Baillie Gifford™

US Alpha
Q1 investment update

April 2024

Investment manager Michael Taylor and investment specialist Fraser Thomson give an update on the US Alpha Strategy covering Q1 2024.

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

Fraser Thomson (FT): Hello, and welcome to this update from our US Alpha strategy. I'm Fraser Thomson, one of our US Equities specialists, and I'm delighted to be joined by Mike Taylor, who is both the head of our US Alpha team and one of the strategy's three investment managers.

Mike, to kick us off, for those who are not familiar with US Alpha, what are its key features?

Michael Taylor (MT): Sure. Like any Baillie Gifford strategy, US Alpha is looking for businesses that can grow over the long term, because we believe it's that kind of business that drives stock market returns. In a Baillie Gifford context, however, US Alpha takes quite a broad view of what those growing businesses could look like.

So on the one hand, we have disruptive businesses that grow extremely quickly, that try to change the world and do often. You can think your Amazons and your Netflixes and so on. So we have that kind of company.

We also have businesses that grow at a more modest rate, but for a very long period of time. You can think of the Walt Disney company that's now 100 years old, etc. Or we look for businesses that grow in a cyclical fashion that might be up one year and down the next, but through the cycle grow quite powerfully.

There you can think of businesses like lithium miner Albemarle, the price of the commodity very high one year, a bit lower the next year, and that introduces cyclicality. So we're return seeking, we're looking for those growth businesses.

But it's also worth saying that we think by blending the different types of growth that might outperform at different times to one another, that creates a different volatility profile than a strategy that focuses only on one type.

So yes, return seeking, that volatility profile being a bit more muted as a result. And to support that, we've introduced a few guidelines around the strategy. So we have 60 to 90 holdings, relatively diverse in a Baillie Gifford context, a minimum number of sectors, maximum position sizes of 6 per cent or the index plus 3 per cent and so on. So that’s a brief overview for you.

FT: Okay, fantastic. So a deliberate blend of different growth styles into a relatively diversified portfolio. I guess that gives you more questions to answer from some perspectives from a broader economic or investment backdrop perspective.

We're settling into a higher interest rate environment than we've been used to previously, lots of geopolitical, global and domestic issues. How do you work your way through that when investing in a more diversified portfolio?

MT: So it's useful to bear that economic context in mind. So there are things to be positive about, employment in the United States is very good. We've seen reasonably strong wage growth, but it's also a mixed picture.

On the other hand, we've had quite strong inflation, like you referenced, geopolitical tensions seem to be rising. However, for us, it's important to acknowledge that economic growth or otherwise doesn't necessarily translate directly into company growth.

The question is, where does company growth come from? Well, for me, growth is a product of entrepreneurship or of innovation. And entrepreneurship and innovation didn't disappear because the 10-year yield hit 5 per cent last year. We think it's alive as well, as alive and well as it's ever been in the United States. So that gets us quite excited about growth prospects across all our different types of growing businesses across the next five or 10 years.

FT: Okay, understood. Returns have actually been quite strong in the absolute sense, both over the past quarter and the previous year or so, but they haven't quite kept up with the broader S&P 500 index. Any reflections on that?

MT: Yeah, I think that's fair to point that out. I think it's important to note that the index over recent history has been driven by a comparatively small number of very large businesses doing very well. The so-called Magnificent Seven, you can think of Apple and Microsoft and so on.

Now, we think many of those businesses are exceptional companies and we own a number of them. However, we've not owned them in quite the same amount as they are in the benchmark.

Now, you might say, well, you like those businesses, why don't you have a benchmark amount? It's important to note from our process, we don't start with the index as a means to build portfolios. We size positions based on the opportunities before that individual company and the range of outcomes it might experience, but also with reference to all the other things that we might invest in.

So, if we take a company like Microsoft, we think that's a really great business, and we want to invest in it, we think it will grow. But we're not going to take a position that's the same size as the index if it means we have to sacrifice investment opportunities elsewhere.

FT: Maybe teasing out one of those big positions in the index and in the portfolio as well, NVIDIA. So, we are at the beginning of an AI revolution. It's become quite a big part of your portfolio, but in the past quarter you have reduced the position considerably.

MT: That's right.

FT: What's the thinking there?

MT: So, NVIDIA, it's worth bearing in mind the Baillie Gifford context here. We've been involved with that company for quite a while, I think since 2016, and it's been in the US Alpha portfolio since we started it. We actually took the opportunity to add to NVIDIA in the autumn of 2022.

And if we think about that period, the company had experienced revenue decline. So, it had been involved in the cryptocurrency ecosystem and so on, and that had kind of come off the boil.

Expectations for the stock were not very high, but we could recognize a fantastic technology, an inspirational leadership team, and several potential opportunities to grow. Now, if we fast forward 18 months, one of those opportunities really has been seized.

The AI revolution, as you described it, is here, and we think that's real and exciting, and NVIDIA is going to be at the heart of it. However, the share price has moved significantly since we made that addition. It's been a very powerful performer, and we think the attention on NVIDIA means that the potential for us to have a differentiated view, whilst it's still there, it's a bit less than it was 18 months ago.

Now, as I mentioned in the previous answer, we'll always size positions in relation to how we think that stock will do, but also what else could we put the money in. So, we're excited about the artificial intelligence revolution, but how can we gain access to it?

NVIDIA is just one way. What else could we do? We recently initiated a position in a company called Duolingo. This is a language learning app. We think it's a magnificent business in many ways with an inspirational founder and the opportunity to grow revenues powerfully as it monetizes its user base.

We think artificial intelligence could have a profound impact for that company, and it's attracted a lot less attention than NVIDIA has received. What is that impact?

Well, when you're learning a language, what Duolingo has been very good at doing is gamifying the experience and getting people motivated and still using the app. What it's been less good at historically is the interaction with another language user.

What an artificially intelligent chatbot might be able to do over the next five years is give you the opportunity to practice your language in a sort of quasi-real way with that chatbot. We think it'll make the learning experience much better.

FT: Okay. So, I guess if NVIDIA is providing the foundations for AI, then Duolingo is one of the examples of how that actually comes to pass in day-to-day life. It's been quite an active period for trading overall for the portfolio to start the year.

So, it's far from restricted to just NVIDIA and Duolingo. Be interested to hear your thoughts on some of the other names you've been bringing into the portfolio or building up within the existing holdings.

MT: I mean, at the moment, we are finding great opportunities across all our different types of growth. There are a couple I'd like to highlight because they're an interesting or fun contrast. So, on the one hand, we started a position in a company called Enphase.

Now, Enphase sells solar energy solutions for the home. In particular, it focuses on microinverters. These are devices which convert solar energy into a form that's usable within your house.

Now, over time for investors, solar energy has been quite a difficult place to be. And it's been a difficult place to be because whilst demand has been strong, having a competitive advantage has proven difficult.

We think Enphase might be a rare example of a company in this realm that does have an advantage. And so, its market share of microinverters has gone from 20 per cent to 60 per cent. And we think that's because the technology is better and because it is focused on distribution, helping the people that install these devices.

Often, if you're an installer of solar equipment, you have to give a guarantee to the householder of something like 25 years. And Enphase's technology is very reliable. They help that installer give a guarantee that will last for the period of the warranty that they're giving their customer.

So, we think competitive advantage, pretty strong, big demand opportunity. At the same time, we've initiated a position in Canadian business Alimentation Couche-Tard. Now, this company runs gas stations, petrol stations.

Now, you might say energy transition, you clearly believe in it because of Enphase. Why would you go for that business? Well, in the long run, petrol stations, gas stations probably is not a growing business.

However, we think within it, a capital allocator like Couche-Tard will be a growth company. They have a profitable core operation and they redeploy the profits of that business into acquiring more gas stations often that are independently or family run.

They plug them, they acquire them for reasonable multiples. They plug them into the Couche-Tard ecosystem and raise their profitability. And by doing that, over the last 10 years, they've been able to grow earnings per share in the region of 20 per cent a year, which is really very powerful.

Expectations are not high for Couche-Tard, but we think the growth engine is intact. So, two new, somewhat contrasting positions within the portfolio. And that's one of the things I love about US Alpha, that we can find growth wherever it is, whatever it looks like.

I'd also like to highlight a couple of additions we've made. We've added to our positions in the portfolio of Nike and Estee Lauder. These are branded goods companies. We think the brands are really strong. They have credible strategies to increase their profitability.

However, in the short term, their share prices have sold off because of trouble in the Chinese market. Now, we don't have time to get into the Chinese economy. There's some turbulence in the short term. We're convinced in the long run; Chinese consumer will be a growth area.

These businesses have great exposure, so we want to build up our position while valuations are attractive and hold it, experience that growth over the next decade.

FT: Great. So, a real variety of ideas coming into the portfolio. Now, I know you will say you're excited about all of the names that you own in the portfolio, but if we could push a little bit on particular areas of excitement or areas of focus for work for the rest of the year, what would you draw out?

MT: Well, I'm excited by all of the portfolio, Fraser. We actually think it's an unusually exciting period for all the different types of growth. Disruption is as powerful as it's ever been.

Valuations for steadier businesses can be quite attractive and capital allocators can move money attractively at the moment because valuations have come off.

However, if I had to highlight one area, I would go for certain parts of the healthcare sector. Now, we're always looking for long-term growth, but if you can purchase growing businesses at a time of short-term dislocation and turbulence that has led to an attractive share price entry point, then that really gets me excited.

Now, the area I'd like to highlight is companies exposed to the impact of GLP-1 drugs where undue pessimism has developed.

So, GLP-1s are drugs which combat obesity, they help their users lose weight. And that's going to be a profound change as these drugs are rolled out and it will impact many companies, but not all.

So, we have initiated a position in a business called Insulet. They make insulin pumps for diabetics. Now, the thinking in the market seems to be GLP-1s mean fewer obese people, means a slower growth in the diabetic market. And that's probably true over time for type 2 diabetes, potentially.

However, Insulet sells pumps primarily for type 1 diabetics and that is a genetic condition. It is not related to lifestyle choices. So, we think there's a great growth opportunity over time as pumps take share from pens and syringes from insulin as they grow internationally.

And at the moment, I can see a share price that has sold off quite significantly on fears that we don't think are relevant. So, great growth business, attractive share price, and an entry opportunity, I find very exciting.

FT: Fantastic. Well, I'm afraid we're up on time, Mike, but thank you very much for your insights. I hope that's given you a view of the breadth of opportunity that we're uncovering at the moment in US Alpha.

If you'd like to find out more, then please head to the company website, bailliegifford.com and look up US Alpha's strategy page. Or alternatively, contact your regular Baillie Gifford contact who will be happy to continue the conversation with you. But until next time, thank you and goodbye.

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US Alpha

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

	2020	2021	2022	2023	2024
US Alpha Composite*	N/A	N/A	N/A	N/A	23.6
S&P 500 Index	N/A	N/A	N/A	N/A	29.9

Annualised returns to 31 March 2024 (net%)

	1 year	5 years	10 years	Since inception
US Alpha Composite*	23.6	N/A	N/A	24.9
S&P 500 Index	29.9	N/A	N/A	30.6

*Inception date: 31 December 2022.

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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