Baillie Gifford

Baillie Gifford Shin Nippon: manager insights

May 2024

Praveen Kumar, manager of Baillie Gifford Shin Nippon, provides an update on recent performance, observations on the market environment and explains why he remains optimistic.

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

Praveen Kumar: Hello and welcome to this annual update of Shin Nippon, the specialist Japanese Small Cap investment trust. I am Praveen Kumar, the manager of the Trust.

Market trends

Japan has been in the news a lot recently as its stock market is trading near all-time highs. This has generated a lot of investor enthusiasm. However, high-growth small caps have been a notable absentee from the ongoing rally which began about three years ago.

This rally is being driven by three broad themes: Improving shareholder returns and corporate governance, the latter boosted by increased Private Equity activity in Japan, interest rate increases, and, finally, a very weak currency.

In practice, this means that most of the best performers have been large cap businesses that are either cyclical, capital intensive, sensitive to interest rates or currency, or those with significant unproductive financial assets on their balance sheet. To our mind, most of these are not secular growth businesses.

All this has meant that high growth small caps have been massively out of favour. There seems to be very little interest in this asset class even among domestic retail investors who have historically been the main buyers.

We are now in a situation where numerous companies in the portfolio are growing their sales and profits at well over 20% but are now trading at extremely low valuations.

We are also finding loads of new high growth ideas that have become very lowly rated. We think this is an excellent starting point for potential future outperformance as and when high growth Japanese small caps come back in favour.

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Performance

As noted in the annual Managers' report, Shin Nippon underperformed its benchmark for the year ending January 31st, 2024. We are very disappointed with this result, and we understand the frustration of shareholders of whom I am one.

Most of our rapid growth online businesses continue to grow their sales and profits at an impressive rate but still saw significant share price declines.

Litalico is a classic example. It provides online training and placement services for adults with disabilities, an area with huge growth potential. Sales grew by 26% and net profits by 118% in the first nine months of the company's current fiscal year and yet, the share price fell nearly 30% over the year to January 31st, 2024.

Online funeral services provider Kamakura Shinsho had a similar story: sales growth of 17%, operating profit growth of 19% in its most recent full year, and management are forecasting even faster sales and operating profit growth for next year, 24% and 35% respectively. Yet, shares have almost halved over the past year.

Strong sales growth, expanding profit margins, even faster growth forecast for next year in many cases and yet, shares being sold off aggressively: this depressing pattern was repeated across numerous holdings in the portfolio over the past year.

Given our high growth-oriented investment philosophy and style, our portfolio naturally has skewed towards such companies. Significant and sustained share price weakness of such businesses in the portfolio was unfortunately not offset by portfolio holdings that did do well in relative share price terms, leading to overall underperformance.

Outlook

It would not be an understatement to state that high-growth Japanese small caps continue to experience a torrid time. However, there are many reasons to be optimistic about the future.

Firstly, there is the simple case of fundamentals asserting themselves. Cyclical and currency-sensitive large caps which have done exceptionally well over the past year in share price terms have seen their valuations reach at or near all-time highs. We believe this to be at odds with their long-term growth prospects which remain decidedly average.

In contrast, valuations of small caps, in general, have compressed significantly. Shin Nippon's high-growth portfolio trades pretty close to the benchmark despite having delivered superior sales and operating profit growth over the past five years, and forecasted to do so again over the next year.

Second, in relation to improving corporate governance and rising shareholder returns, it appears to us that most of the easy gains have been made already and this is reflected in the strong share prices of such companies. From here on, we really struggle to see any positive catalysts for such companies as these are not growth businesses. This could result in investor interest coming back to growth small caps.

Third, with the Bank of Japan moving to normalise interest rates in Japan, we could eventually see a strengthening of the Japanese Yen, which in turn should be positive for domestic-focused

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businesses. The good news is the majority of Shin Nippon's holdings generate almost all of their sales from Japan, so the portfolio is well positioned to benefit from this scenario.

Conclusion

In conclusion, I would like to acknowledge the frustration and disappointment shareholders have had with Shin Nippon's poor performance. As I've discussed, this is largely down to external factors out of our control. Although this period has dented past performance, it has, however, provided a unique window of opportunity for us to double down on cheap and attractive long-term secular growth stories, that we are confident will outperform the benchmark going forward.

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

	2020	2021	2022	2023	2024
Baillie Gifford Shin Nippon PLC	-21.2	68.8	-25.2	-14.0	-20.9
MSCI Japan Small Cap Index	-6.2	24.4	-7.7	5.4	12.4

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

Past performance is not a guide to future returns.

Important information

This communication was produced and approved in May 2024 and has not been updated subsequently. It represents views held at the time of recording and may not reflect current thinking.

This communication should not be considered as advice or a recommendation to buy, sell or hold a particular investment. This communication contains information on investments which does not constitute independent investment research. Accordingly, it is not subject to the protections afforded to independent research and Baillie Gifford and its staff may have dealt in the investments concerned.

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The specific risks associated with the Trust include:

- The Trust invests in overseas securities. Changes in the rates of exchange may also cause the value of your investment (and any income it may pay) to go down or up.
- The Trust's risk could be increased by its investment in private companies. These assets may be more difficult to sell, so changes in their prices may be greater.
- The Trust can borrow money to make further investments (sometimes known as “gearing” or “leverage”). The risk is that when this money is repaid by the Trust, the value of the investments may not be enough to cover the borrowing and interest costs, and the Trust will make a loss. If the Trust's investments fall in value, any invested borrowings will increase the amount of this loss.

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- The Trust can buy back its own shares. The risks from borrowing, referred to above, are increased when a trust buys back its own shares.
- Market values for securities which have become difficult to trade may not be readily available and there can be no assurance that any value assigned to such securities will accurately reflect the price the Trust might receive upon their sale.
- The Trust can make use of derivatives which may impact on its performance.
- Investment in smaller companies is generally considered higher risk as changes in their share prices may be greater and the shares may be harder to sell. Smaller companies may do less well in periods of unfavourable economic conditions.
- The Trust's exposure to a single market and currency may increase risk.
- 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.

Further details of the risks associated with investing in the Trust, including a Key Information Document and how charges are applied, can be found in the Trust specific pages at **www.bailliegifford.com**, or by calling Baillie Gifford on 0800 917 2112.

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