Japan Strategy Stewardship Report

For the Year Ended 30 September 2022

BAILLIE GIFFORD | Investment managers

Risk Factors

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Stock Examples

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Contents

Market update

Ossified employment practices, complicated Keiretsu structures and cosy cross-shareholdings are criticisms commonly levelled at Japan. It was no doubt, therefore, for this reason, that investors were so enthusiastic about the late former Prime Minister Shinzo Abe's third 'arrow' of Abenomics: of structural economic reform.[1] This was widely expected to be the panacea to Japan Inc's problems, cutting through antiquated corporate codes of practice, revitalising profitability and delivering strong shareholder returns.

Ten years have passed since Abe's announcement, and many commentators question its outcome.

One of the caveats that should always accompany embellished political narratives is that quick fixes are invariably rare in the real world. As promising as they appeared, these reforms were never intended to transform Japan's corporate scene overnight. They have, however, been successful in spearheading a momentum for change. Incremental improvements are becoming increasingly apparent as antiquated systems and behavioural barriers built over decades are dismantled and overcome.

Below we outline some of these tangible improvements, a product of political policies and other initiatives, under the three broad headings of Environment, Social and Governance (ESG).

Environmental

Japan's continued reliance on overseas energy supplies has, with uncomfortable echoes of the 1970s oil shock, rendered its economy vulnerable to spikes in global energy prices. Recent geopolitical events have jolted Japan and added fresh impetus to the environmental need to act.

In response, the Japanese government has increased its efforts to tackle greenhouse gas emissions and improve the economics of renewables. These efforts have ranged from the paltry to the ambitious. An essentially nominal nationwide carbon tax operates alongside a substantive regional emission trading scheme in two of Japan's 47 prefectures. One of which, in Tokyo, was Japan and Asia's first Emissions Trading Scheme (ETS). Additionally, Japan will soon have its first national, albeit voluntary, carbon credit market under the auspices of the 'Green Transformation League'. 440 companies – which account for 30 per cent of Japan's emissions – have already signed up. These efforts are expected to help them achieve their 2030 targets while fostering broader ambition for decarbonisation.

The country's 2050 carbon-neutral pledge has also helped spotlight scope one, two and three emission disclosures. Japan generally performs well in this regard: the government has the world's most corporate 'Taskforce on Climate-related Financial Disclosures' (TCFD) supporters by number, with over 800 companies in support, up from 100 three years ago. Japan is third, globally, in setting science-based targets (SBT), after the US and UK, with Sony being the first Japanese company to set targets in 2015. Japan also has the world's highest number of new Asia Pacific RE100 members by headquarters – a global initiative bringing together the world's most influential businesses committed to 100 per cent renewable electricity. In addition, 90 per cent of MSCI Japan constituents now produce sustainability reports.

Our growth bias naturally predisposes us to those at the forefront of environmental change. This position has arguably strengthened recently, as concerns over capital allocation and inaction to the impending impact of climate change have led to deliberate changes in our exposure to the auto and oil and gas sectors. The advent of electric vehicles (EV) has been accelerated by the efforts of original equipment manufacturers (OEMs) outside of Japan. **Toyota's** focus on hybrids and fuel-cell technology has diminished the potential benefits of its belated transition towards EVs. This has implications for other Toyota-Keiretsu-related companies. However, this doesn't mean Japan is bereft of opportunities arising from the EV transition. From the OEMs, we have shifted upstream towards 'picks and shovels' and beneath-the-bonnet enablers of electrification. Examples include **ROHM**, a manufacturer of energy-efficient silicon-carbide (SiC) devices, and **Bridgestone**, a market-leading tyre manufacturer increasingly seizing opportunities in after-sales services and the circularity of its products.

[1]Former Prime Minister Shinzo Abe was tragically assassinated on 8 July 2022.

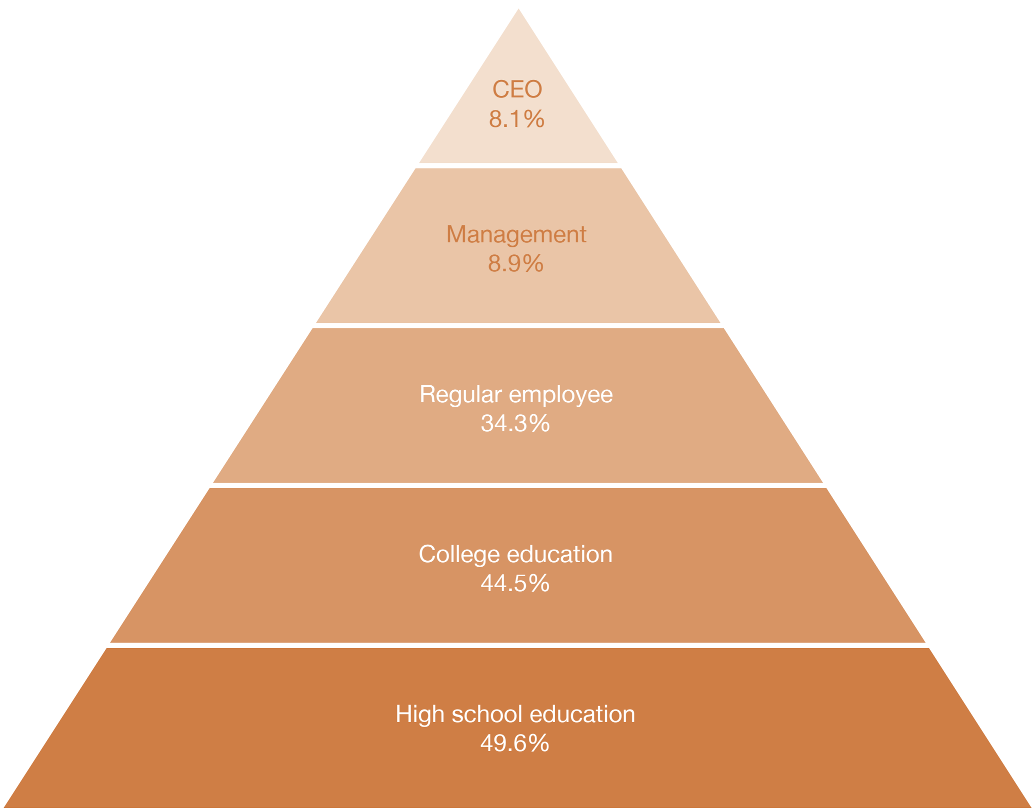
Social

Japan is generally regarded as a forebearer of corporate social responsibility (and, therefore, some aspects of ESG). Emblematic of this is the continued phenomenon of companies offering lifetime commitment to stable employment and strong support to local communities or their jōka-machi (company town). These aspects speak to a firm's central role within society and why the country is still cited as an exemplar of stakeholder-orientated capitalism.

However, this sense of responsibility to stakeholders has tended to stop short of supply chains outside of Japan. The Ministry of Economy, Trade and Industry is now providing guidance to enable companies to extend their sense of responsibility to their entire supply chains. This encouraging development would see companies consider broader aspects of human rights to ensure responsible and resilient supply chains.

Given the country's declining demographic issue, one of the unusual shortcomings in the social sphere has been the unfair treatment of women in the workforce. Accounting for a growing proportion of graduates, yet only a third of regular employees, this represents a vast untapped pool of potential for increasing productivity.

Weighting of women in Japan in each stage in pyramid form



Source: Compiled by J.P. Morgan based on recent data from Teikoku Databank, Ministry of Internal Affairs and Communications '2001 Labor Fource Survey', Ministry of Education, Culture, Sports, Science and Technology '2021 Basic School Survey' and PR TIMES. Courtesy J.P. Morgan Chase & Co., Copyright 2022.

The number of female senior officers has risen approximately fivefold since 2012 but still represents only a meagre one in 13 positions. Although the pay gap has decreased, it remains high relative to countries covered by The Organisation for Economic Co-operation and Development. These failings are attributed to the preponderance of women in irregular employment (at 56 per cent), where opportunities for promotion and advancement are usually limited. Their perceived role as primary carers for elderly parents and young children forces many into these roles, away from full-time work. Japan is aiming to overcome this in several ways. The amended act on the Promotion of Women's Participation and Advancement in the Workplace requires companies to report on pay gaps and other aspects of female employment practice. Earlier this year, the government announced measures that will force companies also to include a broad array of information on issues surrounding human capital and diversity within the annual filings by 2023. These initiatives have made company efforts more visible to investors, opening the door to greater engagement.

Flexible working practices are a notable enabler of female participation in the workforce, and the Japanese government is not standing idle. The Government's Plan for Dynamic Engagement of All Citizens banned irrational differences in compensation packages between regular and irregular employees. It helped encourage the adoption of a wide range of work styles. Covid-19 and the forced adoption of home-based work have also helped companies to acquiesce to alternative work-life patterns.

Many companies are ahead of the curve and have been recognised for their initiatives addressing women's advancement. These include businesses such as the skincare company Shiseido, where the ratio of female managers is over 58 per cent globally and 37 per cent in Japan, and the percentage of female directors is over 46 per cent. The company is now making efforts to achieve a 50 per cent ratio across all regions. **Nidec**, a leading manufacturer of electric motors, is another example. To encourage the creation of a meritocracy, it was an early adopter of working from home and staggered work shifts back in 2017. They also have a comprehensive support system for women before and beyond pregnancy.

Entrepreneurial internet businesses are often the best at experimenting with alternative approaches: **CyberAgent's** 'macalon' package supports female employees' careers by giving generous leave for those trying to conceive with fertility treatment and access to specialised counselling services. **Mercari** conscientiously accommodates pregnancy and childcare needs with subsidised egg-freezing costs, conducts training to support female career development, and encourages spouses and partners to take childcare leave. **Recruit**, **Rakuten** and **Z-Holdings** aim to assist parents juggling childcare with work commitments by providing access to an in-house nursery school.

Governance

In 2014 and 2015, the Stewardship Report and Corporate Governance Code were first published to great fanfare. Their triennial revisions gained comparatively little coverage. The impact of these iterations, however, has been substantial, as evidenced in three ways:

— **Greater Accountability**. Board independence was once a strange idea across corporate Japan. Now 92 per cent of companies on Japan's Prime Index have appointed at least one-third of outside directors, up from 34 per cent in only 2018. And although only 12 per cent have majority outside directors, the number has increased four-fold since 2018, suggesting that the direction of travel is clear. Companies are now going one step further – by disclosing a 'skills matrix' to assess the depth of expertise onboard.

— **Shareholder Returns**. Companies have been repurchasing and cancelling shares at record rates. Years of cash-hoarding have allowed firms to execute buybacks parallel to achieving existing CapEx plans. Companies do not have to sacrifice one to complete the other. Addressing the cash drag allows the company to increase profitability and return on equity sustainably.

— **Active Shareholder Base**. Cosy cross-shareholdings, a standard fixture in the Japanese business community since the Second World War, can allow companies to engage in unprofitable endeavours, sap accountability and often lead to lax discipline. Revisions to the corporate governance code in 2018 have required companies to disclose the benefits and risks of maintaining each cross-shareholding.

However, the Tokyo Stock Exchange reorganisation has created another catalyst to address this systemic inefficiency by forcing constituents to achieve a 35 per cent free float, thereby weeding out the remaining cosy corporate relationships. As a result, the shareholder register has been refreshed. Equity holdings by institutional investors overtook those by stakeholders last year for the first time on record, and 7 per cent or ¥2.3tn of all cross-held shares were unwound in the previous fiscal year alone – representing the fastest rate of unwinding in more than a decade. This has helped drive a structural improvement in profitability, with net profit margins for listed firms surpassing their pre-Covid-19 peak earlier this year.

Sumitomo Mitsui Trust Holdings, the last remaining independent trust bank in Japan, is addressing its book, creating additional upside in the process. It aims to dramatically reduce its ¥1.4tn/900 company portfolio of cross-shareholdings in those where it retains control – it plans to exercise its voting rights based on far more rigorous standards than practised in the past. .

Conclusion

This year the Japanese market has again been a fascinating source of contradictions. Palpable ambition on climate has accompanied stuttering progress on gender equity. That said, the companies we invest in skew towards defying convention and exemplify the best of Japan, which remains an ideal environment for long-term, bottom-up stock-picking.

Baillie Gifford's Stewardship Principles

Reclaiming Activism for Long-Term Growth Investors

We have a responsibility to behave as supportive and constructively engaged long-term investors. We invest in companies at different stages in their evolution, across vastly different industries and geographies and we celebrate their uniqueness. Consequently, we are wary of prescriptive policies and rules, believing that these often run counter to thoughtful and beneficial corporate stewardship. Our approach favours a small number of simple principles which help shape our interactions with companies.

Prioritisation of long-term value creation

We encourage company management and their boards to be ambitious and focus their investments on long-term value creation. We understand that it is easy for businesses to be influenced by short-sighted demands for profit maximisation but believe these often lead to sub-optimal long-term outcomes. We regard it as our responsibility to steer businesses away from destructive financial engineering towards activities that create genuine economic value over the long run. We are happy that our value will often be in supporting management when others don't.

A constructive and purposeful board

We believe that boards play a key role in supporting corporate success and representing the interests of minority shareholders. There is no fixed formula, but it is our expectation that boards have the resources, cognitive diversity and information they need to fulfil these responsibilities. We believe that a board works best when there is strong independent representation able to assist, advise and constructively test the thinking of management.

Long-term focused remuneration with stretching targets

We look for remuneration policies that are simple, transparent and reward superior strategic and operational endeavour. We believe incentive schemes can be important in driving behaviour, and we encourage policies which create alignment with genuine long-term shareholders. We are accepting of significant pay-outs to executives if these are commensurate with outstanding long-run value creation, but plans should not reward mediocre outcomes. We think that performance hurdles should be skewed towards long-term results and that remuneration plans should be subject to shareholder approval.

Fair treatment of stakeholders

We believe it is in the long-term interests of companies to maintain strong relationships with all stakeholders, treating employees, customers, suppliers, governments and regulators in a fair and transparent manner. We do not believe in one-size-fits-all governance and we recognise that different shareholder structures are appropriate for different businesses. However, regardless of structure, companies must always respect the rights of all equity owners.

Sustainable business practices

We look for companies to act as responsible corporate citizens, working within the spirit and not just the letter of the laws and regulations that govern them. We believe that corporate success will only be sustained if a business's long-run impact on society and the environment is taken into account. Management and boards should therefore understand and regularly review this aspect of their activities, disclosing such information publicly alongside plans for ongoing improvement.

Our Process

As long-term investors, we believe a due consideration of a company's material environmental, social, and corporate governance characteristics will enable us to understand its long-term resilience and growth potential better.

As such, ESG factors are not just complementary to achieving attractive long-term returns, but they enable it when done sensibly nd thoughtfully.

Our approach is essentially tiered. At the most fundamental and integrated level, our four-factor research framework includes an explicitly ESG-themed question:

Taking in turn environmental, social, and governance factors, which do you believe are important and relevant to the investment case?

This enables the investment analyst to assess relevant ESG factors alongside growth opportunity, competitive advantage, and financial characteristics for every company we analyse. Importantly, our focus on materiality means the precise ESG considerations will vary depending on several variables, including core business model, size, and sector.

In addition, the Japan team has a designated ESG Analyst who provides additional expertise and support on ESG matters, contributes to stock discussions, and assists the investors in further integrating ESG considerations into their investment research and analysis process.

Where a particular ESG issue warrants additional work, the team may also avail of the support of our central ESG function on AGM voting, ESG data, and emerging ESG-related regulations. We also have independent researchers based in Tokyo who can conduct ESG research where an on-the-ground perspective is helpful.

This process ensures that despite ESG's vast complexity, for any individual company, we have the scope and flexibility to go into the appropriate degree of detail to enable us best to deliver long-term returns for our clients.

Engagement Highlights

Key: Stewardship Principles

Prioritisation of long-term value creation

A constructive and purposeful board

Long-term focused remuneration with stretching targets

Fair treatment of stakeholders

Sustainable business practices

Bank of Kyoto

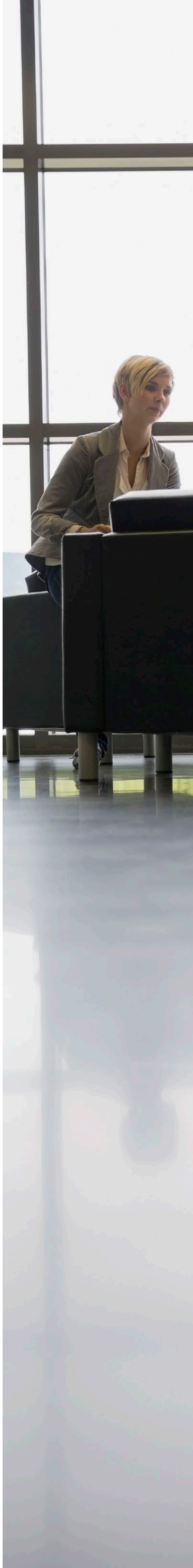
We engaged with the Bank of Kyoto regarding an activist's campaign to increase shareholder dividend payments. We conveyed our view that while we differed with the specific request of the activist, we agreed that the dividend was inappropriately low given the strength of the company's balance sheet. Although our discussion was productive and informative, we ultimately decided it was in our clients' interests to support the shareholder proposal.

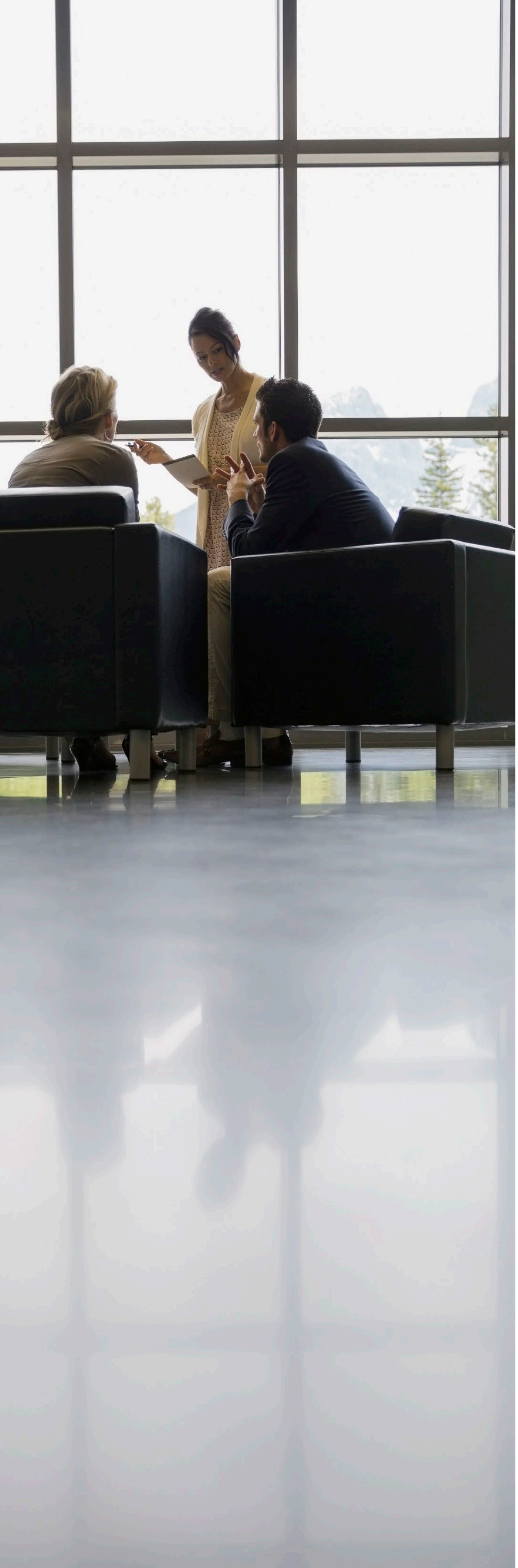
OSG Corp

In 2021 we engaged with OSG Corp on board diversity due to its all-male board. This year we were pleased to see it had appointed a female director, Kayoko Yamashita, a tax expert and accountant expert. A truly diverse board can't be reduced to a set of characteristics. Still, appointments like Yamashita-san are a positive sign that boards that don't exhibit some degree of diversity are increasingly untenable in Japan.

Rakuten

We engaged Rakuten due to its proposal to award stock options to outside directors. Rakuten had previously ceased this practice in 2018, which led us to support subsequent remuneration proposals. While we appreciate the desire to increase alignment between outside directors and shareholders, we remain wary of any potential compromise to non-executive director independence.





Yonex

As part of a review of our Japanese holdings for exposure to potential human rights concerns, we identified Yonex as having relatively limited disclosure. During the engagement, Yonex clarified that it has no exposure to Xinjiang; however, it acknowledged our points regarding actively monitoring beyond a policy and informed us that it is at the start of building a comprehensive management system. Understanding its context as a smaller company, we are encouraged that it has begun to improve its processes and recognise the vital importance of improving in this area.

SMC Corp

We engaged with SMC regarding its emissions disclosure and overall business alignment with a net zero future. We were pleased to hear that it is preparing emissions disclosure and will also disclose in line with TCFD recommendations and intends to set science-based reduction targets. It is also pursuing lifecycle assessments of its products for the benefit of its customers.

Proxy Voting

Voting at company general meetings is one of our most important ownership rights and responsibilities as a shareholder. Consequently, all our voting decisions are made on a case-by-case basis. Our investment style allows us to invest in only those companies we actively support and admire. It is, therefore, the case that many of our final voting decisions are in support of management.

However, we will engage with companies where more information is required or if a resolution conflicts with our stewardship principles. If, after dialogue, we conclude that it is in the long-term interest of both the company and our portfolio investors to withhold or oppose a resolution, we will do so. We will always inform a company of our concerns and rationale when we have reason to vote against management.

By taking this careful, research-led approach to voting and meeting and engaging with management and board members throughout the year, we can apply our voting rights most effectively on your behalf.

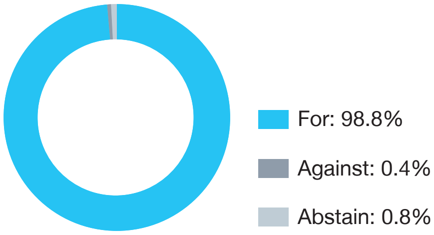
The chart below, which provides a summary of proxy voting in the 12 months to September 2022, illustrates our voting decisions across the resolution categories.

	Number of Proposals	Percentage
Abstain	7	1.0%
Against	8	1.2%
For	657	97.8%
Total	672	100%
Votes with management	659	98.1%
Votes against management	6	0.9%

Based on a representative portfolio as of 30 September 2022. Figures may not sum due to rounding.

Examples of Voting Activity

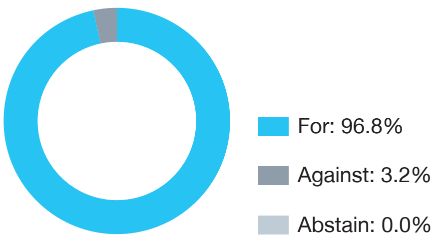
Election of Directors



Kose

Due to a lack of progress on increasing board independence, we escalated our voting approach to oppose the two most newly appointed inside directors while continuing to abstain from the election of President Kazutoshi Kobayashi.

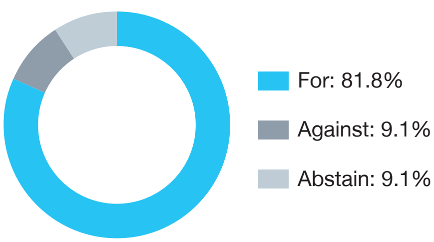
Remuneration



Rakuten

At the 2022 annual general meeting of Rakuten, we voted against a proposed deep discount stock option plan that included outside directors as participants. We do not believe such plans promote alignment with shareholders, and potentially impair independence and objectivity of outside board members.

Dividend



Ain Holdings

We voted against the proposed dividend at Ain Holdings because we believed it to be inappropriately low, given the strength of its balance sheet.

Source: Baillie Gifford. Data from 1 October 2021 to 30 September 2022.
Figures may not sum due to rounding.
Based on a representative portfolio.

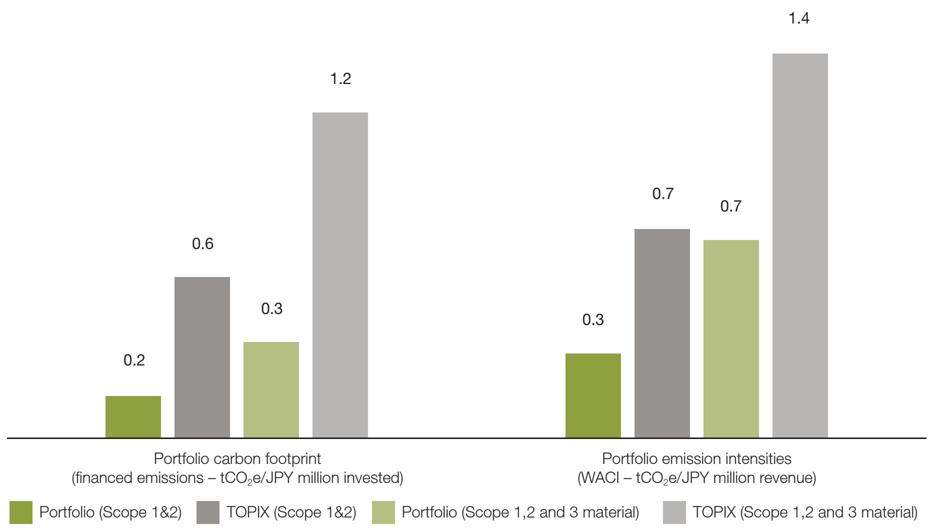
Climate

As long-term investors, we recognise that a changing climate presents risks and opportunities for the companies we invest in. We integrate climate considerations into our investment process using our tiered approach: the investment analyst incorporates climate-material factors into the ESG question of our four-factor research framework, and – where appropriate – additional research and engagement are carried out by our ESG experts.

The Japan team comprises several strategies. We have included the carbon footprints for Japan Growth for illustrative purposes; however, carbon footprints for all strategies are available on request.

The chart below shows that the carbon footprint of our representative portfolio is lower than the relevant benchmark indices.

Carbon Footprint – BGWF Japanese Fund

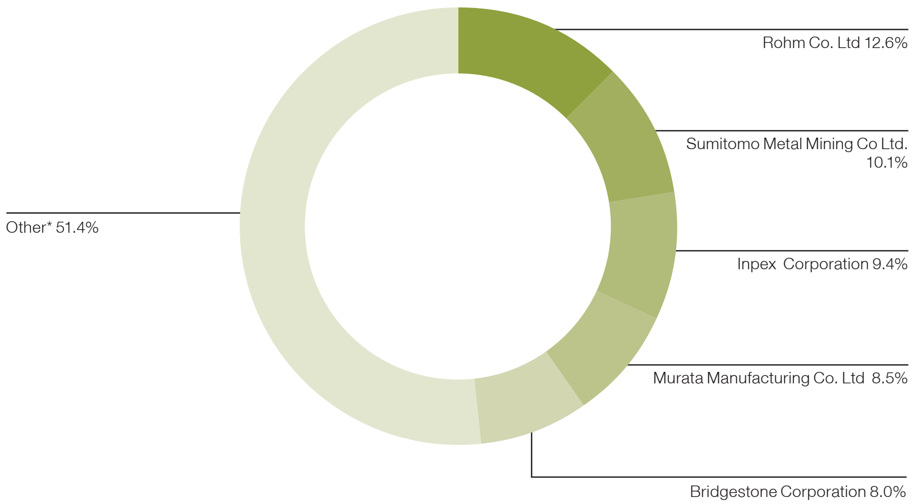


Source: Baillie Gifford & Co. MSCI ESG Research, FactSet As of 30 September 2022
These numbers have not been adjusted for inflation in enterprise value.

The graph above shows two metrics for measuring carbon intensity. One metric measures carbon emissions relative to company enterprise value and the other to revenues. The portfolio value shown reflects the weighted portfolio share of each company we invest in. The metric relative to enterprise value also represents the indicative amount of carbon emissions for each JP¥1m invested (commonly referred to as a portfolio carbon footprint or financed emissions per unit of capital invested).

All metrics refer to scope one, two and three material emissions only and are calculated in line with the Partnership for Carbon Accounting Financials (PCAF) guidance. Scope one emissions are those deriving directly from company activities (such as stack emissions and fuel use); scope two emissions are associated with the electricity a company purchases. Emissions within these scopes are reasonably under the company's control and can be expected to be reported by all companies. We continue to engage with companies and research providers on scope three emissions' availability, comparability and robustness. These are emissions that occur up and downstream of a company's activities and are also known as value chain emissions. While beyond direct operational control, scope three emissions are important indicators of potential carbon risk, and we endeavour to include what information we can gather in our research process.

Top five contributors to the portfolio's Weighted Average Carbon Intensity



*Approximated data.

This data is provided on a 'best endeavours' basis using the available market information, which includes estimated data and unverified company disclosure, so it is therefore open to challenge.

It is based on a representative portfolio as of 30 September 2022.

Interpreting the data

Carbon emission data has limitations. It is based on imperfect calculations and represents a snapshot in time. It does not explain what companies are doing to reduce their emissions, nor does it reflect indirect emissions that occur in the wider value chain.

The only way to do this topic justice is to consider each company's merits and avoid shorthand data points that don't capture the whole picture. If we look at the portfolio companies with the largest scope one and scope two emissions, the nuances in this analysis become more apparent.

ROHM

ROHM (previously mentioned) produces products ranging from integrated circuits to discrete semiconductors. While manufacturing its products entails significant emissions currently, semiconductor products are critical components for EVs, wind turbines and solar panels, which will be vital for meeting global climate goals. We consider ROHM's decarbonisation strategy as both robust and ambitious and includes a target of 50.5 per cent reduction by 2030 and net zero by 2050.

Sumitomo Metal Mining

Sumitomo Metal Mining (SMM) mines, smelts, and refines non-ferrous metals for a global customer base. The nature of its business is highly carbon-intensive, but SMM's products, particularly copper, will be vital for facilitating the global decarbonisation project. SMM does not have a publicly disclosed strategy for achieving net zero by 2050, but during the year under review committed to releasing one by 2024.

INPEX Corp

INPEX Corp is an oil and gas company that provides an important national service in securing a reliable energy supply for Japan. While INPEX has announced a target of achieving net zero by 2050, which includes providing natural gas as a vital transition fuel, we believe its pathway to genuine decarbonisation is complex and uncertain.

Murata Manufacturing

Murata Manufacturing produces and sells electronic components that enable digital transformation, which, in turn, contributes to an environmental objective of more efficient use of resources. Murata's emissions are largely attributable to its energy-intensive high-quality manufacturing. Murata does not yet have a comprehensive strategy for net zero, which would include material scope three emissions. Still, it does have the ambition to derive all of its energy from renewable sources by 2050.

Bridgestone Corp

Bridgestone Corp manufactures and sells tyres for a range of mobility end customers. Tyres have a high level of embedded energy, are compositionally complex and therefore difficult to recycle, and create particulate pollution due to friction with the road. Encouragingly, Bridgestone has consistently demonstrated a thoughtful and deliberate awareness of the ecological impact of its product and an ambitious determination to mitigate it. This includes a realistic decarbonisation plan and initiatives contributing to a circular economy.

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