INTERNATIONAL GROWTH Q1 INVESTMENT UPDATE

Investment Specialist Paul Taylor and Portfolio Construction Group Member Nick Thomas give an update on the International Growth Strategy covering Q1 2023.

As with any investment, capital is at risk. Past performance is not a guide to future returns.

This communication was produced and approved in April 2023 and has not been updated subsequently. It represents views held at the time and may not reflect current thinking.

Paul Taylor (PT): Hello, and welcome to the Baillie Gifford International Growth update for the first quarter of 2023. My name is Paul Taylor, one of the investment specialists on the Strategy, and I'm joined today by Nick Thomas, who's one of our Portfolio Construction Group members.

As a very brief update to the Strategy, what we aim to do is identify international businesses with exceptional upside potential, hold them in size for the long term, by which we mean between five and ten years.

The portfolio turnover in the strategy is, typically, low, around 10 per cent, which is commensurate with our long-term outlook. And we also have a very high active share, around 90 per cent. We are actual long-term growth investors.

So, Nick, thank you very much for joining me. We're only three months into the year, but it feels like there's quite a lot already happened in 2023. Could you tell us a little bit [about] how performance has been so far?

Nick Thomas (NT): Yes, absolutely. Thanks, Paul. As you rightly said at the beginning there, our focus is on long-term returns, but it is nice to say that we have started the year positively, after what's been quite a tough period for us.

We've seen a reversal of some of the trends that have dominated over the previous 12 months. So, more defensive sectors that had helped us a little bit last year, like healthcare, maybe tailing off a little bit in Q1.

Some stocks like Genmab and argenx that had been very good performers last year, being more towards the detractor end this time, that's understandable.

On the other side of it, some of the companies more linked to the technology sector, digitisation, that have been very big detractors last year, as there was such a big sell-off. Quite a strong bounce in the first quarter in those companies, contributing to performance.

Our big holding in ASML performing strongly. Spotify, which had been about our weakest stock last year, had a very strong run in the first quarter, and the payments company Adyen are also doing very well. So, quite a change in regime in the market in the first quarter.

Also, a continuation of some trends that had been running for a while, so our luxury stocks doing very well, Kering and Ferrari, particularly. And perhaps, the one that's most on clients' minds at the moment given the recent stresses in the banking sector, our lack of exposure to finance businesses was a positive help to us, in relative terms. We're in basically no banks in the strategy, and that has helped us.

PT: In terms of the market backdrop, how has the current environment been suiting our style of investing?

NT: Yes, it's been a bit more benign in the last three months, but trying to make sense of the last few years, almost. Which we've been trying to do, and I'm sure everybody has. I can think of three factors that determined how growth investors were doing. There's the long-run fall in interest rates, was definitely a tailwind for the previous decade, and that obviously took a sharp reversal in 2022.

Globalisation and the opening up of markets, I think, was very helpful to us over the previous decade as well. The sharp rise in geopolitical tensions, also, a nasty surprise in 2022. So that's two of the long-term tailwinds turning very negative.

The third one, I think, is really more about lack of industrial innovation. How much change is actually happening in the economy? How much innovation is happening at the company level? I think that's actually the most important factor. From what we can see from our companies and our contacts with management, that's carried on unbroken throughout what has been a very difficult period.

So, we've got three tailwinds, maybe turned into one tailwind and two headwinds over the past 18 months. But in the first quarter, the interest rate one, I think that's been where the most change has been felt.

The market seems to have decided that there's weakness in the economy, there are stresses and strains in the banking sector. That probably means that interest rates have done most of their heavy lifting by now. And so, if that pressure is taken off, perhaps the growth stocks will start to perform based on their growth, rather than how much they're getting derated.

PT: Yes, so it doesn't sound like the recent environment has been perfect for us, have we been able to take advantage of that situation in any way?

NT: Yes, we've been trying to remain hungry and optimistic, to keep searching for opportunities. It would have been very easy to go into our shells and look for more defensive stocks, or back away from a growth style that has been so out of favour. We've been very conscious in not doing that.

I think after an initial phase, maybe early last year, of looking at the resilience of the portfolio, thinking about [how] there's a lot of strain and risk out there, let's check that we haven't got any weaknesses to that that we don't know about.

I think once we'd finished that phase and we were confident that the portfolio does have good long-term financial resilience, we were able to be perhaps a little bit more greedy and start looking for opportunities in stocks that had fallen.

So, the first phase of that was, really, topping up stocks that we knew very well already, that the valuations had become a lot more attractive. And a thing I've really noticed and appreciated in the last few months has been this quite a big wave of new buy ideas that our team's been coming up with. I think that's a really good sign of their positive mentality, and it should give us some interesting new stocks to talk to clients about.

PT: Are there any particular areas we've been focussing on?

NT: Yes, I think the focus has broadened a bit. I think there's quite strong themes in the portfolio in the last ten years or so, around digitisation of the economy. And the consumer internet businesses, the infrastructure providers to those businesses were probably the two biggest themes in our Venn diagram of the portfolio.

That has broadened out a bit. There are two big structural themes that are coming up in importance in the portfolio. The healthcare revolution that's going on is something that we've been excited about for a while, and we found more stocks that we think fit our criteria within that.

I suppose the underlying driver of that is, really, the confluence of big data and genomics. So, much more information about what's happening in our bodies, much more ability to understand and analyse the information, is now leading to treatments, so that's a really exciting area.

The other theme that's coming up strongly is around the energy transition. We can see very clear evidence as to why our sources of energy would be different in the future [compared] to what they were in the past. It's really driven by the cost declines and the efficiency gains in the renewable sector.

It has huge ramifications for all sorts of things, from geopolitics to how individual industries are configured. We're working really hard to understand that, and we've been able to add a few stocks that are linked to that change, particularly in things like battery materials and lithium.

PT: Very interesting. Are there any new buys over the quarter we could share with the audience?

NT: Yes, absolutely. There was one I was looking forward to talking about in the semiconductor area because our exposure to... People know we're very excited about semiconductors, both for the businesses that operate there and the effects it has on the wider economy. It's one of the main underlying engines of innovation, we think.

Our largest holding is ASML, but it's nice to be able to talk about a semiconductor stock that isn't ASML because we've been looking at the value chain generally, trying to think about where could spending go.

Spending on ASML's lithography tools has been very high in the last decade. Possibly, the next decade might be a little more about other bits of the process getting heavier investments, and we've been looking at the industry value chain very closely.

We found a new holding, a Swiss company called VAT Group, which makes vacuum valves. A very important part of the manufacturing process that we think has got really interesting business characteristics, and probably quite high growth potential as well.

Just for a bit of background, these valves are used, essentially, to isolate the air. Clean air is obviously a very important part of semiconductor manufacturing. You want it to be as clean as possible, to have as few flaws, as few failures as possible, so the valves are super important to that.

Our understanding is that as things are developing in the industry at the moment, there's more and more process steps in semiconductors. Therefore, there's more passing of wafers around, so valves [are] more important than perhaps they used to be. It's one of these critical components that's not a big part of the cost, so hopefully, isn't something that price pressure is too strong on.

PT: That sounds a lot like some other holdings we've got in the portfolio, like a Sartorius or an Atlas Copco, which also lends itself some very attractive financial characteristics.

NT: Yes, I think they're really good comparisons, Paul. These engineering businesses, where there's a lot of intellectual property, which allows them to dominate a particular niche- they're critical to the customers' efficiency or end-product, but they're not a massive part of the cost base, so they tend to be allowed to earn pretty good returns, and all those companies have got really good returns.

VAT's operating margin is, typically, over 30 per cent, which is exceptionally high. It's very cash-generative, so it's definitely a high-quality business. But we're not in the business just at buying high-quality companies, we want to buy ones that will grow as well, and I think we've still got a lot of confidence in that business's growth potential within the semiconductor industry.

PT: It sounds like a very interesting business. I'm looking forward to watching it develop as we get to know it better.

NT: That's right.

PT: Just looking at the future, what's really exciting us? What's on the research agenda? Is there anything you can share with us, there?

NT: Yes, absolutely. It's pretty packed at the moment, and that's a good thing. Some of it's exciting, some of it's a bit more defensive. I think, as everybody can tell, the world has become quite hostile and challenging in different ways in the last few years. Some of our research has really keyed around that, so we've been engaging closely with some of the academics that we know well, to try and understand geopolitics. The relationship between the US and China, for example, being an important one.

Sectors that we're looking more closely at, and it's to do with security, cybersecurity being an obvious example that's going to become important. Trying to think a bit more about how the globalised supply chains will be reconfigured.

There's been quite a lot of talk about friendshoring as countries realise that critical components are being supplied by countries that they might be more adversarially dealing with now. That has quite big ramifications, the complete reconfiguring of the semiconductor industry or the EV (electric vehicle) supply chain and battery materials, so we want to make sure we understand that. It may be partly to avoid problems, there might also be some opportunities for us there.

And perhaps, just to end on a more positive note. It's great that we can get out on the road more than we have been able to, recently. Some colleagues [are] heading out to South East Asia shortly, an area we've known has got exciting potential for quite a while. So, going and visiting companies out there, and I hope that throws up some new opportunities that we can talk about in the future as well.

PT: Yes, that's super, thank you very much. I'm sure people are aware we can't be too forthcoming, in terms of what's next at the stock level, but there's clearly a lot going on in the strategy. Thank you very much.

I hope you found our comments useful. 2023 has gotten off to a good start, and we continue to believe that our focus on company fundamentals and long-term growth will continue to add value to clients as it has done over the past 20 years.

We'll continue to take advantage of current valuations of businesses that we think have excellent long-term growth potential, and we'll continue to look for businesses that we believe have those characteristics in the international opportunity set.

That just leaves me to say, thank you very much for your interest in the International Growth Strategy, and we look forward to speaking to you again in the future. Goodbye.

Annual Past Performance to 31 March Each Year (Net %)

	2019	2020	2021	2022	2023
International Growth Composite	-5.4	-1.1	84.6	-27.2	-7.8
MSCI ACWI ex US Index*	-1.7	-15.1	50.0	-1.0	-4.6

Annualised returns to 31 March 2023 (Net %)

	1 Year	5 Years	10 Years
International Growth Composite	-7.8	3.0	7.2
MSCI ACWI ex US Index*	-4.6	3.4	5.2

Source: Baillie Gifford & Co and MSCI. USD.
*MSCI EAFE prior to 30/09/18

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