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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. This week we're discussing the Japanese economy, the performance of Japanese equities and a few of the underlying growth opportunities in the region.

Darius McDermott (DM): I'm Darius McDermott from FundCalibre and this is the Investing on the go podcast. Today, I'm delighted to be joined by Andy Brown, who is an investment director on the Baillie Gifford Japan desk. We are going to be focusing on the Baillie Gifford Japanese fund today. Andy, good morning and thank you for coming in.

Andy Brown (AB): Good morning, thanks.

[INTERVIEW]

DM: So look, Japan is a very complex economy. I've always found it a fascinating place, but how's it looking now? I mean, it seems to be one of the areas that isn't suffering from the really high levels of inflation the rest of the developed economies are, but the Yen is weak. The economy has been closed to the outside world for some time because of Covid, what's of view from Japan today?

AB: Well it is a very interesting juncture for Japan. In many ways it's acting in a very different rhythm to that of the economies that we're seeing in the West, for example, Europe and the US. So, as you alluded to, Japan hasn't really benefited from Covid reopening yet. So as a reminder, it only just ended its restrictions in March. So, we've only had a very recent loosening. Covid went on for much longer in Asia, even though it didn't cause the same level of human tragedy that we've seen in other parts of the world. So, there was a lot of pent-up demand in Japan. So, I think this is really a great opportunity for investors in Japan because we should see a big recovery.

And the second related point is that Japan has very close links with China. And as many people will know, China is still in some sort of lockdown. Different parts of China are in intermittent lockdowns and this has a big effect on Japan. First of all, there's no inbound tourism. And that means that a lot of the growth that some of the consumer names in Japan were experiencing before the pandemic are conspicuously absent. And the second thing is, of course, there's still curtailments in production and, you know, there's still issues with supply chains for a lot of Japanese companies. So, there's a big recovery still to be had.

DM: Are there early signs of that recovery?

AB: There are early signs of that recovery. Some of our skincare names - this is an area that we started to invest in more at the start of the pandemic because it's a very long duration, growth opportunity and very strong brands. And China's going through a process of the middle class becoming larger and wealth gradually increasing, which is very supportive of these sorts of brands. They've started to report slightly better sales recently. And also China has started to loosen its full restrictions very gradually. And that is starting to come through now in Japan.

DM: So, I know tourism from China to Japan was a huge beneficiary to a number of sectors, the skincare being an obvious example, but also the high-end stuff that the Chinese tourists bought.

AB: Yeah, that's right. So that was a big growth opportunity that got a lot of coverage before the pandemic. And I mean, so Japan has now opened its borders for tourism and as a rounder to the audience, actually, Japan's now very cheap for tourists. It’s in such a period of Yen weakness that we can talk about in a while, that it's now a very attractive destination for tourists to visit. So, we will start seeing tourism come back from the West to Japan. But of course, in China, they're still not allowing visitors outside of China in most cases. So that's going to be.. the Chinese tourists tend to spend a lot more, so we should get much more of an impact when China opens up, but in the short term, it will still be helpful.

DM: And you mentioned the Big Mac index, which I found quite interesting with respect to the weaker Yen. Just tell us a little bit about that.

AB: Well, this is something that the economists report on a regular basis, and then, you know, many people will think of Japan as quite an expensive place to go. You know, historically it's been one of the most expensive places in the world in terms of real estate costs. So, in terms of buying things like a Big Mac. And now that's very different. So now the cost of Big Mac in Tokyo is almost half what it would be in somewhere like New York. So, this is a big change and it's just a reminder of how attractive Japan is as a tourist destination. And there's so many interesting things to do in Japan as a tourist as well.

DM: And you said the economy is moving at a different pace and in a different phase. And I suppose the reopening trade as maybe we could summarise that, has happened more in the developed world and it's about to come to Japan. So, maybe now's the time for Japanese equities?

AB: Well, I'd argue that is the case. So, the US and Europe had quite a big recovery as we exited Covid, I guess it would be sort of after the summer of last year, we started to see easing of restrictions and things recovered very quickly and in many ways the economies, these areas are overheating. We don't have a labour market issue, but we have is other inflation issue. And obviously there's various supply chain shocks.

Now, Japan hasn't yet had that recovery. I think in the most recent GDP [figures], the economy fell very slightly. And it fell largely because of supply chain issues and because of lockdowns and continued Covid restrictions. So, it seems very likely we'll get a recovery and Japan will benefit greatly from the loosening of supply chain issues. Japan's has a lot of high-tech machinery. It does very well in areas like automation, semi-conductors and high tech. These are all the areas that have suffered greatly from shortages and supply chain issues that typically centre around China.

DM: Andy, I'd like to ask you a bit, if I may, after the dreadful killing of former Prime Minister Abe, there's been some narrative from Japan that maybe the government will allow them to fade out Abeconomics, that sort of well-known economic strategy that Abe put into place when he was Prime Minister. Do you think that will happen? And if it does, does that concern you?

AB: I don't. I think often the market likes a narrative and Abeconomics was a very nice narrative for people to talk about. But I think in reality, these things get overplayed somewhat. And what we saw with Abe coming to power in 2012 and some of the policies that he put in place, is that they've become very entrenched into the system. It seems very unlikely they're going to change now. The most important one was the more accommodative stance towards monetary policy.

DM: Yep.

AB: And that's much more driven by the Bank of Japan and the government and Bank of Japan have a very strong relationship. So, I think Abe no longer being here shouldn't really make any difference. And we know that Kishida [the new Prime Minister] very much followed the continuation of policy that Abe had started.

The second important change that Abe put in place was focusing more on corporate governance. And of course, Japan has had a series of stewardship codes and corporate governance improvements since then. Again, it's very much entrenched in the system. We now know that that all - nearly all - companies have a third of the board independent now. The challenge of those boards is getting better. We know that dividends are being prioritised more highly. We know that… we've seen a lot of companies improve themselves by selling down non-core businesses and focus more on returns. So, that's all very sustainable.

DM: Yeah.

AB: And I would say it was very tragic what happened with Abe, our thoughts are very much with his family, it's a very sad thing to happen. He had a wonderful impact on Japan, but I do think that the policies are very, very much entrenched now. And I'm not expecting them to change.

DM: Yeah. And from a sort of an equity perspective, that focus on returns, I think, you know, isn't going to go anywhere because of the tragic passing of former Prime Minister Abe. So, let's have a little dig into the fund itself. Structural growth is one area. I know that you are in digital revolution, demand from Emerging Asia and robotics, automation. Tell us a bit about why those areas excite you in Japan. And if you'd like to touch on a couple of stock examples in those areas?

AB: Sure. These areas that you highlight are very longstanding expressions within the fund. And then that's because they are areas where we see long duration, growth opportunities. So really growth over the next decade and beyond. So, maybe if I take each one in turn?

First of all, the digital revolution - it may be surprising to some people, but Japan is actually quite far behind a number of countries globally in terms of its internet penetration. So, when we look at things like internet retail, and a lot of the internet services that we see across the world, Japan is further behind, but it's beginning to catch up. And there's also this quite interesting situation, probably because of the language difference, that there seems to be a walled garden or a niche of protection around domestic internet businesses in Japan. So, the global players are sort of unlikely and have tried and often failed to challenge some of these domestic businesses. So, we get this opportunity to buy into this very long runway of growth, but at the same time need to buy businesses that have quite strong competitive edges that are quite protected.

So, to one of our favourite names, for example, is a business called Cyber Agent. That's actually quite a longstanding holding in the fund. We have added to it relatively recently. And Cyber Agent has three parts to this business. It's the overwhelming leader in mobile advertising. And that's a business, mobile advertising is lowly-penetrated in Japan relative to the UK or the US, for example. So, there's a very long wave of growth there. Cyber Agent has a very strong market share it's by far dominant business there. So, that seems like a royalty of consistent, steady growth, but then there's two other businesses for Cyber Agent.

It has a gaming business where it has an excellent culture of allowing independent gaming studios to flourish and innovate. And that's led itself to having a number of hits over quite a long period of time. Its most recent hit has been a spectacular success for example, and it shares have been weak on the back of that coming-off. So, we've had an opportunity to add to the position. It also has a very strong position in TV streaming. So, it has a business that I would describe as a sort of Netflix of Japan type business.

And interestingly Cyber Agent has been investing a lot of its profits in other divisions into this new area and it's grown very quickly and it was recently given the rights for the football, the

FIFA World Cup in Qatar. Just to demonstrate the power of that platform relative to the traditional TV channels. So, that would be one of our favourite names. Perhaps to choose another name that we bought more recently is Japan's leading cloud-based accounting software business called Free.

DM: Right, tell us a bit about that.

AB: So, this is a business that has half the market in cloud-based accounting software. Japan has a very kind of traditional approach to IT spend. And what tends to happen is companies often don't really have their own in-house IT departments in any great scale. They tend to rely on the big integrators like Fujitsu, and it's often not very effective, not done very well, accounting there's a lot of legacy accounting systems. So, there's a huge opportunity to shift towards these much more effective cloud-based systems that rely on apps that you can kind of pay as you go. You can scale up as you need to.

And Free is a very well-run business. It's got a big inside stake. It's very dynamic. Its top line is growing incredibly strongly, but because it's been hit with this very negative sentiment towards these sorts of businesses over the past year or two, we've had an opportunity to buy into this one. There are many other examples I could give you, but that would cover the digital revolution.

DM: And maybe a bit on automation then and robotics.

AB: The fund has currently 17% of its exposure as at the end of June, in robotics, in different flavours. There's two reasons why we really like this particular area. One is Japan's very good at it.

DM: There's nothing wrong with being good at something, is there?

AB: It's the overwhelming world leader in robotics. And the second reason is because there's a very long runway of growth. Now looking at why Japan's good at it. Well, Japan, as many people will know, has suffered from demographic challenges for a very long period of time. And one way to solve those challenges is to make things more efficient and to automate. So, it's had a long history of making manufacturing more efficient, and it also has a long history of having a unique skill of strength and mechanical and electronic processes. And that's how it is managed to build out this very effective robotics supply chain. It's a very difficult thing to do, to sort of master these very precise movements required - a combination of hardware and software working together in synchronisation. And because these businesses have been so successful, they've done very well overseas. They've become very dominant and they tend to do very well in critical processes. So, there's a reluctance from customers to want to use a second-best supplier. They want to use the best because they don't want to have any, any downtime.

There's an example that I heard a while ago from BMW, that if they have five minutes of downtime, it costs them 250,000 euros, a plant. And it just gives you an idea how important it's for these things to work well.

DM: To continuously work, yeah.

AB: So, Japan has done very well there. And you know, we have holdings in Fanuc, which is the global leader in computer numeric controls. Those are effectively the brains that control the movements of robots. We have a holding an SMC, which is the global leader in pneumatic equipment, which tends to be used in factories. And it's much more efficient than hydraulic equipment. It has less emissions as well, which is very important. And these businesses have just continued to grow very steadily, and they've continued to take market share. They've fought off any challenge from lower cost competition, notably in China. But in terms of the opportunity, this is what gets us really excited: technology is always improving in robotics and as technology improves, it opens up new opportunities, new industries that robotics can use, we can go into…

And so, for example, we now have these new collaborative robots. So, these are robots that humans can work with that have more dexterity and that allows robotics to be used in things like pharmaceuticals. They can be used in more semiconductors and more very niche processes. And just generally the healthcare industry. We have a lot of medical robots now that are proving very effective. And so, robotics is now moving beyond the traditional industries of cars and electronics.

And finally on that one, we're also starting to see a lot of these interesting internet-based platforms. So, Fanuc have a platform called Field, which enables them to do very clever things they couldn't do before. So remote maintenance of their products, for example, managing the whole efficiency remotely, predictive maintenance of the robotic equipment. So basically, just means they can turn things on and off. They can fix things remotely and they can make the whole plant incredibly efficient.

DM: And very interesting. The implications of robotics is only probably early in its lifetime. As you say, that gives that huge runway for growth. So, we've talked about some areas that you like. But one of the areas I know you've moved out of is the car manufacturers, big business in Japan. Maybe you could tell us why you've been selling your car names?

AB: Yeah. When people think about Japan, they often initially think about cars, because it's an area that's obviously got a very strong reputation. And obviously in the eighties and nineties the Japanese car companies kind of took the American market by storm.

DM: Yeah. Dominated.

AB: Dominated and they did very well. And they had this very sort of low-cost manufacturing process, which has been very successful. So, what's changed since then obviously is that a change in preference towards drive change. And you know, electric cars are a genuinely real thing now. And they're growing quickly, and Tesla has shown us the success that can be had there. Now the Japanese companies are now taking, you know, electric vehicles very seriously, but they're really quite a long way behind. And they have to make some quite significant investments.

DM: I was just going to say, it must cost a lot of money for these companies to make those changes and progress.

AB: It does. And Toyota's the first one to comment on, because it's very much the national champion in Japan, and it has stakes in a lot of the other car companies, and Toyota’s a business we've own for quite some time, it's been very successful, but it’s a stale business. But they have such a large and solid base of traditional cars and petrol based, these cars, they've invested very heavily in hybrid technology, which has been leap frogged now by electric cars, and a recent review of the company sort of brought to bear to us that Toyota has to invest a huge amount, as you say, to catch up on electric vehicles to catch up in autonomous vehicles. It still has a huge install base. It still has a huge supply network that are based on the traditional conventional petrol engine vehicles. So, we feel that the capital costs are going to be so high. The terms to investors are going to go down and even if they end up, you know, winning out to the end, it's hard to see how we make attractive returns for our clients.

And Mazda and Subaru are two kind of niche Japanese car companies that we've invested in for some time. And they've been very successful - Mazda in making small cars very effectively and having fun to drive performance cars, and Subaru and having this sort of all-wheel drive vehicles, high levels of safety in a strong franchise in America, but they both have a huge amount of investment they need to make. And they're both very much linked into the fortunes of Toyota. So, we've decided to sell out of all of these names.

DM: Thank you for that. And you know, the transformation to EV over the next decade will clearly have winners and losers. And in the short term, if you don't like the car companies then you shouldn't own them.

So, look just a couple of questions to wrap up Andy. The current market narrative or the investment style that's been in favour, or maybe in Baillie Gifford's case out of favour, for the last year. Tell us just a little bit about the style that you employ and why that's been out of favour?

AB: So, the two distinctive features of our style are that we're very long term and that we're focused on growth. And both of these aspects of our style are greatly out of favour at the moment. So, the market is taking a very short-term view at the moment. And that is because a whole confluence of different factors ranging from supply chain issues, issues with recovering from Covid, inflation, rising interest rates, oil, Ukraine, has led investors' time horizons to contract, as they often do during periods of angst, and focus on businesses that are making money now, rather than on businesses that are making money in the future or expected to make higher profits in the future. And our investing style is all about looking out into the future and trying to find businesses in a decade that are going to be much larger than they are today.

The second thing is that our focus on growth has been very challenging because what tends to happen is higher growth stocks tend to see a lot of their earnings out into the future, so it's related to a long term point. And the market during periods of sort of, when people are optimistic, they put high multiples on those businesses because they can see the opportunities out into the future. Whereas at the moment, the market has been heavily derating these stocks because interest rates are rising and they're worried that we're discounting future cash flows at higher rates.

DM: And those sort of long duration, long cash flow assets have, - not just in Japan, I mean, that's a global phenomenon - they've been very much out of favour in the last 12 months.

AB: What's been unique in Japan is that we actually are not seeing high rates. Which is a great frustration for us, is that, you know, that the stocks are being hit based on the global interest rate rises but actually in Japan, interest rates will be 25 basis points over 10 years. And the Bank of Japan policy is still accommodative. So, that's been the overall sentiment issue. And the second point is that we're actually seeing a very prolonged weakness in quality names as well at the same time. And we've been adding to these names actually,, we've continued to do very badly. So, these stocks, these are businesses that are very strong franchise characteristics, typically very defensible type businesses, very high market shares, and they've would typically be on quite significant premiums to the market. They've now been derated to many cases discounts to the market. So, this is a great opportunity.

DM: To buy those quality compounding type of names alongside your growth?

AB: Exactly.

DM: And let's just wrap it with a brief sales message from you. Why should investors consider allocating some of their money to Japanese equities?

AB: I think Japan should always be a region that investors should think about. Because it has world class companies in areas like robotics, semiconductors, niche manufacturers that are leaders in what they do. So, it should always be some of this considered, but at the moment it seems to be particularly attractive entry point. You know, Japan hasn't had the reopening from Covid yet, Japan is very closely linked to China. The long duration, the long-term growth opportunities for China remain intact. But at some point, we're going to get a snap back when it starts to reopen. And Japan is very well placed to benefit from that. And even with actually China is increasingly suffering from regulatory risks, so Japanese companies provide an opportunity to benefit from Chinese growth, but without the regulatory risks that may be there in China. So, I think the long term opportunity is there, but actually there's a short term opportunity for Japan to enjoy a recovery and valuations are of course, very attractive.

DM: Yeah. And with the Yen being weak could give investors even more, so supercharge returns.

AB: Yeah, exactly. I mean, there's so many things to mention at the moment that I didn't really even focus on the Yen, but of course that's another boost for Japanese companies.

DM: Andy, thank you very much for your time this morning.

SW: One of the oldest Japan funds in the sector, the Baillie Gifford Japanese fund is managed by a large team, based in Edinburgh, and invests in growing Japanese businesses that deliver consistently strong returns to shareholders. To learn more about the Baillie Gifford Japanese fund, visit fundcalibre.com – and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.

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