Baillie Gifford™

Japanese Equities
Q2 investment update

July 2024

Investment manager Tolibjon Tursunov and investment specialist Richard Singleton give an update on the Japan All Cap and Japan Growth strategies covering Q2 2024.

Your capital is at risk. Past performance is not a guide to future returns.

Richard Singleton (RS): Hello. Welcome to the Q2 update for the Japanese Baillie Gifford portfolios. My name is Richard Singleton. I am a product specialist on the Japanese team, and I'm joined today by Tolibjon Tursunov, who is a portfolio manager on Japan here at Baillie Gifford. Welcome, Tolibjon.

Tolibjon Tursunov (TT): Thank you.

RS: I just wanted to begin today by asking, for those who don't know, if you could give a brief summary of how we invest in Japan.

TT: Sure. Baillie Gifford has been investing in the Japanese equities for over four decades now. In 1981, we launched a vehicle that was dedicated to investing in the Japanese markets. And over this period, several things have remained constant. Some others have evolved in the way we invest in the market. Talking about those constants, first is that we've remained focused on analysing the fundamental attractiveness of companies as opposed to taking a macro view or a sector view for example when it comes to investing in those companies so we look for companies which we feel are likely to grow, at very attractive rates, their sales earnings and cash flow over long periods of time. The second constant in how we invest in Japan that has remained so in that period is that we remain focused on backing companies for the long term. So one of the intriguing observations that we have developed in investing, not just in Japan in the last 40 years, but also before in our experience and in our experience in investing in other parts of the world, is that finding attractive companies is only part of the job. Being patient enough, having the right infrastructure to hold on and run your winners once you find them is equally difficult. So this is the second constant, if you like. So we continue to remain focused on identifying companies and holding them, on identifying strong companies with strong earnings growth potentials and holding them for the long term. And today we do this task with 10 investors who are dedicated at looking at the Japanese equities, together with another 100 or so investors around the investment floor, who would be looking to invest in the Japanese equities as part of their international or global mandates.

RS: Thank you for that. That's extremely helpful. So it's been a challenging few years for growth investing in Japan, but it looks like we are now at an inflection point with outperformance for the portfolios over the quarter. I just want to ask you what you think are some of the main catalysts for this change.

TT: Sure. I guess to your point about the difficulty in terms of the performance, yes, it has been. The last two, three, two and a half, three years have been difficult for growth investing in Japan, for long-term investing in Japan, because what we've seen in this period is that the markets have been very, very focused on the cash flow and the earnings potential of companies over a very, very short period of time. And that was caused by people's fear, fear of a runaway inflation, or fear about some of the other macro events that have happened, including the war in Ukraine. And we find that in times of fear, the uncertainty levels in the markets rises to such an extent that people's time horizons are shortened massively. And against that sort of backdrop, when you're investing in companies which are likely to deliver cash flows and earnings not only for the next year or two or three, but over five and ten years, and their value, economic value is rested equally, and sometimes disproportionately in those streams of cash flows, which are likely to come at the longer end of that time spectrum, then you find yourself against a market which is extremely focused, as I was saying, in the near term. So that was the recipe, if you like, and the core reason of why we've seen underperformance. But it's changing. We feel that people's focus is shifting away from those companies. We feel that much of the market that has moved because people were invested in companies waiting for some sort of corporate reform or some sort of corporate improvement in their capital structure. Those kind of themes have largely played out. And we find that from here on in, it's likely, and we're already seeing it as you're referring over the shorter periods of time, we're already seeing a broader appreciation of companies, especially those which are likely to deliver returns over the longer periods, not only in the next quarter or two. The kind of companies which have strong competitive advantages, the kind of companies which are run by able management teams, they are coming back to the fore again, and that's the kind of environment where our skill should become more evident and more appreciated, hopefully. And I do feel that now is the time where we're seeing the change in that, shift away from appreciating the kind of companies with easy fixes, but short-duration prospects towards longer-duration strong companies.

RS: So it's longer-term growth starting to be recognised by the market again?

TT: Yes, yes.

RS: In terms of portfolio activity, I know that turnover remains low and there's strong competition for capital across the portfolio. We already have a few healthcare names in the portfolio, but I know that we've also this quarter bought a new name, Eisai. So I was hoping you could tell us what that does and also why you're excited about it.

TT: Sure. So Eisai is a company that specializes in delivering and developing drugs for neurological diseases. Leqembi is the first drug that was approved by the FDA that came to the market, is the first drug that was approved by the FDA that came to the market, which reduces the onset of Alzheimer's quite meaningfully. So with that drug, we've seen a biological de-risking, if you like, of that profile of that drug. The next stages for that drug are commercial de-risking, if you like, where the company is working on improving its distribution capabilities, including gaining insurers' approval for the coverage of PET scans, which is part of the prerequisites for being issued, being prescribed a Leqembi drug for the Alzheimer's disease. So as we see broader coverage of coverage, insurance coverage in the US and companies setting up distribution capabilities in Europe and China. We feel that there is a very large growth opportunity in terms of the revenue and the cash flows that are available for Eisai to convert. That's a developed part, developed world part. We feel that Alzheimer's as a disease is likely to become the focus point, not only in the developed world, but also in the developing parts of the world. So that adds to the, if you like, longevity of the revenue potential for this company. Yeah, so we're very excited by Eisai, which is why we bought the shares for the portfolios in the Japanese mandates.

RS: Certainly a big opportunity in the Alzheimer's space. So we've touched on healthcare there. I just wanted to ask where else you and the rest of the team are seeing exciting investment opportunities in Japan?

TT: Sure. I mean, the portfolio is made up of companies which operate in a variety of sectors. We run a fairly diversified portfolio and healthcare is one. The other themes that run through the portfolio are skincare, for example, strong franchises, Japanese, that operate in the skincare business. Shiseido, Kao are some examples there. We also own several companies that operate in the semiconductor space, hardware especially. We own stocks in the factory automation theme. And in terms of where we've been looking, we've been in combination with those industries that I've talked about, we've also been looking at perhaps what some people may call as a boring industry, however it's far from it. It's the paint industry because it's an industry which lends itself to players generating strong returns well above their cost of capital if they have brand, if they have distribution capabilities and we find that Japan offers those kind of companies, one of which is Kansai Paint, which in terms of the distribution capabilities we find is one of the best in the world. And their disproportionate exposure to the Indian, rapidly growing Indian market is a big bonus in terms of the growth opportunity for this company. So an exciting growth opportunity, well run, a distribution edge, are the key three ingredients in terms of what we look for. And this is well overlooked by the market because we find that the current multiples being asked for the shares here undervalues all of the other attractive points that I've talked about in this company. So we bought the shares in Kansai Paint for the portfolios.

RS: Perfect. So an exciting time for growth investors in Japan and lots of interesting companies for active bottom-up stock pickers. Thank you very much for joining us, Tolibjon, and thank you very much for joining us everyone else. We hope that was very useful for you. Just before you go, just to let you know that the head of the Japanese team, Donald Farquharson, and product specialist Thomas Patchett have written a paper, Japan: the next opportunity. So if you're interested in finding out about some of these exciting areas in more detail, please do go to our website and you can find that there. Thank you very much.

TT: Thank you.

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

Annual past performance to 30 June each year (net%)

	2020	2021	2022	2023	2024
Japanese Equities All Cap Composite	1.1	32.4	-28.0	10.1	6.2
Japanese Equities Growth Composite	5.0	29.1	-34.2	12.5	5.4
TOPIX Index	3.0	23.8	-19.5	18.1	12.8

Annualised returns to 30 June 2024 (net%)

	1 year	5 years	10 years
Japanese Equities All Cap Composite	6.2	2.4	5.4
Japanese Equities Growth Composite	5.4	1.1	4.3
TOPIX Index	12.8	6.5	5.8

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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