

Where obsession meets opportunity: Japan's 'overlooked' small caps

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Japan's smaller companies represent a "niche and overlooked" asset class, but that's precisely the growth opportunity, says investment manager Brian Lum.

Leo Kelion: January 1970. A 23-year-old Japanese shipping clerk makes a routine, cost-cutting decision, diverting a freighter from the expensive port of Osaka to quieter Onahama. Hours later, 15 men are dead. An unexpected cyclone slams the coast, sinking the vessel and pitching its crew into the icy waves. Struck by guilt, the clerk walks away from shipping and makes the weather his obsession. In time, he founds a company that weaves together data from satellites, earthbound sensors and millions of crowdsourced reports.

Today, Weathernews prevents disasters, guiding ships, airlines and road hauliers around danger. **And as we'll hear, it also ensures convenience stores know when to have extra hot coffee or ice-cream to hand.** Weathernews is just one Japanese small cap to find a gap in the market and expand into related growth opportunities.

We're going to explore many more.

Welcome to *Short Briefings on Long Term Thinking*. I'm Leo Kelion, and in this episode, I'm joined by Brian Lum, investment manager in our Japanese Equities Team lead manager of the Baillie Gifford Shin Nippon Investment Trust and co-manager of our Japanese Smaller Companies Fund. But first, a quick reminder. As with all investments, your capital is at risk and your income is not guaranteed.

Brian, welcome to the show.

Brian Lum: Thank you for having me.

LK: **Brian, it's your first time on this podcast. So, let's start with an introduction. I believe you were born in Asia, but not in Japan. So, can you join the dots and tell me how you got to where you are now?**

BL: I grew up in Hong Kong and I do feel a certain level of personal affinity with Japan having grown up with Japanese manga and anime. And, in fact, the first time I got on to a plane was to Japan. That was in the late 80s. Now, my four-year-old **self can't make many insightful comments about the real estate bubble back then. But I could tell you that Disneyland in Tokyo is pretty good.**

LK: And then you came to Baillie Gifford when?

BL: So I have been at Baillie Gifford for 19 years now. For the bulk of my career so far, I have invested internationally. So, in this context, that means every market apart from the US. And for the past few years, my focus has been on smaller companies and over the past few months, my role has **evolved to focus exclusively on Japan. And I'm very glad about that because Japan is a special market for small cap investors.**

LK: Can you tell me what is the appeal of smaller companies? Because, a lot of the time, on this **podcast, we're talking about the bigger ones.**

BL: **Ultimately, it's about that sense of discovery. A lot of the companies I meet, and I invest in, they are not household names. If I show you my portfolio, you might recognise one or two names. YONEX, the badminton racket company, may be one that you know about. But it's that tantalising prospect, meeting a company for the first time, that there may be a household name 10 years down the line. And that's very exciting. And also because of the nature of companies that we meet, we are growth investors. I get to meet a lot of founders who have built companies from the ground up. They have first-hand experience on what it's like on the ground. And in some ways, they're sharing their vision of the future. And for me, is you get a little glimpse of what is to come. And that's fascinating to me.**

LK: **And how do Japan's smaller companies or small caps there compare to those in other countries?**

BL: The first point to make would be that Japan is a very, very broad market for small cap investing. Outside of the US and China, if you can get access to it, Japan is the deepest market in terms of the number of stocks I can look at. My universe would be somewhere between 2,000 and 3,000 **stocks, and I'm picking 60 or so stocks out of this universe of 2,000 to 3,000. So it's not really the average that matters for me, but having this big number to choose from means that the chances of finding something very interesting also go up.**

I don't know if you've heard of the term the Galápagos Syndrome. This is the idea that in Galápagos you find a lot of unique animals because the islands are isolated and there are a certain set of environmental conditions that shape the evolution of these animals. So, Japan is the same in a way

in that things work differently. There are payment methods that only exist in Japan. There are what they call Kei cars. These are tiny boxy cars that you only find in Japan.

One interesting anecdote would be that Japan had smartphones when we were still playing snake on our Nokias 25 years ago, but it was the iPhone that took over the world because their smartphones are tailored just for Japanese regulations and specifications. So there's good and bad to this phenomenon.

But from a small cap perspective, you have still a sizeable market, you're still talking about 120 million people, one of the top five economies in the world, being relatively insulated from many global leaders. And at home, there are lots of slow-moving, inefficient, large companies operating in these areas. So, this is a great environment if you are an innovative company with a new idea to disrupt and really grow and scale. This set of conditions makes Japan a fantastic place to invest in small cap. In some ways it's kind of the sweet spot for small cap investing.

LK: So, there's a lot of promise there. But I think it's fair to say that in recent years performance hasn't been all what our long-term clients would have hoped. Smaller company, Japanese portfolios are still well off their 2021 peak. And you've been promoted in part to address that. So are you making any changes to our approach?

BL: It is absolutely right that our clients have gone through a very tough few years. But I want to be clear, our focus on growth investing and our focus on investing for the long term, that hasn't changed and that will not change. There'll be no style drift. Also, in terms of the external environment, it has been very tough for our style of investing. What is important is to learn our lessons. But, we need to be careful. Every market cycle is different.

Now, we have made mistakes as a fund. With hindsight, we have paid too much for some companies. We held on for too long for some companies. And within the portfolio, I say that we underestimated some of the correlations. Take, for example, we have a number of subscription-type businesses in Japan. They have operated pretty well in the past few years. But what has happened is that share prices for these companies have gone down together, coming from a very highly rated level to now, I'd argue, a very lowly rated level. Now, this is a mistake with hindsight, but I would say we need to be forward-looking and try to find the best investment opportunities from today. And what we are changing is to introduce a number of new portfolio management tools to make sure that we have the discipline, and really tighten up the process, when it comes to portfolio construction.

LK: So, when you say finding the best opportunities today, how do you find and appraise the very best of Japan's smaller caps?

BL: We do meet a lot of companies. That's the number one approach. When it comes to smaller companies, we can, of course, screen. But it's ultimately very hard to screen for potential. Take an example, in July, I went to Japan to see companies. I met nearly 50 companies over a span of three weeks. And there's really no shortcuts. It is about speaking to lots of people. Speaking to one

company might lead me to another. And it's about building that network and meet as many companies as possible.

LK: Ok, let's focus on some of the companies you met on that trip. I know Weathernews was one of them, and we'll come to them in just a second. But first, can you give me an example of a company that exemplifies the Galápagos Syndrome you talked about a minute ago?

BL: So, one of the companies that we've held for some time is a company called LITALICO. They provide vocational training for adults with disabilities. I use this as an example because it's a very local business. You're talking about a unique set of regulations in Japan, and the company is working with the governments and local authorities. And it's not something that a foreign company would come in and try to take over.

It is interesting because of the market opportunity. Using the definitions of the regulations, 10 per cent of Japan's population can be defined as disabled. So, you've got a long growth runway and LITALICO is really solving a big social issue. What they're doing is train up these users and place them with employers. And Japan is a place that's really held back by lack of labour force. And so, this is an example where there's a big opportunity that feels quite unique in Japan. To give you an idea, they currently run 160 training centres, they already have eyes on 1,000 in the next 15 years. So, it's a company that's not short of ambition.

LK: So you met with LITALICO's leadership. Who was that and what did you learn?

BL: So, I met with the CEO, Atsumi Hasegawa. He was technically not the founder, but he joined the company when LITALICO was very young, and he basically built the company. And it is an interesting example because we can observe the mindset of a Japanese entrepreneur from different examples. And typically, they go through phases. At first, you build up your company, disrupt the sector, or you have an innovative idea, and it scales rapidly and even exponentially for a few years. And that's the most exciting part for these entrepreneurs.

And eventually, there comes a point where they think, ok, in 10 years' time, where will this business be? And they might think that Japan is not big enough for them. They are naturally very long term, so they do look very far out and they are ambitious. And there's a strong builder instinct. And quite often what we see is these entrepreneurs would set their sights on building a different business, quite often in the US, for example.

And when that happens, we observe mixed results. Sometimes things work out pretty well. Quite often they don't. And while they were focusing on a different business elsewhere, the core business could suffer because the founders stepped away.

This is kind of what happened with LITALICO. Hasegawa-san went to the US to build a new business and left a professional manager to run the core business.

LK: So was he doing something different in the US?

BL: So rather than targeting adults with disabilities, he was targeting the incarcerated, and the business is still going, **and it may well work out but what is really reassuring is that he's come back** to focus on the core Japanese business and most importantly with the enthusiasm and ambition very much still intact.

I mentioned earlier that they're hoping to get to 1,000 vocational training centres, **and that's not the only thing that they're doing. They're adding new services.** So, for example, when your users have some sort of disability, there might be opportunities in terms of offering them specialised insurance.

LK: So, **if we turn to Weathernews, it's already the world's biggest maritime weather services provider. So, it's proven that it's adept at international expansion.** So, can you tell me more about what the growth opportunity is for it from here?

BL: Yes. So, as you said, the origins of the business is as a maritime weather service provider. Since this foundation is expanded into land-based opportunities and also aviation-based opportunities. **Let's take land-based opportunities to begin with. So, most of the convenience stores in Japan do subscribe to the service, as you said. There'll be little decisions like, shall we put the umbrella stand over here? And what's the ratio of ramen to ice cream that we should order for the next day?** This might sound trivial, but the convenience stores get a fantastic return on that.

And there are less trivial applications as well. If you are a utility company, you want to know the **temperature for the next day, because if it's hot, everybody will switch their air con on and there'll be a drain on the power grid. If it's a windy day, then the wind farms will be producing lots of electricity and so on.** And there are things like disaster planning.

I was talking to the CEO, and we were discussing this case in Thailand a few years ago when hundreds of cars were lost from a car park. These are new cars parked on a flat surface. And when torrential rain came along, all the cars just sank and got washed away. And the outcome can easily be mitigated. If you know a torrential rain is coming, you just go and park the car somewhere else.

And Weathernews is still at the beginning to explore all of these opportunities to add value. And we all know that with climate change, the frequency and the intensity of extreme weather events are **just going up and up. And so it's a very interesting growth story that's based on not just digitalisation, but climate change, which is certainly a theme.**

LK: And am I right that part of its competitive edge comes in this massive data that it crowdsources from the public, even to the extent that Google formed a tie-up with it for its weather service in Japan. **Can you tell us a bit more about that and how it's trying to put that data to use?**

BL: **Weather forecasting, traditionally, is something that the government takes on. In Japan, it's the same.** You have the Met Office equivalent, if you will. They have high-end weather stations **scattered across Japan. They're very far apart. The government would look at weather forecasts on a grid of squares where it's 20km by 20km.**

For Weathernews, they draw data not just from weather stations, and they do have many of them, but also from crowdsourced data. For example, if you are already subscribing to the service, they will give you a webcam. For example, you point your webcam to the sky and that information about what the cloud looks like in the sky will help inform them about the weather and this weather forecast to a high degree of resolution. Within this 1 sq km, what is the weather forecast?

And they started working with Google fairly recently to try to build a better weather forecasting model. And AI is an important theme here. So, they have been predicting weather, of course, for decades using a traditional physical model. So built on physical understanding of how weather systems work. **But they're now incorporating AI elements where it's not really about physical model, but it's AI** trying to spot patterns between the outcome, the weather and observations directly. And **so they're getting some** interesting results there.

LK: Gosh, that is interesting. Did AI come up as a theme in a lot of the meetings that you had on this trip?

BL: Yes, pretty much every company would have some sort of AI angle but let me give you an example that I think illustrates the potential here. One company that we invest in is called Soracom. You can think of Soracom as a telecom operator, but not for mobile phones, but for things, connected things. The founder CEO talked me through a number of fascinating applications. If you run a factory, for example, typically you would have a few security cameras and you have security guards monitoring your facility to make sure there are no intruders and so on.

But generative AI is getting to this level where it cannot just capture the video image, but it can also **interpret what's going on. So you can have a camera that monitors the shop floor, and you'll know** if everybody is wearing helmets. You can tell, oh maybe someone has just fallen off the stairs, you might want to go and check that out. And all of this without human monitoring. All of that means more and more things to connect. And this is where Soracom makes money.

So, this is one example of the market potential expanding. But the interesting angle here as well is that previously it would have taken somebody months and months to develop an application. Gen AI can help speed up coding massively and a lot of the innovative processes can be automated. **what used to take months now takes hours. And I think it's a great example of how AI can help** accelerate product development, make everything cheaper, and you start to also open up new markets. And this is not a unique example at all.

LK: **So Soracom's got what sounds like a very fast-moving culture.** Presumably that comes down from the leadership. So, **what's the founder's background?**

BL: So, the founder, Ken Tamagawa, he was an engineer at Amazon Web Services, AWS. He used to **directly report to Andy Jassy, who's now the CEO of Amazon. And he's a good example of an** entrepreneur who has learned from the best and brought in some of the ideas and lessons that he has learned from Silicon Valley and come back to build a business in Japan.

One interesting ritual I think he's brought back is the idea of before you even work on a product, you write the press release. It helps everyone visualize the potential impacts of a new product. Culturally, it is very innovative, very fast moving, very free thinking. And Soracom is not the only example. We are finding similar dynamics elsewhere as well.

LK: So, Weathernews and Soracom are both examples of companies trying to use AI to drive new types of growth. Did you also meet with companies for whom AI is an accelerant to their existing business model?

BL: Absolutely. There are companies that may not be considered AI companies, but they benefit from some of the implications of AI. One good example is SWCC. They make copper wires. They also make components that go into power infrastructure. As we all know, AI uses a lot of power. All the datacentres that are now being built, they require high voltages, they consume a lot of electricity. And indeed, the power infrastructure is really one of the key bottlenecks when it comes to AI deployment. So SWCC is very well positioned to benefit from that trend.

LK: So, as you mentioned, you had nearly 50 meetings on this trip. It might seem to our listeners that it would be easier to crack through those by video call from Edinburgh rather than travelling 9,000-odd miles to Japan. **So what's the advantage of having these meetings face to face?**

BL: To be clear, doing Zoom meetings is very beneficial. We are engaging with companies much more frequently than we previously would have. **But there's no replacing face-to-face meetings. One of the important investment factors is alignment. I'll give you an example that's really stuck in my mind. A meeting with a company called Seria. This is Japan's 100-yen store. So, 100 yen is about 50p. The concept is very familiar to us. It's a bit like Poundland.**

And so, everything in their stores are 100 yen. I went to meet them in Ogaki. It's a city about three hours' train ride away from Tokyo. It's a city that I would never visited, had it not been for this company.

The meeting was on a rather dreary Monday morning and the president, whom I met, gave very polite and precise answers but there was this one moment in the meeting when I mentioned the fact that I went to one of their stores in Asakusa in Tokyo and I can just see his eyes lit up and he took his laptop out, opened it up and started showing me the operating system that he looks at.

And he started talking about all the different product lines, what is doing well, what's not doing so well. And he knew before he opened his laptop that the Asakusa in Tokyo store is performing well. Noted that they have something like 2,000 stores and this is a store something like 250 miles away.

And he started clicking on all these metrics to show me why this layout works and how the store decided to place certain product categories here and there and so on. The details are not important, but I can see the enthusiasm of him clicking around and showing me all these things. **And that's alignment. It's about understanding human motivations. It's about understanding what**

someone's interested in beyond just the pay cheque, right? And so I think for a business like this, where success and failure depend on whether you make an extra penny on an item, that **obsessiveness around details is very interesting. And that's my key takeaway from the meeting like this. I don't think I would have got that had it just been a Zoom meeting.**

LK: And were there other meetings, companies that you visited where you were similarly able to **build conviction because you were physically there that you wouldn't have been able to do over a video chat?**

BL: Yes. One thing that Japan is very good at is craftsmanship and precision engineering. A good example here is a company called Kohoku Kogyo. **It's really in the middle of nowhere. You could easily just drive straight past without noticing that there's a world-leading engineering company just there.** Do you know what a capacitor is? So, a capacitor is a critical component in many electric circuits. They kind of look like a little battery. It helps smooth out the ups and downs of electric voltages and so on. And this company, they make the lead terminal.

So, these are the two sticks that come out of a capacitor to connect the capacitor to the rest of the **circuit. I've got a sample here.**

LK: Oh, wow. OK, for those of you who aren't watching the video version of this, this is like a little **metal object about an inch long with two bits of metal together. One's flat and one is rounded.** Yeah. Tell me about that.

BL: So, the flat side is made of high purity aluminium. 99.92 per cent to be precise, and the other **end is the copper wire that's plated by a very thin layer of tin, about a one-fifth of a human hair in thickness there.** It looks just like a little metal object **that's not particularly interesting, but you need a lot of these in, say, an electric car. When these things go wrong, you're talking about very expensive damage to your battery pack.** And so this company makes billions and billions of them

There are about 400 in a typical EV. And Kohoku Kogyu has been making these things for over 60 **years. Again, it's that level of obsessiveness, wanting to make the very best. To the extent that they don't just make these things, they actually make the machines that produce these things.** So I'm able to walk around the factory to understand how all of these work. And within this market, quite remarkably, they have 95 per cent market share when it comes to lead terminals in cars.

LK: And how long does it take you to absorb and act on all the information that you gather on a trip like this before you head off again?

BL: Of course, we are long-term investors. So, we come back, and we ask ourselves, ok, has our assessment of the market opportunities changed? Is the competitive landscape as we thought? We talked about alignment. We talk about scalability and where growth bottlenecks could be. So, these are things that we focus on when we come back. We have that assessment and write up the notes. **And we tend to make very quick decisions where things have changed. But ultimately, it's about building up a picture of the investment case over time.**

LK: But how many of these trips would you do in a year?

BL: So, for example, I'm planning to return in November and meet dozens of companies again. And this time I'll be joined by my colleague, Jared, who co-manages the small cap fund with me.

LK: So, Brian, for listeners who are now intrigued about Japanese smaller companies, but maybe still sitting on the fence, can you sum up why our portfolios deserve their attention?

BL: It's interesting that I just had this conversation with our sound engineer about Japan. And the first thing that he said is: Japan, well, there's a problem with ageing society, isn't there? And there is. And there are other problems, too. Lack of labour force, and you've got a stagnant economy.

And so you have Japan, at least for certain sectors, are known for bureaucracy. These are big problems. And I think what intrigued me is the positive side to this. You have a generation of entrepreneurs and companies that are taking advantage of these opportunities. So we talked about LITALICO right, is they're solving a social problem. We have talked about all sorts of other companies, whether it's on the energy side or connected things, all of these things are tackling productivity issues. So that's very exciting.

So, I would like to emphasise the positive aspect. And the other one is simply that Japan's small-cap growth, in particular, in recent years have really been overlooked. They've done badly and they've been overlooked. And the reason is very simple: it is a niche asset class. Those of us who are considered financially literate by our family and friends often get asked the question: what should we buy? Should we put more money into FTSE 350 or the Mag 7 in the US or NASDAQ, or it could be Bitcoin or whatever it is. No one ever asks you about, should we put more money into Japan's small-caps? That's never a thing. But I think that's precisely the opportunity. That's precisely why it's so overlooked. And so, we are finding lots of exciting growth opportunities.

LK: Brian, it's been fascinating chatting to you. Before I let you go, at the end of the podcast, I always like to ask my guest what book they're reading or have recently finished to get an idea of their wider influences. So, what's new on your bookshelf?

BL: Sure, you get two books for the price of one here. The first book that's on my desk is called *Quantum Computing Since Democritus* by a computer scientist, Scott Aaronson. I've been looking at quantum computing recently after we hosted an expert.

For those less familiar, quantum computing is this new type of computing that promises almost infinite processing power. There are fascinating early examples of how a quantum computer can do a calculation in five minutes that would have taken the best supercomputers of today, the age of the universe, to do. My interest is of course partly investment related. You can just imagine the implications of quantum computing when you think about AI as well. The combination of those, you have some fantastic, quite deep implications there for us to grapple with. And it also reflects my own background as a physics student at university.

The other part is I'm reading some anime. I want to learn a bit of basic Japanese to help me communicate better when I'm in Japan.

LK: It's interesting you mention quantum computing because I know some of the other portfolios invest in PsiQuantum, which isn't a Japanese company. But do your portfolios have any quantum computing companies in them or anything related?

BL: I'm not aware of any direct quantum computing stocks in my universe. But having said that, Japan is very strong when it comes to hard tech. And quantum computing is very much about hard tech. As an example, I invest in a company called Nikkiso. they make cryogenic equipment. So this is equipment that's produced in very, very low temperature environments. So low temperatures can be a very useful piece of equipment for quantum computing. So maybe that will come to something, but it's really an embryonic field and I can't wait to see what comes along.

LK: So one to watch. Brian, thank you so much for coming on to the podcast. I hope we can have you on again.

BL: Thank you.

LK: And I hope you enjoyed listening to this conversation, too. We've shared details of the companies Brian mentioned in the show notes, along with a link to an interview he recently conducted with the chief executive of another holding, the VTubing phenomenon Cover Corp.

I'd also like to encourage you to sign up to our Disruption Week live webinars when I'll be quizzing investment managers from across the business on companies challenging the status quo. The series runs from 10-13 November. Book online via bailliegifford.com/disruptionweek2025 to find out more and reserve a spot.

As ever, please subscribe to the show via Spotify or any podcast app to be among the first to know when our next episode is live or watch the video version on YouTube. But for now, listeners, I look forward to briefing you again next time.

SHOW NOTES

Japan's smaller companies may be a "niche" asset class, but you'd be wise not to overlook them – so says investment manager Brian Lum in this latest episode of *Short Briefings on Long Term Thinking*. He reveals some standouts he recently met with, including a firm using AI to forecast the weather more accurately and another helping people with disabilities get their dream jobs.

Background:

Brian Lum became lead manager of Baillie Gifford Shin Nippon investment trust and joint manager of our Japanese Smaller Companies Fund in May. In this episode, he shares stories from a busy trip to the country, his first in his new roles. And he explains **why Japan enjoys some of the world's best** conditions to nurture innovative and disruptive growth businesses.

Companies discussed include:

Weathernews – a business safeguarding ships and planes from storms and helping convenience stores anticipate which goods will experience surges in demand.

LITALICO – a firm that specialises in providing training to people with mental and physical disabilities.

Soracom – a company blending generative AI with Internet of Things sensors.

Seria – the retailer obsessing over every detail to make a profit from selling goods for the equivalent of 50p (65 cents).

Kohoku Kogyo – the manufacturer demonstrating high craftsmanship to ensure electric cars run safely and smoothly.

Resources:

Baillie Gifford Shin Nippon

Disruption Week

Japanese Smaller Companies Fund

Quantum Computing Since Democritus

Short Briefings on Long Term Thinking

SWCC Showa: rewiring Japan

Virtual visionaries: Japan's Cover Corp rules the VTubing realm

Companies mentioned include:

Kohoku Kogyo

LITALICO

Nikkiso

PsiQuantum

Seria

Soracom

SWCC

Weathernews

Timecodes:

- 00:00 Introduction
- 01:55 Japanese influences
- 02:25 A focus on smaller companies
- 03:55 The Galápagos Syndrome
- 06:25 Learned lessons
- 08:00 Face-to-face meetings
- 08:55 LITALICO training workers with disabilities
- 12:55 Weathernews and climate change
- 15:00 AI-enhanced weather forecasts
- 16:35 Soracom mixes generative AI with the Internet of Things
- 20:40 **Seria's detail**-obsessed 100-yen shops
- 23:15 Kohoku Kogyo's crafted components
- 25:30 The long-term perspective
- 26:30 A niche, overlooked opportunity
- 28:30 Book choice

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