Baillie Gifford Japan

Matt Brett is excited by the opportunity in Japan after recent market falls and has geared up BGFD significantly...

Update
16 November 2022

Overview

Baillie Gifford Japan (BGFD) is managed with a highly-active, resolutely long-term investment strategy aimed at identifying the best long-term growth opportunities in a market packed with innovative companies in a variety of fields. Matt Brett and his colleagues on the Baillie Gifford Japanese equity team aim to ignore received wisdom and short-term chatter and identify companies which can at least double in market cap over five years, ideally looking for those long-term winners which can continue to compound even faster than the market for much longer than this.

The trust has an excellent long-term track record of outperformance. As we discuss in the **Performance section**, it has more than doubled the returns of the Topix Index over a decade. However, it has suffered over the past 18 months as the market has rotated from growth to value amidst rising interest rates, growing inflationary pressures and fears of an imminent global recession. Matt has, however, only become more excited as prices have fallen and his companies have generally performed well, operationally. He has been steadily increasing the **Gearing** level on the trust as the market has fallen, reinvesting in companies in which he has high conviction in the internet and software industries and in premium consumer stocks which have sold off the most over the past year.

BGFD's portfolio tends to have major exposures to technology, both hardware and software, as well as internet-related companies. This area has been under pressure but Matt remains focussed on the long-term prospects and believes periods of underperformance are an unavoidable consequence of high-conviction, long-term investing.

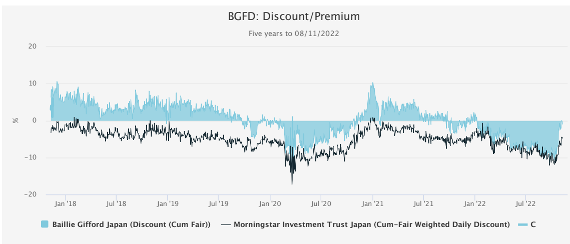
As risk aversion has risen in the market, BGFD's shares moved out to a double-digit **Discount** to NAV, although at the time of writing this has closed to 1%.

Analysts:

Thomas McMahon
+44 (0)203 795 0070

Key Information:

Price (p)	802
Discount/Premium (%)	-1.0
OCF (%)	0.66
Gearing (%)	17
Yield (%)	0.8
Ticker	BGFD
Market cap (£)	750,853,364



Kepler View

It has clearly been a rough year for BGFD, but, as the managers argue, a highly-active strategy is always likely to go through periods of underperformance. Matt's strategy is to find companies with a strong competitive advantage in their field and resilience in their business models, which means that they should be able to compound their earnings faster than the market over the long run. If he has chosen correctly, then we believe this should outweigh the vagaries of valuation, over a long holding period.

Additionally, we note that the valuation of the portfolio at the end of August was in line with the market rather than higher, out of keeping with the historic tendency for the portfolio and implying that the balance of risks may be tilted back in favour of investors. We think Matt's decision to gear up in the light of what he sees as a disconnect between valuation and fundamentals is strong evidence of his conviction.

It may well be that the exceptional outperformance seen in 2020 was a result of particular circumstances which favoured the strategy in multiple ways. However, we would point to the trust's history of outperformance in multiple rising markets (see **Performance**) and the diversity of the portfolio as evidence that the trust has the potential to outperform when risk appetite returns, even if the short-term outlook remains cloudy.

BULL
Exceptional long-term track record
Highly-active approach which brings outperformance potential
Low OCF relative to peers

BEAR
Not a discount opportunity in absolute terms
Structural gearing can amplify losses on the downside and volatility
Active share increases underperformance potential as well as outperformance

Portfolio

Baillie Gifford Japan (BGFD) is managed by Matthew Brett, who aims to invest in companies with the best growth prospects in Japan and to hold onto them for a long time, believing that this is crucial to maximise long-term returns. The strategy is entirely benchmark-agnostic and highly active, with Matt happy to invest in any sector or industry if he thinks he can at least double investors' money over five years.

Matt, like his colleagues at Baillie Gifford, prides himself on original thinking. The bedrock of research is internal work and discussion with his colleagues on the Japan team and the wider equity teams. There are seven investment managers and three analysts on the Japanese equities' team, and debate and discussion is encouraged and valued. Matt can also call on two Tokyo-based independent researchers for ideas. The team try to build a consensus view on the best long-term opportunities they have uncovered and, once they have committed to a stock, will back it with conviction, contributing to the high active share. Their belief is that to beat the market, you have to do something very different from the market. By taking a longer-term view and thinking about the trends that will drive companies' earnings over five years and more, Matt aims to gain an edge over the consensus, which can focus on the shorter term. Growth-focussed strategies like BGFD have underperformed since the start of 2021, but Matt says he is more enthusiastic now than he has been for at least a year in the long-term return potential of the portfolio, thanks to the value that has emerged and the strong operational performance of the portfolio despite the poor economic environment. This is reflected in an increase in the trust's net **Gearing** level in recent months.

A focus far into the future and on industries and companies with the highest growth potential naturally leads to a significant bias towards technology in the BGFD portfolio – new technologies often create new markets for companies to dominate. Japan has a high level of expertise in high-end engineering which helps provide opportunities in hard tech. FANUC is one of the world's leading robotics companies and is a major holding in the portfolio (see table below). Japan is also going through the same internet revolution as we are in the UK, with arguably more domestic success stories, thanks to the lesser presence of the American giants. GMO Internet is an internet infrastructure business with interests in online advertising and media, payments and others. Misumi straddles both categories, selling precision machine parts as well as more mundane manufacturing products online.

Leaving aside high-end engineering and computing hardware, the team estimate that roughly one third of the portfolio is in internet and software-related companies. This includes companies like digital advertiser CyberAgent. It also includes top holding Softbank, a holding and investment company founded and led by Masayashi Son which specialises in technology investments and, therefore, provides exposure to multiple underlying companies and ideas. Softbank's Vision Fund has owned stakes in Uber, ByteDance, Nvidia and Slack amongst many others, and so brings exposure to ex-Japan revenues and trends. The company's shares more than doubled in the aftermath of the first wave of the pandemic as technology outperformed, but have since slumped, albeit not back to their pre-pandemic levels. Matt and the team argue that, given these share price falls, Softbank now offers exposure to its portfolio of companies on a discount to the sum of the parts of up to 50%. They also point to Masayashi Son's strong track record of adding value in multiple fields. As markets have sold off and valuations have fallen, the internet names have largely been amongst BGFD's underperformers and Matt has been adding to them on weakness, employing gearing to do so at times. In the annual results, the manager pointed out that at year end, BGFD's portfolio was trading on the same EV/EBIT rating as the market (13x), despite having much higher expected earnings' growth. This has not been the case for some time.

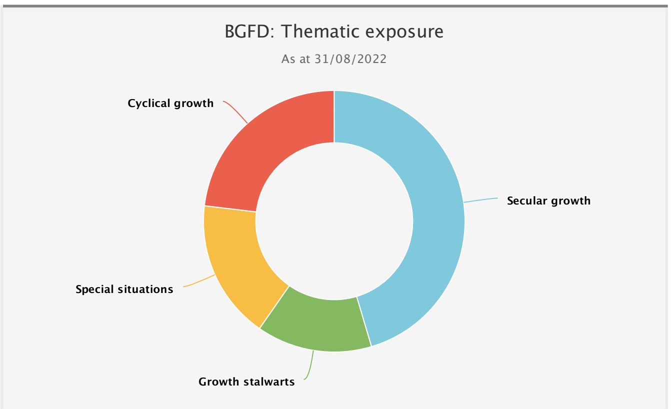
Top Ten Holdings

HOLDINGS	% OF TOTAL ASSETS
SoftBank Group	4.6
Calbee	3.5
SBI Holdings	3.4
GMO Internet	3.3
FANUC	3.2
Sumitomo Mitsui Trust	3.1
Bridgestone	2.9
MS&AD Insurance	2.9
Misumi	2.7
CyberAgent	2.6
Total	**32.2**

Source: BGFD

Rather than by sector or industry, another way the managers look at the portfolio is in terms of four major themes or categories (see chart below). Most of the names discussed already fall within the secular growth category, typically made up of companies serving new or fast-growing markets. The growth stalwart category includes those companies with a more predictable and established source of growth, which often means those in consumer-related areas – snack food manufacturer Calbee and Nintendo are two examples. Many companies in this category have also been underperformers in the sell-off, particularly at the premium end of the market, and in keeping with his long-term investment horizon, Matt has also been adding to these. The special situations category includes those companies that have had poor recent results but which the managers expect to see a turnaround of, which will allow them to hit their long-term growth hurdle of at least doubling over five years – Softbank fits here. Finally, cyclical growth companies are those which have high cyclicality in their earnings, but which, Matt believes, will continue to grow faster than the market over the course of those cycles. This includes Bridgestone, the tyre manufacturer, which is unaffected by the shift from combustion engines to EVs, unlike car manufacturers. However, it still has cyclicality in its earnings as all car sales would be expected to wax and wane with the cycle.

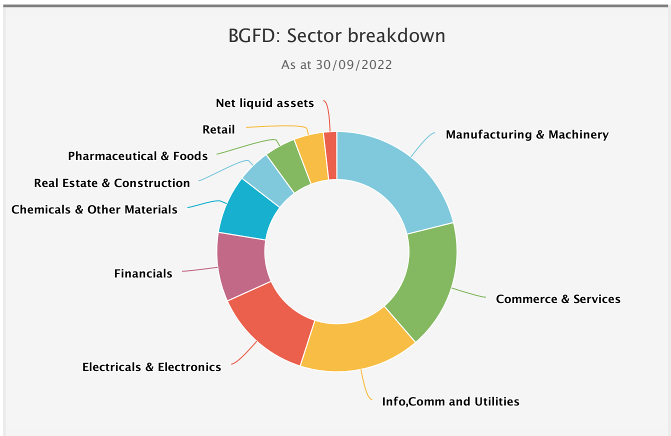
Fig.1: Thematic Allocation



Source: BGFD

For the record, we also show the industry allocation below, although we stress that both this and the thematic breakdown are outputs, not targets, and reflect where Matt and the team are finding the best bottom-up ideas.

Fig.2: Sector Allocation

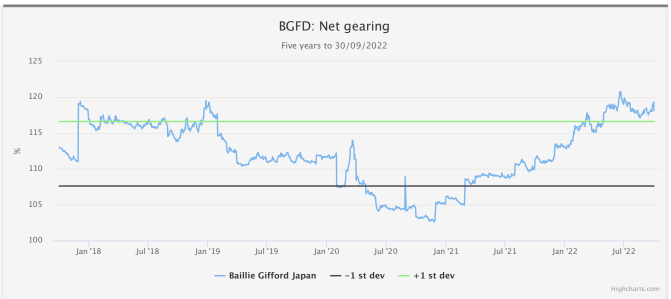


Source: BGFD

Gearing

Matt and the team have raised gearing significantly over the past year as the market and their portfolio have sold off and the opportunity set has grown more attractive, in their eyes. The trust was almost entirely ungeared in the aftermath of the first wave of the pandemic but net gearing has risen steadily since then to 17%, as at the end of September 2022, over one standard deviation above its five-year average, according to Morningstar data (see below). As gearing has been raised, it has generally been invested into the stocks the managers believe are most attractively valued having suffered the most in the sell-off, those being internet-related names and high-quality consumer goods' manufacturers.

Fig.3: Net Gearing



Source: BGFD

The board believes that borrowing will enhance returns to investors over the long term and BGFD has averaged a 12.1% geared position on average, over the past five years. While gearing increases the potential returns in a rising market, it also brings more exposure to a falling market.

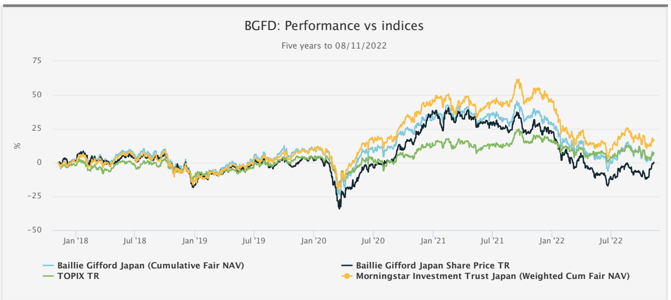
BGFD has a mixture of structural and short-term debt. There are fixed loan facilities maturing in 2023 and 2024 which amounted to 16.9% of net assets, as at the end of the 2022 financial year. There is also a revolving credit facility, arranged during that year, in order to give the managers more flexibility to gear up when they wish to do so.

Performance

BGFD has an excellent long-term track record of outperformance, but it has suffered since early 2021 when a rotation from growth to value was precipitated by the reflationary recovery from the pandemic and then exacerbated by persistent inflation and sharply rising interest rates. Over the past ten years, the trust has generated a NAV total return of 256.1%, which is almost twice the 138.9% total return achieved by the Topix Index. It is also over 56 percentage points more than the closest peer in the AIC Japan sector.

One of the best periods for returns came in the immediate aftermath of the start of the pandemic, as shown in the five-year performance chart below. In 2020, the market looked to technology-related companies which benefitted from remote working and offered the ability to consume goods and services without human contact. Early-stage companies were favoured by central banks cutting already-low interest rates to the floor, which supported companies whose expected cash flows were further into the future. These trends have largely gone into reverse over the past 18 months, which has contributed to a significant sell-off in BGFD's shares. The NAV total return for the whole period has been 7.4%, compared to 7.2% for the Topix Index and 17.3% for the sector average.

Fig.4: Five-Year Performance

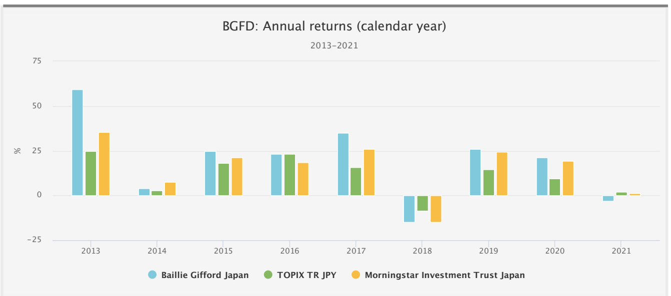


Source: Morningstar

Past performance is not a reliable indicator of future results.

Historically, BGFD has tended to perform most strongly in the best years for the market, as illustrated in the chart below. The last year the market ended down, BGFD underperformed and at this stage it looks likely that the same pattern will repeat in 2022. The trust was down 16% to the end of September in NAV total return terms, while the Topix Index had lost 6.6%. The team note that while this year's drawdown has been unpleasant, it is not unusual for their strategy of investing in Japanese growth equities to experience such negative periods and they view it as a necessary evil of a high-conviction, consistent approach to go through periods of underperformance. Matt and the team are aiming to find the best long-term opportunities in Japan and hold on to them as they develop, which means accepting that they may fall out of favour in the short term.

Fig.5: Returns

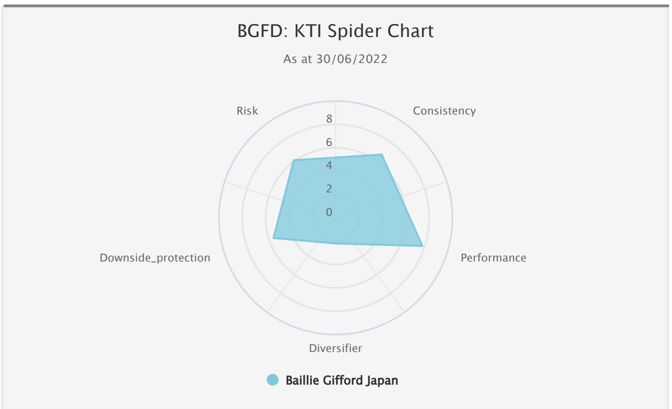


Source: Morningstar

Past performance is not a reliable indicator of future results.

That said, the KTI Spider chart below shows that BGFD has been one of the most consistent Japanese trusts when it comes to beating its benchmark over the past five years. This is measured using rolling one-year periods, with scores normalised to the peer group, as are the rest of our metrics. The alpha the managers have generated is also amongst the best, giving the trust a high score for performance, while its scores for risk and downside protection are around average. BGFD scores low for diversification, which is measured by correlation against the Japanese equity market, global equities and global bonds. This makes sense given that its high-growth style has largely been leading markets over the period, with bonds and growth equities highly correlated.

Fig.6: Performance Characteristics



Source: Morningstar, Kepler calculations

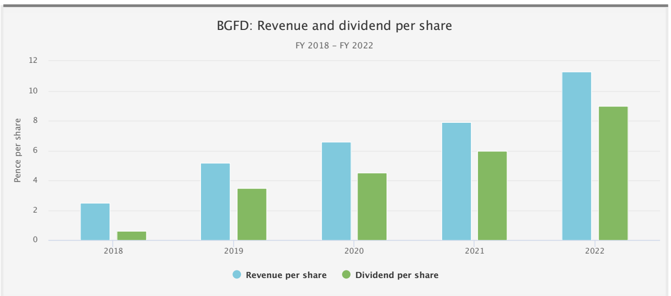
Past performance is not a reliable indicator of future results.

These are all historical numbers and reflect a period for most of which BGFD's style was in fashion. Clearly, the current environment of risk aversion, rising global interest rates and falling global liquidity is not advantageous for the trust's style. History would suggest that it might take a return of risk appetite in markets for BGFD to see another period of good absolute and relative performance.

Dividend

BGFD aims to generate capital growth and, reflecting this objective, costs are charged to the income account, reducing funds available for distribution. There is no progressive dividend policy, although in practice the distribution has growth steadily in recent years. The dividend for the 2022 financial year was 9p per share,

Fig.7: Dividend Per Share



Source: BGFD

Past performance is not a reliable indicator of future results.

up from 6p in the previous year. While this is substantial year-on-year growth, the yield still amounts to just 0.8%, as at the time of writing, so the trust is unlikely to appeal to income-seekers.

Management

BGFD's lead portfolio manager is Matt Brett, who is supported by deputy manager Praveen Kumar. Matt is a partner of Baillie Gifford, having joined the company in 2003. He is also lead manager of the Baillie Gifford Japanese Fund and co-manager of the Baillie Gifford Japanese Income Growth Fund. Furthermore, he is a member of the Global Stewardship Portfolio Construction Group. Praveen also has a long tenure with Baillie Gifford, having joined in 2008. Praveen is lead manager of the Baillie Gifford Shin Nippon trust, a small-cap, growth-focussed Japanese equity strategy.

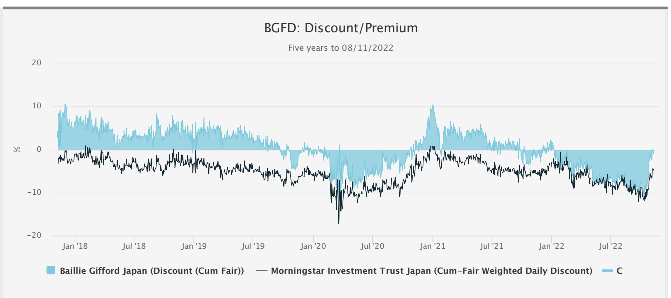
Matt and Praveen work within a team of ten analysts. Baillie Gifford makes a conscious effort to ensure that its teams of analysts reflect a diverse set of backgrounds to ensure independence of thought and that a variety of opinions are brought to the table. For example, one of the Japan team's current analysts joined the team after a successful career as a medical practitioner. Baillie Giffords's partnership structure is designed to encourage long-term thinking by its managers by removing the incentive to focus on short-term goals to satisfy the markets.

Discount

BGFD's shares trade on a 1% discount to NAV, as at the time of writing. During the year, the rating has been as wide as 12%, back to levels seen in the aftermath of the outbreak of the pandemic. The recent closing of the discount seems to be related to a bounce in global markets likely connected to poorer economic data in the US leading investors to lower their expectations for rate hikes – the 'bad news is good news (for the stock market) trade'. In any case, it seems likely the rating will be driven in the short term by general risk appetite amidst the economic gloom. We note that BGFD has traded at a premium for significant periods in the past when risk aversion was high, although there can be no guarantee this will recur in future.

The board has been buying back shares, which could be expected to support the discount or at least improve the NAV per share. Over the year to the end of August 2022, the board bought back 428,750 shares, or 0.5% of those in issue at the start of the year. The board also has the authority to issue shares and has stated it will do so only when they trade at a premium to NAV. There is also an annual continuation vote.

Fig.8: Discount



Source: Morningstar

Charges

BGFD's latest ongoing charges figure (OCF) is 0.66%, calculated at the end of August 2022. This is cheaper than the 0.86% average for Japan trusts, according to JPM Cazenove. The annual management fee is 0.75% on the first £50 million of net assets, 0.65% on the next £200 million of net assets and 0.55% on the remaining net assets, calculated and payable quarterly. With net assets standing at £791m, as at the end of August, we estimate the management fee to be c. 0.59% on an ongoing basis. The management fee is charged to revenue, reflecting the growth focus of the trust, and there is no performance fee. The latest KID RIY is 1.21%, which compares to an average of 1.43% for the sector, according to JPM Cazenove, although we are cautious as methodologies may vary.

ESG

ESG is considered within the stock-selection process and the team aim to understand which ESG risks are relevant on a company-by-company basis. Given their long-term investment horizon, the managers believe it is important to understand how each company is likely to be affected by existing and emerging sustainability issues, which can provide risks and opportunities to the ability to generate high returns into the future. The approach is not exclusionary, but alive to the various competing ESG issues. While the trust does have a low carbon score from Morningstar, Matt and the team will buy individual companies which contribute to emissions, like companies involved in cars with internal combustion engines, tyre manufacturer Bridgestone being an example. Matt and his colleagues look for company management teams which are open to improvement and then aim to encourage positive change within their investments, believing this will lead to better returns for their shareholders.

Morningstar has assigned BGFD a sustainability rating of below average relative to its wider Japanese equity peer group. However, we believe that the long-term view taken on sustainability issues could make it appealing to investors who want to contribute to improvements in society's environmental and social problems.

Disclaimer

This report has been issued by Kepler Partners LLP. **The analyst who has prepared this report is aware that Kepler Partners LLP has a relationship with the company covered in this report and/or a conflict of interest which may impair the objectivity of the research.**

Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that if you are a private investor independent financial advice should be taken before making any investment or financial decision.

Kepler Partners is not authorised to make recommendations to retail clients. This report has been issued by Kepler Partners LLP, is based on factual information only, is solely for information purposes only and any views contained in it must not be construed as investment or tax advice or a recommendation to buy, sell or take any action in relation to any investment.

The information provided on this website is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. In particular, this website is exclusively for non-US Persons. Persons who access this information are required to inform themselves and to comply with any such restrictions.

The information contained in this website is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules. A copy of the firm's Conflict of Interest policy is available on request.

PLEASE SEE ALSO OUR TERMS AND CONDITIONS

Kepler Partners LLP is authorised and regulated by the Financial Conduct Authority (FRN 480590), registered in England and Wales at 70 Conduit Street, London W1S 2GF with registered number OC334771.