Baillie Gifford Japan

BGFD's largest holdings are returning to form...

Update
20 November 2024

Overview

Baillie Gifford Japan (BGFD) is seeing its largest positions perform well as the Japanese market environment seems to be shifting back in its favour. BGFD is a long-term strong performer which has had a weak period of performance as the developed world struggled with inflation after the pandemic and interest rates rocketed higher. Over the last 12 months performance has been positive, and marginally ahead of the index, and both SoftBank and Rakuten, which together make up over 11% of the portfolio, have performed particularly well (see **Portfolio**).

BGFD is managed by Matthew Brett who aims to identify the best long-term growth opportunities in Japan, looking to find companies he believes can return at least 100% over five years. Turnover is low as Matthew invests for the long term, but in recent months he has been finding a number of new opportunities in secular, 'Warren Buffet' growth stories which have fallen onto highly attractive valuations amidst a period in which growth investing has been out of favour.

Matthew's conviction is demonstrated by the significant **Gearing** level he has been running for some time, and this stood at 15% on a net basis as of the end of September. In his view, the economic environment in Japan is likely to remain conducive to growth investing over the long run, with inflation and interest rates low and demographics forcing the country to generate productivity advancements to grow. While a lot of attention has been on the corporate governance story over the past two years, Matthew argues that this often leads to one-off or short-term boosts to company performance, and the more attractive stocks are those that can compound earnings growth over the long run thanks to innovation.

BGFD's shares trade on a wide **Discount** to NAV of 10.8% at the time of writing.

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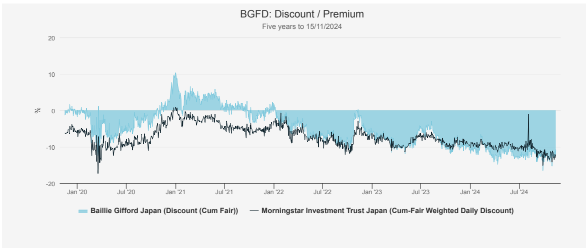
Key Information:

Price (p)	703
Discount/Premium(%)	-10.8
OCF (%)	0.69
Gearing (%)	19
Yield (%)	1.4
Ticker	BGFD
Market cap (£)	595,846,026



Kepler View

A number of environmental factors seem to be turning in BGFD's favour. Japanese inflation has come down over the past year, meaning that rising rates in the country seem less likely, while rates in other developed markets are falling. The global GDP outlook has slowed, meaning that company-level earnings growth is arguably more attractive, while technology has reemerged as the main driver of productivity growth and innovation in stock markets. However, we think the most encouraging developments over the past year are at the stock level, with some of BGFD's largest and longest-held positions performing well operationally and in share price terms, having weighed on performance in 2022 and early 2023. Given how active BGFD is versus the index, and that it is relatively concentrated at the top of the portfolio, single stock factors are important to the outlook. In that light, SoftBank's return to form and heavy investment in the AI industry is particularly promising.

We think there are clear signs that a period of poor performance is over, and the trust has the potential to perform very well again in the future, while the shares trade on a wide discount. That said, BGFD is clearly a risky proposition due to its strong style bias, active nature, and significant gearing, and we think investors should consider these risks carefully.

BULL
Strong long-term track record
Highly active approach which brings outperformance potential
Low OCF relative to peers

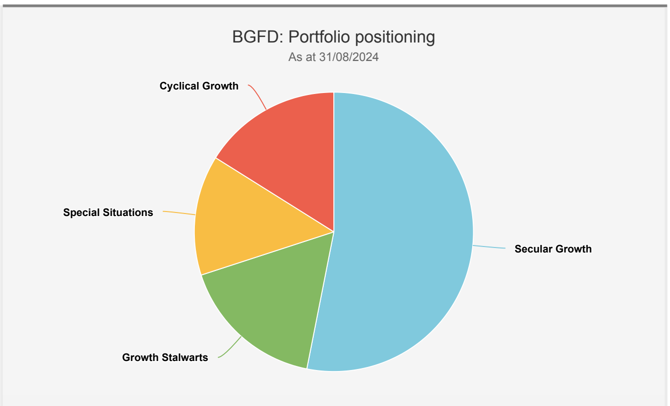
BEAR
Active share increases underperformance potential as well as outperformance
Gearing can amplify losses on the downside and volatility
Economic conditions could lead to the growth style remaining out of favour

Portfolio

Baillie Gifford Japan (BGFD) aims to outperform by identifying companies with the best sales and profit growth prospects, targeting returns of at least 100% from each position over rolling five-year periods. The trust is managed by Matthew Brett of Baillie Gifford's Japanese equities team and deputy manager Praveen Kumar. Matthew and the team take a highly active approach, starting with a blank sheet of paper rather than a list of index components, and set out to look for companies which can grow much faster than the market over the long run. Five years is the minimum time frame the team look out over, but they are ideally looking for longer duration opportunities than this, and as of the end of the last financial year in August, 45% of the portfolio was invested in companies that had been held for over a decade, and a total of 65% in companies held for over five years. The portfolio typically has a very high active share, which was 85% at the end of September. This means there is only c. 15% overlap between their portfolio and the Topix Index, which serves as the benchmark.

The portfolio can be broken down into four categories. These reflect the sorts of companies the team end up investing in rather than the categories they have targeted, but they are informative. Just over half the portfolio is in secular growth stories, which refers to companies with a long growth runway but where the outcomes are uncertain—typically this could mean companies forging new markets or innovating a new product. Growth stalwarts are steadier growth companies, more mature businesses which have highly attractive internal economics which means they should be able to compound high levels of growth year-on-year. Special situations are companies which have fallen on harder times but where the team think the long-term outlook is outstanding, while cyclical growth companies are those which are mature and have more economic sensitivity, so while their compound growth rates should be high, they are expected to wax and wane with the business cycle.

Fig.1: Growth Categories



Source: Baillie Gifford

Given the low turnover management style, change in these allocations is gradual. However, over the past five years, there has been an increasing amount invested in growth stalwarts. This category has grown from 9.4% of the portfolio at the end of the 2020 financial year to 16.9% as of the end of 2024. This reflects the fact that the valuations implied by market prices to these companies have plummeted. Typically, high-quality growth compounders are prized by many investors, and the share price reflects a high multiple of earnings or sales. However, in high inflation, high-interest-rate environment, and during which period investors have feared a serious recession, growth equities have been derated and Matthew has been able to add to some at attractive valuations. A good example is Kose, a skincare company with a growing position in the ever-growing Chinese market. Matthew added the company to the portfolio this year after its valuation fell from › 50 times earnings to a rating in the 20s. He likes the strong brands the company owns and views it as short-termist, the concerns about China's immediate GDP growth which he thinks have hit the stock. BGFD already held Shiseido, another skincare company with greater China and travel exposure, and it was a poor performer over the financial year ending in August as China concerns hit the stock. Matthew thinks the longer-term structural growth opportunity remains intact and believes margins will recover to pre-COVID levels.

Nippon Paint and Kansai Paint are two other new additions in this category in FY 2024, out of a total of six new buys for the year. Nippon Paint is the biggest provider of decorative paint in China, while Kansai Paint has a strong position in automotive paint in India, two of the most exciting paint markets in the world where the team see high volume growth in the years to come. They note that in the paint industry, incumbency, distribution, and brand matter, and both these companies have highly advantageous positions in their fields which adds to the growth potential from a growing market.

These three stocks play on the structural growth trend in the global middle class which has been hit by short-term macro concerns. Arguably new addition Daikin does too, although it sits within the secular growth category. Daikin is a global leader in the air conditioning and heat pump markets. The team view it as a likely winner from concerns about climate change and this shift to more efficient and environmentally safer aircon units within the developed world, as well as growing wealth levels in the emerging markets where air conditioning is often highly desirable. It was another bought-on share price weakness. The team also added dental drill manufacturer Nakanishi over the 2024 financial year, a company which is seeing strong growth in the US market. Pharma stock Eisai was also bought, the manufacturer of a drug called Leqembi which uses innovative science to treat Alzheimer's. The drug has proven its effectiveness, meaning there is a huge potential market globally, with cost being one immediate stumbling block to its adoption.

The new positions give a good sense of what the team is looking for, but the long-term holdings that sit at the top of the portfolio are much more important to determining the returns of the trust and its outlook. Here the news has been very positive over the period, which Matthew and the team view as very encouraging for the trust's prospects.

Top Ten Holdings

RANK	COMPANY	% OF TOTAL ASSETS	GROWTH CATEGORY	HELD FOR
1	SoftBank Group	6.4	Special situation	> 10 years
2	Rakuten	5.0	Secular growth	> 10 years
3	Sumitomo Mitsui Trust	4.2	Cyclical growth	> 10 years
4	SBI Holdings	3.6	Secular growth	> 10 years
5	Calbee	3.2	Growth stalwarts	< 5 years
6	Sony	2.9	Special situation	> 10 years
7	GMO Internet	2.8	Secular growth	> 10 years
8	FANUC	2.6	Secular growth	5 - 10 years
9	CyberAgent	2.6	Secular growth	> 10 years
10	MIXI	2.4	Special situation	5 - 10 years
	Total	**35.7**		

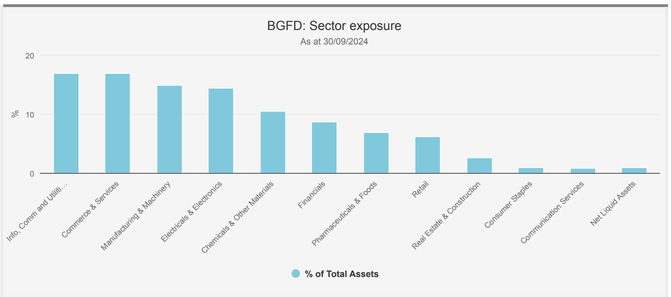
Source: Baillie Gifford, as of 30/09/2024

SoftBank Group, the largest position in the portfolio, has performed well over the past year and is up 33% since the IPO of ARM in September 2023. The IPO was successful, with ARM shares doubling since its flotation. ARM is exposed to the AI boom, providing key architecture behind its implementation on mobile devices and working in partnership with NVIDIA on data centres. The IPO is a clear demonstration of value within the SoftBank portfolio and one of the reasons Matthew and the team like the stock is what they view as its profound cheapness. They estimate the shares trade at about a 55% discount to a sum of the parts valuation. The leverage in the stock has fallen, while management claims there are signs the IPO market might be returning. SoftBank also continues to invest heavily in AI companies, including OpenAI, the creator of ChatGPT, and Matthew views it as a great way to get discounted exposure to such a theme.

Rakuten is another critical stock for the portfolio which has had a good year. Rakuten is behind Japan's largest online ecosystem, with 70 online fintech and e-commerce services. In a way, Rakuten could be viewed as an amalgamation of Japan's Amazon, American Express, Booking.com, and many others. Its decision to invest heavily in establishing a new mobile network was viewed with scepticism by the market, and this business contrasts with its usual capital-light activities. However, Matthew sees it as complementary to the company's ecosystem of services, and as the subscriber base has risen over time, the market has become more interested in the shares. Matthew notes incumbents in the mobile provider sector enjoy mid-teens profit margins, making it an attractive business in itself. Despite a strong rally over the past year, Rakuten's shares still trade at a far cheaper price to sales than the market.

CyberAgent is another long-term holding to have had a recovery year. The company does gaming, online advertising, and on-demand online media although its shares have not risen by as much as SoftBank or Rakuten. The company had seen earnings decline after sales of a hit game slowed, but the stock has been buoyed by an improvement in its media business, where losses have continued to narrow. Given how active BGFD is, we think these promising signs in long-term holdings underlying businesses are very encouraging, but we also think they may demonstrate a trend. After a period of consolidation, the outlook for software, online, and e-commerce businesses seems to have improved, and this is a key theme in the portfolio. Japan's market classifications are a little mysterious, but the chart below indicates that information and communication, utilities, and commerce and services are the largest exposures, which reflects online and e-commerce businesses, while hardware exposure is reflected in high weightings to manufacturing and machinery, and electricals and electronics. Alongside the internet, other key themes in the portfolio include factory automation, exemplified by FANUC, and strong brands, or 'forever franchises', such as the cosmetics companies discussed above or Nintendo.

Fig.2: Sector Allocation



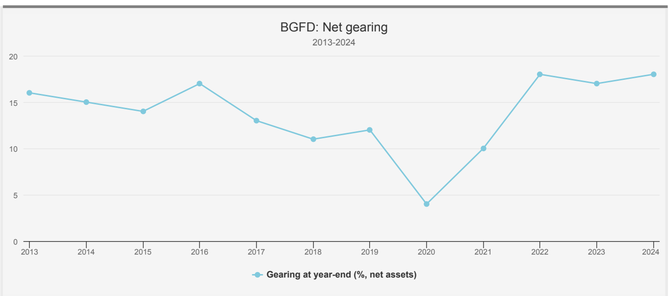
Source: Baillie Gifford

Corporate governance reform has been a popular theme for investors in Japanese stocks this year, and this has seen lots of lower growth, cheaper companies do well as they rationalise structures, buy back shares or distribute dividends. Matthew acknowledges there is plenty of low-hanging fruit in an inefficient corporate sector, but he argues the gains from corporate governance reforms are usually likely to be of relatively short duration. In his view, better returns are to be gained over the long term by finding companies which innovate or which have sustainable growth rates above those in the market. He looks for growth opportunities which aren't dependent on macro factors, even if the valuations of growth businesses are inevitably affected by changing interest rates in the short term. The team also argue that the good returns for cyclical and value businesses in the past few years were as much about an improving global economy and a weakening yen as corporate governance reform. With Japan's modest inflationary pressures seeming to subside over the past year, they view Japan's economy as fundamentally in a similar place as it was pre-pandemic: with low inflation, poor demographics, and a need for companies to innovate and improve productivity to drive long-term growth.

Gearing

The board argues that gearing should enhance long-term returns to shareholders, and BGFD has consistently held significant gearing in recent years. Matthew did reduce the exposure in 2020 as growth stocks rallied sharply but then brought levels back up to double digits over 2021 and 2022. In July 2024, the board agreed on new long-term gearing facilities at attractive rates. The debt matures in three tranches in five, ten, and fourteen years' time, and has a blended average interest rate of just 2.05%. Matthew can hold cash to offset the extra market sensitivity of the portfolio if he wishes but has been running gearing at high levels as he views the opportunity in growth stocks as particularly attractive. We note that gearing increases the potential returns in a rising market, but it also brings more exposure to a falling market.

Fig.3: Net Gearing

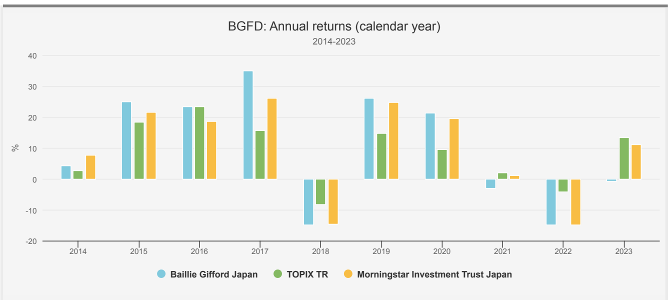


Source: BGFD

Performance

The last decade has really been a game of two halves for shareholders in BGFD. As the below chart illustrates, between 2015 and 2020, the trust was a stellar performer in both absolute and relative terms. However, since 2021, returns have been disappointing. Both 2022 (in a falling market) and 2023 (in a rising market) were tough years, and the upshot is that the trust has delivered NAV total returns ahead of the market over the past decade, but behind those of the market over the past five years.

Fig.4: Returns



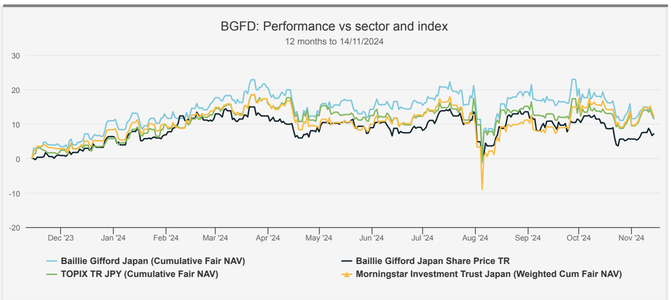
Source: Morningstar

Past performance is not a reliable indicator of future results.

This dramatic change in performance reflects a dramatic change in the economic environment. In 2022, we saw the fastest hiking cycle in US history as the Fed slammed on the brakes as inflation surged. Other developed world central banks had to follow suit. Compounding this were fears about the impact of higher rates on companies and economies. We'd argue that the reality has been much better than was feared, but it is certainly true that investors expected a significant impact on the real economy both in the US and globally. Higher rates impacted the valuation of growth companies, while pre-profit companies also began being treated with more scepticism. For BGFD the health of the Chinese economy can also be important, given its role as a trading partner for Japan, and China has struggled with its own issues through this period.

Encouragingly, returns over the past year have been much better, which may perhaps indicate that the big swing away from growth investing is over. Over the last 12 months, returns have been slightly more or less in line with the index and slightly behind the sector average, as the below chart shows. We think this is interesting, as the narrative around the Japanese market has focussed on the corporate governance reform story as a source of alpha, and investors have favoured this sort of strategy. BGFD's good performance has been powered by some of its largest positions which had been most out of favour during the lean patch, notably Rakuten (up 59% in local currency terms over a year) and SoftBank (up 41%). This contrasts with losses of c. 43% and c. 36% in 2022 respectively.

Fig.5: One-Year Performance



Source: Morningstar

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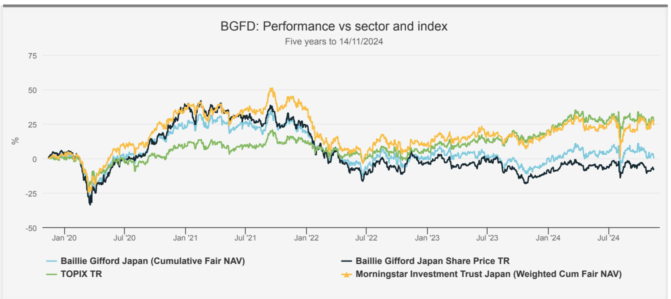
We think it is particularly encouraging that these stocks have been performing well operationally because they are concentrated positions in a very active portfolio. Given this nature, individual stock developments and prospects are very important for the trust, and we discuss both these positions in more detail above (see **Portfolio**).

That said, there are signs that the economic environment is becoming more suited to BGFD's strategy. Last year was a very good one for cyclical companies, which dominate the broader Japanese market, but BGFD's portfolio lagged. Matthew and the team view this strong performance as reflecting the cyclicality and economic sensitivity of the Japanese economy, stock market, and currency, which has long been noted. Japanese assets and the Japanese economy are highly geared to the strength of the global economy thanks to several structural factors. For one, the yen depreciated by 33% in 2023, which gave a huge boost to the earnings of Japanese companies in their domestic currency. However, as the global economy has slowed, the steam has run out of the Japanese market. In the team's view, many investors have confused these developments with more fundamental shifts in the drivers behind Japanese economics and markets. While the central bank has allowed rates to rise slightly, inflationary pressures remain low in Japan, and in the team's view were mainly driven by external factors: a weakening yen and global pricing pressure. In fact, they posit that the country is slipping back into a more benign inflationary environment so familiar from recent decades, which means interest rates are unlikely to rise much.

The corporate governance story has been another theme to have attracted investors in recent years, but Matthew and the team argue that buybacks, dividends, or divestments may bring one-off or short-term boosts to returns, but they make less attractive investment propositions than companies which can deliver high earnings growth year-on-year thanks to providing innovation or superior products. As such, they don't think it is going to be the prime driver of alpha over their long-term time horizon. They argue growth companies are attractively cheap after a period in which they were out of favour, and with the environment no longer working against them, the outlook is positive.

The chart below shows the NAV total return over five years has been 0.4%, compared to 27.4% for the Topix Index and 24.5% for the Morningstar Japan sector average. This compares to ten-year total returns of 144% to the end of September versus 133% for the benchmark.

Fig.6: Five-Year Performance

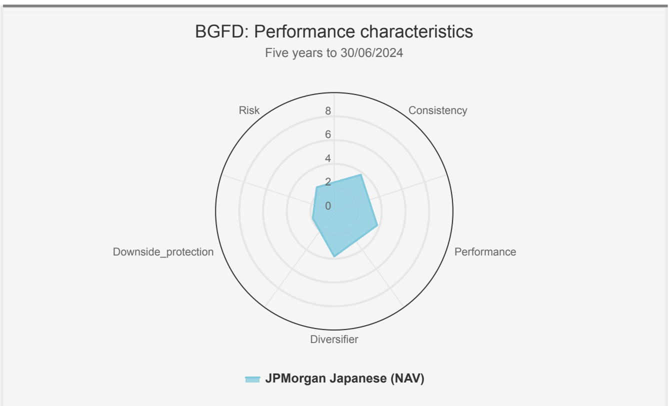


Source: Morningstar

Past performance is not a reliable indicator of future results.

The KTI spider chart below reflects this tough period of returns, 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 while the volatility may remain high thanks to the gearing, if the environment does shift back in favour of the strategy then they should improve over time.

Fig.7: Performance Characteristics



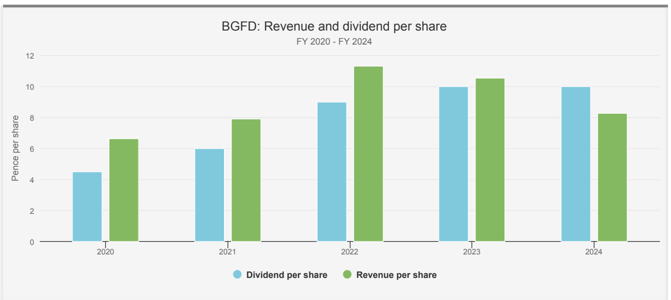
Source: Morningstar, Kepler calculations

Past performance is not a reliable indicator of future results.

Dividend

BGFD aims to generate capital growth and, reflecting this objective, costs are charged to the income account, reducing funds available for distribution as dividends. A single dividend is paid each year, and for the 2024 financial year, the board has recommended it be held at 10p. This equates to a historic yield of 1.4% on the current share price. Revenue per share fell in 2024, from 10.5p to 8.2p. One factor was a notable decrease in special dividends. The board has therefore decided to pay an uncovered dividend, but we note that the revenue reserves are worth c. 1.8 times the dividends proposed for 2024, while the board can also distribute a substantial proportion of the capital reserves should it wish to.

Fig.8: Dividend Per Share



Source: BGFD

Management

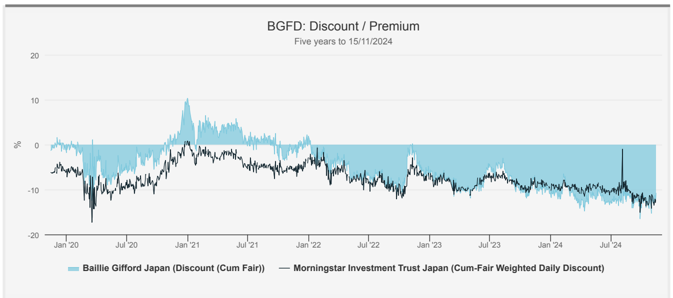
BGFD's lead portfolio manager is Matthew Brett. Matthew is a partner of Baillie Gifford, having joined the company in 2003. He was appointed co-manager in 2008 and took over lead management responsibilities in 2018. He is also the lead manager of the Baillie Gifford Japanese Fund and co-manager of the 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 the lead manager of the Baillie Gifford Shin Nippon (BGS), a small-cap, growth-focussed Japanese equity strategy and a founder member of the International Smaller Companies Team.

Matthew 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, Matthew and Praveen benefit from the work of an ESG analyst focussed 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

BGFD's discount has widened over 2024, along with the average discount in the sector. At the time of writing it stands at c. 11%. This has actually been a period of positive performance for Japan, and for much of the year, it was very much in vogue with investors. The domestic economy was strong enough to see the central bank allow rates to rise, albeit from depressed levels, while the corporate governance reform story was taking effect. However, in the summer, there was a period of sharp volatility in Japanese currency and equity markets, while a snap election was called, leading to the government losing its majority. We think this may have weighed on discounts in the sector in the short term. Another factor to consider is that discounts are generally quite wide across the investment trust sector. Higher cash and bond rates have likely led UK investors to keep less in the stock market, and this may be why Japan trusts were trading on an average double-digit discount early in the year when sentiment to Japanese markets was positive. We think that buying at such a wide discount can be an attractive way to generate alpha over the long term, although investors have to bear in mind that discounts may persist while the current economic conditions do.

Fig.9: Discount



Source: Morningstar

The board has allocated a substantial amount of capital to buying back shares, citing the benefits of providing liquidity and improving NAV per share. They repurchased c. 6% of the trust's share capital in the financial year ending 30/10/2024. There is also an annual continuation vote, and in the December 2023 AGM 91% of votes cast were for continuation.

Charges

BGFD's latest ongoing charges figure (OCF) is 0.69%, calculated at the end of August 2024. This compares favourably to the 0.81% average for the AIC Japan sector. Going forward, the trust will benefit from a small cut to the management fee. This is now 0.65% on the first £250m of net assets and 0.55% on the remainder. There was previously a higher fee of 0.75% charged on the first £50m. 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 0.96%. However, we note the regulation around KID RIYs is changing, and a consensus on how they should be calculated has not yet been formed.

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 in the future. We note Matthew has managed sustainability-focussed funds in the past.

Morningstar has assigned BGFD a sustainability rating of three out of five globes average relative to its wider Japanese equity peer group.

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