Baillie Gifford™

US Equity Growth
Q3 investment update

October 2024

Investment manager Tom Slater and investment specialist Ben James give an update on the US Equity Growth Strategy covering Q3 2024.

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Ben James (BJ): Hello, everyone. Welcome to this quarterly update from the US Growth Strategy at Baillie Gifford. I'm Ben James, an investment specialist director on the strategy, and I'm joined today by Tom Slater, partner at the firm and Head of the US Equity Growth Team. Welcome, Tom.

Tom Slater (TS): Thank you.

BJ: A quick reminder about the US Growth Strategy. We are a long-term active growth strategy aiming to find the exceptional growth companies in America, invest in them in a concentrated portfolio of 30 to 50 companies, and hold onto them for a very long time in order to capture the outsized power of the few outliers that tend to drive the majority of market returns.

So, Tom, I know we're stock pickers, we're not macroeconomists, but I'm going to start, with your forgiveness, on a couple of macro questions before we then focus on the portfolio, how it's been performing, and any notable trading that we've done over the last few months.

So, firstly, everybody seems to be talking about market concentration, Tom. This is when, over the last year or two, a handful of mega-cap tech companies in the US have driven most of the S&P 500's market return.

So, how do you think about that as a long-term active growth investor?

TS: Well, I think when you go through these periods, there's a temptation to say active management doesn't work. What's the point in having active management? And if you actually look at some context, in the past 10 years, you've seen the top 10 stocks in the S&P 500 really drive a lot of the

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return. NVIDIA, on its own, drove a third of the S&P return in the first half of this year. But actually, if you extend the timeframe to 50 years, 70 years, then that's not actually the case. In general, the largest stocks in the market have underperformed the broader index.

But when you go through these periods, it presents a real challenge for active managers. It's no surprise that 90 per cent of US active managers are behind the index over 10 years, given the environment that we've had, that generally, they're underweight in the largest stocks.

You've got to be careful about grouping these companies together. People talk about the Magnificent Seven. They're actually quite different stories. Microsoft, Apple were very big companies 10 years ago, but there were existential questions. I think they've been recategorized. They're now seen as safe, steady, reliable, cash-generative, dividend-paying, so they've been reappraised.

That's very different from NVIDIA or Tesla, which were plucky mid-caps 10 years ago. They were less than $10bn of market cap. And there, it's been driven by really phenomenal growth, coming to dominate their industries and being seen as companies with a big opportunity in AI. So, I think you take different lessons from that. But for us, we think you shouldn't succumb to the temptation in this environment to just own the biggest companies just because they've been doing well, because not only does that drive down your active share, but it means you lose, you join in that market phenomenon of focusing so narrowly when there are thousands of interesting companies out there.

BJ: So, our job is to focus on what could be the mega-caps of the next 10 years, you know, which are the Teslas and NVIDIAs today for, you know, 2035 or whatever?

TS: Yes, exactly. I mean, if you go back to that model about what's driven returns, well, it's stocks like NVIDIA and Tesla. It's identifying those companies early. That's where we can see that we've added value in the past, and that's absolutely our focus, rather than replicating a concentrated index.

BJ: Great. Thanks, Tom. So, a quick one then, and hopefully the final macro one, on interest rates. A lot of people have been asking us about this. The Federal Reserve recently made quite a large cut for the first time in a while to the US interest rate. How do you think about that, the Fed's policy, and how does it impact our US Growth portfolio?

TS: I'd like to challenge the concept that you need a particular environment for growth stocks to do well, certainly the growth that we're looking for. So, people tend to associate it with maybe loose monetary conditions or deregulation or globalisation or some external driver, macro driver. But if your task is to find those biggest companies of 10 years' time, actually, I think there is another factor which is much more important, and that's change.

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Change within the complex system of the global economy is what drives opportunity. It doesn't even have to be expansionary change or positive change. Take an example from earlier in my career of the Indian outsourcers, it was a really strong period in the late 90s that came to an abrupt end with the dot-com bust. Companies suddenly started thinking about, how do I do more with less? How do I earn a better return on my technology spend? It led to a decade of growth in the Indian outsourcing companies. Infosys grew its top-line 40 per cent per annum for a decade.

So, it's looking for where those big changes are coming. That's much more important for us than the impact of a rate cut.

BJ: Thanks, Tom. So onto the portfolio. This is a short time period. Our focus is 5-10 years. But over the last quarter, [the] last 12 months, in fact, since the start of 2023, our performance has been strong. We're ahead of the S&P 500 over this short time period. What's been driving this recovery, and your thoughts, please?

TS: Well, I don't think there's much at all that you can infer from such a short time period on the performance front. We think it's only over much longer time frames that evidence of skill becomes apparent. But I think if you look at the fundamentals of the companies, what we've seen is having had a shock in that post-Covid period, we've seen companies refocus.

So, in a slowing growth environment and in a much higher cost of capital environment, they've addressed their cost bases. We've seen much more prioritisation of expansion projects, much greater acceptance that they have to fund these projects for themselves. And so, we've seen much better alignment of cost and investment with growth.

And growth remains strong. We continue to see these companies doing really well. Not quite the levels they were at in 2020, ‘21, but still very strong growth. And so, it seems to me that they're in really quite a positive place right now: they’ve become more efficient; their margin potential now, as you continue to grow, seems much higher than it did two or three years ago. And I think that’s a really important contributor to what’s going on in stock markets.

BJ: So yes, we’ve seen the profitability of the portfolio after that 2022 period significantly increase, growth is very strong, and they’re also still reinvesting at several times the market rate for future growth. So I think that’s a really healthy position to be in.

TS: Yes, I think so, I think the companies have responded to the environment they’re in, and in the very low cost of capital environment, in [20]21/22, the market was telling them to invest in everything at the same time.

When capital actually has a cost, I think you run your business in quite a different way, and it’s been really encouraging to see the adaptability while still focusing on long-term growth opportunities.

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BJ: So quick one, the last minute, Tom, on trades. NVIDIA's been one of our strongest performing stocks over the last year, but we have made some reductions to it. Can you tell us about that and what we've been putting the money into, please?

TS: Yes, we've taken quite a sum of money out of NVIDIA since the start of the year, and it's really about what we're looking for in terms of returns. We focus on asymmetry, and what I mean by that is, stocks where you can make far more if you're right than you'll lose if you're wrong. And, just given the progress that NVIDIA has made, it's become one of the world's largest companies, as we look out over the next three or five years, it seems to us that there is a bit more of a symmetric potential set of outcomes now. I still believe AI becomes this general-purpose technology with huge application, but I think if that happens, it has to be low-cost. So what does that mean for NVIDIA's revenue base?

But we've also been finding lots of new and interesting ideas. We've recently bought The Ensign Group, and Shark Ninja, two very different businesses. One does the supply of skilled nursing facilities, the other is in small white goods for [the] consumer. And we think both have demonstrated significant advantages in those areas, both are early in their growth story, both – particularly the Ensign Group – addressing areas of unmet need and solving real problems for the system. And so, we're excited to redeploy capital into those companies.

BJ: Brilliant, thanks Tom. So, you've heard from Tom about the market concentration story, the Federal Reserve's interest rate policy, but actually what's really important is change. This portfolio, the US Equity Growth Strategy, addresses monumental change in society. The fundamentals are strong, profitability is excellent, and we're finding what we think are the mega-caps of the future.

Thanks for joining us on this update, we look forward to updating you in a few months' time. Until then, goodbye.

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US Equity Growth

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

	2020	2021	2022	2023	2024
American Equities Composite	109.8	30.1	-57.1	17.5	39.7
S&P 500 Index	15.1	30.0	-15.5	21.6	36.4

Annualised returns to 30 September 2024 (net%)

	1 year	5 years	10 years
American Equities Composite	39.7	14.0	14.8
S&P 500 Index	36.4	16.0	13.4

Source: Revolution, S&P. 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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