Baillie Gifford™

Japanese Equities
Q4 investment update

January 2024

Investment manager Karen See and investment specialist Sarah Clark give an update on the Japan All Cap, Japan Growth and Japan Income Growth strategies covering Q4 2023.

Sarah Clark (SC): Hello everyone, and welcome to our Japanese equities update. My name is Sarah Clark and I'm an investment specialist for the strategy. And I'm delighted to be joined today by Karen See, who's an investment manager from the Japan team. As a reminder, the aim of our Japanese strategies is to find high quality businesses that we think can grow their sales and earnings over the long term.

We take a flexible approach to growth, and this results in a diverse portfolio of some of the best growth companies in Japan. At times our approach can be out of favour as we've experienced recently. But what I hope comes across today is why we think this is a really exciting time to be a growth investor in Japan. Karen, thank you for joining us today.

Karen See (KS): Thank you for having me.

SC: So, I'd like to start by reflecting on performance. So, the past year has been challenging for our strategies. And in the fourth quarter we saw a welcomed turnaround and were ahead at the end of the quarter. How are you thinking about recent performance and the main drivers?

KS: Yeah. So, 2023 has indeed been very challenging for our strategies. We saw a lot of market movements driven by macro factors such as weak yen, inflation expectations, interest rate expectations. We also saw very severe rotation in terms of style away from growth to value. So, with this backdrop, a lot of our holdings really struggled in 2023. However, in Q4, we actually saw a bit of reversal of that.

[The] first thing that happened was a lot of the index heavyweights, that have performed very, very strongly throughout the year, have actually come back quite a bit in Q4. And that's been helpful for us because we don't own any of these, such as big banks or automakers, because we do believe in their growth outlook. And also, we saw that some of the growthier names we own in our portfolios, they have reversed in terms of performance in a helpful direction. They've been really beaten up early in the year. So, this is a good welcome reversal of that.

We also saw, actually, in Q4, a number of our holdings that, because of where valuation has gotten to, we either saw companies announcing share buybacks, or in some cases, management buyouts or tender offers from other companies trying to take the companies private.

And this really reflects where we are at the moment, with some of these high-quality businesses, that it's not only looking attractive to us institutional investors trying to look for great businesses, but also to managers who are running their businesses, to corporates that are looking for either joint venture partners or acquiring other businesses to expand their own business.

So, I think, you know, 2023 has ended on a more positive note for us. But as a whole, it has been a challenging year.

SC: Thanks. That's a really helpful summary. One thing I wanted to ask you about was China, and the exposure that we have through the companies in the portfolio. So, it's remained an area of weakness because the recovery after COVID has been longer than we expected. What types of discussions have the team been having about this?

KS: Yeah, so in our portfolios, the main exposure to China comes from the skincare cosmetic names that we have. So, Shiseido, Kosé, Pola Orbis. We also have some consumer brand names such as Calbee or Pigeon. So, with these names they struggle because consumer spending has just not returned to where it was before Covid. For various reasons, China economically is not doing so great at the moment.

The discussion we've been having on the team is around how happy are we that we've got the right product categories? If we kind of take away the exact timing of when China might recover economically, do we believe we have the right brands in terms of the durability of that brand power? In terms of the how strong a district distribution channels might be? And also, in terms of product categories, do we think that they can stand out from local competition? Have we got it right? Do we need to shift the portfolio in terms of having more exposure to certain product categories?

So those are the debates we've been having. But also, in terms of Chinese exposure, we have the medtech companies such as Olympus and Sysmex. So, these are medical equipment companies that have suffered in 2023, due to the anti-corruption campaign within China that has really slowed down the ordering at hospitals for medical equipment, because everyone's sort of been a bit more cautious about their ordering practices.

The discussion here is around to what extent do we believe these companies still have an edge, longer term. So, yes, the anti-corruption campaign might be a short-term slowdown, but are we happy that the competitive landscape has not evolved to such an extent that they might lose out to local competitors. The Chinese government has a preference for really nurturing local competitors within the medical space, and that includes the medtech space.

Are we happy that these companies are in an area where they're really offering patients value and products that cannot be offered by local competitors, and therefore they are in a much more solid position? Or do we think that actually, potentially, longer term, their potential competitive position might be eroded? So, these are the things that we need to be thinking about and discussing.

And, on the whole, we are very happy with our holdings in this space. Yes, it has been challenging and difficult, and we think a lot of the negatives are reflected in the share price already. So, what we really need to believe in, is that we have an insight in terms of the resilience of these businesses, in terms of how they can emerge from the difficult period and continue to grow going forward.

SC: Okay. Thank you. Let's move on to portfolio changes. So, turnover remains low across the portfolio. I think it would be fair to say that the team have really been doubling down on growth to take advantage of the current valuations. On our last update, when Donald was here, he highlighted Horiba as a company. He was impressed by having recently met them in Japan, and it's now been bought for the Japan Growth Strategy. Can you tell us about a bit about this name?

KS: Yes, so Horiba. Even though it was met by Donald just last quarter, actually it's a name that we've known for almost 20 years and followed quite closely. And this is, I think, a perfect example of how we actually see some of these businesses emerge, from being a small company to a large cap business.

So, what does Horiba do? It measures and analyses anything from gases to liquids to particles. So, it could be used in all sorts of industries. But perhaps the most well-known example would be in the environmental space. So, if you think about emission standards for cars, so Horiba's equipment would be used for that. And in fact, that is kind of the image of what people have of Horiba, which is that exposure to this auto space.

But what we're really excited about for Horiba is in the semiconductor space. So, if you think about how a semiconductor chip is manufactured, the etching and also precision procedures actually require a high level of precision in terms of controlling what kind of gases go into the vacuum chambers when that is being created. And Horiba actually made the mass flow controllers that do this job, and they have 60 per cent market share globally for this particular product.

And what we really excited about is that this is a niche that is big enough to offer attractive growth opportunity for Horiba as a business, but is sort of small enough to not attract too much competition from outside. So, it's a very high returning, highly profitable business that has great opportunity to grow. But currently it's not rated as such, despite a lot of the high level of interest in the market this past year on semiconductor names, Horiba is not really rated as such.

So, we think, going forward not only does it have the opportunity to keep growing this wonderfully high-returning niche, but also to be rerated as a business. So, it's a great addition to our portfolio.

SC: It sounds like a very unique new name. And so, my final question is on valuations. We're still seeing a lot of disconnect between share prices and the fundamentals of the companies that we're invested in. What's your current thoughts on valuations?

KS: As I mentioned earlier, a lot of the share price movement we've seen in 2023 is actually driven by macro factors. What this gives us is as stock pickers is this opportunity to really go out and find companies, high quality businesses, that can grow, that are neglected by the market for whatever reason, because they might not be the flavour of the month, of the year.

And that has been what we've been doing last year. And I think we will continue to do that in 2024 to really find these great businesses that are not priced for the quality and the growth that they have. I think in 2024, this would be a year where we continue to find great opportunities for our portfolio and is a great place to be for not just Japanese investors, but also Japanese growth investors.

SC: Thanks, Karen, and thank you very much for your time today. I think that's a really positive note to end on, as it really does highlight the opportunity that we see. Thank you, everyone, for watching. And if you have any questions on anything you've heard today, please do get in touch.

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

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

	2019	2020	2021	2022	2023
Japanese Equities All Cap Composite	23.7	21.2	0.2	-23.0	7.7
Japanese Equities Growth Composite	21.3	26.5	-3.5	-29.8	10.8
Japanese Equities Income Growth Composite	20.9	14.2	-0.2	-16.9	7.6
TOPIX Index	19.2	13.0	1.1	-14.9	20.0

Annualised returns to 31 December 2023 (net%)

	1 year	5 years	10 years	Since inception
Japanese Equities All Cap Composite	7.7	4.5	4.8	N/A
Japanese Equities Growth Composite	10.8	2.9	3.9	N/A
Japanese Equities Income Growth Composite*	7.6	4.3	N/A	5.3
TOPIX Index	20.0	6.8	5.4	6.1

*Inception date: 31 July 2016.

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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