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Upfront

Japanese equities with Praveen Kumar

April 2024

Financial journalist Cherry Reynard and investment manager Praveen Kumar discuss the latest developments in Japanese equities.

Your capital is at risk. Past performance is not a guide to future returns.

Cherry Reynard (CR): So welcome, Praveen.

Praveen Kumar (PK): Hi, Cherry.

CR: Now, you're an investment manager in the Japanese Equities Team. You manage the Japanese Smaller Companies Fund and the Shin Nippon Investment Trust, and you're a deputy manager on the Baillie Gifford Japan Trust. So quite a full portfolio there, thanks for taking time out today.

Now, having been quiet for decades, Japan is all over the news with markets hitting new highs and price rises back in the mix. How important is all that for investors?

PK: I think it's potentially hugely significant and a lot of the reasons why we're seeing markets do what they have done in the last 12, 24 months. People have been waiting for these to materialise for decades, and the reason why we are seeing them finally take shape has been largely due to a combination of regulatory pressure, which has become more and more intense. And also a record level of involvement of activists who have the tacit support of the authorities, because obviously the authorities have the incentive to force companies to get better. So, things like improving shareholder returns, corporate governance reforms, finally companies are looking at [these], and being a bit braver in terms of putting through price increases as well.

So, a combination of all of these and not to forget the weak currency as well, which has proven to be a tailwind for some of the large cap exporting companies. So, a combination of all of these has created a perfect storm for large cap traditional manufacturing type businesses to drive the market higher, and that's what we've seen happen.

CR: And despite that strength in the large cap, growth stocks have continued to struggle and small caps in particular, which is kind of your part of the market. Can you talk a little bit about why that is and why it might change?

PK: Sure. So whilst all these changes and the stocks that have driven the market up in the last year, couple of years, whilst all this is good for the overall health of corporate Japan, unfortunately, what this has meant is that the real high quality businesses, the fast-growing, dynamic smaller companies, they've been left out.

Essentially what we've seen happen in the last three years, really, is people just not wanting to touch this asset class, which is the Japanese smaller companies asset class, with a barge pole. Virtually every single bit of capital has chased these types of large cap cyclical businesses, companies that have a very nice shareholder returns, improvement, corporate governance story. And unfortunately, in a perverse kind of a way, that's proven to be a significant headwind.

And again, coming back to the currency as well, the yen has blown past ¥150 to the dollar and that has also been a significant headwind. So, a combination of all of these investors just not being interested in growth small caps. Unfortunately, that's resulted in an environment where no one wants to buy this asset class anymore.

CR: And can you see that changing in the near term?

PK: Yes, so one way in which I would like to think about this is some of these headwinds could actually turn into tailwinds. So one example would be, as you know, the Bank of Japan has moved away from its negative interest rate policy to a more normalised interest rate environment. Typically, when interest rates rise, the currency tends to weaken. Interestingly, we've not seen that happen yet, presumably because people were expecting the Bank of Japan to be a bit more aggressive.

But for us, what's more important is not where we are, but where we eventually will get to. So, as this interest rate environment normalises, as we see slightly more interest rate hikes being put through, the currency should start to strengthen, and that's where we will start to see some of these domestic-focused small caps come into their own.

And the other interesting and perhaps more important tailwind is just in terms of valuation. [If] you look at some of these large cap exporter type businesses that have driven the market to record highs, these have been re-rated quite significantly. And the gap between large cap and growth small cap has just widened significantly. The gap is at record levels. So, a combination of these and people focusing on fundamentals, again, should get investor interest back to Japanese growth small caps.

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CR: And I'm interested, I mean, it must be something that lots of fund managers go through at some point in their career. But how do you stay optimistic when the market is running against you and clients are nervous, sort of understandably?

PK: Yes, that's always going to be a challenge as a fund manager, and there are, I suppose, a couple of things that we can hang our hat on in terms of trying to stay optimistic, stay resolute and focus on things that we can control. Rather than obsess and spend a lot of time on things that are outwith our control, things like macro factors or what investors prefer.

So, the couple of things. One is just working within a team environment. So as you know, Baillie Gifford has a very team-based culture. We don't have a staff-and-manager culture, we support each other. And pretty much the whole Japanese team is in a similar boat, because we have a similar style bias towards growth stocks. So for me, as a small cap manager, it's quite critical that I keep getting inputs from the broader team in terms of what they're seeing in other parts of the market, and I feed that into my analysis.

The second thing that actually gives me even more comfort is just where we are in terms of share prices and valuations. We've had such a massive de-rating that you're getting companies growing at 15 per cent, 20 per cent, 25 per cent on 11 times P/E, 12 times P/E. At least in my brief investing career I've not seen valuations reach these extremely low levels. So, the starting point for us is a very, very favourable one, and as and when the asset class comes back in favour I think these stocks should do phenomenally well.

CR: Okay, let's look at the portfolio now, if we can. Is AI a growth opportunity that you're considering at the moment, or that you find in the Japanese market?

PK: Yes, so interestingly, I would almost say AI has also been a bit of a headwind for Japanese small caps. And the reason for that is, you know, obviously we don't have an NVIDIA in Japan. So, people have been looking for a proxy to play the whole kind of NVIDIA, AI story. And the kind of companies they've zeroed in on are these semiconductor equipment manufacturers. So the big, big companies such as Tokyo Electron, which is one of the world's largest semi equipment manufacturers. So, there again, a combination of this AI theme, weak currency, these are big exporting companies, has resulted in these companies doing really, really well.

Within the small cap side of things, we do have a decent level of exposure to AI, so I'd like to segregate that into hardware and software. On the hardware side, we have companies that provide critical building blocks type of equipment, without which the whole AI theme wouldn't be possible. These companies have alarmingly large global market shares, already in some cases as extreme as 65, 70 per cent.

On the software side, we have a large number of companies that are using AI to develop services. One of the companies we own is using AI to automate the legal industry, for instance, where it manages the case load of lawyers, it helps lawyers analyse the past rulings of judges that they're going up against, for instance. A really interesting model. We also have companies that are using AI to improve the lifetime value of customers for ecommerce retailers, and to help them target customers even better. So, there's a whole range of ways in which we are playing the AI theme within the portfolio.

CR: Okay, so what else would you draw out on portfolio positioning? Are there any other themes that you'd highlight?

PK: Sure. We run a fairly diversified portfolio of 75-odd stocks, and there are various themes that are reflected in the portfolio. Artificial intelligence is one. Obviously, labour shortage is a problem that is only getting worse in Japan, so we have a decent exposure in terms of companies that are trying to solve this labour shortage issue.

We also have a decent level of exposure to companies within the semiconductor space, again, you know, a play on AI. But if you take a step back, and if you ask me, 'What have you been doing at a very high level of the portfolio?' If anything, given where we are, and what we've experienced in the last three years, we are trying to force ourselves to be a bit braver and almost increase the growth quotient of the portfolio. Because if we don't do that now then what's the point?

We are reaching a stage where we're not far off from maximum pessimism almost, and in that environment when valuations are so attractive, the asset class is completely out of favour, we are always trying to look for these really strong growth companies. When I say 'growth' I don't just mean in terms of sales, but also in terms of profits. And that is, at a very high level, what we're trying to do, trying to make the portfolio more and more growth-oriented. Because, personally, I don't think we would get another opportunity like this, in terms of when valuations have shrunk to such low levels, to buy a lot of these exciting high growth companies.

CR: Okay great thanks Praveen. We'll pause there and go to the Q&A to look at the questions that have been coming in over the programme.

Okay, so one thing we're seeing: what have you learnt from the poor performance over the past three years? Is there anything that you are doing differently now, or you would have done differently?

PK: There are two main learnings for us from the underperformance that we've seen in the past three-odd years. I think the first one is definitely [that] we need to be a lot more decisive and ruthless, especially when it comes to selling companies. We have a very long-term investment horizon.

But we should not conflate low turnover with laziness. So that's one big, big learning for us, where if we've seen stocks that have run really well where valuations, even for us as growth investors, seem a bit out of kilter. Although we have taken a fair bit of money away from such stocks, I feel looking back, with the benefit of hindsight, we could have been a lot more aggressive.

The second learning we've taken is to try and force ourselves to look in areas that we've historically not even considered, simply because we've just assumed that there aren't any growth companies here. So there is an element of just being a bit lazy in terms of analysis.

To give you an example, one of our recent holdings is a company called SWCC Group, which makes electrical wires and cables, an industry that traditionally we wouldn't even consider. But having seen an interview with the founder, having met her, and she's the first female president of the company since its founding, we saw a very, very clear turnaround growth story, margins expanding and valuations at single-digit P/Es. So that would be the second aspect where we're forcing ourselves to look in areas that we've traditionally not looked at.

CR: Okay, now next question. What are the common traits you look for in Japanese companies?

PK: I would highlight three broad characteristics that we look for in every single stock. The first one is just the growth opportunity. It needs to be large enough to sustain at least five-to-ten years' worth of really fast growth.

Secondly, we look at the business model quite closely. So I, personally, like companies that have a genuinely unique business model and not a business model that's maybe a wee bit different from what already exists. So a genuinely different business.

And thirdly, we spend a lot of time speaking with management, engaging with management, just to try and get a feel for how dynamic, how entrepreneurial these people are. What is their long-term vision? Do they really want to change an industry, scale the business to, you know, a level where it's no longer a small cap? So these would be the three core common characteristics that we look for in companies.

CR: Okay, great. And now I think we've got time for just one final one. What was the last stock you bought, and sold, and why?

PK: One of our recent purchases has been SWCC Group. So I saw an interview of the president in the *Nikkei* and thought it was quite interesting, the way she was turning around the business. First female president, first president from an R&D background. So I organised a call with her, met her in Tokyo during one of my visits, and then thought the story looked quite exciting. No one even knew about this company, you know, a company making electrical wires and cables, not that interesting.

And it was at four or five times P/E. I came back, took a holding, and since we bought the holding last year, it's more than doubled. So, you know, at least some stocks in the portfolio are going up.

The last stock we sold was a company called Pigeon, which makes baby bottles and accessories. And this is a stock that we've owned for well over a decade, and they had a very strong position in China. But over the years, a lot of domestic Chinese brands have become much stronger and taken market share away from the company and management haven't really been able to respond to that competitive threat. So, we lost faith in management's abilities, and their dynamism really, and we just decided to sell the stock.

CR: Okay, great. All right, Praveen, thank you so much for your time today. We will wrap up there.

PK: Thanks, Cherry.

CR: And thank you all for joining us. To find out more about the topics we've discussed on the programme, please do go to the website, **bailliegifford.com**. So, until next time, goodbye.

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