



Baillie Gifford Japan

Matthew Brett: Growth stocks are available at value stock multiples in Japan...

Update

12 January 2024

Overview

Over the last year, Matthew Brett, manager of Baillie Gifford Japan (BGFD), has responded to his growth style being out of favour by leaning into his high-conviction ideas which have done poorly and building up gearing, reflecting his positive view on his portfolio's prospects after a sell-off has left them looking cheap, even though they are largely performing well.

Matt, with deputy Praveen Kumar, aims to find those companies in Japan with the best long-term growth prospects, setting himself the target of finding stocks which can at least double in five years. At times this strategy has produced exceptional **Performance**, but the environment for the last three years has favoured different styles of investment. The last three years have seen weak performance which the managers largely attribute to short-term factors. In their view, while cyclical companies have been in favour this year thanks to an improving macro outlook for Japan, the best long-term opportunities remain in areas of secular growth, particularly given Japan is likely to remain a low growth economy.

The portfolio typically owns plenty of businesses in technology, hard and soft, and in internet-related companies, although the managers find examples of what they are looking for in a broader variety of sectors. As internet-related companies have sold off sharply over the past two years they have been adding to these, and even buying back in to some former long-term winners of theirs which they had sold on valuation grounds (see **Portfolio**).

The conviction is evident in the decision to retain a high level of **Gearing**, with facilities being renewed over the summer. The **Discount** remains wide by historical standards.

Analyst's View

Investors are probably right to be sceptical when managers say they have high conviction in their portfolios: it is an unusually honest manager who will say the outlook is poor (although they do exist!). But when there is tangible evidence of the conviction being claimed, for example when the manager is committing to significant levels of gearing, we think investors should sit up and listen. This is the case with BGFD, for which Matt Brett has been happy to let net gearing rise and buy back into companies in the portfolio which have sold down. If sentiment is cyclical, then the current valuation of many of BGFD's companies seems unlikely to last, and there is the potential for strong returns. Added to this is the potential for returns from a narrowing discount, which is c. 11% at the time of writing.

It is important to note that this is a very active portfolio, and individual stock picks are likely to be crucial to returns. Companies like Softbank and Rakuten, both in the top ten, have idiosyncratic drivers of returns, while many of the companies are at a relatively early stage of development where the risks are higher and the range of outcomes wider.

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BULL

Strong long-term track record

Highly active approach which brings outperformance potential

Low OCF relative to peers

BEAR

Active share increases underperformance potential as well as outperformance

Structural gearing can amplify losses on the downside and volatility

Strength in the Japanese economy could lead to growth style remaining out of favour



Portfolio

Baillie Gifford Japan (BGFD) is managed by Matt Brett of Baillie Gifford's Japanese equities team. Their aim with BGFD is to identify those Japanese companies with the best prospects for sales and profit growth and invest in them for the long run. The rule of thumb is each company should be able to double in value over five years at a minimum, but in reality the team are looking out longer than that. Turnover tends to be around 10% a year, implying an average holding period of a decade, and there are a number of stocks that have been held for longer than that.

Typically, companies with higher-than-average earnings growth should be expected to trade on higher valuations than average, but following a sustained sell-off in growth stocks since 2021 (see **Performance**), this isn't really true for BGFD. Lots of businesses in the 40–70 stock portfolio, particularly those in the internet space, are trading at very low valuations compared to their long-term history. Overall, excluding Softbank (which by virtue of its structure has some complicated accounting), the average EV/ EBIT of the portfolio is below that of the Japanese equity market. Meanwhile, expected sales growth is above that of the market, even including Softbank. The gross margin / RoE for the portfolio is higher than that of the index, indicative of higher quality of earnings too.

Portfolio Characteristics

	FUND	BENCHMARK
Valuation		
EV to EBIT	15.5	14.7
Growth		
Sales 5Y Growth p.a.	6.8	5

Source: Baillie Gifford, as at 29/12/2023

Matt and the team argue this implies a great entry opportunity into their portfolio for long-term investors, and as such Matt has kept net **Gearing** consistently high in the portfolio and indeed higher over the year as the portfolio has fallen in price. Additionally, he has been adding to the stocks that have come off the most, where he believes the long-term prospects remain exceptional. In practice, this means internet-related businesses which have been out of favour. Historically, Japan has lagged Europe and the US in its adoption of the internet, and BGFD has had exposure to a number of companies which are benefitting from catch-up growth in delivering goods or services online. Examples in the portfolio include SBI Holdings, a provider of online banking, broking and insurance amongst other things, CyberAgent, which does gaming, advertising and other media, conglomerate Rakuten and investment company Softbank.

This has been an area of weak performance over the past year. The team acknowledge that some stocks have indeed had issues to work through, but argue that their long-term prospects have not diminished. For example, CyberAgent has seen a dip in earnings from the decline in sales of a hit computer game it published in 2021. This has coincided with a period of ramp-up in its media business, which is still so far loss-making. Meanwhile the company continues to invest in new tools for online advertising, in particular ways to harness artificial intelligence. The team think it has a long runway of growth ahead of it in all these spheres and so have stuck to their strategy of being long-term holders rather than trying to time cyclical entries and exits.

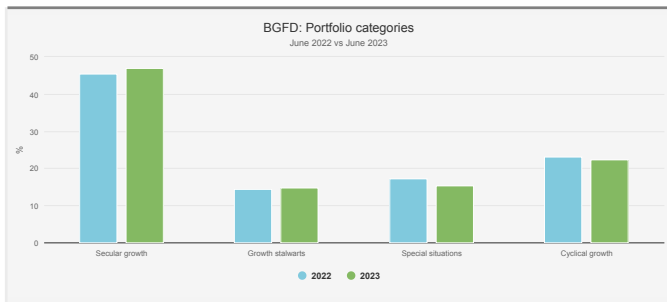
Another weak performer has been Rakuten. Rakuten, which delivers media online amongst other things, has invested substantially in establishing a mobile telephony network. This required investment, hitting profits, and although it has seen rapid growth in users to 6m, 10m are needed to break even. Again, the team think this investment will bear fruit over the long run, and continue to back the company to outperform. Rakuten has been added to in 2023 on weakness, while the team have bought back an old holding M3, a provider of medical services online, which had been sold in 2021 on valuation grounds.

As well as gearing, this has been funded by reducing the position in Itochu Corp. This is a trading conglomerate, and more of a value-tilted pick, that the team have held for a long time, thinking its growth would be cyclical but high over the years. As it has come into favour, the shares have appreciated while the higher-growth businesses have become much cheaper, justifying the switch.

The team classify Itochu as Cyclical Growth, one of the four categories they identify in their fund. Rakuten, SBI, CyberAgent and M3 all sit in the larger, Secular Growth category. There has been a slight move from the former to the latter over the year thanks to this valuation-led move. However, these moves have very much been at the margin, in keeping with the long-term approach of the managers which does not see many buys or sells in the typical year. Bridgestone, the tyre manufacturer, is another Cyclical Growth company to have been sold down, taking profits. The most notable company in the Special Situations category is Softbank. Softbank has not been a major detractor or contributor over 2023, but sold off markedly in 2021 and 2022. The team note it is now so cheap that its price implies no value to the business beyond the stake it owns in recently listed Arm Holdings. The company has had a rough period, but is now starting to look at new investments, having repaired its balance sheet, and the team remain admirers of the CEO Masayoshi Son and his record as an investor.



Fig.1: Portfolio Positioning



Source: Baillie Gifford

Alongside the internet, the other key themes in the portfolio are factory automation and ‘forever franchises’. The automation of factories has been one tool Japan has developed to manage the decline in its labour force. As Europe and China face a declining working age population too, there is an obvious driver behind potential global demand. FANUC and Keyence are the world leaders in manufacturing robots for industry. BGF’s exposure to hard, physical technology has tended to be in this area and in the industrials space rather than in the semiconductor-related names which were strong in 2023 as the market got excited about the potential for AI. However, there are a number of companies in the portfolio which are looking to bring AI technology to bear, including CyberAgent, which has developed the first language learning model based on Japanese characters.

The Forever Franchises theme includes companies like gaming company Nintendo and Shiseido, a premium skincare company that has a strong position in China. This theme captures those companies whose brand is a major strength and driver of exceptional earnings growth potential.

There are a handful of pre-profitable companies in the portfolio, such as Demae-can, Japan’s leading food delivery service, and accountancy software provider freee. Both have been growing sales at 50% annualised, in Demae-can’s case for over five years, which the team think more than justifies an investment at current prices. There are no unlisted companies in the portfolio, unlike some other Baillie Gifford strategies.

Matt argues that the current favouring of cyclical companies in Japan is unlikely to last and has led to the dramatic undervaluation of companies with idiosyncratic drivers of secular earnings growth. Many of these have growth drivers in factors specific to Japan, such as the early stage of internet penetration or the aging population. In a lot of cases, he argues, growth companies are now available at value company multiples. On the ground, he says companies the team are meeting with are generally reporting good news operationally, which is reassuring.

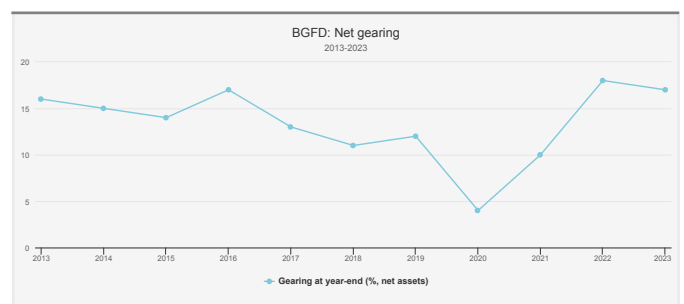
There haven’t been many companies in the internet space reporting a slowdown in business post-COVID, which speaks to the early stage of the internet story. As a result, the team are sticking with the approach that has brought them long-term success, and remain convinced it will bring success once more. If anything, they report the opportunity set for their strategy has grown broader and more attractive.

Gearing

Matt has leaned into gearing as the portfolio has sold off, reflecting his conviction in the fundamental strength of his companies and the even more attractive returns he expects from lower valuations. The chart below shows how he has used gearing strategically, reflecting his view on the opportunity set. As such, over 2020, when growth stocks rallied sharply, he cut gearing down to just 4% at year-end. Over 2021 and 2022, as the portfolio sold off he added back gearing, and as of the end of the 2023 financial year it was c. 17% net of cash, in line with the level one year ago. Since then it has ticked up to 19% as of the end of November, thanks in part to a slight decline in the NAV.

As gearing has been raised, it has generally been invested into the stocks the managers believe are most attractively valued having suffered the most in the sell-off, including internet-related names. Gearing increases the potential returns in a rising market, but it also brings more exposure to a falling market.

Fig.2: Net Gearing



Source: BGF

In August 2023, the board entered into a new two-year floating rate facility for 15bn Yen, 2.8bn more than the facility that was replaced. There is also a floating rate facility that matures in 2024. Together, these equated to c. 17.9% of net assets as of the end of the financial year in August. There is also a revolving credit facility which can be used flexibly. Loan covenants restrict gearing to a maximum of 30% of NAV.

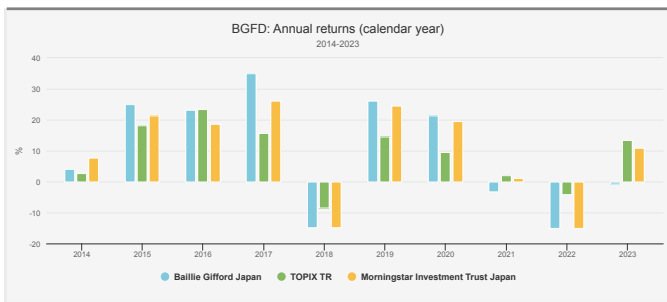


Performance

BGFD has a strong long-term track record. Over the ten years to 05/01/2024, the trust generated a NAV total return of 122.3%, which compares to 117.1% for the Topix Index. The average return for the four trusts with a ten-year track record was 125%. One of the best periods for returns came in the immediate aftermath of the start of the pandemic. In 2020, the market looked to technology-related companies which benefitted from remote working and offered the ability to consume goods and services without human contact. Growth companies, particularly those at an early stage, were helped by central banks cutting already low interest rates to the floor, which supported companies with expected cash flows further into the future. Additionally, the trust did particularly well in 2017 when e-commerce was strongly in favour in global markets.

However, the trust has struggled since early 2021. In that year the reopening of economies after the pandemic led to a rush into value stocks and away from perceived COVID winners. In 2022, high inflation and rising interest rates led to a sell-off in growth stocks globally. As the below chart shows, historically, BGFD has tended to outperform in years in which the market has rallied, but this pattern was broken in 2023. Cyclical companies have outperformed in Japan, and this has seen BGFD's growth-heavy portfolio underperform.

Fig.3: Returns



Source: Morningstar

Past performance is not a reliable indicator of future results.

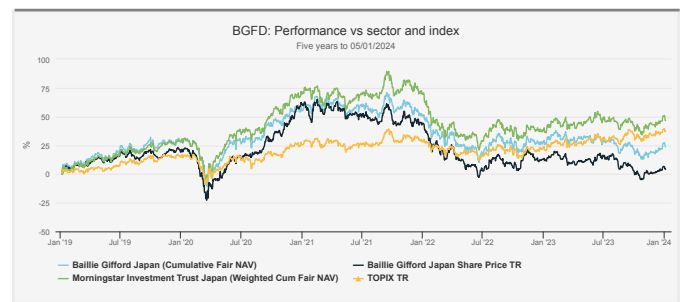
As discussed in the **Portfolio section**, 2023 saw BGFD's high growth portfolio sink onto low valuations, with the portfolio ex Softbank being cheaper than the index, which is the opposite of the ordinary state of affairs. The outperformance of cyclicals has been due to a handful of reasons: first, Japan released the last of its pandemic restrictions in late 2022, leading to hopes of a reopening surge in economic growth. Secondly, inflation has been above target in Japan, opening the possibility that monetary policy will tighten and Japan will escape the zero interest rate state in which it has been stuck for many years. Ongoing corporate governance reforms have also

led to interest in cheap Japanese companies in the hope they will return cash to shareholders and/or improve operational performance. Beyond stylistic factors, Matt highlights that the portfolio is more invested in capital-light software and e-commerce businesses, or others operating via the internet. These underperformed in 2023, while hardware outperformed.

Matt argues that the outperformance of cyclicals is unlikely to persist for long. Japan has previously had periods of optimism as inflation has surged, but these have all been short-lived, and he argues the conditions to see 'regime change' and structurally higher inflation are not there. Additionally, many of the outperformers in the recent period have been beneficiaries of a weak Yen, which has plummeted in value versus the dollar and many other currencies. As currencies tend to mean revert over time, this seems likely to be a relatively short-term driver. On the other hand, Matt believes the superior forecast earnings growth of the businesses in the portfolio should be a more dependable driver of enduring returns. In fact, as discussed in the **Portfolio section**, he has been adding to the stocks in the portfolio which have sold off the most, in particular companies focused on the internet.

The NAV total return over five years has been 23.7%, compared to 37.5% for the Topix Index and 46.4% for the Morningstar Japan sector average.

Fig.4: Five-Year Performance



Source: Morningstar

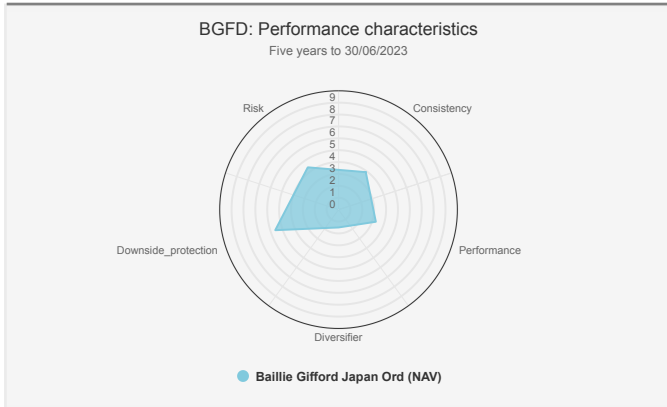
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At its best, when markets are in its favour, the strategy behind BGFD has been volatile but delivered strong returns in rising markets. Thanks to weak relative performance since 2021, BGFD has trailed the peer group substantially over five years. The KT Spider chart below reflects this, with an alpha score below average and a risk score also below average, reflecting higher volatility. BGFD also scored low for diversification, which is measured by correlation against the Japanese equity market, global equities and global bonds. This makes sense given that its high-growth style has been correlated to bonds over most of the period, and led markets until 2023. All these metrics are backwards-looking, of course, and we note that while



the diversification and risk scores have been relatively stable, the performance scores have moved thanks to recent poorer performance and could equally shift again should market sentiment shift.

Fig.5: Performance Characteristics



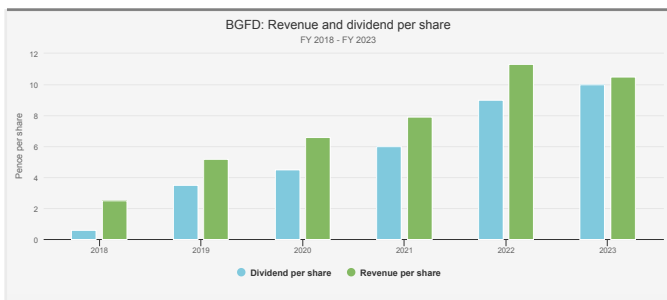
Source: Morningstar, Kepler calculations

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Dividend

BGFD aims to generate capital growth and, reflecting this objective, costs are charged to the income account, reducing funds available for distribution. There is no progressive dividend policy, although in practice the distribution has grown steadily in recent years. The board has recommended a dividend for the 2023 financial year of 10p per share, up 11.1% from the 9p paid in 2022 and 60% on the 6p paid in 2021. While this is substantial year-on-year growth, the prospective yield still amounts to just 1.4%, as at the time of writing, so the trust is unlikely to appeal to income-seekers.

Fig.6: Dividend Per Share



Source: BGFD

Management

BGFD's lead portfolio manager is Matt Brett. Matt is a partner of Baillie Gifford, having joined the company in 2003. He was appointed co-manager alongside Sarah Whitley in 2008, and took over lead management responsibilities when she retired in 2018. He is also lead manager of the Baillie Gifford Japanese Fund and

co-manager of the Baillie Gifford Japanese Income Growth Fund. Furthermore, he is a member of the Global Stewardship Portfolio Construction Group. Matt is supported by deputy manager Praveen Kumar, who was also appointed to that role in 2018. Praveen also has a long tenure with Baillie Gifford, having joined in 2008. Praveen is lead manager of the Baillie Gifford Shin Nippon trust, a small-cap, growth-focused Japanese equity strategy.

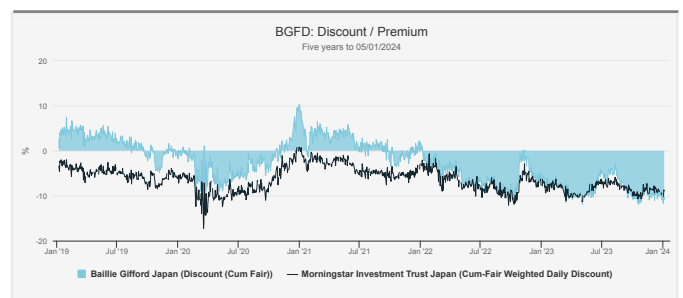
Matt and Praveen work within a team of ten investment managers in the Japan team. Baillie Gifford makes a conscious effort to ensure that its teams reflect a diverse set of backgrounds to ensure independence of thought and that a variety of opinions are brought to the table. In addition to the ten managers, Matt and Praveen benefit from the work of an ESG analyst focused on Japan and two research consultants based in Tokyo who effectively work as investigative researchers for Baillie Gifford. Baillie Gifford's partnership structure is designed to encourage long-term thinking by its managers by removing the incentive to focus on short-term goals to satisfy the markets.

Discount

Discounts widened across the board in 2023, and BGFD has been no exception. At the time of writing its discount is 10.8%. While BGFD's style has been out of favour for a couple of years, it is interesting to note that the shares were trading close to NAV in October 2022 when there was more optimism in markets, which to us suggests demand for its shares could return quickly if performance does.

In Q4 2022, markets focused on the potential for a rebound in China as it reopened post-pandemic, while Japan too was releasing the last of its travel restrictions. While Japan has seen a decent recovery, China has disappointed. Additionally, higher interest rates in key global markets have seen many investors take flight from risk assets. BGFD has traded at a premium for significant periods in the past when risk appetite was high. While there can be no guarantee this will recur, we do think there is value in the current discount, which is wider than the sector average of 8.7%.

Fig.7: Discount



Source: Morningstar



The board has been buying back shares, which could be expected to support the discount or at least improve the NAV per share. Over the year to the end of August 2023, the board bought back c. 0.9% of the shares in issue at the start of the year, and from then until the end of October bought back a further 1.2%. It also has the authority to issue shares and has stated it will do so only when they trade at a premium to NAV. There is also an annual continuation vote.

Morningstar has assigned BGFJ a sustainability rating of below average relative to its wider Japanese equity peer group. It likely won't satisfy purists on ESG. However, we believe that the long-term view taken on sustainability issues could make it appealing to investors who want to contribute to improvements in society's environmental and social problems. We note Matt has managed sustainability-focused funds in the past.

Charges

BGFJ's latest ongoing charges figure (OCF) is 0.67%, calculated at the end of August 2023. This is cheaper than the 0.86% average for Japan trusts, according to JPM Cazenove. The annual management fee is 0.75% on the first £50m of net assets, 0.65% on the next £200m of net assets and 0.55% on the remaining net assets, calculated and payable quarterly. With net assets standing at £790m, as at the end of October 2023, we estimate the management fee to be c. 0.59% on an ongoing basis. The management fee is charged to revenue, reflecting the growth focus of the trust, and there is no performance fee. The latest KID RIY is 1.03%, which compares to an average of 1.38% for the sector, according to JPM Cazenove, although we caution methodologies may vary.

ESG

The managers have adopted a positive engagement approach to ESG. This means that they consider how ESG matters could impact long-term returns, but do not exclude investment in those companies whose record they consider poor. Rather they will look forward at companies which are improving or in which they can effect change and improve practices. Given their long-term investment horizon, the managers believe it is important to understand how each company is likely to be affected by existing and emerging sustainability issues, which can provide risks and opportunities to the ability to generate high returns into the future. A good amount of detail is given in the annual report on which companies the team have engaged with over the course of the year and on which matters, which transparency we think is highly valuable given investor wariness about 'greenwashing'.

While the trust does have a low carbon score from Morningstar, meaning its exposure to emitting companies is lower than the market's, Matt and the team will buy individual companies which contribute to emissions, like tyre manufacturer Bridgestone. Matt and his colleagues look for company management teams which are open to improvement and then aim to encourage positive change within their investments, believing this will lead to better returns for their shareholders.



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