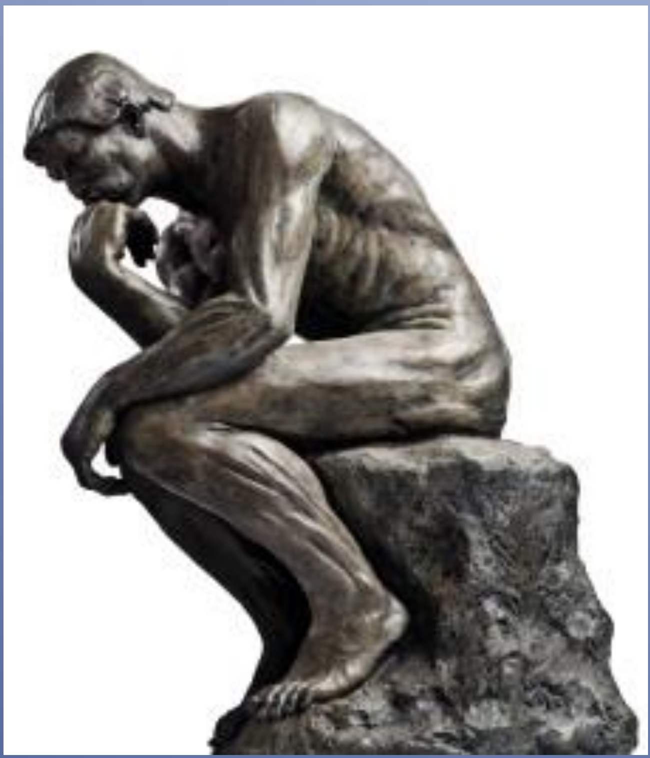

Fund Bites

Baillie Gifford Japanese Fund

The Baillie Gifford Japanese Fund is not part of the portfolios but one that we are currently reviewing. This "fund bites" is a summary of a recent meeting we had with the co-fund manager, Matthew Brett.

Introduction

For years being a Japanese Fund Manager was not really "rock n roll". Even now with optimism in the markets, there are many sceptical investors who have heard the "this is different" story many times.

We currently use the Neptune Japan Opportunities Fund in our portfolios because of the hedging of the Yen and will introduce the GLG Fund from 1 July as a currency airbag. We are constantly looking for alternatives especially if our weighting to Japan increases or if for any reason we need to replace our favoured choices.

Baillie Gifford is a fund manager we use already and we like their processes and style of management. Their approach is stated as more akin to Warren Buffett and they use a questioning process called "kenshiki" which means insight and wisdom. Ultimately they are looking for attractive growth companies with sustainable high returns on capital.

The fund has strong performance figures and blended with the style of management it is worth adding to our watch list.

The Fund

Matthew started by putting in context what is happening in Japan. Effectively they are attempting to break out of Japan's entrenched deflation and low nominal GDP Growth.

There are three key policies:

- Fiscal stimulus (>$100bn of debt-funded spending)
- Expansionary monetary policy (backed by Haruhiko Kuroda as new BoJ Governor)
- Structural reform (e.g. tax reform, considering joining TPP free trade area)

So why is it different and why might it work?

- Stable politics – LDP has strong position in lower house, may take upper house later this year and appointed BoJ governor
- Consensus society – Banks and manufacturers on side, bureaucracy used to working with LDP
- Japan has been out-gunned by Fed in recent years – this could be changing

Of course what could go wrong?

- A self-sustaining recovery might not be generated – resulting in stagflation
- The need for stimulus might de-stabilise the JGB market – resulting in government borrowing becoming unsustainable

In recent weeks the market has raced ahead in terms of performance, although there have been big falls in recent days Matthew feels this doesn't signal an end to the policy. They are less than twelve months into the policy and nothing has changed in terms of the policy. The first two policies have started and the structural reforms are more long term.

Clearly with the structural plans there will be unfavourable policies and the government are not going to outline these until after the elections in the upper house. Once they win the elections (which they are expected to do) then they will have three years to do what they want.

There are three things that Matthew is seeing that is changing the face of Japan. Firstly there are younger CEOs coming to the helm of many businesses and these have more of an international focus as well as the ear of the new government, secondly exporters are much more positive than ever before as a result of these policies and interestingly their attitude is to take more margin rather than market share and thirdly pension funds have started to review their asset allocations and are expected to increase their equity holdings.

The fund focuses on three key areas:

- Opportunity – industry background and competitive advantage
- Execution – financial strength and management attitude
- Why do we differ from the market? – valuation

There are three areas where they are finding a lot of ideas.

So for example, looking at a 10 – 20 year view Asia will automate. So who will they turn to? The likes of Germany and Japan; in factory automation you have companies like SMC, Keyence and Yaskawa Electric. For logistics people want lorries that will last and last – the likes of Isuzu Motors has a good reputation for delivery of high quality trucks and in agriculture the likes of Kubota will benefit from automation of farming.

This idea is called global industrialisation. The second area is Internet Everywhere – so for example, Rakuten is a successful Japanese online shopping site. It recently purchased play.com in the UK. SBI is a low margin online retailer and Asashi Glass make tablet and smartphone glass.

The third area is brand value creation so for example Fuji Heavy make Subaru cars and Don Quijote is a low value retailer who offer products graded on value depending on the floor you are on. So cheap at the bottom and more expensive at the top.

The fund doesn't hedge and although this may impact on the performance they believe this will be minimal.

Conclusion

In summary this would be a good currency airbag fund. Clearly as with any manager they will talk positively about Japan but clearly the policy has not had time to work through. We are also aware that a number of managers have increased their exposure to Japan. Clearly there are risks, if they don't win the elections then this could stall reform and even if they do, then we could find that the policy does not work and if this is the case then there really is nothing left to save Japan. As such this is a final roll of the dice.

And finally, in Matthew's opinion although markets have risen strongly he believes there is still a lot of value to be found in Japanese stocks.

The source of information in this note has been provided by Baillie Gifford and is correct as at 5 June. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase this fund. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise.