

# Profiting from the JPX400

How active strategies can target alpha from the operation of the ROE-based Japanese equity index

## Alexander Treves, Head of Equities Japan

We identify a number of differences between the new JPX400 Index and existing Japanese equity indices and consider the implications for performance. Inclusion in or exclusion from the index can have a significant impact on the share prices of entrants and leavers and there is material value for active managers in identifying these companies through fundamental stock analysis.

October 2015

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This is for investment professionals only and should not be relied upon by private investors.

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## Executive Summary

We review the introduction of the JPX400 index, which selects for companies with superior levels of profitability and which meet minimum standards of corporate governance. We assess its strengths and weaknesses compared to existing Japanese equity benchmarks. Finally, we propose strategies for generating alpha in Japanese equities based on the fundamental analysis of current and future index constituents.

Anticipating index turnover provides opportunities to buy names which can outperform as a result of inclusion and to sell those which are likely to underperform in anticipation of them leaving the index.

As a fundamental investor with both a large analyst team in Tokyo (operating since 1969) and excellent access to Japanese management teams, the focus of Fidelity's bottom-up research effort has always been on finding profitable or recovering companies that make attractive investments. Based on our proprietary FIL Global Aggregates database, we believe that Japanese returns on equity (ROEs) should average c.11% (or low double digits) over the next 2-3 years. Our stock-specific research, which is informed by our proprietary Abenomics Scorecard framework, aims to identify potential inclusions and exclusions from the JPX400 index.

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### Author:

#### Alexander Treves

Head of Equities, Japan

Fidelity Worldwide Investment

[alexander.treves@fil.com](mailto:alexander.treves@fil.com)

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## Introduction: The JPX400

The JPX400 index explicitly selects companies with superior levels of profitability and which meet minimum standards of corporate governance. It is a key part of the Japanese government's drive to foment needed structural reform in the Japanese corporate sector in order to bring about greater capital efficiency. The government's aim is to encourage a sustained increase in corporate value to support a revitalisation of the stock market and improved flows of domestic and international capital.

Launched on 6<sup>th</sup> January 2014, the JPX400 Index - quickly dubbed the 'shame index' by the *Japan Times* - has become the focus of increased attention in Japanese boardrooms and its use has been championed by leading pension funds such as GPIF. Indeed, the GPIF's requirement for some of its equity managers to track the JPX400, rather than TOPIX, has already begun to create something of a new hierarchy in the stock market. The Bank of Japan has also been a buyer of ETFs tracking the index under its monetary easing programme. Since launch, the total balance of investments tracking the JPX400 has climbed to Y2tn-Y3tn (\$16bn-\$24bn).<sup>1</sup>

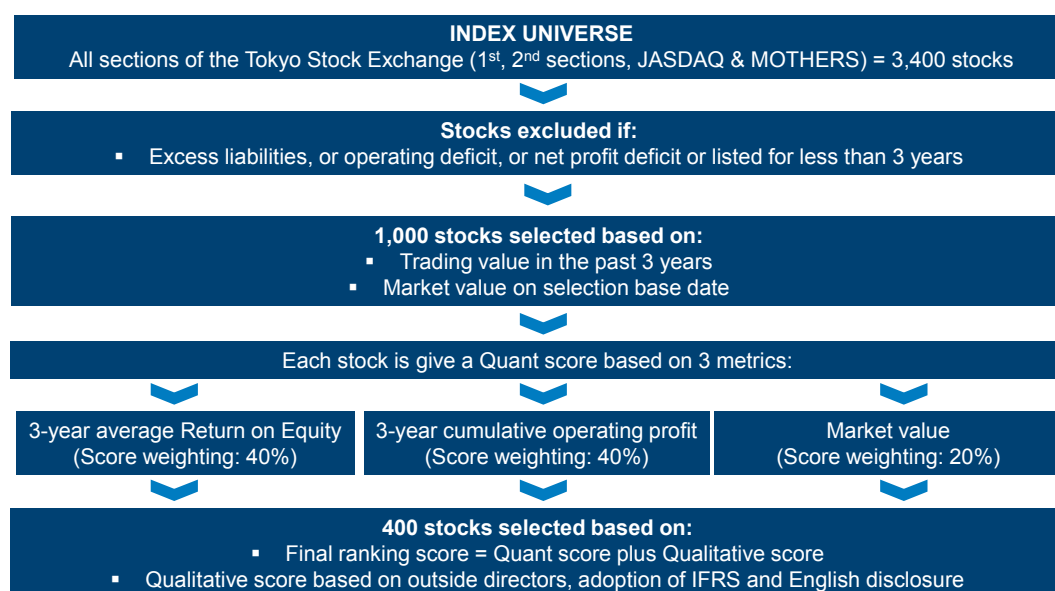
It now looks clear that the management of Japanese companies will no longer be able to ignore low ROEs, since they risk disinvestment and voting opposition from pension funds. The use of the index is expected to grow steadily, as will investor interest in entrants and leavers.

### Construction methodology

- Index selection first involves excluding companies which are less than three years old or which have had negative equity in any of the past three fiscal years;
- Candidate stocks are then scored based on a set of quantitative indicators: three year average ROE (40%); three year cumulative operating profit (40%); and market cap (20%);
- Eligible stocks are then scored on three qualitative factors: the appointment of at least two independent outside directors; adoption or scheduled adoption of IFRS; and disclosure of earnings information in English;
- The 400 stocks which best meet these criteria make up the index, with portfolio weights calculated on a free-float adjusted market cap-weighted basis with an initial 1.5% cap.<sup>2</sup>
- Constituents are reviewed in August each year.

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Diagram 1: Eligibility criteria for the JPX400



Source: Fidelity Worldwide Investment, August 2015.

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<sup>1</sup> Source: Tokyo Stock Exchange

<sup>2</sup> Source: Tokyo Stock Exchange

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## Section 1: Summary of the differences between JPX400 and other indices

In **Appendix 1**, we provide a detailed analysis of the differences between the JPX400 and the TOPIX and MSCI Japan. The key points can be summarised as:

### Commonality with other key indices

- There is relatively high overlap between JPX400 and both TOPIX and MSCI Japan. The ex-ante tracking error of JPX400 versus TOPIX and versus MSCI Japan has been fairly stable at 1.0-1.2% and 1.0-1.3% respectively over the past year.
- Most of the differential risk versus TOPIX comes from the size factor within the Risk Indices<sup>3</sup> group.
- JPX400 has substantially fewer stocks than TOPIX, with 400 versus 1,859, so it has a bias towards large caps.
- TOPIX includes higher volatility stocks than JPX400, but achieves lower index volatility through better diversification. Active money versus TOPIX has been 24-28%.
- Most of the risk versus MSCI Japan comes from stock specific risk, driven particularly by Toyota. Active money versus MSCI Japan has been 18-22%.
- JPX400 has higher stock level correlation due to the deliberate style filter employed in its construction.

### Valuation and returns

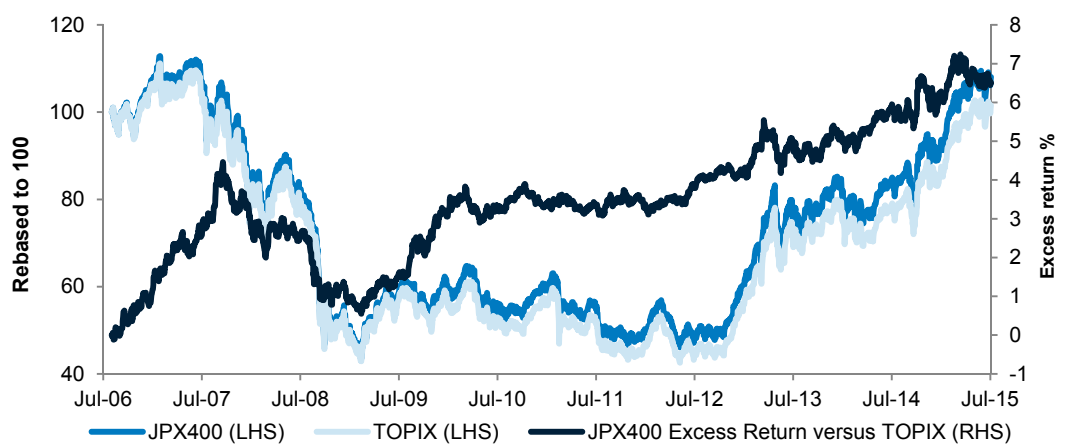
- JPX400's dividend yield is similar to both TOPIX and MSCI Japan: the three indices all fall within the range 1.62% to 1.70%.<sup>4</sup>
- Price earnings (PE) ratios are also in line, at around 18.3-18.8x. The price to book (PB) Ratio for JPX400 is slightly higher, at 1.51x versus 1.4x for TOPIX and 1.44x for MSCI Japan. This reflects the higher return on equity (ROE) of the JPX400.
- The JPX400 index's higher ROE is achieved despite having companies with lower leverage. The higher ROE is driven by higher EBIT margins and superior capital efficiency.
- The largest style tilt is to earnings growth stability, which is also indicative of higher quality, providing an outcome that is consistent with the JPX400's objectives.

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## Section 2: Historical Performance of JPX400 versus TOPIX

Data compiled by the Japan Exchange and the Nikkei demonstrates meaningful historical outperformance of JPX400 versus TOPIX. Sustained periods of relative outperformance have produced a material excess return of 6.5% (relative performance from August 2006 to July 2015).

Chart 1: Comparison of JPX400 and TOPIX index performance



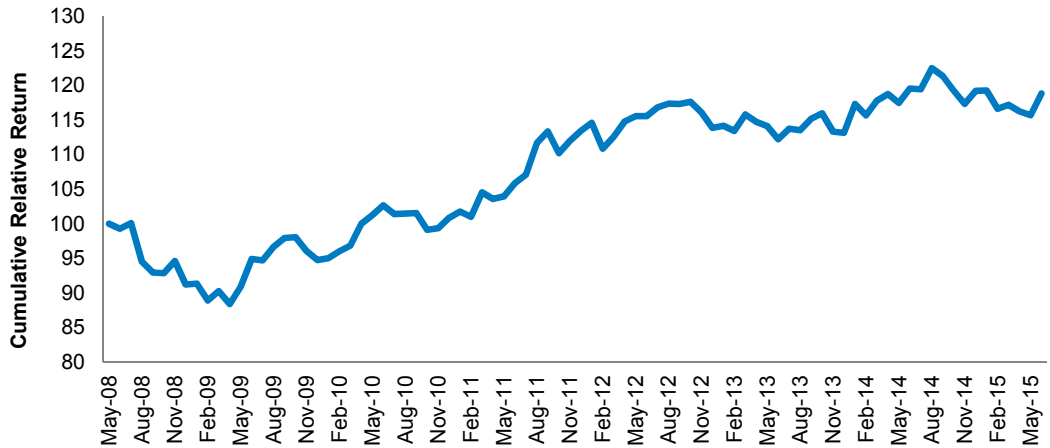
Source: DataStream, as at August 2015. Note that the historical returns of JPX400 prior to its launch in January 2014 are based on a hypothetical simulation by JPX and Nikkei.

<sup>3</sup> The Risk Indices group measures the extent to which style factors such as size, growth, value & momentum are drivers of difference in tracking error.

<sup>4</sup> Based on historical averages from February 2014 to end Jun 2015, see page 12 and appendix 1: table 2 for more details.

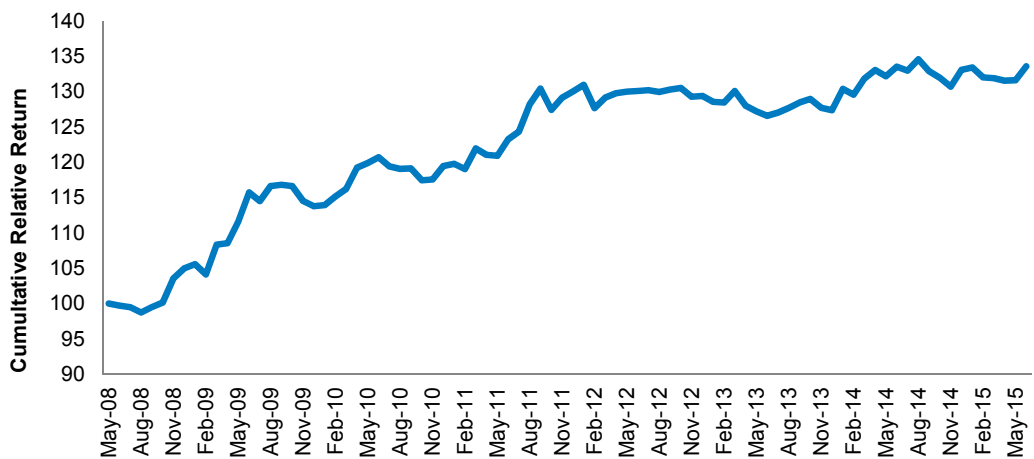
The three-year average ROE factor return has shown stable outperformance versus the TOPIX universe over time (chart 2 below). So too has the three-year cumulative operating profit factor return (chart 3 below). Those factor returns help to explain the historical outperformance of JPX400; insofar as they may be expected to persist, that outperformance can be expected to continue. However, 'lower quality' rallies, for example such as the one in late 2012, can be expected to present periodic headwinds.

Chart 2: Three-year average ROE factor return



Source: FactSet, TOPIX, June 2008-June 2015.

Chart 3: Three-year cumulative operating profit



Source: FactSet, TOPIX, June 2008-June 2015.

### Section 3: Gaining a competitive research advantage in analysing current and future index constituents

#### Historical extent of index changes

Back testing conducted by the Japan Exchange and the Nikkei, below, demonstrates that hypothetical prior period reviews would have led to relatively substantial numbers of replacement issues in the index each year (a conclusion more than justified by the 43 inclusions and 42 exclusions in the latest August review).

Anticipating this turnover well in advance could lead to opportunities to buy names which can outperform as a result of inclusion and to sell those which are likely to underperform in anticipation of them leaving the index. This is important not just for funds benchmarked against JPX400 but more broadly, as the weight of money invested with reference to JPX400 increases. FIL's substantial team of analysts is well placed to use our proprietary forecasts to identify those stocks where changes in fundamentals and governance may qualify them for inclusion or removal.

Table 1: Turnover ratio in periodic reviews

Periodic review in:	2007	2008	2009	2010	2011	2012	2013	2014	2015
<b>No. of replaced issues</b>	47	38	63	57	56	55	54	31	43 inclusions 42 removals
<b>Turnover ratio</b> (Market cap-based, one way)	6.1%	5.6%	10.6%	7.4%	7.9%	6.6%	8.0%	6.2%	5.9%

Note: Scoring based on qualitative factors and preferential 'buffer' rule for constituents of the prior year is not reflected in the above analysis. For 2007-2013, turnover ratio is based on market capitalisation for index calculation as of the last day of August in each year. For 2014-15, turnover ratio is based on market capitalisation for index calculation as of the last day of July in each year. Turnover is calculated as the sum of increments (decrements) in market capitalisation weight for each constituent before and after the periodic review calculation. Source: Japan Exchange Group, TSE and Nikkei Inc.

## Methodology for predicting future changes in index composition

**Step 1:** Take as universe all stocks listed on TSE1, TSE2, Mothers and JASDAQ

Exclude issues which meet any of the following criteria:

- Listed for under three years;
- Liabilities in excess of assets during any of the past three fiscal years;
- Operating loss in all of the past three fiscal years;
- Overall loss in all of the past three fiscal years;
- Designation as 'Security to be Delisted'.

Screen by Market Liquidity Indicator. The top 1,000 eligible issues (i.e. excluding the above) will be selected on the basis of the following 2 items:

- Trading value during the most recent three years;
- Market capitalisation on the date fixed for selection.

**Step 2:** For those 1,000 eligible stocks, measure (1) three-year average ROE; (2) three-year cumulative operating profit; and (3) market capitalisation. **In order to predict changes in index constituents, when calculating three-year average ROE and three-year cumulative operating profit, we use FIL estimates.**

**Step 3:** Rank stocks from highest to lowest based on each measure and apply the following weightings to calculate the overall score:

- Three-year average ROE: 40%;
- Three-year cumulative operating profit: 40%;
- Market capitalisation on the date fixed for selection: 20%.

In addition, in choosing the current JPX400 constituents, JPX uses an element of judgement employed around the following qualitative factors, using a methodology which is not fully disclosed:

- Appointment of at least two Independent Outside Directors;
- Adoption or scheduled adoption of IFRS;
- Disclosure of English earnings information via *TDnet* (a Company Announcements Distribution Service in English).
- Buffer rule: There is also a preferential rule for previous year constituents who will be re-selected as long as their scores are ranked within the top 440.

Note that the JPX construction methodology also applies some sector control. However, the basis of this is also not disclosed, so we do not use it in our predictive methodology.

**By highlighting companies for which our estimates are higher than the street, we can gain some advantage in forecasting stocks which may enter the JPX400 index; and vice versa where we have forecasts below the street for stocks already in the index, and which therefore might be excluded in future reshufflings.**

## Historical results of predicting changes

Historical data on the performance of stocks which subsequently are included in or removed from JPX400 is limited. Although we can simulate index changes prior to 1 January 2014, as the index did not exist at that point we cannot know the effect of the actual flow of funds on stocks affected by those changes.

Since JPX400 was introduced there have been two index rebalances, in August 2014 and August 2015. Taking the rebalancing point in 2014 as T, the table below demonstrates that on both a market cap and equal weighted basis, stocks which were subsequently added to JPX400 outperformed the benchmark, while those which were subsequently deleted underperformed. (It is too early to conduct a similar analysis for the 2015 rebalancing).

Table 2: Prior and subsequent performance of additions and deletions

Market- cap weighted ex. Sony	T-12M	T-6M	T-3M	T+3M	T+6M	To June 15
Additions (% performance)	31.2	7.8	14.0	10.2	4.5	22.9
Deletions (% performance)	9.9	9.8	6.9	18.5	43.6	66.5
JPX400 (% performance)	14.5	6.7	9.3	8.7	12.2	31.0

Equal weighted ex. Sony	T-12M	T-6M	T-3M	T+3M	T+6M	To June 15
Additions (% performance)	34.0	9.1	13.9	10.4	7.5	20.4
Deletions (% performance)	2.6	3.7	5.6	10.0	22.0	38.8
JPX400 (% performance)	14.5	6.7	9.3	8.7	12.2	31.0

Note: T = August 2014 and T+X or T-X is measured in months.

Source: Bloomberg, FIL Limited.

However post-rebalancing, stocks which had been removed then outperformed, despite operating and governance factors which disqualified them from the index. Conversely, recent additions subsequently underperformed. One explanation for this is that the index changes are anticipated by the market, and as such the weight of selling and buying takes place predominantly in advance of the rebalancing.

In this period, there is another stock specific explanation for subsequent “deletion” outperformance. Shortly after being removed from JPX400, companies may announce changes with a view to re-joining the index – for example, Sony announced organisational changes which caused the share price to rise substantially after it was removed from the index. The tables below exclude Sony from the data. The pattern of deletions outperforming post-reshuffle persists, but at a much less pronounced level – particularly on a market-cap weighted basis.

Table 3: Prior and subsequent performance of additions and deletions (without Sony)

Market- cap weighted ex. Sony	T-12M	T-6M	T-3M	T+3M	T+6M	To June 15
Additions (% performance)	31.2	7.8	14.0	10.2	4.5	22.9
Deletions (% performance)	19.0	11.4	9.5	9.6	21.2	32.2
JPX400 (% performance)	14.5	6.7	9.3	8.7	12.2	31.0

Equal weighted ex. Sony	T-12M	T-6M	T-3M	T+3M	T+6M	To June 15
Additions (% performance)	34.0	9.1	13.9	10.4	7.5	20.4
Deletions (% performance)	3.0	3.6	5.7	9.0	19.5	35.2
JPX400 (% performance)	14.5	6.7	9.3	8.7	12.2	31.0

Note: T = August 2014 and T+X or T-X is measured in months.

Source: Bloomberg, Fidelity Worldwide Investment.

One conclusion we can draw from the above analysis is that predicting index changes can add value significantly beyond any approach which simply picks existing constituents within JPX400. This supports active strategies over passive JPX400 funds. It also suggests that having a research capability which can predict changes well in advance offers a material competitive advantage.

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## Screening for future changes

By using the methodology outlined above, based upon forecast return on equity (ROE) and Operating Profit (OP), we can identify likely inclusions to and removals from the index.

We believe an additional area of value is to be found in comparing FIL estimates with Bloomberg estimates, for example in order to highlight cases in which street numbers are too high, causing investors to overestimate the likelihood of a stock subsequently being added to JPX400.

We have been using this methodology allied to our fundamental research to predict changes based on our fundamental research and proprietary earnings estimates.

### 2015 JPX400 rebalancing analysis

For the most recent August 2015 JPX rebalancing, we provide a summary of key comparisons between our forecasts and the actual changes below:

- *For Removals:* Our analysis correctly identified 33 stocks out of a total of 42 stock removals.<sup>5</sup>
- *For Inclusions:* Our analysis correctly identified 33 stocks out of a total of 43 stock inclusions.<sup>6</sup>

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## How a fundamental manager adds value

The JPX400 index is a benchmark which rewards robust fundamentals: companies with above average ROE and operating profit, and which meet higher governance standards. As fundamental investors, with a focus on bottom-up stock selection, these considerations have always been and remain principal areas of focus for our Tokyo-based investment team.

Fidelity engages actively with a wide range of Japanese companies to understand their business models and strategies, as well as their ability and desire to improve shareholder returns. Corporate governance factors form an integral part of our analysis.

Fidelity Worldwide Investment equity analysts rate stocks on a 1-5 scale, where 1 is a Strong Buy, 2 is a Buy, 3 is a Hold, 4 is a Sell and 5 is a Strong Sell.

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## Case study: Yaoko

Yaoko is a supermarket retailer operating in the Kanto region of Japan around Tokyo.

Fidelity's Japanese retail analyst initiated coverage of the stock with a 2-rated "Buy" in December 2014 based on a conviction that Yaoko could deliver better-than-expected sales growth in a strongly growing grocery market in the Kanto region. Yaoko has reaped the rewards of being well exposed to changes in consumer preferences for fresh and higher-quality foods (via in-store delicatessen and seafood counters, for example) while retaining a focus on price. The company has produced strong sales growth based on an aggressive build out of stores combined with a proven ability to manage and re-model its existing stores.

Recognising the potential for the company to be included in the JPX400 index (flagged in our inclusion analysis) and the fact that the market was not recognising the full benefit of existing store remodelling, our analyst upgraded the stock to a 1-rated "strong buy" in May 2015. The stock was subsequently included in the August JPX400 rebalancing; it showed good relative performance in advance of and post the rebalance, benefiting clients in several Fidelity funds.

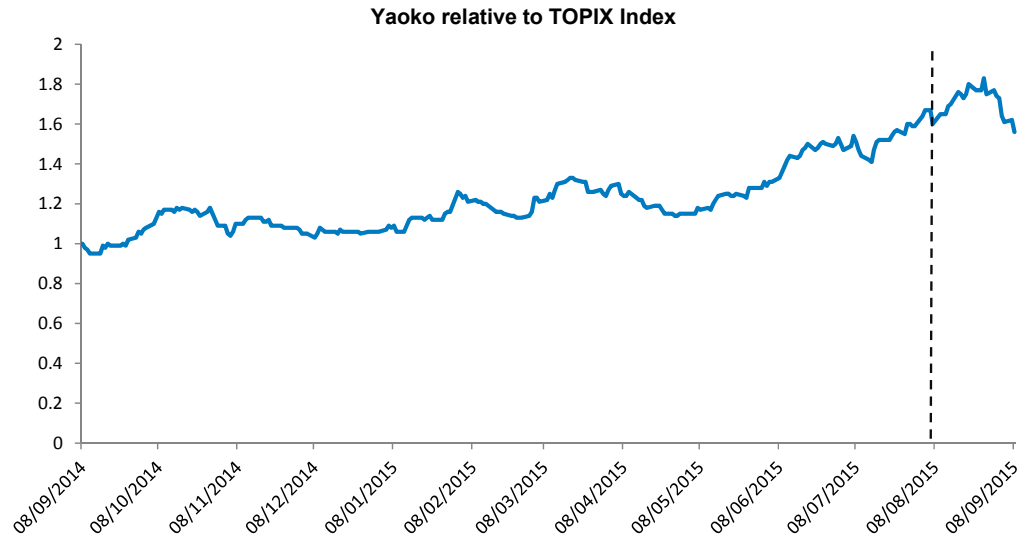
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<sup>5</sup> Note that some removals were made despite the companies scoring within the 400 rankings (Lixil, Toshiba and Toshiba Plant), the implication being that they were removed for qualitative corporate governance concerns. In addition, it seems the buffer rule was not applied universally. In total, five names were removed even although they ranked above 440. On the other hand, 6 names ranked lower than 440, but were not removed this time.

<sup>6</sup> Seven names should not have been added if buffer rule had been fully applied.



Chart 4: Yaoko outperformed the broader market before and after rebalancing



Source: DataStream. As at 08.09.2015.

## Conclusion

The JPX400 index has already had a powerful impact on certain attitudes within corporate Japan and it is also likely increasingly to be taken up by investors.

There are a number of differences between the JPX400 and existing established indices such as TOPIX and MSCI Japan. Crucially, simulations of JPX400 over several years have outperformed TOPIX despite very similar levels of volatility. That outperformance has been driven by three-year average ROE and three-year cumulative operating profit factor returns. These are fundamental factors that are typically rewarded over time by equity markets. In an existential way, the JPX400 index should encourage and contribute to higher returns in Japanese equities and therefore higher valuations within the broader Japanese stock market.

Based on our proprietary FIL Global Aggregates database, we believe that Japanese returns on equity (ROEs) should average c.11% (or low double digits) over the next 2-3 years.

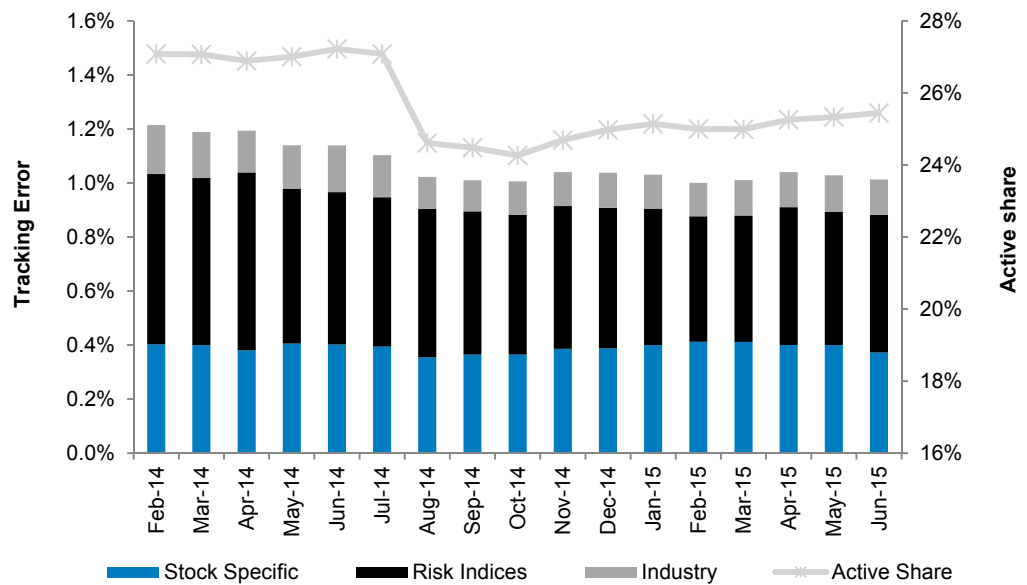
We believe that a fundamental research process can gain an advantage in forecasting entrants to and leavers from the JPX400, with the potential to generate material alpha in Japanese equities irrespective of the reference benchmark used to manage client funds.

## Appendix 1: Analysis of the differences between JPX400 and other indices

### Section 1(a) Tracking error, active money and risk breakdown

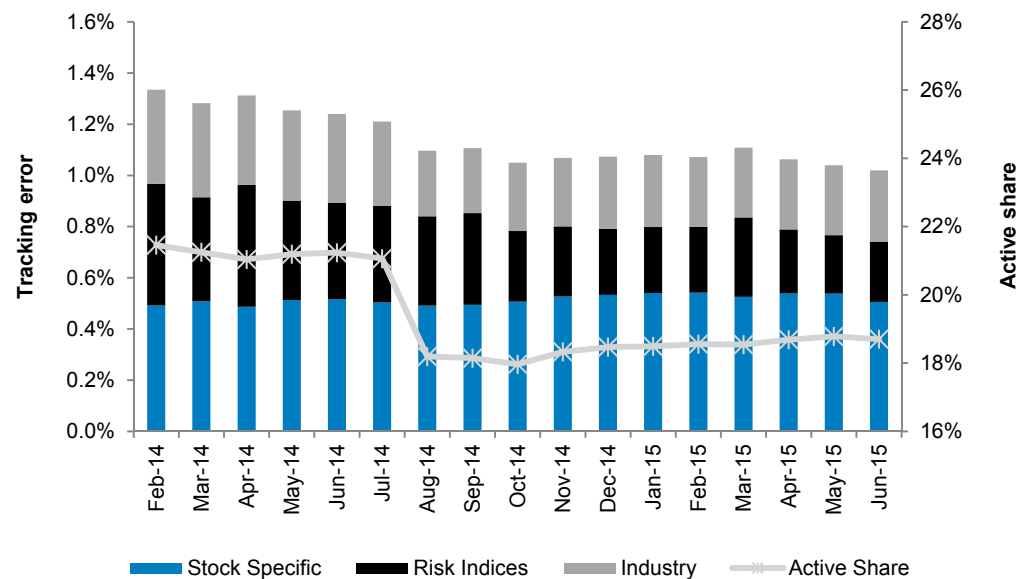
- The ex-ante tracking error of JPX400 versus TOPIX has been fairly stable at 1.0-1.2% over the past year. As chart 1 show, the majority of the risk comes from the Risk Indices group. The Risk Indices group measures the impact of a range of style factors such as size, growth, value, and momentum.
- The ex-ante tracking error of JPX400 versus MSCI Japan has also been stable at 1.0-1.3% over the past year. As chart 2 shows, in this case, the risk decomposition is more evenly balanced, with the major driver being stock specific risk.
- Active money of the JPX400 versus TOPIX has been 24-28%. Active money versus MSCI Japan has been 18-22%. By this measure, JPX400 has more overlap with MSCI Japan than with TOPIX.

Appendix Chart 1: JPX400 versus TOPIX: Ex-ante tracking error breakdown and active money



Source: MSCI Barra Model Analysis, 15.07.2015.

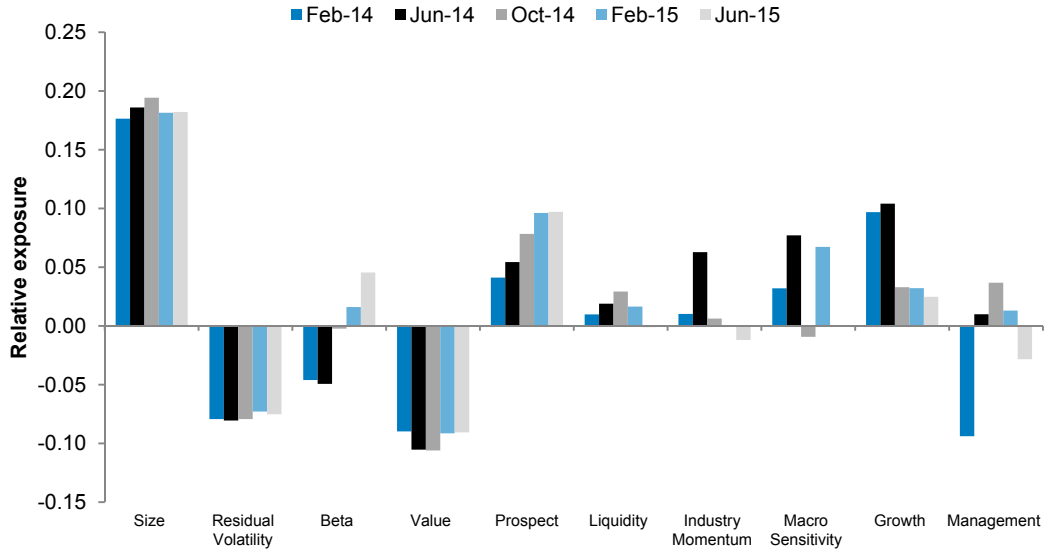
Chart 2: JPX400 versus MSCI Japan: Ex-ante tracking error breakdown and active money



Source: MSCI Barra Model Analysis, 15.07.2015. The fall in active share in August 2014 was caused by index rebalancing.

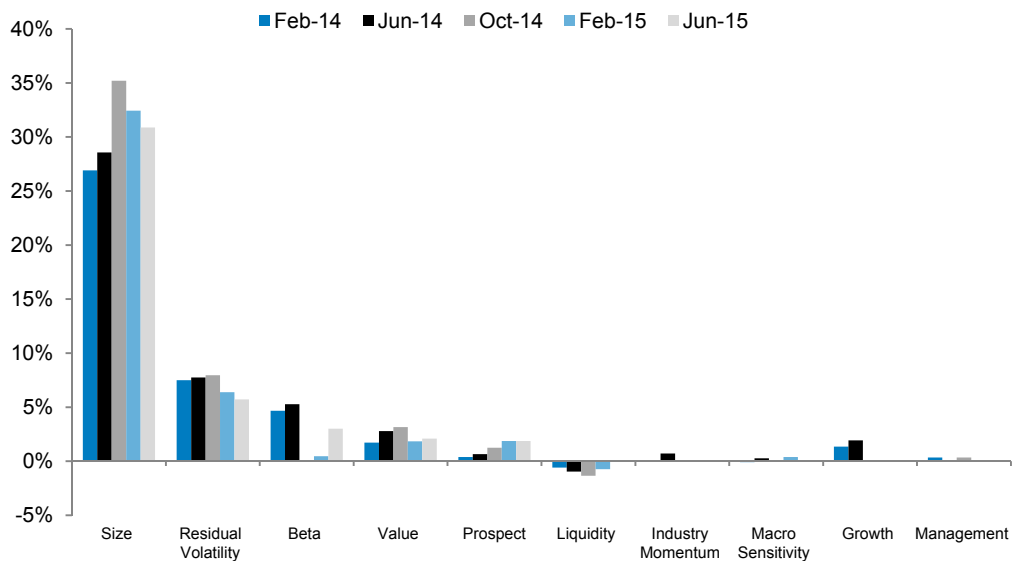
When comparing JPX400 and TOPIX, the size factor is the key driver and the exposures imply that JPX400 has a higher average market cap. As shown in Chart 4, this explains over 30% of tracking error. JPX400 is also consistently underweight the residual volatility factor when compared to TOPIX. In general, a number greater than +/-0.2 would be considered significant. In this context, with a high degree of overlap and low tracking error, anything >+/-0.1 is significant – for example the Size factor for JPX400 versus TOPIX.

Chart 3: JPX400 versus TOPIX: Style indices active exposure



Source: MSCI Barra Model Analysis, 15.07.2015. A relative exposure >+/-0.1 is considered is significant.

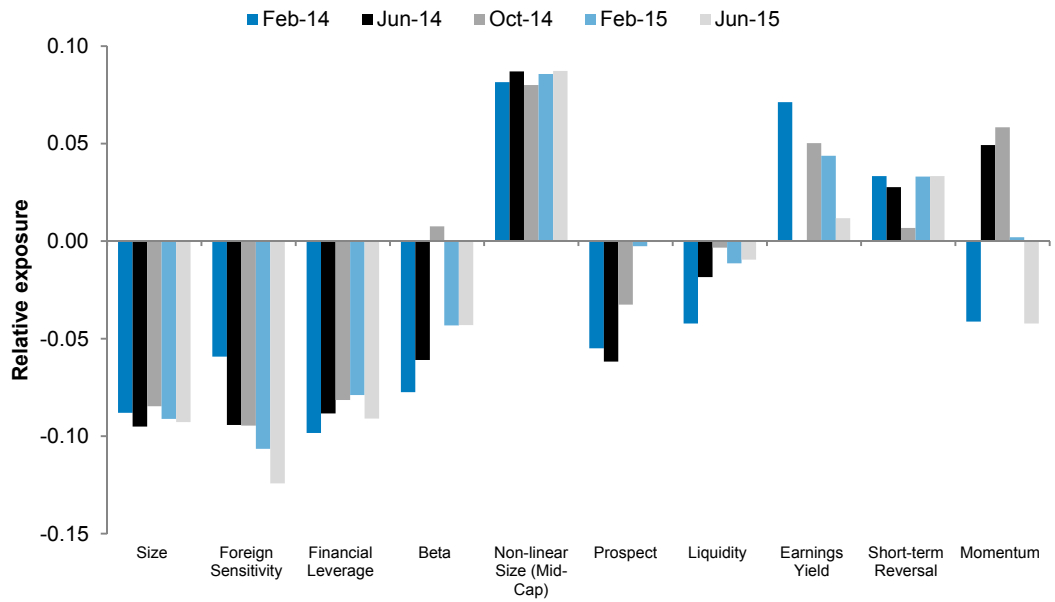
Chart 4: JPX400 versus TOPIX: Style indices percentage risk contribution to tracking error



Source: MSCI Barra Model Analysis, 15.07.2015.

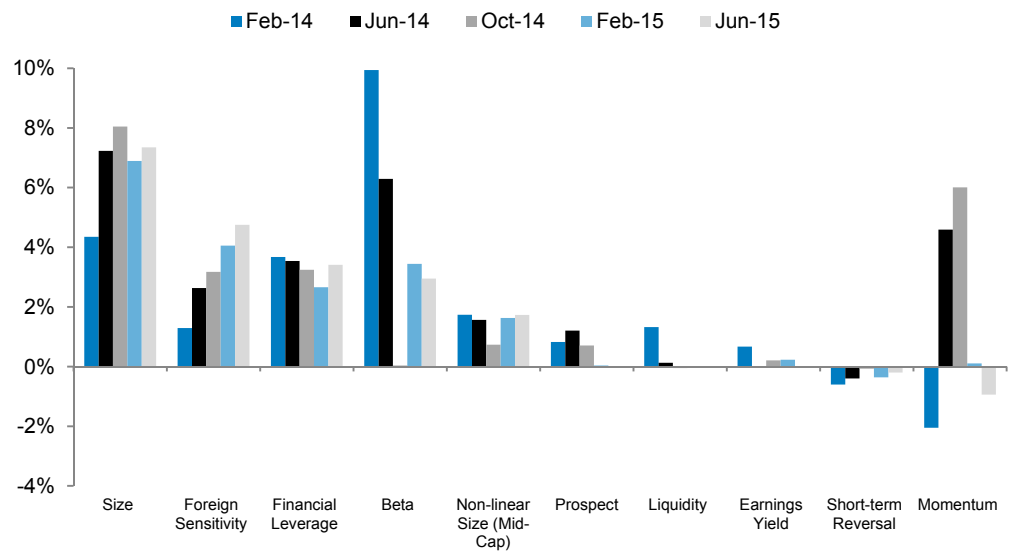
Against MSCI Japan, the risk contribution for individual style factors is less pronounced. While JPX400 is overweight the size factor versus TOPIX due to the index's concentration, it is underweight that factor versus MSCI Japan (as shown in chart 5).

Chart 5: JPX400 versus MSCI Japan: Style indices active exposure



Source: MSCI Barra Model Analysis, 15.07.2015. A relative exposure  $> \pm 0.1$  is considered significant.

Chart 6: JPX400 versus MSCI Japan: Style indices percentage risk contribution to tracking error



Source: MSCI Barra Model Analysis, 15.07.2015.

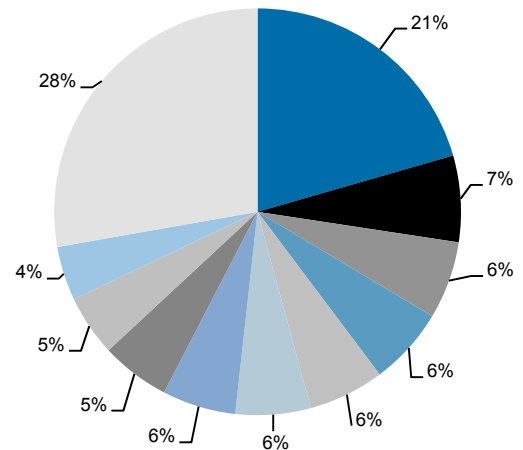
## Section 1(b): Risk by sector

There are some significant differences in sector weights between the different indices. JPX400 is 1.9% underweight transportation equipment compared to TOPIX, and is 0.9% overweight electrical appliances. The electrical appliances are a greater driver of tracking error than the transportation equipment, making up 21% of the risk contribution by TOPIX industry sector (as shown in chart 7).

Chart 7: JPX400 versus TOPIX: Percentage risk contribution by TOPIX industry sector

### Sector Differences (Active Weight)

- Electric Appliances (0.9%)
- Transportation Equipment (-1.9%)
- Pharmaceutical (1.5%)
- Real Estate (0.6%)
- Retail Trade (0.4%)
- Chemicals (0.6%)
- Information & Communication (0.3%)
- Machinery (0.6%)
- Land Transportation (1.1%)
- Electric Power & Gas (-1.2%)
- All Others (-2.8%)



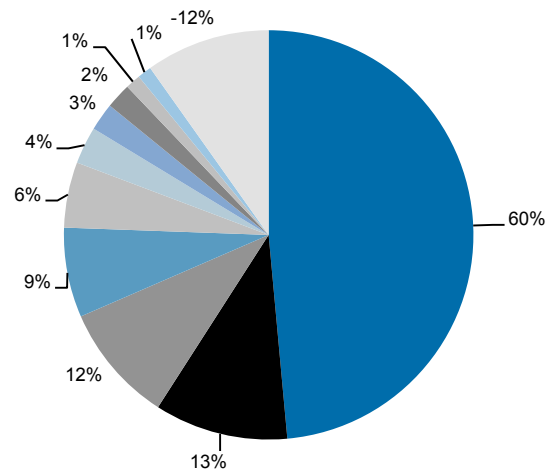
Source: MSCI Barra Model Analysis, 15.07.2015. Data as at 30 June 2015.

Against MSCI Japan, JPX400 is substantially more underweight transportation equipment (3.9%). This difference explains more than half of the risk (60%) versus MSCI Japan at a sector level as shown in chart 8.

Chart 8: JPX400 versus MSCI Japan: Percentage risk contribution by TOPIX industry sector

### Sector Differences (Active Weight)

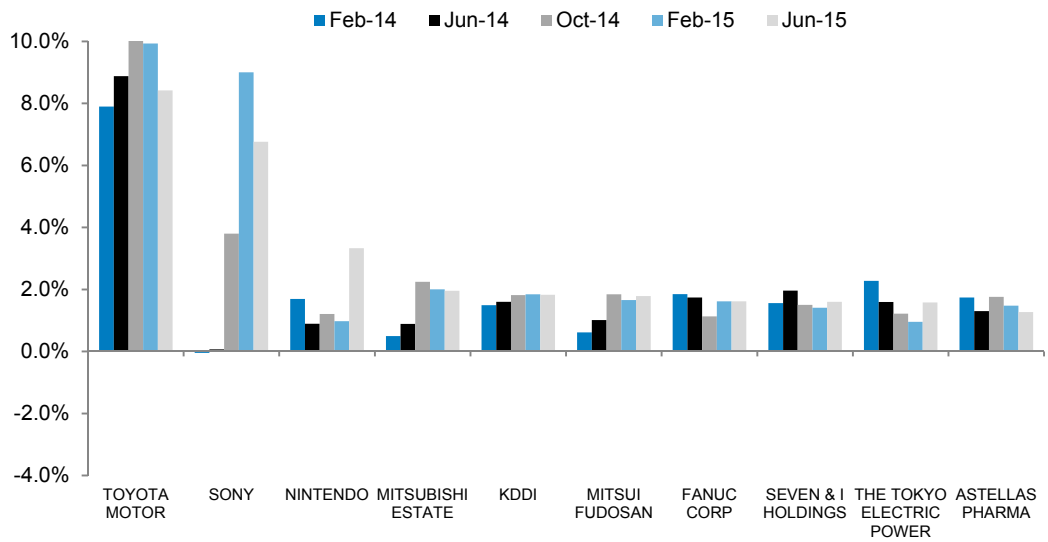
- Transportation Equipment (-3.9%)
- Electric Appliances (-0.8%)
- Banks (-1.1%)
- Electric Power & Gas (-1.5%)
- Other Products (-0.8%)
- Insurance (-0.4%)
- OTHERS (-0.9%)
- Information & Communication (0.8%)
- Precision Instruments (-0.3%)
- Retail Trade (1.4%)
- All Others (7.6%)



Source: MSCI Barra Model Analysis, 15.07.2015. Data as at 30 June 2015. Pie chart numbers do not add to 100 given the presence of positive and negative risk contributions.

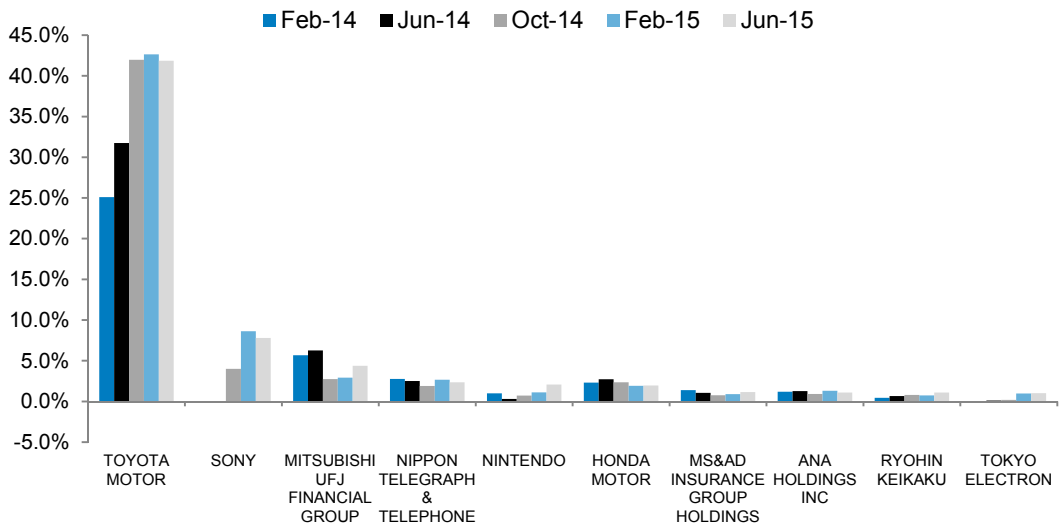
The underweight in transportation equipment is driven by the much smaller weighting in JPX400 of **Toyota**, due to the initial capping of weights in the benchmark at 1.5%. In fact, more than 40% of the risk differential of JPX400 versus MSCI Japan comes from Toyota. While Toyota is also the main driver of individual asset risk versus TOPIX, its contribution is much smaller at 8.4%.

Chart 9: JPX400 versus TOPIX: Percentage risk contribution by asset



Source: MSCI Barra Model Analysis, 15.07.2015.

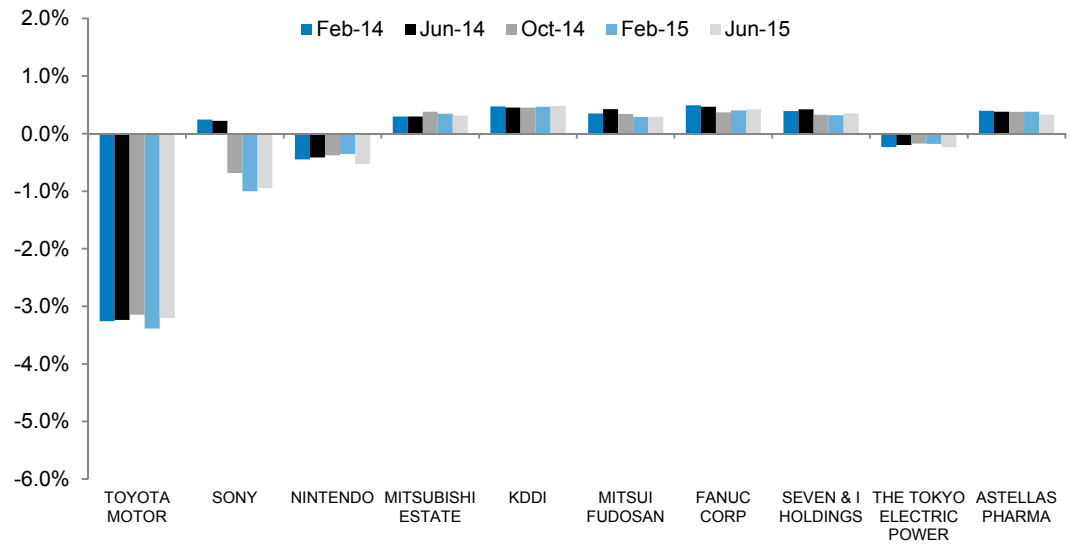
Chart 10: JPX400 versus MSCI Japan: Percentage risk contribution by asset



Source: MSCI Barra Model Analysis, 15.07.2015.

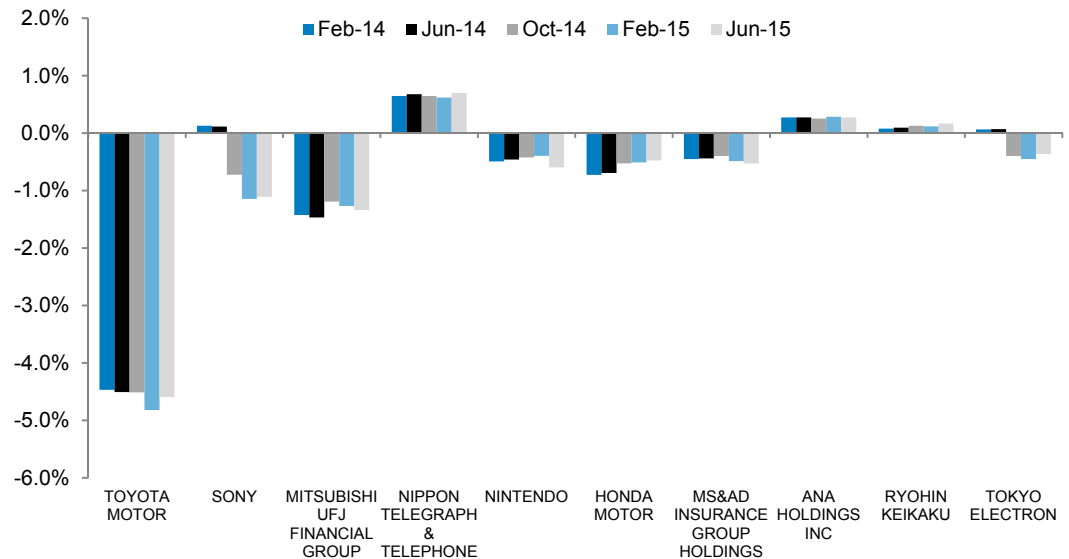
The magnitude of the Toyota underweight is greater versus MSCI Japan given the smaller number of stocks in MSCI Japan versus TOPIX. Against both indices, the use of JPX400 implies an active underweight bet in Toyota of just over 3% versus TOPIX and around 4.5% versus MSCI Japan.

Chart 11: JPX400 versus TOPIX: Active bet



Source: MSCI Barra Model Analysis, 15.07.2015.

Chart 12: JPX400 versus MSCI Japan: Active bet



Source: MSCI Barra Model Analysis, 15.07.2015.

## Section 1(c): Overlap of JPX400 with other indices

JPX400 has substantially fewer stocks than TOPIX: 400 versus 1,859 respectively. There is very high overlap in terms of names: 391 of the stocks in JPX400 are also in TOPIX. Please see Appendix: Table 1 for a detailed overlap summary. TOPIX includes higher volatility stocks than JPX400, but achieves lower index volatility by being better diversified. There is higher stock level correlation between the stocks within JPX400 due to the construction methodology which deliberately targets stocks with certain quantitative and qualitative characteristics, such as higher ROE. TOPIX has no such filter and so the correlation between names within the index is lower.

Table 1: Overlap of JPX400 with TOPIX and MSCI Japan

JPX400 no. of stocks	400
TOPIX no. of stocks	1831
JPX400 vs TOPIX overlap	389
MSCI Japan no. of stocks	314
JPX400 vs MSCI Japan overlap	248
JPX400 Portfolio Risk	19.9%
TOPIX Portfolio Risk	19.9%
MSCI Japan Portfolio Risk	20.2%
JPX400 Diversification Ratio	1.45
TOPIX Diversification Ratio	1.49
MSCI Japan Diversification Ratio	1.44
JPX400 Effective No. Of Stocks	140
TOPIX Effective No. Of Stocks	132
MSCI Japan Effective No. Of Stocks	93
JPX400 Weighted Avg Risk	28.9%
TOPIX Weighted Avg Risk	29.7%
MSCI Japan Weighted Avg Risk	28.9%
JPX400 implied weighted avg. correlation	47.0%
TOPIX implied weighted avg. correlation	44.6%
MSCI Japan implied weighted avg. correlation	47.9%

Source: MSCI Barra Model Analysis, 15.07.2015. Average of monthly figures for Feb 2014 to Jun 2015.

Note that while TOPIX contains many more names than JPX400, the 'Effective Number of Stocks' (ENS) is actually lower than JPX400, highlighting the importance of the weight capping in the JPX400 methodology.

*Effective Number of Stocks is calculated as 1 over the sum of squared weights. If stocks are equally weighted then it is easy to see that more stocks means more diversification. ENS is an attempt to put any weight distribution on an equal footing to facilitate comparison between levels of weight diversification. The interpretation of the figure is that an ENS of 'x' means that the level of weight diversification is the same as for an equal-weighted portfolio of 'x' stocks.*

JPX400 has somewhat more names than MSCI Japan, which has 314 names. The degree of overlap is lower, with 250 names appearing in both indices.



## Section 1(d): Valuation comparison with other indices

JPX400's dividend yield is very similar to both TOPIX and MSCI Japan: the three indices all fall within the range of 1.63% to 1.70%. Price earnings (PE) ratios are also similar at 18.3x to 18.8x. Price to book ratio is slightly higher, at 1.51x versus 1.4x for TOPIX and 1.44x for MSCI Japan. This reflects the higher Return on Equity (ROE) of the JPX400.

Table 2: Historical valuation comparison of JPX400 versus TOPIX and MSCI Japan (Feb14-Jun15)

JPX400 Dividend Yield (%)	1.65		
TOPIX Dividend Yield (%)	1.63		
MSCI Japan Dividend Yield (%)	1.70		
		Forecast FY15	Forecast FY16
JPX400 Price/Earnings Ratio	18.8	16.3	14.85
TOPIX Price/Earnings Ratio	18.5	15.8	14.44
MSCI Japan Price/Earnings Ratio	18.3	15.5	14.18
JPX400 Price/Book Ratio	1.51		
TOPIX Price/Book Ratio	1.40		
MSCI Japan Price/Book Ratio	1.44		
		3-yr average	
JPX400 Return On Equity (%)	8.74	9.60	
TOPIX Return On Equity (%)	8.17	8.70	
MSCI Japan Return On Equity (%)	8.53	9.00	

Source: Bloomberg, FIL Ltd, 15.07.2015. Average figures shown for period from February 2014 to end June 2015. For a detailed valuation analysis since Feb.2014, see Appendix1, table 2.

The JPX400 index's higher ROE is achieved despite its higher exposure to companies with lower leverage (as can be seen in table 3). Therefore the higher ROE is driven not by higher leverage but by companies with superior capital efficiency (see table 3) and higher EBIT margins (see table 4).

Table 3: Debt/Equity comparison of JPX400 versus MSCI Japan

Debt/Equity	Japan JPX Nikkei 400			MSCI Japan		
	Portfolio Average Weight	Portfolio Total Return	Portfolio Contribution To Return	Benchmark Average Weight	Benchmark Total Return	Benchmark Contribution To Return
<b>Total</b>	<b>100.0</b>	<b>28.9</b>	<b>28.9</b>	<b>100.0</b>	<b>27.0</b>	<b>27.0</b>
Debt/Equity Bin 1: > 300.0	8.3	6.3	-0.3	11.2	4.4	-0.8
Debt/Equity Bin 2: 200.0 - 300.0	3.3	3.6	0.2	4.1	0.8	0.1
Debt/Equity Bin 3: 100.0 - 200.0	21.0	24.2	5.3	23.8	24.9	6.3
Debt/Equity Bin 4: 50.0 - 100.0	15.3	27.2	4.2	13.5	26.8	3.6
Debt/Equity Bin 5: 0.0 - 50.0	51.8	37.2	19.3	46.0	37.6	17.6
[N/A]	0.4	12.0	0.2	1.4	8.9	0.3

Source: FactSet, Jan-14 to Jun-15.

Table 4: EBIT margin comparison of JPX400 versus MSCI Japan

Ebit Margin	Japan JPX Nikkei 400			MSCI Japan		
	Portfolio Average Weight	Portfolio Total Return	Portfolio Contribution To Return	Benchmark Average Weight	Benchmark Total Return	Benchmark Contribution To Return
<b>Total</b>	<b>100.0</b>	<b>28.9</b>	<b>28.9</b>	<b>100.0</b>	<b>27.0</b>	<b>27.0</b>
Ebit Margin Bin 1: > 25.0	16.1	27.3	4.3	16.5	25.1	3.7
Ebit Margin Bin 2: 20.0 - 25.0	4.2	65.7	2.6	3.5	60.0	2.0
Ebit Margin Bin 3: 15.0 - 20.0	8.5	32.7	2.8	7.2	35.2	2.6
Ebit Margin Bin 4: 10.0 - 15.0	18.7	25.2	4.8	21.6	23.1	5.3
Ebit Margin Bin 5: 5.0 - 10.0	32.2	28.5	9.5	29.0	26.5	7.9
Ebit Margin Bin 6: 0.0 - 5.0	14.1	27.2	3.7	14.9	29.8	4.3
Ebit Margin Bin 7: < 0.0	2.4	18.4	0.4	2.7	13.0	0.3
[N/A]	3.8	23.7	0.8	4.5	20.6	0.9

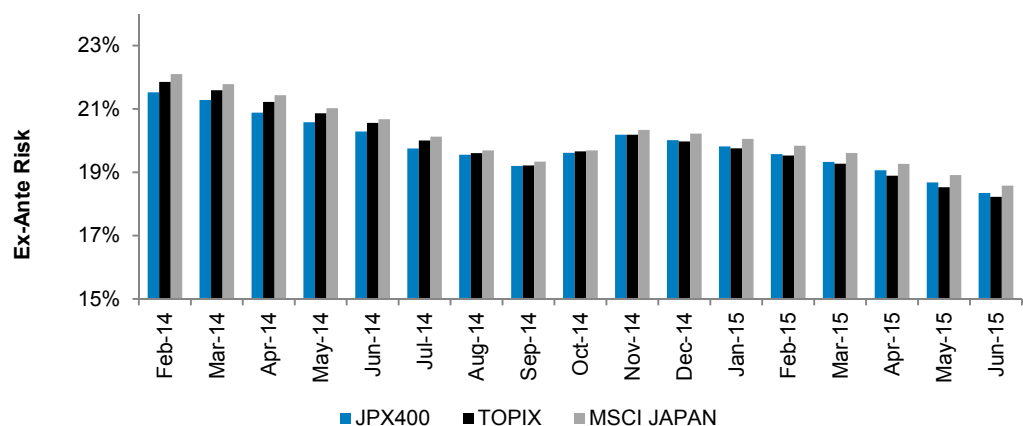
Source: FactSet, Jan-14 to Jun-15.

### Section 1(e): Ex-ante and ex-post index volatility comparison

There is a tight range for the volatility of the respective indices. For the JPX400, it is 18.3%, versus 18.2% for TOPIX and 18.6% for MSCI Japan (as at June 2015).

A portfolio's absolute volatility is a function of 3 things: effective number of stocks; average volatility of the stocks; and the average correlation between the stocks. As explored below, the capping in the JPX400 weighting methodology results in a volatility-reducing level of diversification from the distribution of stock weights (because there aren't any particularly big weights). This serves to lower JPX400 volatility compared to MSCI Japan, but the TOPIX volatility is still somewhat lower overall. This is because the stocks in TOPIX are less correlated than is the case in the JPX400 due to the quantitative filter within the JPX400's methodology.

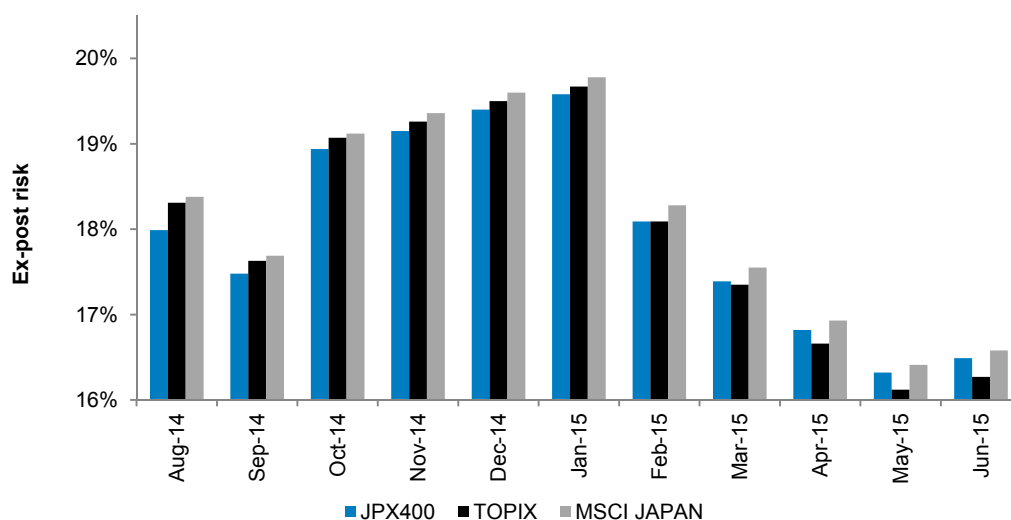
Chart 13: Ex-ante portfolio risk



Ex-Ante Risk of JPX400, TOPIX and MSCI JAPAN is very close, with a range of 18% - 22%. JPX400 is the index with lowest Ex-Ante Portfolio Risk most of the time.

Source: MSCI Barra Model Analysis, 15.07.2015.

Chart 14: Ex-post portfolio risk (260-day historical volatility)



Ex-Post Risk of JPX400, TOPIX and MSCI JAPAN is very close, with a range of 15% to 20%. JPX400 has the lowest Ex-Post Portfolio Risk (260-Day Historical Volatility).

Source: MSCI Barra Model Analysis, 15.07.2015.

### Section 1(f): Market capitalisation profile

With respect to average market capitalisation, JPX400 sits between TOPIX and MSCI Japan. Its weighted market capitalisation is lower than that of the other two indices.

Table 5: Market Cap Comparison by Index

	Average Mkt Cap (JPY Billion)	Weighted Mkt Cap (JPY Billion)	Minimum Mkt Cap (JPY Billion)
JPX400	1106	3305	37
TOPIX	299	3923	2
MSCI JAPAN	1454	4681	266

Source: Bloomberg, 15.07.2015.

### Section 1(g): Portfolio Style Skyline™ index comparison

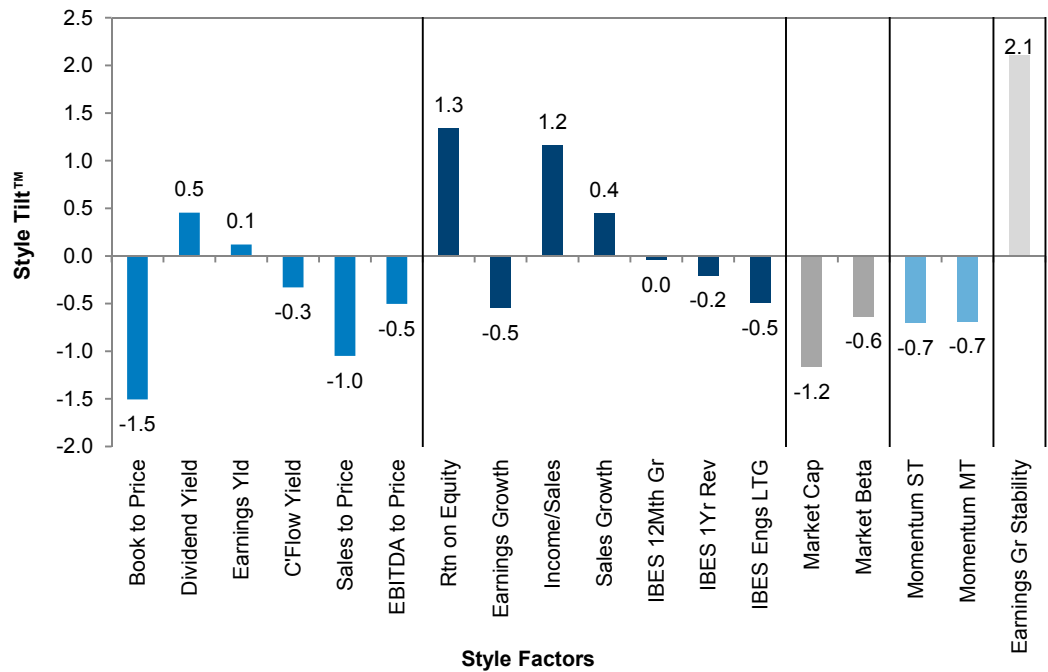
We use the Portfolio Style Skyline™ analysis to compare the JPX400 Index (where JPX400 is the 'portfolio') to first the TOPIX and then the MSCI Japan (where these indices are the 'benchmark') to show style differences between the index.

JPX400 has a somewhat more expensive valuation factor exposure than TOPIX, most particularly for Price/Book Ratio as mentioned above. This reflects the higher ROE and profit margin characteristics of companies in the index.

The largest style tilt is to earnings growth stability, which is indicative of higher-quality companies and as such is consistent with the objectives behind the construction of JPX400. JPX400 has a more pronounced large cap growth exposure than TOPIX, and less in both small cap value and small cap growth, due to the higher average market cap as described above.

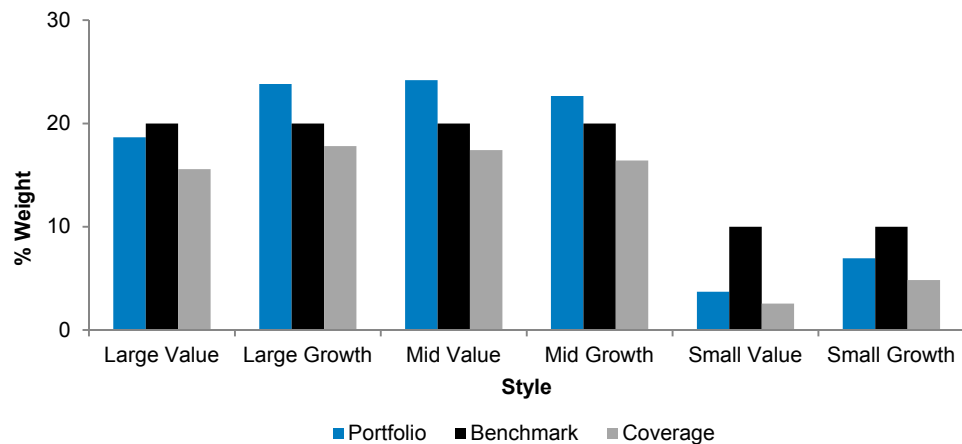
## Style analysis versus TOPIX

Chart 15: JPX400 Portfolio Style Skyline™ versus TOPIX



Notes: Style Skylines™ show benchmark-relative Style Tilts™. Sample Size Adjusted Tilts, calculated from both the size and breadth of portfolio positions, assess the deliberateness of the Tilts and enable comparisons across portfolios of differing structures. TOPIX is the 'Benchmark'. Source: MSCI Barra Model Analysis, 15.07.2015.

Chart 16: Style distribution versus TOPIX (BM)

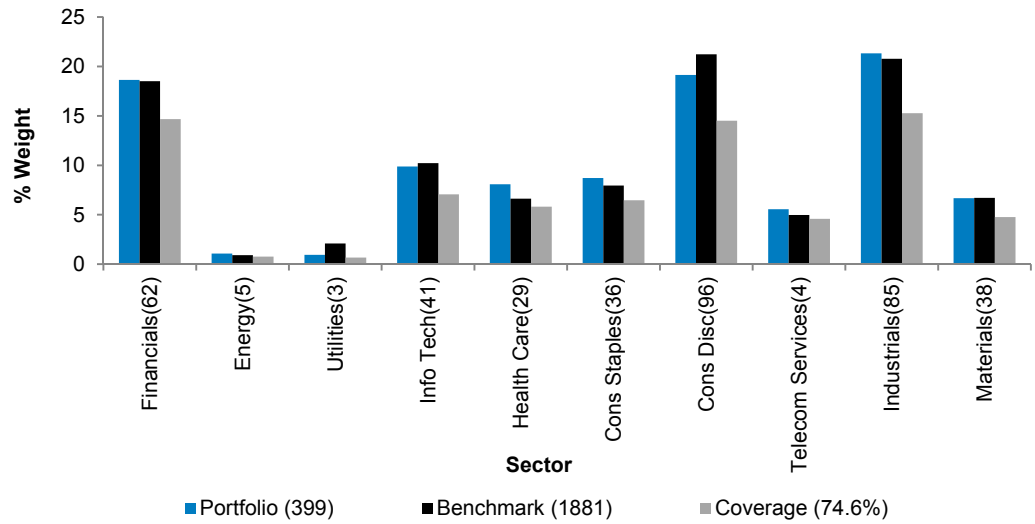


Notes: The Style Distribution shows the proportions of the portfolio and the benchmark invested in each of the basic styles: Large, Mid, Small = Market Cap (40%,40%, 20%), Value, Growth = Book to Price per Share (50%, 50%). TOPIX is the 'Benchmark'. Source: MSCI Barra Model Analysis, 15.07.2015.

**Coverage:** Portfolio Coverage describes the extent to which the benchmark is represented in the portfolio and as such is an objective and practical measure of portfolio diversification. Note that Active Share (a measure of how different the portfolio is to its benchmark) is equal to 100% minus Coverage. A stock's Coverage is defined as the lower of the % weight in the portfolio and the % weight in the benchmark. Summing these numbers for every stock in the portfolio gives a number for the overall Portfolio Coverage, referred to here as Coverage. Since Coverage figures describe the stock commonality between portfolio and benchmark they can highlight the "stock selection" risks within the portfolio.

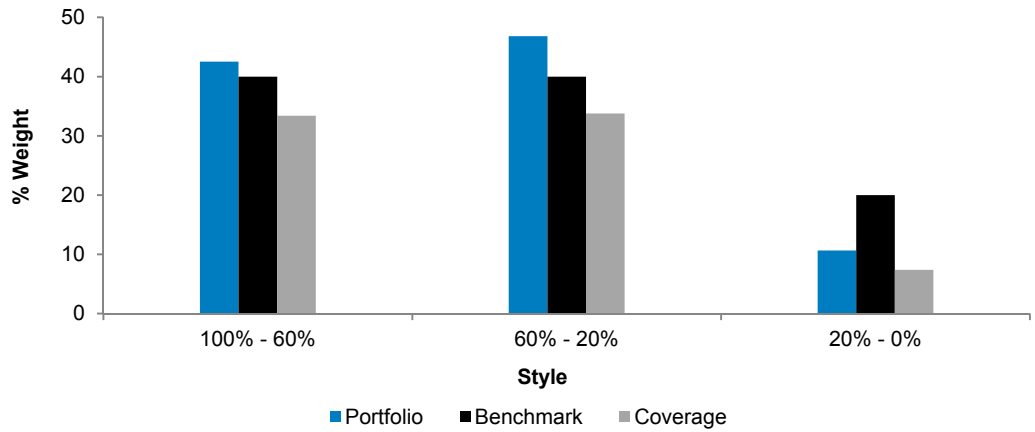
Coverage numbers can be interpreted as follows: **0%** No commonality. **0-10%** Typical for Small Cap portfolios versus a Small Cap benchmark. Or a "hyper-active" manager if not Small Cap. **10-30%** Typical active manager seeking significant alpha potential versus benchmark. Usually some significant active stock, Style, sector, and country/currency positions. **30-60%** Very diversified; highly aware of active risks versus benchmark. Possibly optimized. Constrained sector and/or Style bets - often explicit weight constraints for sectors, countries, and stocks. **60-100%** Enhanced Index to Passive; often optimized. Usually close to benchmark weights for sector/country if Style based or factor driven. Usually very low Tracking Error whether ex post or ex ante. **100%** "Pure" index fund. No active positions.

Chart 17: Industrial sector style versus TOPIX (BM)



Notes: Sector Skylines show the sector weights within the portfolio and the benchmark. Coverage data reveal the diversification across the benchmark, for each sector and for the portfolio overall. TOPIX is the 'Benchmark'.  
Source: MSCI Barra Model Analysis, 15.07.2015.

Chart 18: Market cap distribution versus TOPIX (BM)



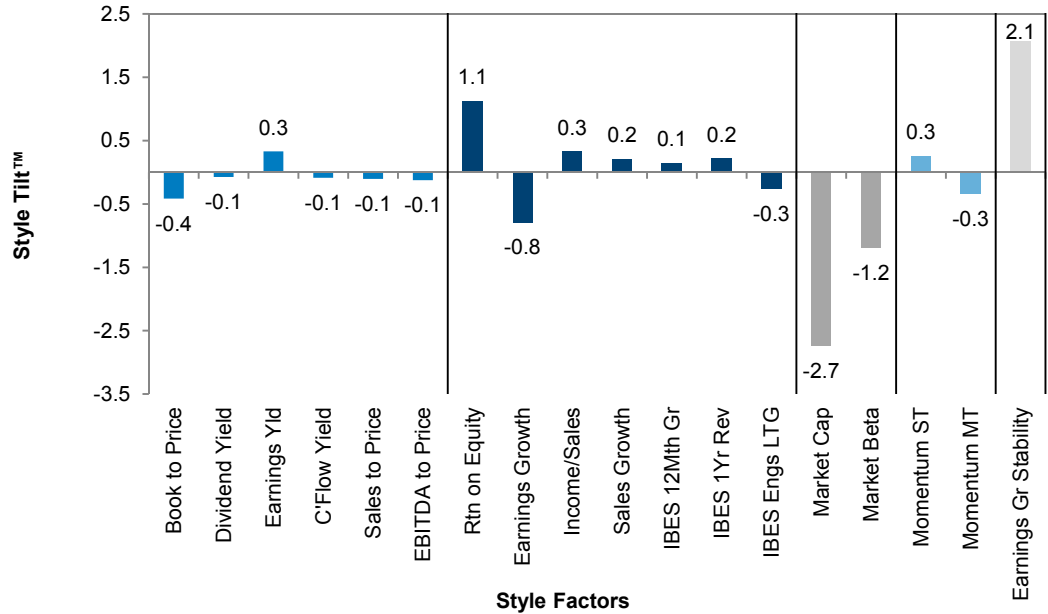
Notes: The Size Distribution shows the proportions of the portfolio and the benchmark invested in each of the basic Size Categories: 100% - 60% represents the top 40% of companies sorted in descending order by Market Cap. TOPIX is the 'Benchmark'.  
Source: MSCI Barra Model Analysis, 15.07.2015.

## Style analysis versus MSCI Japan

There is less of a differential in valuation factors between JPX400 and MSCI Japan than is the case when comparing with TOPIX. With respect to market capitalisation, JPX400 is less exposed to large cap value, and more exposed to small cap growth.

As for the comparison with TOPIX, the most significant single positive style tilt is towards earnings growth stability.

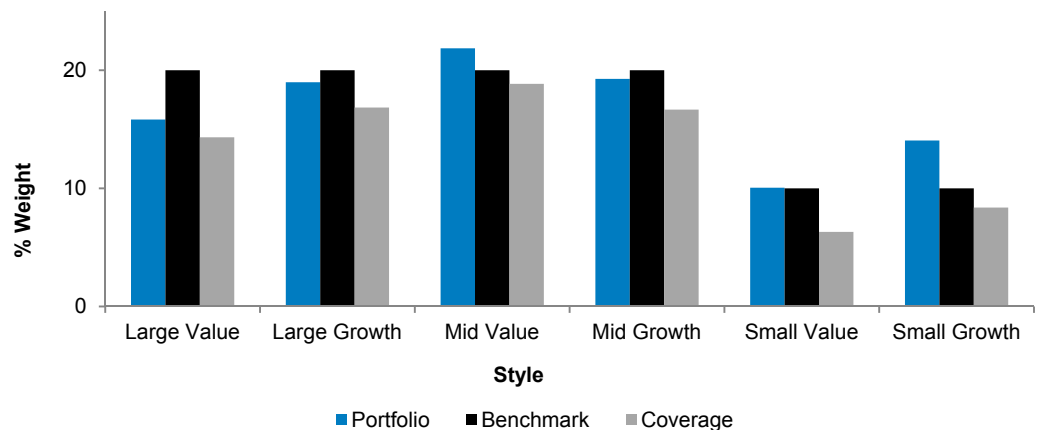
Chart 19: JPX400 Style Skyline™ versus MSCI Japan



Notes: Style Skylines™ show benchmark-relative Style Tilts™. Sample Size Adjusted Tilts, calculated from both the size and breadth of portfolio positions, assess the deliberateness of the Tilts and enable comparisons across portfolios of differing structures. MSCI Japan is the 'Benchmark'.

Source: MSCI Barra Model Analysis, 15.07.2015.

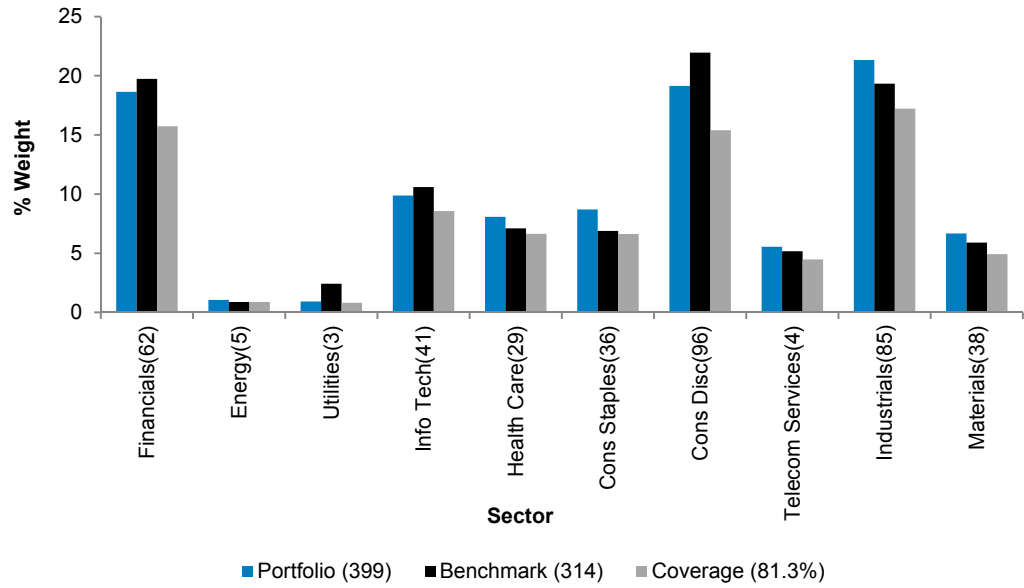
Chart 20: Style distribution versus MSCI Japan (BM)



Notes: The Style Distribution shows the proportions of the portfolio and the benchmark invested in each of the basic styles: Large, Mid, Small = Market Cap (40%, 40%, 20%), Value, Growth = Book to Price per Share (50%, 50%). More detailed sector (and country) adjustment may also be informative. MSCI Japan is the 'Benchmark'.

Source: MSCI Barra Model Analysis, 15.07.2015.

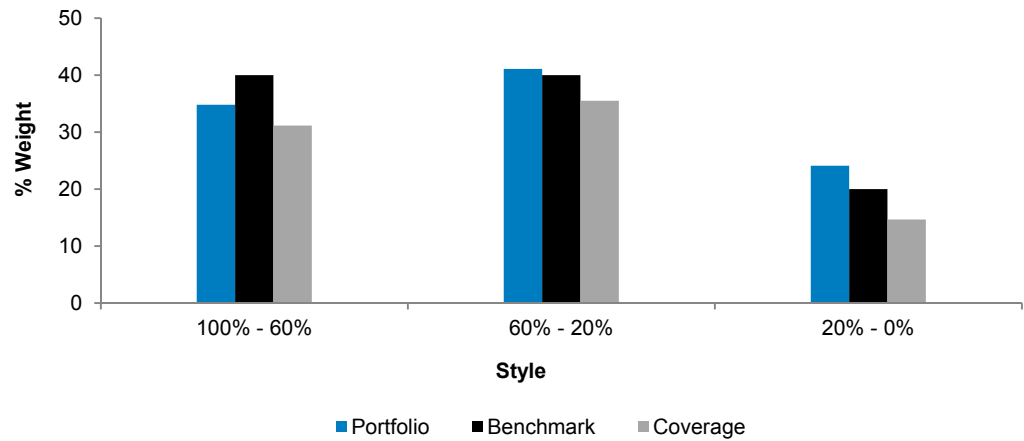
Chart 21: Industrial sector style versus MSCI Japan (BM)



Notes: Sector Skylines show the sector weights within the portfolio and the benchmark. Coverage data reveal the diversification across the benchmark, for each sector and for the portfolio overall. MSCI Japan is the 'Benchmark'.

Source: MSCI Barra Model Analysis, 15.07.2015.

Appendix Chart 22: Market cap distribution versus MSCI Japan (BM)



Notes: The Size Distribution shows the proportions of the portfolio and the benchmark invested in each of the basic Size Categories: 100% - 60% represents the top 40% of companies sorted in descending order by Market Cap. MSCI Japan is the 'Benchmark'.

Source: MSCI Barra Model Analysis, 15.07.2015.

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## Appendix 2: Impact of capping index weights

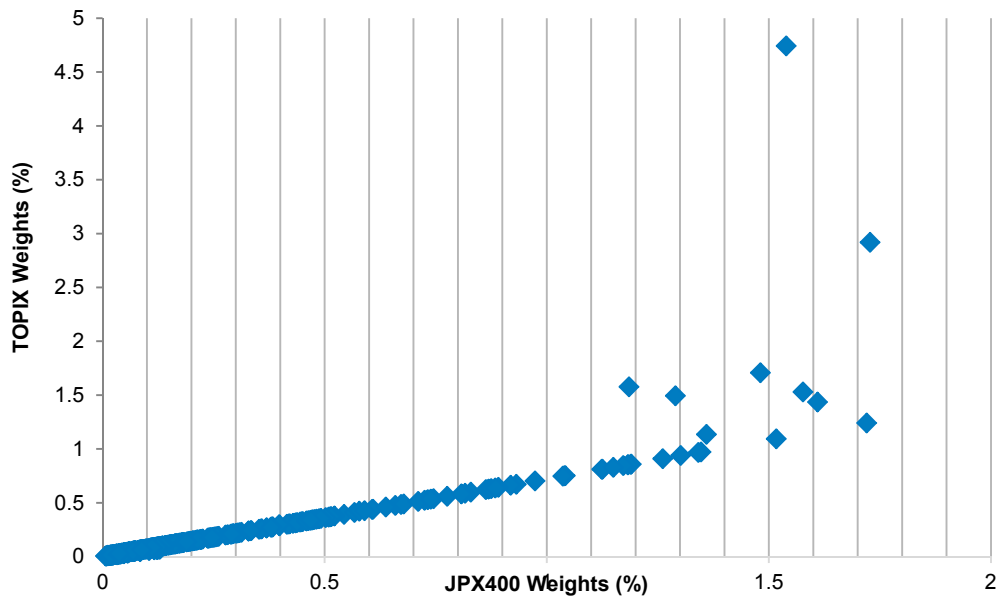
The main differences in index weights for stocks which are included in both JPX400 and TOPIX are explained by the capping rules of the JPX400, by which initial weights were capped at 1.5% - although stocks which have outperformed are able to “drift” above that weight (which explains the presence of a few outliers in the chart below to the right of 1.5 on the x-axis).

This is driven mostly by Toyota - and to a lesser extent - by Mitsubishi UFJ. In general, when comparing index weighting methodologies, anything which reduces the size bias of weighting by market cap tends to boost performance. Examples here would be capping the largest stocks, as with the JPX400, or in an extreme case equally weighting everything. That said, in this case, the performance impact is going to be substantially more stock specific – the question comes down to whether Toyota outperforms.

Chart 23 plots all the stocks in both the JPX400 and TOPIX. It shows that for the overwhelming majority of stocks, the JPX400 weight is 1.37x the TOPIX weight. The only exceptions to this are a handful of the largest stocks, which are those affected by the 1.5% capping, and some other names which have a larger JPX400 weight typically of the order of 1-5bps.

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Chart 23: Index weights comparison for overlapping stocks



Source: FIL Ltd, June 2015

In summary, the differences between the two indices are explained by the fact that they hold some different stocks and by weight differences in the very biggest names, principally due to capping.



## Appendix 3: Fidelity Abenomics Scorecard

Fidelity analysts have been tracking the impact of Abenomics in the real economy using our proprietary Abenomics Scorecard. A historical summary excerpt of our scorecard analysis is shown below. Our analysis of Japanese equities is carried out by a team of 22 equity analysts and 12 portfolio managers based in our Tokyo office (opened in 1969).

### Fidelity Abenomics Scorecard (as at 11 September 2015)

Indicator	Current Value	Type	As of	Source	Trend		
					Current	T-1	T-2
<b>Survey</b>							
Consumer Confidence Index	41.7	Abs	Aug-15	Cabinet Office	↗	↘	↗
Business Condition Coincident Index	112.2	Abs	Jul-15	Cabinet Office	↘	↗	↘
Abe Administration Approval Rate	37	Abs	Aug-15	NHK	↘	↘	↘
<b>Labour</b>							
Job Matching: JAC Monthly Sales 3MMA (M)	21.2%	YoY	Jul-15	JAC	↘	↘	↗
Job Matching: Job Openings to Applicants Ratio (M)	1.19	Abs	Jul-15	Intelligence	↔	↘	↘
Staffing: MF Engineer Utilization Rate (M)	98.5%	Abs	Jul-15	Meitec	↗	↗	↗
Staffing: Recruit Hourly Earning (M)	3.7%	YoY	Jul-15	Recruit	↗	↘	↘
Recruit Part Time Hourly Earning (M)	1.3%	YoY	Jul-15	Recruit	↗	↘	↘
Job Openings to Applicants Ratio ex. P/time SA (M)	1.06	Abs	Jul-15	MHLW	↗	↔	↗
Full Time Workers Payroll (M)	-0.2%	YoY	Jul-15	MHLW	↗	↘	↗
Part Time Workers Payroll (M)	0.3%	YoY	Jul-15	MHLW	↗	↗	↘
<b>Price</b>							
Retail Gasonline (Wk)	-19.1%	YoY	08/31/15	ANRE	↘	↘	↘
Retail Electricity (M)	-3.1%	YoY	Oct-15	Companies	↗	↘	↘
Retail Gas (M)	-14.0%	YoY	Oct-15	Companies	↘	↘	↘
Retailer Average Ticket Size (M)	5.1%	YoY	Aug-15	Companies	↗	↗	↘
Steel (M)	-9.2%	YoY	Aug-15	Japan Metal	↘	↘	↗
Food (M)	10.4%	YoY	Aug-15	MAFF	↘	↗	↘
Household Telecom Expenditure (M)	5.4%	YoY	Jul-15	Statistics	↗	↘	↗
Imputed Rent Index (M)	98.4	Abs	Jul-15	Statistics	↔	↔	↘
Core CPI (M)	0.6%	YoY	Jul-15	Statistics	↔	↗	↗
CPI foods (M)	2.5%	YoY	Jul-15	Statistics	↔	↘	↗
Corporate Goods Price (M)	-3.6%	YoY	Aug-15	BoJ	↘	↘	↘
Corporate Services Price (M)	0.6%	YoY	Jul-15	BoJ	↗	↘	↘
<b>Consumption</b>							
Retailers SSS (M)	5.0%	YoY	Aug-15	Companies	↗	↗	↘
Advertising Monthly Sales (M)	7.9%	YoY	Aug-15	Companies	↗	↘	↘
Residential Rents (M)	1.3%	YoY	Jul-15	Company	↗	↘	↗
Office Rents (M)	4.5%	YoY	Aug-15	Company	↘	↗	↘
Office Vacancy (M)	4.72%	Abs	Aug-15	Company	↗	↗	↗
New Home Sales 3MMA (M)	13.3%	YoY	Jul-15	REEI	↗	↗	↘
Single Family Home Order (M)	11%	YoY	Aug-15	Companies	↗	↘	↗
Retail Sales (M)	1.6%	YoY	Jul-15	METI	↗	↘	↘
Residential Housing Starts SA (M)	7.4%	YoY	Jul-15	MLIT	↘	↗	↗
<b>Export</b>							
Forwarder Air Cargo Export (M)	-8.2%	YoY	Aug-15	Companies	↘	↘	↗
Company Export Order (M)	-1.3%	YoY	Jul-15	Company	↘	↗	↘
Total Export (M)	7.6%	YoY	Jul-15	MoF	↘	↗	↘
Auto Export (M)	9.6%	YoY	Jul-15	MoF	↘	↗	↘
Auto Parts Export (M)	3.4%	YoY	Jul-15	MoF	↗	↗	↘
Machinery Order Export (M)	39.8%	YoY	Jul-15	Cabinet Office	↗	↘	↗
<b>Production</b>							
Company Monthly Sales (M)	18.6%	YoY	Jul-15	Company	↘	↗	↘
Company Domestic Order (M)	-8.5%	YoY	Jul-15	Company	↘	↘	↘
Semi & FPD Mfg Eqpt BB Ratio (M)	1.11	Abs	Jul-15	SEAJ	↘	↗	↘
Capacity Utilization SA (M)	96.9	Abs	Jul-15	METI	↘	↗	↘
Inventory Ratio SA (M)	112.2	Abs	Jul-15	METI	↗	↗	↘
<b>Capex</b>							
Machinery Order Domestic (M)	2.9%	YoY	Jul-15	Cabinet Office	↘	↘	↗
Tankan: Manufacturing (Q)	12.3%	YoY	2Q15	BoJ	↗	↘	↘
Tankan: Non-Manufacturing (Q)	-1.0%	YoY	2Q15	BoJ	↗	↘	↗
<b>Finance</b>							
Lease Capex (M)	6.6%	YoY	Jul-15	JLA	↘	↘	↘
Loan Growth (M)	2.8%	YoY	Aug-15	BoJ	↗	↗	↘
Loan Deposit Ratio (M)	67.3%	Abs	Aug-15	BoJ	↗	↗	↗

Source: Fidelity Worldwide Investment. Data is unaudited.

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October 2015

IC15/128