

# Japanese Equities Q3 investment update

October 2023

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**Investment manager Donald Farquharson and investment specialist Sarah Clark give an update on the Japan All Cap, Japan Growth and Japan Income Growth strategies covering Q3 2023.**

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**Sarah Clark (SC):** Welcome to the quarterly update for Baillie Gifford's Japanese Equities strategy. My name is Sarah Clark and I'm an investment specialist for the strategy. And I'm delighted to be joined by Donald Farquharson, who is head of the team.

Now, as a reminder, this is a strategy which is looking to invest in some of Japan's most innovative and exciting growth companies. And we do that by taking a long-term, patient approach. And we are looking to invest in these companies for a minimum of five years.

So, Donald, let's just jump straight into the questions. The Japanese market has been performing very well recently and it's been a challenging time for the performance of our strategies. So, in your view, what do you think has been driving the growth of the market and why do you think that we have fallen behind?

**Donald Farquharson (DF):** Yes, it's been a difficult period over the last 12 to 18 months, and the last quarter has been no different to that. And I'd say what has been driving the market has been traditional value sectors like cars and banks and some of the lower-end industrial and material companies. And the reason they've been doing well is because of rising inflation expectations, albeit in Japan, still quite modest. Leading to higher rate expectations, which benefits the banks, a weaker currency which benefits a lot of exporting sectors, and the cars.

And also, on the sidelines, the Tokyo Stock Exchange initiatives to boost lowly-rated stocks I think has just encouraged a more value-orientated market.

And it's probably worth reflecting on why we don't own a lot of these sectors, why they are essentially funding the greater growth opportunities that we see elsewhere. The banks, for example, I think they're structurally challenged. If you take a big bank like Mitsubishi EFJ, they have over \$700bn of deposits. They have over \$1.5tn, sorry - over \$700bn of loans [and] over \$1.5tn of

deposits. And I think that's really hard, if you're a bank, to be able to price your loans in a sensible manner.

On the automotive side, I think the Japanese carmakers have approached the challenges of transitioning from combustion engines to electric vehicles in a very linear manner. So, they've tried to transition through hybrid vehicles and that has helped them to an extent. But I think it's meant that they've fallen behind in terms of the move to electric vehicles and it puts them challenged [at] the high end [by] companies like Tesla and at the low end by the Chinese OEMs (original equipment manufacturers).

And then on the industrial side, and some industrials we do own within the portfolio, like trading companies, and they've performed extremely well. But sectors like steel, half of all steel that's produced in Japan is exported and it's exported to markets like China. There is no reason, longer term, why you would position large blast furnaces in Japan to export steel around Asia. So I think again, these are sectors which are doing well now but will be challenged in the future.

And at the same time, some of the stocks that we own have had a challenging period. Companies that are facing China, where recovery has been slower, whether some apparent structural challenges facing the Chinese economy has meant that in areas like factory automation, but also in some of the consumer staple companies that we own, and medtech companies as well, they've gone through a more challenging period.

And some specific stocks like CyberAgent, which is an online media company or GMO Internet, infinite internet infrastructure, they have also had a more challenging period, generally speaking, because they've been investing for future growth. And this is not a market that likes companies that are investing for future growth at this stage, particularly where it means they're losing money.

Now, we have seen some notable improvements in some of our stocks where they've been doing precisely that. A company like Rakuten comes to mind, where they have a very good ecommerce business and a very good financial services and fintech business, but they've been investing in a mobile network which has meant that they've fallen into loss. A lot of the data we're now seeing suggests, one, that they have a very good network and two, they're starting to win subscribers.

So we're encouraged there. We're also encouraged by the recovery in the share price.

**SC:** So, given the current market backdrop that you've just described, and our style of investing being out of favour, would you say that the portfolio is still fit for the future? And have you made any changes to the portfolio recently?

**DF:** In terms of the broad philosophy, no. And as I said, we remain committed to trying to find the best growth companies within Japan, and if anything, we have accentuated that. We've been leaning into growth a little bit more. In terms of the investment process, we have not been making changes.

Of course, what we continue to do is to meet with the companies, to re-examine the hypothesis of ownership. So always to make sure that we are challenging ourselves on why we own these companies and whether we should be making any changes.

Actually, in some cases, the fact that growth stocks have been under pressure, it has enabled us to look at companies that we've followed for a long period of time, but where we've not owned them. And two of the changes that we've made are stocks that I think we know quite well and have followed them for a long period of time but we haven't owned them largely through high valuation.

So Nihon M&A, which is a small boutique advisory house for small companies. They benefit from the fact that there are about three and a half million small businesses in Japan and about half of them are run by someone who is over the age of 70 and has no successor. So there's a very big growth opportunity which actually demonstrates how demographics don't always need to be a negative in Japan.

Another company we've recently bought is Olympus, which is a world leader in endoscopes, and that looks like a company which has a huge opportunity to grow, both in terms of medical procedure but also geographically. That's something else we're excited by.

**SC:** Thanks. It's great to hear about those two new companies that you've added to the portfolio and that you've been able to take advantage of the current valuation. So, my final question is on our recent trip to Japan. We've just returned from a week in Japan where we met with 24 companies, some of which were existing holdings and some potential new ideas. We've not fully had the time to debrief, but I would love to hear which companies have left you feeling the most excited and why.

**DF:** I certainly won't go through all 24. I would say, broadly speaking, in terms of the higher growth stocks in which we're invested, the period going into Covid was generally a good one for a lot of these companies. There were beneficial tailwinds. They became headwinds as the economy went back to a more normal pace and people went back to work.

For a lot of the founders of these businesses, they saw a huge loss in paper wealth as a result of share prices falling. And I think from visits prior to this one, that led to a loss of confidence, which on this trip I saw returning. So broadly speaking, I feel encouraged by a lot of the companies that we've met.

And as you say, we had a couple of meetings with companies that we don't own where I think we need to do more work, but are worthy of consideration. A couple of the foremost in my mind, Money Forward, which is a cloud software-as-a-service company which provides solutions to businesses in the back office and in financial services. I think that's a really exciting business where cloud migration has been woefully slow within Japan, so big opportunity ahead.

And HORIBA, which makes measurement and analysis equipment for the automotive and semiconductor industries, but also actually in a lot of other quite exciting adjacencies to that. It's not a business that I really knew that well, I will admit, but I think it is probably true that the

valuation reflects that it is not well understood as a business more broadly, and that's something I'd like to consider a bit more.

**SC:** Thanks, Donald. That's been a very helpful update today and it's been great to hear that you remain very excited about the opportunity, and that the portfolio is well-positioned to benefit from this.

Thank you to everybody that's watched this. We hope you found it an insightful update and we'll see you next quarter.

## Japanese Equities (including Japan All Cap, Japan Growth and Japan Income Growth strategies)

### Annual past performance to 30 September each year (net%)

	2019	2020	2021	2022	2023
Japanese Equities All Cap Composite	-4.7	12.5	18.2	-34.0	11.4
Japanese Equities Growth Composite	-6.5	18.6	15.4	-40.1	12.8
Japanese Equities Income Growth Composite	-4.1	7.6	16.6	-28.8	10.7
TOPIX	-5.8	7.4	20.6	-28.4	25.9

### Annualised returns to 30 September 2023 (net%)

	1 year	5 years	10 years	Since inception*
Japanese Equities All Cap Composite	11.4	-1.4	4.5	N/A
Japanese Equities Growth Composite	12.8	-2.9	3.4	N/A
Japanese Equities Income Growth Composite*	10.7	-1.0	N/A	4.2
TOPIX	25.9	1.9	4.8	5.2

Source: Baillie Gifford & Co and TOPIX. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

\*Inception date: 31 July 2016.

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