Baillie Gifford

Japan Growth Quarterly Update

30 September 2024

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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 bailliegifford.com

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Historical performance results for investment indexes and/or categories, generally do not reflect the deduction of transaction costs and/or custodial charges or the deduction of an investment management fee, the incurrence of which would have the effect of decreasing historical performance results.
It should not be assumed that recommendations/ transactions made in the future will be profitable or will equal performance of the securities mentioned.

Potential for Profit and Loss

All investment strategies have the potential for profit and loss.

Stock Examples

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Product Overview

Japan Growth is a concentrated, regional equity strategy that aims to produce above average long-term performance through investment in Japanese equities with a market cap of greater than Y150bn. 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

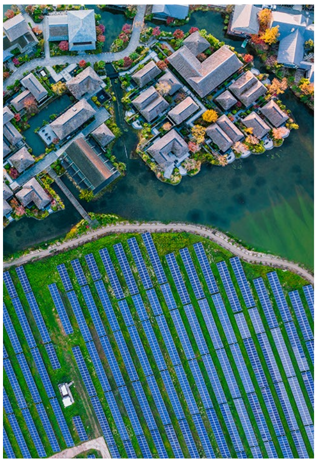
Key Statistics	
Number of Holdings	55
Typical Number of Holdings	35-55
Active Share	79%*
Annual Turnover	19%

*Relative to TOPIX.
Source: Baillie Gifford & Co, Japan Exchange Group.

Although Japanese companies offer access to unique and enduring growth opportunities, these are often concealed by broader market cyclicality

Subsiding economic and yen tailwinds creates a compelling case for growth equities

Earnings expectations well in excess of the market, augur well for long-term portfolio returns



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

Cyclicality is a fact of life.

Although Japanese companies offer access to unique and enduring growth opportunities, these are often concealed by the cyclicality of the broader market. These swings are particularly pronounced in Japan, owing to the export-orientated nature of its largest constituents and flighty foreign capital that accounts for an outsized two-thirds of daily traded volume. We believe that timing these (often unpredictable) vicissitudes is folly, instead, we attempt to look through-the-cycle, calibrating our expectations to capture sustainable long-term earnings growth potential.

Adopting this approach led us to reduce the portfolio's exposure to cyclical stocks in recent years, on the assumption that many may be over-earning. Although premature (with the benefit of hindsight), this decision is looking increasingly prescient, as the pendulum begins to swing the other way.

What next for Japan?

In the last three years, Japan's globally geared market has experienced a robust cyclical upswing. A recovery/ expansionary phase in global economic growth and the precipitous decline in the yen are two standout drivers. The accelerated move this quarter, towards more accommodative measures in both the US and China, however, suggests that such economic tailwinds are easing. The yen's downward spiral also appears to have paused, owing to the Bank of Japan's increasingly distinct monetary approach.

This change in trajectory jolted markets in August, as changes in market trends often do. The fallout, however, was particularly pronounced, with the main market losing a fifth of its value in only three days. One culprit was the carry trade, as investors scrambled to sell stocks to cover margin calls on short yen positions.

These macro factors have held huge sway over market returns in recent years. The economic upswing post-Covid lifted volumes and the yen's fall boosted the price appeal of Japanese products. Autos, resources and related cyclical sectors were big beneficiaries. Shipping, for example, has been the best-performing TOPIX sector since Covid, rising circa 600% as supply chain bottlenecks drove up freight rates. However, the smoothing of supply chains and subsiding global growth could stymie the sustainability of such growth. Autos were another cyclical winner, as illustrated by Japan's $300bn titan Toyota, which realised a 25% boost to full-year operating income from currency movements alone! Large-cap value-orientated stocks such as these, have suffered the biggest fallout this quarter as their cyclical supports appear to have been pulled away.

Assessing such cyclicality can pose several analytical problems to forecasting future growth. At the height of cycles, both revenue growth rates and profit margins tend to be higher, but it is difficult to be sure by how much. Ideally, one could estimate this by calculating the average over an extended period spanning several cycles. However, this too is complicated by changing dynamics during the period (such as company, industry and economic fundamentals) which may render these periods incomparable. Time adds another complication. When expansionary periods (swells) occur for extended periods, people begin to believe that a structural change has occurred which has conquered the cycle. This is further muddied by the occurrence of spuriously correlated events (known as the 'Super Bowl Indicator', where causation is confused with correlation), such as Japan's renewed focus on corporate reform or the end of its 30-year battle with deflation. Conflating such factors may have led some to surmise that the current cohort of winners (autos, resources and shipping) are reflective of the opportunities that the new paradigm presents. An acute problem with such arguments is that they tend to be the most dangerous when they look most reasonable. When the cycles shift, as they inevitably do, demand drops and the costs of over-capacity become apparent. So how do we separate the two and overcome these inevitable oscillations?

Overcoming the ups and downs

"Time in the market beats timing the market" Ken Fisher

As long-term growth investors, we aim to overcome cyclicality by backing quality companies that exhibit robust growth underpinnings. This is evidenced in the following examples, from companies geared towards opportunities in areas such as digitalisation and automation.

Consumer electronics and gaming offer examples of sectors susceptible to shifts in consumer behaviour and economic cycles. However, there are companies operating within that aim to offset this issue, by harnessing digitalisation to expand their offering. **Sony** is one such company. Although often narrowly associated with its (still highly cash-generative) electronics business, Sony is also dominant across three entertainment verticals: music, movies and games, which account for two-thirds of profits. The gaming division is particularly prone to cyclical patterns due to the nature of console generations, with each PlayStation system typically having a 5-7 year lifespan marked by initial hype and strong sales, followed by a maturation period, and ultimately declining interest as the next generation approaches. However, Sony's potential to cross-pollinate IP across their platforms, by embracing digitalisation to enhance content curation and delivery, create significant upside potential to group profitability whilst also minimising their reliance on any one console cycle. During our recent meeting with President Totoki-san during the quarter, in one of the few one-to-ones he grants, he confirmed Sony's ambitions to realise growth by creating greater synergies between the businesses, using transmedia to capitalise on content creation. The upcoming Beatles biopic and virtual concerts are examples of this. They are also excited by the potential of location-based entertainment (LBE), examples being Columbia Pictures' Aquaverse in Thailand and Wonderverse in Chicago, which combine Sony's content (Jumanji, Ghostbusters, Unchartered, Zombieland) with technology (VR/AR, haptics, 360 sound and full-sensory experience). We believe these initiatives offset the impact of short-term fluctuations in earnings, by amplifying value creation in the long run.

Automation presents another example of a long-term structural opportunity that is stymied by short-term cyclicality, with machine tools and tractors offering two ripe examples. DMG Mori is a leading global manufacturer of machine tools with a strong reputation for its prowess in precision engineering –a hallmark of its Japanese-German heritage. Despite this technical accolade, DMG cannot escape the indelible ups and downs of capital spending. Our through-the-cycle support, however, stems from a hypothesis that DMG will boost profitability whilst riding various heavyweight trends like automation, process integration, and energy efficiency. We expect this to be realised from DMG's shift towards the sale of more sophisticated and higher-value machines (including their five-axis machines that cut on three linear and two rotational axes) and software solutions. Not only will this help customers consolidate lines, by extracting both labour and energy costs, but it will also boost DMG's bottom line and widen their technological moat - as more complex machines will mean more advanced programming and in-depth training for operators. Another company that must traverse the capex cycle is Kubota, with the sale of its tractors. This leader in small horse-powered tractors has other inevitable cycles to contend with within its end-markets, ranging from rice prices fluctuations in Japan, America's economic cycle to poor weather in Thailand! Like DMG Mori, we believe Kubota will dilute the effect of these issues in the long-term thanks to the structural undercurrent of rising agricultural and construction spend, especially within Asia. Supported by a profitable agricultural business in North America, Kubota is quickly expanding into the world's largest tractor market, India (which accounts for circa 50% of global tractor demand). The acquisition and consolidation of local Indian player 'Escorts' gives Kubota an entry-level product more in tune with the needs of the local market and exposure to the long-lasting growth opportunity of agricultural mechanisation (which currently sits at ~40% vs ~60% in China and ~95% in North America).

Outlasting the cycle

Our focus on capturing Japan's unique and enduring growth opportunities continues to present compelling long-term appeal. This approach can, however, fall out of favour if the wider market enjoys an unusually long cyclical uplift. Instead of following the bandwagon by chasing the cycle, we stick fervently to our long-term investment philosophy by retaining our focus on quality growth companies underpinned by strong long-term structural trends.

This is beginning to be rewarded, as the cyclical wave subsides some major market constituents are now looking exposed. In contrast, the portfolio, which consists of companies that are continuing to deliver structural-supported earning streams, is starting to pull ahead of the index. With earnings expectations that are well in excess of the wider market, we believe this is just the beginning.

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	-0.1	0.8	-0.9
1 Year	10.1	10.7	-0.6
3 Year	-6.3	3.3	-9.6
5 Year	0.5	5.5	-4.9
10 Year	7.2	8.8	-1.6
Since Inception	7.9	8.2	-0.3

USD	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	6.0	6.9	-0.9
1 Year	21.0	21.6	-0.6
3 Year	-6.5	3.1	-9.6
5 Year	2.3	7.3	-5.0
10 Year	5.2	6.8	-1.5
Since Inception	6.5	6.8	-0.3

EUR	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	1.8	2.7	-0.9
1 Year	14.8	15.4	-0.6
3 Year	-5.3	4.4	-9.7
5 Year	1.8	6.8	-5.0
10 Year	6.5	8.1	-1.6
Since Inception	8.4	8.7	-0.3

CAD	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	4.7	5.6	-0.9
1 Year	20.9	21.5	-0.6
3 Year	-4.5	5.3	-9.8
5 Year	2.7	7.7	-5.0
10 Year	7.2	8.8	-1.6
Since Inception	8.4	8.7	-0.3

AUD	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	2.1	3.0	-0.9
1 Year	12.5	13.1	-0.6
3 Year	-5.2	4.5	-9.7
5 Year	1.7	6.7	-5.0
10 Year	7.7	9.3	-1.6
Since Inception	8.4	8.7	-0.3

Annualised periods ended 30 September 2024. 3 Month & 1 Year figures are not annualised.
Inception date: 31 December 2009.
Figures may not sum due to rounding.
Benchmark is TOPIX.
Source: Revolution, Japan Exchange Group.
The Japan Growth composite is more concentrated than the TOPIX.

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 (%)	13.1	10.6	-27.6	3.2	10.1
Benchmark (%)	2.4	15.6	-13.5	15.1	10.7

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 (%)	18.6	15.4	-40.1	12.8	21.0
Benchmark (%)	7.4	20.6	-28.4	25.9	21.6

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 (%)	10.3	16.7	-29.1	4.4	14.8
Benchmark (%)	-0.2	22.0	-15.3	16.5	15.4

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 (%)	19.7	9.4	-35.0	11.0	20.9
Benchmark (%)	8.4	14.4	-22.4	23.9	21.5

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 (%)	11.6	14.5	-32.7	12.4	12.5
Benchmark (%)	1.1	19.7	-19.6	25.4	13.1

Benchmark is TOPIX.
Source: Revolution, Japan Exchange Group.
The Japan Growth composite is more concentrated than the TOPIX.

Stock Level Attribution

Top and Bottom Ten Contributors to Relative Performance

Quarter to 30 September 2024

Stock Name	Contribution (%)
Toyota	0.8
Rakuten	0.5
MonotaRO	0.4
Tokyo Electron	0.4
TOTO	0.4
Kakaku.com	0.3
Mitsubishi UFJ Financial Group	0.3
Sysmex	0.3
Kao	0.2
Recruit Holdings	0.2
SoftBank Group	-0.7
SBI Holdings	-0.5
DMG Mori	-0.5
Disco	-0.5
Rohm	-0.3
Murata	-0.3
Hitachi	-0.2
Mitsubishi Heavy Industries	-0.2
SMC	-0.2
Horiba	-0.2

One Year to 30 September 2024

Stock Name	Contribution (%)
MS&AD Insurance	1.6
Recruit Holdings	1.4
Disco	0.9
Toyota Motor	0.7
Rakuten	0.7
SoftBank Group	0.6
MonotaRO	0.5
NTT	0.4
Kakaku.com	0.4
Oriental Land	0.3
Rohm	-1.2
Hitachi	-1.1
Shiseido	-0.6
Mitsubishi Heavy Industries	-0.5
Kubota	-0.5
SHIFT	-0.5
Mercari	-0.4
M3	-0.4
freee K.K.	-0.4
Unicharm	-0.4

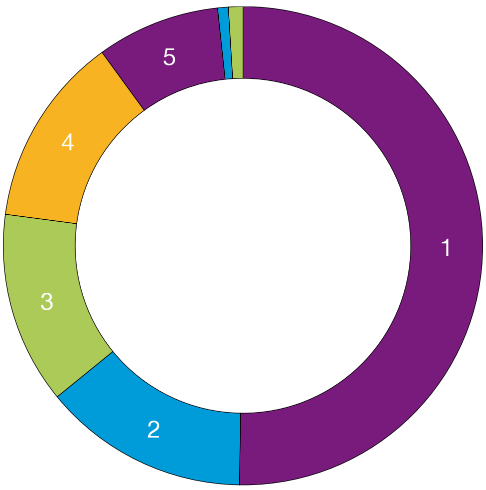
Source: Revolution, Japan Exchange Group. Japan Growth composite relative to TOPIX.

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
SoftBank Group	Telecom operator and technology investor	5.4
Sony	Consumer electronics, films and finance	4.9
Recruit Holdings	Property, lifestyle and HR media	4.6
Keyence	Manufacturer of sensors	4.3
MS&AD Insurance	Japanese insurer	3.7
Sumitomo Mitsui Trust	Japanese trust bank and investment manager	3.7
SBI Holdings	Online financial services	3.4
Rakuten	Internet retail and financial services	3.2
Murata Manufacturing	Manufactures and sells ceramic applied electronic components	3.0
Kao	Manufacturer of household products	2.4
Total		38.6

Sector Weights



		%
1	Manufacturing	50.2
2	Services	13.9
3	Transport And Communications	13.0
4	Finance & Insurance	12.9
5	Commerce	8.3
6	Real Estate	0.7
7	Cash	1.0

Figures may not sum due to rounding.

Voting Activity

Votes Cast in Favour		Votes Cast Against		Votes Abstained/Withheld	
Companies	2	Companies	None	Companies	None
Resolutions	17	Resolutions	None	Resolutions	None

Company Engagement

Engagement Type	Company
Environmental	Kakaku.com, Inc., Kubota Corporation, MS&AD Insurance Group Holdings, Inc., Sony Group Corporation, Sumitomo Metal Mining Co., Ltd.
Social	Amvis Holdings, Inc., Sony Group Corporation
Governance	GMO internet group, Inc., Kakaku.com, Inc., Keyence Corporation, Kubota Corporation, M3, Inc., MIXI, Inc., MS&AD Insurance Group Holdings, Inc., Mercari, Inc., Mitsubishi Estate Co., Ltd., Nakanishi Inc., OMRON Corporation, Olympus Corporation, ROHM Co., Ltd., Shiseido Company, Limited, Sony Group Corporation, Sumitomo Metal Mining Co., Ltd., Tokyo Electron Limited
Strategy	GMO internet group, Inc., Nakanishi Inc., Olympus Corporation

Company	Engagement Report
Kubota Corporation	Objective: As a major supplier of large equipment for construction and agriculture, Kubota can influence the decarbonisation of two materially carbon-intensive industries. This could ultimately be a competitive advantage for the company driving future growth opportunities. We engaged to learn about the company's ambitions for its decarbonisation pathway, including both challenges and opportunities. Discussion: Kubota described the company's roadmap for investments to convert fossil fuel-based industrial heat processes into electric alternatives and substantially reduce the company's operational carbon footprint. Doing so will enable the company to meet its near-term target for decarbonisation, which aligns with the ambitions of the Paris Agreement. However, the company's scope 2 emissions reductions largely depend on the pace of decarbonisation of the Japanese power grid. The company has a very substantial supply chain carbon footprint - both upstream and downstream. The upstream is mainly due to the significant emissions from the supply of Japanese steel to Kubota's manufacturing operations in Japan. Again, the pace of decarbonisation is largely outside of Kubota's control, and the company didn't provide much confidence regarding industry initiatives or ambitions to align with the Paris Agreement. The downstream emissions are from the sale and usage of Kubota's portfolio of predominantly fossil fuel-powered equipment (mostly tractors, excavators and diggers). The company is gradually expanding its product offering to include non-fossil alternatives, such as hybrid, battery-powered, and even hydrogen-fuelled. However, these costly alternative products' adoption is currently incredibly low. With the battery-powered alternatives, the problem is the lack of rural charging infrastructure and the fact that existing technology can only operate for a maximum of three to four hours before recharging - not great for productivity on either a construction site or a farm! Outcome: Kubota faces several challenges with decarbonisation - the company's direct and indirect emissions footprint. The company has determined a credible pathway to reduce the emissions from its operations, but Kubota is also heavily dependent on both the Japanese government and the Japanese steel industry to reduce its indirect emissions materially. Furthermore, as the business pivots towards developing markets to grow its agricultural sales, selling low-emissions alternatives to diesel engines will become increasingly challenging. Consequently, Kubota's decarbonisation will likely remain an engagement priority as we continue to build our knowledge and understanding of the company's progress.

Company	Engagement Report
MS&AD Insurance	Objective: We initiated a meeting with the general insurer, MS&AD, following research which flagged the potential physical risks of climate change to the company's long term returns. We met with members of the investor relations and sustainability team to understand MS&AD's approach to integrating climate scenario analysis into its underwriting and asset management practices. The discussion aimed to provide an introductory assessment of MS&ADs approach and integration of climate scenario analysis as a tool to mitigate climate risk. Discussion: The meeting started by discussing MS&AD's process for developing climate-related scenarios, which included frameworks such as the UNEP Financial Initiative and tools from the World Resources Institute. The assessment had initially focused on flood risk and typhoon impacts, but as it increased its data coverage, it was looking to integrate other impacts. The meeting covered some of the challenges faced during the scenario analysis, including the uncertainties of climate change impacts and the extensive data requirements. There are ongoing efforts to improve the quality of data to enable more precise scenarios, which would provide more value to underwriting and asset management teams. We also covered the governance mechanisms that enabled the outputs of this analysis to be shared between different divisions and discussed at the board level, however, the challenges of data relevance and quality were recurrent themes. The meeting concluded with reflections on the ongoing relevance of scenario analysis and plans for understanding and mitigating climate change's impacts on the insurance business. Outcome: The meeting provided insight into MS&AD's approach to integrating climate scenario analysis into its operations. It highlighted the firm's initiatives and challenges in adapting to and mitigating the risks posed by climate change. We communicated our supportive approach to future engagements on this and look forward to further meetings to discuss progress on data quality and coverage.
Olympus	Objective: We were invited to present to Olympus' management and board of directors. The purpose was to share our expectations for Olympus, focusing on long-term growth prospects and addressing potential risks. This session included a presentation followed by a Q&A, aiming to provide Olympus with insights from an investor's perspective. Discussion: The discussion covered 3 key areas. First, we shared our long-term growth expectations for the company, providing a description of how we anticipate that by focusing on operational efficiencies and market expansion, Olympus can elevate its operating margins significantly. Given the starting valuation, achieving these expectations should result in attractive returns for our clients and outperformance in both Japanese and global markets. Second, we shared some short-term goals that we believe could help Olympus achieve these long-term goals. These included focusing on resolving any final quality assurance concerns raised by the FDA and focusing on market share expansion. Third, we stressed the importance of balancing profitability targets with the need to reinvest in research and development and business development to safeguard the long-term health of the business. Lastly, we reflected on our experience holding Olympus shares on behalf of clients over the long term. We shared that we are supportive of efforts to enhance production efficiency, improve quality, and simplify the business to avoid unforced errors and execute on the large opportunity set. Outcome: The meeting was valuable for articulating our long-term expectations for Olympus. It underscored the importance of being a long-term, supportive shareholder and provided a constructive step towards enabling Olympus's global competitiveness. The meeting established key milestones for assessing progress in subsequent discussions with senior management.

Votes Cast in Favour

Companies	Voting Rationale
Mercari Inc, freee K.K.	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	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.
Tokyo Electron	Tokyo Electron is a Japanese manufacturer of semiconductor production equipment. It specialises in the areas of semiconductor etching, deposition and wafer cleaning, where it has maintained high market share positions for many years. We believe that a combination of long-term underlying growth in the semiconductor market (driven by demand from increasingly broad end markets for chips) and Tokyo Electron's strong market positions will result in many years of profitable, cash-generative growth. This year, the semiconductor production equipment market has started to recover, but the shares have been weak reflecting concern over the dependence on China. Whilst aware of this, we believe this is also discounted and provides an attractive entry point to buy a holding in this long-term growth business.

Complete Sales

Stock Name	Transaction Rationale
BASE	BASE builds digital infrastructure for SMEs to enable commerce across physical and online store fronts. Originally purchased for funds during the pandemic, we saw attractions in Japan's low but growing penetration of online service and BASE's established position among SMEs. However, some of this proved harder than expected to monetise and competition also intensified, leading BASE to shift its attention towards payment systems, another highly competitive area. Whilst some momentum was restored after a post-Covid lull, we were concerned that the opportunity could be smaller and the landscape more competitive than originally envisaged. We therefore decided to sell the holding to invest in other, more resilient businesses.
TOTO	We sold the holding in TOTO, a manufacturer of luxury bathroom equipment, after a period of relative strength in its share price which was largely driven by product price increases in Japan. While we believe this shows the strength of its brand in its domestic market, we are less confident of its brand power in overseas markets, in particular in Europe and the USA, which have been promoted, ahead of China, to be the focus areas of growth for the company over the coming years. We took the opportunity to exit our investment in this period of relative share price strength.

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