Baillie Gifford™

Discovery
Q3 investment update

October 2024

Investment manager Svetlana Viteva and investment specialist Bill Chater give an update on the Global Discovery and Worldwide Discovery strategies covering Q3 2024.

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Bill Chater (BC): Hello, welcome to this quarter's update on the Discovery Strategy. By way of a reminder, the Discovery Strategy is our attempt to find the next generation of really great growth businesses. We want to find these companies when they're small, when they're immature, and when they're still to go through some of their most exciting formative stages of growth.

I'm Bill Chater, investment specialist for the strategy, and I'm joined by Svetlana Viteva, one of our investment managers.

In today's update, we're going to start by discussing some of the market dynamics and how those have influenced strategy performance over the quarter. We're going to discuss some of the operational updates from the more significant holdings. And then we're going to conclude by talking about portfolio positioning and highlight some of the trading that's taken place over the period.

So Svetlana, let's start with the big picture stuff. Maybe you could talk about what you've observed from markets over the quarter, paying particular attention to how that has influenced strategy performance over the period.

Svetlana Viteva (SV): We've discussed on numerous occasions the multiple headwinds which small companies' growth investors have faced over the last three years, and we are starting to see some of these headwinds abate.

Inflation figures have been coming down across key geographies, and we've seen central banks start to loosen their monetary policy and to cut interest rates, including the US Federal Reserve, which cut rates for the first time in four years. So this is all positive and welcome as a development, but it's far from saying that we are out of the woods yet.

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There is still a lot of uncertainty in the market with presidential elections coming up in the US and several other countries, with geopolitical tensions rising in many parts of the world. But we are definitely seeing a broadening of investor appetite outside big tech and AI.

And we're seeing signs of enthusiasm returning to the small companies investment universe, with the biggest beneficiaries this quarter being those sectors which benefit directly from the interest rate cuts. So financials, real estate, insurance and capital markets.

BC: OK, so that sounds positive. It sounds like those interest rate cuts that you mentioned and a receding of some of those headwinds have been supportive for our approach over the quarter. And I think you can see that in the absolute numbers, certainly, which are really encouraging.

But I want to pick up something that you said around the impact of cyclical forces. Now, Discovery as a strategy is all about looking for structural opportunities, long-term structural growth stories. So, I'm interested then about how you think about the impact of cyclical forces and if it impacts at all the investment cases for holdings.

SV: Yes, the first thing to note is that we are actually underweight [in] these sectors compared to the index and whatever names we own in these areas we own for the structural growth stories as you say rather than the cyclical exposure.

The names to flag I guess would be in this context Zillow, Market Access and Tropanion. Zillow as many know is the dominant real estate platform in the US connecting agents with home buyers and home sellers. Inevitably, it is going to always be tied to the health of the US housing market, and a reduction in the interest rates is positive news for them.

The real intrigue for us with that one, though, is the evolution of the business model away from a pure lead generator for buying agents into a provider of a broad array of high value added services to both the agents and the home buyers and home sellers. Early days, but very positive signs in that regard.

Market access, on the other hand, it's an electronic trading platform for fixed income securities. When interest rates change, their clients are going to trade to reposition their portfolios. The intrigue here is just how low electronic trading is within that asset class that market access supports, particularly when compared to something like equities trading.

A really large untapped opportunity as well is large ticket sizes. It's an area that we are monitoring quite closely because the company has just released its most advanced automated trading protocol.

And very briefly, Trapanian, which is a pet insurance company in the US, increasingly in Europe as well, they've had a very difficult last couple of years with veterinary inflation exceeding forecasts, exceeding their own expectations and historic norms, which hurt loss ratios, it hit their margins.

They've repriced the book, margins are up again, and they have the confidence to go out in the market and to acquire new pets. And again, that's a very large, very unpenetrated market.

BC: So I think our clients will find it very reassuring that even in the midst of a bit of a cyclical bounce, you are absolutely focused on the structural stories for our holdings. And I think you've done a very eloquent job of outlining just how early we are in many of those structural opportunities and how exciting the remaining growth potential is.

I wonder if we can shift gears slightly. Another area of the portfolio which has been fairly eye-catching is software. Now, the industry as a whole seems to be under some pressure, so I wonder if you could talk through those dynamics and what you've observed, and then discuss how that's impacting some of the holdings and maybe some of the commentary coming from management as well.

SV: Yeah, there has definitely been weakness in enterprise software, which is the area of software that we have most exposure to. And it seems to be several factors at play there. One is, of course, macro with companies over the last couple of years very much in a belt-tightening mode. So purchasing decisions and budgets were under greater scrutiny.

We have the sense as well that a lot of the incremental budgets were being diverted to AI projects, which is not helpful for the companies we invest in the space, like Appian or JFrog or Sprout Social.

There is a broader concern in the market as well that some software companies might be vulnerable to the threat of generative AI. It's a very early junction and it's hard to have a very high conviction in how generative AI is going to impact these software companies. But our belief is that the companies we invest in are really well placed to embrace that technology to make their own products and services better.

I should also say that there are pockets of strong growth within enterprise software as well, especially around the areas of cybersecurity and access management. Our holding in identity security company CyberArk is one such example where they've just gone from strength to strength as they have broadened and grown the number and the type of identities that they secure.

BC: So it remains a dynamic area of the economy going through a bit of a challenging period, but there's certainly some bright spots within, and you mentioned CyberArk as well, which is an absolutely fascinating business.

I wonder if we could talk about the really encouraging operational developments that we've seen in a couple of our healthcare names. Some of the largest names within the strategy have delivered outstanding results, and I would like it if you could just talk about those in a little bit more detail for our clients.

SV: Yes, positive news from our healthcare holdings. Alnylam, the gene silencing leader, they've released very strong phase three trial data for their drug, going after a form of age-related cardiovascular disease.

And the strength of that data is such that we feel strongly this becomes a first-line treatment, generating billions of dollars in revenue for Alnylam and pushing them into sustained profitability.

Outside of Alnylam, Exact Sciences just disclosed its early results from its blood-based test for colorectal cancer. As a reminder, Exact Sciences already makes the leading screening test for colorectal cancer. It is tool-based, so they've been working on a blood-based version of that.

And the data, whilst early, it looks very favourable compared to peers. And the test is also likely to be much cheaper than everything else that is available on the market, because they don't rely on the use of next-generation sequencing technology.

BC: Brilliant. I think it is just worth reiterating how significant that trial data from Alnylam can be for that business. It really has the potential to be transformational for that company.

Now, the final question from me is around portfolio positioning. I wonder, as a bit of an introduction to this, you could just highlight some of the areas to which the portfolio is exposed and then maybe pick out a couple of trading decisions that have taken place over the quarter and maybe talk a bit about those.

SV: Yeah, so the portfolio continues to be overweight in healthcare and information technology, which is where we have found the most exciting, most promising structural growth stories.

This queue also aligns with recent work that we have done on where in our investment universe which sectors are creating outliers. And the data suggests that more than half of the companies that have gone on to deliver a 5x return have been from those two sectors.

That's not to say that we are exclusively focused on these two areas. We have intentionally broadened where we generate ideas from, which is reflected in the recent additions to the portfolio.

We've recently taken a holding in a company called Energy Recovery, which makes pressure exchange devices. And it has a near monopoly position in desalination pumps. And it's now looking to leverage that technology across new verticals, like refrigeration being the first one.

We've also taken a holding in CryoPort, which is a high-value-added distributor and service provider to the life sciences industry. Again, an area where quality and reputation matters hugely, because the risk of failure is so high.

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BC: Excellent. So, as you say, broadening out slightly the range of ideas, and you've outlined there two really interesting and different businesses that have been recently purchased.

We'll conclude the update there. Before we go, maybe just a few parting thoughts. We're conscious that returns over the last few years have been, frankly, substandard. And we do want to thank clients for the trust and the patience they have demonstrated in the Discovery strategy.

We're actually very optimistic about where the strategy goes from here. We've observed improving operational performance with the growth of the portfolio, re-accelerating an increased proportion of businesses delivering attractive returns.

We're hopeful with some of the changes in the environment that Svetlana has spoken about, an improved sentiment towards our style of investment, that we may begin to see the market's view align a little bit more closely with our own, and that trust and that patience from our clients soon be rewarded. Thank you very much for your time today, and goodbye.

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Discovery (representing Global Discovery and Worldwide Discovery strategies)

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

	2020	2021	2022	2023	2024
Worldwide Discovery Composite	67.8	7.2	-49.4	-6.6	12.1
MSCI ACWI Small Cap Index	3.7	41.1	-24.4	15.8	25.2

Annualised returns to 30 September 2024 (net%)

	1 year	5 years	Since inception*
Worldwide Discovery Composite	12.1	-1.0	4.3
MSCI ACWI Small Cap Index	25.2	9.9	8.2

*Inception date: 30 June 2017.

Source: Revolution, MSCI. US dollars. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite. 1 year figures are not annualised.

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