Baillie Gifford™

International Alpha
Q1 investment update

April 2024

Investment manager Donald Farquharson and investment specialist Sachin Sharma give an update on the International Alpha Strategy covering Q1 2024.

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Sachin Sharma (SS): Hello, my name is Sachin Sharma. I'm an investment specialist for the International Alpha Strategy. Thank you for watching this quarterly video today.

I'm pleased to say that we have Donald Farquharson, who is joining me from Shanghai. He is a partner of the firm. He is the head of our Japanese equity strategies, and he is also a PCG member for the International Alpha Strategy.

Hi, Donald.

Donald Farquharson (DF): Hi, Sachin.

SS: So as mentioned, Donald is currently in Shanghai. He's on an investment trip to Japan and to China. So we're going to get Donald's insights into the International Alpha Strategy Japan exposure. We're also going to hear about his reflections from his current investment trip, and also the long-term outlook for Japanese growth equities.

But firstly, briefly touching on performance, the International Alpha Strategy was slightly behind its rising benchmark this quarter, driven by certain cyclical stocks doing well in certain geographies. However, it's pleasing to report that operationally, portfolio holdings are focused on the long term and delivering as we would hope.

So, Donald, let's start with your week last week in Japan. Which companies did you meet? And what is your sense of the mood on the ground?

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DF: Thanks, Sachin. So I spent a week in Japan. I met 17 companies in 14 cities. I was mainly based in Tokyo, but I went to Osaka, Kyoto, and Nagoya. During that period, I met some of the holdings of the International Alpha Strategy. So Japan Exchange, although we'll mention that one later on, because we've recently just sold it, MonotarRO, Nihon M&A. And then when we get on to what I've been doing this week in Shanghai and why I'm here. I've also met with FANUC and Shiseido. So quite a few of the companies that we've got in the portfolio.

I also, in Japan, spent quite a bit of time thinking around what has been driving the market. It's been a challenging period for some of our Japanese stocks. But reflecting on your earlier comment, that's not been through the fact that they've been operationally disappointing, It's just that the market itself has been quite narrow, and in my view, cyclically driven.

But there was an additional factor and one reason for meeting with the Japan Exchange Group, which operates the Tokyo Stock Exchange. Some of the initiatives that it has been driving to improve return on invested capital right across the market. And it was an interesting discussion because so far it has meant that lower-quality cyclical names that trade at big discounts to their book value have been performing best. And yet, as Yamaji, the CEO of Japan Exchange said, it was never about that. Overall, it's about improving the attractiveness of Tokyo as a market.

But I wanted to meet with some of the more sort of iconic names that perhaps have fallen by the wayside, just to see if there were emergent growth themes. I was meeting with some of the office equipment makers like Canon, Konica, Minolta, Fujifilm. So trying to generate a few new ideas for the portfolio. But overall, to summarise the mood, I'd say it's a good one and an improving one, not least driven by the fact that wage inflation is at the highest levels since I've been looking at this market back in the beginning of the 1990s.

SS: I suppose touching on that, what are your key reflections of the changes that you've noticed to date during your career in Japan?

DF: I've noticed a big change in management and management quality. Just the conversations that one has, their receptiveness to our ideas as investors. They are much more professional, much more outward-looking. And some of that is generational, so you take a company like SMC that makes pneumatic equipment, that was when the CEO position went from the father to the son. We saw a big change in their approach to their shareholders. Some of it is where you've got external management who has come in, as in the case of Sony, the combination of Yoshida and Totoki, I think is a partnership of two of the best managers of any business in Japan.

And then you've got people who have spent much of their careers overseas and bringing some of their learnings. So a good example of that would be Recruit and Idekoba, who for 12 years ran the Indeed business, the job search site, which is well known to many, which has been really the huge and standout success for Recruit. So that's one thing.

The second thing, and related to that, has been the improvement in governance in general. When I started looking at Japan in 1990, the governance model was one of having your major banker as an independent director. And I think that created enormous risk aversion amongst Japanese companies and probably exacerbated the problems that they faced for the next 20 years. So governance is better. And I think that, again, is making companies more inclined to change their operations.

And finally, there's just one of big changes in ownership and alignment. And we see that in companies like Nihon M&A Miyabe-san, SMC Takada, FANUC Inaba, Shimano is eponymous of the Shimano family. But at the start of my career, there were much fewer companies that you could invest in where you had a founder or founding family and very strong alignment between management and shareholders. That's another big change.

SS: Okay, great. So management changes, improvements to governance and far more companies aligned with perhaps how we'd like to invest.

So as we've mentioned, you're in Shanghai at the moment. As a Japan investor, what's brought you to China?

DF: Well, I wanted to test that narrative that China is just simply a huge opportunity for Japan and we needn't worry in terms of the Chinese progression into some of the critical industries that we're investing in, such as factory automation.

So I wanted to meet Japanese companies operating on the ground. And as I mentioned, I met with FANUC, I met with Shiseido, but I've also had the opportunity to meet with a number of industry insiders and also to meet with Chinese competitors, companies like Mindray and Inovance, which have been recent stocks of discussion at some of our International Alpha meetings. So that has been very interesting. I also wanted to get a sort of measure of the economic backdrop, because obviously there have been a number of challenges and trying to decipher the cyclical from the structural of what's going on. And I guess there were two really big takeaways for me.

The first, and it may seem a very obvious point, is the scale of the domestic opportunity which remains. And everyone has been adjusting to the fact that China may have reached a stage of greater maturity and may not grow at the pace at which it did prior to Covid. But even, and this was what Shiseido was saying to me, that even if China is going to grow for the next three years or so at a pace of 3 per cent to 5 per cent, it will still be contributing a quarter of all global GDP growth. So it is significant. What goes on in China is very significant. I'm also impressed by the way in which companies like Mindray have advanced so quickly within their industry. And that is because the scale of the domestic opportunity enables them to do that. And I certainly came away full of admiration for Mindray. Nothing directly, given that we don't own it, but nothing directly for us to worry about. But I think it is just a measure of how quickly Chinese companies can get to becoming world leaders within their industry.

And so the other point I took away was just where the Japanese companies still seem to have a strong competitive edge. And there was a lot of confirmation around the strength of FANUC in terms of industrial automation. It is still for companies that are moving into the robotics area like Inovance and has a large industrial automation business. They said FANUC is the company that we benchmark ourselves on because we only benchmark ourselves to the very best. But also in sort of luxury areas, I think there have been challenges to skincare companies, luxury brands like Shiseido. But again, I felt that there was some reassurance that they have turned a corner and that when one talks about the truly luxury end, Proya and Chinese competitors are not yet competing with them directly in that area.

SS: Okay. So some really helpful insights there to some of our portfolio holdings. And I suppose turning to the International Alpha strategy, what has the team been doing over the recent period in Japan?

DF: So just to sort of set the scene for Japan, we have about 12 per cent of funds exposed with Japanese holdings. Obviously a lot of those Japanese holdings have multinational positions. So geographically, it's not just about what's going on within Japan.

The big changes have been to sell Japan Exchange. As I mentioned earlier, that's largely because the share price in my view does discount the very positive narrative of a rising equity market. And indeed, I think is extrapolating dangerously out. So sadly, because I think it's a very impressive, high-returning business, as you know, from other exchanges that we have held or continue to hold within the portfolio. But the overall growth rate that we can expect of Japan Exchange is probably more moderate, notwithstanding the effects of a rising equity market.

And the other one is to reduce Denso, the automotive parts supplier, to Toyota notably, but to other OEMs. There, the shares have performed strongly for cyclical reasons. The weakness of the Yen helps their business as well. We have growing concerns, and I can say concerns that were only confirmed by my visit to China at the growing competitive threat that not only China poses in terms of electric vehicles and newer drive trains, and just what those companies are capable of delivering in terms of range through better battery technology, but also and impressively where they are in terms of car autonomous driving. And I was really struck by what to me seems to be a big lead over any other country in the world. So I think it was Denso has a number of points that support it in terms of the transitioning of Toyota and other automakers business towards electric. There is always that underlying threat that the Japanese OEMs may be under greater pressure than they were in the past.

And in terms of the stocks that we brought into the portfolio in the last 12 months, Recruit, so I mentioned very briefly, run by a very impressive CEO, Idekoba. It operates the globally dominant recruitment site in Indeed and Glassdoor. It is moving from the area of Jobs Board, which is a smaller market, towards placement and search and ultimately towards the temp staffing market. Had very, very large addressable markets. And it also has an extremely well-regarded and rapidly growing media and solutions, essentially a software as a service business in Japan. So that's a very exciting business in my view. Shares have actually performed reasonably strongly since we bought them, but I'm still encouraged and should the opportunity arise, that's something I'd like to add to.

Nihon M&A is a really interesting company because I think generally the backdrop for mergers and acquisitions in Japan is an improving one. And it's improving for a number of different reasons, but some of it is just simply served by changing management attitude, as I mentioned. Specific to Nihon M&A, which operates with small and medium-sized businesses, principally quite small businesses, it has an enormous opportunity because of the absence of successors to a lot of businesses.

So there are reckoned to be 3.8 million small and medium-sized companies in Japan, two and a half of which are run by someone over the age of 70, and 1.5 million of those are reckoned to have no successor. And that's where Nihon M&A, as the largest advisor in this market, is operating, and I think has a very strong competitive moat around that business, but also an extremely exciting opportunity. So adding to a few things, there are elsewhere a lot of really exciting things to, well, a lot of things that excite me, at least, in the areas of automation, so FANUC, Keyence, SMC, and in gaming and content, Nintendo and Sony. And I'd definitely like to bring more holdings to the team over the course of the next quarter.

SS: Right. So I suppose finally, Donald, we've mentioned there's been a bit of a cyclical rally in Japan, but in your view, what is the outlook for growth stocks in Japan over the long term?

DF: Well, simply, it's helpful that people are once again paying interest or taking an interest in Japan. So that's a good thing. If we look at what has driven the market up until now, it has been large cap, cyclical businesses, and not in my view, the sort of future of Japan. A lot of these, even as I mentioned earlier, Toyota Motor, I think has very significant structural challenges, which it will have to deal with. But a lot of the other sectors that have been performing well have even greater challenges.

So I think that there have been cyclical benefits, and we've seen enormous style rotation within the market, which means that growth stocks, the starting point of valuation is an extremely low one. So these are businesses which, as I've given you a few examples of, they're not underperforming in their industry. Indeed, they're growing extremely rapidly, but they've been ignored with this very sudden reversion to lower value stocks. So I'm encouraged by that, but more broadly, by the level of entrepreneurialism, which one's starting to see the higher level of risk-taking. And I think a bit of inflation just does an enormous amount to encourage companies to take on greater risk.

SS: Well, thank you for your time and your insights, Donald, and I wish you a safe trip back to Edinburgh. And thank you to everybody who was watching today. Thank you.

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International Alpha

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

	2020	2021	2022	2023	2024
International Alpha Composite	-7.2	61.4	-16.3	-5.6	9.0
MSCI ACWI ex US Index	-15.1	50.0	-1.0	-4.6	13.8

Annualised returns to 31 March 2024 (net%)

	1 year	5 years	10 years
International Alpha Composite	9.0	5.2	5.2
MSCI ACWI ex US Index	13.8	6.5	4.7

Source: Baillie Gifford & Co and MSCI. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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