Upfront: episode four

October 2023

Financial journalist Cherry Reynard, investment specialist Claire Shaw, investment manager Matthew Brett and investment manager James Dow discuss private companies, the investment case for SoftBank and the Responsible Global Equity Income Fund.

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

Cherry Reynard (CR): Good morning. I'm Cherry Reynard, your host for Upfront, where we bring you the latest insights on Baillie Gifford's UK funds. Today, I'm speaking with James Dow, co-manager of the Responsible Global Equity Income Fund. James will be answering your questions live, so do send them in by clicking on the dropdown menu on the right-hand side of your screen.

Before James, we have investment manager Matthew Brett talking on SoftBank, one of the world's largest public companies. But first, investment specialist Claire Shaw is here to talk about private companies. Welcome to Upfront.

So welcome to the programme, Claire. Megan was unable to join us today, so we really appreciate you joining us at such short notice. Just this past week, Megan reached out on Baillie Gifford's UK LinkedIn to ask what you wanted to see covered, and private companies has shown to be a popular choice.

Now Claire, as you're an investment specialist on the Scottish Mortgage Investment Trust, we thought this was an opportunity for you to come on and cover the topic. So, let's start with, Baillie Gifford has been investing in private companies for ten years. Why is this asset class of interest to the firm?

Claire Shaw (CS): Yes, Cherry, you're right, we've been doing this for about a decade now. Our first investment was Alibaba back in 2012 when it was still private. And since then, as a firm, we've deployed about $9bn of shareholder capital into private companies.

But in terms of why this is interesting for us, I think there's probably three key reasons why we're interested in this space. The first reason is quite simple, which is that private companies are staying private for longer. If you look at the average age of a company that IPOd back in 2000, I think it was something like four years, and you look at the average age of a company IPOing today, it's more like 20 years. So, what you're seeing is that more of that value is being accrued prior to companies

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going public, and we want to be able to offer our shareholders the ability to access the potential returns prior to these companies listing.

So that would be the first reason. I would say the second reason is that private companies are often home to unique assets. There's often no public market equivalent to some of these companies. So take something like Space X - there is no public market equivalent of Space X. But for us, what we think private companies offer us is almost this kind of lens into the future.

You know, this is where you see emerging technologies, things like synthetic biology, quantum computing, cultivated meat. These companies originate in the private markets. And so what we think that we have, is we get those differentiated insights and hopefully that potential to lead to differentiated returns for our shareholders.

And then the final reason, I would say, is that we actually think we've got an edge in doing this. Private companies have the luxury of choosing their shareholders. So in this space, reputation really matters. And Baillie Gifford have this reputation of being very long-term and supportive shareholders. We think that our philosophy is very well aligned with founders and we see ourselves as being more partners than shareholders to these companies.

So, I think from that perspective, we've built up that kind of reputation over the last decade. And so, when you bring all that together, we think this is a really interesting asset class. And we also think that the closed-end structure of investment trusts is almost the perfect vehicle to access private companies as well.

CR: Absolutely. And the headlines around private companies have centered on valuations, some softness in the IPO market and also more expensive financing. I mean, how are you addressing those concerns?

CS: Yes, you're absolutely right, and there has been a lot of negative sentiment around private companies. And you can really see that being reflected in the discounts of any of the investment trusts that have private companies as part of their portfolio.

I would say a lot of this concern does centre around valuations. People are worried whether private companies are being held at fair value. People are worried that potentially the prices are stale or they're out of date because the majority of the market only value these companies on a quarterly or a six-monthly basis.

At Baillie Gifford we have quite different process. We value these companies much more frequently. We have a very robust process because our investment trusts have a daily traded NAV, so we want to make sure those prices are as up to date as possible.

So in Scottish Mortgage, which is our largest investment trust, I think we've made something like 350 revaluations across that 50 private companies year-to-date. So what we hope to convey is, yes, the market is worried about whether there is that stale valuations, but we think our process is

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robust and is reflecting what is happening in the broader markets.

And then you mentioned the IPO markets there as well. I think it's safe to say the IPO market has been pretty stagnant for the last two years. But we have seen some green shoots of recovery. We had our first company IPO early in the summer, a company called Oddity, which is a tech-driven beauty and cosmetics company. And then you've seen some more high-profile IPOs recently. We saw Arm go off. We saw Birkenstock, we saw Instacart.

So we are starting to see some of that come back. However, I think what I would say is that, while I'm not going to sit here with a crystal ball, there's probably quite a large backlog of IPOs because there's been little activity, you're going to see that build-up. And so, from our perspective, there is that grounds for optimism.

Then I think the final concern, as you mentioned there, is that worry about financing - companies, their ability to raise fresh capital in this environment. And I think that while that might be a worry at the broad level, there's definitely pockets within the private companies where companies have actually been able to raise capital.

We saw Stripe, the payments company, raise $6bn back in March. Northvolt, the Swedish battery company, they've raised just over $2bn, Redwood in the summer. So what I would say is that companies that have that really appealing proposition, that have a really good business model people want to invest in, you are still seeing the ability to raise money in those companies.

CR: Okay, and are you seeing anything within the companies themselves as to how they're adapting to a challenging funding environment?

CS: Yes, I think that private companies are aware that the environment has changed. We've gone from this era of capital abundance to capital scarcity, if you like, and the cost of funding has got more expensive, undoubtedly.

But I would say in the past, private companies have been able to almost chase growth at all costs, knowing that if they ran out of money, they could simply just raise more. And against that backdrop, it's actually quite difficult for companies to build a competitive advantage, because you've got this influx of cheap capital just flooding the market.

I think those days are over now. That kind of growth at all costs is not going to be rewarded. So I think that's actually probably a good thing for our companies, because we should hopefully see their competitive advantages consolidating.

And then the other thing we're seeing a little bit more now, is we're seeing our founders having that strategic courage, if you like, to lean into the volatility there. They're seeing the ability to reinvest in R&D, spend money on capex, their competitors are struggling. They've got some dry powder there available to redeploy back into the business.

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And so, from our perspective, what we're hopefully seeing when you pull all that together is that our companies are adapting, they're being pragmatic, but crucially, because the majority of them have that cash on hand, they're able to kind of execute on the growth plans that they want to.

CR: Okay, so a difficult backdrop, but still reasons to be optimistic, you think?

CS: Yes, I would say so. I think there's a lot of noise out there, and it's really difficult sometimes just to turn off the noise. But I also think what’s helpful in environments such that we're in just now is almost coming back to first principles, what is it we're really trying to do?

We're trying to find exceptional growth companies. We're trying to find those companies that are driving that radical change. And what I would say is that the kind of underlying technological progress that we see rarely gets the headlines. The declining cost of batteries, the declining cost of sequencing a genome. All these things, they're not going to grab headlines in the [*Financial Times*]. But from our perspective, that underlying technological drumbeat continues.

When you look at the structural tailwinds in the portfolio, that's what gives us grounds for optimism. We've got companies exposed to the energy transition, companies that are going to be beneficiaries of that increasing electric vehicle penetration, we just don't see momentum slowing down there. We have companies that sit right at the intersection of artificial intelligence and healthcare. So exciting. Companies such as Tempus who are essentially using AI to help healthcare professionals better diagnose and treat cancer. We have companies such as Zipline who are using drones to revolutionize logistics, delivering medical supplies and healthcare products.

So I think when you pull all that together, we think that our exposure to private companies is almost more of a secret weapon than an Achilles heel. There's really exciting structural trends in this part of the market.

CR: Great, okay. Thank you so much, Claire, for joining us today. That was really insightful.

CS: Thank you for having me.

CR: Now, for those of you watching live, if you have any questions our Q&A function is on the right hand side of your screen, which you can access by clicking the ‘Ask a question’ tab.

Now, as part of each programme, we'll be featuring an in-depth look at some of the transformational companies Baillie Gifford invests in. Today, we're learning about SoftBank, and its goal is to create an information revolution.

Matthew Brett (MB): The bursting of Japan's bubble in the early 1990s created an indelible impression on financial markets. The term ‘Japanification’ was coined to capture the country's woes, an expression that now elicits fear of economic stagnation in other developed nations.

But Japan has since changed. Entrepreneurs are forgoing the stereotypes of ‘salarymen’ and

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directing their focus towards creating new, innovative technologies that are challenging the status quo.

SoftBank is a prime example of this opportunity. SoftBank is an investment holding company of world-leading technology businesses. The company has rapidly evolved since its first foray into internet services and software distribution. From establishing Japan's first web portal, Yahoo! Japan, in 1996, to an early investment in the ecommerce company Alibaba in 2000, to striking up sole rights with Apple to distribute the iPhone in Japan in 2008.

Today, it is focused on the next chapter of transformation, driven by artificial intelligence. SoftBank's largest single holding is Arm, a leading technology provider that recently went public in the US and specializes in designing chips essential for smartphones, cars and datacentres.

SoftBank is also well known for its Vision Fund, the world's largest technology-focused private equity portfolio, with hundreds of companies operating across a variety of fields, the Vision Fund provides the company with significant capital to support the future of disruptive technology.

The company is run by CEO and founder Masayoshi Son, credited for his audacious and experimental approach to investing. There is strong academic evidence of the economic value of having founders at the helm, and we believe it to be critical to good corporate governance.

This is also a common characteristic of our Baillie Gifford Japanese Fund portfolio, which boasts three times as much founder-run exposure than that of the Japanese market. With shares trading at about half the value of their underlying assets, we think that SoftBank is materially undervalued.

Aware of this large discount, Mr. Son has conducted an aggressive buyback policy with ¥4.5tn executed over the last five years alone, equivalent to around $30bn. We believe this offers good evidence of entrepreneurs thinking about value for shareholders.

SoftBank is emblematic of the entrepreneurialism that is challenging Japan's traditional corporate scene. Through its visionary leadership and forward-thinking business model, SoftBank is evidencing how Japan may provide the solutions to shape the future.

CR: So SoftBank spans many different industries, from telecommunications to ecommerce to semiconductors and even robotics. It will be interesting to watch where they might delve into next.

So now to move on, we're joined by James Dow for a fund update. So welcome, James.

James Dow (JD): Thank you very much. My dreams have come true, I've finally made it to morning television, so I'm delighted to be here.

CR: Absolutely. Now you're a partner in the firm and head of the Global Growth team. Can you give me a brief overview of the Responsible Global Equity Income Fund?

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Sure, yes. So, the idea at the heart of the fund is long-term steady compounding. So, growing our clients' capital and dividends year after year after year, relentlessly compounding it higher at a steady rate across cycles. The kind of thing that you look back on after ten years and you say, "Oh, my goodness, how has my wealth grown so much?" because of that compounding away.

And the way that we do that is we invest in companies that we think can do exactly the same thing, growing their earnings, their dividends year after year, very resiliently, that steady compounding over the long term.

So an example I always like to use is L'Oréal, the cosmetics company. If you look back over time, you'd see that L'Oréal has been a terrific investment for shareholders and it's delivered exactly that steady compounding, year after year, getting bigger, paying out dividends along the way. That's the sort of thing that we're aiming for at the heart of this fund.

And what we find is that it's really useful, this fund, for a couple of different types of client. The first chunk of them are what I would call the classic income investors. So, they're folks who are looking for that steady, resilient income stream that grows over time, you know, their income is going up and compounding away over time. That's a big part of the fund's shareholder base.

But then we've got another group of shareholders in there, and what they really like is that, they're not really interested in our income per se. They just like the fact that we're invested in these high quality, steady growth companies that will compound away their capital and grow their wealth. Sort of a - sometimes people call it a 'sleep well at night' fund, you know you've got really good companies you're invested in and they're steadily growing over time.

So, that's the heart of it.

CR: Okay, great. And then obviously, a key word in the fund is 'responsible'. Now, that means a lot of different things to a lot of different people.

JD: That is true.

CR: So how do you define it?

JD: So for us, I think at a high level, it's setting a really high bar for what we invest in - a group of companies that our shareholders and clients can feel proud of that they invest in, that they know they are not going to be causing harm or embarrassment in any way. Those kinds of things, there's a sort of high-level element like that.

What it means in practice is a couple of things. First of all, we just do not invest in certain sectors, certain markets where we know clients just don't want to participate in the profits of those companies. So, for example, tobacco companies or fossil fuels, we just exclude those from the fund.

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We've also got some quite strict criteria around the UN Global Compact principles to do with things like supply chains. So, really trying to avoid the kind of deep harms products and operations that some businesses can be involved in. We just steer clear of those.

So that's part of it. I'd say the other part of what responsible means for us is about responsible ownership. So, once we're shareholders in a company, having regular engagement at a high level in those companies to keep them striving and clearing that high bar and trying to get better all the time and always improving.

So an example would be one of the holdings in the portfolio is UPS, the package delivery company that goes around in the brown vans, right? And part of the question for them over the long term is, well, what are they going to do about the emissions that are coming from their aviation fleet? They're flying packages all over the world. So, we've repeatedly engaged with them, I'm going to say four or five times in the past year or so, CEO-level type of engagement to make sure, "What are your plans? How are you going to decarbonize this over time? How are you going to move away from those emissions?".

So it's that kind of responsible ownership and engagement, another big part of what it means to us to be a responsible fund.

CR: Okay. And the other word is 'income', obviously. And the fund has a yield of around 2.5 per cent, which is which is lower than some of its peers. What's your approach on income?

JD: We've got a pretty strong belief that our approach, which is, as you say, a somewhat lower starting yield, but we think much higher growth over the long term, is basically going to deliver our clients more income and more capital over the long term than the more, let's say, traditional yield-focused approach.

So, you know, if you're an income investor, one way you can invest is you can go out that traditional way and you can buy, you know, banks and oil companies and tobacco and utilities and telcos, and you start with a 5 per cent yield and you feel very clever. The trouble with that approach is that growth is extremely hard to come by in those businesses, and you're often taking quite a lot of risk. You might get your 5 per cent yield, but you don't get much else.

Our view is that our clients will be much better off in the long term by us backing off those high yield names and investing in genuine growth companies, the L'Oréals, the Microsofts, the Apples, the analog devices, all the names in our portfolio. [It's a] lower starting yield, but if we compound away the earnings and dividends there, then we should deliver much better long-term returns to our shareholders in terms of income and capital outcomes.

Microsoft, the classic example, we've owned it, getting on for 15 years now. If you look at the returns it's delivered, it's blown away, you know, Vodafone or whatever else you might have invested in.

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CR: And presumably that helps you manage to an inflationary environment as well.

JD: Yes, definitely, because, number one, these businesses tend to be a lot stronger. Strong balance sheets, very cash generative, secular growth in their business. And that means that if you're in an inflationary environment - and we've seen this, this is not just me, sort of like, “Oh I'm sure it'll be fine” - we've actually seen this with the earnings and dividends paid by our holdings, they are able to keep up with that and price and recover their costs. So, yes, much better off in that sense.

But conceptually, I think there’s this really interesting debate amongst income investors at the moment about, well, now that cash rates are much higher than they were, why not just invest cash in the bank and I get my 4 per cent or whatever?

And I think, again, we’d say our approach is going to do you much more favours because, let's say we're in a world where inflation is 4 per cent and you're getting 4 per cent in the bank. You're not actually growing your wealth and your income in any in real terms. You’re not growing your spending power with that approach.

Our approach, we would say, because we're focused on that genuine growth potential, if we can deliver that two and a half percent yield, but if the profits and share prices can grow eight, nine, ten per cent over time, you know, we're actually growing the savings and the income, the spending power of our clients in an inflationary environment with our approach.

CR: Okay, let's kind of zero in on the fund a little now. So, Novo Nordisk is your largest holding and that's obviously been in the headlines a lot recently because of its weight loss drug.

JD: It has, yes.

CR: Can you talk me through the investment case for that?

JD: Yes, absolutely. So this is a holding we took back in 2016 and at the time - it's interesting now because, as you say, it's in the press and everyone's talking about Wegovy and the appetite suppressant and so forth. But [in 2016] that was something that we were aware of but it was a pipeline project that may or may not come through.

What we invested in in 2016 was really around the strength of the company. Our research told us – we’d known Novo for 20 years, something like that, we'd known about it and been meeting them. It's a very focused, science-driven, innovation-driven company. A really strong culture around genuine novel developments in the science, primarily around insulin and diabetes, that's really its heritage, but very strong in that regard.

Most pharma companies will say, of course, we're focused on the science. My observation would be that's sort of true. A lot of them have other, sort of, motivations they're going after. This company, in my view, a genuine, science-focused company, so that was really what was attractive to us.

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And then you combine that with the core diabetes business and the products, the novel insulins that they developed there. Our view when we invested back in 2016 was, fantastic company, cash generative, very well run, very long growth runway in its core products, very few competitors who were even close to it, this should deliver that steady compounding year after year after year across thick and thin, through cycles that we're looking for in our portfolio.

Now, of course, what's happened more recently is that one of their other projects that they're always looking at to come through has come has come racing through in Wegovy with its appetite suppressant. And our view is that we're in the early days of that still, that is a huge change in the science around that, in people's understanding of what patients need, what they're dealing with.

And so, our view is we've still got many years ahead of us of growth that are likely to come from this very science-focused company, which is committed to always getting better, always innovating.

CR: Okay, and just before we move to the Q&A, you mentioned earlier about the exclusion policy of the fund. And obviously environmental considerations are becoming more important for investments and investors. So what are your thoughts on that?

Well, I guess my main thought is the opportunity that it gives us in the fund for our clients. I'm certainly a believer that, again, we're in the early days of a 10, 15, 25-year transformation of the way that energy is generated, the steady decarbonization of economies. It won't happen overnight, the practicalities of it. But I'm pretty convinced it will come compounding through over time. And so, for us, that gives us lots of exciting opportunities in the fund to invest alongside that and to deliver that steady growth to clients.

So Albemarle would be an example in the fund, the world's leading lithium producer. Which, you know, [is] already being a good investment, committed to a steadily rising dividend. The electrification of vehicles requires Albemarle's lithium at the end of the day.

Schneider Electric, that's a global company based in France. But leaders in some of the electrification kit that goes into things like datacentres and factories and so on to do this transition away from traditional sources of energy.

So, I think that's what it means to me most of all, is there's a lot of exciting opportunities that we can bring our clients to invest in and grow their earnings and dividends for the next 10, 15, 20 years.

CR: Okay, great. Thank you, James. Now to answer a few of the questions that have been coming in to the programme. I have a few.

JD: I did ask my mum to phone in with a couple of soft ones. So if you see it, if you could scroll down to the easy one, "Who's that handsome looking chap on the sofa?".

CR: Mrs. Dow. So right, first one we've got - Microsoft and Apple are in your top ten holdings. Do

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you have any other exposure to Big Tech or the Magnificent Seven?

JD: Right. Short answer is no. Microsoft and Apple are of those well-known names because we think that they are a really good fit with what we're trying to do, that kind of steady compounding, the very resilient franchises.

I think some of those other names, like, let's say, Meta, I think there's probably some genuine questions about some of the social impacts of Meta that we would question. [It's] not a dividend paying company. A lot of those companies are not at a stage in their life cycle where they're additionally paying a dividend. So I'd say Microsoft and Apple are [a] fantastic fit for us. We are very keen on those, but those are the ones that are in our portfolio.

CR: Right. Now, somebody has read your paper on the death of UK equity income and are asking, "Does this limit options for investors?".

JD: No, I'd say the opposite. I think there are some great companies in the UK. You can come across those, sort of, "Oh there's no good companies here in the UK". But there are. Experian would be a good example that we've been shareholders in for a long time. I really like the business, [it] fits what we're trying to do.

I think the challenge with the UK market is, it's not a huge market, and in some ways it's quite a risky market, particularly for sources of dividends. You're getting into quite a lot of old economy companies that are struggling to grow, whether they are Vodafone or the HSBCs of the world.

So our view is, yes, take advantage of those great companies that do exist in the UK, but it's a much lower risk, higher reward approach to also look at really good, high quality, steady growth businesses overseas. Whether those be the ones we've talked about, our Novo [Nordisk]s, Microsoft, analog devices we are holding in our portfolio ANTA Sports. There are many really good steady growth businesses that you can find exposure to globally, if you're prepared to look beyond the little island that we happen to live on.

CR: Okay, and another one, what's been your most recent investment?

JD: Texas Instruments. So that is a leader in making analog semiconductors. Those are the ones you need if you're dealing with real-world signals, sound, pressure, temperature, those kind of things. And what we're forseeing is that the sort of digitization of everything in our lives is going to need more of these chips.

And Texas is a leader there. So, a very strong growth tailwind behind it, [an] extremely well-managed company, good high standards to what it does, lots of tailwinds behind its growth and committed to steadily growing its profits and dividends for another 10, 15 years. So that's recently gone into the portfolio as an example.

CR: Great. I think that's all we've got time for, but thank you so much for joining us today, James.

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JD: You're welcome.

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

A survey will be sent out to you today, so have your say and tell Baillie Gifford what you think of the programme so that the Intermediaries team can focus on the important topics and questions that you want answered.

That's all from us until next year, when Upfront returns with an all new line up. Until next time, goodbye.

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Annual past performance to 30 September each year (%)

	2019	2020	2021	2022	2023
Baillie Gifford Responsible Global Equity Income Fund - Class B-Inc*	N/A	10.8	19.1	-0.7	9.9
MSCI ACWI Index	N/A	5.8	22.7	-3.7	11.0
Sector Average**	N/A	-3.9	21.6	-0.6	9.4

*Inception date: 6 December 2018

**Investment Association Global Equity Income Sector

Source: FE, Revolution, MSCI. Share price, net of fees, total return in sterling.

Past performance is not a guide to future returns.

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