Top-Performing Mutual Fund Finds Hidden Gems In Japanese Small Caps

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Hennessy Japan Small Cap Fund (HJPSX) takes the IBD Best Mutual Funds Award as the top-performing mutual fund in the international stock category because of what fund managers Tadahiro Fujimura and Tetsuya Hirano do every single day: dig deeper than anyone else to find hidden stock gems.

The fund holds about 60 stocks, with the top 10 holdings accounting for about 19% of assets. Hennessy Japan Small Cap at year-end had about 37% of its assets in companies at least once. Personally, during the time I’ve been covering small caps, I have researched 2,000 companies by myself. So, one of the strong points of our investment process is to uncover a broader universe of smaller, attractive small caps that other fund managers don’t cover.

IBD: What’s the average market cap of a company in the fund?
Fujimura: We define small-caps as anything less than $2 billion in market capitalization. The average market cap for a company in our fund is $1 billion.

IBD: Why do you think the fund is doing so well?
Fujimura: Because I’m working very hard. (laughter) We’ve been researching on a daily basis for 20 years. I don’t change anything about our research activities. Sometimes that works well, sometimes not, but we believe that we’re not influenced by the outside environment. Just researching by ourselves and looking for attractive companies. Last year was a good year because we invested very well and that contributed to the performance.

IBD: How long do you hold on to stocks?
Fujimura: The average turnover of the fund is 30%. Our average time horizon is three years or longer. I believe compared with other managers our investment horizon is longer because we’re more focused on long-term fundamentals rather than market trends.

IBD: You say you’re not affected by outside things; do you think the fund is likely to be hurt or benefit from a trade war?
Fujimura: Fortunately in my universe there are few steel, aluminum or raw material-related companies. These types of companies are included in the large-cap companies. Generally speaking, small-caps are more domestic companies.

IBD: What’s going on in Japan’s stock market right now?
Fujimura: I think one reason for our good performance is the better performance of small caps compared with large caps. The Japanese stock market did very well last year for several reasons. The Japanese economy is getting better, and generally speaking, in the early stage of the economy’s growth, large-caps perform well. But this improvement is spreading into other areas, and small caps started getting the benefit of economic growth. That’s one reason.

Another reason is valuation. Small caps were deeply undervalued compared with large caps. The Japanese stock market did very well last year for several reasons. The Japanese economy is getting better, and generally speaking, in the early stage of the economy’s growth, large-caps perform well. But this improvement is spreading into other areas, and small caps started getting the benefit of economic growth. That’s one reason.

Another reason is valuation. Small caps were deeply undervalued compared with large caps. Finally, the valuations are reaching the same level as large caps. So, valuation improvement and earnings growth, combined with economic growth, both contributed to the better performance of the small caps compared to the large caps.

Another thing, large-cap Japanese companies are in trouble. The auto companies, like Nissan Motor and Subaru recently had scandals, Kobe Steel
and Toshiba, too. This was only in the large-cap area, not the small-cap area.
Larger companies generally are facing how to deal with old, legacy assets and adapting to the new environment. But new, smaller companies have the advantage to deal with new technology. I think last year was a typical year for larger companies facing troubles and scandal. But, the smaller companies didn’t have so many troubles.

**IBD:** How is the Japanese economy looking in general?

**Fujimura:** One point I’m focusing on is deflation. The Bank of Japan has been targeting 2% inflation, but it hasn’t achieved that yet. In the Japanese economy, on the retail side, many consumers believe that deflation remains and keep waiting for prices to decline. So, that’s why the domestic economy is still sluggish and waiting to improve. I believe one of the big problems in a deflationary environment is that profit margins are always under pressure. If deflation ends, most domestic-based companies will have room to improve their profit margins.

**IBD:** What do you see as the risks for the market and small caps in particular?

**Fujimura:** Consumer sentiment. Small caps have more consumer-related names in their universe. I believe Japanese consumer sentiment is coming forward because wages are increasing and the employment rate is increasing. But if consumer sentiment is damaged, then small caps are at risk. But I don’t think the environment will worsen. The Japanese yen is getting stronger. However, that may be a risk for export-driven companies.

**IBD:** Any other risks?

**Fujimura:** Energy price increases. The Japanese economy depends on oil imports. If oil goes up that will have a big effect. We need energy efficient infrastructure.