EUROPEAN EQUITIES MANAGER UPDATE

From Atlas Copco to Zalando, the European market is home to some exceptional growth companies. Even in times of volatility, Stephen Paice, head of the European Equity Team, finds ground for optimism.

All investment strategies have the potential for profit and loss. Your or your clients' capital may be at risk. Past performance is not a guide to future returns.

This communication was produced and approved in March 2022 and has not been updated subsequently. It represents views held at the time of recording and may not reflect current thinking.

During the recording of this film we complied with the Scottish Government's guidance on managing the risk of Covid-19.

Stephen Paice: Good afternoon. Like everyone else we have been watching the events unfold in Ukraine with horror and great sadness. Our thoughts go out to those suffering, who have had to flee, and everyone else who has been affected by this terrible act of war.

Unsurprisingly we've had lots of questions about our direct exposure to this within our portfolios (which is minimal), the general selloff in equities, how investors can cope in times like this, and what we are doing or not doing. This short update will however hopefully answer some of those questions.

Looking back it's clear that volatility in European markets is nothing new. We've had the dot-com bubble, financial and European sovereign debt crises, Brexit, trade wars, covid, surging inflation and interest rate expectations, and now of course heightened geopolitical risk.

Now it's been quite easy just to brush these off and say long-term performance is still strong and that's all that matters, and we're not going to change what we do. But we do understand how difficult it is when clients are seeing the value of their portfolio rise so much and then fall.

We invest in our own funds, so we do know what this feels like, and after such remarkable gains in 2019 and 2020 it's hard to see some of those being given back.

Now a lot of what I say might seem like common sense, but in this industry, I think we need to be reminded much more than we need to be taught, and that to deliver outstanding returns we need more patience, trust and optimism.

It's been said that the stock market is really just a device for transferring money from the impatient to the patient, and that time in the market is much more important than timing the market. But a long-term view and low turnover are probably the most important features of successful investing.

It’s widely known that the average fund investor underperforms the market as a result of buying and selling too often, and at the wrong time.

But we also know that even the best performing managers over a decade will regularly underperform even over three year periods, and that some of the biggest winners in our portfolio over the past 10 or 20 years have suffered numerous drawdowns of more than 50 per cent.

It’s only by sticking to your process and riding out the difficult times that will allow you to capture the extreme positive returns on offer.

If you don’t have trust in those managing your investments, or in the companies you give your capital to, it’s harder to be patient. In fact, investors are much more likely to bail at the first sign of trouble.

We have been investing in European equities since 1985 and have a very good long-term track record, and since then we’ve also become significant and, I think, influential shareholders in what we believe are some of Europe’s highest quality and best growth companies, such as Spotify, Zalando, HelloFresh, ASML and Atlas Copco.

And I think we’ve been quite clear and consistent in what we are trying to do, which is manage portfolios of between 30 and 50 of the most innovative and entrepreneurial growth companies in Europe that we believe have the potential to at least double in value over a five-year period.

We are not going to start buying banks just to play the interest rate cycle, or defence companies just because of short-term geopolitical worries.

When it comes to the trust that we have in the companies we invest in, there are three things which have served us well through time.

The first is almost all of the companies we invest in have insiders – families/founders or long-standing management teams. These companies tend to take a longer-term approach to capital allocation, generate higher returns and, in our view, are much more resilient.

The second point is that neither we nor the companies we invest in, like taking on much debt. Conservative balance sheets allow companies to not only survive but to take advantage of weaker competitors in downturns.

And finally, growth. Over long periods of time, sales growth has been shown to be the main contributor to strong equity returns. And when we look at the expected growth rates over the next three years in our portfolios, it’s around 20 per cent per annum, which compares to the market which is closer to 6 per cent.

So very simply, backing the right people, strong balance sheets, and plenty of growth gives us confidence that despite what the current share prices are doing, we believe we have enough future big winners in the portfolio.

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Then of course, there's optimism. It was becoming harder last year to justify some valuations in the portfolio.

We were taking some profits in companies as valuation multiples had run ahead of fundamentals and as it became harder to construct plausible scenarios where we could at least double our money. That's very different now.

Over the last three months, we've seen some companies sell off 40, 50, and even 60 per cent as investors have panicked and become much more myopic.

Some of these companies are not currently profitable and I think Spotify and Delivery Hero are examples, but we can see clear paths to profitability, and two very much larger businesses by the end of the decade.

Delivery hero in particular, which is down 60 per cent over the last three months, is a clear sign to us that the market is focusing much more on whether it generates 44 or 45bn euros in GMV this year, and not the chances of it reaching or even exceeding its targets of 200-300bn by 2030.

Most of the tech companies that we own in the portfolio are however extremely profitable, asset-light and are trading on what we think are bargain prices.

And the sell off hasn't been restricted to tech or digital platforms. Companies like IMCD, Sartorius Stedim, and Nibe, respectively involved in chemicals distribution, bioprocessing equipment, and energy-efficient heating have also been affected.

These, like many other companies in the portfolio, benefit from long-term structural growth, leading market positions, pricing power and now lower valuations.

We are not mindlessly bullish – there are macroeconomic risks but we pay much more attention to fundamentals and operational progress, which for most companies has been very strong.

We then continually reassess whether these companies are being mispriced, and in the current environment I think we now have more opportunities to exploit these inefficiencies.

To summarise then, markets will continue to be volatile and with rapid short-term swings in both directions, which will be almost impossible to forecast.

We are not going to start chasing performance or try to predict the direction of markets, inflation or interest rate expectations. We don't add value by doing that.

What we will do is to continue supporting and investing in exceptional growth companies, that are run by entrepreneurial founders and families with their own money on the line, that have the potential to generate extreme positive returns.

These are the companies making the world a better place, delighting their customers, and driving innovation. And when we find these companies, we will hold onto them for decades and take advantage of the inevitable drawdowns along the way.

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It's hard to be patient and optimistic with the obvious geopolitical and monetary policy risks but for us, the reality is that this is exactly what we must do. And I strongly recommend that everybody watching do the same if you can.

Baillie Gifford European Growth Trust Annual Past Performance to 31 December Each Year (net %)

	2017	2018	2019	2020	2021
Baillie Gifford European Growth Trust	24.5	-15.2	16.9	64.8	4.2
FTSE Europe ex UK	16.9	-9.1	21.3	7.8	17.6

Source: Morningstar and relevant underlying index provider, total return in sterling.
Past performance is not a guide to future returns.

Baillie Gifford European Fund Annual Past Performance to 31 December each year (Net %)

	2017	2018	2019	2020	2021
European Fund	23.4	-12.4	32.9	43.2	8.8
MSCI Europe ex UK	16.7	-9.1	21.0	8.2	17.6
MSCI Europe ex UK + 1.5%	18.5	-7.7	22.9	9.8	19.4
IA Europe ex UK Sector	17.3	-12.2	20.3	10.3	15.8

Source: Baillie Gifford & Co, MSCI, total return.

Past performance is not a guide to future returns.

The manager believes MSCI Europe ex UK is an appropriate benchmark given the investment policy of the Fund and the approach taken by the manager when investing. There is no guarantee that this objective will be achieved over any time period and actual investment returns may differ from this objective, particularly over shorter time periods. In addition, the manager believes an appropriate performance comparison for this Fund is the Investment Association Europe ex UK Sector.

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