Baillie Gifford™

Discovery
Q4 investment update

January 2025

Investment manager Svetlana Viteva and investment specialist Bill Chater give an update on the Global Discovery and Worldwide Discovery strategies covering Q4 2024.

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Bill Chater (BC): Hello. Welcome to today's update on the Discovery Strategy. By way of a reminder, the strategy looks for the next generation of really great growth businesses. We want to find them when they're young, immature, and then hold them for the long term as they grow and scale.

I'm Bill Chater, investment specialist, and I'm joined by Svetlana Viteva, who is one of the investment managers for the strategy.

So, in addition to the usual update on the portfolio over the quarter, we are also going to share some important process enhancements that we have been working on over the last six months or so. We announced these formally to clients in the second half of November, but we've implemented them from the 1st of January 2025, and we want to share an update on that with you, our clients.

Svetlana, I'll bring you in here if I can. Perhaps you could just summarise really why we have looked to make enhancements now, but also what we have adjusted.

Svetlana Viteva (SV): Yes, after a very rigorous review that we did with the help of our investment risk team colleagues as well as other senior stakeholders from within Baillie Gifford, we announced and we have already implemented a number of enhancements to the strategy’s process.

Firstly, we are changing our investment decision-making structure and we are moving to a portfolio construction group in order to enhance a more transparent and a more collaborative decision-making process.

We are introducing a new portfolio construction framework based on the underlying financial maturity of the companies in which we invest. Financial maturity we've identified to be a key source of correlating risk for the strategy and we want to make sure we explicitly incorporate that in the decision-making process.

And lastly, we are strengthening our portfolio diversification guidelines just to make sure that we capture that breadth of opportunities from a different number of industries, geographies as well as stages of development.

BC: Okay so three adjustments, which is fair to say add kind of ballast and robustness to the process, but very much support and drive towards improving our execution of the stated philosophy, and that philosophy is remaining absolutely sacrosanct.

Now, you touched on implementation there, and as I said, these have been introduced formally from the 1st of January. And I know over the fourth quarter, the team was hard at work rebalancing the portfolio to be in accordance with these. Perhaps you could just touch on that process with a couple of highlights.

SV: Yes. So we've effectively finished that rebalancing exercise already. We've shifted around 10 per cent of the portfolio, which is quite significant in the context of the strategy. We have reduced our exposure to our two biggest industries, which is software and biotechnology.

At the same time, we have also reduced the amount of capital which is invested in those least financially established businesses. So, think of companies like Cellectis and Schrodinger. And we've used that capital and we've redeployed it into areas of the portfolio where we felt it can be put to good use. So, companies like Aehr Test Systems, E Ink and Infomart have all received additions during this process.

BC: Okay. So, that's the process enhancements. Maybe now switching attention to what you've observed from the portfolio over the quarter. And we'll start with the big-picture stuff. And I know it's been a busy quarter in markets with quite pronounced swings in sentiment over the quarter. Maybe you could just touch on that and then also discuss how the strategy has performed in that context.

SV: Yeah, the US market's initial reaction to the presidential elections was quite strong. I guess some of that enthusiasm more recently has been dampened with the comments of the chairman of the Federal Reserve about the potential quantum of future interest rate cuts.

Overall, our benchmark finished slightly lower this quarter and more broadly, small-cap markets lagged behind their large-cap peers. Against this context, the Discovery Strategy performed well. We finished notably ahead of the benchmark*, as many of our holding companies had operational progress and that was rewarded in share price terms.

*based on Global Discovery composite. Worldwide Discovery composite underperformed in absolute terms.

BC: So, good performance in a difficult backdrop prompted by operational kind of gains and improvements from the holdings. Maybe you could just highlight a couple of those for clients picking out a couple of notable successes.

SV: One of the stellar performance was Axon, which is posting really healthy results, continues to post very healthy results, growing its top line in excess of 30 per cent while at the same time it's improving its profitability.

The company is seeing a lot of success in markets outside of its core markets, so state, federal and international opportunities are materialising. We've been really excited about how quickly they have integrated artificial intelligence into their own product portfolio and are already monetizing that, leveraging what is a near monopoly position in tasers and body cameras.

There was good news coming from Novocure, which disclosed positive phase 3 trial data from their trial in inoperable pancreatic cancer, a devastating disease where the prognosis for patients continues to be very poor with five-year survival rates at about 10 per cent.

And last but not least, Zillow continues to make very strong progress towards building out a high-value-added service proposition for both home buyers and home sellers, and its newly launched products are gaining strong traction. The company has executed fantastically well in what's been a very difficult backdrop in the market and in light of the recent share price increase, we've reduced our holding size.

BC: Okay. So, now I know you said that in aggregate the portfolio is performing very well, but in any period there's holdings where the latest operational updates prompt more questions and answers. Are there any examples you would point to in the portfolio at the moment?

SV: There was weakness in the shares of our environment on concerns that the incoming administration is going to reduce or completely cut funding to Ukraine, and that's going to impact the short-term demand for the unmanned aerial systems, which our environment sells.

Ukraine, of course, was never a part of the investment case for us, and we remain very confident in the ability of the company to continue benefiting from increased defence spend in Europe, but also in other parts of the world that are seeing rising geopolitical tensions.

The other company where we saw relative share price weakness, TransMedics, a decline in the national transplantation market in the US in combination with a planned maintenance of their own aircraft, meant that they posted weaker than expected results and they have reset their expectations for growth this year. So it is one of the ones where we are doing a bit more work and doing a bit more thinking on.

BC: Okay. Now, we've already discussed a rebalancing exercise that took place within the portfolio, but I know within that there are a few holdings for which it precipitated a complete sale and it was also a bit of an opportunity for us to take some initial positions in companies. Are there examples that you would choose to highlight to clients at the moment?

SV: So we've sold two long-standing positions in the Discovery portfolio. We've sold the accounting software vendor Xero and we've sold the British animal genetics company Genus.

Xero shares have performed very strongly and growth prospects there are already priced in. With Genus, we don't challenge the quality of that technology, but we've been more concerned about the cyclicality and how the stock has been buffeted by the cyclicality in the end markets. We no longer have that conviction that the growth prospects for the company merit a place in the portfolio.

On the other side, we have purchased two new exciting positions. We've taken a holding in a company called Kornit Digital, which is a leader in the digital textile printing market. The textile industry and the garment industry, they are still relying on very manual, very labour-intensive and efficient, very polluting analogue processes.

And through its product innovation, Kornit has managed to close that gap between the analogue and the digital markets, both in terms of price and in terms of the quality of the product itself. So we're excited about an industry that can potentially be on the cusp of change.

The other new holding company called Xometry is an online marketplace which connects buyers of custom industrial parts with what is a very fragmented base of suppliers, machine shops which are specialising in different manufacturing technologies and Xometry is quickly becoming the go-to place for both the buyers and the sellers which makes us excited about the potential runway for growth and improved profitability when it comes to the stock.

BC: So, two fascinating new entrants into the portfolio and those two sales you've highlighted, those are two quite long-standing positions and Xero in particular is one of the strategy's best ever performing single investments. So, quite significant decisions there.

Now, going into a new year, you're always asked, what does the new year bring? What is to be expected from 2025? And perhaps unfairly, I'm going to put you on the spot. And I'm going to ask you, what's on your mind going into the new year? What's your opinion on the outlook for the strategy? And what are you thinking about?

SV: Well, in terms of macro, despite the revisions in the estimates of the interest rate cuts, an environment with gradually declining interest rates is going to be a helpful backdrop for this type of strategy.

Small-cap valuations continue to look very appealing. The average valuation of small companies is still well below historic norms and at a wide discount compared to large-cap peers.

More importantly for us, however, we are very reassured to see improving operational performance for the companies that we invest in. The outlook prospects for them are looking very strong for the coming year. We are seeing expected sales growth and expected earnings growth well ahead of the benchmark. So, quite a lot to be looking forward to in 2025.

BC: Good. Well, that's a really strong, encouraging message to finish on. With that, we'll just thank clients again for their continued trust and patience in the strategy. And we'll conclude today's update and say thank you and goodbye.

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Discovery (representing Global Discovery and Worldwide Discovery strategies)

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

	2020	2021	2022	2023	2024
Global Discovery Composite	83.4	-21.2	-42.6	1.4	-1.8
S&P Global Small Cap Index	16.2	15.3	-18.2	16.0	8.3
Worldwide Discovery Composite*	80.6	-22.3	-41.4	3.4	-2.2
MSCI ACWI Small Cap Index	16.8	16.5	-18.3	17.4	8.2

Annualised returns to 31 December 2024 (net%)

	1 year	5 years	10 years	Since inception
Global Discovery Composite	-1.8	-3.8	4.6	-
S&P Global Small Cap Index	8.3	6.6	7.4	-
Worldwide Discovery Composite*	-2.2	-3.6	-	4.1
MSCI ACWI Small Cap Index	8.2	7.2	-	7.4

*Inception date: 30 June 2017.

Source: Revolution, MSCI. US dollars. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite. 1 year figures are not annualised.

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