Japan Small Cap Quarterly Update

30 September 2024

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Potential for Profit and Loss

All investment strategies have the potential for profit and loss.

Stock Examples

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Product Overview

Japanese Smaller Companies is a regional equity strategy that aims to produce above average long-term performance through investment in Japanese equities with a market cap of between Y50-150bn in any economic sector. We believe the Japanese equity market offers active managers a broad selection of high quality companies capable of delivering attractive and sustainable earnings growth for shareholders.

Risk Analysis

Key Statistics	
Number of Holdings	66
Typical Number of Holdings	40-80
Active Share	96%*
Annual Turnover	17%

*Relative to MSCI Japan Small Cap Index. Source: Baillie Gifford & Co, MSCI.

The relative performance gap has been slowly closing this year and the portfolio was ahead of the market this quarter

Positive macro developments are becoming helpful tailwinds for the domestically orientated portfolio

The portfolio continues to trade at a discount to the market but should achieve much faster sales and earnings growth

Baillie Gifford Key Facts

Assets under management and advice	US$293.0bn
Number of clients	633
Number of employees	1708
Number of investment professionals	376

The tide is turning

After navigating through choppy waters of underperformance, the horizon is finally starting to clear. We have slowly seen the relative performance gap start to close, much like a ship steadying itself after riding tumultuous waves. Since the end of 2021, it has been a challenging period, during which we have experienced a sharp rotation to value, and market returns have been dominated by large-cap, cyclical companies that we believe are more reflective of the past than the future.

An increase in inflation, interest rates and a historically weak YEN have boosted returns for this cohort, and this has been an unfavourable backdrop for the portfolio of high-growth small caps. Within the MSCI Japan Small Cap index itself, the top 20 performing companies since the end of 2021 have an average market cap of ¥900bn, which is a long way from our sweet spot much further down the market cap spectrum where we have an average of ¥184bn.

While these headwinds continue to buffet our sails, there are encouraging signs that they are beginning to moderate, allowing us to chart a steadier course ahead. The US central bank has cut interest rates for the first time in four years, and the YEN has strengthened more than 15% against the dollar since its all-time low in July. Both developments are helpful tailwinds for the domestically orientated portfolio, which derives roughly two-thirds of its revenues from Japan.

In addition to the macro developments, there are also fundamental factors that make small caps compelling relative to large caps in Japan. When looking at the portfolio's characteristics, it is both cheaper and growthier than the MSCI Japan Small Cap index and that is also the case when looking at the large-cap TOPIX index.

So, whilst the large-cap ship has been riding the waves of cyclical sectors and a weak YEN, the small-cap fleet is well-positioned to capture the extreme upside potential that these disruptive companies offer when the asset class comes back into favour.

Reflections from Japan

It remains full steam ahead for the investment manager, Praveen Kumar, who has just returned from a five-week trip to Japan. During this time, he met with 61 companies, of which half were portfolio holdings.

Pricing power

Historically Japanese companies have been hesitant to raise prices, which created a culture where doing so was seen as taboo. Recent economic changes have shifted this mindset due to inflationary pressures and changing consumer attitudes. When meeting with our portfolio companies, it was encouraging to hear examples that have crossed the Rubicon and where management attitudes are shifting. Infomart the online business-to-business food ordering platform linking restaurants with suppliers and Bengo4.com, the online legal platform are two examples. Both have successfully disrupted old-fashioned paper, phone and fax-based business practices by offering digital solutions and have become dominant leaders in their markets. With a focus on profitability, both have been able to take advantage of their market dominance and exercise their pricing power.

Inbound tourism

It was notable how many more tourists there were in Tokyo, the lure of a weak YEN, despite its recent strengthening, still makes it a very appealing holiday destination. There has been a remarkable recovery post Covid. As of June this year, Japan had nearly 18 million tourists compared to 25 million in 2023, and nearly 32 million in 2019. At the current rate, Japan remains on course to attract a record number of tourists this year. The increased spending from tourists is helpful for a range of the portfolio holdings, but in particular, beauty and cosmetics companies, iStyle and I-Ne, and MatsukiyoCocokara a leading drugstore. iStyle stands out after an impressive boost in sales and operating profit of 30% and 137% respectively over the previous year.

China

Previously, China has been a large growth market for many Japanese companies. In recent years, a slowing economy, rising domestic competition, geopolitical tensions, and pricing pressure have all resulted in a souring of the “China dream” for many. Due to these concerns, we were reassured to hear that portfolio holdings such as Nippon Ceramic, the global leader in ultrasonic sensors used in cars and Kohoku Kogyo the EV battery component maker are reducing their exposure to China. As the portfolio weighting is tilted towards companies focussing mostly on the domestic market, we expect the impact from weak Chinese demand to be muted.

Labour shortages

A recurring anecdote in meetings was that the labour shortage is a serious concern for companies in labour-intensive sectors such as construction and manufacturing. These companies are struggling to replace an ageing workforce as these sectors remain unpopular with graduates and younger workers. Whilst this is a headwind for some, it presents growth opportunities for disruptive smaller companies that can help address this problem. One example is SpiderPlus, which is on a mission to digitise Japan’s construction industry. Its Software-as-a-Service application is used for architectural drawing and construction site management, helping to reduce labour intensity and improve productivity. On a recent site visit, we saw this firsthand, and it was striking how effectively site managers can track and manage the progress of a project, create drawings and reports and collaborate in real-time with others, jobs that previously would have taken four or five people.

Domestic Champions

We continue to build up the domestic exposure within the portfolio and now feels like the right time to recycle capital into companies with growth opportunities that depend less on YEN weakness.

New purchase Amvis is a domestic-focused company and Japan’s largest hospice provider. Hospices are a new concept in Japan, a country where patients with terminal illnesses stay over 3x longer at hospitals compared to other developed markets. This has resulted in a very low turnover of patients at hospitals, which in turn has negatively impacted their sales generating ability. In recent years, hospices have emerged as a solution to this problem and Amvis has taken a leading role in providing the infrastructure to care for terminally ill patients, thereby alleviating a lot of the pressure on hospitals capacity. Despite being the leading operator, and more than twice the size of the next largest player, its share of the nursing care market is still less than 10% (which in turn is just 20% of care for terminally ill patients) so there remains a large runway for growth. The recent share price has been weak on the back of concern over regulatory changes, providing an attractive entry point, and we are confident that Amvis can navigate the new regulations.

This was funded by the sale of two exporters, Daikyonishikawa, a car parts maker that generates most of its sales by selling to Mazda, and Nabtesco, a manufacturer of precision gears and a variety of other equipment used in transport, construction, and industrial sectors. Both companies have faced increased competition in recent years and look structurally challenged to grow in a changing macro environment.

Conclusion

The past few years presented significant challenges for our clients, with the portfolio holdings weathering a perfect storm of macroeconomic headwinds. However, as market conditions evolve and volatility subsides, we're observing encouraging tailwinds that look promising for the portfolio's growth. This juncture is particularly exciting, given that the portfolio currently trades at a discount to the broader market but should achieve much faster sales and earnings growth from here. Although we cannot predict the exact timing of this turnaround with certainty, we remain confident in the portfolio's positioning for future success. Our commitment to identifying fast-growing, dynamic smaller companies in Japan remains unwavering, as we believe these businesses will be the cornerstone of the portfolio's long-term performance.

Performance Objective

2%+ p.a. over 5 years vs index.
The performance objective is aspirational and is not guaranteed. We don't use it to compile the portfolio and returns will vary. A single performance objective may not be appropriate across all vehicles and jurisdictions. We may not meet our investment objectives if, for example, our growth investment style is out of favour, or we misjudge the long-term earnings growth of our holdings.

Periodic Performance

GBP	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	6.2	5.8	+0.4
1 Year	-7.4	8.9	-16.3
3 Years	-17.3	1.3	-18.5
5 Years	-6.8	3.1	-9.9
10 Years	5.8	8.6	-2.8
Since Inception	4.5	3.4	+1.2

USD	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	12.7	12.3	+0.4
1 Year	1.8	19.7	-17.9
3 Years	-17.4	1.1	-18.5
5 Years	-5.2	4.9	-10.1
10 Years	3.8	6.6	-2.8
Since Inception	4.0	2.8	+1.1

EUR	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	8.2	7.8	+0.4
1 Year	-3.4	13.6	-17.0
3 Years	-16.4	2.4	-18.7
5 Years	-5.7	4.4	-10.1
10 Years	5.1	7.9	-2.8
Since Inception	4.1	2.9	+1.1

CAD	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	11.3	10.9	+0.4
1 Year	1.7	19.6	-17.9
3 Years	-15.6	3.3	-18.9
5 Years	-4.9	5.3	-10.1
10 Years	5.8	8.6	-2.8
Since Inception	4.4	3.3	+1.2

AUD	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	8.5	8.1	+0.4
1 Year	-5.3	11.4	-16.6
3 Years	-16.3	2.4	-18.8
5 Years	-5.8	4.3	-10.0
10 Years	6.2	9.1	-2.8
Since Inception	4.4	3.2	+1.2

Annualised periods ended 30 September 2024. 3 Month & 1 Year figures are not annualised.
Inception date: 31 December 1989
Figures may not sum due to rounding.
Benchmark is MSCI Japan Small Cap Index (Market cap weighted composite index of TOPIX 2nd Section, TOPIX Small & Jasdaq prior to 30 April 2010).
Source: Revolution, MSCI, Tokyo Stock Exchange.
The Japan Small Cap composite is more concentrated than the MSCI Japan Small Cap Index.

Discrete Performance

GBP	30/09/19-30/09/20	30/09/20-30/09/21	30/09/21-30/09/22	30/09/22-30/09/23	30/09/23-30/09/24
Composite Net (%)	22.9	1.0	-30.7	-11.9	-7.4
Benchmark (%)	2.0	10.1	-12.1	8.5	8.9

USD	30/09/19-30/09/20	30/09/20-30/09/21	30/09/21-30/09/22	30/09/22-30/09/23	30/09/23-30/09/24
Composite Net (%)	28.9	5.3	-42.6	-3.7	1.8
Benchmark (%)	7.0	14.8	-27.3	18.6	19.7

EUR	30/09/19-30/09/20	30/09/20-30/09/21	30/09/21-30/09/22	30/09/22-30/09/23	30/09/23-30/09/24
Composite Net (%)	19.8	6.6	-32.1	-10.9	-3.4
Benchmark (%)	-0.6	16.2	-13.9	9.7	13.6

CAD	30/09/19-30/09/20	30/09/20-30/09/21	30/09/21-30/09/22	30/09/22-30/09/23	30/09/23-30/09/24
Composite Net (%)	30.0	-0.1	-37.8	-5.2	1.7
Benchmark (%)	7.9	8.9	-21.1	16.7	19.6

AUD	30/09/19-30/09/20	30/09/20-30/09/21	30/09/21-30/09/22	30/09/22-30/09/23	30/09/23-30/09/24
Composite Net (%)	21.3	4.5	-35.5	-4.0	-5.3
Benchmark (%)	0.6	14.0	-18.3	18.1	11.4

Benchmark is MSCI Japan Small Cap Index (Market cap weighted composite index of TOPIX 2nd Section, TOPIX Small & Jasdaq prior to 30 April 2010).
Source: Revolution, MSCI, Tokyo Stock Exchange.
The Japan Small Cap composite is more concentrated than the MSCI Japan Small Cap Index.

Stock Level Attribution

Top and Bottom Ten Contributors to Relative Performance

Quarter to 30 September 2024

Stock Name	Contribution (%)
Rak Sul	0.7
Appier Group	0.6
Descente	0.6
Megachips Corp	0.5
Kohoku Kogyo	0.5
KATITAS	0.4
Cosmos Pharmaceutical	0.3
SWCC Corporation	0.3
CrowdWorks	0.2
Yonex	0.2
JEOL	-0.6
Litalico	-0.5
WealthNavi	-0.5
Vector	-0.5
Toyo Tanso	-0.4
Harmonic Drive Systems	-0.3
Fujikura	-0.3
Horiba	-0.3
Lifenet Insurance	-0.3
Ishikawajima-Harima	-0.3

One Year to 30 September 2024

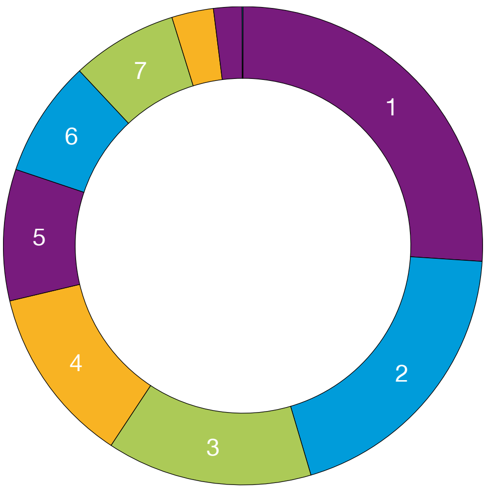
Stock Name	Contribution (%)
SWCC Corporation	1.3
Lifenet Insurance	1.1
Kohoku Kogyo	0.8
Yonex	0.5
Noritsu Koki	0.4
PeptiDream	0.4
Seria	0.3
Outsourcing	0.3
Tsugami	0.2
Megahips	0.2
GMO Financial Gate	-1.2
Litalico	-1.1
Bengo4.com	-1.0
Nakanishi	-0.9
SIIX	-0.8
eGuarantee Inc	-0.8
Iriso Electronics	-0.8
I-ne	-0.7
Enechange	-0.7
Nittoku	-0.7

Source: Revolution, MSCI. Japan Small Cap composite relative to MSCI Japan Small Cap Index.
The holdings identified do not represent all of the securities purchased, sold or held during the measurement period. Past performance does not guarantee future returns. A full list showing all holdings' contributions to the portfolio's performance and a description on how the attribution is calculated is available on request. Some stocks may not have been held for the whole period. All attribution figures are calculated gross of fees, relative to the index from stock level up, based on closing prices. As attribution is shown relative to the benchmark, not all stocks shown are held in the portfolio.

Top Ten Holdings

Stock Name	Description of Business	% of Portfolio
Lifenet Insurance	Provides a range of life insurance products and services.	3.5
Yonex	Sporting goods	2.9
Cosmos Pharmaceutical	Drug store chain	2.8
KATITAS	Real estate services	2.8
Nifco	Value-added plastic car parts	2.7
Nakanishi	Dental equipment.	2.5
RakSul	Internet based services	2.5
JEOL	Manufacturer of scientific equipment	2.5
Toyo Tanso	Electronics company	2.4
Anicom	Pet insurance provider	2.4
Total		27.1

Sector Weights



		%
1	Industrials	26.0
2	Information Technology	19.4
3	Consumer Discretionary	13.9
4	Financials	12.0
5	Communication Services	8.9
6	Health Care	7.9
7	Consumer Staples	7.2
8	Real Estate	2.8
9	Materials	1.9
10	Cash	0.1

Figures may not sum due to rounding.

Voting Activity

Votes Cast in Favour		Votes Cast Against		Votes Abstained/Withheld	
Companies	6	Companies	None	Companies	None
Resolutions	51	Resolutions	None	Resolutions	None

Company Engagement

Engagement Type	Company
Environmental	Avex Inc., Kamakura Shinsho, Ltd., Kohoku Kogyo CO.,LTD., MegaChips Corporation, Torex Semiconductor Ltd.
Social	Amvis Holdings, Inc.
Governance	Avex Inc., Harmonic Drive Systems Inc., Iriso Electronics Co., Ltd., JEOL Ltd., KATITAS CO., Ltd., Kamakura Shinsho, Ltd., Kohoku Kogyo CO.,LTD., MegaChips Corporation, Nakanishi Inc., Nittoku Co.,Ltd., SHO-BOND Holdings Co.,Ltd., Shima Seiki Mfg.,Ltd., Torex Semiconductor Ltd., Toyo Tanso Co., Ltd., istyle Inc.
Strategy	Kohoku Kogyo CO.,LTD., Nakanishi Inc.

Votes Cast in Favour

Companies	Voting Rationale
Asahi Intecc Co Ltd, Cosmos Pharmaceutical, Istyle, Sho-Bond Holdings Ltd, Technopro Holdings, Weathernews Inc	We voted in favour of routine proposals at the aforementioned meeting(s).

Votes Cast Against

We did not vote against any resolutions during the period.

Votes Abstained

We did not abstain on any resolutions during the period.

Votes Withheld

We did not withhold on any resolutions during the period.

New Purchases

Stock Name	Transaction Rationale
Amvis Holdings, Inc. Com Stk	Amvis is Japan's leading operator of chronic and terminal care hospices. It addresses a growing need represented by an ageing society, growing cancer rates, rising hospital service costs, and longer hospital stays (which are over 3x longer than in other developed countries). Despite being the leading operator, and more than twice the size of the next largest player, its share of the nursing care market is still less than 10% (which in turn is just 20% of care for terminally ill patients) so there remains a large runway for growth. Its edge comes from scale and reputation, which confer advantages in recruitment and ensure higher bed occupancy and profitability when compared to peers. The shares were weak on the back of concern over regulatory changes, providing a good entry point, and we are confident that Amvis can mitigate any negative effect. The company is also founder-run, with a large stake in the business.

Complete Sales

Stock Name	Transaction Rationale
Akatsuki	Akatsuki is a mobile gaming company that generates most of its profits from the hit game "Dragon Ball Z: Dokkan Battle", which the company has developed in partnership with Bandai Namco, one of Japan's largest entertainment companies. Our initial hypothesis was that the company would use the profits from this game to diversify its business into new and rapidly growing areas like e-gaming. However, we have owned the shares for over six years now and have been very disappointed by management's lack of progress in this regard. The company also has nearly two thirds of its market cap in net cash and has been extremely reluctant to use this cash pile to either increase dividends or conduct a large buyback. For these reasons we have therefore decided to sell our entire holding and reinvest the proceeds in more dynamic growth ideas in the portfolio.
Daikyonishikawa	Daikyonishikawa is a specialist manufacturer of high margin plastic parts for cars and generates the vast majority of its sales by selling to Mazda. The business has struggled with weak demand over the past few years, mirroring the fortunes of its largest customer Mazda. In addition, it is also facing rising input costs which we believe would be difficult for the company to pass through given its client concentration. We struggle to see a scenario where demand for the company's products bounces back as car makers, including Mazda, appear to be pivoting away from traditional models to electric vehicles and this is an area where Daikyonishikawa has less exposure to at the moment. Overall, we believe the business environment for the company is likely to remain tough long-term and we have little faith in management's ability to develop products and solutions that would be relevant for a new class of vehicles. We therefore decided to sell the entire holding in the company.
Descente Ltd	Descente is a sportswear manufacturer with a portfolio of well-known brands like Le Coq Sportif, Umbro, and the eponymous brand Descente. Japanese trading company Itochu, along with China's leading sports apparel chain Anta Sports, had been the majority shareholders of the company. Recently, Itochu announced a tender offer for Descente, offering a near 20% premium to buy out minorities and take Descente private. Since we originally took a holding in 2019, the shares have risen nearly three-fold so this has been a very good investment for shareholders. Given our status as a minority shareholder and the strong share price performance since we took a holding originally, we feel there is less upside potential and therefore decided to sell our holding.
ENECHANGE Ltd.	Enechange has three businesses: an energy comparison and switching website, a SAAS product for utility companies to monitor and optimise their operations, and an EV charging business. Recently, management disclosed that the company's auditors have refused to sign off on its full year financials for the current fiscal, citing improper accounting practices related to its EV charging subsidiary. As a result, the company will be required to restate its financials over the past couple of years in accordance with proper accounting regulations. Whilst there is no evidence of outright fraud, this incident does highlight significant deficiencies in compliance and audit practices. For a small company, we feel this is a major issue that will take considerable time and effort to sort out, not to mention significant management time. Whilst wanting to be supportive of young, disruptive companies like Enechange, we feel the current issues are deep rooted and will have a material impact on the company's future growth prospects. As such, we have decided to sell our entire holding in the company.
Nabtesco	Nabtesco is a leading manufacturer of precision gears, as well a variety of other equipment used in the transport, construction and industrial sectors. For a while now its businesses have struggled to grow in a sustainable fashion; this is due to cyclical factors, as well as structural headwinds such as increasingly stiff competition from Chinese peers. Moreover, the company's high-margin gears segment, the jewel of the business, has yet to see a sustained post-COVID recovery. To overhaul the company would require a serious round of restructuring, and we are not confident that management are able or willing to see this through. We therefore decide to sell our holding.

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