

Global Alpha: a conversation with the portfolio managers

October 2023

A discussion with portfolio managers Malcolm MacColl and Helen Xiong about what's been happening in markets, portfolio positioning and the current opportunity set.

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

Jon Henry (JH): Hello, and welcome to this Global Alpha Webinar. Thank you very much indeed for joining us. My name is Jon Henry. I'm a Director in Baillie Gifford's Clients Department. Now, of course, were it not for the planned rail strikes in London, we would've been welcoming some of you to our forum, which we were really disappointed to have to postpone. But rest assured that we will be rescheduling this event for early next year, so please do look out for your invite from your regular Baillie Gifford contact.

However, every cloud has a silver lining, and we know that we have clients gathered from right around the world, so we're delighted to welcome you all to our webinar this afternoon. Now, from Baillie Gifford, we have Malcolm MacColl and Helen Xiong, two of your portfolio managers in the Global Alpha [Strategy], and we also have Ben Drury, who is a fellow Director in Baillie Gifford's Clients Department, with whom some of you may be familiar.

So we have around an hour for the webinar. So for the first half or so, we thought we'd chat to Malcolm and Helen a little around what's been happening in markets, the portfolio positioning, and importantly, what opportunities we're seeing for you as we look forward.

And then for the latter 20 to 30 minutes, that's where we need your input. So please use the Q&A function at the bottom of your screens, and please type your questions into the text box and hit submit. These will then feed through to Ben, who will put these questions to the portfolio managers.

This is really your opportunity to ask questions of the portfolio managers. Now, if we don't get to all of the questions, our apologies. We'll do our very best to follow up with you in terms of response to your query. So with that, I think it's time to crack on.

Malcolm, welcome. The operating environment for companies over the last three years or so has been volatile, to say the least, of course initially starting back in early 2020 with the onset of the pandemic, and

latterly seeing the second-order effects of that, if you like, with regards to rising levels of inflation and interest rates and markets across the world.

This appears to have driven volatility at various points. Indeed, the latest quarter, it would appear that markets have continued to take direction from interest rates or otherwise. The portfolio, year to date, looks to be a number of percentage points behind the index to the end of September. So taking a step back, what do you make of the recent environment? And in your views, is the macro continuing to dominate the direction of share prices?

Malcolm MacColl (MM): Yes, thanks, John, and welcome, everybody, and thank you very much indeed for your time. And I think you're absolutely right. This is, to my mind, a continuation of the macro dominating the market narrative, with shifts in interest rate expectations being the critical variable that people are watching.

So clearly, higher rates have had a big impact on valuations, particularly for growth assets, and that's been difficult for ourselves as both investors and we appreciate it's been a very tough time for our underlying clients. And that's something that I'm acutely aware of. However, we remain very pleased with the operating performance of much of the portfolio. And it's highlighted that the relative growth statistics for the fund right now actually look very good indeed.

So if I just look at one number in particular, the three-year forward sales growth number that we have projected for the clients' underlying holdings, it's roughly three times the market average, and yet the valuations that we're paying for stocks just now are roughly in line with longer-term histories.

So for me, this is a period which is difficult, but the macro dominance will eventually fade. We've seen a reset, very significant reset in valuations, particularly of growth companies. So for me, that means that things are looking extremely interesting in a longer-term view. But equally, knowing when this period of markets being driven by the macro is going to fade, that's difficult to call.

JH: And Malcolm, if we can zoom out slightly and look at how potentially a higher rate environment affects how we manage the portfolio or otherwise, and then perhaps just a leg on from that, how might a rate environment where we've got higher rates for longer affect our view of growth?

MM: Well, probably the first thing to say, John, is that from a fundamental perspective, we don't have companies within the portfolio which have significant problems with indebtedness. Indeed, our companies on average have got very strong balance sheets. So we think of our businesses as being in pretty good health, and they have the ability to self-fund their future growth. These are things that we'll return to later on through other questions perhaps.

But the interest payments from companies, or the interest payments that companies are having to make, that's not the problem here. It's again been one much more of valuations being dominated by the rate

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environment more broadly. And I think the question for ourselves is actually one now of unearthing the correct businesses, the businesses with the potential to grow beyond current expectations.

And that's the thing that we need to be focusing our efforts on from a bottom-up perspective, is on unearthing the next set of growth companies, the growth companies of the future. It's retaining a clear mind but also a flexible mind in terms of where that growth is going to come from. And I think that perhaps through questions again later, we might be able to explain some of the new seams of growth that we're finding.

So for myself, the interest rate environment, yes, that does matter, but it's not really hurting us from a bottom-up perspective. And ultimately, I'm a big believer that the vast majority of wealth creation actually comes from compound growth. That's the more important thing here, if we have got patient time horizons.

And that's the thing that we need to be focusing our efforts on. It's on those businesses which can produce that compound growth over a five-, seven-, ten-year time horizon. And ultimately, that will dominate the outcomes for individual companies and the broader portfolio.

JH: Thanks, Malcolm. Welcome, Helen. I think I'll just pick up then on some of Malcolm's points there with regards to perhaps trading on the portfolio. If a period of rapid rate and inflation increases have potentially brought about maybe dislocations and opportunities in markets, what have we been doing at a portfolio level in terms of opportunities, and which way are we tilting the portfolio at the moment?

Helen Xiong (HX): Great. Well, thank you, John, and thank you all for being with us today. I think you hit the nail on the head with the dislocation at the moment. Volatility is not always a bad thing for us. Short-term volatility can be beneficial to the long-term investor. If you have a company whose share price often deviates from what you perceive to be a fair price, volatility gives us the opportunity to buy that company at a price below it, and sell it at a price above it. What we want to do is really put ourselves in a position to benefit from it, take advantage from it.

And I remember at the conference last year, we spoke about how we're getting our shopping lists ready. Well, we've done a lot of trading on the back of that, and we have been taking advantage of some of the more uncertain macroeconomic conditions to make some portfolio changes.

So to give you a brief update, you've probably all heard us talk a lot about semiconductor companies. We've spoken about how some of the semiconductor companies are going through a cycle, driven by excess inventory. But fundamentally, these are all great businesses. So in the last year, we've bought companies such as NVIDIA, AMD, Samsung, Integris, ASM International. Those are all new holdings, and those on top of our existing holdings like Analog, TSMC and Teradyne.

You've also heard us talk about infrastructure and housing. That's another cyclical opportunity. We've purchased companies like Comfort Systems, Advanced Drainage Systems, Eaton, POOLCORP, Floor &

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Decor. All of those are more recent buys. And we've also topped up on some of the disruptive [growth companies] where the operational delivery continues to impress but where share price has perhaps lagged a bit, so companies like Mercado Libre, Trade Desk, DoorDash, etc.

I think on the other side, on the funding side, that's really come out of some of the compounder names, where valuations have held up a little bit better, where we've felt that the growth wasn't compelling enough for the value that they were trading at. So we've taken a little bit of money out of some of those names, and in some cases, we've sold completely.

So here, we're talking about companies like Axon, Booking.com, Pono, AJ Gallagher, etc. So hopefully, what we've done is to increase the long-term growth potential of the portfolio without necessarily increasing the valuation. And as it currently stands, we have a fairly balanced portfolio between the three growth profiles.

JH: Great. Thanks, Helen. Malcolm, I think one of the things that, within the mix of the portfolio, we've been getting a number of questions from our clients on relates to what the portfolio's considered exposure is in an environment where perhaps the consumer might be looking to tighten their belt. Could you perhaps give us a flavour of what the exposure there looks like and how we think about the growth prospects for these types of companies at this point in the cycle, if you like?

MM: Yes, John. So across the portfolio, I think consumer-facing businesses may be 15 per cent or so of the portfolio. In some regards, that might sound like quite a significant number, but we need to remember that that's spread across a lot of different types of businesses. It would include the likes of the ecommerce giants Amazon and Mercado Libre. It would include the Cartier owner, Richemont. It would include the food delivery business, DoorDash, in the US.

And whilst there is an element of consumer demand being important for all of these companies, in each of the cases, we believe that these are very, very strong franchises with secular growth opportunities, with great management teams able to deliver for the future.

In all of these instances, we think that the earnings power, the future profit generation power, the wealth creation power of these companies is building over time, and that's why we're happy to own them in different sets of economic circumstances. In fact, we think that some of them, the likes of Mercado Libre and DoorDash, are actually taking advantage of some of the dislocations in markets right now.

I'd say that we're also very conscious of where perhaps the market expectations are a little elevated relative to current demand trends and where we think that things could sour. So for instance, Helen mentioned a moment ago that we'd taken money out of and sold our holding completely, in fact, in Booking.com, the travel agency business, the online travel agency business.

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That's because we felt that people were extrapolating, or the market was extrapolating good times, and the valuation had actually stepped up very significantly from when we bought that company during the pandemic time, when people were more fearful.

But equally, my attitude just now is one of being on the front foot. It's one of trying to find new opportunities closer to the consumer, where people are fearful. It's one of finding the very best franchise businesses of the future and getting them, effectively, at low valuations, where you're able to buy them, to my mind, on the cheap, when they're really being gifted to you by the market.

Helen mentioned the likes of Floor & Decor, which we think is an absolute category killer within the flooring market, in the retail flooring market within the United States, also POOLCORP, which is a swimming pool servicing company within the United States, a fantastic business, very high profitability business over the course of many cycles. These are the types of assets we're going after, and as Helen says, we've got a shopping list there, but we're trying to be very disciplined about the prices that we're paying to get involved in these companies.

JH: Thanks, Malcolm. I think that the consumer is one element of the opportunity in China. And Helen, we've had a consistent, and understandably so, interest in what the portfolio's exposure to China is. How we're thinking about the opportunity, moving forward. Direct Chinese exposure in the portfolio is relatively modest, around 3 per cent or so. It's slightly more on an indirect basis with companies that generate a significant proportion of their revenues from that market.

Would you be able to give us a little bit of colour on how we see or what we see as the most important developments recently in China, and then what our appetite is for opportunities there as we look forward?

HX: Yes, sure. So I think it's fair to say that investing in China has become harder, because you have all of the geopolitical tensions and rising geopolitical tensions, which we think isn't going to go away anytime soon. And on top of that, you've got the fundamental policy changes that are happening in China right now. And those are all really complex risks that we need to factor into our analysis.

And I think there are two logical consequences of this. The first is that if we are going to take on the extra risk, we want to ensure that we are sufficiently compensated for it. So we don't just want a 30 per cent chance of doubling every five years. Either the probability has to be much higher or the return that we're expected to get has to be much greater. And that probably has resulted in us slightly reducing our China exposure, either directly or indirectly.

I think the second one is, as much as possible, we want to invest in areas where we're fully aligned with the state objectives. And that's easy to say. The question has always been, well, what does the CCP really want? And historically, I think that's been quite difficult to know, because there's always been a lot of different factions within the CCP with competing interests.

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In the last year, we've seen actually a lot of consolidation of that power and a lot of the different factions have been removed. And the upshot of that is that it's now much easier to know what the state objectives are, which are... I would say the first is to shift from the new economy to the real economy. This is their language. And what they want to do is lead in areas like EV, new energy, green tech, etc.

The second would be around national self-reliance. They're very aware that China is very dependent on US for some key technologies, and they want to be self-reliant as soon as possible, because there's the looming threat that the US will cut them off on those technologies. So that's in areas like semiconductors, communication technology, aviation, etc.

And I think the third is around common prosperity. And that's about income redistribution. I think China is very worried about the demographic cliff that they're facing, where the fertility rate in China is now lower than Japan. And they're trying to make it more affordable for people to have families and address some of that income inequality.

So I guess going back to your question of what is our current appetite for Chinese companies, I think the appetite is definitely still there. We can't escape the fact that China is the second largest economy in the world. It's still manufacturing entrepreneurs at an incredible rate. Some of the world-leading companies come out of China.

But the types of companies and the types of opportunities we look for are slightly different to what they were before. We're being more demanding with the returns that we expect from them. And I think one good example here is Li Auto, which is a leading EV maker in China. It's absolutely aligned with the objectives of the state. Its execution has been superb and it's been a very good investment for us. So more companies like that.

And I think it's really interesting at this juncture, where the valuations of some of these Chinese companies are at a point where we're being compensated, or perhaps more than compensated, to take on some of the risks. So I'm not saying and I'm not sure we want to increase our China exposure at all, but perhaps we can increase the growth of the China part of our portfolio without taking on any more risk.

JH: Thanks, Helen. That's great. I think one of the things we were going to do at our London forum was to have breakout sessions covering two of the portfolios, I think we think, most exciting themes and pretty differentiated themes. One is new digital frontiers, as we're calling it, which encapsulates opportunities in cloud computing, semiconductors and ecommerce, and then the other theme, which we're entitling repair, renew and revitalise. And that's centred around the need for infrastructure upgrades and build-out in developed markets, principally the US.

So what we thought we'd do in lieu of actually being able to pad those out quite significantly in person, we thought we'd maybe get Malcolm and Helen just to touch on each theme to just explain a little bit about what we mean by the theme and draw out and highlight an opportunity and an investment case within that.

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So perhaps, Malcolm, if you could just touch a little bit on new digital frontiers, which I think accounts for quite a meaningful proportion of the portfolio as we see it, and give us a little bit of background there, and perhaps an opportunity within that that we're quite excited about.

MM: Yes, sure, John. So in terms of digital frontiers, economies just about across the world might be tough right now, but we think that the waves of digitisation and their broader impacts, that that's going to be felt for many years to come. That's in areas such as enterprise software, the use of advanced automation, the transition towards cloud computing, the development and use of AI-enabled tools.

There's a lot of these technologies that to us are still actually within their infancy or that they have the potential to become much more heavily embedded in the way in which businesses operate out into the future. And we think that that's very exciting, and it's going to be one of the big drivers and enablers of growth companies over the course of the next decade.

And of course, one of the big underpinnings of digitisation is intelligent hardware. And in many regards, I actually think that the pendulum, which swung very heavily towards very asset-light, very much software-orientated businesses over the past ten years might actually be swinging back a little bit more towards value being created towards the hardware end of the spectrum. And I think that the advanced semiconductor companies, some of them already referenced by Helen, is actually quite a good example of what's going on here.

So at the start of the year, we did a lot of work around the semiconductor area, and in particular, those companies who are almost the enablers of the manufacturing of semiconductors, so the semiconductor equipment companies. That's an industry which has evolved and changed a lot over the past several years, predominantly because of consolidation. There's a lot less industry players. They've been acquiring one another, developing larger and more scaled footprints.

What typically happens in industries where you see consolidation is that you get more disciplined pricing, you get higher degrees of profitability, and you see fundamentally stronger business moats, competitive moats which are more lasting. And these are all obviously very strong things for us as investors.

And what we were doing was trying to find businesses which we felt were operating in that area but also towards the bleeding edge, at the front end of the new technologies which were coming through. So as nodes are shrinking within semiconductors, as the costs of manufacturing are going up, as the requirements on yield are going up, who are the real enablers at the front end of this?

And a couple of the companies again which were referenced a moment ago which we were looking at were the likes of Integris, which is an advanced materials company, also makes handling equipment for all manner of different aspects of the actual manufacturing process of wafers and semiconductor chips, and

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also ASMI, which is the former parent company of ASML, the very well-known Dutch lithography business, but this is a business which specialises in advanced deposition technologies.

We think that both of those companies are right at the forefront of, again, the enablement of the new technologies coming through within semiconductors, but also at the forefront of the use of more and more stacking or 3D architectures within semiconductors, both things which we think are very interesting.

And we bought new positions in those companies towards the start of the year, when the market was quite fearful about shorter-term, cyclical concerns and larger levels of inventory within the system. We thought that those were short-term concerns. And actually, that has started to play out quite positively so far. But the most important thing here is we think that there's five, ten years of growth ahead for these businesses. And these are the types of companies we think are actually powering the next set of digital frontiers.

JH: Before we just come on to Helen, a quick reminder to everyone to make sure that you get your questions in via the Q&A function at the bottom of your screen. And just type your question in, hit return, and Ben will pick that up. Helen, so if we move on to yourself for repair, renew and revitalise, could you tell us what that's about, what we mean by that and perhaps some of the companies that we think are driving that exciting opportunity?

HX: Yes. Thanks, John. So I think the US is going through somewhat of an industrial renaissance. And that's driven by a combination of different things. One is the reshoring of manufacturing capabilities, like batteries and semis, or the green energy transition, which is going to require an enormous amount of investment in the electricity grid, and the continued build-out in data centres, etc.

So what we've seen over the last year is that US industrial capex has really shot upwards from this long-term historic trend that it's been on. And a lot of this is supported by favourable policies, so the combination of the Inflation Reduction Act, the CHIPS Act and the Infrastructure Investment and Jobs Act.

Those three together add to about \$1 trillion in spending. And then there's a multiplier effect on top of that, because a lot of the stimulus that we talk about here is not capex, but it's subsidies or tax rebates for operating domestic factories or upgrading infrastructure. So it's encouraging companies to spend on capex.

Now, to put that amount into context, after World War Two, the US had the Marshall Plan to help rebuild Europe. In today's Dollars, the Marshall Plan was a cumulative of \$150bn to rebuild the whole of Europe. And that's shared across 16 countries. And now, the US is planning to spend more than six times that amount on just the US. And that's, I think, creating a lot of opportunities for companies in the portfolio, like Martin Marietta, CRH, Eaton.

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But another area that we've been looking at more recently is air conditioning systems, where Jacob, our analyst, has individually been doing a lot of work on. Now, you wouldn't necessarily think of air conditioning systems as a growth industry. But of the 3 billion people living in the hottest places in the planet, less than 8 per cent of them have air conditioning. Over 90 per cent of air conditioning systems that are installed in the US at the moment would need to be upgraded in the coming years, because they would not meet the new building efficiency standards.

We talked about a lot of the favourable policies that has boosted incentives for improving the energy efficiency of buildings. So the tax deductions that commercial owners can claim for improving the energy efficiency of buildings have gone up by 2.5 times from a year ago.

And I think at the same time, today's energy systems are far more efficient than what they were five or ten years ago, when these things had been installed. So for commercial systems, the energy savings could be as high as 40 per cent, meaning that there's typically a one- to two-year payback period.

So one of the new holdings that we've bought for your portfolio is called Comfort Systems. It's a company that Spencer visited during his trip in the US earlier this year. It hardly has any sell side coverage. No one really writes about it. And it's a commercial installer of electrical and mechanical systems, so air conditioning installation and services is the core of its business.

And we think that one of the largest bottlenecks for the industry will be the skilled labour required to upgrade and install these systems. So organic growth has inflected upwards because of all the construction activity in pharma, semi, EV, data centres, battery plants, etc. And then once they're installed, there's a maintenance and upgrade cycle.

JH: Thanks, Helen. I think that's quite a nice contrast. So I guess the nature of the two opportunity sets, the one that Malcolm described and one that you described, is emblematic, I guess, of the diversity that we're trying to embrace within the Global Alpha portfolio.

I think then, on to our final question before we move on to audience questions. And Malcolm, I wonder if you could take this one. I think going back to the start, if you like, and acknowledging that the past two, three years has been, in our view, exceptional periods in terms of the operating environment for the companies that we invest in, and there's been a prolonged period of uncertainty, in our view, what remains the fundamental driver of performance for the Global Alpha portfolio? And what will deliver the returns for clients over the long term?

MM: Yes. So again, John, absolutely understand that this has been a very tough period for everybody, and for underlying clients particularly, and that the outcomes, both on the way up, actually, and subsequently on the way down, have been far more volatile than we're accustomed to.

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And there have been obviously some difficult circumstances around us, but equally that these are still quite volatile outcomes that we would not have anticipated.

So for me, looking forwards, what are the primary drivers? It comes back to the fundamentals of the companies. It comes down to the fact that ultimately, over longer time horizons, and here I'm looking five to ten years out, it's the wealth creation through compounding which typically drives share prices.

That's the thing which has always been the bedrock of the Global Alpha process over the near 20 years that we've been doing this. It's also been the broader bedrock of the Baillie Gifford processes. And that's what we continue to focus our efforts on. It's the identification of what we regard as being the very best, high calibre growth companies, quality growth companies. And we need to be open-minded as to where those businesses are coming from.

So I think that one of the primary reasons we were actually quite keen to talk about both aspects of digital frontiers, but also, as you were saying there, different elements of where we're seeing opportunities closer to the industrial front within America, is because growth changes in shape over time, and we need to be alert to that. We need to be able to tap into the different seams of growth as they appear in front of ourselves.

But summing it round though, I mentioned at the start the fact that I felt that the aggregate portfolio statistics were giving us a very good waypoint right now, suggesting that the portfolio is in good shape. And when I look at the companies in aggregate, I think that really, we've got a lot of reason for optimism.

So, first of all, we have a very good quality set of companies. That can be looked at, say, through the gross margin profiles, which are far superior to the market average. That's a very good thing. It suggests strong pricing power, an important thing in a more inflationary environment, of course.

They also have far superior balance sheets. So the average net debt to profit levels for our companies is around about half the level of the market. So again, they're lower in terms of their indebtedness, again obviously a positive thing, particularly in a rising rate environment.

But encouragingly, they're also investing more. So they're investing for the future. They're investing for structural growth. So if you take the capital expenditures of our companies and add in the research and development budgets and look at that as a proportion of sales, that number is about 40 per cent higher for our companies than for the market average. So these companies are investing for the future.

And how that plays itself through is when we look at the forward profit growth expectations. So looking three years forward, the expected growth rates for ourselves, it's around about 2.5 times that of the market, so over 12 per cent compound growth for ourselves, less than 5 per cent compound growth for the market. And what we're paying for that, it's roughly a 20 per cent premium. And that's low relative to the longer-term history.

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So again, I don't know when this rate environment is going to shift around, when the macro dominance is going to fade within people's thinking, but I'm very, very comforted by those statistics and very comforted by the quality of the individual assets that we own. And I think that that for me is a very good starting point and something which again gives me a lot of encouragement about future delivery.

JH: Thanks, Malcolm. That's great. I think I can see there are a number of questions that have come in, so I'll ask Ben to chime in now with everybody's questions. Over to you, Ben.

Ben Drury (BD): Yes, thanks, John. Thanks, everyone. Lots of good questions come in already. So if you'd like to ask questions and add them to the list, please do put them on the Q&A area that we have. I think I'll try and package these questions together, and maybe, Malcolm, this is a good opportunity for you to build on some of those points that you've just made, a lot of which focused on the qualities of individual companies.

We've had a collection of questions really asking us to share our views on the challenges that we've seen in markets, how investors have struggled to price assets in response to those challenges, and how we've seen a leg down in growthier parts of the market in particular in response to that. How do you see the portfolio construction process and the shape of the portfolio with regards to the potential for either continued uncertainty, macro variables or additional challenges to come, as we always see in markets?

MM: Yes. Thanks, Ben. Well, I think that's a very good and understandable question. I think of the portfolio as being in a balanced place right now. So we talk about having these three different growth categories or columns, from the compounders, from the stalwarts through to the higher growth, disruptive businesses and then the more cyclical capital allocators. And we're roughly balanced across these three pockets right now. I think that that's a good thing.

And as Helen was highlighting earlier, what we've been doing is gently taking some of the money away from more of the stalwart, compounding area, where there's a higher degree of perhaps certainty over the near-term outlook, and just starting to plant more seeds in some of the higher growth areas and those with the more cyclical underpinnings to them, as we see opportunities arise.

We've been doing that in a relatively modest fashion, but we think it's the right way for us to be positioning the portfolio just now. So a good degree of balance, and in trying to look at where we can upgrade the growth rates of the portfolio without taking the valuations meaningfully upwards. I think that's an important thing.

But also reflecting backwards, I would say that one of the challenges to ourselves, which I think is right, is whether or not we became unbalanced. And I think that actually, with hindsight, we allowed some of the developments in the portfolio to run forward too far.

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And I think that whilst again it's difficult to get the precise timing of these things right, as the higher growth sections of the portfolio, the disruptor section of the portfolio had built up to being over 40 per cent, over 45 per cent, we should've been more aggressive in terms of recycling that capital. Easy said with hindsight again, but that's one of the things which causes me a lack of sleep at night and one of the significant learning points over the past two to three years.

BD: Thanks, Malcolm. A couple more questions, just picking at different themes of some of the areas we've discussed. I think, Helen, we come to you now. We spent a bit of time talking about opportunities in semiconductors, how that exposure within the portfolio has grown as we've identified what we think are really interesting opportunities in this area.

Can you talk a little bit more specifically about the timing of some of these additions, particularly with some of the enthusiasm in some of these names that we saw at the start of the year, and maybe also why some of the concerns we see priced into others, around inventory problems in particular, we see as more of an opportunity than a threat to these businesses?

HX: Sure. So I think on the inventory one, so the semiconductors industry as a whole has always been incredibly cyclical. And that's driven by inventory excess overbuild, etc. In the last two years, we've been through almost a perfect storm for the semiconductor industry, because you had the COVID lockdown, where everyone stopped spending on services and started spending on goods, and at the same time, the supply chain was disrupted, so everyone was buying in excess of what they needed. It was like toilet paper. You were stockpiling a lot of the chips.

And then when the economy reopened, a lot of the demand that people extrapolated during COVID didn't materialise, a lot of the spending shifted back towards services, and so there was an inventory overbuild. And a lot of... Some of those companies suffered.

And I think if we took a step back and looked at the longer-term drivers, you have the combination of almost every long-term structural driver that you can think of, whether it's the green energy transition, electric vehicles, AI, robotics, automation, etc. All of that is underpinned by semiconductors.

Over the last decade, the semiconductor value chain has actually consolidated a huge amount, such that every part of the value chain, there is only about two or three companies operating in that part of the value chain. And along with that consolidation, returns have also risen. So these have become much better businesses, with very, very strong barriers to entry.

And so that was the timing on some of those additions, where we thought, if we could overlook some of the cyclical concerns around inventory, excess inventory in the shorter term, structurally, these are going to be really, really long duration, high quality businesses. And what was the second part of the question, Ben?

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BD: I think it's really a question about a stock like NVIDIA, where it's a relatively recent purchase for the portfolio, but one that's obviously done extremely well this year in the run-up to us taking that position.

HX: Yes, okay. So we reviewed NVIDIA middle of last year. And clearly, it was a mistake not to buy it sooner. I think we bought it in the middle of this year, and it was behaviourally very hard to buy it after it had gone up so much. But ultimately, we think that it's possibly one of the best growth companies of the next decade, and we thought it would be better to fix our mistake by buying it now rather than regret not buying it for the next decade.

AI is driving a change in the computing paradigm of data centres from a CPU-based data centre architecture to accelerated computing, where GPU is one of the most widely used accelerators. NVIDIA owns the most comprehensive AI computing platform, with hardware, system software, platform, application framework.

It's one of the most vertically integrated companies selling into the enterprise. Microsoft doesn't have that level of vertical integration. So it is not a semiconductor company. It's a company enabling AI. Much more of it is going to become software, and it's incredibly sticky.

MM: Ben, I might just add to that that one of the triggers for the purchase was our openness to new news coming through. So as Helen was saying, when you see a stock working extremely well, particularly one that you've been paying a lot of attention to, it's very easy to just say, well, look, I've missed this.

But what we saw with NVIDIA were sets of results coming through which were so incredibly powerful, being driven by this huge demand from artificial intelligence and other areas, but particularly from artificial intelligence, that it was telling us that something really is changing here. There's an inflection, and this company is right at the heart of this.

So what we allowed ourselves to do is move beyond the behavioural hurdles of the purchase, and we started a small position in that. Whether or not the timing is perfect, I don't know, but equally, if we were to see a significant reversal within NVIDIA, we know what our next move is. And I think that that was the understanding that we had whilst discussing the initial purchase.

BD: Thanks, Malcolm. I think that touches on AI, and we've had a couple of questions that maybe we'll come back to in a minute. I think one of the other questions which is quite interesting is we've talked about the repair, renew, revitalise as being a theme where we've actively added nine significant exposures to the portfolio. Can you talk about some of the themes which have maybe been in the portfolio for a little bit longer, where we're also seeing progress?

And I know we were talking very recently about the life sciences area, for instance, as something that seems to be very much out of the spotlight at the moment.

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Can you talk about some of the enthusiasm and where individual company progress is adding up to broader enthusiasm about the direction of travel in an area such as that?

MM: Yes. So one of the things that I've been focusing quite a lot of time on, and so has Spencer, Ben, is on the broader life sciences area, but also those businesses who are the enablers of the life sciences. So we talked about the semiconductor equipment businesses, but here, we're talking about the life sciences tools and consumables area.

And what we've seen within the broader healthcare market is quite a deterioration in growth rates over the course of the last 18 months or so. That's a function of less strong funding for biopharmaceutical production. The biotech landscape is a little bit tougher right now. Also, we're seeing a little bit of a pullback in activity from some of the big pharmaceutical companies, particularly because of policies looking to try to take on some of the more egregious aspects of drug pricing within the United States.

Beyond that, we've also seen less strong demand coming through from China. That's a function of a sticky economy, but also, they're clamping down on certain practices relating to the way in which different tools and different drugs and suchlike are being sold within China. That's almost a corruption-style clampdown. We think it's a relatively short-natured thing. All of this is creating an unsettled environment.

But when we sit back, we think that the broader area of healthcare, of life sciences, this is going to be a growth market, that the combination of what we're seeing with regards to advances in our understanding of biology, our understanding of sequencing and our broader understanding of how to pair that with data and artificial intelligence/machine learning, these are hugely powerful things.

So we've been thinking, well, okay, what's next here? What can we find which is new? So we've been looking at businesses that we own currently, like Thermo Fisher, which has been under a degree of pressure. We allowed a big position to build up there. We then took money out of it on valuation grounds two or three times. We're considering right now, do we put more money to work there?

We have recently purchased a business called Sartorius, which is listed within the European market, which is involved in biopharmaceutical consumables. And we're just gently finding our way into some of these really high calibre secular growth opportunities, given a tougher backdrop, which we don't think will last forever. We think that this tough backdrop is giving us the chance to get involved.

So that would be... Again, it's an area of where we're trying to think more countercyclically than the markets and to get involved at a time when others are a little bit more fearful about the near-term outlooks and when valuations become compressed.

BD: Perfect. Thanks, Malcolm. I said we'd come back to some of the questions on AI, so let's do that. I think, Helen, if you could step in here, that would be quite interesting. Some very open-ended questions really.

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How do you/how do we start to think about the implications of AI where they may be felt most meaningfully across the portfolio? And how are we advancing that work?

And then I think related to that, given the speed of advances in this area, do we still feel that five to ten years is an appropriate time horizon over which to try and form insights into an area like this?

HX: Gosh, okay, you saved the hard questions for me. So I think let's start with the speed. Generative AI has already delivered some incredible things, and the rate of progress is really mindboggling and difficult for me to comprehend at the moment. And I think the most exciting thing is that rate of improvement. There's no signs of that diminishing at the moment.

So without that, I almost cannot make a prediction of what's going to happen in five to ten years. I think the best approach is to maintain a very open mind. I think we're fairly well positioned with a lot of the semiconductor companies which are going to be, not necessarily the picks and shovels, but those underlying technology that powers all of that transition.

Secondly, I think there's clearly a lot of excitement around AI at the moment, and at least in the stock market, that excitement has been quite narrowly directed towards a few handful of companies who are powering those generative models.

And I think if you look at over the last two decades, we've been in an environment of disruptive technology, where we've had the mobile phone and then the internet both... The combination of those two has powered a lot of disruptive business models that have unseated the incumbents, and those companies have now become the incumbents.

It's not clear to me whether generative AI will be a disruptive technology or not. And here, I'm thinking about disruptive technologies versus sustaining technologies, where a sustaining technology is one that makes incumbents stronger and a disruptive technology is one that favours the new upstart.

So I think what we know from generative AI is that it raises the productivity of many white-collar jobs, especially the software developers, and it performs well on many generalised tasks, but if you can layer your own proprietary data set, it performs much better.

So it seems to me that it is possible that for many industries, it's much more likely to favour the incumbents who have large proprietary data sets with data that is already very clean and ready to use and a large existing customer base to which they could distribute their products to.

But I think I'd say this is all speculation at this point, is the caveat. And just to end by where I started, where the rate of progress is just so strong, I think that the best way is just to maintain a very open mind at this point.

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MM: Ben, I don't know if it might help to say something about where we're actually seeing tangible output from a company around this, or tangible aspects of the integration of the technologies. So I suspect most of those on the call would understand that Meta, formerly known as Facebook, has got one of the largest presences within artificial intelligence right now. It's got one of the largest models, which has been made effectively free access out there on the market.

But the way in which it's also integrating AI technologies into the business today is really very exciting. So what they've done is they've integrated AI into their Reels technology, their Reels offering within Instagram. That's effectively the video technologies, which are very similar to what people would see within TikTok. That's led to much better engagement with the Instagram platform, huge uptake in user engagement and much better monetisation opportunities. That's all coming through right here, right now.

Equally, they've also been integrating AI technologies into their messaging platform. So WhatsApp, the platform that the vast majority of us probably use, you're going to see that being integrated into business, to consumer-related interactions. They're already, again, monetising that in certain markets. So these tools are out there. They are real. It's not just things which are in the abstract. I think that the companies are actually benefiting from them today.

Helen has been quite cautious with regards to her outlook on this, saying we don't know where it's going to go. But if you take it to an extreme, I think that artificial intelligence could actually play out to be what we would regard as being a general-purpose technology. That's something like electricity or the internet.

So trying to get your arms around what the addressable market is, that's impossible. But as Helen is saying, you must keep a very open mind and consider where that technology might be sustaining for the likes of Facebook or Meta or where it might be producing fantastic new opportunities for companies, and equally, where it might be very undermining of existing businesses.

BD: Yes, absolutely. Time for a couple more questions still. I think, Malcolm, if we just stick with you, one of the words that we've heard repeated on several points throughout the part of this webinar is that of valuation, valuation discipline and where valuations have been reset across the market.

How do you think about that, the relative opportunities you're seeing, and whether or not...? Or how you would respond, I suppose, to whether or not some of the more recent purchases may be construed as having certain value-type characteristics, particularly maybe in the price that we're paying for those.

MM: So I think that the important thing to emphasise from my standpoint is that what we are looking for throughout the portfolio is underappreciated growth. So I've always found the distinction between growth and value to be a slightly artificial one. You need to have value within the growth. Otherwise, it's of no real purpose. You want to pay the correct price for the growth asset.

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But I've always equally believed that compounding is the primary driver of future value. And that's why I have always biased myself towards the growth assets. And what you need to consider is what price are you paying for the very high growth businesses, and perhaps those with a more compounding-style growth perspective.

Now, within the more recent purchases, yes, there will be one or two companies which will be coming into the portfolio and perhaps they will be at the more compound end of the spectrum, or be ones where it's the capital allocators, where you're getting the opportunity to buy these businesses at a lower valuation.

But equally, as Helen was highlighting towards the start of the call, we've also been putting more money to work in some of the higher growth companies, where we see real operating momentum, where we see their business positions as strengthening.

So the likes of, again, Mercado Libre within the Latin American ecommerce market, we think that they are really positioning themselves incredibly well, also the likes of DoorDash, which we've been putting more money to work in. These are not low multiple stocks, but we do think that they will produce value over the long term, relative to their growth rates. So I think that that distinction is one which it's important for us to tease out a little bit, I guess.

BD: Thank you very much. I think time for just one more question. There are a number of questions we haven't been able to get to, and some of them have come through as anonymous. So if you would like to forward your question, if we haven't answered it so far, on to your usual Baillie Gifford contact, we'll make sure that those are picked up outside of this webinar.

To finish, one of the exercises that we've been doing recently is looking at the higher conviction in terms of the holding size companies within the portfolio and really testing whether the upside on offer justifies that holding size and the conviction that we have is really appropriately reflected. To come to both of you, where were you most surprised in terms of the upside that you see and how that's aligned with some of the larger holdings in the portfolio?

MM: So I'll go first, Ben, and then let Helen catch her breath. So I'll give you two. So sorry, right? So the first one would be a business which we've owned since inception for Global Alpha, and we've actually continuously owned this stock, I think, for 25 years for Baillie Gifford clients, that being Elevance.

It's one of the largest healthcare insurers within the United States. And its long-term growth profile, it's compounded its profits at roughly 12 per cent per annum over our holding period. And as I've been looking at that business, I think it's getting better. I think that its growth profile could actually be increasing, and I certainly think that its profitability outlook is increasing.

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And that's not just because of the core of its healthcare insurance services being strong. They're also building out another broader utility services business which is in a broader area of healthcare which is unregulated. So it's in data analytics. It's in pharmacy benefit management. It's in broader care management. And I think that that could end up being an extremely valuable aspect of that company.

But because people always view these health insurers as being potential political footballs or they don't want to own them going into election years, these types of things, that stock is currently trading on just over 12 times earnings. I think it can double its profits in the next five years. So that would be one which I think looks incredible.

And equally, Helen was talking about this infrastructure area. I was looking at one of the businesses there, Martin Marietta, which is an aggregates business. It's raised its prices over the past 20 years at roughly 5 per cent per annum. We met with the Chief Executive. Actually, we went out for dinner with the Chief Executive two weeks ago.

He was telling me he thinks that the industry has hit a tipping point, that the consolidation of that industry now is such that that pricing will be significantly higher in the future. That's not something I expected to hear, and whilst I was running that through the numbers, I was thinking, wow, this thing could be incredibly mispriced. So there would be two from me, Elevance and Martin Marietta.

HX: I think for me, partly, I think, is just the value of doing this exercise, revisiting the upside of some of our largest holdings. And I think it's probably something that we will continue to do, and extend it to the rest of the portfolio as well. But I guess in revisiting some of them,

Mastercard was one of them as a blast from the past. We owned it for I'd like to say probably 13 years now. And the surprise was just how little the case has changed from when we first bought it. It's just got a licence to print money, and it's done so with remarkable consistency since we've owned it.

And so even today, you would think that the structural tailwind is nearly over. But even when you look at the US, which is one of the more mature markets in terms of digital penetration, the card companies represent just over half of the volume, and much less penetrated in terms of number of transactions, because a lot of the smaller transactions have not yet been digitised. And then above and beyond that, you've got the B2B volumes, which is still at the very beginning, which collectively is twice the size of the consumer consumption expenditure.

And so that's delivered, I think, low-teens revenue growth over the past 17 years. The cash flow conversion has been 100 per cent, because it owns very little assets so is incredibly scalable. The returns have risen very consistently across that period. Pretty much 100 per cent of its cash flows has been returned to shareholders over that period.

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It's used a lot of that to buy back shares. It's de-equitised or shrunk its equity base by approximately 2 per cent a year over the last 17 years, and earnings growth has been over 20 per cent in the last 17 years. And it could probably do that for the next ten as well.

JH: Great. Well, thank you, Helen and Malcolm. Well, it leaves it to me to sound the virtual gong, I think, and bring things to a close. We have recorded this webinar. So should you be interested in the recording to disseminate to colleagues if of interest, then please do let your Baillie Gifford contact know. We can get that sent out to you.

That really leaves me to say thank you to Malcolm, Helen and Ben for all their input throughout the webinar, indeed, to thank you all for watching and say take care. And we'll see you all soon.

HX: Bye-bye.

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

	2019	2020	2021	2022	2023
Global Alpha Composite	7.2	21.5	26.9	-23.4	7.2
MSCI ACWI	8.7	2.9	29.4	-5.7	12.7

Annualised returns to 30 September 2023 (net%)

	1 year	5 years	10 years
Global Alpha Composite	7.2	6.3	10.4
MSCI ACWI	12.7	9.0	10.8

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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