



Baillie Gifford Shin Nippon PLC December 2011

John MacDougall gives an update on Baillie Gifford Shin Nippon to Anzelm Cydzik.

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Anzelm Cydzik: I'm joined today by John MacDougall, portfolio manager of Baillie Gifford Shin Nippon. Welcome John.

You have been investing in Japanese small cap equities for a number of years now and have been manager for Baillie Gifford Shin Nippon since 2007. In terms of your approach to investment in a no to low growth economy such as Japan, how do you go about that?

John MacDougall: Well I think one of the crucial things to remember about smaller companies is they don't tend to be so reliant on the overall growth of an economy, so the fact that Japan isn't growing that quickly doesn't really bother most of the companies that I look at. To highlight this, to give you a feel of some of the niche markets within the Japanese economy where we do see quite high growth rates, would be areas such as healthcare or outsourcing services where large companies are really focusing in on their core competencies and outsourcing to smaller companies. And obviously the internet is another area that is growing really quickly.

So for Shin Nippon, which actually means New Japan, we do try to focus on perhaps a different style of younger more dynamic management who are finding growth through various means. Domestically that might be through innovating and creating a completely new market or by disrupting an existing market and gaining market share.

Lastly, of course, the other obvious area that you can grow in is by exporting to the rest of Asia where the economies are seeing such expansion at the moment. Factory

automation would be a good example of an area where Japanese smaller companies are very strong and are benefitting from selling into the rest of Asia.

Anzelm Cydzik: Well looking at your investable universe, are there any particular areas that you are finding of interest at the moment?

John MacDougall: The investable universe would be all stocks under 150 billion yen market cap and I think there are probably about 1,000 of those that are liquid enough for us to invest in with Shin Nippon. Then the subset of those that would meet the sort of growth characteristics that we look for are smaller again.

In terms of what we are looking at and finding exciting at the moment, one area that is really catching my eye is growth relating to the real surge in people using smart phones in Japan, obviously people are spending a lot more time and spending a lot more money on various games and functions on their mobile phones. So there are lots and lots of different industries that are jumping up to support that area, be it storing all the data that is being produced or payment systems to cope with all the transactions going through online now. So there are lots of different areas that we are finding good ideas.

One other area I would highlight would be a long-term trend for obviously more environmental consciousness and energy efficiency in businesses. That trend has actually been accelerated significantly this year by the tragic earthquake and tsunami. The power shortages that came about after that have really forced companies to look into conserving more power and one of the key ways that many are doing this is by switching over their lights to more energy efficient LED systems. So we have actually taken a holding recently for Shin Nippon in one of the leading providers of LED lighting systems and they are seeing huge order uptakes from supermarkets, convenience stores, offices who are all switching over to LED lighting systems.

Anzelm Cydzik: Interesting. Conversely, are there any areas in the market that don't appeal to you at the moment?

John MacDougall: Well we have a totally benchmark agnostic approach, so we feel quite comfortable in not having holdings in areas that we don't find attractive. So to give you some examples of areas where we look with our five year horizon and we don't see particularly attractive growth prospects, those would be some of the financial stocks; we have got very low weightings within the financial sector. The regional banks, for example, we just don't see how they are differentiated and how they can grow over the next five years. Another similar area would be pharmaceuticals, we think smaller companies are at a bit of a disadvantage there. There are big structural headwinds for the industry, so it is an area we are really happy to avoid and look for growth in other areas.

Anzelm Cydzik: Now Japan has had several Prime Ministers over recent years. The current incumbent is Prime Minister Noda. Are there any straws in the wind to suggest that he has any market for any policies or desire to push them through?

John MacDougall: It's always risky to make any predictions regarding Japanese politics but so far this new chap Noda has come in and the one thing you would point out, which I think would be a big positive if it comes off in the long run, is that he is committed Japan into entering serious discussions regarding joining the TPP. This is the Trans-Pacific Partnership which is a free trade body that America and some of the other Pacific nations are really pushing forward with in the next couple of years to break down trade barriers and really open up economies for free trade. The fact that Noda has come out and committed Japan at least to taking the first step to joining this I think is a great step because it shows he is open to more market friendly policies. He does face opposition at home which is why it has been quite brave of him to do this, so we'll have to watch and see how that develops.

Anzelm Cydzik: In terms of valuations on the market then, how do small cap valuations look at present and how do they compare to your portfolio?

John MacDougall: Japan as a whole is trading at close to historic lows and has been for the last couple of years. Within that, smaller companies themselves probably trade at a slight discount to the overall broader Japanese market. Looking at Shin Nippon, we undertake regular portfolio analysis and the figures that come out of that are currently suggesting that Shin Nippon has much higher growth characteristics and quality characteristics as measured by things like return on equity when compared to the benchmark. And yet when you look at the valuations you are not paying any premium for that growth and quality at the moment. So that gives us some encouragement and excitement that there is no premium for quality growth at the moment. The portfolio seems to be positioned well from that regard.

Anzelm Cydzik: OK, well John, thank you.

John MacDougall: Thank you.