British Empire Trust's Bauernfreund: Why Japan is our biggest special situation

By Jayna Rana
Twitter: @Jayna_Rana

Joe Bauernfreund, manager of the £826m British Empire trust, has been increasing his exposure to Japan in recent months to take advantage of value opportunities as various industries continue to reform under Abenomics.

The trust's portfolio is split into three 'buckets' consisting of family-controlled holding companies, closed-ended funds and special situations, with Japan currently the headline story in the latter portion, representing 17% of the portfolio as at 31 July.

Bauernfreund said: "There are always opportunities that are overlooked. Our strategy focuses on discounts, so we seek out value opportunities and try to buy these companies when they are cheapest and most out of favour.

"When that value starts being recognised we rotate that capital, usually out of the first two buckets, which give up capital for the third. At the moment, Japan is the biggest feature of the third bucket."

Just 12 months ago as at 31 August 2016, the trust was underweight Japan relative to its MSCI ACWI benchmark, with only 10% of the portfolio directly exposed to the region. However, the manager has been steadily increasing this exposure as he continues to find opportunities in Japan, primarily stemming from improved corporate governance and shareholder activity.

"Part of the attraction of Japan is this theme pervading the market whereby funds are engaging more in shareholder activism and are in turn attracting strong flows," he said. "Company profits are growing nicely and we are seeing more realistic valuations."

But to help address any risks, Bauernfreund has taken a 'basket approach', investing in a range of Japanese companies with smaller weightings rather than taking large positions in a select few names.

He added: "Shareholder activism is still in its infancy in Japan and there are fewer guarantees of success. One way of mitigating risk is to have the basket approach.

"This means we can eventually identify one or two opportunities which are more realistic and could end up being bigger holdings."

Having already held some Japanese names which fit into the first bucket of family-owned companies, Bauernfreund said he and his research team became aware of the gradual increase in shareholder activism and saw the opportunity to find companies benefiting from this theme.

"From that, the basket was built

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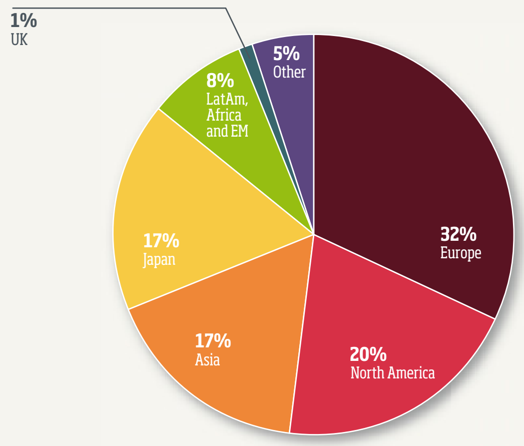
For full investment trust performance statistics

Risk/region breakdown (% of net assets)



As at 31 July 2017. Source: British Empire Trust

by screening for companies with characteristics we wanted. This includes having masses of net cash, a good underlying business with consistent earnings growth, while the presence of large shareholders on the register is useful," he said. "This all fits into our way of thinking."

Commenting on the debate on whether value has made a comeback, Bauernfreund said the evidence is mixed.

He added: "2016 was all about value but more latterly it is more about growth and that pattern is largely driven by mega tech companies. But if we exclude those, we can still see a pattern more in favour of value.

"We do not worry about wider views though, we just do our thing. We are more focused on events that can unlock value such as when a business may be sold, there is an IPO or a corporate transaction in the next 12 months. There is lots of hidden value to be found in these areas."

The team at British Empire is aware of valuation pressures given the average weighted discount across the portfolio has narrowed from 32% in October last year to 25% at the end of June this year, according to investment trust analysts at Trust Intelligence.

The analysts added: "But they believe this trend of discount narrowing can continue as the macro environment remains supportive and they continue to find opportunities within their investment universe."

However in Q3 this year, Winterflood Securities removed the trust from its recommendations list due to concerns over discount volatility.

It said in its monthly report for July: "For global exposure, we have decided to remove British Empire as we believe that, in the current environment of all-time market highs, there is potential for both the fund itself and its underlying holdings to experience significant discount volatility in the event of a market downturn."

Over three years to 29 August, the trust has returned 28%, outperforming both its AIC Global sector average return of 25% and its MSCI All Country World index benchmark on 17% during the period, according to FE.

It is currently trading on a discount of 10.3%, in line with its 12-month average, according to Winterflood.