Baillie Gifford

# UK Core
# Q1 investment update

April 2024

**Investment manager Iain McCombie and investment specialist Kathleen Hunter give an update on the UK Core Strategy covering Q1 2024.**

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**Kathleen Hunter (KH):** Hello, everyone, and welcome to our UK Equity Core update. My name is Kathleen Hunter, and I'm an investment specialist in our UK Equity team. And I'm joined today by Iain McCombie, who is head of our UK Equity Team and lead portfolio manager on our UK Core Strategy. As a brief reminder, our UK Core Strategy is looking to identify some of the best high quality growth businesses in the UK, and then hold on to them over the long term, so at least five years.

Thanks for joining us today, Iain.

**Iain McCombie (IM):** Pleasure.

**KH:** If we start with a bit of a scene setter, the UK Core strategy delivered a positive return during the quarter. However, it slightly underperformed the FTSE All Share. So, would you be able to characterise the market environment over the past few months?

**IM:** Well, quite simply, Kathleen, much ado about nothing, that in a sense of, I think we've been a bit of a holding pattern, that there hasn't been a lot of new news. I think what people do know is the fact that the economy has slowed because of interest rates being higher. But inflation is coming down, which is good news. And therefore, there's short-term speculation about well, when will interest rates come down? And that's really what's driving the market in the short term. Now, for us as long-term investors, we don't really get too involved in that. I don't have a crystal ball. I don't know when rates are going to come down or what inflation is going to be. As you said, what we're looking for are companies with a five-year view, plus, with better opportunity there. So, I think it's hard. There's a problem, when you're talking about a quarter, with not much happening there. To be honest, there wasn't a lot happening.

**KH:** Okay. So, moving on to performance attribution. So, one of the key detractors this quarter has been St. James' Place, again. We've spoken before about some of the share price weakness at the



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end of last year. That was due to a change in their pricing structure. However, has there been any new developments this quarter that's driving those share price moves?

**IM:** Yes. I mean, there has unfortunately, Kathleen. The new chief executive came in and announced that he's also taken a provision against the fact that the company or the advisors haven't been able to document that they've always given contact with all their clients, which is a bit of a surprise to us and to the market. And it's led to speculation as well. How big could that provision be? Could it change over time? And there's a lot of uncertainty about it. Now, what it’s about, the fact that for perhaps 1 or 2 per cent of their business, they haven't been able to evidence in the past that the advisors, their sales force, had actually been in touch with the client. Now, they might have been in touch with them, but they can't evidence it, because until 2021 they didn't have a proper database, sales database, to evidence that. It's very disappointing. I'm not going to lie to you about that, that we'd expect a bit better from them in that respect.

So, we're trying to set that disappointing news against the fact that the share price is discounting a lot of bad news and is giving them no credit whatsoever for the fundamentals, which are actually doing quite well. Actually, last year's numbers, the profits were pretty good. And actually, they took net £5bn of new business, which in a market where basically there's been a lot of pressure, the cost-of-living crisis and so on, was actually a very good number. So, those are the two things we're factoring. And we've been speaking a lot to management, at least a couple of times. We've also spoken to the chairman trying to get to the bottom, trying to understand what the company is doing about it. And to be honest, at the moment, we're still thinking about it. We're not going to try and overreact in the short term to it. But it's very much a live issue for us, I'm afraid.

**KH:** Okay. Well, sticking with performance, two of the big contributors to performance during the quarter were Babcock and Just Group. Now, these are not our usual household names. So, would you be able to remind us, what do these companies do? And why have they been outperforming the market?

**IM:** Sure. Well, Babcock is essentially a defence business and a lot of it is support services. So, for example, it looks after the entire UK submarine fleet, either up in Scotland or down in Devonport. It builds the new Type 31 frigate for the Royal Navy, which is based up in Scotland, they're building it up there. But they also maintain the whole of the army's car vehicles, so about 30,000 vehicles. But it's not just the UK, they have a business in Australia. And believe it or not, they actually also train the French fighter pilots in their training planes. So, that's a Babcock business. So, there's a variety of things there. Now, what's been happening in that business is that a new management team have come in, it was basically a bit of a mess beforehand, a lot of acquisitions and unfocused, too much debt. This new management team have come in, they've done it before, they have simplified the business, got rid of some bad contracts, addressed them. They've improved the finances, they sold off some non-core businesses, they've addressed some working capital concerns that the market had, and they've dealt with that. And really, it's basically changed the culture of the business, which is a longer-term thing. But all the signs are very positive. And they've updated the market and that's one reason why the share price performed well.

So, that's the internal things. But the other really important thing is the market backdrop that we're all aware of, you know, post the Ukraine war, there's a lot more focus on defence spending and


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something like Babcock is really well positioned for that because if you're going to spend more money, particularly in the Navy, Babcock will be a beneficiary of that. But as I say, they've got international businesses too. So, it's not just the UK, other countries are doing the same thing. So, I think it's a very interesting company, in the right place at the right time.

**KH:** Interesting. And Just Group?

**IM:** That's a very different business. Just Group is a bit like, I guess, Legal & General. It's a smaller version of that, in the sense that they're in the pension business. So, what they try to do is, a company that has a pension scheme, if it's fully funded, will seek to take it off their balance sheet and give it to a pension scheme to administer and take on the assets and pay your pensioners. And what's interesting is that this trend has been happening for a number of years, but it's been given a massive boost in the last couple of years because interest rates have gone up. And what that's meant is really, in simple terms, that the funding position for most companies has improved dramatically. And companies are saying, right, okay, now's the time to look at what they call buyouts of the pension schemes. And for people like Just Group, the phone is ringing off the hook.

Last year, they did about 90 deals in the UK, which is huge for this market. A lot of them are smaller deals, the ones you've never heard of, small companies, £50-to-100 million style pension scheme assets, still big numbers, but they all add up. So, we think this company is in a fantastic position because there are still thousands of these pension schemes in the UK. And we think there could be a 10-year opportunity in this market as companies are looking to get rid of their pension schemes. So, that's really good news for Just Group.

And the other important thing for Just, I think the market is getting much more comfortable with their balance sheet. Its strength has much improved in the last couple of years. All the actions that the current management team have done to be able to grow, without putting any strain on their balance sheet or very little strain on their balance sheet, and the market is really responding well to that. But we still think there's lots to go for, because the valuation is still, we think, compelling. They're still trading almost at a half of its book value, which we still think is ludicrously low. So, we're really excited about that company.

**KH:** Great. Interesting to hear about three very different businesses in the portfolio. So, just to wrap up, are there any final messages you would like to leave us with today?

**IM**: I think the key thing, we've obviously been speaking to management teams a lot in the last year or so. And obviously in these tricky times, the key thing is to be a challenging but supportive shareholder and also trying to react the right way to what's going on. So, to take an example, Howden's Kitchens, we've talked about it a lot in the past. Last year, its profits were down. Now, am I disappointed by that? Well, no, because clearly with the economy either in recession or very close to recession, the kitchen market was weak. But actually, Howden's massively outperformed the market. It was flat against the market, down, say, 10 per cent, which is actually a pretty good performance. And although profits are down because eventually costs were going up, that's a short-term issue.

And what's more important is the position in the market, which they're taking share. One competitor has announced that they're almost withdrawing from the market, which is good news. And they're


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keeping investing in the business to improve its competitive position. So, for example, they manufacture a fair amount of the stuff that they sell. And obviously, if you do that, it means that there's no margin suddenly if you're buying it from the outside. Now, they're doing a bit more of that. Now, that could be costing because you have to add to your existing factory lines. But the exciting thing for them is, in the long run, that will pay off.

Now, we're trying to encourage business like that to think long-term. Don't cut back on investment in the short-term because your profits are down. You've got a winning proposition. This is a time to really move forward. And they've got the strong balance sheet to do that. So, it's things like that that we're trying to do. That's one example of encouraging companies to keep focusing on the long-term because, ultimately, share prices do follow fundamentals. So, the businesses that are using these kinds of challenging times to strengthen their positions means that we think, when things get better, they're going to be in an even better position than they are now. And that's exciting for us.

**KH:** Great. Thank you very much for your time today, Iain. And thank you everyone for joining us.

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## UK Core

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

| | 2020 | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|
| UK Equity Core Composite | -22.1 | 52.6 | -4.7 | -7.9 | 8.2 |
| FTSE All Share Index | -22.4 | 41.0 | 7.9 | -3.3 | 10.8 |

### Annualised returns to 31 March 2024 (net%)

| | 1 year | 5 years | 10 years |
|---|---|---|---|
| UK Equity Core Composite | 8.2 | 2.4 | 2.0 |
| FTSE All Share Index | 10.8 | 4.8 | 2.9 |

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

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