Japan Small Companies Quarterly Update

31 December 2023

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All investment strategies have the potential for profit and loss.

Stock Examples

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Product Overview

Japanese Smaller Companies is a regional equity strategy that aims to produce above average long-term performance through investment in Japanese equities with a market cap of between ¥ 50-150bn in any economic sector. We believe the Japanese equity market offers active managers a broad selection of high quality companies capable of delivering attractive and sustainable earnings growth for shareholders.

Risk Analysis

Key Statistics	
Number of Holdings	74
Typical Number of Holdings	40-80
Active Share	95%*
Annual Turnover	18%

*Relative to MSCI Japan Small Cap Index. Source: Baillie Gifford & Co, MSCI.

A shift in macro conditions over the past two years has presented a strong headwind to our investment style, lifting the profit margins of cyclical market constituents where we remain underweight

This looks overdone, creating a rare and propitious opportunity for the strategy looking forward

We remain confident that the innovative, high growth companies that we own in the portfolio remain well-placed to deliver attractive returns over the long term

Baillie Gifford Key Facts

Assets under management and advice	US$287.6bn
Number of clients	674
Number of employees	1831
Number of investment professionals	395

For a number of years until late 2021, this strategy delivered strong outperformance by backing Japan's challenger companies. Despite persisting with that approach, performance over the past two years has been poor, as a volte-face in various macro factors has led to a shift in investor preference, away from growth and early-stage innovators towards perceived beneficiaries of rate hikes and yen weakness.

This change in leadership seems unlikely to persist, as we will go on to explain. But let's recap why it happened in the first place.

A recap on the reset that occurred

After more than a decade of deflation, ultra-low interest rates, and quantitative easing, the past twenty-four months have brought about a shift in conditions and a recalibration of expectations. These effects were magnified by the economic rebound following Covid-19 and the impact of conflicts that have flared up around the world.

Such conditions presented strong headwinds to our investment style, as we have seen mature large-cap stocks in capital-intensive and cyclical sectors perform exceptionally well in terms of share price, helping lift the broader Japanese indices to record highs. Their strong performance was also largely due to improvements in corporate governance and shareholder return policies. A key driving factor for this has been the pressure applied on management teams by both domestic and overseas activist investors.

In addition, the weakness of the yen has helped inflate the profit margin of exporters, who account for a large part of the market. In 2023, diverging monetary policy—which many now expect to converge—saw the value of the yen plummet to levels not seen since 1990, leaving it stretched by most measures. The Big Mac Index, for example, is a light-hearted measure based on the theory of purchasing-power parity using the price of McDonald's Big Mac. At ¥450 in Japan versus $5.58 in the United States, the Big Mac implies an exchange rate of 80.65, a far cry from the 140-150 rate experienced for most of the year. A reversal could quickly suppress foreign sales for some of Japan's largest and most established export industries, such as autos.

One of the most dramatic shifts in the past two years is that of inflationary expectations, a new phenomenon for those under 50 in Japan, as price rises have remained elusive since the early 90s. This has triggered significant speculation that rates are about to rise. In response, many market participants have been backing Japan's banks on the assumption that rising rates will revitalise their loan business. This, of course, fails to account for the structural impediments of the industry, such as the limited demand from a cash-rich populace that holds 55 per cent of their assets in cash (versus 13 per cent in the US). The same concerns have led to the opposite trade being placed on 'long-duration' growth equities, especially small caps at a much earlier stage of their development. Many of these are online businesses that are expected to generate the bulk of their cash flows in the future, typified by many of the holdings in the portfolio. However, we believe this assumption fails to account for the idiosyncrasies of the underlying businesses. Many Japanese industries are fragmented, labour-intensive, and have low internet penetration. If interest rates do rise, they will likely hinder economic activity, leading to a greater need for scalability and efficiency. This situation will likely boost cash flow generation for more agile smaller online businesses, enhance their growth prospects, and increase the premium paid for growth in such an environment.

Growth stocks are now priced at levels that assume barely any future increase in revenues or profits, in stark contrast to their underlying fundamentals. Despite the discomfort from volatility, it is important to stay true to our investment philosophy and process, which has served our clients well over longer periods of time. Being patient and seeing through market noise increases our chances of picking exceptional companies that will deliver attractive long-term returns.

The underlying structural growth drivers that underpin the portfolio remain strong: A shrinking labour force calls for increased digitalisation and more efficient ways of working; global warming and high energy prices provide motivation to decarbonise the Japanese and global economy; the inexorable shift to electric vehicles requires a recalibration of the auto industry; and geopolitics is leading to a reshaping of the semiconductor industry. All these challenges call for dynamic and nimble enterprises run by bold entrepreneurs willing to seize the myriad opportunities these changes create.
The portfolio is at the forefront of enabling these shifts.

Performance

The strongest contributors to performance in the fourth quarter fall into two camps: internet and semiconductor hardware. Internet businesses Demae-Can and WealthNavi saw strong share price performance following an otherwise lacklustre year. In particular, WealthNavi, Japan's top digital robo-wealth management platform, experienced significant growth. Its userbase continues to climb, supported by recent changes to tax-free investing aimed at encouraging domestic participation in the market. This, in addition to new inflationary pressures - which are eroding the cash balances of consumers - could help raise the profile of WealthNavi’s platform. Generally, asset management is highly scalable, and robo-advisory businesses, in particular, offer even greater scalability due to their low labour intensity. There are appealing structural factors at play, as the responsibility for future savings increasingly shifts to individuals.

Semiconductor names were some of the strongest performers over the quarter and for most of 2023. Part of the excitement can be attributed to the advances in artificial intelligence, as illustrated by ChatGPT, arguably one of the most defining developments of the year. This brought about a gold rush for semiconductor-related businesses, presumed to benefit from the subsequent rise in demand. Two companies stood out within this space: JEOL and HORIBA.

JEOL is a manufacturer of electron microscopes and scientific instruments. The company also exemplifies Japan’s prowess in precision manufacturing. It started out specialising in transmission electron microscopes for academic and corporate research and development but found an opportunity to transfer this technological know-how from a low-growth sector to one with more expansion potential. In partnership with Austria’s IMS Nanofabrication, JEOL found a way to disrupt semiconductor manufacturing with an advanced form of e-beam lithography. In traditional photolithography, a ‘mask’ made of glass or quartz acts as a stencil. JEOL’s optical technology has created a device so precise it can send more than 260,000 electron beams, made up of microscopic streams of charged particles, directly onto the wafer. This eliminates the need for expensive masks and has phenomenal accuracy. The company is starting to see increased interest in its products and the share price recently soared following a significant rise in orders, resulting in a 20 per cent increase in operating profit for the first half of the year.

Family-run HORIBA provides another example of Japan’s manufacturing prowess, specialising in analytical and measuring instruments. The semiconductors segment is the main growth driver where the company dominate with a 60 per cent global market share in mass-flow spectrometers, which are used to measure and control the flow of liquids and gases in the semiconductor manufacturing process. HORIBA’s research and development is geared in such a way that it can develop devices to measure any number of things, for example, it was recently involved in the chemical analysis of sand and stone samples from the asteroid Ryugu, collected by the Japanese space agency’s Hayabusa2 spacecraft, helping to unravel the mysteries of the birth of the solar system. One area in which HORIBA is building up its presence is in the automotive emission testing equipment for measuring and analysing exhaust gases, where it currently has an 80 per cent market share. The company is repositioning itself in response to the global transition to electric vehicles by developing instruments to gauge EV battery efficiency. We remain impressed by HORIBA’s progress and think that its nimbleness is key to its ability to solve problems and its ultimate success.

Among the bottom detractors from performance were Nakanishi, Yonex and Kumiai Chemical.

The languishing effects of Covid-19 remain a conspicuous cause of underperformance for some companies within the portfolio, indeed, this was the case with Nakanishi and Yonex.

Nakanishi, the dental equipment manufacturer struggled during Covid-19 as there was less demand for its products with patients staying away from dentists' surgeries and many dentists operating at reduced capacity. Despite a more positive outlook, recovery has been slow and the company recently saw its share price fall as results fell short of consensus. However, top-line growth remains strong, and sales increased by 11 per cent year-over-year, with Asia seeing a recovery and continued demand in Europe and Japan. The company has also been growing its market share in the US dental industry, bolstered by the high reputation of its products.

Yonex, the leading sports equipment company best known for its badminton (and increasingly tennis) rackets continues to see demand for its products in all regions. It is already a leading player in badminton, with good growth potential in India and China. In tennis, its products seem to be gaining share amongst elite tennis players in recent years (using the French Open competitors as a proxy), which should have a ‘trickle down’ effect in time – the US is a key target market. Following the resumption of international competitions, it has seen an uptick in sales promotion activities and recent results saw sales increase by 15 per cent year-over-year, driven mainly by growth in China. Despite these encouraging results, the company saw its share price decline during the quarter.

Like many others in the portfolio, Kumiai Chemical is an example of a company where the share price is completely disconnected from its fundamentals. Kumai is an R&D-type agrochemicals manufacturer producing herbicides, pesticides and fungicides. It may not jump out as an exciting growth company with this description, but it has more than tripled its revenues over the past decade – and growth is accelerating as a result of demand for its herbicide, Axeev, which has been its

core growth driver. A good reminder that growth comes in all shapes and sizes. The fourth quarter saw positive results with top-line growth of 15 per cent over the previous year.
The company has a proven track record of bringing innovative products to market, and we remain confident in its ability to grow from here.

Conclusion

Despite the challenging environment for high growth small caps in Japan, the majority of holdings are continuing to grow strongly whilst their overall valuation multiples have fallen to levels that remain well below their long-term average. Many of the holdings are also demonstrating sustained levels of profitability despite investing heavily for future growth. These are all very positive developments in our view and increase our conviction in their outlook.

This approach will inevitably be out of favour sometimes – we have just experienced an extreme moment of this. But we believe we are at a once-in-a-generation opportunity for high growth investors in Japan.

Performance Objective

2%+ p.a. over 5 years vs index.
The performance objective is aspirational and is not guaranteed. We don't use it to compile the portfolio and returns will vary. A single performance objective may not be appropriate across all vehicles and jurisdictions. We may not meet our investment objectives if, for example, our growth investment style is out of favour, or we misjudge the long-term earnings growth of our holdings.

Periodic Performance

GBP	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	1.8	2.9	-1.1
1 Year	-11.4	7.4	-18.7
3 Years	-15.6	1.9	-17.4
5 Years	-2.6	4.7	-7.3
10 Years	7.3	8.5	-1.2
Since Inception	4.9	3.3	1.6

USD	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	6.3	7.5	-1.2
1 Year	-6.1	13.8	-19.9
3 Years	-17.5	-0.5	-17.0
5 Years	-2.6	4.7	-7.3
10 Years	4.5	5.7	-1.2
Since Inception	4.2	2.6	1.6

EUR	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	1.9	3.0	-1.1
1 Year	-9.2	10.0	-19.2
3 Years	-14.7	3.0	-17.6
5 Years	-1.9	5.5	-7.4
10 Years	6.8	8.1	-1.2
Since Inception	4.3	2.7	1.6

CAD	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	3.7	4.8	-1.2
1 Year	-8.6	10.7	-19.3
3 Years	-16.6	0.7	-17.2
5 Years	-3.2	4.0	-7.3
10 Years	6.8	8.0	-1.2
Since Inception	4.6	2.9	1.6

AUD	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	0.5	1.7	-1.1
1 Year	-6.6	13.1	-19.7
3 Years	-14.1	3.7	-17.8
5 Years	-2.0	5.4	-7.4
10 Years	7.4	8.6	-1.2
Since Inception	4.6	3.0	1.6

Annualised periods ended 31 December 2023. 3 Month & 1 Year figures are not annualised.
Inception date: 31 December 1989
Figures may not sum due to rounding.
Benchmark is MSCI Japan Small Cap Index (Market cap weighted composite index of TOPIX 2nd Section, TOPIX Small & Jasdaq prior to 30 April 2010).
Source: Revolution, MSCI, Tokyo Stock Exchange.
The Japan Small Cap composite is more concentrated than the MSCI Japan Small Cap Index.

Discrete Performance

GBP	31/12/18-31/12/19	31/12/19-31/12/20	31/12/20-31/12/21	31/12/21-31/12/22	31/12/22-31/12/23
Composite Net (%)	13.2	28.8	-15.3	-19.9	-11.4
Benchmark (%)	15.2	3.5	-1.0	-0.6	7.4

USD	31/12/18-31/12/19	31/12/19-31/12/20	31/12/20-31/12/21	31/12/21-31/12/22	31/12/22-31/12/23
Composite Net (%)	17.8	32.9	-16.1	-28.9	-6.1
Benchmark (%)	19.8	6.8	-1.9	-11.7	13.8

EUR	31/12/18-31/12/19	31/12/19-31/12/20	31/12/20-31/12/21	31/12/21-31/12/22	31/12/22-31/12/23
Composite Net (%)	20.0	21.9	-9.7	-24.2	-9.2
Benchmark (%)	22.0	-2.0	5.5	-5.9	10.0

CAD	31/12/18-31/12/19	31/12/19-31/12/20	31/12/20-31/12/21	31/12/21-31/12/22	31/12/22-31/12/23
Composite Net (%)	11.8	30.6	-16.8	-23.7	-8.6
Benchmark (%)	13.7	5.0	-2.8	-5.3	10.7

AUD	31/12/18-31/12/19	31/12/19-31/12/20	31/12/20-31/12/21	31/12/21-31/12/22	31/12/22-31/12/23
Composite Net (%)	18.0	21.1	-10.9	-23.7	-6.6
Benchmark (%)	20.0	-2.7	4.1	-5.3	13.1

Benchmark is MSCI Japan Small Cap Index (Market cap weighted composite index of TOPIX 2nd Section, TOPIX Small & Jasdaq prior to 30 April 2010).
Source: Revolution, MSCI, Tokyo Stock Exchange.
The Japan Small Cap composite is more concentrated than the MSCI Japan Small Cap Index.

Stock Level Attribution

Top and Bottom Ten Contributors to Relative Performance

Quarter to 31 December 2023

Stock Name	Contribution (%)
Wealthnavi	0.8
Jeol	0.4
Lifenet Insurance	0.4
SWCC Corporation	0.3
Horiba	0.3
Harmonic Drive Systems	0.3
Outsourcing	0.3
OSG	0.3
Infomart	0.3
Demae-Can	0.2
Nakanishi	-1.0
Kumiai Chemical	-0.5
CellSource	-0.4
Yonex	-0.4
Nittokud	-0.3
Screen Holdings	-0.3
Shoei	-0.3
Descente	-0.3
Toyo Tanso	-0.3
I-ne	-0.3

One Year to 31 December 2023

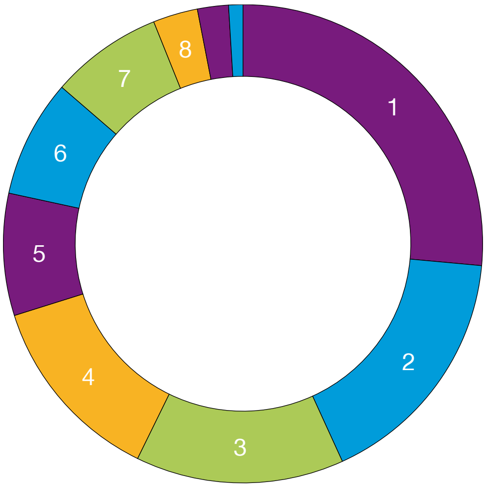
Stock Name	Contribution (%)
Megachips	0.9
Wealthnavi	0.5
Jeol	0.4
Horiba	0.4
Bengo4.Com	0.4
SWCC Corporation	0.3
Jade Group	0.3
Outsourcing	0.3
Kitz Corp	0.2
Asahi Intecc	0.2
Open Door Inc	-1.4
Nihon M&A Center	-1.1
Raksul Inc	-1.1
Snow Peak	-1.0
Kamakura Shinsho	-0.9
KATITAS	-0.9
eGuarantee	-0.7
Shoei	-0.7
Nakanishi	-0.6
KH Neochem	-0.6

Source: Revolution, MSCI. Japan Small Cap composite relative to MSCI Japan Small Cap Index.
The holdings identified do not represent all of the securities purchased, sold or held during the measurement period. Past performance does not guarantee future returns. A full list showing all holdings' contributions to the portfolio's performance and a description on how the attribution is calculated is available on request. Some stocks may not have been held for the whole period. All attribution figures are calculated gross of fees, relative to the index from stock level up, based on closing prices. As attribution is shown relative to the benchmark, not all stocks shown are held in the portfolio.

Top Ten Holdings

Stock Name	Description of Business	% of Portfolio
Cosmos Pharmaceutical	Drug store chain	3.5
Asahi Intecc	Specialist medical equipment	2.9
GMO Financial Gate	Develops and manufactures transaction management systems	2.7
WealthNavi	Operates a wealth management platform	2.6
Megachips	Electronic components	2.4
Lifenet Insurance	Provides a range of life insurance products and services.	2.3
Sho-Bond Holdings	Infrastructure reconstruction	2.2
TechnoPro	IT staffing	2.2
Nifco	Value-added plastic car parts	2.2
eGuarantee	Guarantees trade receivables	2.1
Total		25.1

Sector Weights



		%
1	Industrials	26.5
2	Information Technology	16.7
3	Consumer Discretionary	14.1
4	Financials	12.9
5	Health Care	8.3
6	Consumer Staples	8.0
7	Communication Services	7.6
8	Materials	3.0
9	Real Estate	2.1
10	Cash	1.0

Figures may not sum due to rounding.

Voting Activity

Votes Cast in Favour		Votes Cast Against		Votes Abstained/Withheld	
Companies	7	Companies	None	Companies	None
Resolutions	70	Resolutions	None	Resolutions	None

Long-term investing and sustainability are inextricably linked
The strategy continues to ensure our Environmental, social, and governance (ESG) research, integration and stewardship activities are focused on issues material to the investment case and companies' long-term growth prospects
Our engagements this quarter have covered a wide range of topics, including supply chain transparency, board effectiveness, and remuneration

Company Engagement

Engagement Type	Company
Environmental	CrowdWorks Inc., Cybozu, Inc., Demae-Can Co.,Ltd, FreakOut Holdings, inc., KATITAS CO., Ltd., Kohoku Kogyo CO.,LTD., OPTEX GROUP Company, Limited, Seria Co., Ltd., SpiderPlus & Co., Torex Semiconductor Ltd., WDB Holdings Co., Ltd.
Social	M3, Inc.
Governance	Bengo4.com,Inc., COSMOS Pharmaceutical Corporation, Cybozu, Inc., DaikyoNishikawa Corporation, Demae-Can Co.,Ltd, FreakOut Holdings, inc., Kohoku Kogyo CO.,LTD., OPTEX GROUP Company, Limited, Seria Co., Ltd., Torex Semiconductor Ltd., WDB Holdings Co., Ltd., istyle Inc.

Company	Engagement Report
Katitas	Objective: To engage with Katitas to understand its environmental reporting, including lifecycle assessments, avoided emissions calculations and emissions disclosure. Discussion: During company analysis, we engaged with Katitas to understand more about its initial avoided emissions calculations. By renovating abandoned single-family homes in Japan, Katitas is able to avoid the emissions from demolishing and rebuilding the homes. For a few years, Katitas has stated that the emissions saving is 207 kgCO2/m2 for timber superstructures. However, when looking at the rationale for the analysis and the reference material, it would appear that Katitas' avoided emissions could be higher if a more detailed analysis was undertaken and concrete and steel were included. On in-use emissions, we acknowledge that it is difficult to accurately measure the thermal improvement of the properties. We encouraged Katitas to include the difference in in-use emissions between a renovated property and a new property within a full Lifecycle Assessment. We encouraged the company to reach out for expert help in carrying out full lifecycle assessments for the products and services they provide. This will also help them assess their downstream Scope 3 emissions, which they are already investigating. Outcome: Katitas appreciated the level of feedback on its emissions reporting and is looking to improve the accuracy of its environmental reporting and emissions disclosure by reaching out third-party experts.

Votes Cast in Favour

Companies	Voting Rationale
Crowdworks, Demae-Can, Freakout Holdings, GMO Financial Gate Inc, GMO Payment Gateway, Raksul Inc, Shoei Co Ltd	We voted in favour of routine proposals at the aforementioned meeting(s).

Votes Cast Against

We did not vote against any resolutions during the period.

Votes Abstained

We did not abstain on any resolutions during the period.

Votes Withheld

We did not withhold on any resolutions during the period.

New Purchases

Stock Name	Transaction Rationale
Anest Iwata	Anest Iwata is a manufacturer of air compressors, vacuum pump equipment and paint application systems. Established in 1926, it has a long history of innovation and enjoys a dominant domestic and global market share. It operates in niche but consolidated markets and makes good margins and returns. A feature of its compressors and paint application systems is their environmental friendliness. It sells oil-free scroll type compressors that are lighter and more energy efficient. Its paint application system has been designed to work well with water based paints for automobiles. Tightening environmental regulations are driving demand for its products, which should result in a steady expansion of sales and profits longer-term. The company has a net cash balance sheet, has bought back a lot of shares over the years, and has a very progressive dividend policy. The shares appear attractively valued given the long-term growth prospects and we therefore decided to take a holding.
Oisix	Oisix provides high-quality meal kits and organic food through online ordering. Both areas have been growing from a low base in Japan, and we believe they have a long growth runway ahead. Oisix has strong relationships with organic farmers and has been investing in distribution efficiency which will depress short-term profits but deepen the long-term competitive edge. Founder Mr Kohei has largely delivered on his growth ambitions, and his 13% stake in the business gives good alignment. The recent setback in the share price encouraged us to buy a holding.

Complete Sales

Stock Name	Transaction Rationale
Pigeon	Pigeon is a Japanese baby-care product manufacturer with high market shares in certain categories and geographies, most notably China. We have admired the business and regarded it as having a strong competitive position over the years but recent evidence suggests that this strong position is being eroded rather quickly by a clutch of domestic and foreign peers in China. Consequently, growth has slowed and we worry that the company might not recover to its former profitable levels. We have therefore sold our entire holding in the company.
Poletowin Pitcrew Holdings	Poletowin is a games software debugging company that we have owned for over a decade. It serves both Japanese and global gaming companies in debugging and localising games for specific markets, including providing language translation related services. While the overall gaming industry has grown during this period the company has struggled to match this growth, especially in terms of profits. The company has made numerous acquisitions, mostly overseas, but there hasn't been any noticeable positive impact on sales and profits from these acquisitions thus far. Instead, the company has recently become embroiled in an accounting related issue at one of its overseas subsidiaries. We worry that the group structure has become quite complex at Poletowin due to numerous acquisitions that management have made over the years. We recently spoke to the new management team who indicated that growth from here is likely to be slower than before given rising levels of competition and increasing maturity of the gaming market in general. Overall, we are left quite underwhelmed by the investment case here and hence decided to sell our entire holding in the company.
Tsubaki Nakashima	Tsubaki Nakashima is a leading global manufacturer of steel and ceramic balls that go into ball bearings, which are in turn used across a wide range of industries. However, following a period of private equity ownership the balance sheet is quite highly geared, and it was a surprise to us when management decided to do a share buyback last year. Recently, the company has had an issue where the write-down of an acquisition's carrying value led to a technical breach of some of the company's covenants and the auditor issued a qualified audit statement regarding the company's status as a going concern. Although the situation has subsequently been resolved, it has led to further doubts as to the appropriateness of the company's financial management. The company also issued equity recently which will result in a near 50% dilution over the next couple of years. Given these operational and financial issues, we decided to sell the shares.

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