

TRANSCRIPT: EPISODE 269

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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 shifting gears to discuss Japan, with topics ranging from inflation, stock market growth and dividends to artificial intelligence and cosmetics.

Sam Slator (SS): I'm Sam Slator from FundCalibre, and today I've been joined by Praveen Kumar, who is manager of the Baillie Gifford Shin Nippon investment trust. Thanks very much for joining us today.

Praveen Kumar (PK): Thanks for having me, Sam.

[INTERVIEW]

SS: So, perhaps we could start with inflation. It's obviously the buzzword in the UK, the US and Europe, and it's a problem for us, but in Japan it's perhaps more of a welcome phenomenon? An eye-opening fact I think, is that someone of my age with a 25-30 year career would not have had an increase in wages until this year! So, perhaps tell us more about inflation in Japan.

PK: That's right, Sam. So, we are seeing what I would like to call mild levels of inflation in Japan. So, at the moment, we're looking at something around the 3% mark. That is compared to what we see here in the UK and, you know, most of the other developed economies where inflation's running at twice the rate, if not higher. And, as you said, people are feeling the pinch.

But in Japan, which as you probably know, it's had more than two decades of deflation, and that deflationary mindset is quite well embedded in people's psyche. So, the current environment where we are seeing mild inflation is causing a bit of a shift in terms of how people think about prices. So, for instance, we are seeing a whole range of companies from different sectors raising their prices, for example. Now that is causing consumers to recalibrate the way they think about pricing and their own spending decisions.

Now this, obviously, if it becomes sticky, then it could have a whole range of really interesting implications. The first one worth highlighting is just the sheer volumes of cash-based transactions that still happen in Japan. So, I think along with Germany, interestingly, Japan is probably one of the world's largest users of hardcore cash <laugh>. Obviously, we own quite a lot of online

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payments-related companies in our portfolio on the basis that this situation with cash is not going to be tenable in the long run and people will have to shift. But that shift is being in some ways accelerated by this whole inflationary environment. So, people are taking cash from underneath their carpets and wherever they've got them stashed, and it's finding a home in sort of various areas. One obvious area is the stock market, interestingly, <laugh>.

So, the Japanese domestic investors have notoriously under-invested in their own market and the current inflationary environment is forcing them to seek alternative ways to park their considerable cash holding. The equity market is one obvious area, and we are seeing a steady inflow of funds into the domestic market. One of the companies we own is a robo-advisory firm, Japan's largest robo-advisory firm, called WealthNavi [Inc.] So, they offer a very narrow range of five or six easy to understand products, most of which are focused on the domestic market. And they're seeing quite considerable sums of money come in from retail investors. So, that's one interesting implication of this inflationary environment that we're seeing in Japan.

The other interesting development we've seen is companies across sectors are now aggressively raising prices, partly because their own costs have gone up, but also partly because they see the current environment as an opportunity to try and exercise some of their pricing power, which historically they haven't had, and that's been one of our longstanding issues. So, that has positive implications for their margins in the long run, [and for] their returns in the long run, if these prices can stick. And that also further reinforces this idea that the Japanese consumer's mindset shift from a deflationary mindset to an inflationary mindset is likely to take root. So, a whole range of potentially interesting implications from the inflation situation in Japan, I would say.

SS: What about growth? It's a low bar perhaps, but I think the IMF thinks that Japan will grow by 1.3% this year, which is better than the UK and Europe and pretty much level with the US. Is growth improving? Are you seeing positive signs?

PK: Yeah, so, one thing worth remembering is Japan is a very, very mature economy. And if you add to that the fact that Japan's demographics aren't necessarily that great - you know, it is the world's most rapidly ageing society - so, for such an economy, the trend growth rate, you would say is generally around the 0.5%-1% range. We wouldn't expect the economy over a long period to grow much faster than that.

But the other thing worth bearing in mind is there is very little empirical evidence to suggest any kind of correlation between economic growth and stock market returns. So, if you are able to pick the right sort of companies that have a large growth opportunity, have a very strong competitive edge and are growing quite rapidly at very attractive valuations as we are seeing today, for instance, these companies have the ability to grow irrespective of what happens in the broader economy. They could be domestic focused businesses, they could be exporters. So, I think it's important to make the distinction that economic growth doesn't always have any bearing on returns from the stock market.

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But, having said that, there are quite a few positive tailwinds that the Japanese economy is likely to witness over the next few years. One of the big ones at the moment is obviously the friction between the US and China. So, the US is imposing a range of restrictions on high-end equipment exports and, perversely, because the Japanese tend to have very, very high market shares in a lot of these niche equipment areas like semiconductors or industrial equipment, factory automation etc., they could end up benefiting from this whole trend of moving production from China to other areas. So, you're putting in new factories in the US. TSMC [Taiwan Semiconductor Manufacturing Company Limited], which is the world's largest [semiconductor] foundry, is building huge factories in the US so that needs a lot of kit, a lot of tools, and Japanese companies are among the world-leading providers of those types of tools. So, you could potentially see new avenues of growth open up for these types of companies.

Equally, with an ageing population, you do have certain other pressures in the government. So, things like, how do you manage healthcare, how do you take care of this massively growing base of really old citizens? So, that requires creative solutions. So, we're seeing a lot of healthcare companies coming up with, say, robotic surgery type solutions, for instance. Artificial intelligence, which I'm sure we'll touch on later, is another emerging area of opportunity.

So, overall, I would say the Japanese economy is almost in a bit of a sweet spot at the moment and whatever positive moves in the stock market we've seen so far, it's mainly concentrated on some of these really old-style, traditional companies that are looking more to survive, so, there is maybe a corporate governance angle, or a shareholder returns angle. These are not really the types of companies that are looking to grow. And I think the big opportunity of the next few years is likely to be in the latter type of companies where you're getting growth companies at dirt cheap valuations at the moment.

SS: And another aspect of the stock market is obviously the increase in dividends being paid to shareholders now - we've seen that gradually increase over the past couple of years. But I believe the regulator's recently put even more pressure on companies to return money. What's your take on this and does it impact any of your companies at all?

PK: So, there's been consistent pressure being applied by the regulators, [by] the stock exchange, even the government, on Japanese companies in general to either shape up or ship out, if you see what I mean <laugh>.

So, we started during the era of Mr. Abe [Shinzo Abe, former PM of Japan]. So, you know, talking of sort of 2012-2013 with his whole sort of 'three arrows*' thing that got the fancy investors <laugh>. But ever since then, all these corporate governance reforms, whether it's in terms of the structure of boards - board diversity on the boards in terms of experience, gender, etc., - shareholder returns, these have become quite well-embedded within companies at the moment. So, really these you would expect - or at least I would expect - to continue now even without any additional

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pressure. So, what we are seeing is companies literally falling over themselves to do things like share buybacks, raising their dividends every single year, even if their earnings are quite weak, which is, again, interesting in and of itself, and it's become almost a well-known fact that this is the way to go, if you want to attract overseas investors, if you want to broaden your shareholder register base.

*[*Abenomics has "three arrows": (i) aggressive monetary policy, (ii) fiscal consolidation, and (iii) growth strategy.]*

And one of the other things we're seeing is Japanese companies are increasingly benchmarking themselves versus global peers. So, historically, one of the issues with Japanese companies was that they were very much inward-looking because the domestic market itself was so huge that they didn't really have that necessity of comparing themselves globally and trying to be the best globally. But that has been flipped on its head now because of increasing competition from global peers and pressure from shareholders, etc. So, we are seeing quite a strong, continuing momentum in terms of returning cash to shareholders.

And in terms of the stocks that we own, although we are operating at the smaller end of the spectrum where these types of moves are perhaps less pronounced, nevertheless, we're seeing a lot of our manufacturing-type businesses, for instance, significantly increase their payout ratios. We're seeing some significant share buybacks being announced. Just a few years ago, one of our holding companies, which is a gaming company called Akatsuki [Games Inc.], they bought back around 17% of the shares, which is quite huge! That's probably at an extreme. So, I would say this move towards improved corporate governance, improved shareholder returns, is very much trickling down from the large to mid-caps, [and] now into the small caps. And you're seeing loads of companies starting to behave in that manner now.

SS: And you touched on it briefly earlier - artificial intelligence. Given Japan's ageing population, the [fact] that they've got a decreasing workforce, they've got a really good history in machinery, electronics, AI seems to be pretty much a perfect opportunity for Japan. Is that correct? Are you seeing that?

PK: Yes, that's very much the case. And now we have reached a stage where virtually every other company, you know, companies are falling over themselves to try and work out how best to use the current AI-related tools that are available.

One of the things that Japanese companies or tech companies haven't been good at, and I don't think they will ever be good at, is developing genuinely new software. So, things like, you know, ChatGPT or you know, any other piece of software. So, the fundamental development of software [the Japanese] are extremely weak at, and I don't think the country's set up in a way that will allow change to happen in that area. But having said that, where Japanese companies have been really good is not in so much as developing genuinely new software, but actually using existing tools,

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existing software packages to develop some really relevant, interesting products and business models.

So, I'll give you one example. So, one of the companies we recently purchased for the portfolio is interestingly a Taiwanese company that happens to be listed in Japan. It's called Appier [Group Inc.] - so it's basically 'happier' without the H <laugh>. So, it's run by a husband and wife team - both have PhDs in computer science - and they're from Taiwan, but they set up base in Tokyo and set up the headquarters of this company there. So, this company is using artificial intelligence to develop tools to help small and medium-sized businesses to better understand their customers.

So, they were doing some really clever stuff like marketing to consumers even when they're not on the company's website or if they're just kind of walking down the road, giving them information on their smartphones as they pass through a shop saying, 'Look, this shop is offering so and so for a 20% discount, would you be interested?' kind of thing. And that's a very, very high-level generalisation; they're actually doing a lot more sophisticated stuff to try and increase the lifetime value of existing customers, and also to help retailers identify who are the potential customers that might end up buying their products. And all of this analysis is done by their in-house developed AI models. So, an example of a company that's not created a new, fundamental software as such, but it's using existing technologies to build these various products that are much more relevant for their client base.

So, similarly we are seeing a lot of use of existing AI tools in the legal area, for instance. So, one of the companies we own is a company called Bengo4.com [Inc.]. So, it's an online legal website that matches people with lawyers, so people looking for legal advice with lawyers. And there again, [they're] doing some very clever stuff with existing AI tools where now they've got something called 'legal brain,' so, there's a new suite of products that they've launched. And this set of tools helps lawyers to not just source potential clients, but also helps them in terms of preparing for any upcoming cases, helps them with managing their workload. It basically scans hundreds and thousands of past legal rulings and all the case work and picks out relevant bits of information that's useful for the lawyers in preparing for a particular case. So, some really clever application of existing AI tools. So, I personally think this is likely to become quite a big area.

I suppose the trick is to find out which are the companies that have the best chance of succeeding and thinking about the competitive advantage, the whole sort of culture of the firm and some of these other softer factors because I suspect you will get quite a lot of companies in this space that promise a lot, but don't deliver <laugh>. So, you've got to be careful in terms of which companies you pick.

SS: And perhaps we could just finish with a little bit about one or two of your new holdings that you've got in the fund. A couple that caught my eye were, I think it's I-Ne [Co., Ltd.], the cosmetic company and Spiderplus [& Co.] in the construction industry.

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PK: Yeah, sure. So, I-ne is a fairly recent holding. I met the company in Japan and a few months ago, so it's spelled as I-Ne and it actually stands for Innovation Never Ends <laugh>. So, again, interesting you should pick that out because this, to me it felt very much like an AI-based tech company that just happens to be in the cosmetics business <laugh>.

So, their model of product development, customer analysis is quite interesting, where they've built in-house, they've built their AI model that basically aggregates consumer feedback data from a number of sources, both online and offline, so offline surveys, etc., online through the various forums where people talk about different cosmetic products, [where] they give feedback, etc. So, it kind of scrapes all of that information [together] and it builds this huge database of consumer-generated feedback.

And the company basically uses this AI model to try and understand what are the kinds of products that people are actually interested in? What are the products that are out there that are not really serving the purpose that they were supposed to serve? So, you know, it could be a skin cream or a moisturiser that [the] company selling that, made a big song and dance [about it], but actually when you actually use it, it's not having the desired effect. And they also try and work out, what are the areas that have the most complaints? Where consumers have the most complaints saying, oh, you know, I wish there was a product that did this kind of thing. So, they gather this kind of really detailed, specific feedback and then they pass that on to the product development team and they then work on one or two products which they feel have the best chance of succeeding. They make their own formulations using domestically-sourced, really unique, raw materials. And then they develop the product and start test marketing.

And the validation of this process of theirs, for me at least, lies in the fact that a couple of their star products, these are basically hair care-related products, these were launched six, seven years ago and even today, these are products that are continuing to grow at about 10 to 15%. Now that is some serious staying power because for a cosmetic product [to last] that long, if you know how fast the churn is; you know every other week you have new products on the shelf, right? To be able to continue to grow at that rate is quite impressive. And they're not interested in launching a product every week or every month, they're very, very targeted; their product launch is a very disciplined approach. So, a really interesting business, you know, run by a young entrepreneur who owns quite a large chunk of the business.

Spiderplus is another one of these young up-and-coming software companies, which is trying to digitise the construction industry.

So, the construction industry in Japan is probably one of the worst, if not *the* worst, when it comes to the adoption of IT. It's still very traditional; you use [the] phone, fax, a lot of paper, and they basically built a set of products that completely automates the entire process. So, someone working at the site can easily create and upload drawings using a tablet that runs their products. They can

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share those drawings with coworkers, [and] they can make markings, make notes. It becomes very easy, and you can do multiple projects within that same software.

So, a real no-brainer if you ask me in terms of why this shouldn't become the industry standard in 5-10 years' time. And already, they've made significant progress in terms of getting some of the big construction contractors in Japan on their side and getting them to use their software. So, again, yeah, quite an interesting business targeting an absolutely massive industry.

SS: That was all fascinating, thank you very much. It's good to get a different take on some of these themes that we're hearing a lot about at the moment, so thank you.

PK: No worries, thanks for having me Sam.

SW: The Baillie Gifford Shin Nippon trust aims to provide long-term capital growth by investing in smaller companies listed on the Japanese stock market, focusing on emerging or disrupted sectors, where the manager sees innovative growth opportunities. To learn more about Baillie Gifford Shin Nippon trust, please visit fundcalibre.com

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