Japan Strategy Stewardship Report

For the Year Ended 31 March 2020

BAILLIE GIFFORD | *Investment managers*

Risk Factors

The views expressed in this article are those of the Japan Team and should not be considered as advice or a recommendation to buy, sell or hold a particular investment. They reflect personal opinion and should not be taken as statements of fact nor should any reliance be placed on them when making investment decisions.

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Potential for Profit and Loss

All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk. Past performance is not a guide to future returns.

Stock Examples

Any stock examples and images used in this article 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.

This article contains information on investments which does not constitute independent research. Accordingly, it is not subject to the protections afforded to independent research, but is classified as advertising under Art 68 of the Financial Services Act ('FinSA') and Baillie Gifford and its staff may have dealt in the investments concerned.

All information is sourced from Baillie Gifford & Co and is current unless otherwise stated.

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Foreword

Cian Whelan
Analyst, Governance
& Sustainability

At Baillie Gifford, we interpret our stewardship responsibilities as being a natural extension of our fiduciary duty to clients. We conduct ourselves as diligent stewards of our clients' funds by seeking out and backing unique business models with durable growth prospects, subsequently building relationships with management teams to support their long-term aspirations.

Japan presents a unique backdrop within which to serve our clients. As a market it defies simple explanation, and even the most recently established disruptive businesses typically have strong cultures deeply rooted in Japan's history and tradition.

Sanpo-yoshi is a phrase attributed to the Ohmi merchants of Edo period Japan (1603–1868 CE). Roughly translatable as 'good for three parties', *sanpo-yoshi* refers to transactions that benefit the seller, the buyer and the community that they operate in.

The Edo period was characterised by a strict social hierarchy: samurai at the top, farmers and craftsmen in the middle and merchants at the bottom. As travelling members of this lower class, the Ohmi merchants rarely conducted business from the safety of their own region. Therefore, it was all the more important that they presented their activities as being of benefit to the local communities that they operated in.

We draw two lessons from *sanpo-yoshi*. The first is that, much like the 'honourable merchants' of Hamburg in the 16th century and the anti-slavery Quakers of the 17th and 18th centuries, the Ohmi merchants could be seen as providing historical precedent that explains why Japanese companies are already predisposed to embracing the contemporary environmental, social and governance (ESG) movement. The second lesson resonates with our experiences as investors in Japan: while tightly-knit communities have the potential to seem off-putting to outsiders, success is possible if relationships are built with integrity and respect.

Baillie Gifford has been investing in Japan for over 50 years, and our Japanese portfolios contain individual holdings that we have been invested in continuously for decades. The relationships that we have built with the companies are not created overnight. They are the product of years of honest dialogue and frank engagement. This engagement is a vital component of our stewardship activities, but we want to be clear about what our intent is by engaging.

Our preference for investing in founder-led growth businesses for the long term means our engagement with management is based on a mutual appreciation of perspectives. Founder-CEOs are experts in their businesses: we could never hope to approach the depth of knowledge of a person who has devoted their professional life to a given industry. For our part, we bring an international perspective, informed by a studious appreciation for Japan's unique historical and economic context. We also bring a certain degree of insight gained through decades of supporting many businesses successfully navigate through different phases of growth, from innovative disruptor to societal stalwart, and all the unique variations in between.

A consequence of Baillie Gifford's bottom-up approach to investment research is that meaningfully integrating ESG into our analysis cannot be achieved through third-party ratings or one-size-fits-all metrics. This is especially true of Japan, where western-biased checklists routinely miss the unique strengths of Japanese approaches to corporate governance. Unlike some investors, we don't want our holdings to conform to simplistic preconceptions of 'best practice'. In our experience, true visionaries can't be understood with yesterday's metrics – they are too busy creating the means of success that others will be judged by in the future.

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Our recognition of the unique idiosyncrasies of our holdings does not entail a passivity in our relationships. At times, long-term support means sending clear messages to management through our voting. Where it is in the best interests of our clients and the long-term sustainability of the company in which we are invested, we do not hesitate to abstain or vote against proposals at annual general meetings. However, we view voting as a tool within our engagement toolkit, rather than an output on its own. Our goal in all our engagements is to build a mutual understanding so that a vote does not occur in isolation but is one more step in the growth of our long-term relationship.

As the Japan market becomes a greater target for activists, our long-term relationships built on mutual respect will become even more important for generating value for our clients. While capital markets undoubtedly benefit from a diversity of participants, and companies benefit from being held to account by all stakeholders, including shareholders, we are mindful that noise does not always equal progress. As always, our diligent focus on the long term means we are well-placed to recognise when immediate intervention is required to promote long-term health, and distinguish those from situations where a push for short-term profits compromises long-term growth. It is impossible to create a checklist for discerning between the two, meaning there is no short-cut for company-specific research and engagement tailored to the unique circumstances at hand, built on decades of experience and reputation.

Baillie Gifford's commitment to responsible stewardship of our clients' holdings is as old as our firm. But this tradition is kept fresh and relevant by a process of constant challenge. Just as our investment process requires rigorous and continuous debate, so too does our approach to ESG. Best practice is informed by envisaging what stewardship will look like in the next ten, twenty or fifty years and then taking action to get there. This stewardship report, the first for our Japan team, is intended to inform our clients of our stewardship activities during the year, set out stewardship functions in a Japan context and share our ambitions for how we can leverage stewardship to generate value for our clients in the long-term. While some of the content is necessarily a commentary on what has already occurred, I hope you will join us in looking forward to reflect on how this unique market, and the singular companies within it, might grow, adapt and succeed in the uncertain times ahead.

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

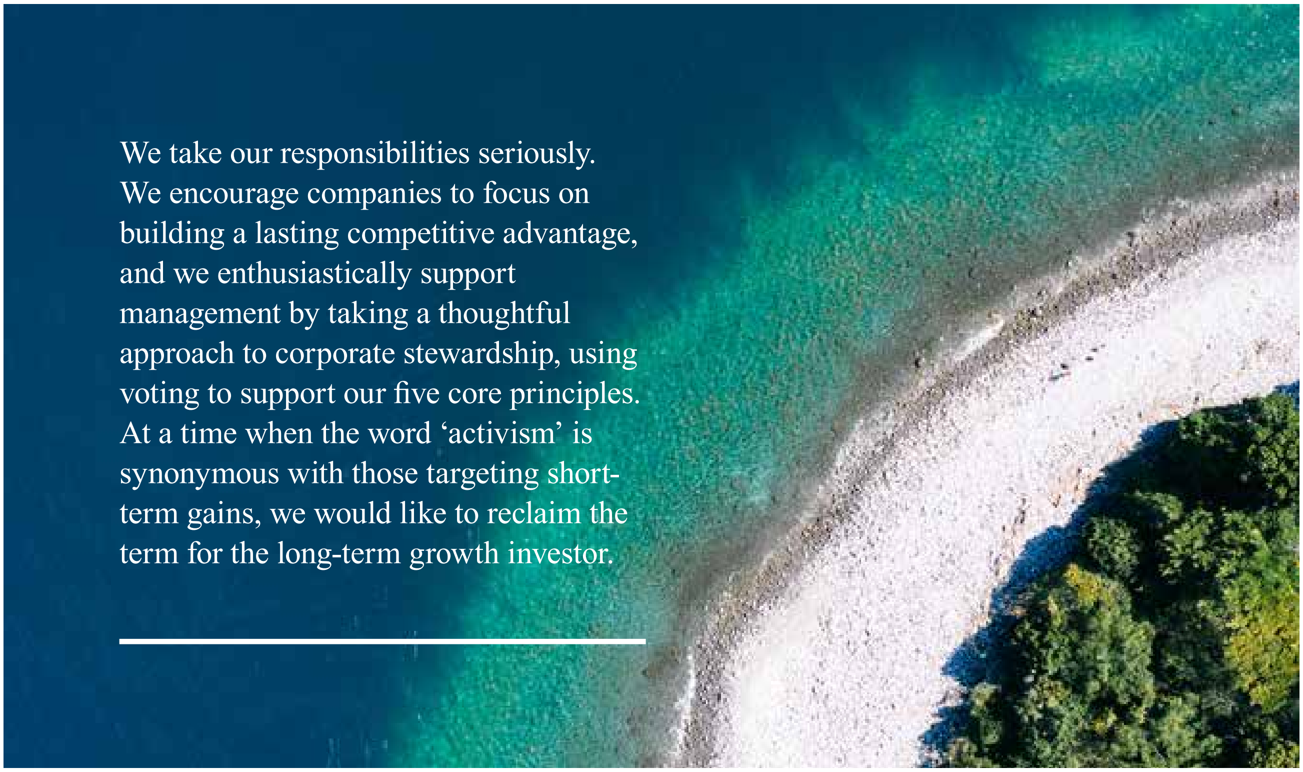
We look for remuneration policies that are simple, transparent and reward superior strategic and operational endeavour. We believe incentive schemes can be important in driving behaviour, and we encourage policies which create alignment with genuine long-term shareholders. We are accepting of significant 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.



We take our responsibilities seriously. We encourage companies to focus on building a lasting competitive advantage, and we enthusiastically support management by taking a thoughtful approach to corporate stewardship, using voting to support our five core principles. At a time when the word 'activism' is synonymous with those targeting short-term gains, we would like to reclaim the term for the long-term growth investor.

Update on Developments within ESG in Japan

Andy Brown
Director
Clients Department

Market Developments

It is now five years since Japan introduced its first Corporate Governance Code and the progress is encouraging. Since 2015 the percentage of companies with at least two independent directors (the minimum requirement of the code) has roughly doubled to 98 per cent and one-third of boards have an independent chair. At the same time, there has been a significant increase in the number of companies that disclose return-on-equity targets and have implemented performance-linked pay.

There has also been a step change in approach to shareholder pay-outs. Several companies have raised their disclosed dividend pay-out targets during the past few years and, notwithstanding an inevitable pull back in recent months, aggregate dividends have been rising, even when net profits contracted in 2018 and 2019. Attitudes to share buy backs, historically less common in Japan than other major markets globally, have also changed. In 2019, for example, share buyback announcements more than doubled and reached a record level. We are optimistic that the recent hiatus during a period of extreme uncertainty will not derail a longer-term trend.

Shareholders of Japanese companies have also raised their game on stewardship. The percentage of voting rights being exercised by domestic shareholders is rising, helped by a trend of companies giving them more notice to prepare for proxy voting and greater dispersion of annual general meetings. There has also been a noticeable increase in shareholder proposals, particularly in relation to governance and director appointments.

In a related development, shareholder activism has gathered momentum, evidenced by the value of activist funds deployed in Japan and the number of formal demands placed on companies. These demands have become more reasonable and constructive and are being met with a more positive reception (both from the media and the companies concerned). The most recent example of this is a recent shift in focus from shareholder pay outs to board independence and diversity in response to the pandemic by two high-profile funds, Fir Tree Partners and Oasis Management. With shareholder rights stronger under Japanese law than elsewhere, we expect interest from activist investors to remain strong.

Japan has rarely attracted attention as a high-carbon-emitting country, but we have seen progress made on climate change, with Japan making a valuable contribution. Over 200 Japanese companies are supporting the recommendations of the Task Force for Climate Related Financial Disclosures (TCFD) and are pro-actively trying to install best practice. What is particularly encouraging is Japan's focus on structures and best practice rather than box ticking; something we would like to see embraced in wider governance related issues. We believe that the framework created by the TCFD offers a helpful way for companies to bring both consistency and materiality to their public reporting on climate change. As long-term investors, we are always very supportive of companies' efforts to integrate climate change into their core strategy, governance and risk management processes, and the TCFD offers a logical framework to do this. The TCFD-related guidance and methodology on areas such as scenario analysis and risk metrics is still developing, meaning there will be further evolution and refinement of the TCFD framework in future years as it becomes embedded in company reporting requirements and regulations.

Although much has been achieved and continued pressure from both the regulator and the behemoth Government Pension Investment Fund augurs well; we believe that Japan's journey towards best practice governance and stewardship remains at an early stage. The levels of diversity on company boards are typically well below that considered appropriate and their focus is often on day-to-day issues, rather than on the more valuable role of challenging management on the strategic direction of the firm. We are also mindful of the limited talent pool of experienced independent directors with Japanese language skills and many companies' preference for appointing business associates informally instead of through executive search firms to find the most suitable candidates. This practice engenders a culture of maintaining the status quo and makes it harder to prevent or uncover malpractice in a timely fashion. Shareholder returns are on an upward trajectory but, given levels of balance sheet strength for corporate Japan, there are grounds for seeing much higher levels. In terms of stewardship, again the direction of travel is positive; however, we are struck that only nine non-financial corporate pension funds (out of approximately 700) have signed up to the code. This needs to improve if there is to be a widespread change in investor behaviour.

Baillie Gifford Client Portfolios

The Board Director Training Institute has helped us conduct analysis comparing our clients' broad market portfolios to the Topix 500 universe of companies. We are pleased they compare favourably on a number of metrics. For example, as at the end of 2019, the share of independent directors on company boards across our holdings was 36 per cent. This compares to 30.5 per cent for the wider market. At the same time, 69 per cent of holdings have established nomination committees and 62 per cent have implemented performance-linked compensation for senior roles. Again, this compares favourably to the market. We have also used an external provider to map the carbon footprint of our portfolios, using the information to prioritise engagement and understand what higher emitting companies are doing to manage climate risk better. We have been pleasantly surprised, not only by the overall profile of our portfolios, but by the responses from our follow-up engagement.

Arguably, most important is the change in behaviour towards engagement we have seen among our investee companies. It is not so long ago that discussions on corporate governance in Japan were one directional, brief and largely fruitless. Since the introduction of the code, this is gradually altering, with dialogues becoming two way and more enlivened. Last year, our Japanese equities team had 41 separate engagement-related dialogues with 27 different companies over a variety of mediums. The majority of these were related to governance issues, including board independence, diversity and approaches taken to shareholder returns, although there have also been some interesting discussions on environmental and social issues.

We are most pleased to see the recent shift in attitudes among some longstanding holdings that for many years had been reluctant to prioritise shareholder returns, despite benefitting from highly cash-generative businesses and cashed-up balance sheets. It seems that the combination of our continued engagement and more recent pressure to comply with the Corporate Governance Code has yielded some success. More progress is needed; but the direction of travel is clear.

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

Sony Corp.

We met Sony to discuss the most recent activist campaign. During the last campaign in 2013, Sony rejected the activist's demands. However, after the activist sold its stake, Sony reportedly reviewed several areas in its business and this has proved beneficial to the company. Once again, Sony is taking a pragmatic approach, selling its stake in medical equipment manufacturer Olympus, realising an approximate 200% gain, and conducting two large share buybacks. Given the increasingly choppy activist waters in Japan, Sony's openness to engaging provides a model for others in the market.

SMC Corp.

Pneumatic equipment manufacturer SMC has long demonstrated a traditional Japanese approach to corporate governance: minimal board independence and low dividend payments have been sources of engagement for many years. The ascension of Mr. Takada's son to representative director, however, holds the potential for improvements in governance. We met with the new representative director and subsequently wrote a letter conveying our shared ambition to take this opportunity to improve SMC's corporate governance to best promote long-term value creation.

COLOPL, Inc.

COLOPL develops mobile apps, with a focus on location-based mobile games. We had a call to discuss reports of misconduct by two employees relating to a newly released mobile role-playing game called Project Babel. The employees in question are alleged to have committed 'ranking fraud', where they spent large sums of money to artificially raise Project Babel's ranking in the App Store. While generally suspected to be widespread, ranking fraud is difficult to prove. In this case, an anonymous whistle-blower contacted the company president, prompting an internal investigation. COLOPL acted swiftly and proactively, convening an investigatory committee of independent outsiders and informing Apple of the allegations. Employee misconduct is a flag for potential cultural problems in a firm, but we take it as a positive sign that the whistle-blower had enough faith in the company's leadership to contact the president directly.

Tsumura & Co.

Tsumura manufactures and sells pharmaceuticals and Chinese herbal medicines. Its governance disclosure is far ahead of domestic peers, it provides remuneration targets, something almost unheard of in Japan. The company says that explaining its approach to remuneration has been a priority, especially the equity component, because a large portion of its revenue is essentially tax funded (thanks to national insurance coverage), so it is aware of the reputation risk of excessive quantum. We also discussed its value chain, and how its direct relationships with farmers allow it to provide long-term contracts at slightly higher prices on the condition that the farmers meet internationally recognised standards.

Mitsui & Co.

Mitsui & Co is a general trading company in Japan. As a trading company it is exposed to a wide variety of sectors with exposure to ESG risks, including the metal resources, energy and infrastructure segments. In terms of disclosure Mitsui is far ahead of the norm in Japan. Our meeting provided us with an opportunity to get into detail about its governance of sustainability, who drives internal debates around measuring and setting targets, and how it has been preparing for disclosing in line with the recommendations of the TCFD.

Sawai Pharmaceutical Co. Ltd.

Sawai Pharmaceutical is a manufacturer of pharmaceuticals that are sold in Japan and the US. We engaged in the lead up to its annual general meeting because its board was beneath our generally accepted threshold for independence of 33 per cent. However, it was making demonstrable improvements in terms of board structure and gender diversity, so we voted in favour of the board and engaged post-AGM. Unusually for Japan, Sawai was happy for us to meet one of its newly appointed independent directors. We had a very positive discussion about the day-to-day running of the board, including the fact that each board session includes an opportunity for the independent directors and external auditors to provide their opinions.

Raksul

Raksul is a printing and transportation business. This year it made a number of positive changes to its corporate governance, including adopting a more modern internal audit committee structure and providing for executives to have more authority over the day-to-day operations of the business. However, it included a restricted stock plan for independent non-executives. Ordinarily this would be a concern because we don't want non-executives to be disincentivised from resigning in protest. In this case, after frank and open engagement with the CFO, we decided we were comfortable with supporting the plan. We requested that our concerns were brought to the attention of the wider board, and that the board consider addressing it in a formal policy. We will monitor how the plan is implemented going forward.

Bengo4.com

Bengo4.com (pronounced bengo-shi, Japanese for lawyer) is an online platform for connecting lawyers with end customers. We like how proactive and forward-thinking management are, and our discussions about ESG did not disappoint. CEO Yosuke Uchida was very comfortable describing how corporate governance is vitally important for its long-term growth. We discussed the skillsets of the directors, and why a mix of different experiences makes for effective board meetings. When we discussed the importance of gender diversity, we discovered that Uchida-san has introduced a number of initiatives internally, but the company hasn't disclosed them in their corporate governance report. We agreed to send examples of good disclosure and to keep the discussion going on how it might improve diversity throughout the company.

Mitsubishi Corp.

Mitsubishi Corporation is a general trading company operating worldwide in industrial finance, energy, metals, machinery, chemicals, and daily living essentials. A member of the Governance and Sustainability Team met investor relations and sustainability representatives during Mitsubishi's annual ESG roadshow. We discussed the company's ongoing work on climate change and broader ESG trends, particularly corporate Japan's response to the EU's green taxonomy.

Fanuc Corp.

Fanuc Corp. manufactures factory automation equipment, systems and robots. We met with Fanuc's senior management to discuss its continually evolving ESG disclosure. Of note this year is a new human rights policy and a procurement policy that includes conflict minerals. We also discussed the new co-bots it is producing, as well as the potential growth of its FIELD system and the impact of 5G, as well as AI and cloud computing. In the course of the meeting we discussed the possibility of introducing performance-based remuneration for senior executives. Subsequently, Fanuc contacted us to provide further feedback ahead of the board's deliberations on executive remuneration.

Carbon Footprint Analysis

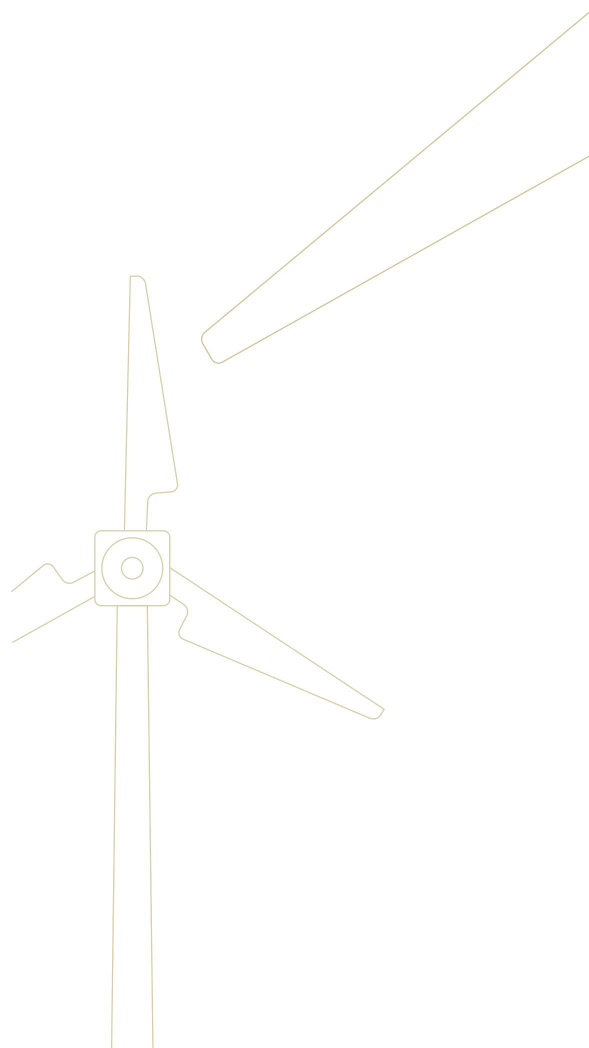
Climate change poses a serious threat to our environment, our society and to economies and companies around the globe. If we are to address the underlying causes, then companies that are high emitters of carbon are likely to face greater societal and regulatory scrutiny, and higher costs to account for the true environmental impact of their activities. Understandably, our clients are also taking an increasing interest in the carbon footprint of their investments.

This section looks at the carbon footprint analysis of our Japan strategy. It illustrates the carbon footprint of the Worldwide Japan Fund, and highlights those companies which have the highest emissions. Analysing the carbon footprint of a business is complex and understanding the reasons for the results can be highly nuanced. However, an analysis, such as the one presented here, provides a starting point for discussion.

We recognise that measuring the carbon emission levels of investment portfolios is far from an exact science. It is made difficult by a lack of disclosure, a lack of standardised reporting of emissions and limitations in the universe of companies covered by data providers. However, tools are emerging which attempt to gather and verify available data, plus estimate carbon data where companies do not disclose it. This enables investors to gain a reasonable picture of carbon emissions at the overall portfolio level. The data presented here is provided by the third-party provider, 'yourSRI', and covers Scope 1 and Scope 2 emissions. Scope 1 emissions are those that derive directly from company activities (i.e. fuel use). Scope 2 emissions arise from the use of purchased energy.

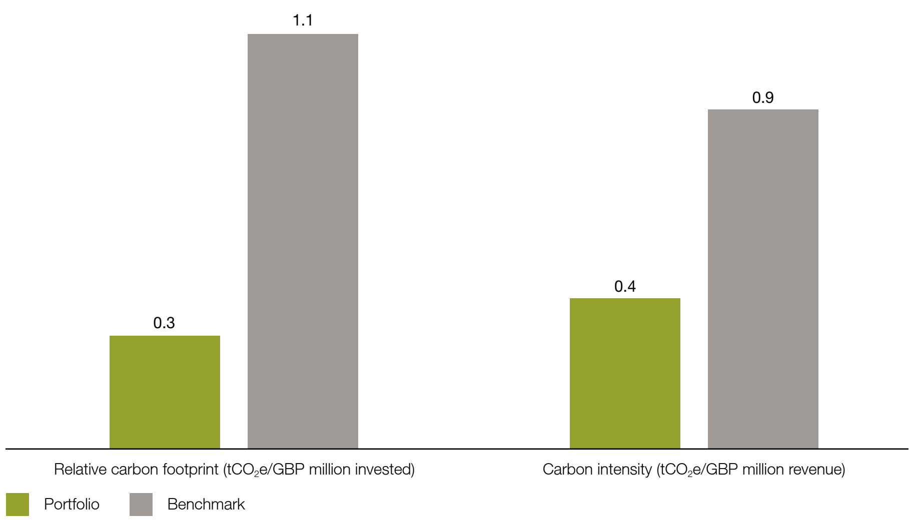
Clearly, as with all approaches, there are limitations. Focusing on the Scope 1 and Scope 2 emissions ignores the carbon footprint of the supply chain, the use of products after production and any post-lifetime emissions. As an example, a car manufacturer relies on a long supply chain, including metal extraction, plastic production and component manufacture; yet these are not captured in its Scope 1 and 2 emissions data. An internal combustion unit vehicle will burn hydrocarbons throughout its lifetime and will require post-use processing. Although the supply chain and post-production usage have extremely high carbon costs, these are outside Scope 1 and 2 emissions data. Taking this a stage further, a manufacturing company that produces a component in-house will always have a higher carbon footprint than a competitor that chooses to outsource the component's production to a supplier. This applies irrespective of the efficiency (or not) of the supplier's manufacturing process, because the supplier's footprint is not captured in the calculation of the manufacturer's carbon footprint. Being aware of the obvious shortcomings and nuances within this analysis helps us to develop a fuller understanding of the information and how to interpret it.

The following charts show that the Japan Worldwide Fund has a lower carbon footprint than its benchmark by comparing what the carbon footprint would be if you invested one million yen into the fund versus one million yen into the Topix. We have also provided details of the carbon intensity of each strategy. This shows the total carbon emissions per one million yen of revenue generated by each strategy compared to that of the index and allows us to measure the efficiency of the strategy with regards to emissions per unit of financial output. From this, we can see that all three portfolios also have a lower carbon intensity than the index.



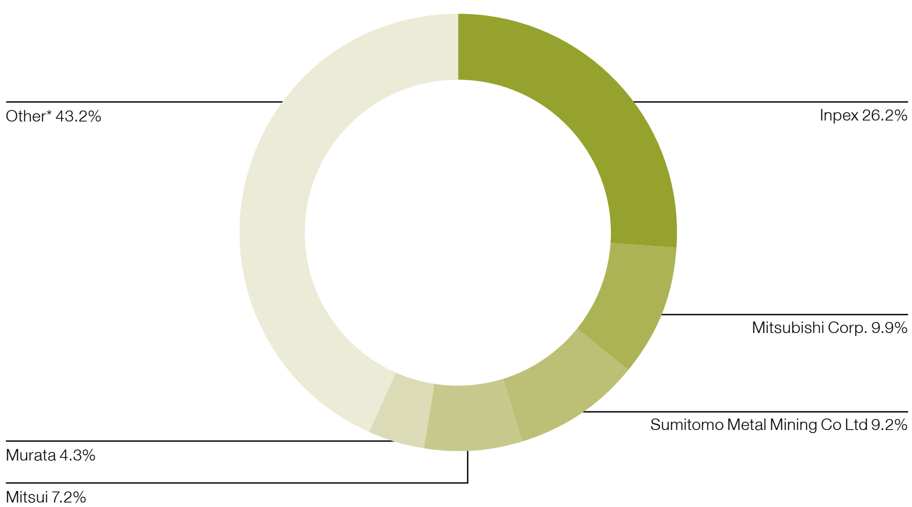
> *Being aware of the obvious shortcomings and nuances within this analysis helps us to develop a fuller understanding of the information and how to interpret it.*

Carbon Footprint and Carbon Intensity



Top Largest Percentage Contributors to Carbon in the Portfolio

Function of Holding Size and Emissions



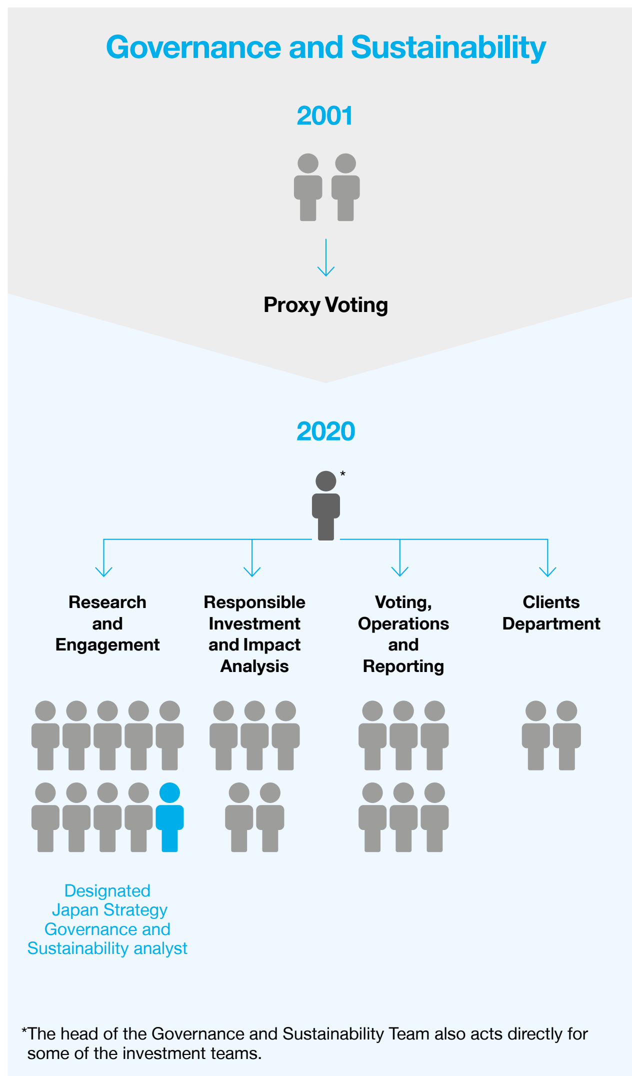
*Approximated data.

Based on a representative portfolio for Japan Growth as at 31 March 2020.

Proxy Voting

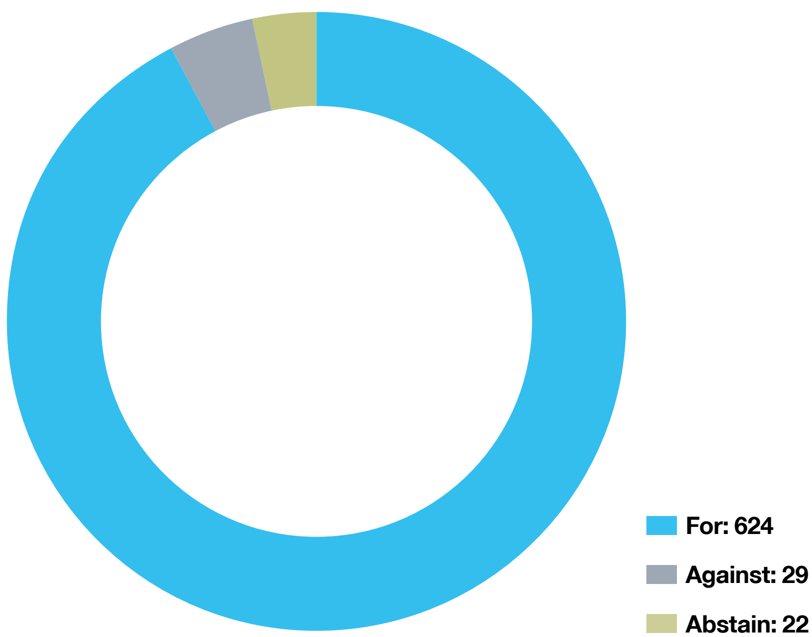
Baillie Gifford's Governance and Sustainability Team has continued to grow and evolve to reflect the increasing sophistication of our research and engagement, and to help meet our reporting requirements. In 2019, the team was divided into two specialist groups: Research and Engagement; and Voting, Operations and Reporting. This enables most of our analysts to work on our research and engagement activities and a smaller group of analysts to take responsibility for our voting, operations and reporting. Our total team, incorporating both areas, now comprises 24 people.

The Japan Strategy has a designated research and engagement analyst who can participate in engagements alongside the portfolio managers and works with them when we are consulted by investee companies. For Japanese portfolios, the designated research and engagement analyst manages the voting of the largest holdings in the portfolios and provides a point of contact in relation to the analysis and instruction of all other votes implemented by the Voting, Operations and Reporting Team. We are open-minded about the best framework to govern and manage a company and sceptical about the usefulness of a more prescriptive approach. While we consider the analysis provided by third-party proxy voting services, we do not follow their recommendations. All our voting decisions are made on a case-by- case basis that is grounded in our own company research and engagement. This rigour ensures a regular pattern whereby the governance arrangements of each holding are reviewed at least once a year. For each meeting, we take an active approach to voting and engage with companies where more information or discussion is required. When this is the case, the governance specialists often work alongside the portfolio manager to harness both investment and governance expertise, with a view to reaching a voting decision that reflects the nature of the individual business, its strategy and our expectations of it.



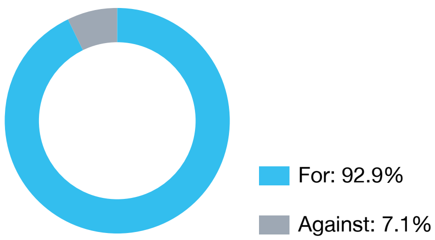
The following chart summarises the proxy voting activities of our Japanese Worldwide Fund for the one-year period to 31 March 2020. The data show that we supported most of resolutions proposed by management. This should not be a surprise as we seek to invest in management teams that we trust and respect and with whom we have a shared vision for the company's long-term future. A vote against a management resolution is not taken lightly and we will typically have a dialogue with management before, and sometimes also after, the general meeting to explain our thinking and share our view on how the matter might be resolved.

Japanese Worldwide Fund Proxy Voting Record



Examples of Voting Activity

Remuneration

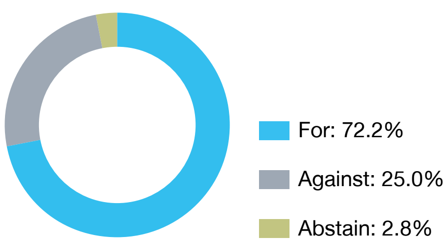


H.I.S. Holdings Inc.

In Japan, executive and non-executive remuneration is receiving greater interest, and the frequency of our holdings proactively consulting us on remuneration-related topics is increasing. Traditionally, excessive quantum has not been an issue in Japan. Instead, poor pay structures are those that exacerbate the tendency for conservative risk-aversion and demonstrate no link between pay and performance. Disclosure around remuneration tends to be poor, and even where companies appear to be making improvements, for example by introducing performance-based bonuses, they may do so a way that creates additional corporate governance problems.

H.I.S. Holdings Inc. is a travel agency that operates globally. At the 2019 AGM H.I.S. sought shareholder approval to pay bonuses to its directors, including the independent outside directors. While generally in favour of performance-based pay, we believe it is inappropriate to remunerate independent outside directors in the same way as executives because it could potentially conflict their independence. On this occasion we voted against the relevant proposal and have noted it as a topic for engagement in the coming year.

Dividends

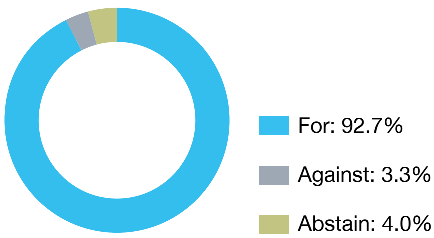


Misumi Group Inc.

Due to historical and cultural reasons related to the relationship between companies and their lenders, Japanese companies have tended to hold large amounts of cash on their balance sheet. Whereas in other markets there is an expectation that companies will proactively respond to changing conditions year-on-year by increasing or decreasing the dividend as appropriate, in Japan there is a tendency to set three-to-five-year forward-looking dividend pay-out targets that are conservative enough to be achieved regardless of performance in an individual year. As corporate governance improves and Japanese companies are becoming more cognisant of foreign shareholders' expectations, we are seeing a general trend away from so called 'cash-hoarding'.

Misumi Group Inc., which produces precision machinery parts for a range of industries and geographies, is an example of a cash-hoarder. At a number of past annual general meetings, we have voted against the proposal to approve the final dividend because we believe the company could be making more efficient use of its balance sheet. However, we do not treat our vote in isolation to our other engagement practices. In addition to voting, we also communicated with Misumi prior to and subsequent to the 2019 AGM to ensure that our vote was understood in the correct context. Misumi have been improving its board independence year-on-year, so we are optimistic that efficient capital allocation decisions will follow in due course.

Director Elections



Iida Group Holdings

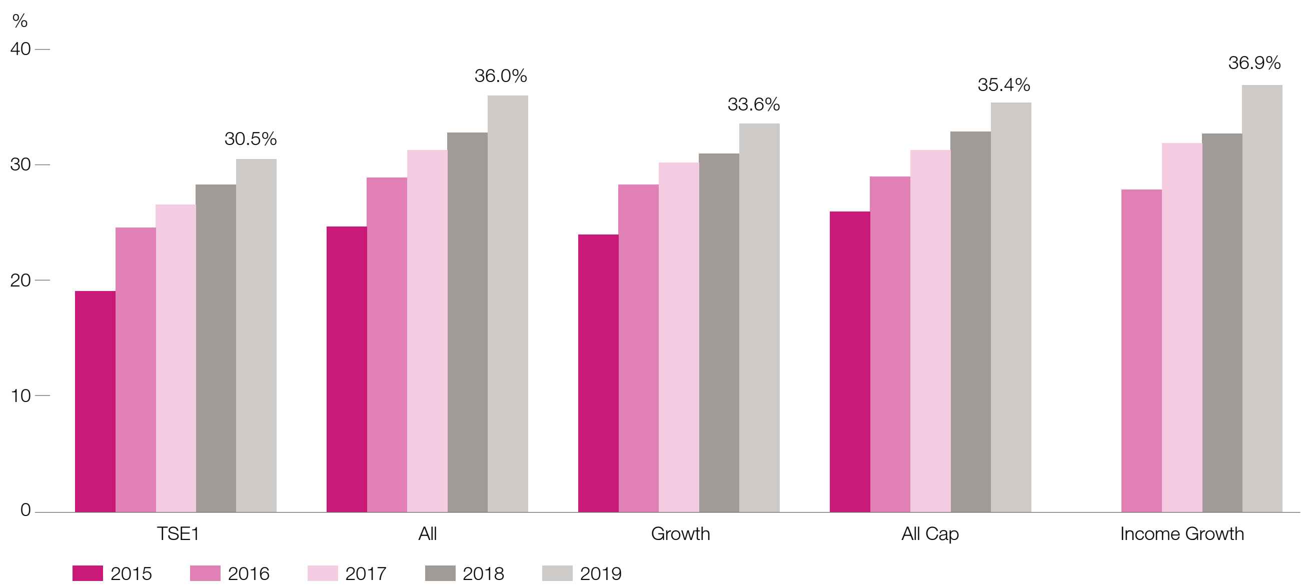
Meaningfully voting on board governance issues in Japan requires an attentiveness to the historical context of corporate governance and company leadership in the market. The executive officer system as we understand it is a relatively modern import to Japan, and the traditional Japanese governance structure, the *kansayaku* board, a two-tier structure of a predominantly management board and a statutory auditor board, might superficially look similar to ex-Japan boards but is in practice quite different. We are agnostic as to board structures, because each has its own strengths and weaknesses. Instead our preference is for each board to demonstrate a healthy diversity of perspectives to provide constructive and purposeful challenge to senior management.

Iida Group Holdings designs, constructs and sells residential properties in Japan. Iida Group uses the *kansayak*u-style board and has two independent outside directors (for an overall board-level independence of 17 per cent). The Japan Corporate Governance Code suggests at least two independent outside directors. However, we encourage our holdings to go beyond this basic requirement and strive for a board that is at least one-third independent. At the 2019 AGM, after discussing the matter with the company, we decided to oppose the election of the chair and a newly appointed non-independent inside director. As market practice improves we are having to take voting action on board composition less with each year. Companies, such as Iida, that are doing the bare minimum are becoming increasingly rare, making our multi-year engagement with Iida on this issue all the more important.

Appendix

Firms With Performance-Linked Compensation

Independent Non-Executive Directors % (company-basis)



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