Baillie Gifford™

Japan Growth
Q3 investment update

October 2024

Investment manager Donald Farquharson and investment specialist Sarah Clark give an update on the Japan Growth Strategy covering Q3 2024.

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

Sarah Clark (SC): Hello and welcome to this Q3 update for the Japan Growth Strategy. As a reminder, we take a flexible approach to investing in a concentrated portfolio of Japan's best growth companies. My name is Sarah Clark. I'm an investment specialist and I'm joined today by Donald Farquharson, who is head of the Japan Team and lead manager for the Strategy. Welcome, Donald.

Now, the plan for today is to talk about performance, also portfolio positioning. But before we get into that, I wanted to start by asking you about the macro environment. There's been lots going on there. We've seen a market crash, an increase in the yen, another increase to interest rates, and most recently, a new prime minister. What are your views on all of this and any implications for the strategy?

Donald Farquharson (DF): Yes, as you say, there was quite a lot going on during the quarter, although to a sterling-based investor into Japan, the market was down 6 %, the currency was up 6 %, so they may actually believe that nothing has happened at all.

But you're right, during that period, there was a market crash. The market recovered the same level after five days. But I think it does highlight that the cheapness of the yen, the very low interest rates in Japan do lead to some extreme levels of periodic volatility. A new prime minister, I think the LDP is a party managed for stability. So, we probably don't need to think about the change from Kishida to Ishiba.

The big one really for me is the currency, because it has been a major tailwind for a lot of the weaker businesses and sectors to which we haven't been exposed within the portfolio. This is becoming less of a tailwind, and I think that's leading to a sort of a normalisation within the market. Attention is starting to focus on where we have been focusing our portfolio, which is on longer-term structural growth rather than shorter-term cyclical momentum.

SC: Lots going on there, but potentially some positive developments in terms of the currency for our more domestic-orientated portfolio.

And moving on to performance, we're slowly seeing that relative performance has started to improve this year. And we're seeing a shift back towards growth companies again. In terms of attribution over the quarter, Rakuten and its ever-growing online ecosystem was one of the largest contributors. What's been driving its share price recently?

DF: Well, it's not just recently. I mean, Rakuten's share price has been recovering over the last 12 months, and it is one of the bigger contributors over that period as well. And I think Rakuten suffered for a period of time because of the investments it was making in its mobile network business that it was trying to build up, which meant that it was losing money. And we've seen that across a number of holdings in the portfolio that, where companies have been making aggressive investment for future growth, this has tended to be penalised by the market.

So, what we're seeing now with Rakuten is the mobile business is seeing the fastest growth of net subscriber growth of any of the networks. They seem to have stabilized the position around the borrowings behind that. By the end of this year, they should be cash positive on the mobile business. And that is allowing everyone to focus on the bits that we have always said were extremely good and extremely strong: the ecosystem, as you describe it, around financial services, and around the e-commerce business.

SC: Thank you. It's good to hear of some signs of progress there for one of our largest holdings in the portfolio. Sticking with performance, any themes across the companies that have been detractors over the quarter?

DF: If there were a theme, it would probably be around semiconductors. So, just as a reminder, the three stocks most exposed there within the portfolio is ROHM, which makes power semiconductors principally. DISCO, which makes semiconductor production equipment, equipment to dice and grind wafers for semiconductors. And Horiba, which makes a component used in the production process, mass flow controllers. And they all three were weak at a time when the semiconductor market share prices were under a lot of pressure globally.

The interesting thing was that we started the quarter not owning Japan's leading semiconductor production equipment company, Tokyo Electron, but by the end of the quarter, we had. This was a positive contributor over the period, we now have a holding.

SC: That's a good segue into portfolio activity. So, turnover remains low. You've added two new names to the portfolio this quarter with Tokyo Electron being one. What does that company do?

DF: So it is, as I mentioned, it's a semiconductor production equipment company. In other words, what it does is integral to the process of producing semiconductors. It operates in a number of different areas, but principally in etching and deposition are the areas where it is best known and where it has globally a leading position. And what I think is very interesting here is the capital intensity of producing semiconductors has been rising, but it has been going mainly into the area of lithography, which is not where Tokyo Electron is operating. But increasingly, we see opportunities for it to take a larger share of the production pie.

SC: And shifting gears to the second name that was bought, Amvis, which is completely different. Can you tell us a bit about that company?

DF: A very different business, as you say. So, Amvis is Japan's leading hospice operator for end-of-life care. And a lot of that currently is done within hospitals. And hospital stay in Japan is much longer than it is elsewhere. There is definitely, from the government side, support for a lot of that care to be moved out of the hospital into the hospice, and we think that Amvis is extremely well-positioned to benefit from that trend.

SC: Okay. And any brief comments on how these purchases were funded?

DF: There were two stocks which we sold during the period. One, TOTO, which is known for its bathroom ceramics. Part of the investment case here was refurbishment of Japanese properties. And that part of the business seems to be doing reasonably well. The bit that hasn't been doing so well is its overseas operations, and principally those operations in China, where there is obviously a great glut of unfinished properties. And it will probably take quite a long time, notwithstanding the recent stimulus by the Chinese government, it'll take quite a long time for that business to recover.

So that's one that we decided to sell. The share price had actually been quite strong, giving us an opportunity to exit. And Base was the other one, which is a small company which enables companies to build their online presence, a little bit like Shopify. It was coming under a lot more competitive pressures. We had less conviction in its ability to take the share of the market that we'd originally thought it might. So, we decided to sell that.

SC: Thank you. That's a good run through of the recent changes to the portfolio. And final quick question for me before we wrap up. You were recently in Japan. Any highlights from that trip you'd like to share with us?

DF: When I go to Japan, I always try to see some new holdings and some existing holdings. This time it was much more focused on the existing holdings, and I met with a lot of the CEOs of companies and CFOs of companies when I was out there. Probably if I was to single out one, where I came away with a very strong and positive impression was Nidec, which has gone through quite a difficult period, largely because of its investments in automotive e-axle motors. The new CEO has come from that area, and I'm impressed both by what he's already achieved, but also by the vision that he has for the company going forward. So, I think this is a very positive development.

SC: Thanks, Donald. That's a good point to finish on.

So, just to recap on the main points from today. Performance is starting to improve. We're seeing helpful changes in the macro backdrop, which is positive for our portfolio and style of investing. And we're seeing continued progress operationally in some of our largest holdings.

Thank you, Donald, for your time today. And for those of you at home listening, please do get in touch if you have any questions on today's recording.

Japanese Equities Growth

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

	2020	2021	2022	2023	2024
Japanese Equities Growth Composite	18.6	15.4	-40.1	12.8	21.0
TOPIX Index	7.4	20.6	-28.4	25.9	21.6

Annualised returns to 30 September 2024 (net%)

	1 year	5 years	10 years
Japanese Equities Growth Composite	21.0	2.3	5.2
TOPIX Index	21.6	7.3	6.8

Source: Revolution, Japan Exchange Group. US dollars. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite. 1 year figures are not annualised.

Past performance is not a guide to future returns.

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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
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Telephone +44 (0)131 275 2000 / bailliegifford.com