Baillie Gifford™

UK Core
Q4 investment update

January 2024

Investment manager Iain McCombie and investment specialist Kathleen Hunter give an update on the UK Core Strategy covering Q4 2023.

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Kathleen Hunter (KH): Hello, everyone, and welcome to our UK Equities Core Strategy update. My name is Kathleen Hunter. I'm an investment specialist in our UK equity team. And today, I'm joined by Iain McCombie, who is the head of our UK Equity Team and the lead portfolio manager on our UK Core Strategy.

As a quick reminder, our UK Core Strategy is looking to invest in what we believe to be the best high-quality growth companies in the UK and then hold them over the long term. So, at least five years.

So, Iain, shall we start with a bit of a scene setter? The UK Core Strategy delivered a positive return over the quarter, and outperformed the FTSE All Share, building on what was an encouraging year for investment performance. However, it's fair to say it has been a bumpy ride. So how would you characterise the market environment over the past few months?

Iain McCombie (IM): Well, Kathleen, as you said, we're trying to invest on a five-year view rather than trying to worry about what happens in a quarter. But clearly, you're asking me what happened in the quarter. That is an interesting one, actually, because I think there's a kind of, almost, a two-way pull that's going on in the market.

If you look at the economic situation, higher interest rates are starting to bite a bit. So, we're starting to see a slowdown in growth. On the positive side, however, we're seeing inflation starting to abate. So, I think there's a kind of mixture of things, whether you would be glass-half-full or glass-half-empty.

And I think the market, from my reading of it, and I'm no expert, would be suggesting that the market is starting to look through some of the bad news, and starting to think actually things might be getting a bit better. Maybe rates might come down and inflation is looking much more settled than it was, even six months ago.

So, what does that mean for companies? Because that's what we're interested in. Well, some of our cyclical businesses, some of them actually performed poorly during the quarter, and other ones performed well because people are looking beyond [the short term]. But equally, I think it still comes back to, it depends. You know, some companies if they had good trading were performing well in share price terms. The market was also punishing companies that had disappointing [trading]. So, I think that nothing much changed there.

But I think there's a degree of uncertainty of what's next. There's a lot happening this year with politics and so on. But we are not really bothered by that. What we are trying to do is find great businesses for the next 5 to 10 years.

KH: Excellent. Well, speaking of great businesses, in terms of performance attribution, Marks and Spencer has clearly been a really big contributor, both over the quarter and over the past year, whereas St James's Place has struggled. Is there any stock-specific stories happening with those companies?

IM: In a nutshell, yes. I mean, with M&S, first of all, I wouldn't characterise it as a great company... yet. I mean, I hope it'll be a great investment. It's certainly a good year, last year. I think what the story of M&S is, it's recovering from a low base, but it's definitely recovering. The management team that we've gotten to know, I think, are doing a really good job.

And what was illustrated in the course of the year was they had a better-than-expected trading update, which – when people were saying interest rates are high, inflation is high, this is really bad for retail – what we actually saw was quite good numbers, unexpectedly good numbers. And the share price has responded really well to that.

But what's really more important to us, is that they're accelerating some of their transformation by, for example, shutting down some of their older tired stores and opening up new stores. And the fact it's trading a bit better means they can accelerate that process, which I think is really important for the long term.

In terms of, as you said, the big detractor in the quarter, and probably for the year, was St James's Place. Now that's the wealth manager and, in some respects, it's still doing what we've always liked about it. It's got that sales force that's bringing in new money from their existing clients or new clients. Now with a cost-of-living crisis, that's been a bit tougher, but it's still seeing inflows, that's really important. But in the short run, what's been really driving it was an announcement that they're changing their fee structure for some of their products. And, in a nutshell, what it means is that their clients are going to get a fee cut, and that's going to be funded by the shareholders earning a bit less on those products.

And that's particularly impacting the business in the next couple of years, and the shares didn't really respond well to that. But we were trying to look at the longer-term implication of that. And actually, if you look at it on a on a 5-to-10-year view, the cash flow impact is much more muted than what the market's reacting to.

So, we'll have to see if there's an impact. Will clients' behaviour change? We don't know yet, because it's going to impact in a couple of years. The other thing about it is that there's a management change. The long-standing CEO is retiring. There's somebody from outside coming in, who used to be the finance director and acting chief executive of Prudential, who we rate very highly. So, he's going to be looking at the business.

And your question is, probably, well, what are you doing about this? Well, we're reviewing it. We've met the management. We've met the new CEO to discuss it, talk about what they think about the issues and the opportunities for the long term. And for the moment, we're staying we're sticking with St James's Place, and we will obviously see how events go in the short term. But we are still looking at the longer term and we still see it as a growth business.

KH: Great. And so, in terms of portfolio activity, turnover has continued to be low over the whole of last year, as we would expect. However, the market volatility has thrown up some interesting opportunities. And I see that you've bought two new holdings over the past few months. So, would you be able to talk us through the rationale for buying Kainos and Diploma?

IM: Sure. Well, as you said Kathleen, the majority of the holdings are exactly the same from a year ago, which may be a bit boring, but that's really an important point about the conviction in the portfolio. But we are always on the lookout for opportunities, and I think both are quite interesting.

Kainos is one you may not have heard of. It's a Northern Ireland business, it's based in the UK and the US. It does software implementation and a particular software called Workday, which is HR software for companies. And when you decide to get that product, you need somebody to implement it into your systems. And that's where Kainos comes in and they actually do that.

Now that business is growing very strongly, but because of some of the cyclical issues I was talking to you about earlier, there's been a slowdown in that growth rate. So still growing, but not quite as fast. Now, the market didn't like that, when they announced that, and the shares fell very sharply.

Now, this is a business I've been looking at for a number of years. And I just felt [it was] maybe a little bit too expensive because it has been highly rated because it has been growing quite strongly. But now it's still growing very strongly, but the rating has come way back. And I think there's an opportunity to take a position in Kainos. And that's what I've done.

Diploma is slightly different. It's a business I've been following for about a year-and-a-half very closely. I met the management team. I got to know them a bit, very impressed by them. Diploma is a value-added distributor. So, this, for example, is selling things such as seals for some big trucks. Now you think, well, that doesn't seem very interesting, but if that digger, or something, breaks down, time is money. You can't work on the site. So actually, if you can get overnight that replacement seal, you can get back on your digger. People are willing to pay for that. It's kind of low value, but quite high margin. And they make about high teens margins, which for distribution is very, very attractive.

So, this is a business that is very niche-y. It's got good market positions in these kinds of small areas of distribution, but it's growing very nicely. So, it's in growth areas. They're using their cash flow to make acquisitions to build out their portfolio. And there's a lot of synergies with that too. So, the shares pulled back a little bit, as you said, with some of the volatility in the market. And I've been waiting for that. And I've decided to take a holding in that, and I'm very excited about that one as well.

KH: Great. I look forward to hearing more about those two companies over the coming years. Is there any other final message you would like to leave us with today?

IM: Yes. despite all this volatility in the macro and, even individual companies, we're still doing what we're always doing. We're looking at the resilience of our existing holdings and if we still think the long-term story is good, then we want to stick with them. And that's why when you said earlier that portfolio turnover remains low, there's a reason for that.

And I think particularly when, yes, we've had a slightly better year in terms of performance, but our longer-term numbers, there's a lot more to do. That's why we we're sticking with our portfolio because we think its earnings growth is faster than the market; the valuations are down, but the balance sheets are better than the market. It's a classic, better, faster, cheaper. That's why we're sticking with the portfolio and that's why we remain very upbeat, looking forward.

KH: Excellent. Well, thank you very much, Iain. And thank you, everyone, for joining us today.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

UK Core

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

	2019	2020	2021	2022	2023
UK Equity Core Composite	27.6	-0.9	14.5	-24.2	14.5
FTSE All Share Index	24.0	-6.9	17.2	-10.9	14.4

Annualised returns to 31 December 2023 (net%)

	1 year	5 years	10 years
UK Equity Core Composite	14.5	4.7	2.0
FTSE All Share Index	14.4	6.6	2.6

Source: Baillie Gifford & Co and FTSE. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

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