



# Japanese Equities

Philosophy and Process



*Japanese Equities*

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# Introduction

*As a company with over a century of experience of patient investing, run by partners whose only task is to seek out long term success, we understand the approach Japanese businesses take to find positive returns, because it mirrors our own.*

Our Japanese equity business is defined/differentiated by its heritage, people and consistently applied philosophy of bottom up, patient long-term investing. We believe these hallmarks have underpinned our consistent track record of creating value for clients over the long term.

## Heritage

We have been managing Japanese equity mandates for over 40 years, during which time we have experienced various bubbles (Japan's own along with the dot.com one, that burst at the turn of the century), and several natural disasters (including the great Hanshin & Tōhoku earthquakes). We have also witnessed a near transformation of the Japanese equity market from one dominated by major banks, telecoms, and utility companies to something far more tech orientated. This has helped weather our approach to growth investing, into one that works against all backdrops.

## People

Original investment ideas and differentiated thinking are the ultimate drivers of our investment returns. That process is enriched by the diversity of the Japanese Equity Team, one that combines stability and experience, with fresh thinking and change; a team with expertise in business analysis, made up of individuals with contrasting experiences; that combines regional insight with a global perspective.

## Patience

Adopting a long-term investment horizon allows us to capture unrecognised growth in all of its guises by overcoming the vagaries of cycles and short-term share price movements. At the same time, it allows our clients to benefit from the value created by Japan's most successful companies.





# Japanese Equity Strategies

	<b>Japan Growth</b>	<b>Japan All Cap*</b>	<b>Japan Income Growth</b>	<b>Japan Smaller Cos*</b>
Inception	2009	1984	2016	1983
Time horizon	5 years+	5 years+	5 years+	5 years+
Typical annual turnover	10–20%	10–20%	10–20%	10–20%
Index	TOPIX	TOPIX	TOPIX	MSCI Japan Small Cap
Guideline no. of holdings	35–55	45–65	45–65	40–80
Max stock position	10%	10%	10%	10%
Min effective no of stocks	20	25	25	N/A
Min effective no of industries	7	7	7	N/A
Min Market Cap Guideline	>¥200bn	>¥100bn	>¥75bn	N/A

\*Currently closed to new segregated enquiries.

The strategy aims to achieve a targeted outperformance above benchmark of at least 2% for Japan All Cap, Japan Growth and Japan Small Cos and 1.5% for Japan Income Growth per annum over rolling five year periods. As the strategy is not constructed with any great reference to an index, we are happy to be measured against Topix, MSCI Japan or FTSE Japan Indices.

The performance target stated is in no way guaranteed, nor is it intended to be precise. We believe it to be a reasonable estimate of the amount by which we can outperform the relevant benchmark in the long term through the consistent application of our investment process, taking into account the opportunity set and the characteristics of the markets in which the strategy invests. Factors that may lead to Baillie Gifford failing to meet our investment performance objectives in future include a significant change in market characteristics such that our growth investment style is unrewarded for a period of time; or misjudgement of the prospects for long-term earnings growth for a significant number of individual stocks in which we invest.



# Opportunity

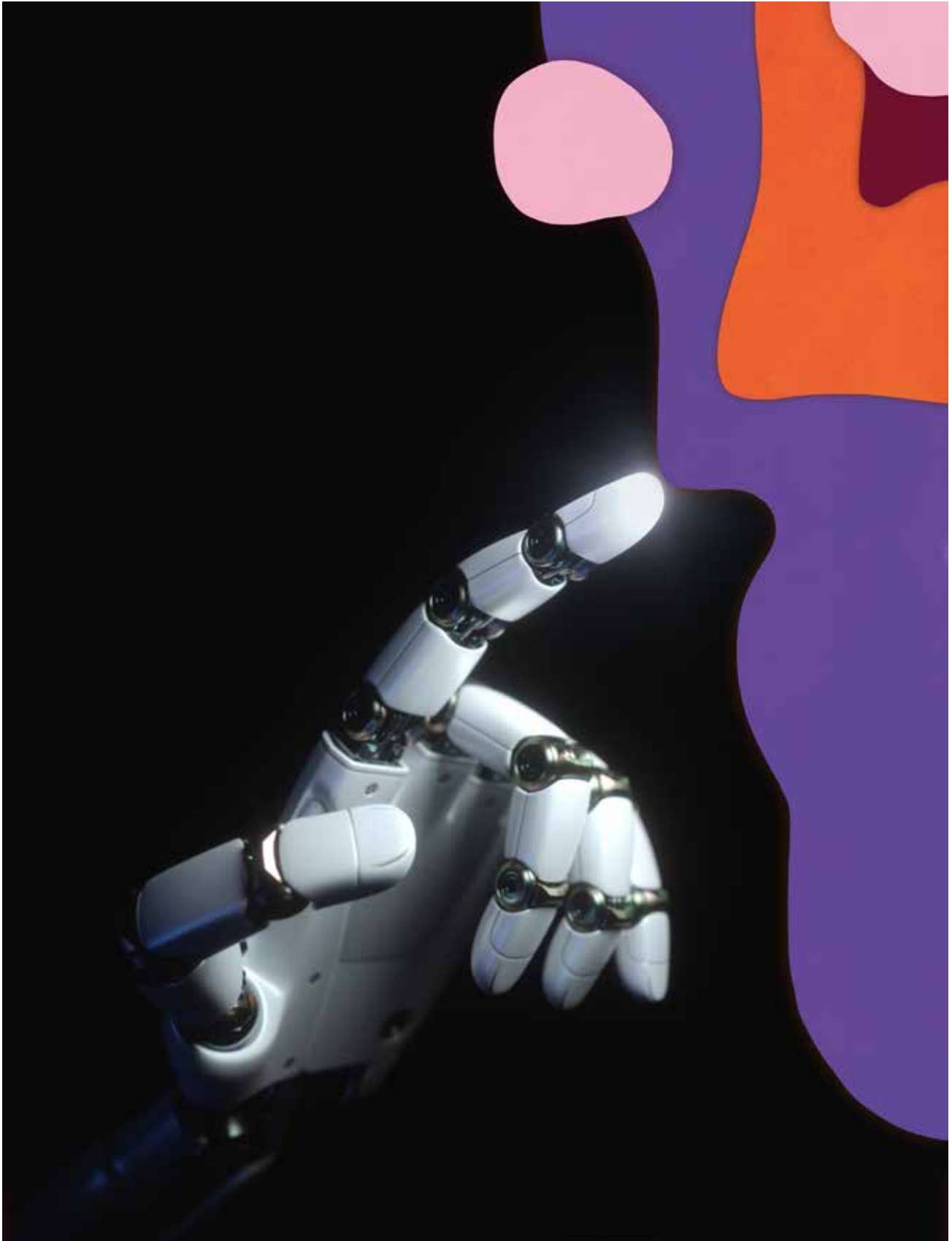
*Finding opportunities consistently from the 1980's to the 2020's*

Japan is the world's third largest economy, home to unique technologies and an emerging class of digital disruptors. Our 40+ years of experience managing Japanese equity mandates, combined with a patient long-term approach allows us benefit from those at the vanguard of innovation and entrepreneurialism.

There are plenty of examples to be found in areas such as robotics and automation, or in the manufacturing of complex electronic components, where Japan retains its technical edge. Less obvious, are the emerging class of entrepreneurs that are helping the country tackle its digital transition. Japan is also home to some of the world's best-known brands, many of which are primed to benefit from the premiumisation trend within Asia, from rising wealth across the region.

These are just some of the opportunities emerging for bottom-up, selective bottom-up stock pickers within Japan.





# People

*Meet the team that has backed Japan the longest.*

## Japanese Equities team



### Donald Farquharson – Japan Growth

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Donald heads the Japan Equities Team. Donald is the co-manager for the Japan Growth strategy (and related Growth strategy segregated accounts) which he has run since its inception on 31 December 2009. He is also a member of the International Alpha Portfolio Construction Group (PCG). Donald has over 25 years' investment experience dedicated almost entirely to Japanese equities: He spent 20 years working for Schroders as a Japanese specialist and latterly Head of the Pan Pacific equity team and manager of the Schroder Japan Growth Fund plc. Between 1991 and 1995, he headed Schroders' research team in Tokyo. He graduated with MA (Hons) in Arabic Studies from the University of St Andrews in 1987 and is a CFA Charterholder. Donald joined Baillie Gifford in 2008 and became a Partner in 2017.



### Matthew Brett – Japan All Cap & Japan Income Growth

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Matthew is an Investment Manager in the Japan Equities Team. He is Manager of the Japanese Fund (and related All Cap strategy segregated accounts), Manager of the Baillie Gifford Japan Trust, and Co-Manager of the Japanese Income Growth Fund. He is also a member of the Global Stewardship Portfolio Construction Group. Matthew graduated BA (Hons) in Natural Sciences (Psychology) from the University of Cambridge in 2000 and holds a PhD in Psychology from the University of Bristol. He joined Baillie Gifford in 2003 and became a Partner in 2018.



### Iain Campbell

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Iain is an Investment Manager in the Japanese Equities Team. He is Manager of the Developed Asia Strategy and is a member of the International All Cap Portfolio Construction Group. Iain graduated BA in Modern History from Oxford University in 2000, and worked for Goldman Sachs and travelled in Asia, before joining Baillie Gifford in 2004. Iain became a Partner of the Firm in May 2020.



### Praveen Kumar – Japan Smaller Companies

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Praveen is an Investment Manager in the Japanese Equities Team. He is the Manager of the Japanese Smaller Companies fund (and related Japan Small Cap strategy segregated accounts), Manager of the Shin Nippon Investment Trust, and Deputy Manager of the Baillie Gifford Japan Trust Plc. He is also a member of the International Smaller Companies Portfolio Construction Group (PCG). Praveen graduated BEng in Computer Science from Bangalore University in 2001, and an MBA from the University of Cambridge in 2008. He previously worked for FKI Logistex before joining Baillie Gifford in 2008. After completing the investment graduate trainee programme Praveen joined the Japanese Equities Team as an Investment Manager in 2011.



### **Tolibjon Tursunov – Japan Growth**

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Tolibjon is an Investment Manager in the Japanese Equities Team. He is co-Manager of the Japan Growth strategy (and related Growth strategy segregated accounts). He joined Baillie Gifford in 2011 and spent time working on our regional as well as large and small cap global equities teams. Prior to joining Baillie Gifford, he worked in the corporate finance department of an FMCG company, before founding a price comparison website in Central Asia covering insurance, banking, and telecom sectors. Tolibjon graduated LLB in Law from Queen Mary University of London in 2008 and is a CFA Charterholder.



### **Karen See – Japan Income Growth**

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Karen is an Investment Manager in the Japanese Equities Team. Karen is a Co-Manager of the Japanese Income Growth Fund. Karen graduated BSc (Hons) in Economics with Japanese from the University of Birmingham in 2011 and is a CFA Charterholder. Karen joined Baillie Gifford in 2012.



### **Minahil Naveed**

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Minahil is an Investment Analyst in the Japanese Team. Before joining the Japan team, Minahil worked in the Emerging Markets Team and European Team. She joined Baillie Gifford in 2019, after completing her MPhil in Development Studies at the University of Cambridge. Minahil graduated magna cum laude from Bryn Mawr College in 2017.



### **Andrew Brown**

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Andrew is a Client Service Director with responsibility for Japanese equity clients. Andy is also the Chair of the Japan Product Group and European Product Group. Andrew maintains a close relationship with the Japanese Investment Team and conducts regular stock research and investment trips to Japan, as part of his specialist client service role. Prior to joining Baillie Gifford in 2007, Andrew held roles at Scottish Widows Investment Partnership and Ernst & Young. Andrew graduated from Durham University with BA (Hons) in History and Politics in 1998 and is a holder of the UK Securities Institute Diploma. Andrew joined Baillie Gifford in 2008.



### **Thomas Patchett**

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Thomas is a Japanese Equity Specialist with responsibility for Japanese equity clients. He is also a member of the Japan Product Group. Thomas maintains a close relationship with the Japanese Investment Team, participating in stock discussions and portfolio meetings, as part of his Specialist Client Service role. Prior to joining Baillie Gifford in 2015, he worked as a Private Banker at Barclays Wealth & Investment Management. Thomas graduated BSc (Hons) in Business Management from Kings College London and is also a CFA Charterholder.

**Paul Schwerda**

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Paul joined Baillie Gifford in 2018 and is an Investment Analyst in the Japanese Equities Team. He graduated PhD in South Asian Studies from Harvard University in 2017. Prior to this he gained an AM in South Asian Studies from Harvard University in 2015 and an MA in Indian Studies from the University of Tübingen in 2011. Reflecting his long-standing fascination with Japan and his experience of living there, Paul is particularly interested in identifying those companies that will shape Japan's economic future. Furthermore, he is intrigued by questions of impact and ESG and keen to explore them in a Japanese context.

**Mirbahram Azimbayli**

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Mirbahram joined Baillie Gifford in 2018 and is an Investment Analyst in the Japanese Team. He graduated BSc in International Relations from the Middle East Technical University (METU) in 2016 and MPhil in Russian and East European Studies from the University of Oxford in 2018.

**Jennifer Ireland**

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Originally from Canada, Jennifer completed her medical degree at the University of Glasgow in 2010. She practiced for over a decade in various specialties including paediatrics, primary care and musculoskeletal medicine before joining Baillie Gifford in 2021 as an Investment Analyst in the Japanese Team.

**Cian Whelan**

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Cian is a dedicated Japanese ESG representative. Cian joined Baillie Gifford in April 2019 as an analyst in the Governance and Sustainability Team. He previously worked for Glass Lewis as a corporate governance analyst and ESG specialist for the Northern Europe Team from 2017 to 2019. Prior to that, Cian completed a PhD in 2016 on the potential issues around mainstreaming ESG in China. Cian's areas of interest include the evolving conversations and expectations of ESG, with a particular focus on South-East Asia.

The Japanese team also employs two Tokyo based researchers, Satoko Ishino and Akiko Hirai, who provide additional insight and input into the investment process.





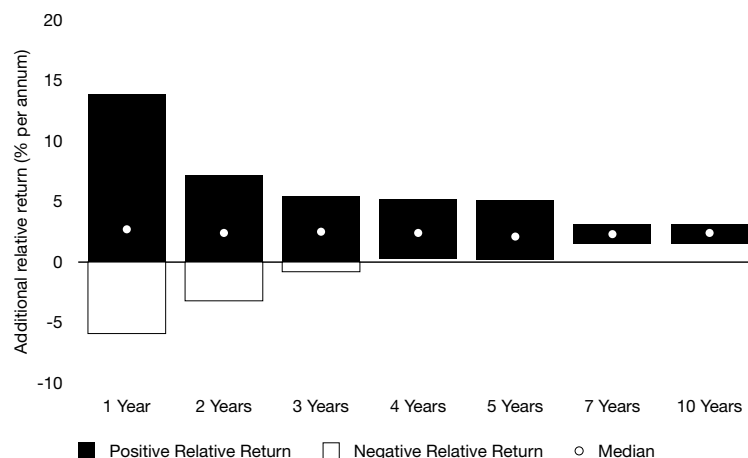
# Philosophy

*We aim to create value for our clients by finding and investing in Japan's most promising growth companies. We do so, by employing a flexible approach to growth investing, and using time to our advantage.*

## Time is our greatest asset

Adopting a long-term approach allows us to frame investment opportunities differently to the rest of the market. We consider the unique attractions of individual companies, and we do so over five-year time periods and beyond. This long-term focus enables us to eschew the ephemeral vagaries of markets, cycles and share prices – to unearth exploitable and under appreciated opportunities that will ultimately deliver long-term outperformance.

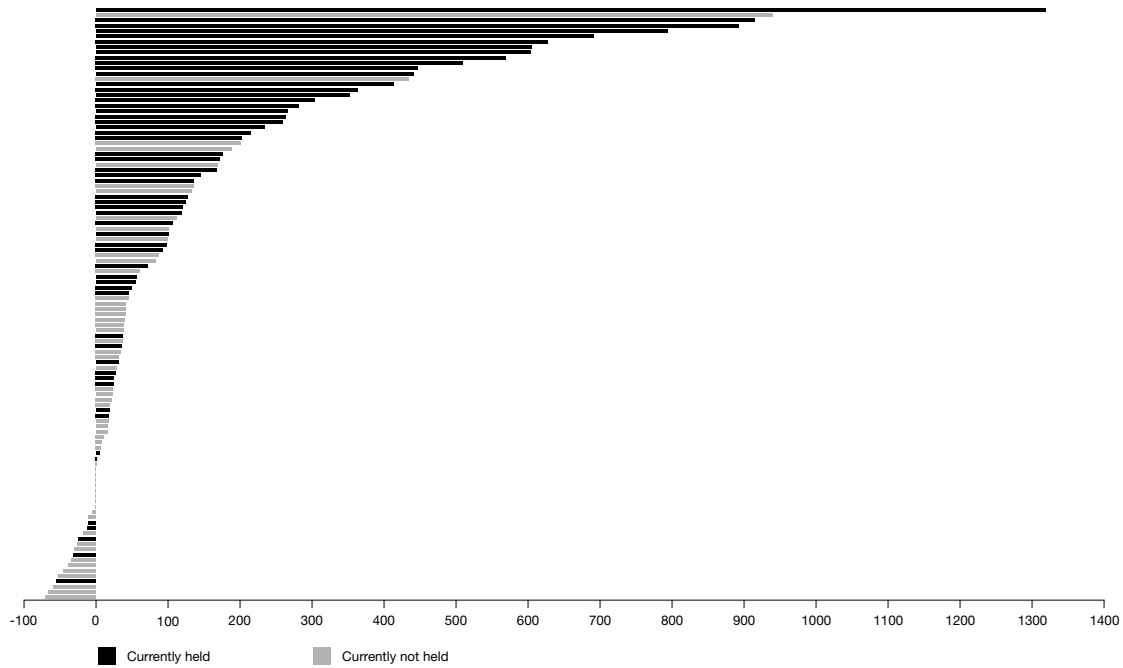
### Range of returns over rolling periods



Source: StatPro, Tokyo Stock Exchange. As at 30 September 2021, net of fees. The figures above show results after analysing annualised returns over each quarter for the Japan Growth Composite (31/12/2009 to 30/09/2021) vs TOPIX.

For our clients' portfolios, long-term returns are determined, by seeking out, investing and continuing to back a relatively small number of exceptional businesses which grow to multiples of their starting size. This approach will inevitably lead to some mistakes along the way, but by focusing on opportunities for major upside potential and supporting them for significant periods of time – by running our winners – we are able to capture the inherent asymmetry of equity market returns.

### Cumulative absolute return of Japan Growth Stocks – 10 years to 30 September 2021



Source: StatPro. Japan Growth composite. Returns in Yen. Some stocks were only held for part of the period.

### Flexible approach to growth investing

Our experience has highlighted that growth can come in various guises, from companies of all shapes and sizes. As such our portfolios are invariably built, from the bottom-up, with a diversified mix of companies from across all sectors and industries.

The commonality is that each investment must present a plausible pathway to doubling over a five-year period. But of course, there are various ways to climb a mountain. Be that through a gradual (compounding) approach, or via a more vertical (exponential) axis.

By focusing on businesses with attractive structural growth opportunities, with strong and sustainable competitive positions, high-quality earnings and aligned management we will optimise our exposure to Japan's best of breed growth opportunities.



# Investment Process

*We see Japan differently to others.*

## Idea generation

In pursuit of Japan's most attractive growth companies, we aim to generate original investment ideas by utilising a variety of sources. In addition to the more conventional inputs such as meetings with senior management and scrutinising company reports and accounts, we utilise private company analysis, bespoke and thematic reports from our independent researchers in Tokyo, investment trips (not limited to Japan), links with academia and industry experts.

## Research and debate

Companies that pique our interest are subject to our four-factor investment framework analysis. This process is intended to focus attention on key fundamentals that we believe are most pertinent to delivering long-term growth.

## Opportunity

### How big is the opportunity over 5-10 years?

First, we look at the favourableness of the environment in which the company operates.

Is this a blue ocean opportunity in terms of the addressable market? Are there favourable industry dynamics, such as weak incumbency? Is the industry or market undergoing structural change? What will be the effects of environmental and technological shifts in the long-term and which companies are likely to benefit?

## Resilience +

### How durable/adaptable will the competitive advantage be in five years' time?

We then explore whether the company has identifiable qualities that we believe will allow it to thrive in the complex environment in which it operates.

One way of thinking about Resilience is as dynamic and durable competitive advantage. How replicable is their edge, and is it sustainable? Another view is from the customers' perspective. How much value is the company adding? If it did not exist how much would it be missed? We are less interested in their competitive moat right now than, how deep it will be in five years' time and whether it will get deeper from there.

Another important aspect is the competence and alignment of management. Are leadership able to organically create new value organically? Is there a strong record of execution that gives us confidence in the future decisions? Can we see evidence of genuine ambition and vision? Are they aligned with wider stakeholders?

A business with high resilience should also have excellent future financial characteristics. An ideal investment will see its returns improve as it grows, and profits will be effectively converted to free cashflow. For those businesses that are more economically sensitive we look for evidence that profits and returns can rise through capital cycles and ideally make investments for our clients at what we believe to be favourable entry points.

Together these factors help us to identify whether we think the company in question will successfully execute on the opportunity that exists.

## Sustainability

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

We believe that ESG factors can have a material impact on a company's ability to generate long-term value. As such, we explicitly address these issues within the research framework.

Here we explore how the company intends to address environmental, social, and governance factors. The relevance of each is based upon the perceived materiality to the long-term sustainability of the company's business. As a result, key ESG considerations will vary depending on the industry sector, and core business activities of each company.

## Upside

### **What is the likelihood of over 2x upside?**

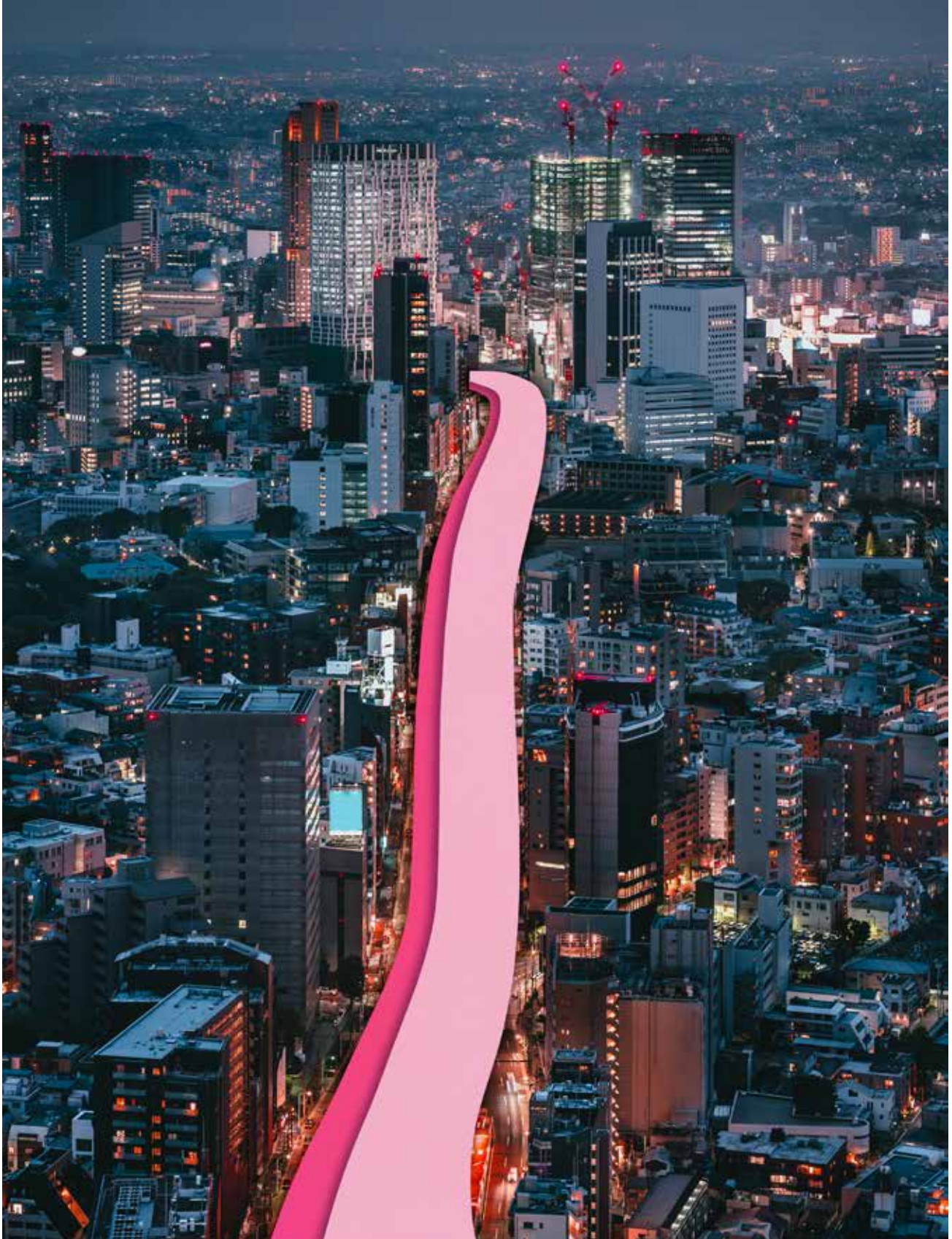
This dimension brings the investment case together, indicating to us whether a holding meets the high bar that we look for. We prefer to focus on the return we might realistically expect to make if we invest in the shares, aiming off conventional valuation metrics, which often tell us very little about the upside potential.

We assess the probability weighted average upside, considering both realistic base case scenarios as well as blue sky outcomes.

### **Decision**

The final decision will lie with the manager(s) of the strategy, depending on individual conviction and broader portfolio context, whilst taking any relevant guidelines into account.

To assist in this process, the investment managers meet formally fortnightly to review the portfolio and prospective investments.



# How We Think About ESG

*Not just seeking out the best Japanese companies, but those with the best practices.*

We believe that by considering each company's environmental and social impact, and their governance practices, we will not only mitigate any financial risk from their activities but also help companies become more robust and contribute to long-term returns. As such there are two core ways in which we integrate ESG considerations:

## 1. Embedded into our research process

Each member of the team integrates ESG into their analysis via an explicit question within the four-factor investment framework, which is boosted by the specialist input of the team's dedicated ESG analyst.

## 2. Ongoing Engagement

We seek to deliver long-term returns for our clients and to benefit society. Therefore, we have a responsibility to behave as supportive and constructively engaged long-term investors. Our approach favours a small number of simple principles which help shape our interactions with companies. These stewardship principles are as follows:

- Prioritisation of long-term value
- A constructive board
- Long-term focused remuneration with stretching targets
- Fair treatment of stakeholders
- Sustainable business practises

## Additional Considerations

### Screening

We apply the UN Global Compact principles screen; excluding businesses that are inconsistent with the set of ten responsible business principles that cover human rights, labour, environment and anti-corruption.

### Avoiding controversial investments

We avoid companies involved in activities that cause environmental or social harm that are likely to face increasing regulatory pressure and disruption. This includes companies with significant exposure to armaments, tobacco, thermal coal, tar sands, and arctic drilling.



# How We Manage Risk

*Risk. Going beyond box ticking.*

We believe that permanent loss of capital is the most important risk to any portfolio, over and above model-based risk measures and historic share-price behaviour. We attempt to mitigate this risk in various ways:

## **Fundamental analysis**

Our first line of defence is extensive due diligence. New buy ideas - and current holdings – are subject to thorough reviews by the Japanese Equity Team, with input from a plurality of Baillie Gifford research teams.

## **Portfolio risk**

We seek to maintain an appropriate level of diversification at the overall portfolio level by embracing pragmatic risk guidelines which are formally reviewed on a regular basis.

## **Liquidity risk**

We maintain a Product Group rule that we will not hold more than 10 per cent of the portfolio in stocks where we hold more than 8 days' trading volume at time of purchase. This ensures that the portfolio remains sufficiently liquid to enable positions to be exited or client cash flows to be managed with minimal impact.

## **Independent Oversight, beyond box ticking.**

We have an independent Investment Risk Team at Baillie Gifford which provide value-added analysis on portfolios, that goes far beyond the concept of an investment risk function being only adversarial risk police. While part of their toolkit includes an ability to disagree and constructively oppose based on various oversight mechanisms and risk guidelines, they also play a role as engagers of portfolio managers: providing perspectives on the portfolios (on capital allocation, behavioural biases and decision making analysis for example) with the aim of improving the investment process, to achieve better outcomes and minimise opportunity costs.

This reflects our pragmatic approach to risk management.

## **Investment Risk Philosophy**

### **Patience is a virtue, and fundamentals dominate long-term returns**

Short-term volatility shouldn't unduly influence long term decisions

### **Focus on value-adding relationships with Investment Teams**

Provide bespoke analytics and research

### **Focus on downside risk as well as on potential upside foregone**

### **'Risk' is not a single number solution**

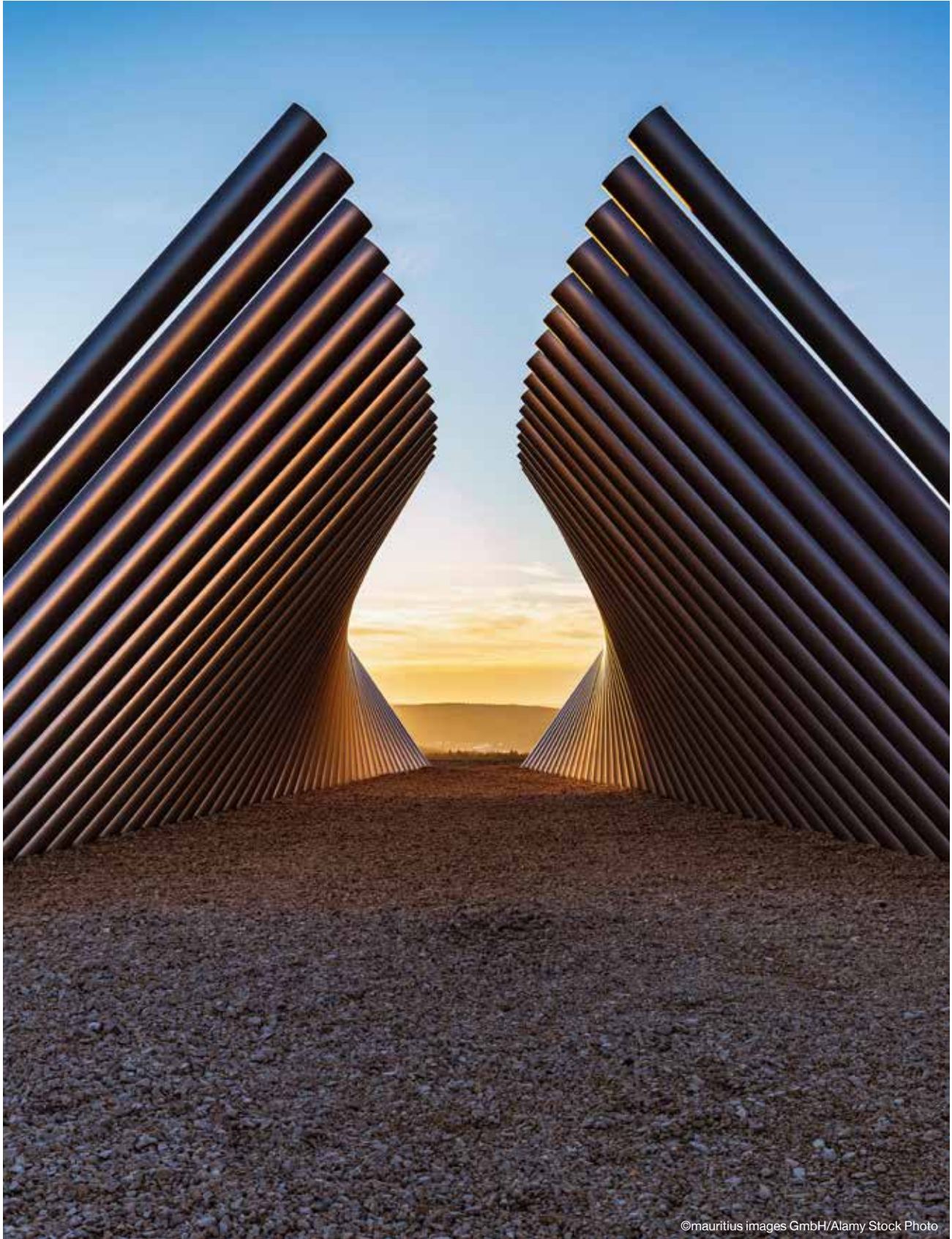
We recognise the limitations of risk model and use critical thinking to interpret outputs

### **Beyond box ticking**

Value adding and engaging analysis drawn from a variety of measures and perspectives









# Why Invest with Baillie Gifford

*Long term. Patient. Consistent ownership. Sharing the same values as great Japanese companies also allows us to share in their success.*

Baillie Gifford was founded in 1908 in Edinburgh where it continues to have its headquarters and is an investment partnership, wholly owned by the people who invest for and look after our clients. Through each successive generation of partners our sole focus on generating superior long-term investment results for our clients has been the bedrock of our growth.

## **Partnership defines us**

Our structure allows us to put our clients' needs first rather than dance to the tune of external shareholders. It brings stability and a long-term time frame to everything we do in our business, whether choosing the best investments for our clients' portfolios or continually investing in the firm and developing our people. Partnership also brings independence, allowing us to be truly active investors. Our portfolios are shaped by where the best investment opportunities lie, rather than where the index dictates. We encourage personal responsibility, creating a strong culture of inquisitiveness, debate and respectful trust in which our investors are nurtured, and thrive.

# Conclusion

*Our unique organisational culture allows us to add value for our clients after fees over the long-term through the consistent application of a highly distinct investment philosophy. We are proud of our record but at the same time always strive to improve and like the companies we invest in, have a stated goal of being world leading in what we do.*



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