CC Japan Income & Growth

Kepler INCOME & GROWTH RATING

CCJI's strong relative performance continues to be driven by stock selection...

Update
08 November 2024

Overview

Over the past 12 months, Richard Aston, lead manager of the CC Japan Income & Growth Trust (CCJI), has made several adjustments to his portfolio in response to ongoing, significant changes in Japan. One key development has been the Bank of Japan's (BoJ) decision to raise rates for the first time in 17 years. This change has benefitted CCJI's financial sector holdings, particularly banks and insurers, and prompted Richard to add several high-quality businesses to the portfolio, notably Japan Securities Finance (JSF), which he views as having strong long-term growth potential.

In addition to monetary policy shifts, corporate governance reforms continue to play a pivotal role, especially in transforming Japan's dividend culture. Many of CCJI's underlying holdings are placing a much stronger emphasis on enhancing shareholder returns. Companies like ZOZO and JAFCO have showcased their efforts in this by greater utilisation of their cash reserves, returning value to shareholders through increased payout ratios, more consistent buyback programmes and dividend payments.

Since inception, CCJI has maintained an unbroken track record of consecutive annual **Dividend** increases, achieving compound annual growth of 8.5%. Additionally, the trust's fully covered dividend yield of 3.0% surpasses the TOPIX's yield of 2.3%. Over the same period, CCJI has also delivered strong relative **Performance** against its benchmark, the TOPIX Index, and, despite volatility in Japan's stock market this year, it has outperformed over 12 months too, delivering NAV total returns of 11.1%, compared to the TOPIX's total return of 8.8%. Key contributors include companies like Sumitomo Mitsui Financial Group and Mitsubishi UFJ Holdings.

CCJI has been awarded a **Kepler Income & Growth rating** for 2024.

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Analyst's View

Uncertainty has been a recurring theme when investing in Japan, and recent investor unease has been heightened by factors such as the weak yen, the unpredictability of future Bank of Japan (BoJ) actions, and concerns over the potential impact of a US recession. Despite this, we maintain an optimistic outlook for Japan, driven by positive inflation, rising wages and the ongoing benefits of corporate governance reforms. Additionally, two relatively recent developments have created further opportunities in the market: the BoJ raising rates for the first time in 17 years and Japan's growing role in the semiconductor market.

To capitalise on these emerging opportunities and those in under-researched parts of the market, we believe Richard's expertise makes CCJI a potentially compelling option for investors. CCJI's portfolio is well-positioned to thrive in a market undergoing significant corporate governance changes and could also stand to benefit from the latest market developments. Richard has taken advantage of recent market volatility, adding several new investments to the portfolio, such as JSF and JAFCO, which he believes could benefit from long-term monetary policy shifts, and Macnica, which is poised to help satisfy the growing appetite for Japan's semiconductor capabilities.

CCJI has outperformed its benchmark over the last 12 months, largely driven by stock selection, particularly Richard's ability to identify opportunities across the market cap, which has consistently added alpha throughout his tenure. In our view, whilst Japan's market may continue to experience swings of volatility, Richard's balanced focus on total return – considering both capital and income growth as key components – sets CCJI apart from its more growth-focussed peers, making it potentially less susceptible to sharp style shifts. Overall, we believe CCJI offers a differentiated approach for investors seeking exposure to Japan.

BULL
Long-term outperformance driven by manager's stock selection
Strong dividend growth potential, with dividends in Japan boosted by corporate governance reforms
A core focus and desire to achieve dividend income combined with capital growth differentiates it from the peer group

BEAR
Use of gearing can magnify the losses in a market downturn
Given its 'core' nature, the trust may underperform during aggressively style-driven markets
Whilst offering a greater return potential, having a greater exposure towards mid- and small-caps can increase risk

Portfolio

Richard Aston boasts over three decades of experience in the industry, and has developed a deep familiarity with the Japanese market from his time living in Japan and extensive coverage over his career. This has enabled him to foster strong relationships with company management and establish a solid reputation in Japan. Richard has leveraged this experience to hone a differentiated approach to investing in Japan, something he's employed over his tenure managing CC Japan Income & Growth Trust (CCJI). The trust launched in December 2015 to take advantage of the significant upside potential on offer from listed Japanese equities, driven largely by the impact of Japan's corporate governance reforms.

In this, Richard's approach sets CCJI apart from its peers in the sector, in our view. He pursues strong total returns, considering both capital and income growth as two key components, unlike most peers in the sector, which tend to incorporate a more growth-heavy focus. Consequently, this makes CCJI stand out as a 'core' strategy, given the portfolio offers investors an attractive income profile without compromising on the quality or growth potential of its underlying holdings.

Longstanding Japanese equity investors are no strangers to volatility, something its stock market has experienced very recently. In 2024 the market climbed to record heights, experienced its largest decline since 1987 and then returned to record heights, all in a matter of a few days. Richard acknowledges there are plenty of factors driving such near-term volatility but argues that long-term structural drivers in Japan, such as the corporate governance reforms, are more significant than shorter-term issues like currency gyrations or political changes. As such, he has remained focussed on the long term, investing in high-quality, attractively valued companies and continues to categorise them into three segments within the portfolio: dividend growth, forming the bedrock of the portfolio; stable yield; and special situations (see **previous note**). This disciplined approach has led to an impressive **Performance** track record and a strong **Dividend** profile since the trust's inception.

Unsurprisingly, corporate governance reforms remain a key focus for Richard, particularly the positive impact they're having on the dividend culture in Japan. He seeks companies across the investable universe that are not only committed to shorter-term shareholder value enhancement but also those embedding the changes into their long-term strategy. Recent portfolio additions reflect this focus, including Japan Securities Finance (JSF), a unique company in Japan involved in securities finance, trust banking, and real estate leasing. JSF has demonstrated strength not only through its recent improvements to its payout ratio but also by growing distributions at an average rate of 17% per annum since 2014, making it an attractive addition for Richard amid recent share price weakness.

Other notable examples include ZOZO and Nintendo. ZOZO, a company in which Richard recently increased his stake, has responded positively to Tokyo Stock Exchange (TSE) initiatives by raising its payout ratio above the minimum requirement, boosting its share price and climbing into the portfolio's top ten as a result. Nintendo, which has also entered the top ten over the last 12 months, was added to on valuation grounds. Whilst Richard acknowledges the need for improvements in Nintendo's dividend policy, he remains optimistic about its long-term growth, particularly given upcoming product launches and its potential to significantly enhance shareholder value in time, given its strong cash position.

Top Ten Holdings

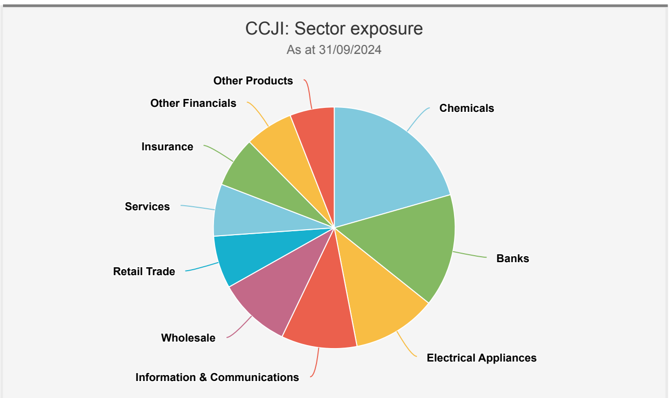
HOLDING	PORTFOLIO WEIGHTING (%)
Sumitomo Mitsui Financial Group	8.0
Mitsubishi UFJ Financial Group	6.8
ITOCHU Corporation	5.4
SoftBank Corp	4.9
Shin-Etsu Chemical Co	4.7
Nintendo Co	4.7
ZOZO	4.7
Tokio Marine Holdings	4.4
Hitachi	4.1
Mitsubishi Corp	4.1
Total	**51.8**

Source: Chikara, as of September 2024

Another key development is the Bank of Japan (BoJ) raising rates for the first time in 17 years, leading to a more normalised monetary policy that has benefitted several sectors, particularly financials, where CCJI has substantial exposure. As shown below, the trust holds large absolute positions in banks and insurance companies, which have performed well amid rising rates. Over the year, Richard also identified new opportunities in this space, notably adding JAFCO, Japan's leading private equity and venture capital firm, to the portfolio. Richard notes that JAFCO, with its strong market presence and wide network of relationships, is well-positioned for growth, supported by its parent company, Nomura, a leading financial group in Japan. Additionally, the firm's decision to introduce an interim and final dividend based on investor feedback is seen as a significant positive by Richard, enhancing its long-term appeal.

Another important trend in Japan is the rising demand for semiconductors and growing enthusiasm around artificial intelligence. Alongside this, manufacturers are seeking to diversify production away from the likes of China and Taiwan due to geopolitical tensions, creating new opportunities for Japan to strengthen its presence in the semiconductor space. In response, Richard has made some recent portfolio adjustments, including the addition of Macnica, a leading provider of semiconductors and integrated circuits. Its strong market presence, sharp increase in volume growth and ability to command higher prices for its equipment made it an attractive new addition to the portfolio. To fund most of these changes, Richard reduced positions in Socionext and Tokyo Ohka Kogyo after sustained share price strength, and fully exited holdings in Open House and Benefit One due to a deterioration in their fundamentals and the challenges each company now faces.

Fig.1: Top Ten Sector Allocations

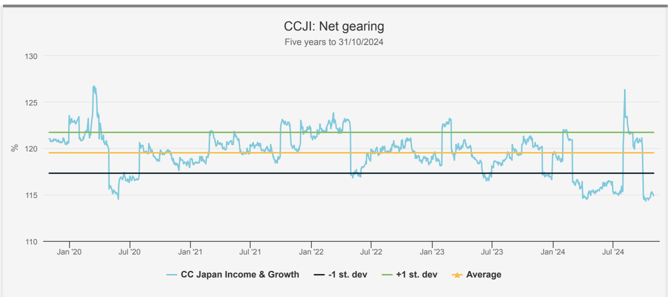


Source: Chikara

Gearing

The board has agreed to maintain structural gearing of around 20%, although the official limit is 25% of NAV at the time of drawdown. The structural nature of the gearing is something that the manager, Richard Aston, actively supports. He believes that consistent and sensible use of leverage, acknowledging it can amplify market movements in the short term, can enhance long-term returns of both capital and income for shareholders, and remove any additional market timing risk or temptation.

Fig.2: Gearing



Source: Morningstar

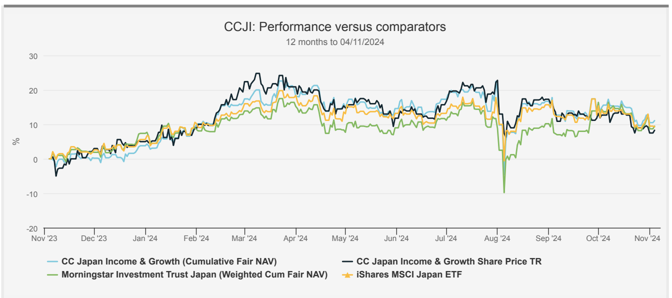
At the time of writing, CCJI's net gearing sits around 14.9%, below its five-year average and the board's target over the long term. Gearing is employed primarily through derivative contracts for difference (CFDs), given their low cost and flexibility. The board also has a bank overdraft facility with a borrowing limit of £12m or the equivalent in Japanese yen. In CCJI's latest financial results ending 30/04/2024, £2m of the overdraft had been utilised on the Japanese yen bank account.

Performance

Richard Aston focusses on delivering strong total returns to shareholders by investing in high-quality growth businesses at attractive valuations, also emphasising demonstrations of financial resilience and favourable attitudes towards shareholder returns. Consequently, he views both growth in capital and income as key components to the process, aiming to provide an attractive income profile without compromising on the quality of the portfolio's underlying holdings or their long-term growth potential.

This approach sets CCJI apart from others in the sector, which tend to lean more towards growth-focussed strategies. This balanced approach and Richard's strength in stock selection have been key differentiators for CCJI, driving its impressive performance track record since launch. Over the past 12 months, a variety of portfolio holdings have performed well, contributing to CCJI's outperformance relative to the TOPIX Index, delivering NAV total returns of 11.1%, compared to its benchmark's total return of 8.8%, to 04/11/2024. An ETF tracking the MSCI Japan Index is shown below for comparison.

Fig.3: One-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

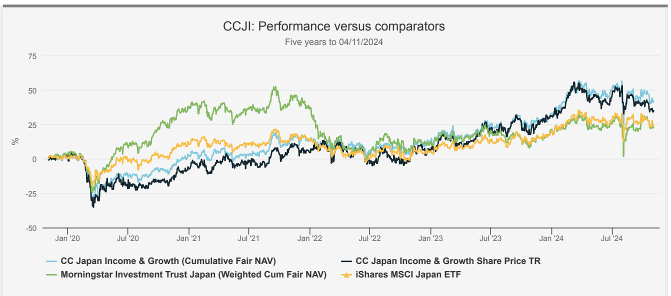
CCJI's exposure to financials was a significant contributor to returns during this period. The Bank of Japan's (BoJ) first rate hike in 17 years, meaning a now somewhat normalised monetary policy, benefitted interest rate-sensitive sectors, notably financials, to which the trust has roughly 25% exposure. This includes banks like Sumitomo Mitsui Financial Group and Mitsubishi UFJ Holdings, as well as insurers such as Sompo Holdings and Tokio Marine Holdings, all of which performed strongly. Additionally, Richard notes that these companies, given the current market backdrop, also enhanced shareholder returns in pursuit of balancing their growth objectives with greater capital efficiency.

Additionally, ongoing geopolitical tensions, particularly with China, have led to significant shifts in global trade relationships and supply chains. Many companies are moving to reduce their reliance on regions vulnerable to geopolitical disruption, restructuring things like supply chains, something that has benefitted Japan. The country is well-positioned to address strategic vulnerabilities in certain sectors like technology or industrials, where it has maintained competitive advantages. Companies such as Socionext and Shin-Etsu Chemical were strong performers, benefitting from their industry-leading positions and as potential beneficiaries of global realignment.

However, it hasn't been completely smooth sailing this year. Several factors arose, contributing to elevated investor uncertainty, such as the weak yen, questions about the future actions of the BoJ and concerns over the potential impact of a US recession. These challenges have made Japan's domestic economy appear sluggish and resulted in share price weakness for companies whose results are more heavily reliant on the performance of the domestic market. One example of a company that has suffered recently is DIP Corporation, an internet job recruitment services company. Richard acknowledges his disappointment in their recent performance but remains optimistic about their focus on long-term growth opportunities and consistent shareholder returns.

Given Richard's focussed investment approach, periods of short-term underperformance can be expected, particularly when markets are driven by specific style factors. For instance, 2019 and 2020, two periods we covered in our **previous note**, saw CCJI underperform as growth investing dominated. This is a risk worth bearing in mind. However, it's also important to note that Richard is a long-term investor with a proven track record of delivering strong performance and consistent **Dividend** growth. Over the past five years, CCJI has delivered a NAV total return of 41.9%, compared to its benchmark return of 24.8%. Since its launch in December 2015, CCJI has also demonstrated outperformance, achieving NAV total returns of 148.8%, outpacing the TOPIX's total return of 95.1%.

Fig.4: Five-Year Performance



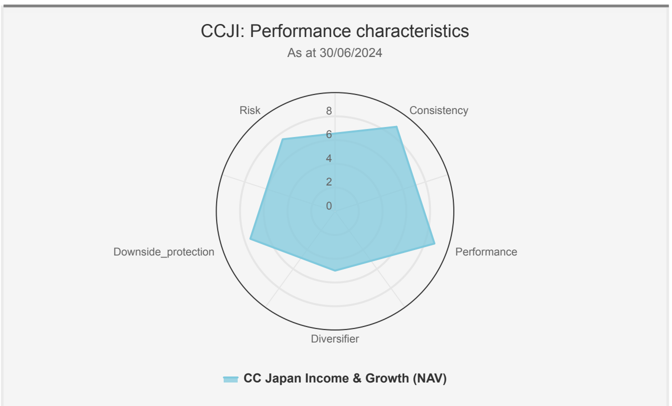
Source: Morningstar

Past performance is not a reliable indicator of future results.

Our proprietary KTI Spider Chart shows how CCJI has performed versus a peer group of all Japanese and Japanese small-cap trusts over the past five years, in some key categories. A selection of key characteristics is considered, with ten being the maximum score, and a higher score indicating superior performance in that characteristic.

CCJI ranks highly for performance, based on its risk-adjusted alpha, and also demonstrates one of the highest consistency scores, reflecting the number of months it has outperformed its benchmark. The trust also scores well on risk and downside protection, benefitting from Richard's more balanced approach that blend aspects of growth and value. This has resulted in a diversified portfolio of high-quality companies that have shown resilience in difficult market conditions. However, CCJI's lowest score is in the diversifier category. We attribute this to its higher correlation with the TOPIX Index, given the trust's more balanced and core approach distinct from the wider peer group, which employs more growth-oriented approaches.

Fig.5: KTI Spider Chart



Source: Morningstar, Kepler calculations

Past performance is not a reliable indicator of future results.

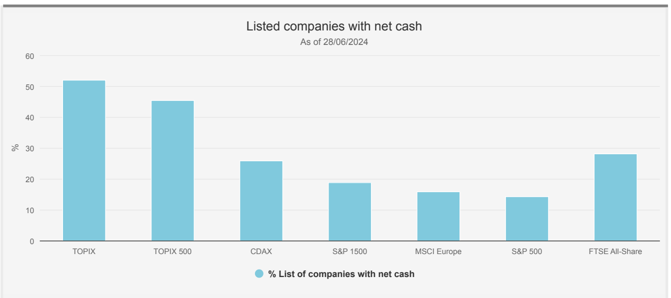
Dividend

Japan's corporate governance reforms continue to bolster the standards of listed Japanese companies, placing an emphasis on enhancing corporate value and capital efficiency. These reforms have not only supported Japan's economic growth and helped it escape deflation but have also reshaped management behaviour across the country. Many companies that have been historically prone to hoarding cash are now more willing to better utilise cash-heavy balance sheets by increasing shareholder returns, through share buybacks and increasing dividends, or pursuing private equity deals.

Nomura, a leading Japanese financial group, recently highlighted that these reforms are already yielding tangible results, with shareholder payout ratios (dividends and buybacks) on the TOPIX exceeding 60%. Richard Aston concurs, citing that corporate governance reforms are increasing momentum behind larger dividend payouts and share buybacks among many companies in CCJI's portfolio, such as JSF, which has grown distributions by 17% per annum since 2014, ZOZO, which increased its dividend payout ratio to 70% last year, and JAFCO, which has introduced both an interim and final dividend for investors.

Consequently, we think this shift makes the income story in Japan increasingly appealing. As highlighted below, approximately 52% of Japanese listed companies have net cash positions on their balance sheets, a significantly higher proportion than in other global markets. This surplus cash means there remains considerable potential for further income growth, and, against this backdrop, we think CCJI is well-positioned to capitalise on Japan's evolving income opportunities. Offering a fully covered dividend yield of 3.0% the highest in the AIC Japan sector and above the TOPIX's yield of 2.3%, CCJI also presents a compelling choice for investors seeking diversified income sources outside traditional equity-income spaces.

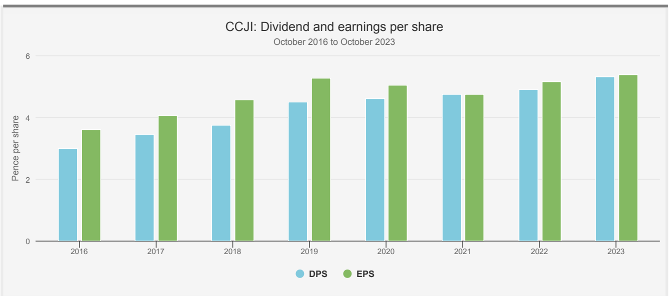
Fig.6: Net Cash For Listed Japanese Companies



Source: FactSet, MSCI, FTSE, Bloomberg

In the trust's latest results for the six months to April 2024, dividend earnings per share increased by 3.23% compared to the prior year, with the board declaring a first interim dividend of 1.60p per share. Net revenue in the first half of the financial year remained steady at 2.66p per share. The board is also continuing to strengthen revenue reserves, which now stand at around £6.4m, providing 1.3× coverage based on last year's dividend (1.2× coverage the year prior). Additionally, the trust retains a special reserve

Fig.7: DPS & EPS



Source: Morningstar

of £64.7m, available for distribution in the event of an unforeseen revenue shortfall, offering additional dividend support, if required.

Management

Richard Aston boasts over three decades of experience in Japanese equities and is viewed as a veteran in the space. He has been at the helm of CCJI since its launch in December 2015 and also manages its open-ended equivalent, the Chikara Japan Income & Growth Fund. Richard's deep familiarity with the Japanese market, gained from frequent visits and extensive coverage over his career, has helped him build strong relationships with company management and establish a solid reputation in Japan.

Richard is supported by deputy portfolio manager and analyst Megumi Takayama and analyst Theo Wyld. Megumi, who joined Chikara in December 2018, has primarily focussed on Japanese small- and mid-sized companies throughout her career. Her expertise, including a strong background analysing the IPO market, stems from a career that started at Bloomberg in 2006, followed by roles she's held in Japanese equity sales at SMBC Nikko and Nomura.

Theo joined Chikara in October 2024, having spent over five years at Ruffer where he was latterly the co-manager of the Ruffer Japanese Fund. Prior to this, he spent three years as a research analyst covering UK and global equities at JM Finn.

Discount

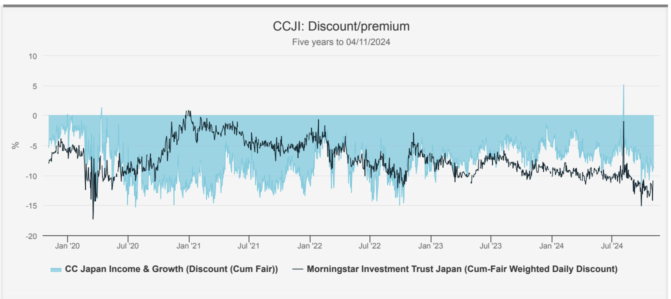
Before 2020 CCJI traded close to par or at a premium, in our view due to the tailwinds that came from being the only income-focussed Japanese equity strategy in the UK-listed investment trust space. Its underlying portfolio and strategy differentiated it from peers in the sector, a distinction that largely remains true today, despite some other trusts placing a greater emphasis on income more recently. However, since 2020 a flurry of wider macroeconomic pressures has weighed heavily on both CCJI's discount and the broader investment trust sector. By late 2022 the trust's discount was wider than its peer group average.

CCJI's discount has narrowed considerably since its double-digit highs in 2022, driven by its sector-leading NAV total returns and attractive income profile, and is trading at an 8.6% discount, at the time of writing. This is narrower than its five-year average of 7.8% and wider than the sector's weighted average of 12.3%, according to JPMorgan Cazenove. Despite this movement, the discount may still appear wide, given CCJI's strong relative returns against its benchmark since inception (see **Performance**), as well as its consistent dividend growth and attractive yield, the highest in the AIC Japan sector.

We think broader market pressures are the primary factor behind the current discount level, rather than any reflection of the effectiveness of Richard's strategy. For example, investor concerns remain elevated over Japan's economic direction, the weakness of the yen, the future actions of the Bank of Japan and the potential impact of a US recession. Additionally, Richard suggests UK cost disclosure rules, specifically their inconsistent interpretation, as a factor that has further widened discount. However, he notes that with recent clarity from the regulator on cost disclosures, this pressure could ease over time.

We think there is potential for CCJI's current discount to narrow further, if performance continues, economic pressures ease and it continues to offer investors differentiated exposure to Japan's growth potential and its evolving income opportunities (see **Dividend**).

Fig.8: Discount



Source: Morningstar

Whilst the board recognises the importance of managing the discount for existing shareholders and holds the authority to buy back up to 14.99% of shares, no shares have been repurchased in the last 12 months, to 04/11/2024. The board believes that investment performance and the income offered are more critical factors in managing the discount than share buybacks. Additionally, CCJI has a three-yearly continuation vote, with the next one scheduled for the 2025 AGM.

Charges

CCJI's latest ongoing charges figure (OCF) is 1.05%, which compares to the 0.79% weighted average of the AIC Japan sector. This includes a management fee of 0.75% of the NAV, with 80% of this charged to capital and the remaining 20% to revenue. There continues to be no performance fee payable. The latest KID RIY is 1.43%, although we would caution that calculation methodologies can vary.

ESG

Whilst CCJI doesn't explicitly target sustainability objectives or ESG outcomes as part of portfolio construction, these factors have been central to Richard Aston's process since the trust launched in 2015. One of the primary reasons for CCJI's launch was to capitalise on the improvements deriving from then Prime Minister Shinzo Abe's governance reform policies. As a result, Richard places a particular emphasis on corporate governance, drawing on active engagement with company management to improve corporate standards and strengthen relationships between companies and shareholders.

Both the board and Richard believe that ESG-related issues can also impact the long-term performance of an investment. By thoroughly analysing ESG factors, they aim to gain deeper insights into a company's management quality and operational performance. Overall, this approach helps them better assess the long-term growth prospects and resilience of the companies they invest in, especially amid changing market conditions.

Morningstar awards CCJI three out of five globes for sustainability when looking across open- and closed-ended funds in the Japan equity sector.

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