Atlantis Japan Growth Fund focuses on Japanese companies that have a clear secular growth profile. This approach can, but does not necessarily, result in a bias towards small and mid-cap companies.

Brokerage coverage, particularly of small and medium-capitalised companies can be minimal in Japan leading to market inefficiencies. This provides the team with the opportunity to add substantial value against the market through its proprietary in-house research.

Given the recent change of lead adviser, we believe that it may be appropriate to look at the past performance of the open-ended Atlantis Japan Opportunities Fund, where Ms Setaishi has been lead adviser since 2003, rather than the three-year performance of AJG. We note that over the last five years, Atlantis Japan Opportunities Fund has been a very strong performer, with NAV TR comparable to that of Baillie Gifford Shin Nippon (BGS) and significantly better than Fidelity Japanese Values (FJV) which also changed its portfolio manager in 2015, and JPMorgan Japan Smaller Companies Trust (JPS).

**Figure 7: Atlantis Japan Opportunities Fund vs. peer group**




**Source: Morningstar**

Ms Setaishi believes that the current economic expansion in Japan, now in its sixth successive quarter, is well balanced with positive contributions from external demand, household consumption, and private sector capital expenditure components. Despite a steady rise in workforce participation (employment numbers are back to 1998 levels), the labour market continues to tighten progressively. This is feeding into higher consumer confidence and household consumption. Corporate surveys indicate a broadening commitment toward capital spending as companies re-shore production.

While the fund has a bias towards mid and small cap companies with 67% of the portfolio invested in companies with a market capitalisation of less than £2bn, there are no market cap constraints that the fund must adhere to. Similarly, the sector breakdown emerges out of the bottom-up stock selection process. The advisers regularly visit/meet the management of the companies in the portfolio to reassess the prospects. AJG's largest holding as at 31 May 2017 is Nittoku Engineering (6145 JP) which represents 4.6% of the portfolio. It was already part of the portfolio when Ms Setaishi took charge of AJG as lead adviser but as her confidence in the company's business grew she doubled the fund's holding in the company. Nittoku is the world's leading manufacturer of coil winding machines. It has over 40% market share in Japan and over 30% worldwide. Its products include miniature chip coils for IC cards, mobile phones, automobiles (electric vehicles need more coils), machinery, etc. The manager believes that sustainable growth is possible due to growing applications for existing and new products and volume growth. The company is also a beneficiary of increasing factory automation.

**Table 1: AJG top ten holdings, sector breakdown and market capitalisation breakdown as at 31 May 2017**

| Top 10 holdings | (%) | Sector breakdown | (%) | Market capitalisation (£bn) | (% TNA) |
|---|---|---|---|---|---|
| Nittoku Engineering Co | 4.6 | Industrials | 38.0 | | |
| Nidec | 3.4 | Information Technology | 32.9 | > 10 | 15.2 |
| Nihon M&A Center | 2.9 | Consumer Discretionary | 11.5 | 5-10 | 3.2 |
| Panasonic | 2.8 | Financials | 9.2 | 2-5 | 20.5 |
| Cresco | 2.5 | Materials | 8.0 | 0.5-2 | 22.7 |
| Daifuku Co | 2.5 | Health Care | 4.9 | < 0.5 | 44.2 |
| Tokyo Electron | 2.5 | Consumer Staples | 1.3 | | |
| Benefit One | 2.4 | | | | |
| Star Mica Co | 2.4 | | | | |
| Trusco Nakayama | 2.3 | | | | |

**Source: Company data**

In October 2014, the board of AJG proposed an annual subscription right to grow the size of the company, improve liquidity and reduce the total expense ratio. The rights also reflect the positive view of both the board and the investment adviser of the investment opportunity in Japan. All shareholders now have the right to subscribe for one new ordinary share for every five ordinary shares held on 1 October each year. The subscription price is the undiluted net asset value (NAV) per share on 2 October the previous year. Shareholders have an opportunity once a year to exercise their subscription right. Any rights that are not exercised effectively lapse. New ordinary shares issued because of the exercise of the subscription rights rank as ordinary shares and are themselves eligible for future subscription rights.

In addition, shareholders can redeem 5% of the outstanding shares of the fund, at six-monthly intervals on 31 March and 30 September (or, if such date is not a business day, the previous business day) of each year, subject to board approval.

The directors also operate a hard discount control mechanism whereby the company is obliged to hold a continuation vote should the shares have traded, on average, at a discount of more than 10% to the NAV per share during any rolling 90-day period, in normal market conditions. If the obligation to hold a continuation vote is triggered, the vote will be held no later than the next practicable annual general meeting of the company.

As the subscription rights are embedded in the existing shares and are not separately listed, there is no dilution effect if they are exercised when economically viable. We consider a hypothetical situation where the NAV of AJG rises from 100 to 130 between 2 October of the previous year and 30 September for the date in question. The return for the shareholder is 30%, even though performance tables will show an increase of 25%, because of the dilution. As far as the investor in AJG is concerned, the return is still 30%, especially if the investors immediately sell the new shares in the market upon exercise. **Thus, we re-iterate that these subscription shares lead to no dilution of returns for an investor if the investor exercises his subscription shares when it is economically viable to do so. However, in terms of performance numbers it does hurt the portfolio manager's track record.**

The additional supply of new shares could lead to the discount widening in the trust. However, in the case of AJG, given the other measures adopted by the board we view the discount to be well contained and unlikely to erode shareholder returns in the medium to long term.

**Figure 8: AJG diluted NAV performance since 1 May 2016**

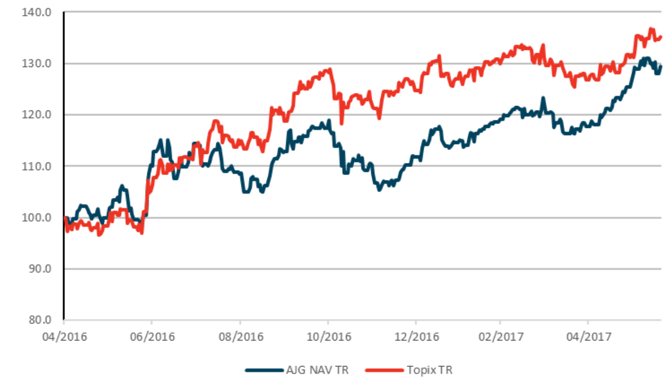
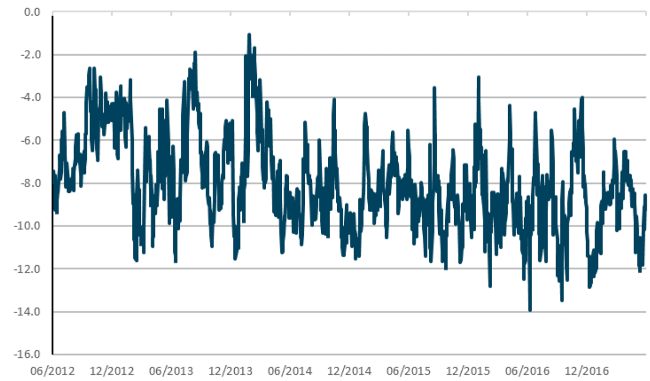



**Figure 9: AJG diluted discount (%)**




**Source: Morningstar**

We believe that investors should buy AJG for exposure to the Japanese equity market. We find the five-year performance record of Ms Setaishi to be extremely impressive as witnessed by the returns of the open-ended Atlantis Japan Opportunities Fund. Should these relative returns be replicated in AJG, we would expect the fund to both grow over time as well as be re-rated in terms of the discount it trades at.

## Investment Funds research disclosures

### Explanation of Investment Funds recommendations

Stockdale Securities Limited uses a three-tier system for its investment funds recommendations. Investors should carefully read the definitions of all ratings used in each research report. In addition, since the research report contains more complete information concerning the analyst's views, investors should carefully read the entire research report and not infer its contents from the rating alone. In any case, ratings (or research) should not be used or relied upon as investment advice. An investor's decision to buy or sell a stock or investment fund should depend on individual circumstances (such as the investor's existing holdings) and other considerations.

Investment funds ratings are explained as follows:

BUY: Total returns expected to be in excess of those from the fund's benchmark

HOLD: Total returns expected to be in line with those from the fund's benchmark

SELL: Total returns expected to be lower than those from the fund's benchmark

Total return is defined as the movement in the share price over the medium- to long-term, and includes any dividends paid.

Distribution of Stockdale Securities' investment funds recommendations:

Stockdale Securities must disclose in each research report the percentage of all investment funds rated by the member to which the member would assign a "BUY", "HOLD" or "SELL" rating, and also the proportion of relevant investments in each category issued by the issuers to which the firm supplied investment banking services during the previous 12 months. The said ratings are updated on a quarterly basis. This recommendation system differs from the recommendation system used on non-Investment Fund research.

Investment Funds recommendation proportions in last quarter

| | BUY | HOLD | SELL |
|---|---|---|---|
| Funds to which Stockdale has supplied investment banking services | 100% | 0% | 0% |

Source: Stockdale

The company has seen this research but no material changes have been made as a result.

Somers Limited is the substantial shareholder (84.6%) of Stockdale Securities Limited. Utilico Emerging Markets Limited and Somers Limited both have a significant common shareholder, UIL Limited.

Analysts' remuneration is based on a number of factors, including the overall results of Stockdale Securities, to which a contribution is made by investment banking activities. Analysts' remuneration is not based on expressing a specific view or recommendation on an issuer, security or industry.

**This research is classified as being a "marketing communication" as defined by the FCA's Handbook. This is principally because analysts at Stockdale Securities are involved in investment banking activities and pitches for new business and consequently this research has not been prepared in accordance with legal requirements designed to promote the independence of investment research. Therefore, the research is not subject to any prohibition on dealing ahead of the dissemination of investment research. Nevertheless, the Firm's Conflict of Interest Management Policy prohibits dealing ahead of research, except in the normal course of market making and to satisfy unsolicited client orders. Please refer to www.stockdalesecurities.com for a summary of our conflict of interest management policy in relation to research. This includes organisational controls (departmental structure, a Chinese wall between corporate finance and other departments, etc), procedures on the supervision and remuneration of analysts, a prohibition on analysts receiving inducements for favourable research, editorial controls and review procedures over research recommendations and a prohibition on analysts undertaking personal account dealings in companies covered by them.**



**Stockdale Securities, Beaufort House, 15 St. Botolph Street, London EC3A 7BB** **Email: firstname.surname@stockdalesecurities.com**

**Investment Funds Contacts**

| **IF Sales/Market Making** | | **IF Research** | |
|---|---|---|---|
| Matthew Kinkead | +44 (0)20 7601 6626 | Saumya Banerjee | +44 (0)20 7601 6629 |
| Richard Harris | +44 (0)20 7601 6107 | **IF Corporate Finance** | |
| Darren Papper | +44 (0)20 7601 6632 | Robert Finlay | +44 (0)20 7601 6115 |
| Calum Summers | +44 (0)20 7601 6631 | Owen Matthews | +44 (0)20 7601 6118 |
| Pauline Tribe | +44 (0)20 7601 6623 | Rose Ramsden | +44 (0)20 7601 6110 |