Baillie Gifford™

Sustainable Growth
Q1 investment update

April 2024

Investment manager Toby Ross and investment specialist Amy Anderson give an update on the Sustainable Growth Strategy covering Q1 2024.

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

Amy Anderson (AA): Hello and welcome to the Sustainable Growth Quarterly webinar.

My name is Amy Anderson, I'm an Investment Specialist in the Clients Department here at Baillie Gifford and I'm delighted to be joined today by Co-Manager of the Sustainable Growth Strategy, Toby Ross.

Toby, thank you so much for joining me. Now, if it's all right with you, I'd really like to just jump straight into it and kick off with a question on performance.

So, at the start of this year, the strategy has delivered decent absolute returns. However, we are lagging a relatively narrow market. So, could you please talk to the drivers behind that and your thoughts there, please?

Toby Ross (TR): Of course, Amy, I'm delighted to be here today. Your point is exactly right. At the start of the year, generally, we've been pretty pleased by the operational performance of our companies as they've reported their results over the first quarter.

By and large, they've been performing in line with our long-run expectations. There are a couple of examples which have been a bit weaker, MarketAxess is one that springs to mind, but the market in those cases seems to have completely overreacted to those.

So, we are happy with the operational performance and where there has been some share price weakness, more inclined to be adding rather than retreating from those names.

The second sort of broader phenomenon is the one you referred to around the narrowness of markets, which I think has been quite a feature of the last year in equity markets more generally. I was looking at this the other day - over the last 12 months, mega caps, so companies with a market cap of over $200bn have returned 33 per cent, mid caps have returned 7 per cent and small caps have returned minus 10 per cent.

So, it's been a huge dispersion in the returns based on the size of the companies you invest in. Now, by and large, we're not in the smallest companies, but because we're focusing on the winners of tomorrow, we are a bit more exposed towards the mid-cap end of the spectrum rather than the very largest companies in the index.

Our natural hunting ground is in that sort of $5bn to $25bn range. And I think that has been a bit of a headwind, one reason we've lagged a bit over the start of the year.

AA: Can we just delve into that a little bit more, please - around the narrowness of the market? How are you managing that in terms of your portfolio construction? And my second question there is actually, do you see this reversing?

TR: I'll take the second one first, which is, yes, but I don't know when. We've seen periods of crowding like this before in markets, and 2000 was one such period where everyone's crowding into the same relatively small number of stocks and 'fear of missing out' in markets goes up.

Those periods tend to reverse, but it's very difficult to know when. Now, in terms of what you do as managers, you basically have two choices. One, is you try and reduce your benchmark relative risk by buying the things that everyone else is buying.

Now, that could mean buying companies where you're less convinced about the long run growth prospects. We've made a conscious choice not to have any investments in banks or big pharma companies, but we could move in that direction. Or moving into companies where we'd have to expose a lot of our capital into a couple of industries, so more into tech and things like that to look more like the benchmark.

The other option, which is our strong preference, is you stick to your knitting. You focus on finding the best underappreciated long-term growth stocks that you can find, and you focus all your effort there. So that is what we think is the best thing to do – to focus on real diversification rather than minimising your benchmark relative risk.

AA: So where are you finding those underappreciated long-term growth opportunities? I noticed that if you compared the top 10 holdings today versus that at the end of 2023, there is a slight shift in the names in that composition, so perhaps you could talk us through what's driven that and where you are finding those opportunities.

TR: Absolutely. Well, it comes back to exactly this point about trying to make sure that our big holdings are in the things we've got the greatest long-run conviction in. So a good example of that is something like Illumina.

Illumina is now a top three holding for the fund. Now, it's a stock we've held for many years in the strategy. For those who don't know it, it has 80 per cent of the market for genomic sequencing. They are providing a critical underpinning for things like cancer diagnosis screening, which I think is going to be a massive growth market over the next decade.

What's exciting about the company is I think there's the potential for them to be a real second order beneficiary of AI (Artificial Intelligence) because I think the value of the data that they help companies to create and assess could increase really quite dramatically as we find more ways of analysing and assessing that data. But that's a company which is now valued at $20bn.

They've had some specific challenges over the last year and some management changes. But I find it quite easy to see how that company could, in five or 10 years' time, be a mega cap company. It's a $20bn company today that could be worth multiples of that. So that's the sort of name we're trying to make sure we've got most of our capital in, the mega-caps of tomorrow rather than those of today.

AA: Thank you. And sticking with the theme of activity and what you and the team have been up to, one of the new purchases for the strategy is Carlisle, which is a commercial roofing company. Could you talk us through your enthusiasm behind that, please?

TR: Yeah, it's not quite as glamorous as curing cancer or cancer diagnosis screening. But I think it's a fascinating company. And it's not a very well-known company. There are only five analysts, I think, who cover it.

So it's an American company. They provide insulation for roofing for commercial premises, which might not sound that exciting. But energy usage in buildings is an enormous drain and has an enormous climate impact. And Carlisle helps to reduce that. And over time, you see standards for insulation going up and up and Carlisle is a key beneficiary of that.

And their R&D is helping to improve the efficiency of buildings across America. So it's a great little company, very long growth runway ahead of it. And we think a total bargain at the moment.

AA: Now, one other question that we're getting a lot on at the moment is that on the topic of China. I'd be really interested to hear your thoughts on how you're approaching investing in a region that has become more difficult to invest in over recent years, and also any activity and how that's reflected in the portfolio.

TR: Sure. Well, we start from a position of having relatively little of our capital directly invested in China today.

And it's an area where there is huge divergence between investors in terms of their attitudes towards it. But what we tend to focus on more is fundamental business quality and the management teams that we can invest alongside and their opportunities that they have ahead of them.

And I think we're at this really interesting moment where there's a cluster of really high quality businesses that could be leaders on the world stage, hold their heads up high to many Western multinationals that are run by founder visionary CEOs that are helping to really address important systemic challenges, but that aren't being valued as such that you can find in China today, that are being given away very cheaply.

We should absolutely be looking at those companies. One name we've bought for the portfolio is Center Testing. It is a founder-led company. They help test things like food quality or test the safety of consumer products and things like that. Basically trying to raise the standards of consumer products and things in China.

Two years ago, you'd have been paying something like 50 times earnings for that company because of its quality, but we've just bought it for 20 times.

And I'm off to China in a couple of months' time. There's another five or six companies that I'm seeing there where the story is very similar, where two or three years ago, the multiples reflected the quality. But today, because of this kind of cooling around China, that you get these high quality franchises really on sale. So I think it's a really interesting time to be going shopping there.

AA: Now, you've spoken about a couple of new purchases. I'm interested to hear where that funding is coming from.

TR: Sure. Two broad areas. One is a couple of holdings where we think the competitive environment has just got much tougher for the businesses and we're less convinced about the long run growth opportunity.

One example is NIBE, the heat pumps manufacturer. The growth in demand for heat pumps has attracted in quite a lot of competition from some big global companies. And I think it's just going to be harder for NIBE to stand out in future.

The other area is that we did an exercise at the start of the year where we looked at our top 10, 15 largest holdings and tested ourselves on how much money do we really think we can make out of these over the next 5, 10 years? Are these really where the upside is greatest? So we went through these in a rigorous way, [asking] how hard would we have to work to double our money here?

Now, in quite a lot of the holdings, the answer was, yes, we're still very confident in this. TSMC, for instance, one of our largest holdings. But in a couple of other areas, we thought actually, valuations have moved quite a long way and we're finding we're having to work harder to justify making money.

So we made reductions to Shopify, NVIDIA, Spotify on that basis. The net result, of course, is kind of coming back to what we were talking about with Illumina at the start, trying to make sure that our largest holdings, those top 10, are really in companies where we're super enthusiastic about the long run opportunities they have and that the money is in those names rather than just those that have done well over the last year or that are the biggest benchmark weightings.

AA: So focusing much more on tomorrow's winners, not focusing on today's?

TR: Absolutely.

AA: Well, thank you, Toby, so much for your time today. And thank you to our clients who were able to join us to listen in. Of course, if you have any questions or feedback, please do not hesitate to get in touch with your regular Baillie Gifford client contact.

And in the meantime, we look forward to speaking with you again soon. Thank you.

Sustainable Growth

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

	2020	2021	2022	2023	2024
Sustainable Growth Composite	-5.0	107.1	-19.0	-20.8	12.9
MSCI ACWI Index	-10.8	55.3	7.7	-7.0	23.8

Annualised returns to 31 March 2024 (net%)

	1 year	5 years	10 years	Since inception
Sustainable Growth Composite*	12.9	7.3	N/A	10.6
MSCI ACWI Index	23.8	11.5	N/A	11.1

*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.

Past performance is not a guide to future returns.

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