Baillie Gifford™

International All Cap
Q1 investment update

April 2024

Investment manager Joe Faraday and investment specialist Richard Gall give an update on the ACWI ex US All Cap, EAFE Plus All Cap and Developed EAFE All Cap strategies covering Q1 2024.

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Richard Gall (RG): Hi everyone and welcome to the Quarter 1, 2024 International All Cap Strategy update. This is a long running strategy – well in excess of 30 years, and throughout that time our aim has remained largely unchanged – to deliver attractive returns through a diversified portfolio of what we believe, are the best international companies out there.

Quick introductions just before we get started. My name is Richard Gall. I'm an investment specialist and a client director on this strategy, and I'm joined today by Joe Faraday, who's actually the longest running, the longest standing, member of the Portfolio Construction Group, who I think joined, keep me right Joe, in 2007. Joe has recently set up a dedicated central desk for the strategy alongside Iain Campbell, and that's probably a topic we'll come back to later on in our discussion.

But today the plan really is to cover what has been undoubtedly a tougher period of performance for the strategy. In spite of that, we've been broadly encouraged by the growth we're actually seeing at a company level across the portfolio, our idea generation, which I think it's fair to say, has remained robust. And then we'll close by talking about whether there are genuine reasons to be enthusiastic about the portfolio's performance from here, and I think that's a good place to bring Joe in. And perhaps, Joe, could you start by sharing some of your reflections on maybe the broader investment environment over the more recent past. That sounds like a sensible place to start today, Joe.

Joe Faraday (JF): Well, thank you, Richard, and good day, everyone.

I think as we, the Portfolio Construction Group, look out across the world, it's quite fair to comment that, look, clearly 2024 is going to be this big year for elections. You've got about half of the world by population voting, and that means politics or geopolitics are going to really remain at the fore. I think it's also really important to cite that growth really is firmly on the agenda. You've got expectations out there that global GDP will be three to three and a half percent in the next few years, and clearly that usual mix of Japan, Europe and UK being a little bit lower, and EM being a fair bit faster. And then all eyes for everybody out there is on inflation rolling off.

We're seeing that, sure, at a company level, and central banks being poised to bring down rates, but we'd cite or safeguard that the pace of that is unknown, and that could take some quite considered time. Now I think what's actually more important for us is the insight that we see and hear, and also we were trying to exploit from the companies across the opportunity set and that we're trying to invest in on your behalf, and having that ownership mindset to how we about invest for you over the long term.

So I want to share what we're seeing and hearing from all the different companies and do a whistle-stop tour of the world. And we'll start in Japan. Iain was out there in early March again. Quite simply, Japan is cheap. You can eat out for 10 bucks. Tourism is coming back. The consumer is coming back almost in a vengeance. That's great to see. You've got the Tokyo Stock Exchange shape up or ship out policies, gaining traction. That's got teeth. The tone for all the companies in which we're invested in is for strong demand. And I think it'd be remiss to say that, sure, real GDP in Japan is only running at about 1 per cent, but nominal GDP is running at 7 per cent. And actually, both of those are pretty much near record highs. So there's lots of growth and excitement that we're seeing from across wider Japan and the companies that we're invested in there for you.

If I jump across to emerging markets more widely, Alex has been in Taiwan, kicking the tires and thinking about a lot of the technology and industrial companies there, some of the semiconductor ones in particular. And that's important where we have direct exposure there, but also the read across more widely for the likes of the Japanese and European industrials and companies that benefit from the supply chain or the competitive landscape or how they're all going to fare longer term. So that's been invaluable and helpful. We've met with and considered quite a few Latin American businesses. There's a new purchase I'll come on to later, but speaking to that management team was absolutely key, giving us the confidence to take that holding. And we met Raia Drogasil, quite a longstanding holding the pharmacy chain and hearing the family member there talk about the returns remaining high and ongoing commitment to store our apps was great to see and hear. And I should probably also mention India, strong growth continuing there. Alex and I spent some good time there at the tail end of last year. A few other colleagues have been out visiting, thinking about companies and we're seeing growth and it's about calibrating that with valuation levels.

The last area and also it's absolutely key is UK and Europe. Generalization would be that top line growth is a little bit soft across the board. Profits coming through that bit more strongly. One example of really a deep dive research or getting underneath the skin of companies would be Milena spending the whole day with Autotrader in Manchester. So Nathan, the CEO, Catherine, the CEO, a whole raft of the management team and really deepening our understanding of that business. We've owned it for a decade, but let's make sure we want to own this for the next decade and beyond as well. And I think the last general comment, and this is for UK, Europe, but actually across the portfolio is that we think considering the growth that we're seeing or uncovering is that valuations look really compelling at this point.

RG: Thanks, Joe.

A lot of really interesting stock specific information in there. But can we take it up a level for a moment and think about the portfolio performance over the past quarter? And there's been strong absolute performance from the portfolio, but the relative performance has been weaker.

Would you mind just honing in on some of the main drivers of that relative performance?

JF: Yeah, sure. So relative performance is a little bit soft to somewhat behind depending on variant and benchmark on the strategy. So I'll cite three headwinds, Japan, China, the consumer stocks very widely.

So Japan is a combination of what we have in the portfolio and also don't have. There's been some weakness for some of the consumer-orientated businesses, certainly those that are exporting from Japan into the likes of China. So Unicharm would be one such example there. But another quite key factor on Japan is also what we don't own in the market. I mentioned earlier that Tokyo Stock Exchange shape up or ship out policy. That's really impacted large value segments of the wider index. Clearly, we have no to low exposure in those types of companies. But those have been doing exceptionally well at these times. And the hope here or the long-term aim is that that becomes more pervasive. And there is this broad, encouraging backdrop for a large number of much wider range of company and the holdings that we have in Japan.

The second one would be China. Geopolitics is really at the fore. There's been a savage derating of domestic Chinese holdings and also those have indirect exposure into China. We feel we're seeing PE multiples for businesses in China now actually on par with what you'd see as price-to-book multiples for US counterparts. So there's definitely value there. But it's about having conviction in the growth, the treatment of minorities, the edge, the durability of companies we're spending ever more time considering.

And then the last comment on the detractors around the consumer complex and what's quite interesting there, it's the staples and discretionary companies. So in staples, there's the likes of Jeronimo Martins, the discount food retailer that's seen a softening in growth, inflation rolling off and a bit more competition. But we're committed to that in terms of long-term growth, deployment of capital. We're excited what we're seeing in that company. And then the other end, luxury goods companies, these are on really low multiples compared to their histories. But again, we're stopping and thinking through those very carefully. They're strong and enduring brands, but making sure that there's that resolve and that they can perform and their growth does show and shine through.

Let's just turn to some of the positives very briefly. The three factors there I would cite would be AI, semis, and some of the healthcare-orientated businesses. In AI, semis, we'd cite Tokyo Electron. In online, quite a wide range, the likes of Spotify, music streaming, Adyen, payment platform, train line and train ticketing in the UK. And there's a combination of top line growth and also profitability coming through for those businesses. And then in healthcare, it's worth us citing Lonza. That was quite a notable detractor in the latter parts of last year, but that's really come through. We spent some key time with management there. They're expanding capacity. Capex to sales is running 30 per cent. They're doing acquisitions. It's great to see that business coming through. So a wide range there across the detractors and some notable positives to really be citing as well.

RG: Okay, thanks for that, Joe.

One of the areas we talk a lot about within Baillie Gifford, more broadly even, is about the importance of operational progress and operational performance. But I imagine there's degrees of variance within that. I mean, thinking about the portfolio as it stands, can you talk a little bit about that and to whatever extent it's possible, could you group that into where companies are exceeding expectations, where they're doing what we want them to do, and then perhaps there's ones which are lagging.

JF: Yeah, sure.

So on that count, those bands haven't really changed in proportions. I frame it as a quarter, a half, a quarter ahead, tracking in line, and lagging. And what is really important, that's against our expectations. We're not talking about compared to consensus. We're talking about compared to where we expect these companies to track in order to deliver strong outperformance from them. Let's just pick on a few examples that are well ahead of expectations would be Games Workshop, the Warhammer figurines business, Nemetschek, the building construction design software business, really strong top line, strong margin profiles from those companies. So that's really good to see in that continuing tracking in line.

Two examples there would be Reliance Industries, the Indian Petrochem Telecoms retail group, again, deploying lots of capital, but we'd like to see them execute a little harder, faster there, and profitability to start coming through. Spotify, seeing strong growth and profitability come through, but can they ratchet that even a bit more higher than what we're expecting would be even more encouraging to see. And then in the tougher times grouping, I think I'd club in this a couple of the health care businesses, Mettler Toledo, and Sartorius in lab equipment, biopharma equipment. They've seen that Covid roll off, but growth is still being quite somewhat lacklustre. We'd like that to resume or pick up. And then a couple of Japanese companies, Shimano and Olympus, have seen soft or soggy end market demand. It's about getting that resumption of the growth rates there. So with the ones in that latter category, it's testing that resolve, ensuring that they will execute and that growth or the quality will show through longer term, and scrutinizing that to ensure that will be very much the case.

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RG: Sure. And it's very clearly one aspect of the strategy which remains undented is that of idea generation. There have been some new purchases over the quarter. I wonder if you'd possibly talk us through those new purchases and help us to understand the opportunity that we are seeing that perhaps others are not seeing as clearly. And I suppose the one that sticks in my mind is Unilever, given that has been a past holding until, I think, 2017.

JF: Yes, so Unilever is a great example. A comparison with back then - we're now buying this on a lower valuation multiple. And we think the fundamentals are way more attractive than when we sold it back in 2017. So we will return to holdings if we think there's an opportunity to do so. But it's got to be a combination of valuation and competence and the growth for quality of the business. Unilever, we think there's really strong structural growth from emerging market frontier consumption. It's a brilliant way of getting exposure into that. We think the financials are exemplary, the returns, the free cash generation. If anything, we'd love to see them deploy even more capital into that ongoing flywheel of high returns. And then also quite key is there's quite a new CEO who's pushing on accelerating growth and right-sizing the group in some ways. And there's some early encouraging developments that he's already pushing through on that count. So Unilever, the case of it's that growth, the quality of the business, alignment from management, and how well this business could do over the next five, 10 years, the reason for me taking a position there.

There's been a few other new purchases. But I think the other one I'll cite is a company by the name of B3. And the B, you can think of it standing for Brazil. And the three stands for the fact it actually has three exchange businesses. It's got dominant positions across basically cash equities, fixed income, and derivatives. And it's actually a real special combination of those. Normally those are owned by different parties in quite a lot of other markets around the world. We've done a huge amount of work on stock exchanges the past year. These are really high quality businesses in terms of the margin profile, returns, cash flow. And in Brazil in particular, we're becoming ever more upbeat on the rise of the middle class there, as well as its exposure and some confidence around what the long-term market outlook would be for some of the commodity complex. And so what levels of growth could endure, and then what you could get from the exchange business from the ongoing rise of the Brazilian economy or Brazil Inc.

RG: Okay, thanks, Joe. And there were also some sales and some reductions.

JF: Yeah, so there's healthy competition of space in the portfolio on the sales. We let go of Kao and Sugi to Japanese companies who are concerned around execution there. Coupang was sold primarily on the concern around what the likely long-term level of profitability and also the capital allocation that's been happening within that business and what that could mean for long-term returns. And then the other notable sale would be Adidas, which has been out for over a decade, and that was primarily on valuation grounds. So letting go of certain businesses, making way for those that we think are far more attractive bringing through into the portfolio.

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RG: Okay, thank you very much.

And I guess stepping away from the portfolio just for a moment, I mentioned at the start of the call that there have been some enhancements to the overall process and the strategy, for example, the central desk, which you and Ian have set up. Can you say a bit more about that?

JF: Sure, so the core aims of enhancing the strategy by having the central desk is for complementary research, portfolio construction, and portfolio monitoring purposes. It's early days, we're only a month or so in, but idea generation is really strong across the board, but that ability to do that complementary research as well in addition to what the other four members of the PCG are bringing through. And myself personally, I've done some deep dive work on a couple of additional UK names. We've been debating those and we'll see where they come through into the portfolio. Doing some added work on various emerging market financials, so the Brazilian exchanges, the recent purchase, are quite a good example of that. Also doing some work on some of the banks across emerging economies and a further area would be Canadian industrials. So lots of work going on in that complementary research area.

In terms of the construction and monitoring aspects, we're working ever more closely with our dedicated risk analyst, James Taylor. We have our deep dive quarterly risk review there was even more rigor to that this prior quarter. And Iain and myself were spending that much more time thinking about the importance of idiosyncratic stock-specific risk and making sure we're really aware on top of, comfortable with where there's sector country or thematic exposures showing through in terms of the portfolio.

And I think the other comment I just want to make in terms of enhancements, we obviously had Alex Summers. formally joined the start of March. We worked with him since last summer, but him getting up and running, adding to the debate, having that additional pairs of eyes, his penchant for more quality, aligned management teams and what that also bodes well for the names you bring through into the portfolio or how we think about that for the existing holdings as well.

RG: Great. Well, I know this is perhaps a predictable question to end on, but it's also a suitable one, I think. I mean, could you share some of your thoughts around your and the rest of the team's outlook from here, Joe, and maybe share some of or highlight some of the areas that make you feel most excited?

JF: Yeah, so three areas, ongoing advancements in technology. So the semis demand and that becoming more pervasive. So it's not just AI and data centres. This is about it sparring onto autos, industrials, automation and becoming much more wide. So that is a structural 5, 10 plus year growth driver.

The second one is I've talked long about this now for the last year or two, and I think it's gaining more traction is capital deployers and capturing with that the trends in reshoring, the energy transition, decarbonization, electrification. And quite simply, you just need a lot more industrial kit in a lot more places.

And then the third would be along the lines as we discussed earlier with Unilever, but emerging market and frontier market consumption and the ability to get direct and indirect exposure into that.

So those would be three areas, but I think unified with that is the opportunities, but it's also the holdings in the portfolio and fundamentally how we think current valuations just aren't capturing the full growth potential or the quality of the underlying holdings right across the portfolio.

RG: Great, Joe, and thanks a lot for your time today.

So I suppose pulling that together and peeling back the portfolio here, we've got a genuinely eclectic mix of what we believe are genuinely world-class businesses. We can see growth for years across these underlying companies. And importantly, that growth is balanced with quality and it's balanced with resilience. And the final point Joe made is a very, very important one - that the current valuations of the companies in your portfolio are not capturing the full potential that we see. So I think it's fair and it's right to feel optimistic about the future from this point.

And in an attempt to end on that optimistic note, thank you very much for listening today and I hope you enjoyed and found the update and we look forward to updating you again soon.

International All Cap (including ACWI ex US All Cap, EAFE Plus All Cap and Developed EAFE All Cap strategies)

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

	2020	2021	2022	2023	2024
ACWI ex US All Cap Composite	-5.7	66.6	-16.4	-7.9	3.9
MSCI ACWI ex US Index	-15.1	50.0	-1.0	-4.6	13.8
EAFE Plus All Cap Composite	-6.8	60.7	-15.6	-6.4	2.4
Developed EAFE All Cap Composite	-6.5	61.5	-13.9	-7.4	2.3
MSCI EAFE Index	-13.9	45.2	1.6	-0.9	15.9

Annualised returns to 31 March 2024 (net%)

	1 year	5 years	10 years
ACWI ex US All Cap Composite	3.9	4.7	4.2
MSCI ACWI ex US Index	13.8	6.5	4.7
EAFE Plus All Cap Composite	2.4	3.9	3.7
Developed EAFE All Cap Composite	2.3	4.3	3.7
MSCI EAFE Index	15.9	7.9	5.3

The International All Cap Strategy comprises three distinct variants. Overall, the variants are broadly similar, with the key difference being the degree of exposure to emerging markets listed holdings.

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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