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[INTRODUCTION]
Darius McDermott (DM): Welcome to the Investing on the go podcast by FundCalibre, I'm Darius McDermott and I'm delighted to be joined today by Matthew Brett, manager of the Baillie Gifford Japanese fund and the Baillie Gifford Japan Investment Trust. Matthew, thank you so much for joining us today.

Matthew Brett (MB): Thank you Darius.

[INTERVIEW]
[0:21]

DM: I always find Japan fascinating. It's a really interesting market, not just on a stock level but also at a country level. And I'd like to talk to you about firstly about a couple of themes, which I know were on your thinking last year, the first one is internet and then secondarily, factory automation. Maybe if you could tell us, in a bit of detail, about some of those things please.

MB: Yeah. So as you say, those are the two biggest themes in both portfolios and a quarter of the portfolio is roughly in internet-related businesses and another about 15% are in the factory automation and robotics areas. We think that these are two really exciting growth themes for the future.

On the internet area, it seems to us that it's been a huge progression over the years from the internet being based on desktops to the mobile internet.

DM: Yeah.

MB: And what we can do now the internet is on smartphones, is so much bigger and more disruptive than than it used to be. And so we still see very big opportunity there. And then on the robotics area, what's so exciting for us is how robots are being used beyond the car industry and the electronics industry. How they can be used in many different ways and I think what's held robots back has been the difficulties with controlling them, the difficulty with the autonomy of the robots. But the improvements in machine vision and AI make using robots a lot more widely than they've been used.

DM: Because presumably there's lots of input parts into the robots for which are another investment opportunities that you think you might look at?

MB: Yeah, you're absolutely right, and one of the real strengths of the Japanese is in the component manufacturing.

DM: Yes, that's correct.

MB: And that is something that of all the things the Japanese do very well, that absolutely high precision manufacturing. So yes, those two themes of the internet and robotics are, as they were last year, the two big themes in the portfolio.

[2:23]

DM: And do you see that continuing for a while? I mean I know you like to play secular growth themes, they've still got some legs to run or have some of them got a bit hot on a valuation type basis?

MB: Yeah, I mean I think both of them are themes that it seems highly likely they're going to be in the portfolio for a long time period because I think that's really where the growth opportunities are. And I think when we consider how little we change the portfolios from year to year and both the [Baillie Gifford] Japanese fund and the [Baillie Gifford] Japan Trust had turnover of under 15% last year.

DM: So not much. That's quite low in an industry standard.

MD: Yeah. What that means is 85% of the portfolio this year is the same as it was last year. And the reason we do that is because where we've got these companies that we think can grow over the long term, we don't want to fiddle around with that we just want to let those companies continue to do the growing and to benefit over time from that growth.

[3:25]

DM: And is there a robotic name or a stock on the robotic side that we may have heard of or that you find most interesting?

MB: Yeah, so we hold a variety of different names in that area, but some of the names are FANUC and Yaskawa Electric. These are two of the very biggest robot companies globally. I think what's interesting about robots is that there's only kind of a couple of handfuls of robot stocks globally. About half of those are listed in Japan. And there's also other automation related stocks that are exciting. So things like SMC [Corporation], which makes pneumatic valves or Keyence, which is effectively a consultant for automation.

So there's quite a number of ways in which we play at this broad theme, but it's definitely one that that's fairly exciting. And I think, as a whole, you can see it's an easy sale outside of Japan when the Japanese come and they say “well would you like to be able to manufacturer things to a Japanese quality standard?” Then people are very much bought into that and happy to invest in those areas.

[4:33]

DM: And another topical stock and actually I believe your biggest position is SoftBank. Tell us a bit more about SoftBank. I know at a headline rate it invests in other businesses, technologies and newer startup companies. It's your biggest stock, what's to like about it?

MB: Yeah and also it's not just our biggest stock, but it's been our biggest generator of headlines over the past year with [its investment in] WeWork in particular drawing a lot of headlines. But I think what some of the reporting has not got quite right about SoftBank is the overall mix of the assets.

DM: Yeah.

MB: So we think the SoftBank assets are really, really good. Over half of the assets are the big investment in Alibaba, which is China's leading eCommerce company. So you've got the largest eCommerce company in the largest market in the world and we think that's a huge opportunity. Then they've got some telecoms companies and the Vision Fund [the world’s largest technology focused venture capital fund] of which WeWork is part, is only about 15% of the value of SoftBank, and within that 15%, WeWork is about 3% or 4% of the value of SoftBank group as a whole.

So when there are difficulties in that one area, of course it's not wildly helpful, but still the vast majority, 95% plus of the portfolio of SoftBank is absolutely fine. So that would be the first positive. The second thing that excites us about SoftBank is we add up the value of all these different things and then we compare it to the market cap of software.

[6:11]

DM: I was just going to say, is it possibly totally different?

MB: Yeah and the market cap of SoftBank is only about half the level of the value of the investments. In fact, basically the market cap of SoftBank is covered just by the stake in Alibaba on its own, which is quite extreme and quite exciting.

DM: And do you think that's as much to do with the Chinese internet names having broadly been very positive in the last three, five years, or almost the opposite and under appreciation of Japan equities holding back the market cap of this, cause you say it's not that difficult to work out the share of SoftBank in Alibaba and then extrapolate it and go this market cap is wrong.

MB: I think it's probably more to do with the negative headlines we've had from some of the other parts of the SoftBank business. You have things like the Vision Fund and WeWork where there have been concerns but again this has been Mr. [Masayoshi] Sons' investment style for many years. You know he invests in early stage things and he tries to see them grow over time and, of course, that's how he ended up with a big, very, very valuable stake in Alibaba, which he got in early and has benefited from that over time.

And that's the third thing we really like about SoftBank is we think Mr. Son, as a manager, is an incredibly value-added person. He came from a poor background and he's currently Japan's second richest person. And that just doesn't really chime with some of the headlines that we see about SoftBank because you know from our point of view he's one of Japan's top managers and top investors.

DM: And let's be honest, if you are an early stage investor in multiple companies, one or two of them are always going to go wrong. Right? I mean that's almost just a law of averages. So did the WeWork, or the failure that WeWork IPO, I know it was read through to SoftBank, did it cause a lot of volatility in SoftBank's share price or did it…

MB: Yeah it wasn't helpful to the share price and we took the opportunity to add a bit more at that stage and subsequently the shares have been stronger again. And I think it is interesting sometimes that it does feel that at times, share prices overreact to pieces of news that well, interestingly are not core to the investment case and that does sometimes give us opportunities, yes.

[8:40]

DM: **A**nd I'd like to talk about, Prime Minister Abe, he's now the longest serving Prime Minister. How do you think he's done? Sort of, what is it now, four, five, six years maybe of, how's his school report read in respect to some of his early plans and achievements of Japanese business and investment?

MB: Well I think overall the great thing that Mr. Abe has brought to the Japanese politics is stability.

DM: Yes.

MB: It was a period after Mr Koizumi when there seemed to be a Japanese prime minister every few months and that created a great deal of uncertainty and disruption. And I think now, one of the real positives about investing in Japan, is that politics is very simple. You know, the Japanese, they're a country on their own, everyone in that country agrees they want to be part of the same country and they all agree that they're separate to their neighbours and it's all very clear. And I think that that just provides a helpful background for investment. And I think what Mr. Abe has managed to do really is generate a bit more confidence in the individual business people in Japan that actually, you know, if you have a more stable political background you can get on and invest, you can run your business, you can try and make some money. And I think that we see the unemployment rate in Japan is very, very low and there are definitely opportunities for people and I think that much really boosted the confidence.

[10:07]

DM: A lot was talked about the sort of three arrows and this sort of inflation target and the Quantitative Easing, which were sort of nominally easier to try and achieve. Not maybe not so much on inflation, but I've met a couple of Japanese managers recently and they've been really focusing on the governance side, the unwinding of cross share holdings and these are sorts of things which I've heard for a very long time, but is there evidence that you're seeing that this is actually happening? It's subsidiaries de-investing finally from parent companies or some incidents actually taking them back over. Is this something that's causing opportunity for you?

MB: Yeah, I think the third arrow, this is really this idea of structural reform, is really best thought of as a quiver of arrows on its own rather than a single thing. And what we've seen there, is these things take actually quite a long time to play out. And some of the things that have happened, like the introduction of the Japanese corporate governance code and the stewardship code, these things don't sound very exciting, but they're really quite important because they change the relationship that Japanese boards, Japanese companies have with shareholders and they make the companies a lot more interested in the shareholders.

So for example, if we go back 10 years, you know many, many Japanese companies didn't have an independent director at all. Now almost all Japanese companies have two independent directors and about a third have a third or more independent directors on the board. And that's just a massive difference from the past. And it means there's much more…

DM: Are they truly independent? Are they able to be a non-executive director as would be thought of maybe in the UK or the United States? Are they, do they have power?

MB: Well, I think the first stage of any kind of process of change is to get the structures right and I think to start with the structure is right now is an encouragement to have independent directors. But of course as you say, and one of the challenges for Japan is it doesn't have a culture of independent directors.

DM: No, so they've got to grow up into it.

MB: So now we've got the right structures in place and we've got independent directors on the boards. Those independent directors are now growing and developing in that role.

DM: And their skills sets…

MB: And their skill sets are growing. And so I think, you know, this is my point to go back to the start about it being a quiver of arrows and these kind of structural reforms take time because these things you, it's almost like another decade long journey, it doesn't happen instantly, but I think it's very helpful overall for us as investors in Japan that these changes have taken place.

DM: Matthew, that's brilliant, thank you very much for your time today. For more information on the Investing on the go podcast, please visit **fundcalibre.com**