

As with any investment, your capital is at risk. Past performance is not a guide to future returns.

Hello, I'm Amy Maxwell from Citywire. Today, I'm joined by Brian Lum, the new lead manager of Baillie Gifford Shin Nippon, the trust dedicated to high growth Japanese small-caps. Now Brian stepped into the role in May this year, at a time when the trust had undergone a difficult spell and many shareholders were understandably questioning what needed to change. His challenge now is two-fold. To reset the direction of travel and to show why he believes this portfolio still has the potential to capture some of the most exciting fastest growing companies in Japan. Today, we're going to talk through that transition. The opportunities he sees and how he's approaching the task of turning performance around. Brian, welcome. Thank you very much for joining me today.

Hello, thank you for having me.

A very quick reminder to our audience, that at any point during this discussion you can submit a question using the Q&A box in your interface. I'm going to interview Brian for the first 25 minutes and then we'll have some Q&A to follow after that. Do put your questions in at any time during the discussion. Brian, let's begin with your arrival as lead manager on the trust. That was in May this year, as I said in the introduction. You're six months into the job. What's changed in the portfolio and can you tell us a little bit about how you're settling in?

I think the first point to emphasise is really what isn't changing. We remain very much long-term orientated. Our investment horizon is five to ten years. We will remain unashamedly biased towards high growth in the growth versus value spectrum. We will remain a genuinely small-cap investment trust. Now, this combination of characteristics is not in fashion currently, but we believe in what we do so there will be no style drift. As you said, with a change in personnel, of course there will be changes in the portfolio. We are going through a period of higher-than-average portfolio churn, I would say. When I first took over in late May, there were 70 names in the portfolio. Today, after our ongoing exits are completed, we're down to about 60 names.

I've indicated to others in the past I consider 50 to 60 a better range. Of course, we want to express our conviction better. I want to more deeply engage with the companies that we invest in, in a thoughtful way, whilst being still broad enough to give us that decent chance to capture outliers. The other change I would flag is that we are no longer bound by an upper limit for new purchases for the investment trust, of Y150 billion on market-cap. This really better aligns the investment trust with the small-cap Japan index against which we're measured. Some of our new buys really take advantage of this relaxed limit. Again, I would emphasise that we remain very much focused on small-cap investing.

Quite a lot of refining. You're already down by ten names and maybe another ten to go. Plenty of action going on there. Let's delve deeper into the market itself. As you've alluded to, there has been a complete capitulation in interest. It's highly a highly unfashionable market, but valuations, therefore, are also quite compelling. Can you talk to us a little bit about how you view the market. What's on offer and maybe, correct some perceptions for our audience, who may be looking at an old Japan and not seeing the opportunity in the new Japan quite as you do.

Let me break that question down into two parts. There is a structural element to why Japan is an interesting market for us. Also, a cyclical one that I alluded to. I think when you mention Japan to most people, you would hear a lot of perceptions around a super aging society. A lack of labour is a big factor and within this, there's a lack of IT know-how and a lot of the industries in Japan, major industries in Japan have huge inefficiencies. All of those are very much valid. I would say that problems and these societal challenges and opportunities are very much two sides of the same coin. Shin Nippon literally means 'new Japan'. We are very much about investing in companies that are tackling these huge problems head on.

To give you an example, when one of our investments, a real estate platform, GA Technologies can match buyers and sellers in four days, rather than 80 days as is typical Japan, there is an incredible opportunity and that's based on eliminating prevalent inefficiencies. Another example would be the lack of labour in construction. We have a company called Katitas, which is the dominant player in refurbishing 30, 40, 50-year-old houses in a market that traditionally prefers new builds to pre-owned by six to one, somewhere in that region. Less labour to build. Katitas have a great opportunity. These are just some of the opportunities that we see. I think the point that I'm trying to make here is that we are picking about 60 names out of a universe of two to 3,000 names. It's a very broad market.

Shin Nippon is about exposure to the new Japan and not the average Japan, along with all the problems. I think that's the structural angle to why Japan very much excites me as a stock picker. There's a cyclical one. Japan small-cap growth is very much a niche asset class. I think family and friends have often asked for my advice on investing. Shall I buy Bitcoin? What about gold? Shall I buy jewellery now or I should put some money into FTSE100 or the mag7 in the US or even Japan large-caps? No one has ever asked me about Japan small-caps. The implication here is that when this asset class is out of favour, it is really out of favour. Simply because no one needs to invest in Japan small-caps.

I think we're at this point where it's really a capitulation in sentiment in small-cap investing in Japan, at least from what I can see. The past four companies that came to visit me in Edinburgh, all Japan

small-caps of course, they ended up coming to Edinburgh just to see me, no one else. Edinburgh is a place with a decent number of asset managers, but all of my peers within the city, many of them are giving up investing. That is precisely the opportunity. I would go as far as saying having invested internationally, that means everywhere apart from the US for the past decade plus, this is probably the most overlooked corner of the global equities market. Of course, I'd rather see outperformance and shares going up all the time, but taking a step back and think about long-term, we have a really exciting opportunity to invest just at the time when nobody seems to be interested in these companies.

Let's delve deeper into that. It's totally unloved, it's really quite niche. Especially at a time when everybody's in quite concentrated trades this does make sense as very much as a diversifier or as a decorrelated exposure. Let's talk about Japan for its uniqueness. You've written before about the so-called Galapagos effect. Do you want to explain to our audience what you mean by that and how it permeates into the culture and investment opportunities?

Of course. Galapagos is, of course, an island just off South America. It's isolated. This is a place where you find [marker 10:00] lots of unique animals. Being an isolated land mass with a unique set of conditions, meant that evolution worked its magic to create all sorts of animals that you don't see anywhere else. The parallel with Japan is that there are of course, periods of history in Japan, where Japan is quite isolated. Things often work differently in Japan. From payments to cars and historically, phones as well. Famously, Japan really had what we now call smart phones when we were all playing snake on our Nokia's, right? They are often cultural nuances and preferences and regulatory quirks at play as well.

The point that I'm making here is that quite often, global leaders in software or tech, find Japan quite a challenging place to break into. Local disrupters often have a honeymoon period, if you will, where they can scale whilst being somewhat protected by fierce foreign competition. On the other side, let's not forget, Japan is still quite a sizeable market. Population is shrinking, but you're still talking about 120 million people. It's still number five in GDP terms in the world. You've got this combination of an element of protection from global competition and a sizeable market. In some ways it is, for me, a sweet spot when it comes to small-cap investing.

Perhaps you could give us a flavour of some of the types of companies that this unique set of circumstances would bring up?

I've got maybe two examples here. One is software companies. Quite often you find, in Japan, software companies that may look a bit like what you find elsewhere. The example that I have in

mind is online accounting companies. In America you've got a company called Intuit. That's very powerful and strong market positions around the world. There is a challenger from New Zealand, called Xero. They have got strong positions in Australia, in New Zealand and UK and so on. Neither of those companies bother to enter Japan, just because of these various market quirks. In Japan, you ended up with a number of Japan companies that are disrupting, but they have seen the playbook from elsewhere. They have this runway that you would not expect similar startups from other countries to have.

One investment that we have in Shin Nippon is called Litalico. It is a company that runs a lot of vocational training centres for adults with disabilities. This is the sort of business that's very, very local in nature. They've grown very fast, but it's a business model that's unique to Japan because of the regulatory environment. Again, it's a high growth company that's somewhat immune, but very exciting for very esoteric reasons.

We spoke at the beginning, that you've been in the job for six months at the helm now. In that time, you've actually visited Japan twice. Do you want to talk to us a little bit about the wide range of companies and characters that you have met on those trips and how it may have shaped your thinking around the portfolio?

I would say that that's the best part of job. Most interesting part, certainly. I get to meet a lot of unusual characters. Japan is really a highly conformist society. People tend not to like to rule break. Jaywalking is not really a thing. When you have this conformist culture, entrepreneurs really stand out. To give you some examples of people that I've met. I met a CEO that turned up to a meeting in a Hawaiian shirt and sandals. I met a CFO that greeted in the driveway whilst nursing a robotic baby. I've met founders who were professional footballers and world leading jet skiers. Another one of our CEOs, a company called Inforich, which has rental battery stands for charging smart phones scattered everywhere in Japan. He was an ex-rapper with a major music label.

These anecdotes don't make investment cases, of course, but the point is that there's a whole emerging generation of business leaders in Japan who are ambitious, who are freethinkers. Willing to challenge the status quo. They have a broad range of perspectives and motivations. When we are looking for innovative and disruptive companies, being different is a prerequisite and I think looking at different characters that are operating in Japan, I'm seeing lots of promising signs of people willing to do that.

I suppose, this is a generation who have grown up with the idea that Japan is constrained by corporate culture. By demographics. This is a generation that how is entering a stage where it can actually do something about it. I imagine what you're seeing the ground is that they are choosing to do so.

Exactly. There are lots of things that remain very rigid in Japan. There are lots of companies where the length of your tenure at a company determines your seniority. On the flipside, where you have younger, more innovative companies willing to break the mould, they're in a privileged position to attract outstanding talents that may view that they are a bit stuck in a large company. There isn't the same stigma anymore, to people moving jobs mid-career. A lot of our companies are also much more active in attracting talented female employees as well, which is an untapped talent pool. It's not a uniquely Japan phenomena, of course, but it is a big factor. There are lots of opportunities in terms of companies taking advantage of the various demographic and cultural quirks out there.

You mentioned the flipside of the conventional story. Let's carry that theme on. Let's now talk about AI because it's been peppered through the discussion. We've talked about the concentration of those headline grabbing exposures. Nvidia, Softbank, etcetera. In your portfolio it's much more hidden. Can you talk to us about this hidden AI exposure and how it plays out?

For all of us AI is now firmly part of our everyday life and it's the same with businesses. Every company that I met has some sort of AI angle. Whether it's good or bad. The more obvious examples within Shin Nippon, would be companies using AI to enhance their existing products. For example, we have a company called Bengoshi, which is a legal tech company. They're using AI to amplify lawyers' productivity. In cases where previously, you would take a whole day to prepare for a case, now it takes half an hour. We have companies like Harmonic Drive, who make a component for robotics. They will be a beneficiary as and when humanoid robots become ubiquitous. All of the companies are using AI to an extent, to streamline their operations.

Software developers can do so much more than before. Really, lowering costs of development and importantly, lowering the cost of experimentation. We have numerous examples where per head productivity is now increasing 20%, 30%, 40% year-on-year. This is, of course, not unique to Japan, but is particularly exciting for a market where labour shortage is a chronic problem and where IT expertise is a real bottleneck. AI is a de-bottleneck event. It's an important theme [marker 20:00] in Japan. I think in terms of our research for our companies we consider, we systematically ask ourselves, is this company taking advantage of AI? Will the competitive landscape be transformed by AI? Have AI de-bottlenecked a company's growth potential? Whether they are using AI responsibly and so on. I suspect it's a major theme.

It's a defining characteristic of the portfolio, how a company harnesses AI.

Of course, we're overweight on companies that are innovative and we consider nimble in their management. The use of AI is symptomatic of companies that fit that mould. That of course, go on top of companies actually using AI to develop products. It is a very powerful theme, even though it may not be the obvious place to go when you want to gain AI exposure.

We do need to touch upon the underperformance and some of the lessons that have been learnt from that. Before you stepped in, there has been a tough period. You've mentioned the fact that the market is deeply, deeply unloved. Can you talk us through some of the adjustments or some of the drivers that will move you beyond this era?

I do want to acknowledge upfront that Shin Nippon has been a real dog of the investment trust sector. I've been a shareholder myself, for many years before joining the team and running this fund. Certainly, feel the pain too. I'd summarise that the underperformance in the past five years or so, is really a result of being on the wrong side of a number of key factor exposures. Think about growth versus value. Think about large-cap versus small-cap and I would say that we are small even within small-cap in Japan versus the US, for example. The weak yen has hurt us significantly. We do run a domestic orientated portfolio and we have also made mistakes when it comes to stock picking. Paying too much for some businesses.

I would say that we underestimated some of the correlations within the portfolio. For example, many of our highly rated software companies and subscription type companies have really derated together. Hindsight is useful, of course. I would say that we have significantly refined our portfolio construction process. When it comes to stock picking, we are still very much about high growth and being long-term and so on. We are now much more aware of correlations, certainly. We are actively looking for high growth across a broader range of opportunities. For example, one recent new buy is a real estate company called Kashiwazaki [? 23:24] Capital. We have added to a chemical company called KH Neochem. Both are genuine growth companies.

These are in sectors where historically they are not known for growth. It's about being open minded and seek broader range of growth. I do want to add, as an investment trust, we have been around of four decades. The past five years have been incredibly challenging, but we haven't forgotten how to invest. Actually, three of the last four Shin Nippon managers by the way, are still at Baillie Gifford and I speak to them regularly to learn lessons and learn from their experience and so on. The point is that we need to learn lessons from the past five years of course. I think applying the lessons learnt from 2020 to 2025 to the next five years blindly, wouldn't be the right approach. For us we need to

be clear about what we are as investors. Being growth and long-term orientated and being willing to take risk where necessary.

It is not about booting everything out that hasn't worked systematically and change for the sake of it. We need to be measured and thoughtful about how we turn this around. I am confident that we are on the right track, despite recent challenges.

That draws the interview stage to a close. I have been looking at the Q&A box and there's quite a few questions that have come in from the audience. The first one is on corporate reform culture. "Do you think having a move progressive dividend policy would help narrow the discount and improve the total return?"

It is certainly one of the levers that companies have to pull. I would say that corporate reforms, the benefits have come through for the large-caps more markedly in recent years. These are companies that are higher profile and when it comes to naming and shaming these companies, it works better when these companies are high profile, rather than obscure small-caps. What is very clear is that company management, even small-caps, the [unclear 26:06], they're much more aware of what good practices look like. Companies are thinking about their balance sheets much more. CFOs now understand the importance of return on equity, for example. I would say that corporate reforms and continued corporate reforms under the new Prime Minister should be a tailwind for the asset class as a whole.

In the past two years, I would say we were in relative terms, hurt by that in the sense that we tend to invest in good quality companies with fewer things to fix. I would also add that some companies can get quite illiquid pretty soon. In some ways, we often advise companies to use dividends, rather than share buybacks, for example because when you buyback shares too aggressively, you end up exhausting your liquidity and that's an issue as well. We do actively engage with all our companies to try to nudge them in the right direction.

There's another question related to this, "Are the corporate governance reforms a help or hinderance to the trust?"

In relative terms, it had been a bit of a hinderance, but as I said in the long-run, I do see it as a good thing. Companies are very willing to engage and we're now engaging with terms that everybody understand. I suspect that there'll be more to come in that there remain some companies with inefficient balance sheets. Not using capital in the optimal way. I would say that our investment style typically points us to companies with huge ambitions and so on. Corporate governance is more of a secondary factor. In some cases, we have even advised companies to not increase their

dividend, even though that's really the general direction for most companies in Japan. We mustn't forget what the stock market is really for. It is about capital allocation to the companies that can use capital in a productive way.

In some cases, we need to remind companies, hang on a minute, you have a fantastic business generating very high returns and you've got long growth opportunities ahead. If you can deploy that capital productively yourself, don't give it back to us. It's a case-by-case exercise.

That goes to the point of the next question which is all about being a small-cap investor and how you monitor the transition from being a small-cap to a mid-cap investor. "What are some of the pain points along the way and some of the opportunities involved in that?"

Shin Nippon is about investing in growth companies and we have more than our fair share of very immature companies. Within the portfolio, there's a spectrum as well. We have this framework where I would classify each company into one of four profiles. The most immature one I called emerging prospects. These are typically companies that are loss-making or in some cases, even pre-revenue. Effectively, these are high potential [marker 30:00] companies that haven't yet established a full business model. Then we have got companies called rapid scalers. These are companies that now having working products. They are usually profitable and they are in this most exciting stage of ramp up. This is the core engine of the portfolio.

Then we have two other categories called cyclical gainers. Cyclical gainers are companies that are usually in the semiconductor space or something to do with capital equipment. These are companies that can go up and down, depending on market conditions in their industries, but there is nevertheless, a structural growth angle underneath it. Finally, we have proven winners. These are companies that are still pretty high growth. We're talking about high single-digit growth typically, but the market position and business model are very much established. A good example here would be Yonex, which is the leading badminton racket company in the world. The reason why I categorise these it to track the development of companies throughout this maturity spectrum and follow how they develop.

We do size our positions in accordance to that. Let's say I have the same conviction in Yonex as I do with a emerging prosect company, but from a portfolio standpoint, it would make more sense to have a much bigger position in Yonex versus something that can go bust tomorrow. It is something that we actively take into account when it comes to portfolio construction. I would say that this is one of the evolutions of how we invest under my management.

You said earlier that your holding period is generally five to ten years. Do you find that it takes most companies to move out of the small-cap spectrum or do some companies just operate within that niche and stay within that niche?

We are a bit of an incubator for the rest of my colleagues here at Baillie Gifford. Sometimes companies can graduate out of this portfolio in a few years' time. Other times, it could take decades. It really depends. As part of my own education, I looked at a Qatar small-cap portfolio back in the 1980s and I found some names that we hold today in large-cap funds. The SMC and Kians [? 33:01] of the world. They've been spectacular investments over the very long-term. That's what we're hoping to achieve. Because of our long-term nature, we like to run our winners, but there is a practical element that we want to remain a genuine small-cap portfolio. I would say that typically, when things run above a trillion yen in market-cap, hands on heart I can't say they are small-caps anymore and we have to think about an exit.

Our most recent example is a company called Monotaro. It's a distributor of parts to businesses and they've been a phenomenal investment over decades, but it got to a point where it really isn't a small-cap anymore and I had some reservations about valuation and we made an exit. We do make an exit, but overall, I would say that we'd like to run our winners within the confines of being small-cap.

I'd got an audience member here who'd like to learn a little bit more about the very specialised niches critical to the AI infrastructure. You did touch upon this a little bit earlier in your explanation of the hidden AI stocks, but do you want to talk to us a little bit about not just the software, but maybe some of those in fibreoptics. Niche sectors that are integral to global supply chains and maybe, emphasise that message for our audience?

One thing that I find Japan is excellent with is craftsmanship. In industrial terms that means precision engineering. I tend to think of them as Japan's little giants if you will. In absolute terms these are small companies but they utterly dominate the niche. That's the case in the AI supply chain as well. You mentioned optical components. The company that I'm thinking of is called Kohoku Kogyo. It's a company that makes something called optical isolators. These are components that go into the huge subsea data cables that go between continents. There're some big cables that go between Japan and the US, for example or go across the Atlantic between Europe and the US.

Hugely critical.

Hugely critical. They should last for 40, 50, 60 years and they cannot fail, otherwise it's very, very expensive to fix and so on. You've got a company like Kohoku Kogyo that has half the market. It's an

unknown company apart from the keenness of Japan small-cap nerds. They make very good margins from that. They are critical parts of our infrastructure as AI takes hold. There are other companies that have a growing exposure to semiconductors. One company that I'm thinking of is called Geol. They're perhaps better known for selling high-end microscopes to universities. Now universities don't really have that much money to throw around on electron microscopes and so on and margins are usually quite low. Geol also sells something called multibeam mask writers to the semiconductor industry.

That's highly correlated to a company called ASML. They make EUV lithography machines. If you want exposure to high-end semiconductor manufacturing, the market tends to think of ASML, but you've got a company like this that's not known for being a pure semiconductor company, yet have a significant and growing exposure to it. That's another example of hidden exposure to AI. It doesn't have to be complicated stuff. We have companies that make copper cables. We've got datacentres being built left right and centre and some of the companies that supply into our power infrastructure also benefit significantly from the AI boom. This is very exciting for me, in that I find lots of companies that are indispensable to this mega trend but, yet, overlooked because they are not the first name that spring to mind when you think of AI.

We've got another question here. The word 'incubator' has struck a chord with one of our audience members. "Being an incubator for startups means that Shin's shareholders don't reap the benefits of the early-stage investment. Exiting at the right time is critical. How do you judge when this might be?!"

I would say that in the past few years, certainly it has been difficult investing in the classic incubator ideas. Unproven names and so on. Simply because the market environment has not been conducive to their development. It's much harder to raise capital. I'd say that our unlisted investments overall, have been difficult overall, albeit, we recently exited one, having doubled our money. It's called Money Tree. I would somewhat pushback on the assertion that Shin Nippon shareholders don't reap the benefits in that. We do have the capabilities to run winners to a decent degree. I typically would start thinking about investing when market-cap is above Y30 billion. If everything goes well and they run to Y1 trillion, that's 30X return.

I mentioned Monotaro earlier, that's a company that has returned many, many times our investments in the past. We do have some capabilities to run winners and it remains core to what we do. [marker 40:00] When it comes to putting together an investment case, we do often come up with scenarios to say what needs to happen for this company to go 3X, 5X, 10X? Understanding the

scalability of these companies are absolutely critical and of course, not every company that we invest in would have that potential to go 10X, but scalability is very much core to our thinking.

To close out, it's not an easy one. We've got an investor here who's been an investor for 15 years and seen little return for their pain in this time. "What am I likely to see soon to keep me invested?" We've heard a lot about some new ideas and lots of on the ground insight, but if you could just articulate some of the main messages that you want to give to shareholders?

Our performance has been shocking over the past five years. I take some comfort that a lot of that underperformance is down to derating. In terms of our portfolio-

Do you want to break that down for what that means for investors?

Derating means the valuation multiples, how highly valued our companies are, that price tag has come down a lot. It's not like our companies are not delivering. Many of our companies continue to grow very strong, 10%, 20%, 30%. The market is attributing a much lower value for that revenue or earnings base. That derating cannot continue forever. To give you an example of the opportunities that we are now seeing. In the index as a whole revenues are expected to grow at 2%, 3%. Our expected growth [unclear 42:06] based on third-party projections would be something like 11%, 12%. In terms of margins, we are significantly above where the index is. If you look at the valuation of our portfolio, in aggregate, it's only slightly above the index.

Having been through a period of savage derating and as we've seen over the past five years, I think we're at a point where I'd say that valuation is an incredibly important part of why a performance from here should return. Now, I wish I had a crystal ball to tell you what the catalyst is and things can be very volatile. Looking back in our history, there'll be periods of time where we underperform massively by more than 20% and so on at quite a few points. There are also periods where we outperform by 20%-plus a few times over our past 20 years or so. What I'm focusing on is to get the input right. We continue to find great companies. To continue to invest with conviction and focus on things that we can control. I'm optimistic that we are at a point where sentiment is near the bottom and things will look better from here in the next five years versus the last five.

Investment rule number one is valuation, valuation, valuation. You couldn't get much lower than where we are right now.

Let me draw one example, the real estate company that I mentioned earlier, it's one of our more recent buys. They've grown earnings by more than 100% every year for the past three years. They are well on track to grow 50% earnings year-after-year for the next three. It's yours for ten times PE. It's not an isolated case. We have other companies that are trading at very depressed earnings. We

are a high growth house and remain so, but I'd almost argue at this point in Japan small-caps, we are growth and value rolled into one. It is very uncomfortable I would say, because we are underperforming by significant margins, but I'm hoping with hindsight in five years' time looking back, we'll see this point as I can't believe we could have picked many of these companies at this sort of price.

Could you just clarify for the audience how the investment trust structure plays into potentially the NAV and the share price?

Of course, the main driver for the share price would be NAV. That's the net asset value of the vehicle. We also have premiums and discounts to contend with. I think when I first took over back in May, the discount was as wide as 15% or even more. That has narrowed a little bit now. 9% or 10% is quite typical day-to-day more recently. That premium and discount can fluctuate depending on sentiment. I talked about the illiquidity of some of my underlying investments a bit earlier. With Shin Nippon that's also the case. It's something that we keep an eye on and the board of directors keep an eye on. From my vantage point, my priority is to make sure that we invest with ambition and discipline and when it comes to managing discounts and so on, we are doing what we can in terms of share buybacks. Ultimately, my primary focus day-to-day is on stock picking.

Thank you, Brian, so much for your time. That is all we have time for today.

Annual past performance of Baillie Gifford Shin Nippon PLC to 30 September each year

	2021	2022	2023	2024	2025
Share price (%)	4.0	-37.5	-17.1	-8.1	15.0
Net asset value (%)	7.0	-31.9	-10.8	-5.8	7.3
Index* (%)	10.1	-12.1	8.5	8.9	19.9

Source: Morningstar, MSCI. Share price, total return in sterling.

*MSCI Japan Small Cap Index.

Past performance is not a guide to future returns.

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- The aim of the Trust is to achieve capital growth and it is unlikely that the Trust will provide a steady, or indeed any, income.

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