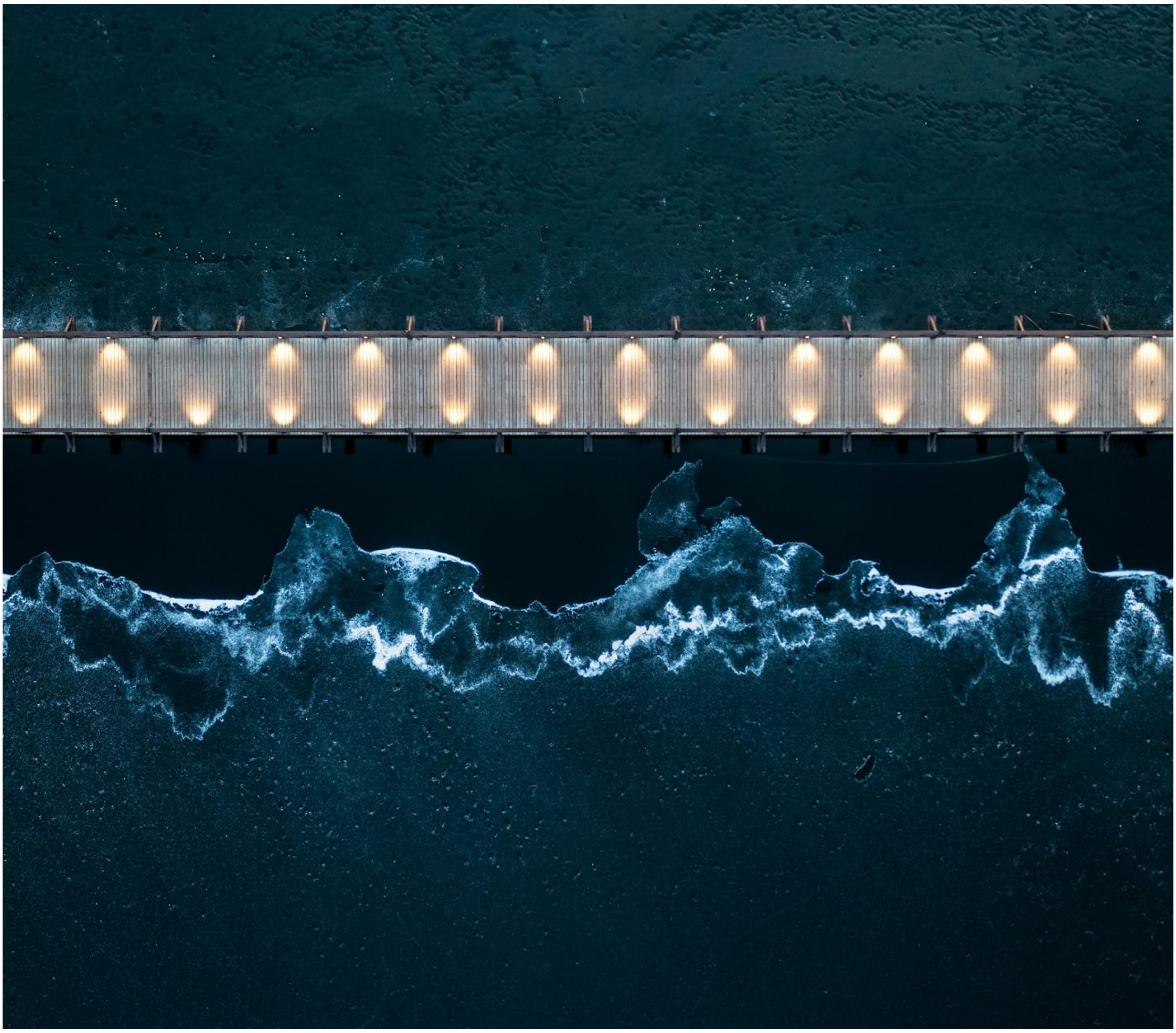
Baillie Gifford

Japan Income Growth Quarterly Update

31 December 2023



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Past performance is not a guide to future returns. Changes in investment strategies, contributions or withdrawals may materially alter the performance and results of the portfolio. Material market or economic conditions will have an impact on investment results. The returns presented in this document are gross of fees unless otherwise stated and reflect the reinvestment of dividends and interest.
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Potential for Profit and Loss

All investment strategies have the potential for profit and loss.

Stock Examples

Any stock examples, or images, used in this paper are not intended to represent recommendations to buy or sell, neither is it implied that they will prove profitable in the future. It is not known whether they will feature in any future portfolio produced by us. Any individual examples will represent only a small part of the overall portfolio and are inserted purely to help illustrate our investment style. A full list of portfolio holdings is available on request.

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Product Overview

Japanese Income growth is a regional equity strategy which aims to invest in attractive growth investments whilst generating an above market yield. 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. At the same time, improving attitudes towards corporate governance and strong corporate balance sheets should support dividend growth.

Risk Analysis

Key Statistics	
Number of Holdings	53
Typical Number of Holdings	45-65
Active Share	85%*
Annual Turnover	6%

*Relative to TOPIX. Source: Baillie Gifford & Co, Japan Exchange Group.

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

Three areas within the portfolio excite us: Secular growth, stalwarts and special situations. We expect these companies to deliver strong growth into 2024 and beyond

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 2021, this strategy delivered strong outperformance by backing Japan's most promising growth 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 quite a different set of companies having their day in the sun.

This change in leadership seems very 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 over a decade of deflation, ultra-low interest rates and quantitative easing, the last twenty-four months brought about a shift in conditions and a recalibration of expectations. These effects were magnified by the bounce back in economic activity post-COVID, in addition to the effects of conflicts that have flared up around the world.

Such conditions presented a strong headwind to our investment style, lifting the profit margins of cyclical constituents of the market where we remain underweight. As a reminder, the portfolio is very different to the underlying market, and deliberately so. We have nothing in around half of the Topix 33 industries - including some of the top-performing sectors over the past twelve months such as Iron and Steel, Marine Transportation and Construction - because their mid-long term growth prospects are poor and remain so despite the change in market conditions. Indeed, we think many of these companies – and the macro tailwinds that have propped them up – now look overstretched.

One such example is Toyota: despite single-digit sales growth, Toyota shares have risen circa 60 per cent in the past three years. This ascent probably reflects improving expectations, the company's newly announced EVs initiatives, and a weak Yen, which was one of the worst-performing currencies in 2023 providing a boon to Japan's export industries. However, we believe the picture looks rather less rosy when you strip out exogenous and ephemeral macro factors and examine industry fundamentals.

The weak Yen is one such factor. 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 biggest export industries, such as autos. Evolving industry fundamentals also paint a rather bleak picture for Japan's leading original equipment manufacturers (OEMs). In the last few years electric vehicles have overtaken internal combustion engine (ICE) vehicles by most growth measures (they are expected to have accounted for nearly one in five car sales in 2023, up from one in ten, two years ago). This shift has significant implications for industry incumbents such as Toyota, which once dominated global car sales. Their slow adoption of EV technology has seen them relinquish market share to new industry entrants such as BYD, the world's largest EV maker after overtaking Tesla in 2022. This has implications for Japan as a whole, which in 2023 was displaced by China as the world's biggest auto exporter. The case for a reversal of share price fortune for export giants such as Toyota seems strong, and as such we are happy not to own the shares today.

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' equities, typically online businesses expected to generate the bulk of their cash flows in the future. 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 online businesses, enhance their growth prospects, and increase the premium paid for growth in such an environment.

Significant shifts in the market backdrop can often cause unfavourable trends to emerge in the short term - as market participants reposition towards presumed beneficiaries of this new market paradigm. These shifts are often overdone. We believe this has created a rare and propitious opportunity for us to double down on companies capable of adding significant alpha of their own accord. We believe this recent dark period for growth investors will come to be seen as the time-to-buy moment for outperformance over the next ten years.

Doubling down on durable growth

To steal a famous investment metaphor, the market is currently acting like a voting machine, with share prices reflecting their popularity given the perception of rate changes.

In the long term, we are confident the market will be more of a weighing machine, with share prices reflecting company-specific factors such as the relative opportunity to grow revenue and expand margins, and the durability of an edge. This has important implications for the three main areas of the portfolio.

Secular Growth Opportunities

Secular Growth opportunities represent the largest unifying theme amongst the stocks, and about a third of the whole portfolio. These are loosely defined as innovative and disruptive businesses, where the pace and potential impact of the company's growth are often misunderstood by the market.

Some of the biggest detractors to performance over the past few years sit within this bucket. Examples include CyberAgent, Rakuten, and MonotaRo, companies which have lost almost half of their market cap over the past three years. The first obvious question is, has something gone wrong with these businesses? During that time frame all three companies grew their sales by at over 15 per cent compounded. If we didn't know the share price return, we would certainly be more than happy with the impressive revenue growth they are posting. So why have they done so poorly in share price terms and why is this about to change?

The majority of share price weakness can be attributed to multiple compression. Despite sales growth that is higher than the market, our secular growth stocks have experienced a decline in their price-to-sales multiple over this period, this contrasts with a rerating up for the wider market. The market may believe this is warranted in cases where profits are depressed. However, we see this investing for the future as a necessary component to capturing future growth; the cost of cornering a market whilst others retrench. For example, Cyberagent is investing heavily in its AI toolkit, which aims to transform the economics of online advertising and cement its position as a leading online advertiser within a structurally growing industry. Meanwhile, Rakuten has been rolling out a new mobile network that will allow it to solidify the strength of its ecosystem, and capture a greater share of consumer spend in Japan. Meeting with the founder Mikitani-San in November proved particularly fruitful; the company is exploring alternative ways of boosting subscriber growth, which already appears to be playing out: subscriber growth has surpassed 6 million putting them well on track to achieve profitability in the mobile arm in 2024. The derating of its share price in recent years provides a low hurdle for an attractive upside from this point on.

Whilst being home to the portfolio's largest detractors, this bucket also benefits from some of the most dramatic technological transformations to have taken place in 2023. We would posit that the defining development of 2023 from an investment perspective was the leap forward in AI large language models, as typified by ChatGPT. CyberAgent and Rakuten have been preeminent in their application of this technology. CyberAgent, for example has been using 'Kiwami Prediction' to develop automated and individually tailored 3D banner ads that could transform the economics of advertising. Although excitement around AI has centred around semiconductor chips, we expect this to broaden out to application providers, which are expanding dramatically within Japan as digitization continues to advance.

Growth Stalwarts

Growth stalwarts present another important plank of the portfolio with a clear avenue of upside. These are 'enduring growth companies' or 'compounders' that benefit from high-quality franchise characteristics, dominant market share, durable competitive advantages, and pricing power. Many of the holdings within this bucket have been acquired in the past few years as Covid created an unusual snag in their cash flow streams – by denting high-margin travel and retail sales - providing an attractive entry point for the long term.

Although tourism within Japan has since recovered, Chinese tourism remains 65 per cent below pre-Covid levels. The sluggish recovery of the Chinese economy and the unfortunate Fukushima water release depressed sales well into 2023; however, green shoots are beginning to appear. In time, we believe companies such as Shiseido, a global skincare and cosmetic company, will be well-positioned to benefit from the rise in Asian middle-class wealth.

There is good reason for such ambition: per capita spend on skincare is above $100 in South Korea, Taiwan and Singapore, yet merely $36 p.a. (20 per cent of US levels) in the world's biggest market, China. Skincare has been the fastest-growing segment, increasing its share of cosmetics sales in stark contrast to what we have witnessed in the West. In addition, Japanese skincare brands remain highly regarded by neighbouring Asian consumers. We may therefore be downplaying Shiseido as “just” a growth stalwart – there is a clear secular growth case for it too: what’s not to like?

Special Situations

Talking of likes and dislikes, the third main grouping in the portfolio is almost defined by being disliked: Special situations. Special situations are out-of-favour companies that often harbour a catalyst for a rerating that we think is about to be triggered. Softbank, as one example, is an investment holding company with a $60bn market cap, run by founder Masayoshi Son.

Softbank’s major investments comprise of ARM - which has a near-monopoly in mobile phone chip design - Softbank Corporation, as well as many AI-related investments in the vision fund. Softbank boasts a strong track record, having been involved in six of the 15 largest IPOs by market cap over the past decade, including the recent re-listing of ARM which was 6 times oversubscribed. Despite such success, the company trades at a significant discount to the sum of its parts. Their stake in ARM alone, for example, is worth circa $65bn, eclipsing the entire market cap of the group. We are confident this will narrow, as $29b+ value in late-stage companies (including ByteDance, Paypay and Kavak) in the vision funds is realised, as ARM continues to command a growing share of a rising opportunity in semiconductors, and through further buybacks. The company has led the country with record share buybacks in recent years, with Y5 trillion ($30-40bn) executed over the last five years alone.

Although SoftBank often elicits derision within certain circles for its aggressive backing of new ventures - most recently receiving widespread criticism for its support of WeWork - it is this very approach that has allowed the company to succeed and scale where others have failed. Yahoo!Japan, Alibaba, Vodafone, Sprint and ARM all provide examples of the astute value-added ability of its founder CEO Masayoshi Son. Their backing of some of the most disruptive technologies to have emerged since the smartphone provides us with confidence that Softbank will surpass a 2x valuation of over $120bn in time.

Conclusion

We see compelling reasons why the companies in the portfolio will return to favour soon. After all, the companies in the portfolio are of higher quality with greater historic - *and expected* - sales growth and profitability than the market. It seems to us that these factors will likely transcend macro considerations and sentiment and that their share prices will start to respond pretty soon.

The long-term quality growth philosophy that we live and breathe 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 growth investors in Japan, and that our clients’ patience– for which we thank them for - is about to be rewarded.

Performance Objective

1.5%+ gross of fees 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	4.4	3.4	1.0
1 Year	1.5	13.3	-11.8
3 Year	-1.5	3.5	-5.0
5 Year	4.2	6.8	-2.6
Since Inception	5.9	6.7	-0.8

USD	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	9.0	8.0	1.0
1 Year	7.6	20.0	-12.5
3 Year	-3.7	1.1	-4.8
5 Year	4.3	6.8	-2.6
Since Inception	5.3	6.1	-0.8

EUR	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	4.5	3.5	1.0
1 Year	3.9	16.0	-12.0
3 Year	-0.4	4.6	-5.0
5 Year	5.0	7.6	-2.6
Since Inception	5.5	6.3	-0.8

CAD	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	6.3	5.3	1.0
1 Year	4.7	16.8	-12.1
3 Year	-2.6	2.3	-4.9
5 Year	3.5	6.1	-2.6
Since Inception	5.5	6.2	-0.8

AUD	Composite Net (%)	Benchmark (%)	Difference (%)
3 Months	3.1	2.2	1.0
1 Year	6.9	19.3	-12.4
3 Year	0.3	5.3	-5.0
5 Year	4.9	7.5	-2.6
Since Inception	6.9	7.6	-0.8

Annualised periods ended 31 December 2023. 3 Month & 1 Year figures are not annualised.
Inception date: 31 July 2016
Figures may not sum due to rounding.
Benchmark is TOPIX.
Source: Revolution, Japan Exchange Group.
The Japan Income Growth composite is more concentrated than the TOPIX.

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 (%)	16.2	10.7	0.7	-6.5	1.5
Benchmark (%)	14.6	9.5	2.0	-4.1	13.3

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 (%)	20.9	14.2	-0.2	-16.9	7.6
Benchmark (%)	19.2	13.0	1.1	-14.9	20.0

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 (%)	23.1	4.8	7.4	-11.5	3.9
Benchmark (%)	21.4	3.7	8.8	-9.3	16.0

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 (%)	14.8	12.2	-1.0	-10.9	4.7
Benchmark (%)	13.2	11.1	0.2	-8.7	16.8

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 (%)	21.1	4.1	5.9	-11.0	6.9
Benchmark (%)	19.4	3.0	7.3	-8.7	19.3

Benchmark is TOPIX.
Source: Revolution, Japan Exchange Group.
The Japan Income Growth composite is more concentrated than the TOPIX

Stock Level Attribution

Top and Bottom Ten Contributors to Relative Performance

Quarter to 31 December 2023

Stock Name	Contribution (%)
Benefit One	0.4
GMO Internet	0.3
Seria Co Ltd	0.3
Infomart Corp	0.3
Nintendo	0.2
Toyota Motor	0.2
DMG Mori	0.2
Takeda Pharmaceutical	0.2
Honda Motor	0.2
OSG Corp	0.2
Shiseido	-0.4
Shin-etsu Chemical	-0.4
Pola Orbis Holdings	-0.4
Recruit Holdings	-0.3
Tokyo Electron	-0.3
Denso	-0.2
Sumitomo Mitsui Trust	-0.2
Sony	-0.2
Lasertec	-0.2
Milbon	-0.2

One Year to 31 December 2023

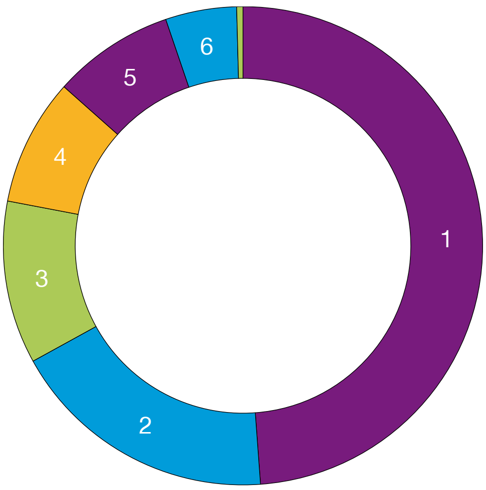
Stock Name	Contribution (%)
DMG Mori	0.7
Benefit One	0.4
Daiichi Sankyo	0.4
Bank Of Kyoto	0.4
Japan Exchange Group	0.3
Takeda Pharmaceutical	0.3
Itochu	0.2
Denso	0.2
Olympus	0.2
Astellas Pharma	0.2
Shiseido	-1.4
Pola Orbis Holdings	-1.2
Park24	-0.8
Calbee	-0.7
Pigeon	-0.7
Sumitomo Metal Mining	-0.6
Mixi	-0.6
Fanuc	-0.6
GMO Internet	-0.6
Tokyo Electron	-0.6

Source: Revolution, Japan Exchange Group. Japan Income Growth composite relative to TOPIX.
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
SBI Holdings	Online financial services	4.1
GMO Internet	Internet conglomerate	3.9
Sumitomo Mitsui Trust	Japanese trust bank and investment manager	3.7
FANUC	Robotics manufacturer	3.4
DMG Mori	Machine tool manufacturer	3.3
Tokio Marine Holdings Inc	Offers property and life insurance	3.3
MS&AD Insurance	Japanese insurer	3.2
SoftBank Group	Telecom operator and technology investor	3.2
Nintendo	Gaming consoles & software	3.0
Bridgestone	Tyre manufacturer	3.0
Total		34.1

Sector Weights



		%
1	Manufacturing	48.8
2	Finance & Insurance	18.2
3	Transport And Communications	11.0
4	Commerce	8.6
5	Services	8.2
6	Real Estate	4.8
7	Cash	0.4

Figures may not sum due to rounding.

Voting Activity

Votes Cast in Favour		Votes Cast Against		Votes Abstained/Withheld	
Companies	2	Companies	None	Companies	None
Resolutions	28	Resolutions	None	Resolutions	None

Long-term investing and sustainability are inextricably linked

The strategy continues to ensure our enviornmental, 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	DENSO Corporation, PARK24 Co., Ltd., Seria Co., Ltd., Unicharm Corporation
Social	Olympus Corporation, PARK24 Co., Ltd.
Governance	CyberAgent, Inc., Kakaku.com, Inc., MISUMI Group Inc., Nidec Corporation, Nintendo Co., Ltd., Olympus Corporation, PARK24 Co., Ltd., Pola Orbis Holdings Inc., Rakuten Group, Inc., Seria Co., Ltd., Sumitomo Mitsui Trust Holdings, Inc.
Strategy	DENSO Corporation, Nidec Corporation

Company	Engagement Report
Olympus Corporation	Objective: We met with the CEO of Olympus, Stefan Kaufmann, to understand Olympus' status in the diagnosis and remediation of issues raised in recent warning letters from the FDA. This meeting sought to cover the underlying drivers of the FDA complaints and establish a starting point for future monitoring and potential engagement. Discussion: When Kaufmann assumed leadership, Olympus had three main priorities: innovation for growth, patient safety and sustainability, and productivity. However, following the FDA warnings, Kaufmann elevated patient safety to the top priority. While partially symbolic, this reorganisation was shared to be an important beacon for refocusing the manufacturing and quality assurance functions at Olympus. We questioned the underlying drivers of the FDA complaints, and Mr Kaufmann shared that part of the cause for the FDA letters was a clash between Japanese manufacturing practices and American regulation, as well as disjointed internal systems that led to longer feedback loops. Olympus is currently working on improving the capacity of the quality assurance and product safety team, which Mr Kaufmann now believes to be industry-leading. Mr Kaufmann also acknowledged that strengthening internal information flows between teams could have facilitated more effective issue escalation. To fix this, Olympus are implementing new IT tools building faster feedback loops while attempting to enable a culture where the escalation of issues is more acceptable. Part of the incentives to enable this change include the introduction of product quality-related targets in employee bonuses. There are a lot of moving parts, but we were glad to hear that Mr Kaufmann recognised the importance of change management, rooting out the drivers of these issues and monitoring the changes he has implemented. Outcome: We came away from the meeting positive about the directionality of remediation and with a greater understanding of Mr. Kaufmann's efforts to improve patient outcomes. The meeting also provided insight into Olympus' ongoing efforts to address the FDA's concerns and provided us with some data points for future monitoring.

Votes Cast in Favour

Companies	Voting Rationale
Colopl Inc, CyberAgent Inc	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
Benefit One	Benefit One is a fringe benefits platform for employees. It is the market leader with almost half of the market, having done an opportunistic acquisition of the number three player during Covid. Market growth should pick up going forward as companies work hard to retain workers by improving their benefits package. This is a fundamentally cash-generative business with good return characteristics and a healthy payout ratio. Shares have been de-rated over the last year due to the tapering off of its vaccine-related business. It's now trading at a multiple that looks attractive with a 3.5% yield. We decided to take a holding.

Complete Sales

Stock Name	Transaction Rationale
Benefit One	Benefit One is a fringe benefits platform for employees. It has the largest market share with over 10 millions employees on their platform. It was attractively valued for what is a very cash generative business with excellent competitive position. Since taking a holding, there had been two tender offers to acquire stakes in the company. The higher bid aims to eventually delist Benefit One and it's unclear whether there will be further counter-bids. With the share price now trading above the higher bid price and the facts of the investment case materially changed, we have decided to sell out, locking in a decent profit since initiating a holding a short time ago.

Holdings Information	Please note the fund portfolio information contained within this report is confidential, proprietary information and should be maintained as such and not disseminated. The content is intended for information purposes only and should not be disclosed to other third parties or used for the purposes of market timing or seeking to gain an unfair advantage
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