MARTEN & CO

Review of investment trust range | Investment trusts

20 May 2016

Fidelity Closed-End Funds

A regular publication looking at Fidelity and recent developments in three of its investment trusts – Fidelity Asian Values (FAS), Fidelity Japanese Values (FJV) and Fidelity Special Values (FSV).

In this issue:

- Fidelity Asian Values soars to the top of the performance tables in the AIC's Asia ex Japan sector.
- Fidelity Japanese Values expands as its subscription shares are exercised. The new manager, Nicholas Price, is having a positive impact.
- Fidelity Special Values' manager, Alex Wright, says he is taking advantage of market volatility to pick up attractively valued stocks.

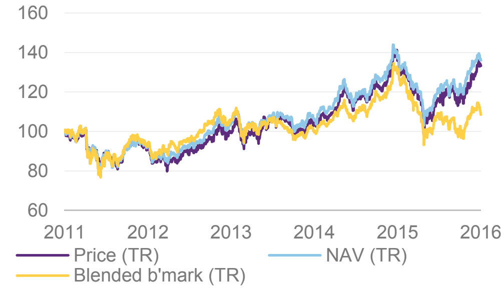
We also include a special feature on Fidelity Japanese Values as its new manager and investment style deliver outperformance of its benchmark.

Special feature: Fidelity Japanese Values – a new start

Nicholas Price assumed responsibility for the management of FJVs' portfolio on 1 September 2015. We look at how the Japanese economy is changing (hopefully for the better), delve into Nicholas' approach to managing Japanese equities and review the factors that he thinks will influence Japan's stock market in coming months.

Fidelity Asian Values perf.

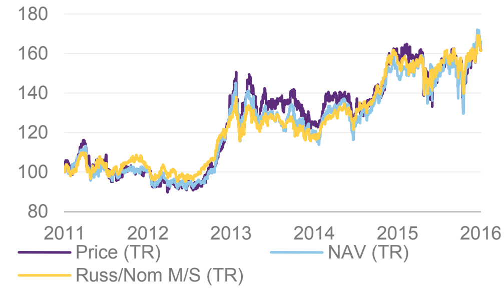
Time period 30/04/2011 to 30/04/2016



Source: Bloomberg, Morningstar, Marten & Co.

Fidelity Japanese Values perf.

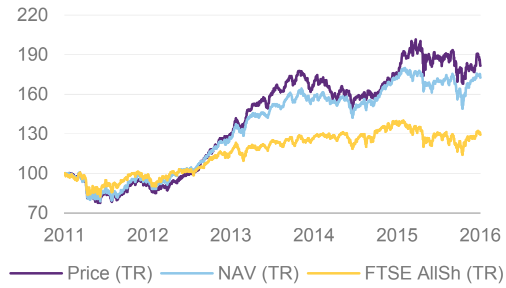
Time period 30/04/2011 to 30/04/2016



Source: Source: Bloomberg, Morningstar, Marten & Co.

Fidelity Special Values perf.

Time period 30/04/2011 to 30/04/2016



Source: Bloomberg, Morningstar, Marten & Co.

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Recent developments at Fidelity

As the new managers of Fidelity Asian Values and Fidelity Japanese Values bed themselves in and demonstrate outperformance of their respective benchmarks, Sam Morse, manager of Fidelity European Values (FEV) celebrated five years as manager of FEV at the start of 2016. From the date he started managing the fund to the end of April 2016, FEV has delivered around twice the return of its benchmark index (FTSE World Europe ex UK) with a total return to shareholders of 67% compared with a 34% return for the index. Despite a difficult start to 2016 for the Chinese market, Fidelity China Special Situations (FCSS) is also well ahead of its benchmark over most time periods.

Generally then, Fidelity's investment company business appears to be firing on all cylinders.

Fidelity International

Fidelity International has around US2.1trn of assets under management. It has a significant presence in London, Hong Kong, Tokyo, Singapore and Sydney.

Fidelity International (Fidelity) is a global investment management organisation that has substantial expertise in equity and fixed income investments, as well as other assets classes. It has c US$2.1trn of assets under management, about half of which is invested in equities, and offers an impressive range of funds to both private and institutional investors. Fidelity maintains a global network of fund managers, but has a significant presence in London, Hong Kong, Tokyo, Singapore and Sydney. Managers are supported by an extensive analytical team that also has a global footprint (Fidelity has a network of around 350 investment professionals located in over 13 countries) and Fidelity is renowned for both its bottom-up stock-picking investment process as well as a focus on long-term performance.

Fundamental investment process

Portfolio managers are incentivised on the basis of their long term performance.

Fidelity's managers, whilst having access to extensive macroeconomic analysis and market-cycle information, do not have top-down macro views imposed upon them. Instead, asset allocation decisions reside with portfolio managers, whose incentive schemes are primarily based on the longer-term performance of the funds that they manage. Managers and analysts will typically form opinions taking a three-to-five-year view. They maintain projections over this time frame and are not encouraged to follow fads or trends. Fidelity's core approach is that, irrespective of the strategy (growth, value, etc.), each investment opportunity is researched in depth, from the bottom up, with a view to ensuring that every holding is a sustainable longer-term investment. Following this approach, consistently, has been a pillar of Fidelity's success during the last 40 years.

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20 May 2016

Fidelity Asian Values

Noticeable performance improvement

Nitin Bajaj has been manager of Fidelity Asian Values (FAS) for just over a year and, since his appointment, FAS has become the best performer in its peer group in NAV terms (second in terms of share price). Over the year to the end of April 2016, FAS has beaten its new benchmark by 13.7%.

Long-term growth from small-cap Asian ex Japan companies

FAS aims to achieve long-term capital growth by investing in a portfolio of companies that are listed on the stock markets of the Asia ex-Japan region. FAS invests in the stock markets of the major economies of the Asian region, such as China, Hong Kong, Taiwan, Korea and Singapore, as well as the less developed markets of Malaysia, Thailand and Indonesia.

Nitin Bajaj, the portfolio manager, is a value investor who prefers to invest in small- and medium-sized companies, as they tend to be less well researched and, therefore, more often mispriced. His investment decisions are based on rigorous fundamental analysis, with a bottom-up stock-selection approach, making use of Fidelity's proprietary research resources.

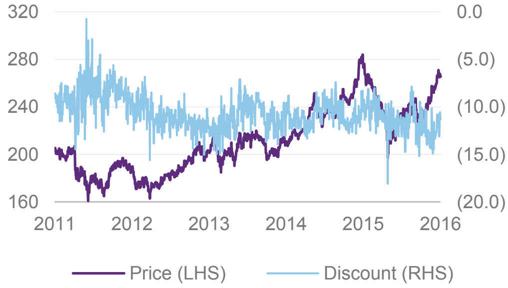
Year ended	Share price total return (%)	NAV total return (%)	Blended b'mark index* TR (%)	MSCI AC Asia ex Japan TR (%)	MSCI World Index TR (%)
30/04/12	(8.0)	(7.0)	(6.5)	(8.0)	(2.0)
30/04/13	8.3	12.4	13.4	13.7	21.8
30/04/14	4.1	0.9	(6.1)	(6.2)	7.5
30/04/15	31.0	30.0	29.9	29.5	18.0
30/04/16	(1.9)	(0.8)	(16.0)	(14.5)	0.5

Source: Fidelity Asian Values, Bloomberg, Morningstar and Marten & Co. *Note: The blended benchmark index comprises the MSCI AC Far East Ex-Japan Index until 31 July 2015 and the MSCI AC Asia ex-Japan Index thereafter.

Sector	Asia ex Japan
Ticker	FAS LN
Base currency	GBP
Price	256.00
NAV	289.54
Premium/(discount)	(11.6%)
Yield	0.8%

Share price and discount

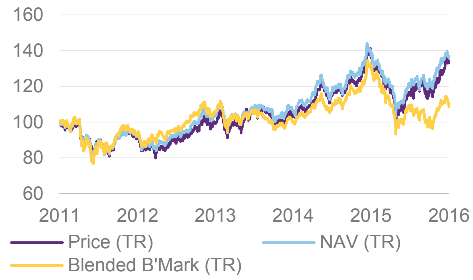
Time period 30/04/2011 to 30/04/2016



Source: Morningstar, Marten & Co

Performance over five years

Time period 30/04/2011 to 30/04/2016



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	13 June 1996
Manager	Nitin Bajaj
Market cap (GBP)	172.8m
Shares outstanding	67.5m
Daily vol. (1 yr. avg.)	56,472 shares
Net gearing	1%

Wholesale transformation

A new manager, new investment policy, new benchmark and noticeable improvement in performance

Nitin Bajaj assumed responsibility for the management of the fund on 1 April 2015 and so has only recently completed his first full year in charge of the portfolio. The period since he was appointed has seen a noticeable improvement in the relative performance of the fund, to the extent that it is the second-best performing fund in its peer group over the past year. Nitin's arrival was accompanied by a number of other changes to the way that the fund is run, including the adoption of a new benchmark index, the MSCI All Countries Asia ex Japan Index, with effect from 1 August 2015. The new benchmark includes India, a country that Nitin knows well and one that is now the destination for a meaningful proportion of the trust's assets (17.4% at the end of March 2016 – see Figure 4 on page 8). Shareholders approved a change of investing policy for FAS in November 2015. The new policy allowed for greater use of derivatives within the portfolio.

The manager selects stocks from a large universe of companies (over 17,000). He is looking for value stocks that he thinks can make 50% returns for the fund over a three-year period, while seeking to protect the downside risk by avoiding companies with stretched balance sheets, poor cash flow, high margins relative to history and few competitive advantages.

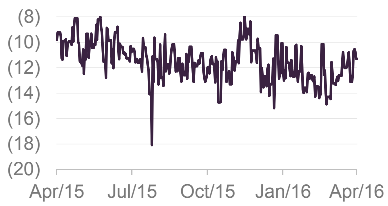
A stock-picking fund

Benchmark weightings have no influence over the size of stock positions. Stocks are selected after rigorous analysis of the characteristics of the business. Higher conviction ideas become larger positions in the portfolio.

The manager acknowledges the challenges faced by Asia, notably rising debt levels in China but believes stocks in the region are, on average, attractively valued. Whilst the rapid rise of debt in China is a concern, he says that there is still good growth in some of the new economy areas focused more on services and consumption. India is faring well, boosted by the impact of a lower oil price and Prime Minister Modi is making some progress with reforms. One of the best-performing markets in recent times has been Indonesia, on sentiment that the pace of reform here has picked up. The recent election in the Philippines creates some uncertainty but, in the manager's view, economic policy is unlikely to deviate much from much from the relatively successful policies of the recent past. He is wary of Korea which also faces an election and where he thinks corporate governance standards need to improve.

Premium/discount

Figure 1: Premium/(discount)



Source: Morningstar, Marten & Co

FAS's discount has moved within a narrow range over much of the past year, spiking briefly when the market became more concerned about Chinese growth towards the end of August 2015. In recent months it has been on a narrowing trend. Today FAS trades on a discount of 11.6%. Over the past year it has traded as wide as 18.1% and as narrow as 7.8%.

FAS has powers to buy back its shares if the board thinks this is warranted and it can hold repurchased shares in treasury. FAS has said it would only reissue shares at NAV or at a premium. No shares have been bought back in recent years.

Portfolio

Figure 2: Top 10 overweight positions at 31/03/16

Holding	Sector	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31/08/15 (%)	Percentage point change
Power Grid Corp of India	Utilities	3.6	0.0	3.6	3.9	(0.3)
Religare Health Trust	Healthcare	2.9	0.0	2.9	3.4	(0.5)
TISCO Financial Group	Financials	2.6	0.0	2.6	2.6	0.0
Zhejiang Supor Cookware	Cons. discretionary	2.3	0.0	2.3	0.8	1.5
WPG Holdings	Information tech.	2.3	0.1	2.2	2.2	0.1
G8 Education	Cons. discretionary	2.0	0.0	2.0	2.3	(0.3)
Ascendas India Trust	Financials	2.0	0.0	2.0	0.5	1.5
Cognizant Tech Solutions	Information tech.	2.0	0.0	2.0	1.8	0.2
New Oriental Education	Cons. discretionary	2.0	0.1	1.9	2.3	(0.3)
LT Group	Industrials	1.9	0.0	1.9	1.2	0.7

Source: Fidelity Asian Values, Marten & Co

Power Grid Corp is India's central transmission utility. It is a regulated business. There is significant need for an expansion of India's power sector and this has been one factor in driving compound annual growth of earnings of 20% over the past five years. Despite this strong growth, it is trading on a forward p/e of 10x. Religare is a property company that owns hospitals in India, which the manager describes as an underpenetrated and growing sector.

TISCO Financial Group provides automotive finance to the Thai market. The manager thinks problem debts have peaked in this market and, with a high return on assets and improving earnings, it could be a potential acquisition target. Zhejiang Supor Cookware is China's leading cookware manufacturer. The manager thinks it benefits from being majority-owned by French company, Groupe SEB.

WPG Holdings is a distributor of semiconductors and other technology to manufacturers. It has a market-leading position in Asia in what the manager considers is a high barrier to entry industry. Its sheer size and the associated economies of scale give it a defensible business model in his view. It trades on 9x forward earnings and has a dividend yield close to 8%.

G8 Education operates day care centres in Australia. Ascendas India Trust owns a number of IT parks in India. Cognizant Technology Solutions is a US listed company but is an IT services provider based in India. China's New Oriental Education is positioned to take advantage of the growing middle class in China and the associated demand for education. It has been expanding the number of classes it offers. LT Group is a tobacco, food and beverage company based in the Philippines.

Figure 3 shows the breakdown of the portfolio by industry sector as at the end of March 2016. The portfolio has a significant overweight exposure to consumer discretionary stocks, positioning it to take advantage of the increasing purchasing power of the Asian consumer. By contrast, the biggest underweight exposure is to financials stocks. Nitin feels that many banks in the region look stretched, especially those in China. In addition to problems with non-performing loans in some markets, a compression of interest rate spreads is putting downward pressure on margins.

Figure 3: Sectoral allocations at 31/03/16

Heading	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31/08/15 (%)	Percentage point change
Consumer discretionary	23.9	8.8	15.2	25.1	(1.2)
Information technology	18.4	24.0	(5.7)	17.8	0.4
Financials	17.7	30.7	(13.0)	18.3	(0.5)
Industrials	10.4	9.0	1.4	8.4	2.0
Consumer staples	8.5	5.6	2.9	8.9	(0.4)
Health care	6.5	2.6	3.9	6.2	0.3
Utilities	5.8	4.2	1.6	5.2	0.6
Materials	4.2	4.6	(0.4)	3.3	0.9
Telecommunications	0.8	6.4	(5.6)	1.4	(0.6)
Energy	0.7	4.2	(3.5)	1.0	(0.3)
Total sector exposure	**97.0**	**100.0**	**(3.0)**	**95.6**	**1.4**
Net cash	3.0	0.0	3.0	4.4	(1.4)
Total	**100.0**	**100.0**	**0.0**	**100.0**	**0.0**

Source: Fidelity Asian Values, Marten & Co. Numbers may not add up due to rounding errors

The geographic allocations shown in Figure 4 show an overweight exposure to India, a market that the manager likes and knows well and one which is a clear beneficiary of depressed oil prices. There is a corresponding underweight exposure to China, where the manager finds it harder to find companies with management teams he trusts, and to Korea where he thinks much-needed corporate governance improvements are not materialising.

Figure 4: Geographic allocations at 31/03/16

Heading	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31/08/15 (%)	Percentage point change
India	17.4	9.5	7.9	14.2	3.2
China	14.3	28.0	(13.7)	13.1	1.2
Taiwan	13.0	14.5	(1.5)	15.5	(2.5)
Hong Kong	8.4	12.3	(3.9)	10.8	(2.4)
Singapore	7.4	5.7	1.7	7.4	0.0
Australia	7.4	0.0	7.4	8.0	(0.6)
Korea	7.3	18.3	(11.0)	8.6	(1.3)
Thailand	5.7	2.6	3.1	5.3	0.4
Philippines	4.0	1.7	2.3	n/d	n/a
Indonesia	3.9	3.2	0.7	4.3	(0.4)
Malaysia	2.0	4.1	(1.9)	2.0	0.0
Other (including cash)	9.2	0.0	9.2	10.8	(1.6)
Total	**100.0**	**100.0**	**0.0**	**100.0**	**0.0**

Source: Fidelity Asian Values, Marten & Co. Numbers may not add up due to rounding errors

Performance

13.1% outperformance of the benchmark since the new manager was appointed

The period since Nitin's appointment has seen a noticeable improvement in FAS' performance. Figure 5 shows that, since the beginning of April 2015, when Nitin took over, the fund has generated a total return on net assets of 1.2% against an 11.9% fall for the blended benchmark and an 11.5% fall for the MSCI AC Asia ex Japan Index (the new benchmark). Fidelity says FAS benefited from being underweight China over the nine months to the end of March 2016 and overweight to Australia. An underweight to South Korea was unhelpful, as smaller companies, in particular, in that country had a good run. An analysis of performance by sector over the same time frame shows FAS doing relatively well from an underweight to financials and overweights to consumer discretionary and industrials.

Figure 5: Total return performance to 30/04/16

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Since 01/04/15* (%)
NAV	1.2	9.6	13.8	(0.8)	30.2	36.0	1.2
Share price	3.3	11.7	15.4	(1.9)	33.7	33.2	1.9
Blended benchmark *	(2.8)	5.8	2.3	(16.0)	2.4	8.6	(11.9)
MSCI AC Asia ex Japan	(2.8)	5.8	2.3	(14.5)	3.8	8.6	(11.5)
MSCI World	(0.3)	4.3	4.3	0.5	27.5	52.1	(0.6)

Source: Fidelity Asian Values, Bloomberg, Morningstar and Marten & Co. *Note: Nitin Bajaj was appointed to manage Fidelity Asian Values from 1 April 2015. Fidelity Asian Values blended benchmark index comprises the MSCI AC Far East Ex-Japan Index until 31 July 2015 and the MSCI AC Asia ex-Japan Index thereafter

At a stock level, the largest positive contributor to FAS' performance over the nine months to the end of March 2016 was New Oriental Education, which added 1.38% to the NAV over that period. One boost for its stock price was the announcement that Tencent Holdings had invested alongside the company in an online education business.

In uncertain markets, tobacco stocks have been in favour because of their stable earnings. The trust's holdings in Indonesia's Gudang Garam and HM Sampoerna and the position in LT Group all benefitted. Another notable positive contribution came from FAS' holding in Zhejiang Supor Cookware which is benefitting from rising expenditure on household goods in China. The largest negative contribution to performance though came from a retailer of household goods, International Housewares Retail.

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Fidelity Japanese Values

Improved performance and liquidity

Nicholas Price has been in place as manager of the Fidelity Japanese Values (FJV) portfolio for eight months and already he is building a track record of outperformance of FJV's benchmark. Unfortunately, this has been accompanied by a widening of FJV's discount, in common with many of its peers. We are optimistic though that, if the manager can sustain outperformance, this, coupled with the increased liquidity in FJV's shares following the successful exercise of its subscription shares, should help attract new investors to the fund, narrowing the discount.

At the end of April 2016, FJV issued 22.5m shares as its subscription shares were exercised, expanding the company by almost 20%.

Long-term growth from Japanese-listed equities

The investment objective of the company is to achieve long-term capital growth from an actively managed portfolio of securities primarily of small- and medium-sized Japanese companies listed or traded on Japanese stock markets.

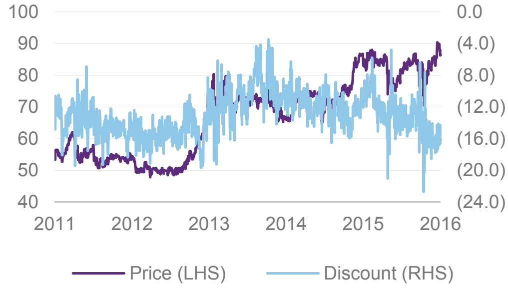
Year ended	Share price total return (%)	NAV total return (%)	Russell/ Nomura Mid-Sm Cap TR. (%)	TOPIX Index TR (%)	MSCI World Index TR (%)
30/04/12	1.2	2.1	2.3	0.9	(2.0)
30/04/13	35.9	29.1	24.9	26.7	21.8
30/04/14	(10.1)	(10.7)	(8.6)	(10.6)	7.5
30/04/15	25.8	26.7	32.7	30.9	18.0
30/04/16	4.1	11.4	4.0	0.9	0.5

Source: Bloomberg, Morningstar, Marten & Co.

Sector	Japan Small Co.s
Ticker	FJV LN
Base currency	GBP
Price	88.00
NAV	104.31
Premium/(discount)	(15.6%)
Yield	0.0%

Share price and discount

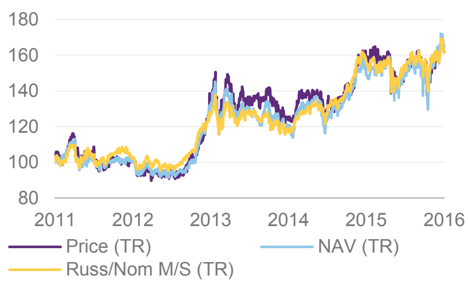
Time period 30/04/2011 to 30/04/2016



Source: Morningstar, Marten & Co

Performance over five years

Time period 30/04/2011 to 30/04/2016



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	15 March 1994
Manager	Nicholas Price
Market cap (GBP)	119.9m
Shares outstanding	136.2m
Daily vol. (1 yr avg.)	148k shares
Net gearing	17%

New manager, new approach

New manager in place for eight months

Nicholas Price took on responsibility for FJV on 1 September 2015. Nicholas has a long history with Fidelity's Tokyo-based investment team (dating back to 1993 when he joined as a research analyst) and has built up a good track record managing a number of other Japanese equity funds for the Fidelity group. His style can be described as "growth at a reasonable price".

Targeting companies whose valuations do not reflect their growth prospects

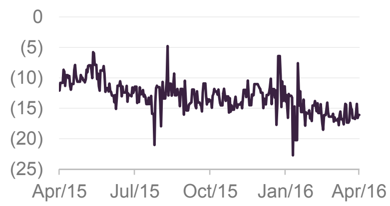
Nicholas aims to identify companies that are growing but whose growth is not reflected in their valuation. He says that these valuation anomalies can occur for a number of reasons but often the companies will be misunderstood by investors because they are not well-researched. For example, they could also be in a state of flux where new products and markets are being accessed, or their end market is changing and the market has not realised this. Often he will target companies where he feels investor sentiment is at odds with the fundamentals of the business.

Strong sell discipline

Nicholas believes in the importance of maintaining a strong sell discipline: taking profits in positions that have done well and recycling into new names to maintain performance, selling when valuation targets are reached and cutting positions when the fundamentals of the underlying business deteriorate.

Premium/discount

Figure 6: Premium/(discount)



Source: Morningstar, Marten & Co

Over the past year, FJV's discount, like that of many other investment companies, has been on a widening trend. At the time of publication, the discount was 15.6%. Over the past year the discount has moved within a range of 22.7% at its widest and 4.8% at its narrowest.

The widening discount does not reflect the outperformance of FJV's NAV relative to its benchmark since Nicholas Price took up the reins.

FJV has powers to buy back shares. Over the course of 2015 it did not exercise these powers but, in the first four months of 2016, it bought back 500,000 shares. Shares bought back may be held in treasury and reissued but the board has said that any reissue of shares would only be done at a premium to NAV.

Performance

Figure 7: Total return performance to 30/04/16

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Since 01/09/15 (%)
NAV	1.6	7.9	9.8	11.4	26.0	66.0	9.7
Share price	0.4	4.1	5.7	4.1	17.7	61.8	6.1
Russell/Nomura Mid/Sm	1.1	2.5	4.7	4.0	26.2	61.3	6.9
Topix	2.6	3.6	3.5	0.9	18.1	50.9	5.7
MSCI World	(0.3)	4.3	4.3	0.5	27.5	52.1	8.0

Source: Morningstar, Marten & Co, *date of manager's appointment

Outperformance of 2.8% since new manager appointed

Since Nicholas Price took on the management of the portfolio on 1 September 2015, FJV's NAV has outperformed its benchmark, the Russell/Nomura Mid Small Cap Index by 2.8% and is now ahead of its benchmark over most time periods. FJV has also outperformed the Topix Index (the index of all the companies listed on the first section of the Tokyo Stock Exchange).

Fidelity says that the main drivers of performance over the year to the end of March 2016 were stock selection, the portfolio's overweight to the services, chemicals and real estate sectors and an underweight exposure to banks. Generally, the trust's communications holdings were unhelpful over this period.

Portfolio

At the end of March 2016 there were 87 holdings in the portfolio. Relative to the Russell/Nomura Mid Small Cap Index, the fund's benchmark, the portfolio was weighted towards smaller companies (weighted median market cap £2.8bn versus £3.4bn for the index). The average market cap in the portfolio is higher than it was under the previous manager, as Nicholas has a stronger preference for medium-sized companies over smaller ones relative to the previous manager.

There was at the end of March, as you might expect, a strong bias to faster-growing companies – FJV's portfolio was, on average, expected to deliver earnings growth of 20.6% against 8.8% for the Index and was also estimated to be generating a higher return on equity (9.7% vs. 7.8%). This faster growth comes at a price – the average p/e ratio for the fund was 16.7x against 14.0x for the Index and price'/cash flow 13.0x against 8.0x.

Figure 8: Top 10 overweight positions at 31/03/16

Holding	Sector	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31/08/15 (%)	Percentage point change
Aeon Financial Service	Other finance	7.1	0.2	6.9	0.0	7.1
Nissan Chemical Ind.s	Chemicals	6.5	0.2	6.3	0.0	6.5
Kubota	Machinery	6.0	0.0	6.0	0.0	6.0
Orix	Other finance	4.3	0.0	4.3	0.0	4.3
SoftBank	Information & comms	4.1	0.0	4.1	0.0	4.1
Kosé	Chemicals	3.7	0.2	3.5	0.0	3.7
Kakaku.com	Services	3.6	0.2	3.5	0.0	3.6
Zojirushi	Electrical appliances	3.4	0.0	3.4	0.0	3.4
Makita	Machinery	3.4	0.4	3.0	0.0	3.4
Nippon Shinyaku	Pharmaceuticals	3.1	0.1	2.9	0.0	3.1

Source: Fidelity Japanese Values, Marten & Co

The manager identifies a number of investment themes within the portfolio:

- The growth of Asian consumption and consumer finance (stocks such as Aeon Financial Service, Orix and Kao)
- Dynamic growth in e-commerce (stocks such as Kakaku.com, SoftBank and M3)
- Environmental technology (stocks such as Kubota, Rinnai and Keyence)
- Structural growth in tourism (stocks such as Zojirushi, Fujita Kanko and HIS)
- Deregulation in residence sharing (stocks such as Next and Apamanshop)
- Providers of online delivery
- Growth in global solar cell demand

Kosé is a cosmetics company that is taking market share from rivals in Japan. Its products are also popular with tourists.

Kakaku.com is a price comparison website and restaurant review company and a long-standing holding within the portfolio. It operates a number of websites covering areas such as online shopping, travel, real estate, insurance and movies but its fastest growing business is Tabelog, its restaurant search engine.

Zojirushi is a relatively new introduction to the portfolio. It makes rice cookers and thermos flasks which it sells in Japan and overseas and which are very popular among inbound tourists. It's the growth of sales to non-Japanese buyers that is accelerating the growth in revenue. Overseas sales within Asia attract higher margins than those it can achieve at home and this is driving profit growth.

The manager also highlights Yonex, a new position that lies outside the top holdings. It is the world's largest manufacturer of badminton equipment and also serves the golf and softball markets. Exports have been growing strongly in recent years and these now account for almost half of sales. Exports have been helped by demand from China.

The biggest industry sector overweights within the portfolio are to the machinery, services and other finance sectors – as is evidenced by the top 10 holdings. By contrast, the fund is underweight land transportation, banks and construction.

In recent times, in addition to exploiting the investment themes mentioned above, Nicholas has been adding to positions in exporters that he believes have been oversold and stocks that should benefit from the new regime of negative interest rates. Profit taking has been centred on domestically focused companies that have performed well – these include a number of e-commerce and communications companies.

Fidelity Special Values

Taking advantage of volatility

Fidelity Special Values (FSV) is a fund that thrives on volatility and uncertainty. It seeks to exploit mispricing created by swings in investor sentiment. The manager took advantage of the market setback in January to build positions and add to gearing. The manager believes that the forthcoming EU referendum is also having a distorting effect on the UK market and is positioning the fund accordingly.

Having traded for some time close to asset value, over the short term, FSV's discount has widened to 7.8%. This seems at odds with FSV's strong track record of outperformance of the FTSE All-Share Index.

UK-focused special situations

FSV aims to achieve long-term capital growth by investing in special situations. The portfolio is primarily focused on UK-listed equities and whilst it is an all-cap strategy, there is an inherent bias towards small- and mid-cap companies. The manager has adopted a value/contrarian style.

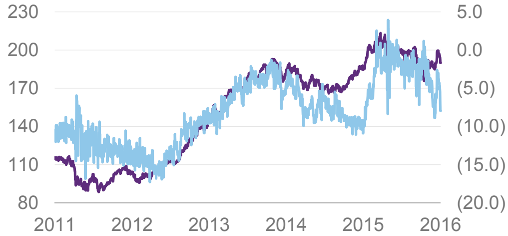
Year ended	Share price total return (%)	NAV total return (%)	FTSE All-Share TR (%)	MSCI UK Value Index TR (%)	MSCI World Index TR (%)
30/04/12	(8.8)	(5.3)	(2.0)	1.5	(2.0)
30/04/13	42.6	33.4	17.8	19.3	21.8
30/04/14	29.2	24.9	10.5	10.2	7.5
30/04/15	3.9	9.2	7.5	3.0	18.0
30/04/16	4.1	0.1	(5.7)	(12.2)	0.5

Source: Morningstar, Marten & Co.

Sector	UK
Ticker	FSV LN
Base currency	GBP
Price	183.25
NAV	198.74
Premium/(discount)	(7.8%)
Yield	1.8%

Share price and discount

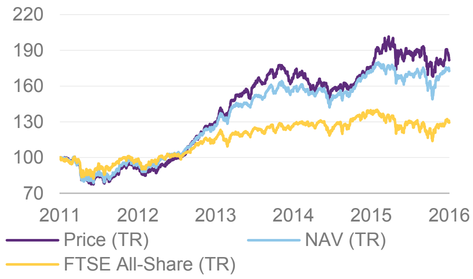
Time period 30/04/2011 to 30/04/2016



Source: Morningstar, Marten & Co

Performance over five years

Time period 30/04/2011 to 30/04/2016



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	17 Nov 1994
Manager	Alex Wright
Market cap (GBP)	496.0m
Shares outstanding	270.6m
Daily vol. (1 yr. avg.)	227k shares
Net gearing	14%

Value/contrarian style

A value/contrarian style, capturing sentiment changes and earnings recovery and identifying unrecognised growth potential

FSV has been managed since September 2012 by Alex Wright in a value/contrarian style. He identifies stocks that have experienced some difficulties but may, in his view, have scope for a recovery that is not reflected in the valuation of the company. Successful investments will not only experience a recovery in profitability but also benefit from improved sentiment that puts a higher multiple on these earnings. Alex will also invest in stocks that he believes have growth potential that is not recognised by the market. The nature of this stock-picking strategy means that the portfolio bears little resemblance to the make-up of UK benchmark indices. Up to 20% of the portfolio can be invested in companies listed on overseas exchanges.

When Alex selects investments for the portfolio, he is looking for stocks whose downside is limited because they are already trading at excessively low market multiples or have assets that support the valuation.

Exploiting volatility

The volatility that we saw in markets in recent months was useful in creating opportunities for FSV's portfolio. Fidelity believe that market sentiment can lead share prices to overshoot in such a scenario. The manager has been taking advantage of the situation to expand the portfolio, deploying more gearing, which has risen from 8.9% at the end of August 2015 to 14.1% at the end of March 2016.

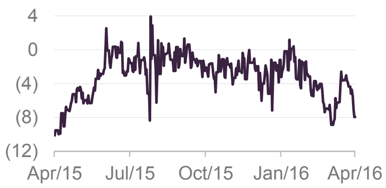
Gearing is provided by contracts for difference (CFDs). This has been offset since 2013 by a short position on FTSE250 futures and FSV may also have short CFD positions against some stocks held in the portfolio.

Monitoring the likely effects of the EU referendum

Like many managers of portfolios of UK stocks, Alex is monitoring the effect of the forthcoming referendum on Britain's membership of the EU. He has identified one stock in the portfolio where he feels a "leave" vote could have negative consequences for its business model. He sees a potential impact on the valuation of sterling, believing a leave vote could trigger a devaluation of the pound, which would have a translational benefit for the profitability of many UK companies with overseas earnings. Alex has been reducing the portfolio's exposure to sterling but, in any case, domestically focused stocks have been doing well and consequently do not feature much in FSV's portfolio.

Premium/discount

Figure 9: Premium/(discount)



Source: Morningstar, Marten & Co

For much of the past year FSV's share price has been trading fairly close to NAV but, in recent months, in common with many other trusts, FSV as seen its discount widen. Today it stands at 7.8%.

The discount narrowing that occurred about a year ago followed the splitting of FSV's shares (on a five-for-one basis) which made it easier to invest smaller amounts of money in the company. FSV's board also committed to keep the cum income discount in single figures. FSV has been buying back shares, it bought 300,000 in March for example.

Portfolio

Figure 10: Top 10 overweight positions at 31/03/16

Holding	Sector	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31/08/15 (%)	Percentage point change
Citigroup	Financials	5.4	0.0	5.4	3.9	1.5
Royal Mail	Industrials	3.8	0.2	3.6	2.4	1.4
Carnival Corporation	Consumer services	3.8	0.3	3.5	3.0	0.8
CRH	Industrials	4.3	0.8	3.5	2.8	1.5
HomeServe	Industrials	3.3	0.1	3.3	2.5	0.8
Ultra Electronics	Industrials	3.2	0.1	3.1	3.0	0.2
Lloyds Banking Group	Financials	5.3	2.2	3.1	3.0	2.3
Wolseley UK	Industrials	3.6	0.5	3.1	2.9	0.7
Regus	Industrials	3.1	0.1	3.0	3.1	0.0
Countrywide	Financials	2.8	0.0	2.8	1.0	1.8

Source: Fidelity Special Values, Marten & Co

Alex has a high-conviction position in banks, making financials FSV's largest sector exposure. Citigroup and Lloyds Banking Group (Lloyds) are the second-and-third-largest positions in the portfolio. The much anticipated increase in UK interest rates has not materialised and rate rises in the US have been minimal so far; which depresses banks' earnings. Many banks are trading at discounts to book value and are therefore priced for capital destruction. The manager thinks this is not going to happen. He says that banks are no longer obsessed with growth of their loan books and M&A activity and are now run more conservatively. Lloyds has exited non-core markets and reintroduced its dividend (a move that Alex thinks caught markets off guard). The manager believes banks could become solid dividend payers in time.

The largest position in the portfolio is Royal Dutch Shell (Shell). It is an underweight position relative to the FTSE All-Share Index however (5.9% versus 6.8% at the end of March 2016). Alex thinks the dividend is under threat as it is not covered by cash flow, though the BG Group deal should help in that regard. Shell has curtailed or delayed some projects and the manager thinks that it is exhibiting better capital discipline and its strong position in LNG is also helpful. Fidelity sees the oil price stabilising in a range of \$40-\$60 as low prices restrict capital expenditure in the sector. Improved cash flow and a covered dividend could, Alex believes, drive Shell's share price higher.

CRH, an Irish company, is the third-largest building materials company globally. It expanded in 2015 with the acquisition of assets that Lafarge and Holcim were forced to sell to gain approval for their merger. The manager believes that these assets were acquired at attractive prices, reflecting CRH's strong negotiating position. CRH has been able to consolidate positions in many markets and consequently the manager thinks margins, which are currently below historic levels, will rise over time and could exceed previous peak levels. Alex is also optimistic that CRH will benefit from increased infrastructure spending in the US.

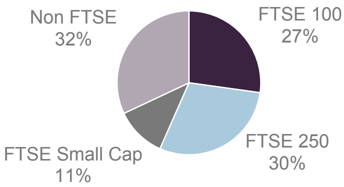
Other building materials companies in the portfolio include roofing and insulation company, SIG, concrete and galvanising company, Hill & Smith, and plumbing company, Wolseley UK (Wolseley). The attraction of Wolseley is a recovery of the residential construction market in the US. The manager topped up the holding after problems in Wolseley's industrial division triggered a profit warning.

Figure 11: Sectoral allocations at 31/03/16

Heading	Portfolio weight (%)	Index weight (%)	Percentage point difference	Portfolio weight 31/08/15 (%)	Percentage point change
Financials	41.5	23.9	17.7	40.2	1.3
Industrials	31.5	10.8	20.7	29.7	1.8
Consumer services	16.5	13.0	3.5	17.1	(0.6)
Oil & gas	8.7	10.6	(1.9)	9.3	(0.6)
Technology	7.0	1.5	5.5	2.7	4.3
Health care	5.3	8.4	(3.1)	3.8	1.5
Consumer goods	5.2	17.6	(12.4)	6.8	(1.6)
Basic materials	3.9	5.0	(1.1)	4.3	(0.4)
Telecommunications	2.2	5.2	(3.1)	2.1	0.1
Utilities	0.0	4.0	(4.0)	0.8	(0.8)
Total sector exposure	**121.8**	**100.0**	**21.8**	**116.7**	**5.1**
Other – FTSE250 short	(7.7)	0.0	(7.7)	(7.8)	0.1
Total equity exposure	**114.1**	**0.0**	**14.1**	**108.9**	**5.2**
Gearing	(14.1)	0.0	(14.1)	(8.9)	(5.2)
Total	**100.0**	**100.0**	**0.0**	**100.0**	**0.0**

Source: Fidelity Special Values, Marten & Co

Figure 12: FSV portfolio by index



Source: Fidelity Special Values

Most of the industrials sector exposure is actually represented by support services companies and the portfolio does not have much exposure to engineering stocks. The industrials exposure includes boiler insurance company, HomeServe, which FSV bought into after the FCA made it change its sales strategy. Alex sees HomeServe as a cash generative, capital light, defensive company. It is expanding in the US, consolidating a fragmented market.

Ultra Electronics (Ultra), which also sits under industrials, is a defence company that operates in niche, high-tech areas such as surveillance and electronic warfare. It has grown through piecemeal acquisition and the manager believes it is starting to leverage its size. He thinks Ultra is undervalued because its fragmented business model is hard to analyse.

Performance

Figure 13: Total return performance to 30/04/16

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	Since 01/09/12* (%)
NAV	0.2	5.1	1.9	0.1	36.5	72.6	75.6
Share price	1.3	1.5	(2.8)	4.1	39.7	81.7	94.9
FTSE All-Share	1.1	3.9	0.0	(5.7)	12.0	29.4	30.5
MSCI UK Value	3.6	6.2	0.1	(12.2)	(0.4)	20.5	14.7
MSCI World	(0.3)	4.3	4.3	0.5	27.5	52.1	52.3

Source: Morningstar, Marten & Co, *date of manager's appointment

Over the year to the end of April 2016, FSV has beaten the FTSE All-Share Index by 5.8% in NAV total return terms. This has helped extend the fund's lead over its benchmark over the period that Alex has been managing the fund, to 45.1%.

The lack of exposure to large-cap mining stocks has helped performance for much of the past few years but there was a headwind to performance from the portfolio's underweight exposure to consumer goods. The bias to small-cap stocks has been beneficial as these have outperformed larger companies over the medium term. Fidelity says that the largest contribution to FSV's performance, however, is stock selection.

Stocks that the manager has identified as making a positive contribution to performance in recent months include Hewlett Packard Enterprise and Synthomer (both positions that lie outside the fund's largest holdings). The big banks holdings (Citigroup and Lloyds) have fallen so far in 2016 though they are off their lows. Shell has been moving up, making about 17% year to date.

Special feature: Fidelity Japanese Values – a new start

A new manager, new investment approach, improved performance and a bigger fund

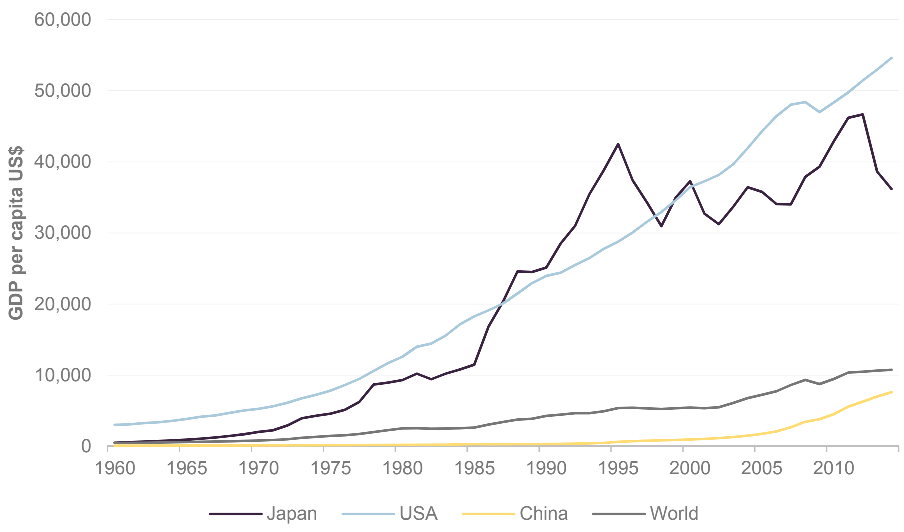
Japan is the world's third-largest economy (after the US and China) yet the 10 investment companies that make up the AIC's Japan and Japan Smaller Companies sectors have a combined market cap of just £1.7bn. For many years, a lack of growth in Japan's economy may have put investors off its stock market. This started to change a few years ago, though, with the election of a new, reform-minded government led by Shinzo Abe. FJV boasts a new manager, new investment approach, improved performance and it is expanding. Its focus on fast-growing but attractively valued medium-sized Japanese companies is designed to benefit from the growth of the more dynamic sectors of Japan's economy.

The new Japan

After many years of depression, Japan's GDP per capita is behind the US but Japan sits in the midst of some of the fastest-growing countries in the world

Japan's economy experienced rapid growth through the '70s and '80s but experienced a severe recession in the mid '90s from which it has struggled to recover. Japan is also burdened with an ageing and shrinking population, with almost twice as many citizens over the age of 65 as under the age of 15. Japan is still a rich country but it has been overtaken, once more, by the US in terms of GDP per capita (as Figure 14 illustrates). One of the factors that will have a significant influence on Japan's future, however, is the growth of China. Japan is an Asian country, it sits in the middle of some of the fastest-growing countries in the world and China is its largest trading partner. This latter point has been unhelpful in recent months as Chinese growth slows but it will be an important factor in Japan's growth for years to come.

Figure 14: GDP per capita for Japan, US, China and the world



Source: World DataBank., GDP per capita in current US$

The domestic economy has been stifled by deflation and consumers have shown a reluctance to spend. A lot of the efforts of the government and central bank have been directed towards encouraging modest inflation and combatting this problem.

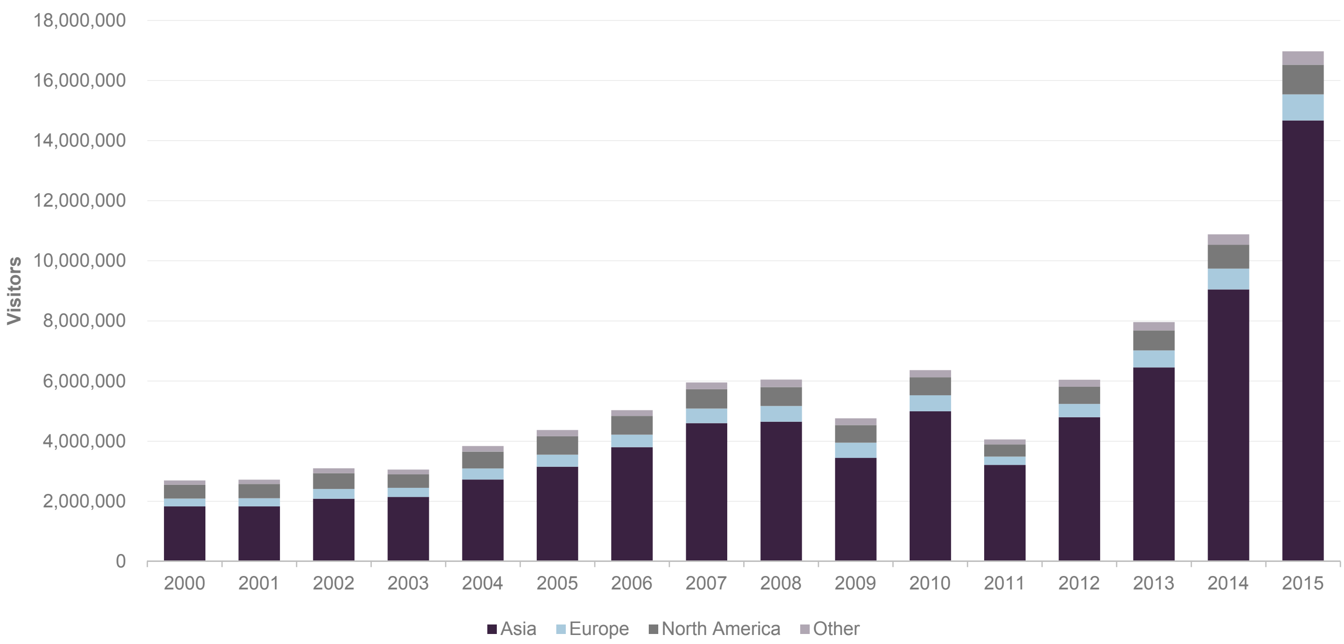
In 2012, a new government, led by Shinzo Abe, was elected with a mandate for reforming the economy. He introduced his “three arrows” economic policy – aggressive monetary easing, a flexible fiscal policy and a package of structural reforms designed to liberate the economy such as encouraging greater female participation in the workforce. The election and accompanying policy shift contributed to a sharp weakening of the Japanese yen. From September 2012 to June 2015 the yen/dollar exchange rate moved from around 78 to 125, boosting Japan’s export potential. In recent months though, this trend has reversed somewhat.

Corporate governance reforms ae having an impact

Although the impact of the monetary easing part of the policy has been questionable, some of the most impactful reforms, from a stock market perspective, have been those designed to improve corporate governance standards. Companies that suffered from sclerotic management, complex cross-holdings and a tendency to hoard cash have been encouraged, through a variety of measures, to become more efficient. The effect has been that dividend payout ratios and share repurchases are rising, as are returns on equity.

Today, consumer confidence is relatively stable but not buoyant. Some sectors of the economy though are doing well. For example, tourism is booming. As Figure 15 shows, tourists have been flocking to Japan. Numbers were depressed by the earthquake and tsunami in 2011 but, even between 2012 and 2015, numbers rose 2.8x. A lot of this growth is coming from China.

Figure 15: The growth of inbound tourism



Source: Japan Tourism Marketing Co.

One of the things that Nicholas Price, manager of FJV, has been keen to point out is that there are many companies in Japan that can prosper, even in a low growth environment, as the shape of the economy changes. New technologies and industries create opportunities for dynamic companies as the old industrial behemoths decline.

A new approach

Nicholas Price assumed management of the fund on 1 September 2015

FJV was managed for eight years by Shinji Higaki. At the end of July 2015, FJV's board announced that Shinji would be stepping down and the role would pass to Nicholas Price. Nicholas took up the post on 1 September 2015.

Nicholas has been working in Fidelity's Tokyo office since 1993, initially as an analyst and, since 1999 as a portfolio manager. In addition to FJV, he manages the FIJ Aggressive Growth Fund, the FF Japan Aggressive Fund, the FIJ Japan Growth Fund and a number of segregated domestic and overseas accounts.

Growth at a reasonable price

Nicholas' style can be summarised as "growth at a reasonable price". He aims to identify 80-120 holdings for the portfolio from a universe that comprises over 3,500 Japanese-listed equities. Screening these to eliminate stocks with insufficient liquidity reduces the "investable universe" to around 1,000-1,500 stocks. Nicholas draws on the research produced by Fidelity's substantial team of 18 analysts* (based in Tokyo and focused on Japan), some broker research, his own investment ideas and the information gleaned from over 300 company visits each year. This produces a number of candidates worthy of further investigation. Nicholas prefers to focus on companies that are generally not well covered by third party-firms (under-researched companies may also be undervalued companies). Conversations with company management are cross-checked against information from their competitors, clients and suppliers.

Companies that interest Nicholas in particular include those that are benefitting from a fundamental improvement in trading (maybe opening up new export markets or launching new products), a change in the trading environment (increased adoption of online sales for example) and companies where market sentiment is at odds with their prospects.

Value determined by examining long-term fundamentals of each business

Bias to medium-sized companies

Value is determined by examining the long-term fundamentals of each business, where its valuation sits today relative to history, competitors and from an assessment of its earnings growth potential.

This is a stock-picking portfolio, one where Nicholas has free rein to decide on its composition, and it will bear little relationship to the composition of the benchmark index. Nicholas typically runs a maximum 6% overweight to any one stock and a 10% over or underweight to any industry sector. His portfolios tend to have a bias towards mid-cap growth companies. He feels that these tend to generate more attractive returns on equity and are more likely to have management aligned to shareholders' interests and properly incentivised.

A typical holding period for a stock is estimated to be one to three years. Each position is reviewed by a Fidelity analyst at least once every 120 days. Stocks will be sold if they reach the manager's valuation target or if the business case deteriorates. Nicholas regularly trims winning positions and recycles cash into new investment ideas.

Strong sell discipline

Fidelity believes it is Nicholas' strong sell discipline that has, for the funds that he has been running for some time, minimised the number of down quarters.

* Note: as of 31March 2016.

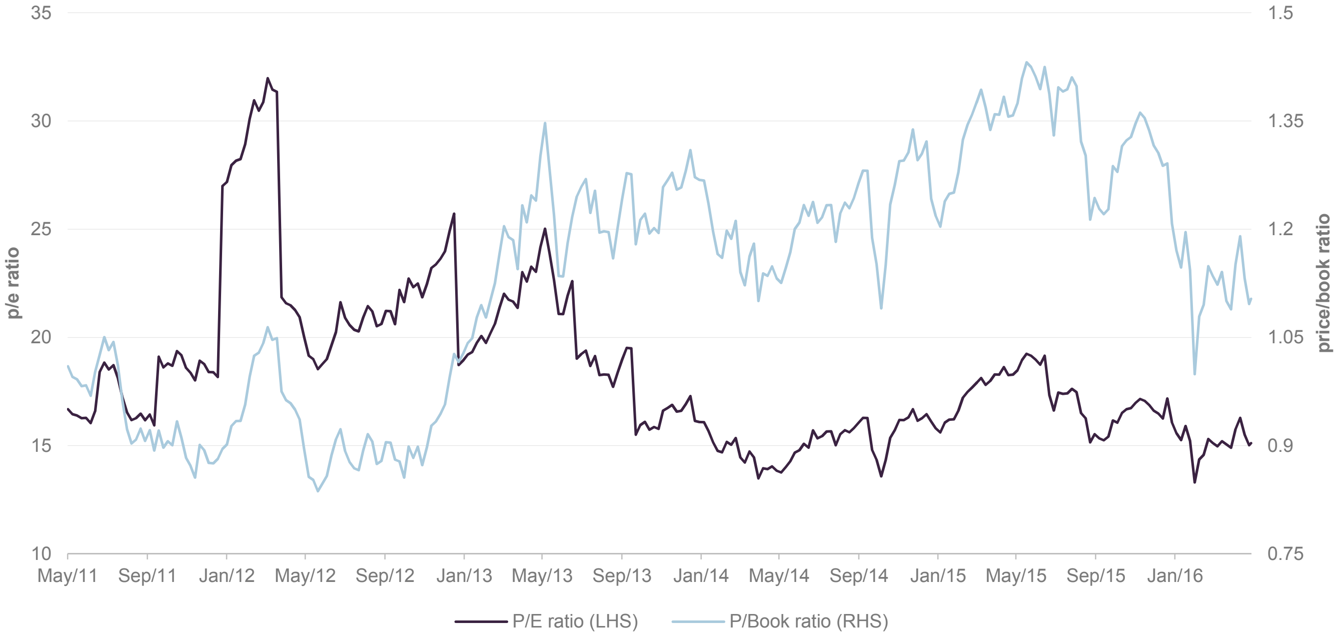
Manager's outlook

The Japanese government and central bank have been engaged in a programme of reforms and stimulus designed to encourage economic growth and modest inflation. One of the most recent measures adopted was the imposition of a negative interest rate by the Bank of Japan.

There are some positive forces at work within the Japanese economy, such as signs of wage growth, which could translate into increased consumer spending. However, the manager thinks that the economic outlook for Japan remains difficult. The slowing of Chinese demand is unhelpful for export prospects across Asia and yen strength has not helped in this regard.

Generally, Nicholas thinks analysts' growth expectations are too optimistic. However, Nicholas believes share prices, which have been weak since the start of 2016, have overshot on the downside and no longer reflect fundamental value, even adjusting for the overenthusiasm of analysts. This is creating opportunities to add attractive stocks to the portfolio at reasonable prices. The valuation opportunity is illustrated in Figure 16 below.

Figure 16: Topix index p/e ratio and price/book



Source: Bloomberg, Marten & Co

The introduction of the stewardship code and corporate governance has been positive for Japan in Nicholas' opinion. It has led to companies making more efficient use of their balance sheet – increasing dividends and share buy-backs and encouraging capital expenditure and M&A activity. This in turn is improving returns on equity.

One of the themes that Nicholas has been backing within the portfolio is a surge in Chinese tourism into Japan. He is also backing areas such as companies that benefit from increased automation and the growth of the non-bank financial sector.

Previous research publications

Readers interested in further information about Fidelity Asian Values, Fidelity Japanese Values and Fidelity Special Values, may wish to read our previous Fidelity closed end funds note of October 2015. Please click here.

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