Baillie Gifford™

International Alpha Q4 investment update

January 2024

Investment manager Jenny Davis and investment specialist Andrew Brown give an update on the International Alpha Strategy covering Q4 2023.

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Andrew Brown (AB): Hello, my name is Andy Brown. I'm an investment specialist for the International Alpha Strategy. Today, I'm joined by Jenny Davis, the co-manager of the International Alpha Team and decision maker on the International Alpha Strategy. Jenny, Hi.

Jenny Davis (JD): Hi, Andy. Nice to speak with you.

AB: Nice to speak to you, Jenny. Let's begin by reflecting on the past year, on 2023, and how the investment environment played out.

JD: Yeah, I think it's a good opportunity for us to take stock and maybe set 2023 in context as well. I mean, if we go back to 2019, just before the pandemic, it's been a wild ride over this five-year period. We've had obviously Covid and then we've had war in Europe breakout, then the sharp shift from negative interest rates to the fastest rate rise in history.

And multiple one-in-100 year events hitting at the same time. And that has led to volatile markets, volatile performance for our client's portfolios versus the index. What we've done through that period, is we have stuck to our philosophy, which is to believe that fundamentals drive share prices over the long term. Right now, the fundamentals of the portfolio remain really strong.

We've also stuck to our process, which is to believe that if you try and chase short-term volatility, you'll miss the long-term opportunity. So you've got to remain patient, got to remain focused on long-term opportunities. And indeed, the turnover has also remained low and within its normal range. And we've also stuck to our portfolio construction, which is to build a portfolio with four different types of growth in it.

So different business models, some idiosyncrasies to each of them, which means that they should move at slightly different times, a degree of resilience therefor in the portfolio, albeit very much within a growth style.

AB: Yeah.

JD: So 2023, coming out of that period of time, has actually delivered a more normal experience for our clients. It’s delivered 19 per cent in absolute terms and that's about 3 percent ahead [of the benchmark] in relative terms. So, it could be worth just diving a bit more deeply into that.

AB: Sure. So we did do well last year, which stocks performed strongly?

JD: We had a pleasingly diverse range of contributors actually in 2023, which speaks to why we build the portfolio this way with different types of growth in it.

AB: Yeah.

JD: A couple of patterns perhaps to spot would be that the likes of MercadoLibre and Shopify, which are both rapid growth stocks for us, both contributed very strongly to performance. And I think what's happening there is that they're emerging stronger as some of their peers are struggling, so the likes of Americana going bust [in Brazil] is a big competitor of MercadoLibre for example. Both [Mercado Libre and Shopify] have pulled that lever and have proven to the market that they can be profitable, which has been rewarded very significantly and again, shows they are emerging stronger in a difficult time.

And then we've also had some cyclical stocks contribute quite well, too. So the likes of Ryanair and CRH and Kingspan. And again, the pattern here is essentially having competitive advantages that enable them to emerge stronger than their peers in the downturn. Ryanair is a fantastic example here, where countercyclical capital allocation of buying new planes has actually meant that they've come back much stronger after of Covid than they were before and much stronger than their peers.

So a couple of different themes going on. But perhaps the main story being that of [companies] emerging stronger from a difficult time. And then our detractors, I guess [are] also worth talking about again. A bit of variety in terms of types of business, but a couple of themes that we can draw out. One would be exposure to China. We've seen an exodus of foreign money [coming out] from

Chinese exposed stocks. We've also seen a change in the domestic demand environment. So that has hit Meituan, which is a Chinese food delivery company. It's also hit AIA, which is [a] Hong Kong based insurer, but has a big Chinese business as well as a cross-border business. And it's also hit Shiseido, which is a Japanese [cosmetic] company that sells into China. So that's one area.

And then the other area that has been a detractor, is some of the Covid winners that haven't bounced back quite as strongly yet as others. So that would be payments business, Adyen, payments, and then also BioNtech, which obviously was a powerhouse in terms of providing the vaccine during Covid, but an inventory reset and the need to reinvent itself in new areas is leading to some uncertainty in the stock.

We continue to have conviction in all of these holdings, though.

AB: That's very interesting. So on the on the positive contributor side, there was a real variety of different business models, different countries, different types of stocks represented. But on the negative side, it seems to be more thematic.

JD: Yeah, I think that's absolutely fair. And sometimes when there's a thematic sell off, it can actually provide you [with] an opportunity. So we're having some live debates around whether we should add to some of these or not. And there's some fundamental work going on to try and test our conviction there.

AB: Yeah, interesting. And in terms of portfolio activity, what have you been doing during the year or indeed not been doing against this quite bumpy backdrop?

JD: So our core job is to look for businesses that can deliver faster growth for longer, and we lose sight of that at our peril. There is no market environment that excuses us that main task. So we've been sticking true to that and that has led us to eight new buys and seven complete sales, which is within the normal range of a sort of annual cycle for us in terms of changes to the portfolio.

All of those new buys are exceptional businesses. They all stand up on their own merits. The buys have been across a range of different types of growth, as have the sales. So also in keeping with our portfolio construction of a portfolio that has four types of growth in it and a degree of balance. Some of the new buys are worth highlighting or perhaps some of the themes within our trading. We have moved to an underweight position in China, after a few trims to positions that we have made, but also some repositioning.

We've sold two stocks that are exposed to cross-border flows: Hong Kong Exchanges and Futu. And we've taken a holding that's very much domestically exposed. So that's Moutai, which is a politically aligned, fast-growing domestic Chinese luxury spirits company, and that's for those that have Hong Kong stock connect open. Moving on from China we've been accessing some of the growth in AI and in EVs through semiconductor stocks.

So we've taken two new holdings here. One is Technoprobe, an Italian company that has a dominant market share in probe cards to test the functioning of really advanced semiconductor chips.

AB: Yes, it’s a fascinating businesses that we saw together last year {in Italy].

JD: Exactly. We had a site visit and saw the amazing lasers. And then we've also taken a holding in Silergy for those that have Taiwan open, which does power semis, and that gives it some exposure to the growth of electric vehicles, particularly coming from China. And then we've also put some money into India. We've taken a holding in Reliance, which is a powerhouse of a conglomerate.

I mean, they're using this hugely cash generative couple of businesses in petrochemicals and in energy to fund really disruptive and significant growth areas such as mobile data, retail and renewables as well. So really driving growth for the whole economy there.

AB: Well, that sounds like some really interesting new purchases for the strategy. And I know there's also lots of ideas that are sitting there on the substitute bench if you like.

JD: Yeah, absolutely. We've got a really healthy watch list at the moment. We've actually had to introduce an extra stock discussion this year, we've had so many ideas coming forward and we're trying to be quite thoughtful on how we use our watch list. Where we have fundamental research on the business that we might want to own at some point, and then a clear set of triggers that could lead us to take a holding.

And what's really interesting about the watch list names is that they're quite diverse themselves, so they range from sort of recession proof discount retailers through to quality compounders, where the valuations come down through to biotech names where there's been an absolute sucking sound in the funding for biotech. But there are some absolute gems in the rubble there that we think will actually go on to be a big platform biotech businesses.

So a few different areas that we're hunting around in and waiting for an opportunity.

AB: That's sounds very encouraging. And one thing that clients have been asking about over the past year are lessons learned from this very difficult period for investment. Can you talk a bit about that?

JD: Yeah, absolutely. I think it's vital that we constantly try and improve and learn from our behavioural mistakes. Although one thing I would say is that if you try and chase the short term, you can miss the long term. And so [implementing] learning from your mistakes at the bottom can be also a bad idea.

One example I'd give to that would be Atlas Copco, a stock that we've held since 2002 in International Alpha. Over that whole time frame since inception, it's had drawdowns in the share price of more than 20 per cent at ten different times. But over the time frame, it's delivered ten times the return of the index. So sometimes having conviction is actually the key skill. However, there are some lessons I think we have been learning in this time, which hopefully set us up better for the future.

One would be on valuation. So if we go back to 2019, the beginning of the five year period that I've been talking about, everything was expensive and you've sort of got two options at that moment in time. One is to ask for more growth in your new buys. The other way would be to look for what I'd call quality at a reasonable price.

And whilst we very much did both, history tells us that the timing of some of our higher growth purchases was not great. And I think therefore one of the things we're really trying to do is use more valuation lenses. The risk team are helping with valuation feeds into some of our broader discussions and we're trying to think through which lenses help us in which areas and when.

So for example, thinking about relative quintiles of growth and valuation rather than the sort of absolute hurdles that we've used in the past. And then another lesson I think that we're trying to incorporate at the moment is thinking about the macro.

We have entered a world in which geopolitics simply does impact businesses to a greater extent I believe.

We're looking for businesses that can be masters of their own destiny, but that requires us to understand their alignments or misalignments with various broader forces. So at our recent away day, we had a 'prepared minds' exercise where we tried to think through a whole range of different scenarios. If this happens, then what? How well exposed are we to the positives, and how negatively exposed might we be?

What therefore should we be researching? Which opportunities could arise or work if the potential areas of weakness show up? So yeah, [we are] just trying to incorporate it into our research flow and our fundamental thinking about stocks rather than necessarily having an overlay or trying to react to the macro or trying to make a bet on the macro. It's very much trying to think about how do we continue to find businesses that are masters of their own destiny in the next ten years.

AB: Well, thank you. So [we're] sticking with our process and philosophy that served our clients well for many years, but also making some valuable improvements. So, Jenny, just to wrap up, as we look forward in 2024 and of course, over a longer time frame as we like to do, what makes you optimistic?

JD: There are a few things. I suppose the first thing would be to say that international markets delivered a much more diverse range of positive performance than we saw in the likes of the US, where a really concentrated handful of stocks delivered all of the returns. And I think that speaks to the breadth of opportunity in front of us as international managers, which is endlessly exciting.

We've got this expanding number of listed companies. They're far less well covered than the US and cheaper than the US. So we've got some market inefficiencies that are there to be taken advantage of in front of us. And I think also that breadth of returns in international markets, you know, different countries, different sectors, which I think it speaks to the fact that future returns should be less vulnerable from here.

The next thing that I'd say is that whilst rates have impacted performance in recent years, we now think that rates are much more appropriately reflected in the market multiple. So hopefully a stock picking market will come to the fore in due course. We also have this rich watch list, as I've been talking about, and a really productive team that have been really fired up about the fact that the market is on sale and we've seen valuations come back into [an appropriate] range. There are a whole host of different hunting grounds for us to be looking at. So really exciting from that sort of bottom-up level as well.

Finally, I would say that our philosophy is that fundamentals drive share prices over the long term. When you look at the portfolio on an aggregate level, the forward earnings growth is more than twice the pace of the index. The returns are higher and that's on stronger balance sheets. Our balance sheets on aggregate, in fact, have a net debt to equity ratio of zero so they're self-funding, which is a huge advantage at a time when the cost of capital has significantly increased.

So I think fundamental strength should power, future performance and share prices.

AB: Well, listening to you certainly makes me feel optimistic. Thank you very much. And thank you, everyone, for listening.

International Alpha

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

	2019	2020	2021	2022	2023
International Alpha Composite	32.8	26.7	-0.5	-28.9	19.0
MSCI ACWI ex US Index	22.1	11.1	8.3	-15.6	16.2

Annualised returns to 31 December 2023 (net%)

	1 year	5 years	10 years
International Alpha Composite	19.0	7.2	4.9
MSCI ACWI ex US Index	16.2	7.6	4.3

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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