

International Smaller Companies Q2 investment update

July 2024

Investment manager Charlie Broughton and investment specialist Eoin Anderson give an update on the International Smaller Companies Strategy covering Q2 2024.

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Eoin Anderson (EA): Hi and welcome to the International Smaller Companies update for quarter two 2024. My name is Eoin Anderson, I'm an investment specialist on the strategy. I'm joined today by Charlie Broughton, one of the three portfolio managers who looks after the strategy. As a reminder, International Smaller Companies is a strategy which looks to invest in a broad portfolio of small, exciting and most importantly growing businesses from the international equity universe. Today, Charlie and I hope to cover performance, portfolio positioning and also touch a little on idea generation and how the team are feeling at the moment.

So starting at performance, before we go into portfolio specifics, stock specifics, is there anything at a market level that you would like to highlight?

Charlie Broughton (CB): Thanks Eoin. Yeah, I think broad context here is important. As you know, it's been a really tough couple of years to be a small cap growth investor. Unlike most economic recoveries, in this case, we've seen small caps lag their large cap peers, so much so they've given back a fair quantity of the ground they gained over the prior decade almost. It's too early to say anything for sure. But going into 2024, coming through 2024, I think we are seeing green shoots of recovery there. A number of factors behind this, I mean, at the forefront probably is the promise of looser monetary policy. But I think more important in terms of how we do this is, well, firstly, ongoing valuation discounts, record valuation discounts in some cases relative to large cap years. And even more importantly, operationally. The companies we own in the portfolio continue to deliver, they continue to execute their business plans and do what we'd want them to be doing so I think this probably has played a large part in seeing stronger performance over the period.

EA: Any themes that you would draw out from the stock specifics? It sounds like they're generally performing well but anything you'd like to highlight?

CB: Yeah, there are a couple of broad themes that played a part over the quarter for sure. The first one would be M&A. We had two holdings: video game outsourcer Keywords Studios, and German LinkedIn equivalent New Work, both of which were approached with acquisition bids to be taken private. This helps us short term. Longer term we are often more concerned here. As you know, when we build an investment case it tends to be for a five or ten-year period, so to see a business bought out a couple of years into that, we think that probably means our clients don't benefit from the full upside potential there. Much more positively, AI has definitely been a driving factor in the portfolio over the period. As you'll know, there's been a huge amount of hype in the area, particularly captured by NVIDIA's progress in the US. We're spoilt in that the international smaller company universe has just a huge depth of companies feeding into the semiconductor and the AI supply chain. And again, within the portfolio, looking at performance over the period, you'll see kind of strong contributions from businesses like Global UniChip or ASPEED, even our newer holding ViTrox, all of which feed directly into this, many of which supply NVIDIA directly.

Obviously, we don't expect this to all be smooth sailing, it'll be volatile, there's a lot of change, but we think it's really exciting that we have exposure to these kind of areas of growth. What I would say, I mean these are thematically important, again as you know, we are fundamentally bottom up stock pickers and for us we are looking at individual stocks delivering over long periods of time. Looking at some of the names that have done well over the period, it's great to see businesses like Xvivo Perfusion succeed. This is a Swedish business who make technology for organ transplants - it's no secret that this is one of the great unmet medical needs of today. Something like 90 per cent of people in need of a new organ don't get it, so it's not an exaggeration to say that Xvivo is literally saving lives. It's one of two companies in this area that they dominate the space, and I think it's really encouraging to see the market kind of realise both how good their technology is, but also how big this opportunity could be for them.

EA: On the less positive side, is there anything you would highlight there?

CB: Yeah. The past few months, frankly, the past few years, it's been hard being a small cap investor in Japan, particularly a growth small cap investor. The market has been through a number of cyclical macro changes that I think have created a real headwind. The Yen has fallen consistently for the past, well, for a long period of time now, hitting record lows just recently, actually. And this has meant that export companies have really benefited. These tend to not be where we find long-term growth opportunities. The capital has been flowing towards them. Equally, the Tokyo Stock Exchange has made a real effort to push companies to more shareholder-friendly behaviour. This has meant fixing balance sheets, returning cash to shareholders, all things which, again, draw capital into them, but don't tend to be where we think the long-term growth will come from. So good news is this should be cyclical. This should reverse long-term. We firmly believe there's companies that can grow their earnings and grow their cash flows over time that will generate shareholder returns. But it's meant that in the short term, we've had to spend quite a bit of time focused down on our Japanese holdings, making sure the fundamentals are in place, that they're doing what we want them to be doing.

EA: And maybe bringing us on, therefore, to portfolio activity, have these reviews resulted in any activity, particularly the Japanese holdings or anywhere else?

CB: Yeah. I mean, there have been some tough conversations. We've had a couple, I think, cosmetics business, Kitanotatsujin or food delivery company, Demae-Can. These were both companies which frankly hadn't delivered what we'd expected of them at this point. This wasn't just share price volatility. Operationally, they weren't doing what we thought they should be doing. In those cases, when the investment case has changed, we will reallocate capital. We sold those positions. The good news is, in other reviews, I think of businesses like JMDC. This is a Japanese aggregator of medical data. They help improve health outcomes in Japan by using data. Or Sansan, which is a super interesting business. They help Japanese companies manage their contacts, their client lists and their internal databases. In both cases we reviewed those businesses and they were ahead of what we wanted them to be despite the share price not reflecting that, so in those cases we built those positions.

EA: Anything else, any other activity, any other new purchases? I think you mentioned one earlier on when you were discussing AI.

CB: Yeah of course, we've had a number of new ideas competing for capital in the portfolio. One which we acted on this quarter was ViTrox. This is a really interesting business. As you probably know, semiconductors have only gotten smaller over the years, and they've hit the limit. There's only so much smaller they can get them. And what this has meant is that to progress, to create more advanced chips, you need to start doing more complex things. And for most fabs, this has meant stacking. This has meant layering chips on top of one another, which is great, works really well. Except traditionally, the way you survey chips for defects whilst you were making them was you used the camera, a high-resolution camera, to look for errors. That no longer works. Well, ViTrox are the leader in X-ray machines for semiconductor supply chains. So they will use an X-ray to look inside the chip and look for any problems. They were one of the first to develop this technology and they are by far the leader. They have a 30 per cent market share. What's really exciting is unlike some of their bigger, less focused competitors, they are reinvesting every penny they make into making that technology better and better. And we think this builds a really long term competitive edge for them. It's run by founders who still own 50 per cent of the business. They're determined to make Malaysia a semiconductor hub. It's a really interesting geographical position in that they are very agnostic to the big semiconductor powers. So for us, we think ViTrox stands a good chance of being the heart of a new Southeast Asian semiconductor ecosystem. So we're very excited about that one.

EA: So that hints at a very exciting theme and maybe broadening the theme out to idea generation more broadly. How's the team feeling? Are you finding lots of exciting ideas? Could you just give us a feel for that?

CB: Yeah, for sure. I mean, I think for any active manager, idea generation has to be at the heart of what they do. It's definitely my favourite part of the job. And I think even more so for international smaller companies, our universe has 20,000 companies in it. There's a lot of idea generation to do, and there's a big pool to fish in. So it really is a stock picker's dream. We've seen the ideas flowing, flowing thick and fast. I had a look the other day. I think we met 700 small caps in 2023, it was last year, and that cadence has continued. We've covered 40 plus different countries. There really is an exciting universe to hunt in. There's lots of signs that the market's continuing to grow. One really exciting thing we've seen in 2024 so far has been the return of growth small cap IPOs in Europe, where even a year ago, the thought of IPO'ing a growth company in Europe was just, it wasn't going to happen. And we've seen a few of them in the last few months. So this is really encouraging for us as it obviously renews and refills our universe of stocks to pick from. No, I think overall, we're really positive. We think we own an exceptional group of companies and we see no shortage of new ideas to compete with them for the portfolio.

EA: Thanks very much, Charlie. And I think that sums it up really well. Very excited about the portfolio. Lots of strong idea generation coming through. Lots to be optimistic about.

Thanks very much for joining us and we look forward to talking to you next quarter.

International Smaller Companies

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

	2020	2021	2022	2023	2024
International Smaller Companies Composite*	11.5	47.1	-38.7	18.5	-0.6
MSCI ACWI ex US Small Cap Index	-4.0	47.6	-22.1	11.5	11.8

Annualised returns to 30 June 2024 (net%)

	1 year	5 years	10 years	Since inception
International Smaller Companies Composite*	-0.6	3.4	N/A	4.2
MSCI ACWI ex US Small Cap Index	11.8	6.6	N/A	6.5

*Inception date: 28 February 2019.

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.

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