Baillie Gifford™

Sustainable Income
Q2 investment update

July 2024

Investment manager Steven Hay and investment specialist Tom Danaher give an update on the Sustainable Income Strategy covering Q2 2024.

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

Tom Danaher (TD): Welcome to the Sustainable Income Strategy Update for the second quarter of 2024. My name is Tom Danaher and I'm an Investment Specialist. I'm joined today by Steven Hay, one of the co-managers of the strategy. For those new to the strategy, Sustainable Income invests across asset classes to provide clients with an attractive monthly income stream. It aims to grow that income in line with inflation, supported by capital, which also maintains its real value.

So Steven, let's start by reflecting on what's been a mixed quarter across different asset classes. What are your key reflections on the moves that we've seen in markets of late?

Steven Hay (SH): Thanks, Tom. Well, it's been a quarter where financial markets have rewarded risk. And I think the main reason for that is that the global economy has actually proved itself to be more resilient than people thought. So we've not seen a global recession, we've managed to accommodate with rates, interest rates a bit higher than we were before. Companies have managed to keep on growing their earnings. So the wheels haven't fallen off. And you've seen, you know, it's a quarter where equities have outperformed bonds, as you might have expected. And within bonds, you've seen the, I guess, the higher risk part of the bonds, the corporate bonds have outperformed government bonds, and the additional spread for corporates has come down relative to government. So overall, a quarter where risk has been rewarded.

TD: So against that backdrop of positive risk sentiment among investors, how has Sustainable Income fared in performance terms? And could you just touch on some of the key drivers there?

SH: Sure. So the Sustainable Income strategy has had a modestly positive performance over the quarter, just around two thirds of 1 per cent up. Equities, which have been a long term, very positive contributor to our returns have been, again, a positive contributor. It is worth saying, however, Tom, that we are holding the types of companies that have really resilient income, established companies that we think they can grow their income over time. It tends not to be the types of companies, the likes of NVIDIA, companies that have been very successful very recently, because their payout ratios are very low, the dividends are very low, and they're just not suitable for a strategy like ours. So they don't often feature in the portfolio. Elsewhere, you've seen property and infrastructure do quite well, show some recovery after a weakness over the last year or two. And that's really been because rates have stabilised and begun to come back down again. And then on the government bond side, you've seen a little bit of weakness. We've priced out many of the rate cuts that we'd expected. And so yields rose modestly over the quarter. And I think that from here, with those higher yields and diversification that government bonds offer, just in case things don't work out quite as well as we all expect, then they provide some offset in terms of higher income in the portfolio.

TD: So as you say, positive risk sentiment and investors have been rewarded for staying the course in equities rather than diversifying into other asset classes. Could you just touch on some of the changes that you've made to asset allocation during the last few months?

SH: Yeah, so we've taken 2 per cent out of equities over the quarter. And although the operational performance from our companies has been very good, and we've been happy with that. We are very mindful that the blended yield of our equity portfolio is 2 to 2.5 per cent, which is significantly lower than what is available in many of the other asset classes. And so we've used that money to add into property and infrastructure. And those asset classes, you know, we've seen over the last couple of years, they've been under pressure. Yields have been rising. That's been particularly damaging for them, they've been out of favour, but now we see the opportunity is much more attractive when they've lagged equities, we believe they can now catch up and so that's where we've been putting our money.

TD: So now Sustainable Income is richly diversified across asset classes and we've got a bespoke portfolio for each of those asset classes. So thinking about the bottom up, could you just touch on some of the activity within the portfolio during the last few months?

SH: Yeah, so it's been interesting. So in the corporate bond portfolio, as I said, spreads have come in. So a lot of corporate bonds have done well. We've been looking for where there might be even better opportunities elsewhere. And we've seen we've added a high yield bond into the portfolio issued by Brightline East. So this is a US privately owned fast rail network operator and it's built a rail network in Florida. And getting Americans off their planes, out of their cars, and into trains could be a real winner from a climate point of view. And it's estimated it could reduce emissions by three quarters within the state. And we also think from a financial point of view, it's a great deleveraging story the market hasn't appreciated, as we think passenger numbers will pick up more than the market expects. So with a current yield of 13 per cent, we think that's really attractive. Meanwhile, we've one sale in the portfolio from our equity portfolio. So Kering, which is the French luxury goods manufacturer, we've held this company for a long time, it's done very well. But we just there's been some churn in the management team, which we've been unhappy about. And the leverage in the company has increased quite a bit, which means the income is less resilient than we would like. So taking those two factors together, we decided to take that position out of the portfolio.

TD: Okay, so let's go from the real micro back to the macro. And Steven, before coming into fund management, you worked at the Bank of England. So I'm interested in your perspective at the moment. How do you think your former colleagues will be thinking about the prospect of interest rate cuts here in the UK?

SH: Well, I think first of all, Tom, they'll be sighing a massive sigh of relief because they'll be seeing that the global inflation trend has turned and is coming down. So they were really worried about where inflation was going, but particularly in the UK. So they'll be relieved about that. And I think although in wages, there's still a question mark about wages being a bit sticky in the UK. I think the overall trend is for inflation to come down. We will see rate cuts, and I'm sure they'll be looking at that. I think it's more a question of how much and when rather than if. I'll stick my neck out and say I think we're going to get a first rate cut in August. So there you go, you heard that here. And I think more broadly, I think the macro outlook is pretty good here. You know, rates coming down, inflation under control, growth looking not bad at all. So I think the prospects for favourable total returns from Sustainable Income look pretty good from here.

TD: Yeah, as you say, you know, if that were to play out, a gradually improving outlook for investors in multi asset portfolios. Could you just think about an asset class at the moment that you're particularly excited about and share some thoughts there?

SH: Yeah, I mean, I think the one that we're probably most enthusiastic about at the moment is infrastructure. So we've been adding there gradually over the year, and it's now about 20 per cent of the portfolio. And I think with hindsight, we've maybe been a little bit early into this one, but it's definitely the sector that offers the most appeal going forward. So a couple of tough years as interest rates have backed up and yields have backed up, and it's been difficult for those companies which have much more bond-like in terms of the cash flows. But they look very attractive from here. Just to pick a few examples, in particular in the UK renewable space. So UK Renewable Trusts, such as John Lang Environmental Assets and Greencoat UK Wind. These look attractive, but also overseas. So we see the likes of Terna, which is building an electricity grid in Italy, which will be very important for the transition. So we think they're very cheap and offer great return prospects from here.

TD: Yeah, as you say, infrastructure is a rich source of ideas within the team at the moment and very diverse in nature, both in the UK and overseas. Again, let's take a step back. Could you just touch on the outlook for income growth at the strategy level? What should our clients expect in terms of their distributions during the coming months?

SH: Sure. Well, as the name suggests, a sustainable income is what is really, really important to our clients. And what we're looking for is to have a stable, attractive level of income that can grow in line with inflation. And we look to pay out the natural income that the strategies investments deliver, the dividends and the coupons that naturally come in, we pay out on a monthly basis. So people get a regular payout. And the strategy currently yields around 4 per cent. Now, it's been a challenging time over the last five years, you don't need me to tell you, but with the pandemic hitting dividends more broadly, and then the inflation spike, it's been a hard task to meet inflation with income growth. The good news from here is that we're seeing our income growth exceed inflation. So that's nice to see. So with inflation in the UK around 2 per cent, we've got expected income growth this year of around 4 per cent. So I think the income growth prospects are much better than they have been in the recent past.

TD: Lots of reasons to be positive. Well, thank you, Steven.

So to summarise, this was a mixed quarter for the Sustainable Income strategy in performance terms. So positive returns in equities and infrastructure were mostly offset by weakness in government bonds. And Steven's explained why we have modestly reduced equities in favour of property and infrastructure of late. But overall today, the portfolio is really well balanced between equities, bonds and real assets. We also shared the outlook for income growth, and Sustainable Income's distributions are expected to grow by around 4 per cent in 2024. So with inflation now under control, interest rates, as Steven says, likely to fall, we can be really optimistic about the return opportunities that lie ahead. So please do get in touch with your usual Baillie Gifford contact if you have any questions, and thank you very much for watching.

Sustainable Income

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

	2020	2021	2022	2023	2024
Sustainable Income composite	0.6	16.3	-5.7	5.0	-1.3

Annualised returns to 30 June 2024 (net%)

	1 year	5 years	10 years	Since inception*
Sustainable Income composite	-1.3	2.7	N/A	3.8

Source: Baillie Gifford & Co Limited. GBP. *Inception date: 30 September 2018.

Past performance is not a guide to future returns.

Net of fees returns have been calculated by reducing the gross return by the highest annual management fee for the composite.
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