

Europe, chips and rising Japan

September 2025

Speaking to Stephen Paice, Head of European Equities, we discuss why Europe's back in fashion, and investment specialist Sarah Clark explains her enthusiasm for Japanese equities

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Cherry Reynard (CR): Good morning, I'm Cherry Reynard, your host for Upfront, where we bring you the latest insights on Baillie Gifford's UK funds. Today, I'm speaking with Baillie Gifford partner Stephen Paice, who'll be answering your questions live, so do send them in by clicking on the drop-down menu on your screen. Before the audience questions, we have investment specialist director Qian Zhang on TSMC, the company powering the future with cutting-edge semiconductors. But first, investment specialist Sarah Clark is here to talk about what's happening in the Japanese market. Welcome to Upfront.

So, welcome to the programme, Sarah. Now, for viewers who may not know you, you are an investment specialist in Baillie Gifford's Japanese equity team, which makes you very well qualified to talk about the Japanese market today. Now, Japan's done well, relative to its global peers, over the past few years, I wonder if we could start talking about some of the drivers behind that?

Sarah Clark (SC): Yes, sure. So, it's been a really extreme period in Japan over the last five years, and the stock market has done very well but that success has been driven by cyclical factors and not deep, structural change. And just to give a bit of a recap, over the past few years, during Covid we saw global trade flows collapse, and then they rebounded really sharply in 2021, 2022, before easing off. And on top of that, we saw the currency fall from 100 to 150 yen against the dollar, which is all-time lows for the currency.

And it was these two factors, the booming exports and the very weak currency which was the dream scenario for Japan's cyclical companies, which we don't have exposure to. So companies like the mega-banks, the autos, the trading companies, they've dominated returns over the past few years, but that's now changing because global trade is fragmenting, we're seeing supply chains being rerouted, and arguably that currency tailwind has already played out.

So, it's leaving these companies very exposed. If we look at autos, for example, they have been slow to transition to EVs, they face increased competition from the likes of the US and China, throw in tariffs, that's just another added complexity. So, Japan was very good at the cars of the past, but

not so much the cars of the future. So we are seeing market expectations have reset, and Japan is undergoing some really significant economic change at the moment.

CR: So, let's unpack that economic change in a bit more detail. What are you seeing?

SC: So, we've now seen the end of deflation. Japan has lived with flat wages, flat prices, for 30 years, and that mindset is now changing. So we're seeing inflation, and of course inflation increases people's costs, but what's really encouraging is we're seeing this backed up in wage growth. So nominal wages are up 5 per cent for the first time in 30 years, and that matters because rising wages supports consumption, it improves profitability, and it gives companies the confidence to continue to raise wages.

CR: And then, a perennial problem for the Japanese market has been the tendency of consumers and businesses to hoard cash, the hold onto cash. With inflation rising, wages rising, are you seeing that changing at all?

SC: Yes, so, Japan's cash-hoarding culture is definitely changing. In Japan, households hold more than half of their assets in cash. And compare that to just 13 per cent in the US. And Japanese corporates are no different, so they're sitting on more than \$2 trillion dollars in cash and deposits, and over \$500 billion in cross shareholdings. But for the first time in a decade, inflation is now making holding cash costly, and that's a really powerful incentive for capital to move into equities and investments. And if you add in the corporate governance reform, which we're also seeing, this is encouraging companies to get fitter for the future, to improve their balance sheets, then it's a really exciting tailwind for many companies.

CR: Yes, absolutely. Those all sound like very positive developments, as you say, for Japan's economy and for growth investors, what does that look like in terms of stock market performance?

SC: So, over the past 12 months, we have seen performance turn around, which was really positive. There are a few reasons for this. We don't have exposure to those large, cyclical sectors, so the Japanese fund has a high active share of 84 per cent, so it is a differentiated portfolio. We don't have access to those index heavyweights, so the mega-banks, the trading companies, the autos, which I highlighted earlier. The fund is looking to invest in Japan's best growth companies, and that's across the market cap spectrum in a concentrated portfolio.

And in terms of the positioning, we're not relying on any macro tailwinds. So, we're looking for companies that can continue to grow through different cycles, and that are underpinned by some really exciting structural growth drivers, so things like healthcare, gaming, automation and AI are just some examples.

CR: Okay, and I think it's reasonably clear what the growth story might be for AI and automation and healthcare, and how they may be reshaping industries, but you mentioned gaming, talk about that in a bit more detail.

SC: Sure. So, gaming is one area that we have consistently had exposure to over the years, and it's arguably where the opportunity just keeps getting more and more exciting. And we are invested in companies like Nintendo and Sony, and what's really exciting here is the strength of the IP that these companies have, and characters like Super Mario and Sonic the Hedgehog, which are unique characteristics which have stayed relevant through the decades and they just keep appealing to generation after generation.

But what really excites us beyond the latest game or new console cycle is the ability to be able to monetise this IP. And that's across different media formats, whether that's TV, movies, merchandise, even theme parks. And if we look at the latest Super Mario Brothers movie, it grossed over \$1.3 billion annually, making it the most successful video game movie ever. But it's not just Nintendo we're seeing this with. Sony's done it with the Last of Us, which started as a PlayStation game, it's become a TV hit series. Sega Sammy, which owns Sonic the Hedgehog, it's had those Hollywood hit movies. And then, there's also Square Enix, which is possibly the lesser known company out of these, but it's arguably sitting on a treasure trove of unexploited IP with its Final Fantasy franchise, so could easily follow the same playbook as your Super Mario or your Sonic the Hedgehog.

CR: Absolutely. So, let's shift focus to a different tech landscape. One of your largest holdings is Softbank. I wonder if you could just talk a little bit about the investment case for that?

SC: Sure. So, I guess for those less familiar, Softbank is an investment group company that was founded by Masayoshi Son. So, it started out as a telecoms company, and it's grown to be a global tech investor. And it's best known for the bold bets that's taken in its Vision funds, and for owning ARM, which is the UK chip designer. And it's its exposure to ARM that's really important, because ARM's chip designs are essentially the plumbing for modern-day computing. So it's powering 99% of smartphones, and increasingly being used by companies like Nvidia, Amazon and Apple to help with their AI workloads.

And on top of this, we get access to the Vision funds, which is hundreds of global tech companies worldwide. It includes OpenAI, which is the company behind ChatGPT. So this is positioning Softbank as one of the largest financial backers. It's arguably one of the most critical components in the AI economy. So when most of investors look to Nvidia for that AI play, through Softbank you're getting access to ARM, to OpenAI, hundreds of global of tech companies, but at a fraction of the price. And that's what makes Softbank a really compelling way for us to access the AI opportunity.

CR: And just finally, Sarah, can you talk a little bit about the outlook for Japan from here?

SC: Sure. We're obviously seeing a lot of positive changes happening in Japan and, of course, performance has turned over the past 12 months, which is really positive. Portfolio companies are projected to grow their sales and earnings over the next three years well ahead of the market, yet the fund is trading at market-level valuations, so you're getting US-style growth but without the US-

style prices. And that's the anomaly that we see in Japan today, and it's what makes the Japanese fund stand out.

CR: Absolutely. Okay, brilliant. All right, thank you for all those insights today, Sarah. Thanks for joining us. And for those of you watching live, if you have any questions, simply click on the Ask a Question tab. Now, as part of each programme, we feature an in-depth look at some of the transformational companies Baillie Gifford invests in. Today, we're learning about TSMC, the company powering all your favourite gadgets.

Qian Zhang (QZ): Semiconductors are tiny silicon chips that acts like the brain and nerve systems of every digital device we use today. Without them, say goodbye to smartphones, cars, or even washing machines. Chips are the invisible engines of modern life, and more than 90 per cent of the world's most advanced ones are made by a single company, TSMC.

What makes TSMC special is the expertise and scale in the indispensable industry. In the 1980s, it pioneered the foundry model, splitting design and manufacturing. Designers like Nvidia create the blueprints, and TSMC manufactures them a scale for many customers. This focus enables the company to relentlessly pursue technological leadership through deep research and development, and massive capital investment.

Take a single gigafab, TSMC's mega-factory. It cost over 20 billion USD to build, and spans the area of 140 football fields. Inside, cutting-edge chips are made with transistors just 3 nanometres wide. To visualise that, imagine fitting a million of these tiny switches across the body of a garden ant. That level of micro precision and that kind of scale is almost impossible to replicate.

We've invested in TSMC over 20 years, and it has grown nearly 30 times. It hasn't been all plain sailing. TSMC can be a tricky stock to own. The chip industry is famously cyclical. Half of the company's quarterly earnings miss analysts forecasts, R&D cycles are long, and demand shifts fast. In 2020, ChatGPT wasn't even considered in the company's valuation. You might possibly wonder what we saw that others didn't. Certainly not predicting the quarters. It's seeing years and decades. Our process explicitly asks, what could a business earn in five years or more? This gives us a differentiated angle on identifying a company's significant long-term earning power. As AI spreads across industries, the world will need faster, thinner, smarter chips. TSMC will continue to shape the world's silicon future.

CR: That was investment specialist director Qian Zhang introducing TSMC. To think that components 20,000 smaller than a human hair power our devices, and TSMC's aim is to go even smaller, is truly remarkable. Now, to move on, we're joined by Stephen Paice for a fund update. So, thanks for joining us today, Stephen. Now, to introduce you to those watching, you are head of the European Equity team and one of Baillie Gifford's 59 partners. So, to kick off, a year has passed since the Draghi report which outlines various measure to improve competitiveness in Europe, have you seen any tangible changes or impact on the way companies are behaving?

Stephen Paice (SP): Well, I think the very quick and short answer to that is no, we've not seen any real, tangible effects coming through yet. This is something that was picked up recently in the *FT*. They looked at a Belgium-based think tank who calculated that, of the 380 or so proposals that Draghi had put forward, only 11% had been implemented so far. So, this isn't really surprising. Urgency and cutting through red tape are hardly Europe's superpowers. But it's worth pointing out that the proposals that he put forward represent a very blue-sky case for Europe, and if we had a deeper and more integrated capital market, if we had less bureaucracy, if we had another 800 billion invested each year, supporting innovation and infrastructure, that would represent a massive upside case for Europe. And I don't think we need all of this to happen to have a good, positive outcome.

But his main point was quite valid, and it sounds very similar to what Sarah was saying about Japan. Europe, as a continent, saves a lot, we don't really invest enough. And the numbers are very similar, where Europeans save almost three times as much of their disposal income as Americans, yet their participation in equity markets is much, much lower. They have €33 trillion in savings, and about a third of that is invested in low-returning bank deposits. So you can only imagine what the positive impact would be if some of that was redirected or channelled into risk capital which would support innovation and infrastructure.

But I think we're starting to see some tangible signs there, that the Savings and Investment Union may have some potential in the coming years. So I think the general outlook is pretty positive. But I think the other thing worth mentioning is that there is a big difference between talking about some of the broader themes, whether it's European competitiveness or macroeconomics or politics versus what we're interested in, which is can we find companies that happen to be domiciled in Europe that are going to make us a lot of money? And on that front, it's a very different prospect.

CR: Okay, interesting. What about the shift we've seen in Germany, with this loosening of the fiscal rules and promised investment into defence and infrastructure spending? That all sounds quite positive as well.

SP: This is much better, and it kind of links in with what I was saying earlier about the requirement for more funding and investment. Now, the numbers that are coming out of some of those fiscal programmes, they might add up to 100 billion, 150 billion per annum, so we're getting a little bit closer to Draghi's 800 billion number, but I think that the real signal is actually pretty profound. This is quite unprecedented, it's monumental in terms of a policy shift.

So European governments, from really the Global Financial Crisis 2008 onwards, have been following a policy which is being driven by prudence, it's been driven by austerity. And this has manifested itself through cost-cutting, it's shown up through bank's deleveraging. So I think today were seeing a big shift, led by Germany, that shows that government's are really starting to understand they are partly responsible for creating conditions that will enable growth companies to thrive, whether that's being channelled through increased spend in defence, infrastructure, or just making it a little bit easier for companies to start up and do business.

So I think, on that front, it's pretty positive. We've seen false dawns before in Europe, many times, but I think this feels quite different. We're starting to see GDP inflect, all be it from a very low base. Inflation seems to be under control. Central banks have cut rates quite a lot in Europe, the ECB's now down at 2 per cent. And of course, we have that kind of valuation support. So I think the foundations for continued success in Europe seem to be pretty solid just now.

CR: And it does seem to have influenced sentiment towards Europe equities, which I think are still just about top of the leaderboard for the year to date. Why do you think that is? What have been the main drivers for that?

SP: I think some sceptics would say that investors are just becoming a little bit less optimistic on the US and a little bit less pessimistic towards Europe. But I think there are a couple of other drivers behind the outperformance in Europe in recent years. And I think the first one relates to that narrative that investors are seeing and looking at Europe as a continent which is becoming a bit more pro-growth. They're looking at some of those macroeconomic indicators, which are looking a lot better than they have done in recent years. So I think that's been a part of it.

The other part relates to diversification when it comes to building portfolios. And I think what we've seen with the concentration of big US tech and the fallout from tariffs, this has really prompted investors to look at asset allocation, and moving maybe a bit of money out of the US market and into some of those other regions, like Europe, like Japan, which arguably look a little bit cheaper. So I think those are probably the two main factors.

CR: Yes. And my perception is that the markets have been led by areas like banks, very value-focused areas, and it's been quite a difficult time to be a growth investor, as you are. Now, I'm just wondering what might change that?

SP: Yes. So, over the last four years, since 2021, we've really had a perfect storm. This has probably been one of the worst environments for growth investing as far as I can remember. And obviously, we had Covid, we had a war in Europe, we had inflation running out of control, we had interest rates rising faster and to a higher level than we have done since probably the 1970s. So a lot of those factors led to a sell-off in growth companies, long-duration assets which typically make a lot of the money in the future. And when interest rates simply go up, the valuations of those companies come down. So that has been a big headwind. We had to deal with growth rates slowing down as we came out of Covid. We had to deal with some inventory build-up during that period. So the set-up for growth investing has been terrible.

But, conversely, when we look at some of the money that's been flowing into Europe, particularly this year, to avoid any kind of issues with tariffs, money will be invested, or has been invested, in Europe domestic companies which are generating all the money within Europe, so no tariff issues. And the biggest recipients of that money have been financials. And banks and insurance companies account for almost 20 per cent of the Europe index. So banks have done very well, they have rerated a lot, but they've also seen a lot of earnings improvement in revision upwards. At the

same time, a lot of these other growth sectors have been moving the other way. So I think the set-up there is as bad as we could get, but, looking forward, I think things look very differently.

But the question on when and how does growth get back to outperforming, I think we need to see a few things. One would be interest rates staying relatively low. And I think, at that 2% level, this is kind of a decent outcome for us. We also need macroeconomic stability, and I think that that will feed into a much improved sentiment for investing in companies that are innovating and trying to change the world, rather than just paying a lot of money out to shareholders through dividends. So I think those two features are quite important.

But lastly, one of the most important factors is that these companies and these sectors which are traditionally defined as growth, they need to get back to showing earnings growth leadership. And at the moment, we have a lot of digital platforms, companies like Spotify, the world's largest audio streaming platform, we have Adyen, which is a payment processing business, Prosus, which owns a big chunk of Tencent, which is a big Chinese social media and gaming company, these companies are growing very well just now. Arguably, they might not be rewarded for that growth as much as they should be, but it really comes in some of those other sectors that have seen quite a lot of headwinds, or cyclical headwinds.

And when we look at semiconductors, specifically in our portfolio we have companies like ASML, which is arguably the most important tech hardware company in the world. Without its lithography tools, we couldn't produce any of these semiconductors at the sizes we need today. ASML is another one with deposition tools. We have luxury goods companies. They have had a very tough period more recently. LVMH recently posted one of its worst organic sales growth numbers in 20 years. So, we have industrials, companies like Atlas Copco, which produces air compressors, or ICMD, which is a chemicals distribution business, we have lots of these companies that have faced cyclical headwinds, so those earnings haven't come through yet. But I think where we are today, we're starting to see a lot of green shoots, and hopefully an inflection point.

So I think when we look at the broader portfolio, we're pretty confident as we can be, or optimistic. Because when we look at the valuation for the fund, we're paying almost 20 times forward earnings. This is a small premium, in my view, to the market, which is about 15, but for that we get a lot more growth, we get higher quality companies, we get companies with less debt, and we get companies that are managed by people that we trust, whether it's a founder or a family. So as I said, I think it's only a question of time before this turns around.

CR: Great, okay, that seems like a positive note to turn to the Q&A. So, now to answer the questions that have been coming in over the programme. So, questions. Okay, the first one is on AI. Obviously, the US seems to have dominated the conversation around AI, but a question on what role with Europe play in the development of AI.

SP: So, I don't think it's that controversial to say that Europe has lost the AI war, at least when it comes to large language models. I don't think there is any way we can keep up with the amounts being spent by the big tech companies and the hyperscalers in the US. But I don't think that

necessarily matters. You only have to think back to the TMT bubble and think about the companies then who were spending the most and investing the most in capital equipment, and whether they were the ones that actually profited most over the next ten or 15 years.

So when I look at the opportunities in AI, we do have some other ways to play that theme. We have companies which are enabling AI and the progress there, so we have, as I said, companies like ASML, we have some other semiconductor companies, ASML, Soitec. We also have IT consultants. They will be helpful to those smaller companies, or the corporates, that are trying to adopt some of these technologies. And I think when you look at the other companies, a lot of those are adopting a lot of those tools to become better as well, and I think this is quite important.

So we could look at some of private companies, we've got a Portuguese drone company which is using AI to build its software platform. We have an Italian company called Bending Spoons which buys up very cheap consumer apps and is using its AI tools to monetise those in a much better way. And we also have a whole host of other companies that are using AI to become better, and these are some of the digital platforms, and companies that have very large user bases with data, Spotify, Prosus, Adyen, these can all use AI to become more efficient. And even some of the more traditional companies, Ryanair's using AI to work out how to use less fuel, these types of things. Roche, the big pharma company, is using AI to help improve R&D productivity and cut the costs of clinical trials. So I think those benefits from AI are going to be far more widespread, and we don't necessarily have to have some of the LLM models that you see in the US to do well.

CR: Okay, right. Next question is on Novo Nordisk, which has had quite a torrid time recently. So, what's driven Novo Nordisk's research share price movement? Where is it headed next? And why might it still be worth holding?

SP: So, Novo Nordisk probably at this time last year, or last summer, was the most valuable company in Europe, so everything at that point was going well. And this was driven by some of the drugs it had produced to treat obesity, to help with weight loss. But probably this time last year, things started to change. One of those things was that its competitor, Eli Lilly, coming out with drugs which were just more effective. We also had a problem this year, because of the shortages of these medicines, that allowed some companies in the US to exploit a loophole which enabled them to manufacture and sell knock-off drugs, which affected the Novo Nordisk growth rate. So a couple of these things combined, the share price is very weak, and that then caused the foundation, the Novo Nordisk Foundation, and the board to effectively sack the CEO. So everything that probably could go wrong went wrong for Novo Nordisk.

But when we look at the opportunities from here, over the next five years, we can see that some of these problems are going to go away. The new CEO's coming in, he's addressed some of the cost issues. But fundamentally, Novo Nordisk still has a fantastic pipeline of very innovative drugs, not only to treat diabetes, to help with obesity, but lots of other comorbidities that come along with diabetes. So at the moment, my personal view is that Novo Nordisk looks tremendous value, because the valuation multiple has collapsed, and I think it's being totally mis-priced.

CR: Okay, great. And then just finally, in the last sort of minute or so, wouldn't be complete without a question on tariffs. Do you expect that to have a big impact on European companies, and I guess the companies in your portfolio in particular?

SP: It depends. Aluminium, steel, autos, these are some of the sectors which are most affected. If you look at the aggregate stats, I think about 20% of revenues of European companies are generated in the US, but a big chunk of that is from services. Another big chunk of that would be from revenue that is generated from things manufactured in the US. So all these things are kind of exempt from tariffs, so the amount of revenue which is subject to some of these tariffs is relatively small.

And when we look at the types of companies that we have in portfolio, one of the best ways to mitigate some of the problems with tariffs is the ability to be able to pass increased prices on, or those tariffs on, to customers. And given the qualities of the companies that we have in the portfolio, most, if not all, of these companies should be in a very good place to pass these on without affecting the underlying profitability of the company pretty well.

CR: Great, okay, thank you so much, Stephen, for all those insights today, we'll wrap up there. And thank you, all, for joining us. To find out more about the topics we've discussed on the programme, please go to the website, bailliegifford.com. The UK intermediaries team are here to help, so do get in touch if you have any questions. Until next time, goodbye.

Baillie Gifford Japanese Fund

Annual discrete performance to 30 June each year

	2021	2022	2023	2024	2025
Class B-Acc (%)	18.0	-18.7	6.1	6.0	5.0
Index (%)*	10.7	-8.4	12.9	13.5	6.9
Target (%)**	12.4	-7.0	14.6	15.2	8.6
Sector Average (%)***	13.2	-11.4	12.7	10.6	7.3

Source: FE, Revolution, Japan Exchange Group. Total return net of charges, in sterling. Share class returns calculated using 10am prices, while the index is calculated close-to-close.

*TOPIX (in sterling).

**TOPIX (in sterling) plus at least 1.5% per annum over rolling five-year periods.

***IA Japan Sector.

Past performance is not a guide for future returns.

The manager believes this is an appropriate benchmark given the investment policy of the Fund and the approach taken by the manager when investing. In addition, the manager believes an appropriate performance comparison for this Fund is the Investment Association Japan Sector.

Baillie Gifford European Fund

Annual discrete performance to 30 June each year

	2021	2022	2023	2024	2025
Class B-Acc (%)	35.7	-39.2	12.1	8.0	1.5
Index (%)*	22.6	-9.8	20.0	13.0	9.6
Target (%)**	24.5	-8.4	21.8	14.7	11.3
Sector Average (%)***	23.7	-12.6	18.4	11.7	9.1

Source: FE, Revolution, MSCI. Total return net of charges, in sterling. Share class returns calculated using 10am prices, while the index is calculated using close-to-close.

*MSCI Europe ex UK Index (in sterling).

**MSCI Europe ex UK Index (in sterling) plus at least 1.5% per annum over rolling five-year periods.

***IA Europe Excluding UK Sector.

Past performance is not a guide for future returns

The manager believes this is an appropriate benchmark given the investment policy of the Fund and the approach taken by the manager when investing. In addition, the manager believes an appropriate performance comparison for this Fund is the Investment Association Europe Excluding UK Sector.

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