Baillie Gifford Shin Nippon

BGS has the best long-term track record in the Japanese sectors...

Update
05 April 2022

Overview

Baillie Gifford Shin Nippon (BGS) is an unashamedly high growth strategy, with manager Praveen Kumar aiming to identify those small Japanese companies which have exceptional growth potential and can grow an initial investment many times over the course of multiple market cycles. **Performance** has been outstanding over the long run, the trust more than doubling the returns of its nearest peer over the past decade. This has been boosted by some exceptional returns in single stocks; the portfolio's top performers over the past decade have returned two or three thousand per cent, and the majority of the best performers remain in the portfolio as Praveen thinks the returns potential is still exceptional.

This outperformance has come at the expense of volatility. The portfolio is tilted to the smallest companies, often less liquid and driven by sentiment, and tends to be run with gearing, all of which raise the market price risk. The strong exposure to the growth factor is another risk to bear in mind and has contributed to a sharp sell-off in the trust's NAV and share price over the past year.

Praveen remains focused on the operational performance of his holdings and reports this has remained strong over the period, with the sell-off attributable to sentiment and external factors. He has, therefore, not made major changes, believing the majority of his portfolio is looking as promising as it was pre-pandemic, if not more so (see **Portfolio**). BGS has usually traded on a premium over the past five years but has fallen onto a small **Discount** during the sell-off of the past year.

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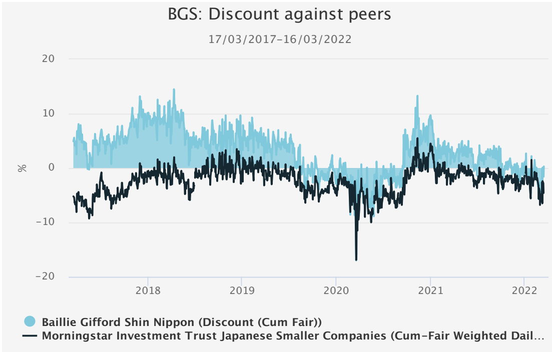
Key Information:

Price (p)	176.6
Discount (%)	-0.4
OCF (%)	0.71
Gearing (%)	11
Yield (%)	0.0
Ticker	BGS
Market cap (£)	554,969,889



Kepler View

Praveen's approach is to be patient and long-term, and this has paid off in a big way in the past. We think investors will need to demonstrate the same qualities to benefit from this strategy. The volatility we have seen over the past year is extreme – a 30% sell-off in 12 months – but the trust has always tended to be more volatile, and a portfolio with such an active set of exposures should be expected to underperform at times. Over the long run, if Praveen has picked the right stocks, then their earnings growth should be more significant to long-term returns than valuation multiples, although there is potential for further downside on the way and no guarantee the amount of outperformance in the future will be the same as seen in the past.

We think BGS has exciting growth potential for investors who can stomach the risk, offering exposure to some areas in which Japan excels – high-end manufacturing – as well as to global trends to digitalisation and increased healthcare spending. The portfolio is cheaper than it was in the past, and BGS' own share price rating is lower, which should increase future return potential. That said, the current economic environment looks less favourable to growth stocks than it did a few years ago, so there may be more volatility in the short term.

BULL
Excellent track record of adding alpha
Highly active and long-term in approach which increases alpha-generating potential
Has the lowest charges in the sector

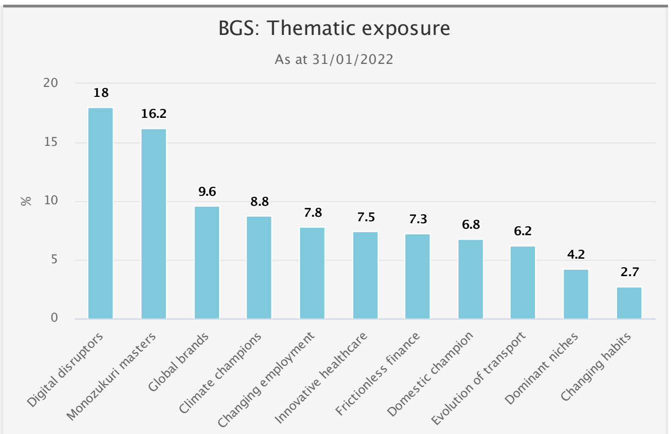
BEAR
Tends to be very volatile, with gearing contributing
Growth factor is out of favour and this could weigh on the trust in the near future
The Japanese market can be very sensitive to a global recession

Portfolio

Baillie Gifford Shin Nippon (BGS) aims to maximise long-term growth while investing in Japanese small caps. The management team take a long-term view on investments and aim to identify disruptive companies and to hold them through cyclical changes in sentiment and revenues until their potential is realised. This brings with it substantial volatility, as we discuss under **Performance**, but has been a highly successful strategy over the long run.

Praveen sets out to identify companies that have the highest growth potential - looking for those with disruptive models, which mean they have a large addressable market. Japan has a reputation for stodgy corporate governance in its large businesses, but it is also home to an entrepreneurial culture in the small-cap space which produces companies at the leading edge of many technological and social developments. Many of these could be considered "digital disruptors", and these form a core part of BGS' portfolio. Companies here include cloud software company Cybozu, online payments facilitator GMO Payment Gateway and Bengo4.com, which facilitates signing documents digitally. Praveen tells us that he would expect this to be one of the dominant themes in the portfolio over the long run, given the potential for disruption that the internet offers. BGS also offers substantial exposure to innovative companies in healthcare, chemicals and synthetic materials and robotics. The below chart breaks the portfolio down into some key themes as of January 2022.

Fig.1: Thematic Exposure



Source: Baillie Gifford

Monozukuri is Japanese for manufacturing, and one theme in the portfolio is highly specialised market leaders in this industry. For example, Tsugami creates lathes that are used to precisely craft hard materials components. Shima Seiki manufactures computerised knitting machines which can independently create garments – effectively robots used for textile manufacturing. The climate champions theme has seen some recent additions, with online energy provider switching service Enechange and Spiber, a manufacturer of synthetic alternatives to leather and cashmere, both bought in 2021.

This categorisation highlights common themes in stock picks, but Praveen doesn't set out to find companies in these categories. He is very open-minded about where ideas come from, with the critical elements being the growth potential and trajectory. The idea is to look for asymmetric payoffs: where the potential upside is many times the downside. This is aided by looking for opportunities from the smaller end of the small-cap market where the growth potential is higher.

Praveen aims to outperform by looking out further than most market participants, and this is borne out by the statistics. Last year's turnover was higher than average thanks to the disruption of the extremely volatile markets since the pandemic hit, but it still only rose to 13.4%. In fact, as of the end of January 2022, 20.6% of the portfolio by value was in a stock held for more than a decade, and a further 33.4% in companies held for over five years. Only 12.2% of the portfolio is in companies held for less than two years as of 31 January 2022.

One of the longest-held stocks in the portfolio is MonotaRO. MonotaRO runs an e-commerce platform for construction and other industrial supplies. The shares returned c. 3,500% in the ten years to the end of January 2022. GMO Payment Gateway is another to have been held for over a decade, and the shares have made over 2,500% on a total return basis in that time. It still makes up almost 2% of BGS' portfolio and is in a top ten position. While BGS has had some losers over the same period, these are mathematically limited to 100% (although none have quite made it that far), with the portfolio exhibiting the desire for asymmetricity of returns.

Praveen's long holding period is in part a function of his decision to eschew timing the market. As he is aiming to identify and benefit from companies that can grow through multiple market cycles, this implies a tolerance to shifting valuations during the cycle and to experience drawdowns when the market or Praveen's preferred stocks are out of favour. However, during the sharp run-up of digital businesses in the aftermath of the first wave of the pandemic, valuations did get too high in some positions. For example, Praveen sold down significantly M3, the online drug marketing platform, although it remains in the portfolio at a lower weight.

Fundamentally though, Praveen believes in taking a step back and not being too influenced by what is going on in markets. BGS' portfolio is highly exposed to the growth factor in investing: the value in many of its stocks is in assumed earnings growth far out in the future. This brings with it sensitivity to rising interest rates or the anticipation thereof, and this has likely contributed to the significant falls in BGS' NAV over the past year. Praveen tells us he thinks there have been some technical factors too, with social and economic restrictions leading to a boom in retail trading during the peak of the pandemic, which has since subsided. Many retail favourite stocks have been sold down significantly – in many cases taking them to pre-pandemic lows in valuation. However, operationally performance has generally been very strong, with the sell-off in the portfolio due to a shift in sentiment rather than company fundamentals. An extreme example of Bengo4.com, which reported a doubling of its profits in 2021, during which period the stock cratered by 60%. Needless to say, Praveen has held on to this one.

Following the emergence of the pandemic, Praveen and the team went through the portfolio line by line, checking there were no "hidden time bombs". They believe there have been very few companies that have seen a fundamental shift in their outlook. One exception was H.I.S, the travel agent. BGS had held this stock since the 1990s, but a deterioration in the balance sheet meant it was unlikely to make a strong recovery from the hiatus in travel caused by the pandemic. The company had also failed to make headway in its online offering. During the more troubled markets of the past year, the work has continued. Praveen is less concerned about the impact of inflation in Japan due to its demographics and technological advances that tend to be deflationary in nature. Although inflation in Japan hasn't been a problem for Japanese companies for many years, Praveen has nevertheless been satisfying himself that his portfolio companies have the pricing power to combat rising inflation in the near term. He has sold JP Holdings, the largest private-sector child daycare services provider in Japan, as he believes it will struggle to raise prices as it only has one customer - the Japanese state.

Leaving the short term aside, Praveen remains focused on trying to identify the next multi-cycle growth opportunities and ensure his current holdings retain high enough growth potential. One area of interest is outer space. There is a flourishing of companies operating in space in Japan, and Praveen tells us five companies are in the initial due diligence phase. The team is also continuing to research the unlisted space for potential investments. Traditionally there have been few opportunities outside of public markets in Japan, but that is changing, and Praveen expects the exposure to unlisted companies to rise meaningfully from the current 3%. This could further increase the differentiation from the index, although with a ten-year average active share of almost 95%, there is already almost no commonality with the market. The aim is for any unlisted holding to offer something that can't be accessed in the public market, such as Spiber, discussed above, or Gojo, which operates microfinancing programmes in emerging markets.

It should be clear that BGS is a high-risk strategy. Praveen is looking for companies with high growth potential and pays no attention to the index. Holdings are often in new industries and in the small end of the small-cap market, with their share prices suffering from swings in sentiment. In some cases, they are unprofitable, which can lead to extra volatility, especially if forecast profits don't come through. Risk is reduced by being well-diversified, with 82 holdings at the end of January and 3.2% of the largest position – positions are usually trimmed back when they reach 5% of the portfolio irrespective of growth potential as a risk management tactic.

Gearing

BGS runs with a modest level of fixed, long-term gearing. As of the end of January, invested gearing stood at 11% of NAV, with potential gearing of 15%. Praveen tells us he is aiming for 10-12% on an ongoing basis, investing more when stock specific ideas present themselves rather than trying to time the market.

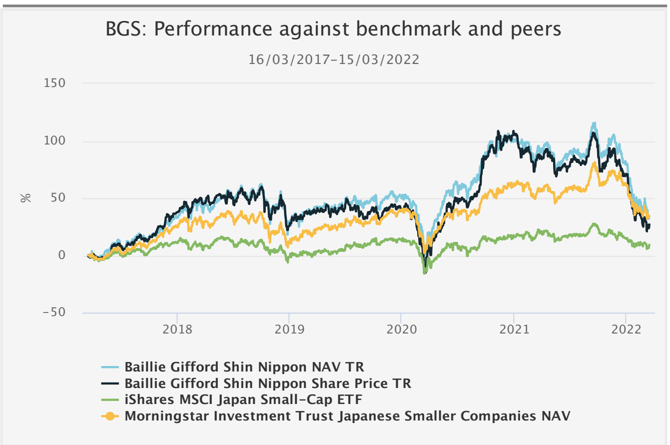
BGS has three loan facilities, all in Yen, with fixed interest rates ranging between 1.4% and 1.693%.By the articles of association, gearing is limited to 50% of shareholders' funds, although the board has committed to not raising it higher than 30% at the time of drawdown. However, gearing levels are discussed by the board and managers at every board meeting, and the current facilities would not enable being more than 15% geared as at 31 January 2022.

Performance

BGS has produced exceptional returns over the long run. In the decade ending 17/03/2022, the trust generated a NAV total return of 377.4%, almost twice the nearest peer's (186.4%). This compares to a total return of 143.7% from the MSCI Japan Small Cap Index. This has been achieved with a high beta (almost 1.4) and volatility significantly higher than the two peers with a track record that long. Volatility has always been a part of the journey with BGS.

Focusing on the past five years, BGS has again outperformed. However, a sharp drawdown over the past year has reduced the quantum: the NAV total return has been 34.2% versus 9.3% for passive investment in the market (via the iShares MSCI Japan Small Cap Index ETF). BGS is down 30% over the past year as growth has sold off against value in the Japanese small-cap market as elsewhere. The peer group average over this period is 34.4%, so almost exactly in line with BGS' return, with the trust having given up its extra alpha versus peers in the sell-off.

Fig.2: 5-Year Performance

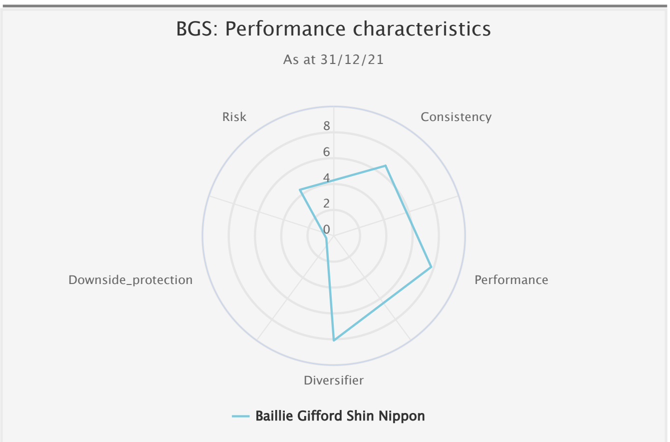


Source: Morningstar

Past performance is not a reliable indicator of future results.

We show below our proprietary KTI Spider Chart. This shows how BGS has performed versus an expanded peer group of all Japan and Japan small-cap trusts over the past five years in some key categories. Each category is scored out of ten, and scores are normalised to the peer group. Even after the recent sell-off, BGS scores highly for performance which looks at alpha versus a benchmark rather than absolute returns. It also stands out for diversification, which score is a blend of correlation to the UK index, global equities and global bonds. We think this is an interesting benefit of investing in BGS: it offers good diversification as well as alpha potential, which should improve risk-adjusted returns on a portfolio if it repeats in future. The spider chart also shows the high risk and low downside protection which is the cost of this outperformance potential.

Fig.3: KTI Spider Chart

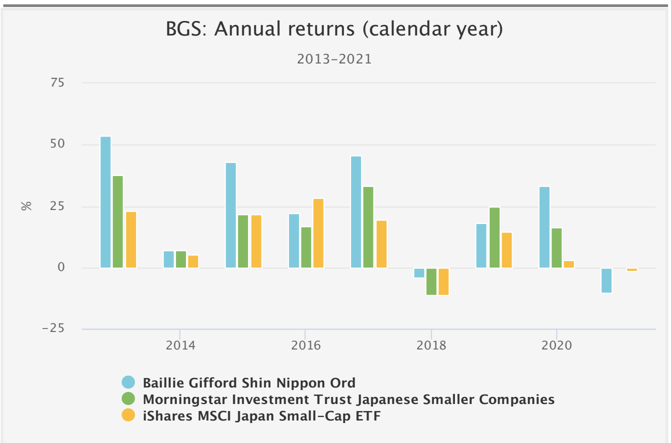


Source: Morningstar, Kepler calculations

Past performance is not a reliable indicator of future results.

As might be expected from a highly active strategy, excess returns have been lumpy, as the below chart illustrates. In 2020 the trust did exceptionally well, boosted by its digital disruption theme: companies providing goods and services online outperformed during the COVID-19 induced lockdowns. Last year, 2021, saw a lot of the heat come out of this market, and traditional value areas such as banks, energy and mining outperformed. BGS has little exposure to these areas and has also seen some of its biggest winners in the digital disruption space come down to earth. In fact, Praveen suggests some have even gone underground, trading on lower prices or valuations than they have done for many years and are now even more attractive on a long-term view. Praveen's focus is always on outperforming over the long run, and he thinks focusing on secular growth trends is the way to achieve this, accepting that volatility and periods of underperformance, such as last year, is an inevitable consequence of this approach.

Fig.4: Annual Returns



Source: Morningstar

Past performance is not a reliable indicator of future results.

Dividend

The company is focused on capital growth and does not pay a dividend. All fees are charged to the revenue account, which is in deficit.

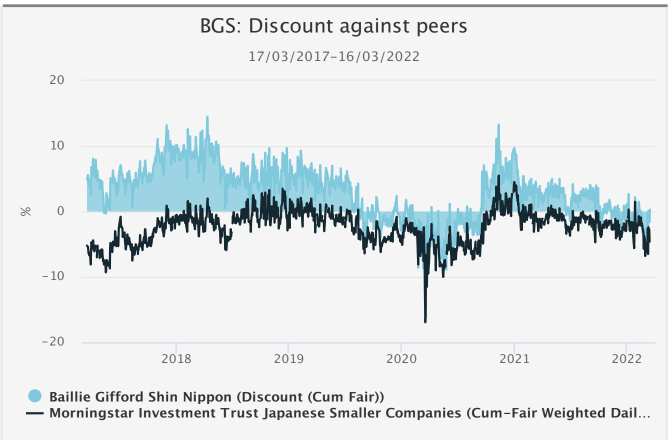
Management

BGS has enjoyed strong continuity of management approach and personnel over the years. Praveen Kumar has managed the trust since December 2015, when he replaced John MacDougall, who had been in charge for eight years. Praveen joined the Japanese desk as an investment manager in 2011, having been with Baillie Gifford since 2008. He is part of a Japanese equities team of nine based in Edinburgh led by the head of Japanese equities, Donald Farquharson, who has 33 years of experience. There are also two researchers based in Japan who provide thematic input, attending trade shows and conventions to generate ideas about broader trends in the country. Praveen also manages the open-ended Baillie Gifford Japanese Smaller Companies Fund and is the deputy manager of the all-cap Baillie Gifford Japan trust.

Discount

BGS has traded on a premium for most of the past five years but has fallen onto a discount in recent months as markets have sold off, and growth portfolios like those of BGS have underperformed the market. At the time of writing, the discount is -0.4%, which is well below the five-year average 3% premium. This could prove an excellent long-term entry point, although it may take a reversion in style leadership for BGS to recover a sustained premium rating.

Fig.5: Discount



Source: Morningstar

The board have taken advantage of the trust trading on a premium in recent years to issue new shares and grow the trust. In the financial year ending January 2021, BGS issued as much as 7.8% of the share capital as of the start of the year. In the year ending January 2022, shares worth a further 4.3% were issued. Issuance should improve liquidity as well as lowering the expense of managing the trust to shareholders. Although the board has the ability to buy back shares, it has not done so in the past two years. It has stated that it will consider doing so when the shares start trading at a substantial discount to NAV.

Charges

The trust has an OCF of 0.71%, the lowest of the four Japanese smaller companies trusts. This is largely thanks to the management fee being the lowest of the four trusts in the sector, although the growth in the size of the trust in recent years has also contributed, and BGS is now by some way the largest trust in the peer group. The management fee is charged on net assets on a tiered basis. On the first £50m, the manager is paid 75bps, on the next £200m 65bps and on the remainder 55bps. At the trust's current size (£627m in total assets), that amounts to a rate of 60bps. The KID RIY is 1.21%, lower than the sector average of 1.46%, although we note methodologies may vary.

ESG

Sustainability issues are integrated into the stock selection process, with ESG analysis considered as a part of the investment decision and ongoing monitoring. In keeping with their long-term approach to investment, Praveen and the rest of the Japan team aim to be constructive shareholders, engaging with company management in the interest of long-term value creation. The investment case for many of BGS' holdings involves their contribution to environmental issues (via the climate champions theme or the future of transport theme) or social issues – via expanding access to employment, for example. Improving governance is a key theme for investors in Japan, given the commitment of the government to improve corporate practices in the interest of efficiently allocating capital and improving economic performance. Praveen tells us governance is typically good at the companies he is looking at, given they tend to be entrepreneurial and focused on growth. That said, BGS does not have ESG objectives and so may not satisfy ESG investors. Morningstar rates the portfolio as low for sustainability based on an analysis of its underlying holdings, although we believe this may reflect the absence of information for some of its holdings, particularly the smaller ones, so would not over-emphasise this. With effect 1 March 2022, the board welcomed Abigail Rotheroe. Abigail is a former fund manager who has since specialised in impact investing and sustainability, and we believe her appointment indicates interest by the board in strengthening the trust's credentials.

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