Baillie Gifford™

UK Growth Trust: manager update

July 2024

Investment managers Iain McCombie and Milena Mileva chat with Investment specialist Kathleen Hunter, exploring their unique investment philosophy and the resilience of their growth-focused portfolio amidst challenging markets.

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Kathleen Hunter (KH): Hello everyone and welcome to our update on the Baillie Gifford UK Growth Trust. My name is Kathleen Hunter, I am a client director at Baillie Gifford and today I'm joined by Iain McCombie and Milena Mileva who are both partners at Baillie Gifford and co-managers of our UK Growth Trust. Our plan today is to have a 20 to 30 minute discussion on the recent drivers of performance, our key areas of enthusiasm and the reasons why we remain confident in the outlook for the portfolio. We'll then move on to a 15-minute Q&A where we'll answer some of the questions that have already been submitted prior to the webinar and if you would like to ask any other questions throughout our webinar, please do just use the Q&A panel at the bottom of your screen.

So, to kick us off, Iain, could you please briefly remind us of what your investment philosophy is and why you believe in it?

Iain McCombie (IM): Sure, Kathleen. Well, good afternoon, everyone. I think if you know Baillie Gifford then this is probably not going to be a big surprise to you, but the three key tenets are that we're active, we're long term and we're growth. Let me put that in the context of the UK Growth Trust, when I say active, we want to be very different from the index and we have an active share of about 85 per cent, which is very high for the UK market because of its concentrated index. And we think that's the best way to generate long-term returns by doing something different from the benchmark and believe in the stocks that you own. And then we're also long-term. Now, when we identify companies that Milena and I have in the portfolio, we have just over 40 stocks in the portfolio, we want to run them for as long as possible, because we want to have those superior fundamentals working for you. And actually, since we've taken over the mandate, our portfolio turnover has remained very low, well below 10 per cent, which is consistent with our long term patient approach. And the last thing is that we're growth investors. We think there are lots of opportunities for growth investing. I'm sure we'll come on to that later in the webinar. But the nutshell is, we are trying to find individual companies with superior growth rates to the market over the long term. And we want to own them for as long as possible.

And this slide is actually really quite useful in terms of making this point. Share prices follow fundamentals. And what this does here is it shows the UK market split into quintiles in terms of growth. And what you can see on the right hand side is that the fastest growing businesses perform the best. And this is very consistent when you do it globally or in the US or in Europe, but also in the UK. So, we think this is very much an underpinning to what we're trying to do.

KH: Great, thank you very much for that introduction to our philosophy.

Now moving on to performance. Since taking over the management of the Trust about five years ago, performance has been disappointing. So, I think it would be worth just delving into what's happened here and why our investment approach hasn't worked recently.

Milena Mileva (MM): Yes. I mean, as you say, Kathleen, we took over the management of BG UK in the middle of 2018. And for the first couple of years in 2019 and 2020, we were actually off to a pretty good start with the portfolio outperforming the broader UK equity index. But the last two years have been significantly more challenging, as you can see here with 2022 being an especially poor year for our relative performance. And I think to summarise that, there are two key reasons, as far as we can see. The macroeconomic backdrop (following the end of the pandemic and supply chain disruptions and the war in Ukraine with interest rates rising very sharply everywhere) has been by far the most dominant influence on investment outcomes over this brief period. And it has been an environment which has not been very conducive to our growth investment style with interest rates rising very rapidly and the market trying to work out through the imperative of discounting at the higher rates.

I think both Iain and I have been very upfront with shareholders since the beginning that we have a very pronounced growth bias, and we don't expect to outperform in all market environments. And I guess we have been in an environment where any long duration growth company has been hit indiscriminately regardless of any fundamental operational progress which might have been made.

As Iain alluded to earlier on, of course, our index is very concentrated and some of the large index constituents, the resource companies, energy companies and banks have been beneficiaries of the macro over the last couple of years. We remain of the view that these are short-term cyclical tailwinds, but these companies will not be able to grow at above average market rates in terms of our investment time horizon. So, we remain comfortable with not owning them, but they've certainly been a headwind to our relative performance.

KH: Okay, thanks for that.

So, our style of long-term growth investing has definitely been out of favour. However, some people in the audience might be asking, could we have done anything differently to reduce the magnitude of losses?

IM: I mean, that's something that we've been asking ourselves and also the board have been asking us. They asked us to do some work on this. And what we did, we worked with our risk team at Baillie Gifford to look at various scenarios, which we think are plausible scenarios.

And what we looked at, for example, is if we'd equally weighted the portfolio, if we'd capped our holdings at 4 per cent in the portfolio. And actually, I think perhaps the most interesting one is if we'd actually sold or reduced some of, with retrospect and with hindsight, the most overvalued stocks and reinvested them back into the portfolio. This is a credible scenario, and I'll come back to that in a second, but we think that's a realistic scenario to keep investing in growth because as I said, and Milena also said, we are strongly growth investors. And what the numbers show is that it would not have made much difference. Therefore, what do we conclude from that? Well, really, it's been a style thing and as Milena has said, the evidence seems to back that up. And therefore, we don't think it's something we could have done differently. Now, obviously, the other question is, well, you could have bought other things that have done well, but these are value stocks. It would have meant buying things like Shell, BP, HSBC that, sure, they would have outperformed if you had had that perfect hindsight. But then we would have been accused of style drift. That would be very much against our philosophy of buying companies that we do not believe have long term attractive growth fundamentals. So, it’s been uncomfortable and unfortunate, but we still believe in our portfolio, and we think that it's really been a style thing that's been really against us there.

KH: OK, thank you for that. That's helpful. However, in addition to that, has there been any individual stock mistakes?

IM: Well, Kathleen, the short answer is yes, of course. I mean, the reality of all fund management, particularly with a growth investment style, is you are going to make mistakes. Companies you think have really interesting growth potential but for either internal reasons or external reasons they don't match that potential and yes, we've had some of those.

Now the two questions that we've looked at, one is whether we have we been making more mistakes than normal in that respect because you're always making mistakes and the dirty secret of fund management is that when things are going well, nobody cares about it. But when things are not going so well, everybody, rightly, focuses on that. But I don't think that's the case.

The second thing which I think is interesting is that we looked at all the sales that we have made since we took over the mandate, more really from a business analysis point of view. And what was interesting in that respect was that of all the things that we sold, all but one have actually underperformed. So, what that tells us is that it gives us some confidence that in terms of our analysis of businesses, we don't think what we're trying to do is broken, that we can identify when something's not working, and we can do something about it and resell it. And the vice versa, that things we like are still attractive so that gives us some confidence but definitely we're not hiding from the fact that we have made mistakes.

KH: OK thank you. That is really helpful context for understanding what has happened over the past few years. Now, if we shift gears slightly from here and look ahead, why do you think the Trust looks attractive today, either for existing or new investors? Milena, I wonder if you would take that.

MM: Yes gladly. I mean, I think the key reason for that, Kathleen, is really the chart that Iain chatted over in the beginning of the webinar here. Over a meaningful timeframe, we do believe that share prices ultimately follow fundamentals and the fundamentals of our portfolio in terms of its growth, in terms of its quality and resilience are more attractive than that of the average company. And importantly, we believe strongly that these fundamentals are sustainable, which is important because we invest over long periods of time. So, we think over time, this gets rewarded and recognised in superior share price performance. And I think that is the reason that, we have been through a very turbulent period for our investment returns. But as Iain said, our portfolio turnover has remained exceptionally low. I was looking at the data of the 15 top detractors to our performance since we've taken on the trust. We are invested in 11 of those companies still. So, I think that should be taken as a strong confidence in these companies and in their underlying growth potential. And I really want to stress this point to our shareholders, because I do not think it should be taken as complacency or, just blinkered devotion and rabbit in the headlights type thing in the context of a difficult performance period. There has been a very deliberate process which underpins this conviction that the long-term potential of our holdings remains unrecognised and substantial. And one of the evolutions we have made to our process over the recent years is that we have been going out on the road a lot, visiting our companies, their offices, and we have been spending a good part of the whole day, six, seven, eight hours on average with individual holdings. And we really think that this type of interaction and engagement is allowing us to calibrate and understand the long-term risks and opportunities for our companies in a much greater degree of depth and nuance than would have been possible in the past and really hopefully to drive the appropriate behavioural responses to those investments. So, it's something we intend to continue doing on an annual basis going forward with our individual investments.

And I think here we have just given the slide that you're sharing currently, we've just given the flavour of some of the holdings that we think are just very exciting growth investments in the UK. It's again, I think, stressing the point that they are quite an eclectic bunch. They come from different industries, different business models. I think that's quite important as bottom-up stock pickers. Our job is really to uncover the individual strengths and unique characteristics of companies, which will be very powerful over the long term but might not be recognised by the market in the short term. And I think that is what we're trying to do.

There is sometimes this equating of growth investing with technology investing, which we think is misguided and one-dimensional. Growth companies can come in all shapes and sizes, and our portfolio is hopefully reflective of that fact. We have long-term holdings here, like AutoTrader and Experian and Ashtead, where we are really enthused, even though we have held them for many years, that actually the potential here is now bigger than it was when we first invested. Their competitive positions with scale have become actually a lot more entrenched over the years. I think all of them, we can argue the addressable opportunities they have are bigger than they were when we first invested in them. So, we remain very enthused. There are companies like we've spoken about in the past to shareholders like Renishaw and Genus, where we just think there's been a wealth of IP, which is compelling and has been developed on the back of very longstanding investment in research and development. And it's not properly recognised by the market, often for cyclical issues, which

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kind of obscure the longer-term earnings power. And we have some much younger, earlier-stage companies like Wayve and Creo Medical and Oxford Nanopore. They're small holdings in the Trust, but we like to see them as, seeds for the future. These are companies that are really at the vanguard of pretty breakthrough innovation and hopefully their progress will be realised over time, even if it might not be done in a very linear fashion. And we have companies like Games Workshop and 4imprint that we have been invested in a long time. And again, they are ones where very much the confidence in the management team and the stewardship of the companies is one of the key reasons why we think the businesses will continue to be very successful over the next 10 years and beyond. So hopefully a good spread of ideas that we remain enthused about and, in many cases, have been adding over the last couple of years on the back of share price weakness.

KH: Great. Yes, it sounds like a very eclectic mix of really interesting businesses. You also just mentioned that turnover has been pretty low over the past few years, but would you be able to give us a couple of examples of where you have made any changes to the portfolio?

MM: I think in terms of new buys and additions, I think the thing to emphasise is that a lot of our activity has really been in the existing portfolios for the reasons that we have just gone over. We remain very strongly convinced that these companies are undervalued, and we have been leaning into share price weakness, especially in cases, where there's been short-term cyclical issues, which have kind of clouded the longer-term attractions. Great examples here would be Kainos, Genus and AJ Bell. Those are the companies where we really think they have strong fundamentals long-term, but there's been some cyclical issues that have somewhat obscured the long-term earnings power. So, we have been adding to those.

We haven't made a huge amount of new purchases. There was only one new buy over the last year, which was the online card retailer, Moonpig. It is a company which listed in 2021 and we were not involved in it, but we noted it as a potentially quite attractive long-term growth company. And we subsequently invested in it at the end of last year because we think it's again, one of those companies, it was a beneficiary of the COVID period and the shares have struggled a lot in the aftermath of the pandemic, partly as the shares have struggled a lot in the aftermath of the pandemic, partly as the COVID unwind has taken place, but also because clearly people worried about consumer discretionary spend. But equally, this company has very appealing structural features. It has a large base of, we think, potentially very valuable customers. It is investing a lot in data science, and we think this would hopefully drive significant value creation from that very large existing customer base. So, we have taken an opportunity of share price weakness then and purchased it for the Trust.

KH: Great, thank you. Well, sticking with stocks, earlier on Iain, you mentioned that this is a really concentrated high conviction portfolio. You have only got 41 stocks in the portfolio at the moment. What are your biggest positions and why?

IM: Well, our biggest three holdings are AutoTrader, Experian and Games Workshop. And they are all over 5 per cent holdings. Milena talked a little bit about all of them earlier. But the thing I would want to stress here is the growth mindset of the management teams and the fact that they're all eclectic. They're not just technology businesses. They're quite different, but they have that growth mindset and they're looking for ways to expand their markets so for example something auto trader a lot of people on the call will know Autotrader they probably think of it as a kind of that's where you can look for second-hand cars and it does a fantastic job there is the dominant player in that market. But what we've been really interested in is how they've been looking at how they can build on that fantastic position, get involved in the chain of, a customer wanting to buy, wanting to get finance for it, and helping that, because that can be one of the sticking points, and taking a little bit of a cut out of that. And that's kind of interesting it could be involved in new cars because as the UK market is evolving there that the way you buy cars is changing now we don't know where that that could work but they're on it they're looking at that and that's the kind of thing that Milena and I really like is companies are being thoughtful disciplined and trying to invest in a future. To me, it's always this underlying, there's not interesting companies in the UK. But these are three fantastic examples of companies with really strong IP and really strong competitive positions. Particularly something like Games Workshop, it is unique. There really isn't anything like it. Experian is a world leader in what it's doing and Autotrader is a really dominant player in the UK so that's why they're big positions. They're very profitable, they've got great growth prospects and we're very happy with them.

KH: Great thank you for that. Well, the final question from me before we move on to questions from the audience, would you be able to briefly summarise very simply why you're confident that the portfolio will be able to outperform over the long term?

MM: Yes. I think we have been consistent in executing our process. We have been evolving it and making it better as we always should, but we're sticking with it we think it has the capacity to add value over the long term. We think the portfolio is frankly populated with some very attractive long-term growth investments and that potential is just not recognised, so we will remain quite patient and steadfast in owning them and see that through.

KH: Great. Now we'll move on to the questions that we've received from the audience in advance of the webinar. So, the first one that has come in is very topical. Given the upcoming UK election next week, someone has asked, what impact do you expect to see from the UK election?

IM: Okay, I'll probably take that one. Well, I'm obviously not betting on it because that's a bit too topical at the moment. Look, I mean, we're bottom-up investors. And actually, if you look at the data, it would suggest that whether it's Labour or Conservatives, there's not a huge difference in terms of the long-term economic growth. So actually, it might not make a huge difference to us. But I don't want to give the impression that we don't think about this, or we don't care about it. For example, there's a holding we don't own in the Trust, we own it elsewhere. It’s a company called Trainline. I’m sure people will know about it and we have spent a lot of time thinking about that and how it could be impacted by a change of government. When we look at the existing portfolio of the Trust, it's hard to say there's something there that we're particularly worried about with a change in government. And it could be a positive thing. There's been a bit of a sort of waiting for something to happen. What's the catalyst? Well, maybe a change of government and the emphasis on growth. The opposition are certainly talking about wanting to grow the pie and that's not necessarily a bad thing for growth investing so we’ll have to see. But we're very comfortable with the portfolio as it is at the moment.

KH: Thank you. Another question has come in. So has there been any impact on UK equities due to China-US trade wars?

MM: I don't think there are huge vulnerabilities in our portfolio to escalations of these trade tensions. I mean, in fact, there probably is an opportunity for some of our holdings. And, it's not just a reflection of China and the US. It's just generally after the pandemic, people and countries are a lot more concerned around supply chain resilience and self-sufficiency and it's creating opportunities. I mean companies like Ashtead for example are benefiting in the U.S. from the growth of big construction projects. Projects like this, and semi-conductor fabrication plants, which obviously the U.S is quite keen on doing in response to the Chinese trade tensions. Again any investments in automation that come on the back of those types of things are probably good for companies like Renishaw. Yes, I think there are opportunities in some cases where some of our companies might have been competing against Chinese indigenous competitors. The potential for these competitors to make big dents abroad is probably now less likely than it was. And then I suppose there are always some negatives around it. I mean, I guess Prudential would probably be one holding which obviously has been affected by Chinese and US trade tensions, though obviously the operational performance of the company has not been, but clearly, it's weighing on sentiment. But on the whole, we do not think we are exposed to any significant escalation there.

KH: Okay, thank you. Another question referring back to, some of the earlier discussion. So, in an uncertain economic world, whatever the next big event might be that could cause another spike in interest rates, what would we do differently to avoid underperformance if we are unwilling to drift from our long-term growth investment style?

IM: That's an interesting question. I mean, it is hard to give a definitive answer to that. What we are not going to do is style drift. And also, what we are trying to do is to own companies for the long term. And as Milena very eloquently said earlier, we are not going to outperform in all markets. We are not an all-weather fund, we are very much a growth fund, and higher interest rates and rates going up is not good news for growth investing. As we've seen in the last couple of years, we have had companies that have very good operational performance, but the share prices haven't done very well because people are saying in the short term, we don't like growth businesses. And we think that will come good, but you have to be patient. And I think Milena and I would be the first people to say that it's not as simple as saying oh well we could sell something and come back to it because actually it's hard enough to find attractive businesses, but then you're saying you're so skilful that you can sell it and you can come back and time it perfectly to get back into it again. I think Milena and I as kind of worriers, we would always worry that you might do one well, but you might do the wrong one. You might not buy it back in time and therefore you look pretty stupid. So, what we have tried to do, we think this is the beaty of the closed ended structure of investment trusts, we try to identify the 40 most attractive names that we can and own them for as long as we can and not get distracted from that. We think that's the really key thing. Now, if you thought interest rates are going to go up, and something bad has happened, I'm sure we would look at the portfolio. We will always keep testing the resilience of our portfolio so we're not saying we'd not do anything but we do on a case-by-case kind of basis I think.

KH: Great thank you. Another question has come in. So, you appear confident in the future but what are you most worried about? I'm sure there must be something.

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MM: Yes. I mean, we are always worried about getting the investment analysis part wrong. That is what we would always be worried about. And that is what we try to get better at all the time. Because it is our bread and butter. So, whilst Iain is saying mistakes will always happen, we try our best to be as robust and rigorous in the analytical side of things to avoid it and to buy companies that are genuinely of that exceptional quality where you can. You can be relaxed about owning them over long periods of time because their competitive positions are very strong, and they are basically run by people you trust. So, I think that is the key one for us is making mistakes on that basis that people worry, that I would personally worry about.

IM: I think, yes, I agree with that. Two other things for me. We are very aware that shareholders have had a really tough period in the last couple of years. And we don't want to sound as though we don't care, or, we're not being really thoughtful about it, we really care a lot about it. As Milena said, we've kicked the tires in our process, we've seen things we can improve on, so, we're not sitting here being complacent or arrogant about it. You always worry that, people are saying, you've got to do something, or you're not doing something. We think we have done the appropriate things to position ourselves to deliver better performance in the future. But we think the core of what we are trying to do is unchanged. As Milena said, rightly, we can always get better. And we are trying to do that.

I think the other thing we worry about is that the UK has been a little bit out of favour, we worry about opportunistic M&A. The fact that people will kind of come in and potentially offer bids for companies that we think potentially undervalue the long-term potential and we've seen a little bit of that in the portfolio the last two or three years. Abcam. Abcam. HomeServe. HomeServe and Euromoney, Ultra Electronics. These are frankly, businesses, we'd all been quite happy to keep owning because I think they're all really good businesses. But the reality is that bids came in, shareholders wanted to sell, boards wanted to sell. So that is something you worry about. And we are starting to see a little bit more of that with a few household names starting to happen there. In one sense, it's good, the fact that it backs up the fact that at least you're owning attractive businesses, but we want to own them for a long period of time and not to just take the money and run for a 20 per cent uplift.

KH: Great okay thank you. We've got a couple of stock specific questions. The first one is looking to try to understand what prompted the decision to reduce our position in Rio Tinto?

IM: I'll take that one. Look, I mean, we like Rio Tinto. It has a very strong position in iron ore and in copper, but it's a decent business, it's not the most exciting kind of business. And really, we've used it a little bit at times as a kind of source of funds to add to things that we think have actually got potentially more exciting growth potential. And I think that's the kind of thing about the portfolio, we are very agnostic about the types of growth we like. We like fast growing businesses; we like emerging growth businesses and we like kind of steady growth businesses. And we also have cyclical growth businesses. And I think Rio is probably one of those ones that's a bit cyclical and has done quite well. And what we've been identifying more recently is the kind of market, where really attractive growth businesses have been derated and we've seen that as an opportunity to add to things. Kainos is a great example of that where we've really liked it for a long period of time. We waited, we were patient and we've been rewarded with that because the opportunity has come and we've been adding to it and building into a pretty decent position in the fund. So, part of that was funded from Rio Tinto, for example.

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KH: Okay, great. Another one on Bodycote this time. So it's just with regards to the recent change in CEO. Could this be a catalyst for future growth?

IM: I'm not sure in that one in particular I mean i think it's been well run for a number of years. If there are any people on the call who remember Bodycote from 15 years ago, it's a very different business now. It used to be a pretty crappy business, very cyclical and low margins and I think the outgoing CEO did a really good job of turning that around so I think the new CEO coming in has got a really great platform for the future but I don't think it's as much about the CEO it's just about the operational business and the environment. It's got very good positions in things like aerospace and automotive EV's and so on. It's got a lot of opportunities, but it is cyclical so there's things going on at the moment. It's doing okay today but i think it's really well positioned for the future. This is a world-leading business and it's one of the biggest players of scale in the heat treatment area. There is really nobody else. And its main competition is actually in-house. And actually, with ESG and so on, it's much better for you to do it through Bodycote than do it yourself. So, I think there are lots of opportunities for Bodycote. We've met the new CEO, but it's very early days. We'll have to see what he says. But certainly, there's no sign there's going to be any kind of big change in what's going on in the last few years. And we're pretty comfortable with that.

KH: OK, thank you. One other stock question that's come through, sort of a similar theme with regards to your views on, management. This time at St. James' Place.

IM: That's an interesting one. I mean, look, it's been one of our poor performing stocks and I think people on the call are very well aware of that and I won't insult people by saying what's happened. I mean, we know the new CEO from his days at Prudential. We think he's very good. And in a way, it's been pretty much a baptism of fire for him. But I think he's very determined to kind of get to the bottom of it and move on. And we'll see, there's obviously regulatory uncertainty on that. But to me, he's trying to do the right things. And we will wait to see. He's got a review coming up, with the interim results, where we'll see if there are any kind of further changes he wants to bring in. But I think he's bringing in energy, he's somebody coming in from the outside, and he's reiterated to me a number of times that he thinks this is a growth business and there is a growth opportunity there so we'll see. While we're sticking with it, there's a lot of uncertainty there at the moment, but the valuation arguably might be capturing that.

KH: OK, thank you.

MM: I think, Kathleen, just to put it in a slightly bigger context, we have been debating the overall space. We have exposures in a few areas there and have had for many years. So, we've been actively debating the extent to which the industry backdrop might be becoming less compelling over the next five to 10 years. I mean, we know there are a lot of very attractive long-term drivers for the UK savings market, but there are also other things going on around regulation and competition, and we're just trying to debate the overall space and be quite selective about our exposures.

KH: OK, thank you. So, the final question which we have had through, as companies stay private for longer, someone has asked if the UK Growth Trust can invest in private companies?

MM: Yes, we can is the short answer. Up to 10 per cent of assets can be invested in private companies. We only have one investment we've made so far. We've always said that we are looking for things that are genuinely additive to public investments that we can't get anywhere else. This is the advantage of the investment trust structure because as the question suggests, it's a trend not just in the UK, everywhere in the world companies are staying private for longer. We have only made one investment in a company called Wayve, which is an autonomous driving company, and we will continue to look for other very additive investments in this area. But we are being quite thoughtful and cautious about the way we do it. We only want to choose very attractive, exceptional opportunities.

KH: Great. Well, thank you very much, Iain and Milena, for your time today. And thank you, everyone, for joining us and for all of your questions. We hope that was useful.

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Annual Past Performance to 31 March 2024 each year (net %)

	2019	2020	2021	2022	2023
Baillie Gifford UK Growth Trust PLC	-13.9	57.4	-18.8	-9.2	1.5
FTSE All-Share Index	-18.5	26.7	13.0	2.9	8.4

Source: Morningstar, FTSE. Share price, total return in sterling. Returns reflect the annual charges but exclude any initial charge paid.

Past performance is not a guide to future returns.

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- Market values for securities which have become difficult to trade may not be readily available and there can be no assurance that any value assigned to such securities will accurately reflect the price the Trust might receive upon their sale.
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- The Trust's exposure to a single market may increase risk.
- Share prices may either be below (at a discount) or above (at a premium) the net asset value (NAV). The Company may issue new shares when the price is at a premium which may reduce the share price. Shares bought at a premium may have a greater risk of loss than those bought at a discount.
- The Trust can buy back its own shares. The risks from borrowing, referred to above, are increased when a trust buys back its own shares.
- The aim of the Trust is to achieve capital growth. You should not expect a significant, or steady, annual income from the Trust.

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