SUSTAINABLE GROWTH Q2 INVESTMENT UPDATE

Investment specialist Alasdair McHugh and investment manager Katherine Davidson give an update on the Sustainable Growth strategy covering Q2 2023.

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

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Alasdair McHugh (AM): Welcome back for the second instalment in this series of quarterly videos. These are short updates that serve as a summary of the portfolio changes we've made over the last few months, as well as the investment performance that we've delivered for you, our clients. Also, they serve as a chance for us to answer some of the questions you've been posing us over the last few months.

As a reminder, in Sustainable Growth we're looking for companies that are sustainable in both senses of the word, so enduring growth and enduring good. Our belief is very much that those two things are mutually reinforcing, if your time horizon is sufficiently long.

I'm Alasdair McHugh. I'm an Investment Specialist in the strategy, and I'm pleased to be joined today by Katherine Davidson, one of our lead portfolio managers. Katherine, welcome.

So last time around, Katherine, Toby sat in your seat and we talked about plastic pipes. And understandably, some clients have been interpreting that as throttling back on growth and questioned the timing of that, which I think is a fair question. So can you start, please, by reassuring us that that's not the case?

Katherine Davidson (KD): Sure, and firstly, like Toby I am very much excited about plastic pipes. But more importantly, when you look at the behaviour of the portfolio year to date, you can see that the really big outperformers have been names like in Nvidia, Tesla, Shopify, Spotify, all very recognisable growth stocks.

So this is still very much a growth portfolio. We still have the latitude to invest in all the exciting growth names that are coming through from the scout network as well as plastic pipes. And actually, when we look at the portfolio characteristics, one quite reassuring thing is that the three year forward earnings growth for the portfolio is three times that of the benchmark, and it's 50 per cent higher than it was a year ago, which I don't think I would have guessed. So that should be reassuring on that point.

So what we are trying to do is not throttle back the growth, but it's to bring a bit more balance to the portfolio. So focus on durable growth rather than just high growth. And when we're looking back on 2022 and 21 and with the benefit of 2020 hindsight, we probably ran our winners a bit hard and we've been trying to manage the position sizing to a flatter portfolio. So actually recently we've been taking some profits from some of those names that have outperformed.

AM: Okay, thanks. And we can certainly see that coming through in stronger performance numbers year to date, with the portfolio a few percent ahead of the benchmark, which is pleasing. And I think that is driven by continued exposure to growth.

So you mentioned a few of the names there, but Nvidia, Tesla, Shopify are all coming through as top contributors to performance and it looks like emergence of generative AI is proving to be a bit of a catalyst for that.

So we're pleased to have exposure through the value chain, whether that's TSMC and NVIDIA in semiconductors, Alphabet or Amazon within the infrastructure space, all four of those held since 2016, and Shopify or Ocado that are deploying the technologies to great effect.

We should say there are some losers from the emergence of this technology. So Chegg is a holding that we've sold in the last month or so, but overall the portfolio is definitely a net beneficiary and we're pleased to be positioned to ride this new wave of growth as it as it rolls in.

The changes made really focused us more on the duration of growth rather than its pace, we would say. So a year since we started making those enhancements to philosophy, to process to the team. Can you talk us through how they've shone through in portfolio characteristics, please?

KD: As you say, this has been a gradual process over the last 12 months the turnover's not really blown out. So this will take a little while to come through in the portfolio characteristics. But the really important thing is that now it's really embedded in our process. One of our key investment questions is around resilience and companies that can make their own weather, and you can see some encouraging signs.

So one of the stats that we look at is the number of double negatives in the portfolio. So companies that are not making positive earnings or positive free cash flow. Those that are most at risk in a sort of rising rate environment or worsening macro, and despite the deterioration in the macro environment over the last year, that number has fallen from 18 stocks to nine. So we've halved the number of double negatives in the portfolio, which is a big improvement.

And you can see it coming through in some of our recent investment decisions that we've taken for the portfolio as well. So, for example, towards the end of last year, we exited your position in Affirm a buy-now-pay-later company, which is very vulnerable in this kind of macroeconomic environment.

At around the same time, we redeployed capital into a UK mid-cap steam engineering company. This is sounding dangerously plastic pipes, I'm aware, but it's a really good little company called Spirax Sarco. The really exciting thing about this company is not the stellar growth rates for the next couple of years, but it's the consistency. So, they've been listed since 1986 and they've never printed a loss in that time. They’ve consistently grown earnings and the dividend. The average organic growth at the top line has been 7 per cent over that 40-something year period.

And if you can find those kind of compounders, the returns can be just as good as from high growth names. So Spirax has outperformed the benchmark tenfold since it listed, and I didn't think many clients would object to holding those kinds of companies, even if they are a little boring.

AM: Yeah, I think clients will find consistency exciting at this point in the performance cycle for sure. How about the broader shape of the portfolio then? Is the fund exposed now to a wider range of themes, would you say?

KD: Yep. So we don't really think about it in terms of themes as such. It's all driven by bottom-up stock selection. But I think the big advantage of having the central team in place is that we can now bring a lot more holistic oversight of the portfolio and think a lot more about the bets that we've got on, the risks we’re running and making sure that we're fully cognizant those are all intentional.

And so for example, how we’re thinking about position sizing. We talked earlier about flattening the portfolio and at the end of last year we purchased a new position in Texas Instruments for our clients. A semiconductor company, absolutely fantastic company, but we already had positions in NVIDIA and TSMC at that point and we weren't necessarily wanting to triple up our exposure to semiconductors, you know, it's a very volatile sector. So, we actually funded the TI position by trimming the other two names to keep the sort of aggregate exposure and the same but with lower stock-specific risk.

Another example would be Schneider Electric, a European electrical equipment manufacturer that we purchased for clients last month, and our position sizing in that was informed by some correlation analysis that we did with the risk team, which told us that that stock behaves quite a lot like some of the other stocks in the portfolio. So making sure that again, we didn't have undue exposure to one segment of the economy.

AM: We've certainly been working even closer than ever with our risk team recently, so that's another positive.

Part of the rationale for establishing our central desk was really to deepen the research that we're doing on sustainability. And part of that has been a new framework that includes a mechanism for scoring companies on four key sustainability criteria. Is there evidence of companies being held to a higher standard in that regard?

KD: This is a really tricky one because sustainability is not really something that we think you can quantify. So it's very hard to evidence and we could point you to MSCI scores or something like that, but there's a reason we don't use them in our process, so that would be a bit hypocritical.

We think the stocks in the portfolio should do the talking and we encourage our clients to hold us to account on the stocks we own and how we engage with them. So maybe a couple more stories instead.

For example, we recently switched our position from Netflix into New York Times. They're both media companies, they've both got a story to tell about creating influential content. But Netflix alongside, you know, Don't Look Up and other thought-provoking stuff, is also spending money on another series of *Is It Cake?*, which I love by the way.

Whereas New York Times, unlike most of its peers, has really invested in its journalistic workforce and focused on maintaining journalistic integrity. So really, really thoughtful, impactful pieces speaking truth to power.

Things like the Harvey Weinstein affair that they exposed and kicked off the MeToo movement, and the reason they're able to do that is because they've got the backing of the founding family who are really long-term shareholders, and we're really excited about being invested alongside them.

AM: Excellent. And I think New York Times is a great diversifier for the portfolio as well, which is something that, you know, to my previous question about its broader shape, it actually benefits from some of these really sad, catastrophic events that we've seen unfold over the last few years. So, for example, during the Ukraine war, subscriber numbers ticked up, right?

So the purchase and sale, you know, we're very aware of that's sort of the beginning and the end of our journey with a company. But there's a big middle bit that we're very interested in as sustainable investors, namely our ability to engage with them. Anything over the last quarter you want to update us on in terms of engagement?

KD: Before I do that, I'm just going to nitpick that, because actually the purchase is not really the start of our relationship with the company. A lot of times there's a lot of engagement that goes on during the due diligence process, as you know.

AM: Yes. As I should know!

KD: And that goes on behind the scenes. And there are things where the purchase decision will actually be contingent on our engagement successes. So things like Starbucks, for example.

But ignoring that, to answer the question, yes, we've been very busy on the team. We've got our priority list of engagement candidates that we've been working through. One notable example this quarter was Fastenal, a US manufacturer of, literally nuts and bolts, which we owned because of its impact on supply chain efficiency.

They produced these vending machines that go on sites and significantly reduce waste and improve uptime. But some concerns came to our attention, primarily from employee review sites around the culture, some D&I issues at the firm.

So we have an investigative journalist on the payroll at BG, which I love, and we sent her out to investigate this a bit further, and she came back with a really thought-provoking but concerning picture from a range of former employees of the company.

And we're going to give them a right of reply, obviously, we used that to kick off an engagement with the CEO and CFO. And actually, I think that was the most disappointing part for me, was that they didn't really recognize it as a problem or see any urgency to address it.

And while that may not have an immediate impact on the financials, we do think that over a sort of ten-year investment horizon that will impede their ability to attract and retain the best staff in an increasingly diverse US workforce. So we took the decision to try to divest that position and to reinvest the capital elsewhere.

AM: Yeah, and I think that answers a question that we frequently get from our clients, which is, does your engagement process have teeth? That's a really good illustration that it does.

We've also been engaging quite a lot with Illumina over the last few months, and that's something that's written up in our in our quarterly letter as well as in our forthcoming sustainability report, which we should plug and flag.

Hopefully this will be available over the next few months, towards the end of the quarter perhaps. We've got a report on our progress towards net zero and our ambitions in there. We've also got a bit of analysis of how the portfolio contributes to what we see as the three big global challenges: people, planet and prosperity. So, our clients should definitely look out for that coming in the next few months.

Just finally then, I'm aware you've been away from the desk, you've been on the road this quarter visiting the US and visiting lots of companies. Any blossoming new ideas coming from that trip?

KD: I'm glad you asked me that because I know Toby got to talk about his trip and I wanted to prove that I am also allowed out of the office.

So I was in Chicago the other week with one of our senior partners and I saw 22 companies in three days, plus an exciting visit to a composite recycled decking factory!

Actually it was the first time I've been out on the road since Covid, and I'd forgotten how invigorating it can be, how much I enjoyed it. I came back with loads of really eclectic ideas, everything from the world's leading manufacturer of hard hats to a social networking platform for doctors. And I'm just really keen to get back to the desk and start working on them.

AM: Good. Well, I'm glad that when you're out and about, we are working you hard with 22 meetings in three days.

So, listen, thank you very much for your time today. I think the key points for our audience are that there is excitement for growth building within the portfolio and particularly around the emergence of generative AI, and the many as yet unimaginable use cases that we're going to let Katherine get back to the desk and start thinking about.

The portfolio resilience has improved markedly over the past year because of some of the changes that we've been making, and we've also rebalanced the portfolio but really retain positioning for a range of different growth drivers, which is very pleasing indeed.

So again, if there are any questions, any topics you'd like to see addressed in this video next time around, please do let us know and we'll thank you for your time today and your attention.

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

	2019	2020	2021	2022	2023
Sustainable Growth Composite	5.2	29.7	53.4	-45.2	12.7
MSCI ACWI	6.3	2.6	39.9	-15.4	17.1

Annualised returns to 30 June 2023 (net %)

	1 year	5 years	Since inception*
Sustainable Growth Composite	12.7	5.3	10.4
MSCI ACWI	17.1	8.6	10.0

*Inception date: 31 December 2015.

Source: Baillie Gifford & Co and MSCI. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.
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