Baillie Gifford™

International All Cap Q3 investment update

October 2023

Investment manager Iain Campbell and investment specialist Katie Muir give an update on the ACWI ex US All Cap, EAFE Plus All Cap and Developed EAFE All Cap strategies covering Q3 2023.

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

Katie Muir (KM): Welcome to this International All Cap Strategy third quarter update. As a reminder, the International All Cap strategy aims to deliver attractive long-term returns by investing in a diversified portfolio of international growth companies. I'm Katie Muir, and I'm an investment specialist for the strategy. I'm joined today by Iain Campbell, who is one of your portfolio managers. Iain [has] been a decision-maker on the strategy since 2010, and today, we're going to provide an update on performance and on the portfolio.

So Iain, it's been a challenging period this past few years in terms of performance for the strategy. And we had another period back in probably the early to mid-2000s that were similarly quite difficult. Can you maybe share any lessons learned or reflections from you and the team?

Iain Campbell (IC): Yes, you're absolutely right. It has been a challenging period, and we're not happy with the performance that we've delivered to clients. And we feel an acute responsibility to turn it around. So what are we doing about it? Well, first of all, we're trying to be true to our investment philosophy. We remain resolute growth investors doing bottom-up stock picking and taking a long-term view. So nothing's changed there. And I think it's really important for our clients to understand that we're not going to alter our style. And I think that comes through in the sorts of companies that we're adding to the portfolio now. We're still going after growth.

Secondly, we're looking to learn lessons from the experience of 2022, and we think we could have been a bit quicker at reacting to the rapid valuation increases in 2021. We were making reductions to some of our holdings based on valuations, but we could have done a bit more. So we are working closely with our risk analyst to ensure that we have the right tools in place to make sure we're able to react quicker if such a situation should arise again.

Thirdly, we're ensuring that there's a good diversity and breadth in the growth drivers of the new stocks that we're buying now. We are growth investors, but we need to make sure that the sources of that growth are well-diversified. And again, looking at what we've added to the portfolio this year, I think we are doing that. So far this year we've bought six new holdings. Two of them have been materials companies, two have been IT equipment companies. One has been a financial company and we have bought one consumer staples company.

Finally, I would say that this strategy has been in existence for nearly 30 years, and we've been through challenging periods and drawdowns in the past. And at times like this, it's more important than ever that we look at our underperforming stocks and make a clear distinction between those that are not performing operationally, in which case we should move on and sell. And those which are performing or demonstrating good operational performance, in which case it's an opportunity to add. So this process is what we spend our time on, and it's where the team is really important, not only in bringing new ideas into the portfolio, but challenging what we already own.

KM: So maybe honing in on more recent performance, [over] the summer months, the macro uncertainty has increased. We've seen rising yields, and the oil price has been on the rise again. How has the strategy fared in that environment?

IC: Yes, well, it's been a challenging environment for the strategy. And in the third quarter, our performance has suffered from some of those factors. So digging into the third quarter, in particular, the macro backdrop has been unhelpful for growth equities. It's tended to be value as a style which has been in vogue and that's not been helpful for our performance.

So as you say, we've seen rising oil prices and good performance from the energy sector where we have very little exposure. We've seen rising bond yields, which tends not to be helpful for the valuations of more rapidly growing companies. So that's been a challenge. And we've seen growing concerns around economic growth and in particular the health of the Chinese economy. And that's not helped the sentiment around some of our stocks, which are exposed to Chinese consumption, for example, the luxury goods companies.

The second point I'd call it is that the rotation to value has been particularly extreme in the case of Japan, and several of our Japanese holdings have underperformed as a result.

And there have also, in the third quarter, been stock-specific issues. So, Adyen, which is our European payments company, delivered weak results in its US business and that hurt the share price. And Farfetch, which is a UK-based online luxury goods company, downgraded its full-year forecasts on weaker end demand and that was also unhelpful for its share price.

But it's not all been negative. Defensive names like United Overseas Bank in Singapore and Cochlear, which is an Australian healthcare company, those have performed well. And Denso which is a supplier to the auto industry in Japan, has also performed well as COVID related supply chain disruptions in the auto industry have been solved. And a number of our UK holdings have performed well as well. So companies like Games Workshop and Trainline have delivered decent operational performance and good share price performance. So, there have been some bright spots in what was otherwise a challenging quarter.

KM: Thanks. And maybe coming back to Japan, you know that that's been a sort of notable headwind. Can you maybe talk about some of the factors that have been driving that pronounced value rotation?

IC: Yes. So, as I say, it was a surprisingly dramatic rally in deep-value stocks in Japan. And there seem to be a few reasons behind that. A weaker yen, rising inflation expectations, but also a bit of a buzz around corporate governance reform, which might lead to more shareholder-friendly practices in lower-quality companies in Japan. And this has meant that our holdings, which tend to be in higher-quality growth businesses have fallen out of favour temporarily.

But again, as elsewhere, there have been some bright spots. So our holding in Z Holdings, which is a Japanese online conglomerate, has done well. In particular, its efforts to digitise the Japanese payments industry through its app PayPay seems to have good momentum. And our recent new holding in Cosmos Pharmaceutical, which is a discount food retail business, has really been a beneficiary of inflation. So in share price terms, it's also done well in the most recent quarter.

KM: So as growth investors, have there been a lot of attractive opportunities in the Japanese market?

IC: Yes, absolutely. And we're trying to be disciplined about this. But where the long-term investment case remains strong, but the shares have sold off. We've been adding to existing positions.
So to give you an example, Sysmex is a Japanese healthcare company. It makes medical testing machines. We've held this for several years, and its consistently moved into new markets. Most recently it's been moving into the surgical robots market, and it's been developing new tests. It's recently developed a blood test for Alzheimer's disease. But as a well-managed growth business its shares have been out of favour in the most recent quarter, and we've taken the opportunity to increase our position sizes there.

A similar case would be Olympus, which is another Japanese healthcare business. Again, we think the long-term investment case is intact, but the share price has been weak. So we've been adding there as well.

KM: And in terms of other portfolio activity, we've also been finding new opportunities outside Japan. Could you maybe touch on some of those?

IC: Yes, absolutely. So, we've taken a new holding in a company called Air Liquide, which is a French industrial gases company. It's a company with a very strong market position built up through organic growth and acquisitions. It now has a 30 per cent global market share. The excitement here is really around the potential for growth for this business to accelerate as a result of more demand for industrial gases related to efforts to decarbonise the economy. And also from onshoring industry to the US and to Europe, and to schemes like the IRA, which is supportive for industrial investment.

The second new purchase I would highlight would be Hong Kong Exchange. We think this is a really special business, a virtual monopoly. It is the only stock exchange in Hong Kong. However, there's clearly a lot of concern about the Chinese economy at the moment, and this has had a knock on impact on the valuation of Hong Kong Exchange. So we think we are being offered an opportunity to buy a great business at a very attractive price.

We've also added a couple of new names in the semiconductor space. In both cases, companies which we think have really attractive positions in the semiconductor supply chain. And the examples here would be Tokyo Electron in Japan and Soitec in France.

KM: It's encouraging to see lots of diverse new ideas coming into the portfolio, as you say. There's also been a few holdings [sold] in the most recent quarter which included Zalando and NIBE. Could you maybe talk about the rationale for the sale of those holdings?

IC: Yes. So, we're always monitoring our existing holdings. Testing whether our conviction remains strong in the growth potential and in the competitive edge. Whether the management team are executing well and whether there remains upside in the valuation. So, for Zalando, which we sold in the quarter, which is an online apparel retailer, we think that growing competition in the online apparel market is going to make it much more difficult for this company to get to the sort of market shares that we originally thought it could. So, we've moved on from that holding.

In the case of NIBE, which is a European heat pumps maker, we've been reducing this over a series of months now, and the concern here is more around valuation. It's simply much more highly valued than it was when we originally took the holding.

KM: And perhaps to finish. It has been a challenging period and particularly over the summer. What gives you grounds for optimism from here?

IC: Well, I'm very optimistic when I look at the portfolio and when I look at our new holdings. One of the positive things about growth being out of favour is that we are able to buy and add to positions in really great growth businesses at very attractive prices. So there are businesses that we are adding to the portfolio now that we've admired in some cases for years, but where concerns about valuation have held us back.

And it's very exciting to be able to get the chance to add them now to the portfolio. And I'm excited to see how they will grow and develop over the next decade. The other thing that makes me optimistic is the good operational progress being made by the vast bulk of holdings in the portfolio. A lot of these companies continue to execute very well, and while there are some near-term challenges, for some, the longer-term opportunity remains intact.

And this is a portfolio that's skewed towards businesses that have strong competitive positions, strong balance sheets, and are strong enough to weather tougher macroeconomic environments. And we think that they will emerge from this environment stronger.

KM: Great. Thanks, Iain, for joining me today. We hope you find it useful and look forward to updating you again soon.

International All Cap (including ACWI ex US All Cap, EAFE Plus All Cap and Developed EAFE All Cap strategies)

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

	2019	2020	2021	2022	2023
ACWI ex US All Cap Composite	0.2	28.4	19.4	-39.6	12.6
MSCI ACWI ex US	-0.7	3.5	24.5	-24.8	21.0
EAFE Plus All Cap Composite	-1.5	24.7	17.1	-38.5	12.5
Developed EAFE All Cap Composite	-1.5	24.3	20.5	-39.6	12.8
MSCI EAFE Index	-0.8	0.9	26.3	-24.8	26.3

Annualised returns to 30 September 2023 (net%)

	1 year	5 years	10 years
ACWI ex US All Cap Composite	12.6	0.9	3.4
MSCI ACWI ex US	21.0	3.1	3.8
EAFE Plus All Cap Composite	12.5	-0.1	2.9
Developed EAFE All Cap Composite	12.8	0.1	2.9
MSCI EAFE Index	26.3	3.7	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.

Past performance is not a guide to future returns.

The International All Cap strategy comprises three distinct variants. Overall, the variants are broadly similar, with the key difference being the degree of exposure to emerging markets listed holdings.

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