Baillie Gifford™

US Equity Growth
Q3 investment update

October 2023

Investment manager Tom Slater and investment specialist Ben James give an update on the US Equity Growth Strategy covering Q3 2023.

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

Ben James (BJ): Hello, I'm Ben James, an investment specialist on the US Equity Growth strategy at Baillie Gifford. I'm joined today by Tom Slater, head of US Equities and a partner at the firm. So, Tom, in the first half of the year, some optimism returned to the US market. We saw strong fundamental progress at a number of our holdings that was rewarded in their share prices.

In the last few months, though, fear seems to have returned, and there's an overwhelming focus, in the press at least, on the decisions that the Federal Reserve is going to make in terms of interest rates. So, market sentiment feels fragile. Some of our holdings haven't fared as well in the last few months [as] they did in the first six months. So, can I get your take on all this, please?

Tom Slater (TS): Yes. So, market sentiment will do what market sentiment will do. And I don't think that we will create value for our clients by trying to predict market sentiment. I don't think we will create value for our clients by predicting what the Fed is going to do. Because the economy is a complex system. It’s really, really difficult to get that right and to make money by getting that right.

So, we try to step away from thinking about that too much. I mean, it's always interesting to talk about, but it shouldn't inform your investment decisions, and instead focus on what's going on at companies. And what we've seen there is a lot of progress this year. You know, it was a really difficult environment last year. I think companies have woken up to the fact that they need to fundamentally rethink their strategy because you've got a different cost of capital, you've just got a different operating environment.

And then we've seen companies make significant progress down that path, whether that's taking out excess capacity, whether it's thinking about their cost base. And that adaptability is something that we prize very highly in the companies that we own.

BJ: So we're seeing that adaptability and efficiency sort of coming through in the in the companies at a portfolio level?

TS: Well, if you take the example of Amazon, which is one of our largest holdings, that business had to deal with a very challenging set of circumstances over the past three years. It had taken them 25 years to build out their distribution infrastructure then they doubled it in the next two years. It's sort of unprecedented for a business at that scale with hundreds of billions of dollars of sales to grow as fast as they did.

But when you do that, inevitably inefficiency creeps in. And so, we've seen ecommerce go from that accelerated position back to the long-run trend line of taking share from physical retail. And what Amazon have been faced with is trying to deal with “how do we drive efficiency that was so challenging in that period where everything was so frantic?”. And we've seen real progress now in Amazon's retail business and starting to drive capacity utilization, starting to drive up margin. And so that would be a tangible example.

Maybe a slightly different example would be a business like Shopify, which is an operating system for merchants. And in the environment that we were in a couple of years ago, they were moving further down the path towards doing delivery for their customers because that's what customers were demanding. That's a lower margin business. It's quite a different business. But to fulfil customer needs they were pushing down that path. But as they've seen the environment change, the cost of capital has changed, they've said, right, we need to focus, we need to move away from that strategy. Sold the assets. Focused back onto the core software business.

And to bring in another theme to this, part of the reason for doing that is that they just see the developments in AI, generative AI, as fundamentally changing the landscape. And if they're not absolutely focused on the core, if they don't have to really rethink, rewrite a lot of that software stack to take advantage of these new capabilities, they're going to be left behind.

This is unlikely to be a decade like the 2010s where you saw incremental technology gains. This is likely to be a decade where there [are] paradigm shifts in technology. And so being on your A-game, being focused, and that's why we like these businesses with founder-managers that can focus on product, that can adapt to that changing environment.

And so, again, the market might care, market sentiment might care about what's happening with interest rates and whether they're going to stay higher for longer. We’re much more focused on: can these companies adapt to this environment? What are we seeing? What are the changes? And there the news, I think, is really positive.

BJ: Okay, thanks, Tom. So on the positive side, then, some of the trading we've done over the last three months in the portfolio I think reflects that optimism. Are there any particular examples you want to pick out?

TS: Okay well, on the on the new purchases side, let's just stick with that AI point for a second. We've been adding to Amazon. That's partly about the efficiency in the retail business, but it's also their cloud services business ought to be a really big beneficiary of what's going on with AI. These systems are going to run on the cloud. People aren't going to do this in their own data centres. And Amazon have one of the strongest cloud positions.

But they also, if you think about the Alexa voice assistant, will get much better with this technology. And there are already 500 million endpoints out there that they can deploy this to. So I think that's a really big opportunity for them.

We've been adding to Meta Platforms, the owners of Facebook and Instagram. These are platforms where a huge amount of communication is happening. And if you can use, if businesses can use, generative AI to communicate with their customers, these are where their customers are. This is where these conversations are happening, the 2 billion-plus users on Facebook Messenger or on WhatsApp. And you've got a founder who's really tech-savvy, who understands the opportunity and is investing behind it. So they would fall into that category.

There's another set of additions we've been making, which are to businesses which have just been operating really well. I'll pick out Coursera as an example of that. Education is a market which is really slow to change, but the opportunity we've seen there is that they have this huge, engaged user base that you can bring into doing credentialing and courses. And actually, over the period that we've owned it, it's really executed on that. Now, the share price has been all over the place. But if you look at the underlying operational performance, it's really good.

The final category I would pull out would be new purchases. We've bought a Holding in Oddity, which is an online beauty business, a category in which- there is some online sales in beauty but the business model hasn't moved online.

And if you have an online business model, it's quite different. You don't start a product off in the promotional bins of your local Sephora and then try to do 'repeat' online. If you start online, you think about the business differently. It's about 'repeat'. It's not about what the new shiny thing is. And you need a different approach to merchandizing, a different approach to range. And then you need all the digital tools to engage with your customer, whether it's targeted advertising, whether it's tutorials on Instagram or YouTube. And it's how do you do all that in an online world? And they've shown with the Il Makiage brand that they can do this really successfully, and profitably, and then with the Spoiled Child brand, they've shown that they can repeat that success. So I think that's really exciting.

BJ: Can I just jump in on Oddity? It's a company we knew and invested in elsewhere when it was private. And for the last 18 months, the IPO market has been, it's been almost dead. But it had a successful IPO. Is there any signal we can take from that?

TS: Yes. Well, for us, investing in IPOs I think is really difficult if you don't know the business already. And therefore, knowing what's in the late stages of the venture capital pipelines, knowing those management teams, seeing what they do, seeing if they execute on their promises, is a really helpful input on if you're going to make a decision to buy something when it goes public.

As you say, there's really been very little coming to the market in the past 18 months. But I think there are some green shoots there, there have been a few transactions. And I don't think we're bouncing back to 2021 levels, but from a market that there's just been nothing happening, I think we're moving, you know, there is sufficient confidence that you can actually start to see some activity returning.

BJ: Great. Any other transactions you want to pick out?

TS: So, on the new buy side, Sprout Social, which is a platform for helping businesses manage their social media presence. I think the tools to do that just continue to grow in importance, and I think there's some dynamics in that industry which make this a really attractive point to be considering Sprout. At the same time, it's an environment where growth companies like that one have been really out of favour. So I think there's an interesting entry point.

And then I've talked about some of the additions, the purchases. What have we been funding that from? We've sold out of Illumina, which is the genomic sequencing machine business. And there there was still, I think, the opportunity in genomics is still huge, but we've seen that their execution has been below what we might have hoped over a significant period of time. That's brought in activists, you've seen a change in management and we don't think it's going to be that easy to bounce back from that. And when there are opportunities elsewhere, we've decided to move that capital.

We've also sold out of MarketAxess, which is [a] bond trading platform. We've owned this for nearly a decade, and the hypothesis has been around market share gains for digital platforms and in moving from more conventional ways of trading. And that's happened, but it's just been a much slower process than we thought, and that's been true across lots of different market environments. I think that process still happens over time. But when you think about the pace of growth and the scale of growth that we're looking for, I think it's just not quite lived up to what we hoped. And so again, sell it, deploy that capital to elsewhere in the portfolio.

And I'll maybe pick out a couple of others. We've reduced Shopify and Tesla. Now, we added to both of these businesses right at the end of last year. You've seen rebounds in the share prices over the first half of this year, you're talking about that positive market backdrop. So we've just taken back a bit of that capital that we added, again to deploy into some of these other opportunities.

BJ: Great. Thanks for that colour, Tom. So to summarize and finish up here, can I get your thoughts on, why now? Despite the headlines of negativity, why now, actually for us, we see this as a great time to be a long-term selective growth investor in the most innovative market in the world, the US?

TS: Well, I think in a way it's a result of some of the things you were talking about. You know, when you've got the market being driven by sort of sentiment about macro, you've seen the market move

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in a highly correlated fashion because you've seen valuations come down reflecting what's happened to long-term interest rates. There's not been a lot of discrimination. And at the same time, you've seen a small handful of really big companies that have driven all of the market return. And a number of those companies, to me at least, look really quite expensive. You know, take Apple, it's on a high twenties multiple of near-term earnings and there hasn't really been any significant growth in that business. People have valued the safety that it represents.

But I think as you see confidence sort of come back into the market, and you combine that with the fact that you have some really strong growth drivers, whether that's the transition in our energy model, and you've seen capital flowing really quite strongly into the semiconductor business in the US as a function of the IRA (the Inflation Reduction Act) and into carbon-free forms of energy generation, I think that will drive investment and confidence and opportunity.

We've touched on AI. I think that is a universal technology which offers this promise of bringing machine intelligence to all sorts of settings. Again, it's universal, there's going to be great businesses created on the back of that. It's going to require shifts in the paradigm of the way we do things, and that's generally generated new and exciting businesses.

And then healthcare continues to move on. And because of regulatory constraints, quite rightly, it moves at a slightly slower pace. But the technologies that are being deployed there are just so much more powerful than we've had in the past.

So, I think you have this environment where great new companies are being built, being created, and the starting point is a reset in valuations and a market that's myopically focused on a small number of issues, I think that's really exciting for long-term growth investors.

BJ: Brilliant, thanks, Tom. As we say around the desk, innovation carries on whatever the weather and provides opportunity for change and for long-term investment.

Thank you for watching and we look forward to updating you again soon. Thank you.

US Equity Growth

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

	2019	2020	2021	2022	2023
American Equities Composite	-9.3	109.8	30.1	-57.1	17.5
S&P 500	4.3	15.2	30.0	-15.5	21.6

Annualised returns to 30 September 2023 (net%)

	1 year	5 years	10 years
American Equities Composite	17.5	4.5	12.1
S&P 500	21.6	9.9	11.9

Source: Baillie Gifford & Co and S&P 500. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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