Baillie Gifford™

Upfront: episode eight

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Financial journalist Cherry Reynard, client relationship manager Megan Rooney, and investment managers Lesley Dunn and Iain McCombie delve into recent market volatility, explore how Diploma is supplying critical equipment to entities such as Formula One, and discuss the Strategic Bond Fund.

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

Cherry Raynard (CR): Good morning. I'm Cherry Raynard, your host for Upfront, where we bring you the latest insights on Baillie Gifford's UK funds. Today, I'm speaking with Baillie Gifford partner, Leslie Dunne, who'll be answering your questions live. So do send them in by clicking on the dropdown menu on your screen.

Before Lesley, we have investment manager Ian McCombie talking on Diploma, a company that supplies specialist parts for many different areas, including Formula One.

But first, client manager Megan Rooney is here to answer some of the questions that have been filtering into the team over the last few weeks. Welcome to Upfront.

Welcome, Megan. Now, it's been a while since our last episode in June and of course, markets never stand still. Can you start with a recap of the past few months?

Megan Rooney (MR): Hi, good morning. It's nice to see you again. So if we cast our mind back over summer, as you say, a lot has been going on. We saw US job figures get published, and that sparked a lot of fear in the market that the US economy might not be as strong that everyone had thought it was. We saw Japanese authorities signal the end of free money. We saw a turn in fortune of the

Mag 7. And on top of that, we saw the Vix spike to levels reminiscent of the global financial crisis. And then last week, of course, we saw a flurry of monetary policy announcements. So everyone knows by now that the Fed cut rates for the first time in four years, whilst the Bank of England, Japan and China all kept rates where they were for the time being.

CH: Okay, great. And let's talk about that bout of volatility in a bit more detail. It was quite an uncomfortable moment in August, right?

MR: Indeed, especially for Japan. So Japan's TOPIX fell 12 per cent in a day, at the beginning of August. That's its largest dip since 1987. And there were a few reasons for that. So two reasons. Like I mentioned there, those US job numbers indicating that the US economy might be a bit weaker. And that was combined with a strengthening of the yen against the dollar. Now, we saw the yen strengthen on the back of the Bank of Japan's decision to increase rates there. And then that's what caused that fall off. Now, that was indiscriminate. The whole market went down, especially exporters and financials. But you would forgive investors if they were suffering from whiplash, because the next day not only did markets rebound, but they surpassed those highs. So super volatile.

CR: OK. And let's talk about that yen strengthening. I mean, the yen has been weak for a long time. And what does that strengthening mean in practice?

MR: A few things. So you may have heard about the yen carry trade this summer. So that was institutions, investors borrowing low-interest yen and using that to buy overseas assets. That had been a great trade since the pandemic. But when we saw that yen strengthen, that started to reverse. People started to unwind those positions. And that injected a huge amount of volatility into the market. I saw estimates anywhere from $4 trillion up to $20 trillion were involved in that trading strategy, so huge numbers. But a strengthening yen also impacts Japan, and in particular its exporter heavy index. But for us in our Japanese positions and our funds, we are deliberately in underweight the most cyclical industries. So for example, we've been making a conscious decision to move away from autos. We've been selling out of positions like Subaru, Toyota, and Denso, which is the largest car manufacturer in Japan. For us, what we like instead about Japan is those structural growth opportunities that we believe underpin the economy. So things like digitisation, automation, and the increasing wealth of the Asian neighbours around them. So we're much more excited about companies such as SoftBank or the skincare companies like Shiseido. And that's where we think earnings growth will come from, even if that macroeconomic overlay in Japan does shift in the short to medium term.

CR: OK, great. And you mentioned a sell-off in the Magnificent 7 there. I mean, that feels significant. Can you talk about that in a bit more detail?

MR: Indeed. So the confluence of all those developments there unleashed quite a brutal sell-off in the Mag 7, so much so that it's now underperforming the wider S&P 500. If we look at some of those numbers in particular, it has been really quite violent. So NVIDIA, since its peak in June 18th, it has shed over $700 billion in market cap. I don't know about you, Cherry, or the audience, but those size of numbers throw me into a tizz to be honest. But what that looks like, $700 billion, is this roughly the same market cap as Mexico and Turkey combined. Now, that's massive. And that was despite NVIDIA posting earnings over summer, confirming that revenues have doubled over to $30 billion. But the market is greedy. It wanted more, and it expected more.

CR: OK, yeah, those are big numbers. So where does that leave us now?

MR: So it shows that the market environment as a whole is very fragile, which we've been talking about for some time, but also highlights that stock volatility at an individual holding level. And for us as active investors, we believe that we can actually use that volatility to top up our positions of weakness and go into new positions as well on a valuation basis. So over the last 12 months, we've been trimming some positions from our winners and recycling that capital. So we've been using some capital from the likes of NVIDIA.

CR: OK, I mean, NVIDIA has obviously been quite a big holding in some of the Baillie Gifford funds. Does that mean you don't like it anymore, or where are you with it?

MR: So in our current period of underperformance, one of the questions we get asked about the most is our sell discipline, our conviction, our concentrations, and we're very cognisant of that. To be clear, we still like NVIDIA, but we've held it since 2016. And we do think, given that market fragility at the moment, it gives us a great entry point into other really exciting growth opportunities.

CR: Okay, talk me through a few of those.

MR: So, I want to talk about salads and a company called Sweetgreen, which are bringing high-end salads to fast food in the States.

CR: Okay, that doesn't sound quite as exciting as AI, I have to say, but...

MR: No, it maybe doesn't get people excited as much. But for a company you've maybe not heard of, and same with the audience, maybe it'll amaze you that year to date, approximately, the share price is up 230 per cent, at close of play yesterday. So, it's a phenomenal business and we only get to uncover companies like that through active stock selection.

CR: Okay. So, tell me why you like it.

MR: There's a few reasons why we like it. So, there's still a huge runway for growth there in terms of store expansion. Currently in the States, there's around 220 stores. If we compare that to McDonald's, they've got 1,200 stores just in the state of Texas. So, a huge runway for store expansion there.

On top of that, they're a really innovative business. They've now got robots making their salads. So that means they can make up to 500 salads per hour. That's 50 per cent more efficient than humans. We all know how it goes. Increased efficiency leads to higher profitability.

And then lastly, their customers are really sticky, and they're really plugged into the zeitgeist. I was in New York this summer visiting a friend, and she suggested we go out for lunch. I thought, we're going to go out and get a $2 slice of pizza. She dragged me to Sweetgreen. And I have to say, it was really impressive. The quality ingredients are really high. They are queued out the door. Customers like her are hooked. So really popular in the States at the moment. And I've also got some great news for you. If you don't want to wait in those queues, you can actually get your salads delivered to you now.

And coincidentally, that's why a company called DoorDash, who we also invest in in the US, and that's one of the stocks that actually our US team have been recycling some of that capital from NVIDIA into. So you probably can guess, DoorDash is a delivery company. It delivers food around the States, much like a Deliveroo. We're really excited about it. It's continued to increase market share. It's poised to go into things like groceries and it's outcompeting the likes of Uber Eats.

CR: OK, great. So I can get a robot-made salad delivered to my door. That feels very space-age.

MR: That's more Baillie Gifford.

CR: Yes. Now, there's been a lot of focus on the UK this week with the Labour Party conference, and I think everyone is looking for some kind of good news story. Are there any?

MR: Yes, there are, you'll be pleased to hear.

So a good news story, again, a very different business that I would highlight is something like the Keller Group. So that is a ground engineering company. It's up approximately 90 per cent year to date, so a really great business. If you are building a railway bridge or skyscrapers, they come in and look at the foundations, make sure it's structurally sound. One of the beneficiaries of the Infrastructure Act that Biden's put through in the US, actually. So their US business is generating a lot of profits there for them.

And then another company I would highlight is Shaftesbury Capital. That is a London property company. It owns the likes of Covent Garden and Seven Dials. So those shopping destinations. But what's really interesting about them is they get really niche brands to create their flagship stores. And that acts as a honeypot for people to come into the area. So if you want to buy an Away suitcase, for example, which is a company we hold in our investment trusts, it's a private company,the only place in the UK that you can get a physical Away suitcase is in Covent

Garden. So it's that kind of create a linchpin to attract shoppers, which is really exciting. And they've just taken over Carnaby. So if you're in Carnaby or in London over the next few years and you see that regeneration come through, that's a great work of Shaftesbury Capital at play.**CR:** Brilliant. OK, thank you so much for joining us this morning, Megan. Now, for those of you watching live, if you have any questions, simply click on the ‘Ask a Question’ tab.

Now, as part of each programme, we feature an in-depth look at some of the transformational companies Baillie Gifford invests in. Today, we're learning about Diploma, your one-stop shop for low-cost but critical equipment delivered fast.

Iain McCombie (IM): When it comes to distribution, service matters. Expensive construction equipment breaks down, but it's the access to replacement seals and filters the next day that stops a business from losing money due to idle machines.

Diagnostic healthcare equipment can save lives, but it's the engagement with medical professionals that identifies the right equipment and the guaranteed servicing that keeps it running. Diploma owns a collection of distribution businesses focused on value-added products and services. From interconnectivity and cabling to seal products and life sciences, Diploma is inserting itself into its customers' value chain by providing solutions to real problems with customer service at the forefront. In 2022, they even moved one of their US warehouses closer to an important airport hub, meaning customers can order later and still be guaranteed next day delivery. Choices that we think deepen its competitive edge.

The beauty of Diploma is the cost of small parts is often low, but the value is high to the customer. So margins in many of their businesses are often in the high teens, which is extremely good for a distributor. Cash flow is also impressive, so the company has ample funds to make bolt-on acquisitions. We're excited about Diploma. Not only do we think it has an organic growth story with decent exposure to areas such as electrification, industrial automation, infrastructure and renewables, but it also has the ability to make value-added acquisitions that typically build out its geographical exposure or expand into logical adjacent areas to where it already sells.

Now it takes a talented management team to execute this, and CEO Johnny Thompson has impressed us by having a clear, disciplined vision and track record, both at Diploma and in a previous role at Compass Group. While Compass is a different business in one sense, in other ways, it has already achieved what Diploma has started to do. Become a value-added global business with decentralised DNA.

CR: So that was investment manager Iain McCombie introducing Diploma. Now to move on, we're joined by Leslie Dunne for a fund update.

So welcome, Leslie.

Lesley Dunn (LD): Hi.

CR: Now, a quick introduction for everyone. You've been a partner in the firm since 2023 and you're head of Credit and co-manager of the Strategic Bond Fund. I wonder if we could start with a brief overview of the fund.

LD: Yes, absolutely. So the Baillie Gifford Strategic Bond Fund is a best-of-corporate-credit fund. So we follow a very straightforward approach. We have two main levers in terms of adding value for clients. So the first of those is bond selections. We are looking for resilient businesses that have attractively priced bonds in issue. And the second lever that we use to pull is active management of credit risk. So active asset allocation through the cycle to approach the current market conditions. The output of that is a diversified portfolio of 65 to 80 names that we believe are the really best ideas from global corporate bond markets, that we believe is well positioned to outperform fixed income markets over the long term through a combination of outyielding the index and avoiding defaults.

CR: OK, great. Now, Baillie Gifford isn't known for taking big macroeconomic positions, but is that any different for a fixed income investor?

LD: Yeah, so I think it's a fair observation that the macroeconomic environment is more pertinent to fixed income investing. But what I would say is that with our fund, you shouldn't expect us to take big macroeconomic positions. We are very focused on the economic environment and the investment environment in terms of our asset allocation. So we're either looking to invest to areas of the market where we think there is the best potential value or parts of the market where we think there is the greatest margin of safety. So that's the strategic part of what we do.

Our process takes into account the major macroeconomic factors and analyses the data and the trends within those. And we're also very focused on the company fundamentals that we're looking for in each of the individual businesses that we're looking at. We also assess the momentum and valuation in all the different markets that we look at. And it is the combination of those three factors together that determine portfolio positioning at any point in time.

And it was using that framework that really allowed us to stay overweight high yield in the aftermath of the Covid crisis, when we believed that high yield had the best opportunity of outperforming investment grade as the recovery took hold. And it's also that strategy that allowed us to reduce our high yield exposure at the beginning of this year as the market became more accustomed to the likelihood of a soft landing and spreads became more expensive.

CR: OK, let's talk about that economic environment in a bit more detail, if we can. There's been a flurry of monetary policy announcements, as Megan talked about earlier. There's still clearly a lot going on with inflation and interest rates. And there's a big election coming up, plenty of geopolitical conflict and even worries over recessions and lingering worries. How is all that influencing your thinking?

LD: Yes, so I think you're absolutely right to say there is a huge amount going on at the moment. And I think the first thing I would say is that we cannot predict the future path of inflation or the outcome of an election with any degree of confidence. I think things like that are reliant on the interplay between a number of variables, all of which are highly volatile and unpredictable.

What we are focused on, as I say, is looking at the macroeconomic environment in a broad context and we do think that the macroeconomic backdrop currently is fairly benign, and we are aligned with the market in thinking that a soft landing is the most likely outcome.

Our primary focus is on that bottom-up company fundamental analysis, and I think it's fair to say that corporate fundamentals, at least at the market level at the moment, are pretty strong. So we are seeing some areas of pressure in lower-rated parts of the market or in some more cyclical sectors like autos. But at the market level, company fundamentals are robust and we think there's potential for those to improve even further as interest rates start to come down.

Just touching on valuations, spreads are tight by historical standards. But we believe if you take into account the benign economic backdrop and that strong company fundamental position, that spreads are actually fairly valued at the moment. And if we put all of those three factors together, then we end up broadly neutrally positioned from a credit risk perspective.

The fund currently has a large overweight to BBBs, which is the lower end of the quality spectrum in terms of investment grade companies. But we have a huge amount of diversity within there. So there are companies like Telereal, which is the securitisation of the BT exchanges in the UK. We also have Pinewood, which is a, I don't know if you've heard of them, but they're a business based in London. It's a television studio. They make all the James Bond movies. They do a lot of production for Netflix.

And the reason we're overweight that BBB part of the market is because that's where we believe there is the best risk-adjusted returns for our clients, but it also allows the fund to outyield the index without going much further down the rating spectrum into high yield, where we see a significant increase in default risk.

I think the other point to note is that, as I say, spreads are tight by historical standards, and there isn't a huge amount of scope for them to tighten further. So we have a lot of dry powder in the portfolio currently so that we can deploy that in the event of any market volatility that we see.

CR: OK, but in aggregate, still a reasonable time for corporate credit?

LD: Yeah, absolutely. I mean, I think, as we've talked about, the backdrop for corporate credit at the moment is very supportive. And we believe our approach to investing in corporate bond markets can really exploit that. So we have a through-the-cycle, return-seeking approach. And our philosophy is founded in the belief that corporate fundamentals are reflected in valuations over the long term and that investors are ultimately rewarded for taking credit risk, they're rewarded for avoiding defaults.

I think it is really interesting that the yield on the market currently is about 6 per cent and data would show that the current yield on the market, regardless of what that level is, is a good indicator of the return you can expect from the asset class going forward. So with that 6 per cent starting yield, it's not unreasonable to expect a 6 per cent return from the asset class over the next five years. And that's a far more exciting prospect than it's been for quite some time.

And I think further beyond that, given the approach that we have of outyielding the index and avoiding defaults, then our fund is well positioned to add even further value beyond the return on the market.

CR: OK, great. You mentioned a couple of them there, but I wonder if we could drill down into some of the companies you're investing in. Perhaps you could talk about one or two holdings that you've got at the moment?

LD: Yes, absolutely. I think a good example of how I would articulate our philosophy and process would be Annington. As I've been saying, what we're trying to do is find bonds that are issued by resilient businesses that have the potential for capital appreciation. I don't know if you're familiar with Annington, but it is the owner of a number of Ministry of Defence properties in the UK. So the Ministry of Defence sold these properties to Annington back in 1996, and it leases them back on a 200-year lease. So Annington want to sell the properties now, having realised a huge amount of value, and the Ministry of Defence want to buy them back. But the value at which that transaction can be executed is subject to a courtroom battle at the moment, mainly because Annington want to sell to the highest bidder and the Ministry of Defence want value for money and I'm sure you can understand those two data points are not aligned.

Our analysis shows that the current bond price is the floor on the valuation for the estate and there are several ways in which the estate could be valued much higher than that and we would see significant capital appreciation in the bonds at that point. That's not going to be quick. This is a courtroom battle. There is already appeals in place. It could take some time to play out. But as patient investors, we can be rewarded for holding on for the long term and realising that value for our clients and also position sizing that in the portfolio so that they get the benefit of that.

So I think a really good example of a resilient business that is offering good value for money and I think it's also important to say that in the meantime, as we wait for that story to play out, we are being rewarded handsomely with a 6 per cent coupon. This is a business that has super high-quality cash flows given the covenant of the tenants.

CR: Yes, absolutely. And then obviously the portfolio has a global remit. So what opportunities are you seeing outside the UK?

LD: I think a good example of that would be a new issue that came to the market in the summer this year, so International Workplace Group (IWG). It is a business that provides hybrid working locations and has thousands of those globally. And we think the aspect of our investment process that is highlighted here is that bottom-up approach and not starting from the sector level. And the reason I say that is that IWG is very similar to WeWork, which is a business that ultimately defaulted. So I think a lot of investors looked at IWG through that lens and wrote it off quite early on.

But because we don't do that and we start from the bottom up, our fundamental analysis showed that IWG is a diversified business. It is global. It has a de-risk business model, which can actually capitalise on the growth opportunity that's available in the marketplace. Also, it has a balance sheet which is lowly levered. It's generating a lot of cash flow so it can de-lever even further. And that's really important because we are appreciative that this is a cyclical business.

And just to highlight the inefficiencies in the market, that bond came with a 6.5 per cent coupon at a time when Euro BBBs were trading at 4 per cent. So there is an opportunity of a resilient business whose bonds are offering value because of an inefficiency in the market that our approach lets us capitalise on and add value for our clients.

CR: Great. OK, thank you, Leslie. Now to answer the questions that have been coming in over the programme.

Right, so we have some questions coming in from the audience here. First one. You talked about having dry powder to deploy in the event of volatility. When would you deploy this and what would you deploy it into?

LD: Okay, so I think that what we're waiting for really is a better valuation entry point. We've talked a bit about spreads and how they're relatively tight versus historic levels, so it's a wider spread level is really what we're looking for.

In terms of what we would do, I think it really depends what triggers that sell-off. That could come about because there's a broad market correction, there's just a risk-off sentiment. And what would happen in that situation is you would see a decompression in spreads, much clearer demarcation between the resilient businesses and those that aren't. And I think that's really where our bottom-up bond picking really comes to the fore.

We will be rewarded for our bond picking approach that can make that demarcation that we're currently not being paid for currently. And in that situation, what you would see is the risk of the overall portfolio going up. So we would add to high yield, we would own more subordinated financials and more corporate hybrids.

CR: Okay, great.

Now we seem to have a happy holder here. “I hold the Strategic Bond Fund for many of my clients. The performance has been relatively strong versus the sector in the last year. What's driving this? And can it continue?”

LD: So I think what has driven performance this year really is the output of that strategy that I've been describing, the approach that I've been describing. It is partly our active asset allocation. So we came into the beginning of this year with a long risk position. We were overweight, high yield, and we owned more subordinated bonds than we do currently. As that soft landing became priced into the market and spreads tightened, we have actively allocated away from our riskier positions and reduced that far closer to a neutral allocation. We've also utilised our bond selection and our sell discipline to ensure that we are recycling our best ideas into areas where we see that there is value. So some of the biggest positions we've had in the fund have been some of our top performers this year. So CPI would be a good example. That's a Central and Eastern European property company. It's had quite a torrid time. High interest rates don't help these companies. It means property values go down, their funding costs go up. But fast forward to this year and that dynamic has completely turned on its head. We've seen those bonds rally because CPI is benefiting from interest rates starting to come down. And we believe it has all the tools in its toolkit to be able to enhance that even further. But as the bond prices rallied, we've reduced that large position and locked in some of that added value for clients.

CR: Okay, great.

I think we've got time for just one more. “Personally, I think passives do a good job of replicating the bond indices at low cost. What's the case for active management?”

LD: That's an interesting one. Yes, I think that's right. Active management does have a place. I would say that it's interesting that passive investing in fixed income markets is less prevalent than it is in equity markets. And I think there are good reasons for that. You know, the bond markets are more complex, they are more opaque, we have far more constituents in them and those constituents change more frequently. So I think it is much more difficult to replicate fixed income markets. But with specific regard to active management and our style in particular, I think there are three key differences that I would pull out.

And the first is that active managers just cannot identify the best opportunities in the market and scale those appropriately to the benefit of clients, which is exactly what our strategy is trying to do. In fact, they are doing the exact opposite of that. They are buying things that come into the index and selling things that go out. Now, they could be buying very high and selling very low. So in actual fact, what they're doing is making those inefficiencies in the markets even worse. And that means that we can benefit, active managers can benefit from those.

I think the second point I would pull out is that passive investors are forced to own the lowest rated bonds in the markets, the highest risk positions, the ones that are most likely to default. And our approach is to try exactly to avoid those types of things.

And then finally, I would just say that by their very nature, passive funds are designed to match the yield on the index, whereas what we are trying to do is out-yield the index. So they're closing off a very attractive avenue of return for their clients. So I would argue quite strongly that there is a real case for active management and fixed income.

CR: Brilliant.

OK, we'll wrap up there. Thank you so much for your time today, Lesley. 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. The UK Intermediaries Team are here to help. So get in touch if you have any questions. Until next time, goodbye.

Annual past performance to 30 September each year (net%)

	2020	2021	2022	2023	2024
Strategic Bond Fund B Inc	2.4	4.3	-21.1	7.7	13.0
*Index	2.9	2.8	-20.0	9.1	11.1
** Sector average	3.6	4.6	-14.5	4.9	11.8

Source: FE, Revolution. Total return net of charges, in sterling. Share class returns calculated using 10am prices, while the Index is calculated close-to-close.
*70% ICE BofA Sterling Non Gilts Index / 30% ICE BofA European Currency High Yield Constrained Index (Hedged to GBP).
**IA £ Strategic Bond Sector

Past performance is not a guide to future returns.

The manager believes that appropriate comparisons for this Fund are the Investment Association Sterling Strategic Bond sector average, given the investment policy of the Fund and the approach taken by the manager when investing and a composite index comprising 70%: ICE BofA Sterling Non-Gilt Index and 30%: ICE BofA European Currency High Yield Constrained Index (hedged to GBP) being representative of the strategic asset allocation of the Fund.

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— Custody of assets involves a risk of loss if a custodian becomes insolvent or breaches duties of care.
— Bonds issued by companies and governments may be adversely affected by changes in interest rates, expectations of inflation and a decline in the creditworthiness of the bond issuer. The issuers of bonds in which the Fund invests may not be able to pay the bond income as promised or could fail to repay the capital amount.
— The Fund's concentrated portfolio relative to similar funds may result in large movements in the share price in the short term.
— Derivatives may be used to obtain, increase or reduce exposure to assets and may result in the Fund being leveraged. This may result in greater movements (down or up) in the price of shares in the Fund. It is not our intention that the use of derivatives will significantly alter the overall risk profile of the Fund.
— The Fund's share price can be volatile due to movements in the prices of the underlying holdings and the basis on which the Fund is priced.
— The manager can charge some, or all, expenses to the Fund’s capital, reducing its value. This amount can vary from year to year.

Further details of the risks associated with investing in the Fund can be found in the Key Investor Information Document or the Prospectus, copies of which are available at bailliegifford.com.

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