

# Capitalising on change: Japan's growth champions

August 2024

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## Short Briefings on Long Term Thinking – Episode 41

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**Leo Kelion (LK):** Imagine Hiroshima, four years after the Second World War. Out of the city's ashes, a company arose with a simple mission. To nourish a nation where fresh food was scarce and malnutrition rife.

Calbee took its name from the calcium and vitamin B it packed into caramel wafers to provide nutritious treats. And over the years that followed, the snack firm outpaced rivals by being at the forefront of change, seizing on cheap wheat imports to create its famous shrimp crackers, and more recently exploiting new breakfast habits to drive Japan's granola boom. Calbee's ability to take advantage of upheaval is a trait that Baillie Gifford's Japan team also seeks out in other companies, as we're going to discover.

Welcome to *Short Briefings on Long Term Thinking*. I'm Leo Kelion, and I'm joined by Matthew Brett, a manager in our Japan Team. Matthew's also manager of the Baillie Gifford Japan Trust and our Japanese Fund, in addition to being a partner in the firm.

Over the next half an hour, we'll uncover other stories like Calbee's, Japanese firms capitalising on transformational changes in the world around them to deliver long-term growth. But first, a quick reminder, as with all investments, your capital's at risk and your income is not guaranteed.

Matthew, welcome to the podcast.

**Matthew Brett (MB):** Thank you, Leo.

**LK:** Before we explore some of the companies you back, I'm curious to know what attracted you to investment, because you studied for a PhD in psychology before making the leap.

That's right. And I'd done my undergraduate degree and then after that I was really keen, having trained as a scientist, to actually try and do some science. And the three years of doing the PhD gave me enough time to understand that things were getting more and more and more specialised. And really, what I wanted to do was learn about things more generally. So in the end, I concluded I was poorly suited to be a research scientist. And fortunately, Baillie Gifford were recruiting and I joined.

**LK:** And then you joined its Japan team in 2005, and you visited Japan itself many times since then. How would you say Japan and its companies have changed over the past two decades?

**MB:** The most striking things really are the way things have become very much more electronic, very much more digital over time. I really remember those early trips to Japan, printing off, a couple of ring binders worth of materials to carry with me. Because the moment you left Edinburgh in those days, bizarre though it sounds now, you were cut off from most information.

And in terms of the companies themselves, there are many more companies now involved in those newer activities that have developed over time. The internet space was really a handful of companies back in 2005 in Japan. And now, there are many, many companies doing really exciting things.

**LK:** So what distinguishes the Japanese market from others in terms of hunting for growth stocks?

**MB:** One is the sheer depth of the Japanese market. There are well over one and a half thousand listed companies in Japan. And that's great, from a stock picking perspective, because you can find really interesting companies. And the other thing is, Japan hasn't been a market that's done hugely well over the past 20 or 30 years. And, as I looked at it on Friday, for example, NVIDIA as a single company was worth roughly three-quarters the value of the entire Japanese market. And that's really quite an incredible statistic when you think about it. And, from a perspective of finding opportunity, it clearly suggests that if you can find a company in Japan that can grow its earnings over time, you're unlikely to be paying a super high price for that company. And I think that's just really exciting as a growth investor.

**LK:** You're not based out in Japan though, so how do you find those opportunities?

**MB:** Well, obviously, we, as you pointed out we regularly go to Japan. And we spend quite a lot of time visiting smaller companies where sometimes there's not as much information available. And the best way to find out is simply to go visit and talk to them and have a good conversation. Once you get into the medium and the large-cap companies, we do know pretty much the landscape of where the significant companies are. And then it's more about trying to understand, which ones are actually going to be good growth companies. And that really is more about the thinking and the research.

In many ways, it's better to be based further away from the noise, to have the opportunity to talk to our colleagues from different desks in Edinburgh especially, you know, when you have market volatility. In some ways being that distance away, and in many ways, we also work the night shift in Japan because we work when the market's closed, I think really helps with a long-term perspective because we don't see the share prices moving minute by minute, hour by hour. What we see is a new share price each morning, and then we've got all day to think about it and whether we wish to make any changes. Then if we want to do anything, we can place the order, go home, have a good night's sleep and come back refreshed the next day.

**LK:** I want to turn to a paper your team recently published, Japan, the next opportunity. It acknowledges that our Japanese portfolios lagged the performance of Japan's main index, the TOPIX in recent years, which obviously isn't your aim. Why was that? And why do you believe circumstances are now swinging back in your favour?

**MB:** there's a couple of aspects to it. And the first is entirely within our own control. In the past few years, we haven't had any really knocking-it-out-of-the-park type of winning return from an individual company. And historically, you know, we've had a few of those and they really help the returns. And the second thing that's affected us is the impact of Covid and more specifically coming out of Covid. When we went into Covid, that was actually a very strong relative time for our portfolios as many of those internet businesses continued to operate, even amidst the challenges that were happening globally.

But coming out of Covid, we've had quite a tricky situation for someone who likes to invest in long-term growth opportunities. We've had a very, very strong economic recovery. We've had high inflation and we've also had a very weak yen. And those things combined basically have meant that the place to be in Japan for the past few years after Covid has been in the most cyclical companies you could find, whether those are shipping companies or car companies. Those are the types of things that really flew in the past few years.

But in terms of looking forward, I think a lot of that now has already happened. And the reality is many of the businesses that we invest in have continued to be able to grow their earnings. And as I think a lot of these more cyclical companies will naturally run out of steam. The companies that we invest in generally should be able to continue to deliver sales and earnings growth. And that, of course, is very valuable. And the market, is likely to turn back to appreciating that value there.

**LK:** Let's focus on those companies that you expect to outperform. Your team's paper explores four structural changes starting with digitalisation. What does the term mean?

**MB:** Basically digitalisation is just the move of the economy from old-fashioned paper-and-pencil type of systems, onto computers and then ultimately onto software-as-a-service or internet type of businesses.

**LK:** Japanese businesses are notorious for their love of paper, using fax machines and operating cash-only stores long after many other parts of the world. So how are things changing, and what's the opportunity for your portfolios?

**MB:** What's been changing is that the Japanese, you're quite right, have this real liking for form-filling and paper money and things like that. And that, I think, has meant that in the initial phases of digitalisation, the Japanese perhaps were slightly slow to adopt these type of things. But what we've seen, and this is very classically Japanese as well, is once an idea develops, then everyone adopts it really quite quickly. And what we've seen in recent years has been a complete shift in mindset when it comes to money, particularly, enhanced by Covid, where people appreciate electronic money is just a lot cleaner. It's more convenient.

And in my recent trips to Japan, I've come across restaurants that are card-only, which would be unbelievable even a few years ago. I've even come across a convenience store that would only take cards. Nowadays, you can easily land at Tokyo and get a bus, a train, a taxi, all using card, no trouble at all. And it's only really once you get out into the more rural parts of Japan now that you start to see cash-only becoming more prevalent. So that's been one really big change in the past few years. And the other thing that's been driving the adoption of digitalisation is the demographics of Japan. We know Japan has an ageing population. If they want to keep going with the current lifestyle quality, they now have to become more efficient.

So in many ways, Japan's gone from being a bit of a laggard with these trends to actually possibly moving faster than many other countries at the current time.

**LK:** Oh that's interesting. So, it's leapfrogging us in a sense. Can you give me an example of one of the companies you invest in that's doing that?

**MB:** Well, so one of the obvious ones is Rakuten. They, for example, have pushed into various areas of digitalisation. So online credit cards, where they've built that business up to be the largest credit card business in Japan. Online travel, where again, they've built that business up to be a very, very substantial business. And also e-money types of QR, readers, etc.

**LK:** You talk about the QR codes, those are like the digital barcode things. What's the advantage of that over the kind of tap-and-pay with your phone that we have over here?

**MB:** The advantage of that is you can plug the QR code into a variety of different things, so it can be attached to a credit card, it can be attached to e-money, it can be attached to your bank account. And I think that's one of the advantages is the flexibility of it. It also requires very little infrastructure to read a QR code compared with a kind of near-field communication type of chip.

**LK:** You mentioned that Rakuten provides a disparate range of online services, but what holds them all together is its loyalty points scheme. That gives customers an incentive to use more than one part of its platform, doesn't it?

**MB:** Yeah, that's absolutely right. They've almost got a multiplier effect where if someone uses more than one service, the discounts kind of add up and multiply together. So, someone who uses many of the services gets basically a better deal. And because Rakuten evolved most of these services internally, they all use the same ID. And so, it's really easy for a customer, for example, who signed up to the Rakuten Bank to become a customer of Rakuten Mobile because most of the information that's needed is already present. So, the whole process can happen very, very smoothly.

**LK:** we've covered digitalization as one growth driver. Let's move on to a second, accelerating automation. More than half the world's industrial robots are made in Japan. So what's the growth opportunity from here?

**MB:** It's true that Japan is very, very strong in robotics and automation. The real excitement at a high level with robots is it's one of the things that almost hasn't really happened yet. And what I mean by that is, anyone who's read your sci-fi or watched Star Wars, et cetera, there's loads of robots in those worlds. And there are very few robots in our world. I mean, there's a few in car factories and things like that. But that is quite rapidly changing now. And whether it's autonomous cars, which essentially are a type of robot, or service robots trying to carry trays around restaurants and things, we're starting to get there. And the real excitement for us is that various developments in AI and machine vision should make the opportunity for automation and robotics a lot bigger than it used to be.

And in terms of individual companies, SoftBank, for example, had its Pepper robot, but it's got a variety of different robot opportunities now ahead of it in that service type of area and logistics. But then also we've got companies, in the wider automation space. So, for example, DMG Mori makes machining centres. And these, in the past, would be operated by a single operator. But increasingly, they're put into the factory in a way that the product can kind of work through them in a more conveyor belt type of system. And the accuracy of these machines is incredible. I mean, they cut to within a few microns accuracy. So, we're talking about a tiny fraction of a millimetre accuracy. And simply put, it's difficult for companies to get to that level of accuracy.

And, of course, there are competitors trying, but it's difficult. And that, ultimately, if you want to cut something very, very accurately, which you need for all kinds of industries, then ultimately you end up with buying from the Japanese still.

**LK:** You mentioned machine vision. Keyence is another one of the companies you invest in, isn't it? Because I think they do amazing things. They're the chips that let the robots see, is that right? And they can kind of spot tiny little flaws that human eyes wouldn't pick up.

**MB:** That's right, and what Keyence do is they go into customers' factories and they look around they say 'oh look we could help you here.' And of course, the margin on doing that is incredible if they can help the company to make their processes more efficient. And this whole vision area is quite central to where the progress can be made in robots. Because robots are already strong. They're already very accurate in terms of their movements. The problem with robots right now is, to be frank, they're a bit thick. They don't know where they are necessarily

and that makes them very dangerous. You have your arc welding robot in a car factory or whatever kept quite carefully in a cage away from the humans for obvious reasons. Whereas if you can start to develop the machine vision and the robot has awareness of what is around it, then you can get into the space of ‘cobots’ where the robot can be packing boxes alongside a human. And if there’s contact between the robot and the human, well, as long as the robot stops moving quickly, it’s all okay.

So, I think this area of vision, it’s the understanding of what the robot’s seeing that we really mean by vision. A bit like a human. You know, the human has eyeballs and they provide the raw input. It’s a camera basically. But the really smart stuff is knowing instantly, well, that’s a cat, that’s a dog, that’s a table, that’s a broken glass, that’s dangerous, that’s safe. Those types of bits of knowledge are the kind of things that increasingly we’re going to see developing in the space of automation. And that’s why I think we are still very much you know at the bottom of the foothills of the opportunity in automation.

**LK:** So this is potentially a huge market, but Japan doesn’t have it all to itself. China in particular is making inroads. What do you think will help Japan maintain its edge over the five to 10 years that we look to when we invest?

**MB:** We need to be super careful about Chinese catch-up. The Chinese are becoming more and more able. They’re very ambitious. That being said, it depends what we’re talking about. It’s relatively easy to catch up in more basic type of activities. For example, making cars. It’s very difficult to get to micron accuracy when it comes to cutting. It’s very difficult to have the relationships with factories and the decades of experience with machine vision in production lines. So those things are the challenges that the Chinese still face. And I think this is an area where it’s perfectly possible that we’re going to have multiple winners doing different things.

**LK:** We’ve discussed digitalisation and automation. The paper identifies the rising wealth of Japan’s Asian neighbours as a third growth driver. What does that involve?

**MB:** We know that Asia is a big growth opportunity ahead of it. It’s an area of the world that has decent demographics overall, that has rising wealth overall. And we also know that Japan within the region is the most developed country and therefore it has things that other countries, other people in those countries desire over time. So, for example, think about an area such as skincare where there is a lot of demand.

There always has been for people to maintain their youthful good looks for as long as possible and the Japanese have a very good reputation, obviously, for skincare but also for Asian skin and that reputation does give opportunity for those companies and we hold several of them in the portfolio, slightly different features to them. But to pick one out, for example, KOSÉ has this very established family management, quite a cautiously managed company. Those features are quite helpful when taking the long view in terms of seizing the opportunities there.

**LK:** You also invest in Shiseido, another skincare company that dates back to the 1800s. I guess its heritage and also its reputation for innovation gives it an advantage.

**MB:** There are a couple of aspects to that. I think the innovation for a cosmetics company is obviously important to stay relevant and to keep up to date with the trends. But the thing that's the most difficult to replicate – and you see that with skincare brands outside of Japan as well, like L'Oreal – the thing that's difficult to replicate is that brand, that feeling, that confidence that consumers have that this company really knows what it's doing. There are some areas of life where people can go out and they can create new brands relatively quickly. Skincare tends not to be one of those areas. It is difficult. And also, people have great loyalty to skincare brands in a way that they don't to other types of products. Someone who has become a happy consumer of something like Shiseido may well continue to buy their products for decades. And that can, of course, be very valuable.

**LK:** The fourth theme of the paper is meeting the unmet healthcare needs of an ageing population, not only in Japan but other parts of the world, including the UK. How's that relevant to your portfolios?

**MB:** One of the big areas of innovation in the past few years has been in healthcare. Whether that be gene testing or using AI to screen for cancer. There's really been huge innovation. And of course, the Japanese have been involved in innovating as well.

For example, we've got a holding that we've taken relatively recently in a company called Eisai. And Eisai has developed a drug called Leqembi. And Leqembi is the first drug to market which is able to slow the progression of Alzheimer's disease. And this is really huge. If we go back over the decades, Alzheimer's has been one of the most difficult diseases to treat. But they've got a drug now that is slowing significantly the rate of cognitive decline. It's approved in the US, in China, in Japan already. And we think that it's the type of drug that could be of huge benefit to society. That's what I really mean by those types of innovation, where companies are able to really do something valuable for society and ultimately get the returns from it.

**LK:** The prevalence of Alzheimer's is huge, isn't it? Is there anything that Eisai is doing that might be able to tackle it at an earlier stage rather than just trying to slow down dementia once it's ready set in?

**MB:** One of the most exciting opportunities is that you can see the biomarkers for Alzheimer's often decades before symptoms develop. So, when you look at these amyloid plaques that develop in Alzheimer's, the amazing thing really about the human brain is that it's so resistant to damage. It will keep being able to function even with significant damage. Now, of course, in the end, it can't cope and people develop symptoms of dementia and those get worse over time. At the moment, what they've shown is that their drug can help people once they've developed symptoms. But what's interesting is it appears that the drug over time clears some of the amyloid from the brain. And of course, that raises a really interesting question. Look, could you start the treatment earlier? And they've got a trial going on at the moment looking at that.

So if you've identified that people have these biomarkers for Alzheimer's, could you begin treating them before any symptoms? And might that delay even the onset of symptoms? Now,

we don't know what the outcome of that's going to be yet. But the idea of early treatment is a very appealing one.

If you have a blood test at 50 and you understand, well, look, you know, this is what is happening under the surface, but you could begin to treat that with drugs from Eisai and potentially other things in development by other companies. It's perfectly possible that you could delay even the onset of dementia for so long, ultimately, that it may no longer be a problem. Now, that is a big dream and we're a long way from that yet, but each of these dreams has to start with some single steps and Eisai has made a very important step in that direction.

**LK:** Well, that would obviously be wonderful in a huge market. What other companies are you investing in in this sector that address healthcare needs of the aging population?

**MB:** Another one to highlight would be PeptiDream which has a library of synthetic peptides, and they can be used either directly to treat things or they can be used to conjugate with drugs to allow the drugs to get into other areas of the body.

**LK:** Peptides are kind of mini protein-like molecules, aren't they, that can be used for a variety of uses. They're using AI, aren't they, to increase their rate of discovery? Can you tell me about what that opportunity looks like?

**MB:** Yes, so you're quite right. So these many peptides are naturally occurring, but what they have done is make new peptides which don't naturally occur. And as a result, those peptides are likely to have different properties. They may do different things. But the big question is, you've got this big library, what's useful what isn't and yes AI as a whole is really helping you know PeptiDream, their customers, pharmaceutical companies in general to really accelerate that process of trying to understand look when we look at this peptide and when we look at this protein what might it fit with? What might it help?

So you move away from that old-fashioned, random, 'oh well, we tried this and this happened' type of approach. And you can start to think a little bit more efficiently about what might fit with what and have what effect even before you start trying it in the real world.

**LK:** We've discussed four structural growth drivers, digitalisation, automation, the rising wealth of Japan's neighbours and the healthcare needs of an ageing population. But obviously, those aren't the only structural growth trends. If we return to Calbee, the snack maker we talked about at the beginning of the show, how does that justify a place in your portfolio?

**MB:** On the surface, maybe a lot of the innovation of a company like Calbee happened in the past. But the reality is, there's a lot of innovation happening today. They're producing, for example, pea-based snacks and lentil-based snacks, which have higher protein content, and also pushing into areas that are innovative for Japan, such as having breakfast cereals. So I think what is important with these companies is you can continue to have innovation.



**LK:** Calbee's Harvest Snaps are popular in our house, but I never knew they were made by a Japanese-owned brand before preparing for this show. Matthew, before wrapping up, we like to end the podcast by asking what book our guests are reading or have recently finished. So, Matthew, what's new on your bookshelf?

**MB:** Well, I've actually been reading a book by Kohei Saito called *Slow Down*. He effectively is arguing that capitalism is very destructive to the environment. And the answer to that is degrowth communism. You know, I find it very interesting because I think his critique of the environmental damage of capitalism is good. There are definitely things to think about there, particularly in terms of how regulation might develop in order to get the good aspects of capitalism without the destructive. I'm not sure I'm yet quite with him on the return to Marxism. But, you know, there's no point really in reading books that you completely agree with. You want to read things that give you new ideas and new challenges.

**LK:** New ideas, new challenges. Is there anything then that you've read in the book that might influence your investment decisions because presumably, the solutions that he's proposing are at odds with the investment case for the companies you back?

**MB:** Yes and no. I think one of the bits that he would certainly recognise would be increased efficiency as being helpful in general. Something we've been thinking about for years with our portfolios are what things can be done more efficiently and what things can't when you look at, for example, things like companies that do fossil fuel extraction, the core issue with those companies from a long-term investor's point of view is that there are other ways to power things. You don't have to dig out hydrocarbons from the ground and burn them. There are other ways that can work.

On the other hand, there are companies that do have significant emissions associated with them. For example, we hold a company called Sumitomo Metal Mining, which extracts copper and nickel. But those metals are absolutely vital for an energy transition and for electronics and for various uses. And they can't really be substituted.

What we're trying to do with all of these things is try and understand, which parts of the universe that we have access to, actually are going to show the growth and actually have the opportunity ahead of them, and which aspects don't.

In that context it is important to read, we really are at the limits of, possibly past the limits of what the environment is able to accommodate. And therefore you do need a much harder push towards efficiency in a variety of ways. And I think that is where, clearly the better opportunities are going to be.

**LK:** We'll link to the book in the show notes, *Slow Down: How Degrowth Communism Can Save the Earth*, by Tokyo University professor Kohei Saito. It's certainly not often that we recommend a book from a Marxist author. Matthew, it's been a pleasure talking to you. Thank you for coming on the podcast.

**MB:** Thanks Leo.

**LK:** And thank you for joining this conversation. You can explore more of our Japan team's thinking in the paper we discussed, *Japan: the next opportunity*, which we've also linked to in our show notes. And if you'd like to hear more from Matthew, I recommend his recent article on Japan's online banking revolution, where he picks out three companies in the sector with particular promise.

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But for now, listeners, I look forward to briefing you again next time.

## Show notes

Upheaval can create opportunity. Baillie Gifford's Japan Team seeks out companies that will derive the greatest long-term benefit from transformational forces impacting business and broader society. In this podcast, investment manager Matthew Brett identifies four 'structural growth' drivers and the portfolio companies taking advantage of them.

### Background:

Matthew Brett is the investment manager of The Baillie Gifford Japan Trust and our Japanese Fund, as well as co-manager of the Japanese Income Growth Fund. In this episode of *Short Briefings on Long Term Thinking* he discusses four forces creating long-term growth opportunities:

- Japan's late embrace of digitalisation
- the rising spending power of its Asian neighbours
- the accelerated adoption of industrial automation
- the unmet health needs of an ageing population

Brett also names some of the Japanese companies driving these changes or otherwise gaining advantage, including ecommerce conglomerate Rakuten, skincare beauty firm Shiseido, machine vision specialist Keyence and Alzheimer's drug developer Eisai.

**Resources:**

[Japan: the next opportunity](#)

[Kohei Saito: \*Slow Down – How Degrowth Communism Can Save The Earth\*](#)

**Companies mentioned include:**

[Calbee](#)

[DMG Mori](#)

[Eisai](#)

[Keyence](#)

[KOSE](#)

[PeptiDream](#)

[Rakuten](#)

[Shiseido](#)

[SoftBank](#)

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