
SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 22

Investing in Japan: What's changed and what's next?

MB – Malcolm Borthwick

MA – Matthew Brett

MB Hello and welcome to *Short Briefings on Long Term Thinking*. Thanks for joining us. I'm Malcolm Borthwick, editor of Intellectual Capital at Baillie Gifford.

The Baillie Gifford Japan Trust is 40 this year. A lot has changed in Japan in four decades: 21 different prime ministers have come and gone, companies such as Sony, Toyota, and Toshiba have helped Japan dominate the world as an exporting powerhouse. Yet the country has also endured decades of economic stagnation, and the population of the world's largest city, Tokyo, has grown by 30 per cent to 37 million. During this time, the Japan Trust has endured and flourished.

But enough of the past. As long-term growth investors, we look to the future. So, what about the next decade? To discuss this, I'm joined by Matthew Brett, manager of the Baillie Gifford Japan Trust and the Japanese Fund.

But before we start our conversation, some important information. Please remember that as with all investments, your capital is at risk, and your income is not guaranteed.

And I'm delighted to say that Matt and I are back in the Edinburgh studio after over a year of being away. So, it's great to have Matt here with me and to chat to a three-dimensional person.

Matt, great to have you with us

MA Thanks, Malcolm.

MB So, Japan. What's next?

MA For us, very much. The first 40 years, as you say, has passed, and what we are thinking about really is the next ten years, looking forward to the 50th anniversary of the Japan Trust. Actually, there's a lot that I'm more excited about looking forward ten years than I am for the past years.



MB So, how have things changed, Matt, in terms of the choice of companies that you have now to invest in?

MA I think that's a really fascinating point. If we go back to the late 1980s, which is a bit before my time, Japan was very much dominated just by the big financials, the big banks, and clearly that didn't deliver a great return for the next 15 years or whatever. When I started looking at Japan back in 2005, really, it was a mixture of three things were the big parts of Japan.

We still had the remainder of the big banks. We also had the car companies, and we had some of the big manufacturing conglomerates in Japan.

But as we look at Japan today, I think it is quite fascinating how the index of Japan has changed quite a bit. When we look at the top parts of the index now, it's mainly dominated by a mixture of technology companies and also internet-related businesses are the main parts. Toyota is still in there as well. But in general, it's become, I think, a much more interesting place to invest for a growth investor. We've got, basically, a bigger opportunity set of exciting businesses.

MB We've seen a proliferation of both growth and disruption, offering more opportunities. How do you think these opportunities will evolve over the next decade? Which sectors, ideas, companies will dominate?

MA I think the internet has been a huge area of opportunity for us, both as a firm and also within Japan. We still think that is a huge opportunity, that the internet basically allows people to do things cheaper, more efficiently, and better than the offline in many cases. We think that that gives opportunities across retail, across financial services and many other areas.

Another big area that's much more Japan specific is in the automation-related companies. So, for example, the big robot companies and other automation companies. And we can see at the moment in the world the various supply-related challenges that we're having. One of the obvious solutions to that is to make more things more efficiently than we're doing at the moment, and I think Japan has a huge amount to offer the world in that sense.

And then finally, a new area for us that's been emerging in the past little while has been we've started to get a little bit more exposure to some of the cosmetics and skin care-related companies. This is a slightly different type of opportunity for us, where we can see the increasing wealth in the rest of Asia, and Asian skin care looks at the Japanese brands very, very favourably. And so, we think that that could be a really interesting way for us to play the rising wealth trends continuing across Asia.

So, those are just three areas that are exciting. There are many individual companies within that.

MB Robotics is interesting, Matt. We talked about the exporting companies in Japan which have dominated. The TOSHIBAs. The Sonys. The Toyotas. But what about the world-leading robotics firms in Japan? Because Japan is still very much at the



cutting edge and ahead of the game here, isn't it?

MA Yes, I think you're absolutely right. When we look at the major robotics companies globally, there are two handfuls of those globally, and one of those hands is basically in Japan.

And I think what really makes the Japanese very, very good at this area is a whole combination of things. The materials that they have to start with. The quality they put into the steel and things like that is very, very high. The precision engineering is very good. Their standards of quality are immensely high.

And so, one of the ways that many parts of the world have been increasing their manufacturing prowess is basically to buy in the Japanese technology. Your robots and computerised numerical controllers from Fanuc. Your robots from the likes of Yaskawa. Machine tools from DMG Mori. So, Japan really is providing, I guess, the picks and shovels of the modern era, and I think that that should continue.

When we look at up-and-coming automation companies from other areas of the world, yes, China is making big strides in automation, and has as a national priority improving their skills in this area. But when it comes to the high end, the simplest and easiest way is still to buy from the Japanese and to really quickly increase the production quality.

MB Matt, you joined the Japanese equities team 16 years ago, when dividends were virtually non-existent, probably, in Japan. This has changed a lot to what we see now, in terms of a lot more Japanese companies paying dividends. How do you see that evolving over the next decade?

MA I think this is another real area of excitement, where Japan is just in a very different place still to many parts of the world. So, as you say, you go back 15-odd years, and for Japanese companies, the dividend was very much an afterthought. Some companies in that stage were actually paying a fixed dividend, and you'd ask them, why is the dividend ¥50? And they'd say, well, it just is ¥50. There was no relation whatsoever with the profits of the company.

Then we've seen a period where Japanese companies have moved towards paying out a certain percent of profit. But during the global financial crisis, there was quite a big setback in the dividends in Japan.

Whereas what we've seen during the current crisis is quite a different situation, where the Japanese companies have been much more reluctant to cut their dividends in the current crisis. And so, we've actually seen a very resilient approach to the dividends. And this is backed, obviously, by the large amounts of cash that many Japanese companies still have.

So, as you say, when we look forward over the next ten years, I think we're probably somewhere around halfway through this trend, in the sense that, yes, Japanese companies pay a lot more attention to the dividends, and yes, they are now paying attention to the stability of those dividends as well. But still, over half of Japanese companies have a net cash position, and sometimes it's still very big.



And so, I think the scope to continue to grow dividends ahead of earnings in Japan is probably far better than in many parts of the world. And I think that's just an excitement in Japan that really is, I think, quite different to how many people's perception of the Japanese market is.

MB I always found the perception of Japan interesting, Matt. As a journalist, I was the BBC's Asia Business editor, Japan as a country or as an investment opportunity used to divide opinion. In the UK and people outside the UK who are listening might not get this comparison, but it always seen as somewhat Marmite. Why do you see Japan as splitting opinion so much?

MA I think one of the things about Japan that really sticks in people's mind is there was this period in the 80s when Japan was a really dominant type of force. We've got books in the Baillie Gifford investment library about Japanese management, *kaizen*, taking over the world and so on. And obviously, then, at the end of the 80s, we had that great crashing of that bubble. And then there was a period of 10, 15 years of Japan really, I think, lost some of its own confidence, and I think investors probably lost a lot of confidence in Japan at that time.

And so, what I find, actually, when I meet investors is there are two groups of people that are more optimistic about Japan. One is the older investors, who were around during that 80s period and understand that Japan had very strong characteristics at one stage. And then the more recent investors, who maybe started looking at Japan as I did 15 years ago, when a lot of the more difficult period had already passed by that point, and actually the stock market since then has delivered decent returns, and there's been interesting companies.

So, I think that, the experience of different cohorts looking at the Japanese market I think is what has created a lot of that kind of Marmite approach. Obviously, there's a kind of middling cohort, who started investing in Japan in 1989, and for the first ten years had a pretty difficult time. Maybe it's hard for those people to shake the impression that Japan is somewhere to lose money rather than to make money, but that hasn't been the experience for a good 15 years now.

MB When you go to Japan, how different is the perception from the reality?

MA I think it's just hugely different, isn't it? So, I remember first going to Japan. It'd be, what, 2005, 2006. And you've been told by some of your colleagues outside the Japan team, to be clear, that Japan is a declining and declined place, etc., and you have this vision of one of those old Western films, turning up, and the tumbleweeds going across this declining and decrepit place.

So, anyway, so you turn up, and I first went to Osaka, and my first thought was, gosh, look at these big buildings. Look at how well organised everything is. My colleague who was with me at the time said, wait until you get to Tokyo. It's a good job I started in Osaka because the shock might've been too much. And then you get to Tokyo, and it's just the most fantastically well organised, clean, efficient city. So, there's this perception, as I say, that things stopped happening in Japan in 1989 or whatever, but that's not true at all.



Japan continued to develop. The real estate market was very dynamic. And so, I think it's a great place now for any of the listeners, I think, to go and visit, because people also have an impression of Japan as very expensive, but actually I think a lot of that relative expense has disappeared over the years.

And it is just such a fascinating place because of the way it's so developed, but it developed with its own history and its own identity. And so, it's very developed, but obviously very different to the Anglo-Saxon world, and I think that does make it just a very interesting place.

MB Are we making a mistake possibly by comparing Japan to markets that we are very familiar with, like the US, and Europe, and more specifically the UK?

MA I certainly think, as with anything, we look through our own cultural prism, don't we, at things? And this applies not just to Japan, but to China and other countries. It's very easy to assume that our ways of doing things are the correct way or the best way. I think what we would have to say, for example, is that Japan, people talk about this lost decade and so on, but the lost decade was very much a lost decade for investors in the stock market. Remember unemployment in Japan remained very, very low.

And for Japanese society as a whole, that was a very good thing. So, there was a bit of a choice that went on at that stage to protect the employees rather than to protect the shareholders.

Now, is that the wrong or the right thing? I don't know. It's different. And one of the things I personally find quite fascinating is the way that, over the years, Japan has become more shareholder focused over time, but also it seems to me that the Anglo-Saxon model has actually become a bit more Japanese. In the sense that, in the past, the dominant, the shareholder value and focusing on the shareholder at the expense of everything, that now feels a very old-fashioned way to think about capitalism.

Nowadays, people think about the various stakeholders in the business. They think also about the externalities of the business. And that's something, actually, the Japanese, in their own way, have been thinking quite deeply about for decades. So, it is curious how these things can converge over time, and what seems odd maybe ten or 15 years ago, now actually seems much, much more internationally comparable.

MB Matt, thanks so much for joining us on the podcast *Short Briefings on Long Term Thinking*. It's great to be back in the studio and really enjoyed the conversation. I hope you, the audience, have enjoyed it too.

MA Thanks, Malcolm.

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