Baillie Gifford™

Japanese Equities Q1 investment update

April 2024

Investment manager Donald Farquharson and investment specialist Sarah Clark give an update on the Japan All Cap and Japan Growth strategies covering Q1 2024.

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Sarah Clark (SC): Hello everyone, and welcome to our quarterly Japanese equities update. My name is Sarah Clark, an investment specialist for the strategy, and I'm joined today by Donald Farquharson, who's head of the Japan team.

Now, for the regular viewers, you may notice that Donald and I are not in the studio together this time, and this is because Donald is joining us from Shanghai, having just spent a week in Japan and this week in China.

We'll come on to the details of his travels, but first I'd like to start by touching on the market environment. So Donald, since the start of this year, Japan has hit the headlines again, and that was for reaching all-time market highs, the first time since the bubble burst in 1989.

And also, the Bank of Japan has announced the end to negative interest rates. So both of these are quite symbolic moments, and I think it's signalling the strengthening of Japan's economy. Do you feel that the backdrop is improving for growth investors?

Donald Farquharson (DF): Thank you, Sarah. Well, the simple answer to the last bit of the question is yes, I do think it's improving. In terms of the Nikkei at all-time highs, Bank of Japan changing its stance on policy rates, I would say that that is more signalling.

When I started Japan in 1990, the index was roughly at the level where it is today. And it is great to have a different narrative that we can move on and talk about, but we're not referencing back to some number in 1989. But it doesn't make a big difference, it is just a number.

Similarly, the Bank of Japan's move was relatively cautious, moving from negative 0.1 per cent to 0.1 per cent, and stopping its asset purchases, although it hadn't really been doing much asset purchasing of late.
Again, I think it's quite cautious signalling, and indeed, on the day when it raised rates and it changed its policy for the first time since 2007, the yen actually weakened, which suggested a lot of that was discounted.

But as you said, it's been encouraging to see better share price performance from a number of our holdings, indeed, from a very large number of our holdings. It's still notable that even in a quarter where share prices and portfolio returns were quite strong, we were still behind the benchmark.

And largely most of that attributable to two stocks that we don't own, Toyota Motor and Tokyo Electron. So two quite different industries with different reasons for why the share prices are doing well now.

But of our top 10 contributors to the portfolio in the first quarter, nine of them were up over 30 per cent. So we're getting some really quite strong returns from a number of very different holdings. And it's good to see also stocks like SoftBank, which has benefited from the listing of Arm Holdings at the end of last year.

Arm now has a market cap of $130bn. SoftBank owns 90 per cent of that. And SoftBank has a market cap of just under $90bn. So on that holding alone seems relatively undervalued, and its discount to net asset value, despite strong performance, is still widened.

But also good to see a stock like Rakuten, which has struggled in share price terms over the last three, five years, returning quite a strong performance in the first quarter. And I think that's some improving feelings around its financing, but also around its mobile business.

So quite a lot for us to be pleased with, to see good, positive operational improvement. And I think the general mood on the ground, I found, from companies was quite a positive one, not least buoyed by quite strong wage inflation.

SC: Thanks, Donald. It certainly sounds like a positive picture, and that things are moving in the right direction. And last week, you just spent a week in Japan, you've met with a lot of companies.

How were things on the ground there? And are there any highlights from those meetings that you can share?

DF: Yes. So when I was in Japan, a sort of usually busy schedule of visiting Tokyo, mainly Osaka, Nagoya, and Hamamatsu, one of our holdings, Hamamatsu Photonics is based there.

So four cities, 17 companies, and quite a lot of holdings that we have in the portfolio, MS&AD Insurance, Mizumi, Japan Exchange, Hamamatsu Photonics, as I said, Kubota Monotaro. So quite a long list, I won't go through all of them.

But also some of the newer holdings, like KOSE, it's a new holding for the all-cap strategy. It's actually been held in the growth strategy for several years. But there again, a brightening backdrop, KOSE is a cosmetics company with some very high-end prestige skincare brands, and quite high exposure to China.

So one of the meetings I've had, not necessarily this being one in Japan, was with the online brand manager for KOSE in China, and just hearing a little bit about some of the initiatives that they're working on. So KOSE was a highlight.

I saw Kao, didn't mention that earlier on, but just, I think it's indicative of how quickly some things are changing. Kao has struggled for 30 years to raise prices, despite being a product leader in a number of different household products. Its average price is now going up by 13 per cent. And in its strongest areas, like detergents, prices are going up 19 per cent.

So we're seeing a different mood where companies see a restoration of their ability to raise prices. I think it just unblocks the whole management cycle in terms of what they're able to do.

I also had a very good meeting with Mizumi. So they're doing a lot of work on digitalizing the ordering system and embedding them themselves with their major customers. So I thought that was good.

And I'm also interested to hear some of the initiatives that Kubota, the agricultural machinery maker, they also have a construction machinery business, and some really encouraging signs of how that business is performing in Asia, where you've seen significant urbanization and their smaller excavators are more useful in urban environments. So again, that and their Indian business escorts doing extremely well.

SC: So lots of positives to take away. Well, it sounds like you've had a busy week. I don't think clients would be surprised to hear that you've been in Japan again, but they might wonder why you just spent a week in China. Can you tell us what the purpose of that trip was and who you've been meeting with?

DF: Yeah, sure. And I think we've regarded China for a long time as just being a major opportunity, be it for the consumer brands that we own, the skincare companies, cosmetics, but also for factory automation, a positive for the automotive sector for a long period of time as well.

So I wanted to examine how that situation seems to have changed. I was based here where Baillie Gifford have an office in Shanghai, so I've been meeting the team in the Shanghai office. But I also flew down to Shenzhen, which is where a lot of the manufacturing is done.

I met with a couple of leading competitors to our holdings. So Mindray is a medical equipment maker. It competes directly in the in vitro diagnostics area with Sysmex. So just talking to them, modest but not direct competition to another holding Olympus.

And Innovance, which is a company engaged in industrial automation, competing with companies like Omron and like Nidec. I also met another company which more directly competes with Nidec in small harmonic drive motors.

So part of this was about looking to see where the Chinese competitors are and where we could have a higher degree of conviction about the Japanese competitive modes. And also just to get a sense of, because the backdrop of China economically doesn't seem as good as it was, whether that is likely to be a structural or is more of a cyclical headwind.

So the takeaways for me, and I should say in addition to meeting some Chinese companies, I met with FANUC, I met with Shiseido, two companies which have very important businesses in China.

And I've also spent most of today meeting with industry experts from a number of different competitors and Japanese companies. So a lot of corroboration of hopefully the investment case that we have for a lot of our holdings.

Very simply and at a high level, I still think this is an enormous opportunity for our holdings. As Shiseido said to me, even if China grows 3-5 per cent over the next three years, it will still contribute a quarter of all global GDP growth. So it is very important.

That's not to say necessarily whether it will grow at between that rate, but if we're looking at more modest rates of growth, China is still extremely important. And one of the other things that has really struck me has just been the speed of advancement in a number of different industries.

And we've worried ourselves and in terms of not having much exposure to automotive OEMs, we've worried ourselves there that China is catching up rapidly.

But one of the things that was really brought home to me is the extraordinary advancements that they've made in autonomous driving, the level of progress there. And I spent a bit of time playing around in an automotive showroom just to get a measure of what cars are now capable of doing.

And I could have gone from that showroom back to my hotel unassisted, and that would have been possible. They're still calling that sub-level three, but it is well above level three autonomy. So that's another thing I've taken away.

For the Japanese companies, I got some reassurance in terms of where their moat lies, how they're regarded, and a lot that gives reinforcement around the case for some of the factory automation names that we own.

I also was heartened by some of the initiatives that Shiseido is taking, and just simply saying that the learning processes in Chinese skincare are just so much faster than they are in any other part of the world. And some of the learnings they're taking from China and feeding back to the operations in Japan.

SC: Thanks, Donald. Well, another busy week, but it sounds like it's been very useful and you've gained a lot of insight from those meetings.

The final question I want to ask you is on Outlook. So we are long-term investors, our time horizon is looking at five years and beyond. What are the main growth trends that you're excited about for the future and for the portfolio?

DF: I think there is still a lot to go for in terms of the digitalization of the Japanese economy. That's very broad-based across our funds and clients will have heard us talking at great length to that theme.

Automation also is something that we've spoken about a lot, but something that was brought home to me in visiting the FANUC operations here in China is just how much of their offering now is away from traditional industrial robotics that are delivered for the automotive industry towards the collaborative robots.

So the examples of what they're selling, there are as many collaborative robots used in industry as there are the large and iconic yellow industrial robots. That, again, is very important.

And artificial AI is something I think which is applicable to companies within the semiconductor industry. So we have a number of names in that area. But it's also applicable in terms of the usage of data.

So companies like CyberAgent, for example, applying large language models. So there's a lot of interest there. And indeed, SoftBank, you could say, is a very broad-based theme on artificial intelligence.

So I think there are a lot of things for us still to be excited about. I'm excited about the continued premiumization of demand within Asia for a lot of the consumer product areas. And I'm encouraged by the direction of travel, literally, in that area.

SC: Thanks, Donald. And I think that's a positive note to end on. And I guess just to summarize our chat today, I think it's fair to say that the backdrop is definitely improving in Japan. Things are headed in the right direction and the portfolio is well set up to capture the future growth.

Thanks very much for your time today. We really appreciate that. And thank you to everybody for listening. If you have any questions on anything that you've heard today, please do get in touch. And we look forward to speaking to you next quarter.

Japanese Equities (including Japan All Cap and Japan Growth strategies)

Annual past performance to 31 March each year (net%)

	2020	2021	2022	2023	2024
Japanese Equities All Cap Composite	-13.1	59.2	-12.2	-11.3	11.0
Japanese Equities Growth Composite	-11.8	55.8	-17.5	-12.7	11.6
TOPIX Index	-7.2	38.9	-7.2	-3.5	24.3

Annualised returns to 31 March 2024 (net%)

	1 year	5 years	10 years
Japanese Equities All Cap Composite	11.0	3.6	6.3
Japanese Equities Growth Composite	11.6	2.0	5.3
TOPIX Index	24.3	7.5	7.0

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.

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