Baillie Gifford

International Growth
Q1 investment update

April 2024

Client relationship director Nick Thomas and investment analyst William Dudley give an update on the International Growth Strategy for Q1 2024.

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

Will Dudley (WD): Hello, my name is Will Dudley and I'm an investment analyst on the International Growth Strategy here at Baillie Gifford. I'm joining you today because five years into our career, equity analysts get the opportunity to spend some time on secondment in our Clients Department to help us get a better to know the clients base that we have and its needs.

I'm joined here today by Nick Thomas, who's been a member of the International Growth Portfolio Construction Group since its inception 20 years ago. In this meeting, we'll touch on recent returns as well as some reasons we have for being optimistic about the future. International growth is a long-term active growth strategy. We're looking for 50 or so of the most exceptional growth companies in the investable universe of international markets. These are companies with rapid or robust growth potential that we can own for at least the next five to ten years to allow for competitive advantage to translate into financial success.

Now, this can be a really valuable investment strategy when it allows us to capture the extreme winners and you can see that in our long-term results. But Nick, it can also be quite volatile in the short term. So, talk us through how things have been going recently.

Nick Thomas (NT): Yeah, that's right. That's a really good summary, Will. Yeah, it can be volatile, but we think it is the way to deliver excellent long-term results. I mean, I guess over that 20-year period, we've tried to lean into our competitive advantages as active managers, which we think are to do with a long time horizon and high tolerance for stock-specific volatility. So, that's what we've been trying to accentuate. That's made us more exposed to the fluctuating success of growth as an investment style.

So, I guess you could say the decade since the financial crisis was very positive for growth. Innovation flourished. Discount rates were low. The stocks did very, very well. Then we ran into an exceptional style rotation as the pandemic came and went. The big rise in inflation and the shooting up of interest rates gave us a very painful period in the portfolio in the last two or three years, and we underperformed the benchmark very sharply. We feel like that phase is ending now. We had a good quarter in the fourth quarter. We were ahead of the benchmark. This quarter, Q1, the portfolio was up about 4 per cent in absolute terms, about 1 per cent behind in relative terms, but a calmer environment for us to really focus on our stock picking.

WD: Macro has been a big driver of recent returns then, but we're bottom-up stock pickers. So, could you give us an idea of what have been the main contributors to the portfolio recently?

NT: Yeah, exactly. I'll go through three positives and three negatives. So, on the positive side, we had Spotify, the Swedish music streaming company. That's been one people have questioned for a long time. Yes, you can grow very quickly. Can you make profit? Can you make cash flow in the long term? They've had a really successful pivot, I would say, in the last 18 months from burning cash to grow fast to reporting much more positive margins, very good profit numbers, but also keeping their subscriber growth going. So, the market is very happy about that, and that share has been performing really well. We thought they could do it. It's great that they've proven that they can.

One that's perhaps a more proven business model that's also been doing well is ASML, the Dutch semiconductor equipment maker. Their lithography machines are really powering a lot of the cutting-edge semiconductors going into things like AI applications at the moment. So, it's not surprising that their order books are full. Their results have been very good. That stock has been performing really, really well, and that's a big holding in the portfolio, so that's been really helpful.

And then finally, a stock that we've talked about quite a lot over the years is Ferrari, the Italian sports car manufacturer. They seem to be navigating this transition away from just internal combustion to more of a balanced portfolio with hybrids and possibly even EVs in the future really, really well. We weren't sure if their brand could carry that, but it looks like they can. They've also launched several new models in the last couple of years, which have been very well accepted. So, again, strong order books and great profits from Ferrari.

On the downside, we've had a few stocks not doing so well at the same time. So, Ocado, which is a British company which makes warehouse automation used in food deliveries, they've struggled a little bit in the last couple of years. They've perhaps not had as much demand as we would have hoped from supermarkets buying their equipment to then compete with other supermarkets not using it. So, that's been a little disappointing. We still think there's plenty of potential there, but it's not looking quite as strong.

One of our semi-stocks, Aixtron, actually not doing quite so well, perhaps a rarity in that industry just now, having a bit of a cyclical downturn in their bit of the industry and a profit warning about sales and margins this year, but we think well-placed for the longer term.

And then, finally, Pinduoduo, the Chinese ecommerce business. This has been performing really, really well in the last 12 months. They are the owners of Temu, the app that a lot of Western consumers are now using to get cheap goods straight from Chinese factories, like delivered to their door. Its burst to prominence has now brought a little bit of scrutiny about how the taxation works, what are the import duties they should be charged, maybe some regulation coming onto that company, which might have dampened the shares a little bit in the short term. So, as always, a balanced, positives and negatives.

WD: Some strong operational progress then from our companies, but our clients will rightfully be thinking of long-term returns from here. We're very optimistic as a team about the future. Could you give us a sense of what we're most excited about at the moment? Where are we finding the biggest opportunities?

NT: Yeah, we are excited, aren't we? I mean, I guess the way we've tried to sort of make sense of the world and explain it to clients is around some long-running growth trends that are well-represented in the portfolio. So, we've spoken in the past about the growth of luxury goods consumption or how the renewables sector is going to change the way we consume energy or how healthcare is going to be transformed by genetics. So, big deep trends that we can then find great businesses to ride those waves.

The one that's on everyone's mind at the moment is AI. So, this is something we've been thinking about for six or seven years in the portfolio. It's quite well-represented. We've got some of the picks and shovels makers, you could say, particularly in the semiconductor sector. We also have quite a lot of businesses that use AI to deliver the product to their customers and make their own businesses better. So, we think it's pretty well-represented in the portfolio. We've got to think quite creatively. We think it's a real trend. There's serious money being spent on buying the equipment and using it in the real world. It's not a fad. It's not hype. We've got to think about how will that evolve in the future? How will competitive edges work in the world of AI? Data has probably got quite a lot to say in that question. And certainly, at the moment, we've got to think about the valuations quite carefully because it's been a very hot sector. Quite a lot of future profit growth has already been priced in. Is there still a lot to go for? So, those are questionings that we're really wrestling with just now.

WD: You mentioned quite a few different themes there, not just AI, but also the revolution in healthcare and renewables, digitalisation. And I would say that as an equity analyst, one of the things that makes international growth such a great strategy to work on is that you get the chance to research a lot of these different really exciting long-term investment themes. So, for example, over the past year, I've looked at quite a range of different companies. I've looked at a few Chinese electric car manufacturers, including BYD and Li Auto. But then I've also looked at drug development manufacturing companies, including the Swiss CDMO company, Lonza, and then even a couple of semiconductor companies as well, the engineered substrates company, Soitec, which is based in France, and the Japanese semiconductor testing equipment company, Advantest. And actually, just on those last two, that's a theme I've actually been exploring quite closely in my work in the past few quarters, which is this drive we're seeing in the semiconductor industry to pursue new forms of technology and engineering techniques to enable them to keep producing that increase in computing power and devices that have lower energy consumption every year.

So, while we're on the subject of analysis, maybe now's a good time to talk about how our analysis has been translated into changes in the portfolio. Now, turnover in the portfolio remains low in line with our 5 to 10-year time horizon, but we have made a few changes. Could you just talk us through those?

NT: Yeah, yeah. And just in passing, I think it's great that you listed all the work that you're doing at the moment. It's an interesting blend of looking at competitors to holdings and looking at potential new investment ideas. And that's a good illustration of the life of an analyst. So, thanks for sharing that.

Yeah, so two new ideas coming into the portfolio this quarter. So, we've taken a holding in Hermes, the French luxury goods company, mostly leather goods. I think a great paradigm of a family stewardship of a brand over generations that creates a heritage that's almost impossible to compete with. It's well-recognized as a very strong company, but we think the longevity of its growth is not fully priced in. So, that's still a good company for us to buy now.

The second new holding that we've taken is in Kinaxis, which is a Canadian software company offering supply chain software both to logistics industry players and also to some large multinationals. So, we think their sort of modern cutting-edge software has a lot to offer to the companies operating a very complex supply chains where there's a lot of disruption from geopolitical events that cause constant readjustments. The value out there is really, really strong. So, that's two new holdings in Hermes and Kinaxis.

We've also topped up a couple of businesses that we've got increasing conviction in. So, Coupang, the Korean ecommerce company, and Elastic, basically a search business that uses AI to find unstructured data within companies. So, two holdings that we've increased quite a bit as well. Now, you mentioned work that you've done on the Chinese EV sector. I think one thing that that's highlighted is just how competitive it is. So, we've actually taken the decision to sell our one holding there, which is NIO, which we've had for some years. Great growth potential from NIO, but question marks about profitability and I think we've decided to come out of that based on that. And we've also trimmed three stocks that have performed very well, perhaps they're pricing in more of their growth than had previously been the case. So, we've taken some money out of ASML, Ferrari, and Spotify.

WD: Thanks, Nick. So, in summary, there are continuing signs that macro pressures on growth are abating and when you combine that with our exposure to long-term investment themes, as well as strong operational performance at some of our companies, that puts us in a really strong position for returns in the years ahead and it makes us especially optimistic about the next 5 to 10 years.

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We hope you found this a useful update on the International Growth strategy. If you have any questions, please do reach out to your client contact. Thank you for joining us. Goodbye.

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International Growth

Annual past performance to 31 March each year (net%)

	2020	2021	2022	2023	2024
International Growth Composite	-1.1	84.6	-27.2	-7.8	5.7
MSCI ACWI ex US Index*	-15.1	50.0	-1.0	-4.6	13.8

Annualised returns to 31 March 2024 (net%)

	1 year	5 years	10 years
International Growth Composite	5.7	5.3	5.6
MSCI ACWI ex US Index*	13.8	6.5	4.8

*MSCI EAFE prior to 30 September 2018.
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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