INTERNATIONAL ALL CAP Q2 INVESTMENT UPDATE

Investment manager Iain Campbell and investment specialist Katie Muir give an update on the International All Cap, EAFE Plus All Cap and Developed EAFE All Cap strategies covering Q2 2023.

As with any investment, capital is at risk. Past performance is not a guide to future returns.

This communication was produced and approved in July 2023 and has not been updated subsequently. It represents views held at the time and may not reflect current thinking.

Katie Muir (KM): Welcome to this short update video for the International All Cap strategy. For those of you less familiar with the strategy, our aim is to invest in the best international growth companies. So what do we mean by that? We mean those companies that offer superior long-term growth prospects.

I'm Katie Muir, and I'm an investment specialist for the International All Cap Strategy. And I'm delighted to be joined by Iain Campbell, one of the portfolio managers. Iain has been a member of the Portfolio Construction Group since 2010 and is here today to provide an update on more recent performance and the portfolio’s positioning.

So Iain, the investment environment has been more mixed of late. And for the strategy, relative returns have been a little bit weaker after a strong start to the year. Can you maybe start with some of the drivers of recent performance and also comment on how the companies/individual holdings have been navigating the current environment?

Iain Campbell (IC): Yes, well, we can't get away from the fact that the last few years have been challenging from a performance standpoint, and we haven't delivered the sort of results that we aim for. And it was really the early part of last year, which was most challenging, when we saw a surprise rise in inflation and rising interest rates. And this had an impact on companies’ operational profits and on their valuations.

Turning to this year, to 2023, having had a better start to the year in the first quarter, the second quarter of the year was more mixed and our performance did lag the index. Now, as usual, it's difficult to generalize about the drivers of performance over shorter-term time periods, but looking at where the areas of weak share price performance were, part of that came from a slower than expected recovery in the Chinese consumer.

We had hoped that as China reopened, we would see a recovery in consumption and a recovery in travel by Chinese tourists. And we have a number of holdings in the portfolio that stood to benefit from this. So companies like Shiseido in the cosmetics industry or AIA, in the life insurance industry, as well as companies in the luxury goods sector where we have a handful of holdings.

Now, as it turned out, the second quarter saw a more sluggish recovery, a weaker performance from Chinese industrials and weak consumption as well. And those companies, which should have benefited from a reopening, saw weaker share price performance.

The second area of weakness was more company specific and really related to lingering adjustments post Covid. So, for example, a holding in Sartorius, which is a pharmaceutical equipment maker, it suffered from inventory adjustments at its customer base, while our holding in Zalando, which is an online retailer, suffered from an adjustment as consumers went back to purchasing in physical stores rather than online.

KM: Right. So that's been some of the shorter-term performance headwinds. What about what's been going well in the portfolio?

IC: Yes, Well, turning to positive performance, a big theme of the quarter was excitement around what's been broadly described as AI, which grew when large language models like ChatGPT were launched. And particularly more recently when NVIDIA issued some bullish forecasts, andit stands to be one of the big beneficiaries of the increased demand for computing power. Now, we had holdings in the portfolio that benefited from this, so companies like ASML and SMC both saw strong share price performance as suppliers to the semiconductor production industry. And for our clients that allow us to hold emerging market stocks, we also benefited from our holding in TSMC, which is a semiconductor fab business.

In terms of other bright spots in the portfolio, we saw strong share price performance at Xero and Spotify. Xero spelt with an 'X' is an Australian cloud computing business, while Spotify is the well-known music streaming platform. In common with many other disruptive tech businesses both these companies announced measures to reduce costs and focus a bit more on profitability, and that was taken well by the market.

Another bright spot was among some of our industrial holdings. So a couple of examples of that would be Atlas Copco and Ashtead. And for those companies, really it was a continuation of strong performance, but much better than the market had expected after more bearish expectations at the beginning of the year.

KM: Great. So it sounds like overall operational performance has been pretty encouraging. But actually the market uncertainties over the past couple of years has created some opportunity to add some interesting new names to the portfolio. Can you maybe talk about how the portfolio is currently positioned?

IC: Yes. So as a reminder, we're looking to buy long-term holdings in companies that have strong competitive positions. Companies that operate in an industry with a tailwind for growth and companies that are run by trustworthy and ambitious managers.

Our portfolio is the output of a bottom-up stock picking approach. But there are some long-term tailwinds that underpin growth among various of them, and we've tended to divide the portfolio into four, when we think about these tailwinds.

The first is the tailwind of demographics. Which is creating opportunities for companies which can help solve the problems of demographics and reduce costs. The second is the growth opportunity that comes from the rise in the number of middle-class consumers. The third is the opportunity from applying innovation and technology to industry and manufacturing. So areas such as factory automation or electric vehicles. And the fourth is the shift to online of industries such as retail, media and more recently, payments. So our approach is to buy and hold, but particularly to buy when pricing dislocation offers attractive opportunities.

KM: Great. And so where, maybe give us an example of where we've seen some of those compelling opportunities at the moment?

IC: Yes. So a good example was a new purchase we made this quarter. A company called Nippon Paint. Nippon Paint is headquartered in Japan, but over half of its profits come from its operations in Asia and in growing Asian markets like China, Indonesia and Malaysia. And having learned the lesson from US companies like Sherwin Williams, we're aware of how attractive decorative paint businesses can be. There's a combination of the benefits of local networks, the benefits of scale, the importance of brand, and the combination of that can make for really attractive, profitable businesses.

So why did we take this holding now? Well, it really comes down to what I said about looking for attractive pricing opportunities. Nippon Paint has seen near-term margin weakness because of the rapid run-up in oil prices and a lot of its inputs are petrochemical-based. This fall in margin has resulted in a fall in the valuation of the business, and it's fallen to a point where we think it offers a really attractive opportunity to buy a great business at a bargain price. We expect to hold this business for the long term. Decorative paint usage in China and other Asian mortgage markets is much lower than in developed markets. So we think there are many, many years of profitable growth ahead of this company. If I refer back to those four growth tailwinds I talked about, Nippon Paint falls into that camp of benefiting from the growth in emerging markets, middle-class consumers.

KM: Great. Yeah, it's great to see Nippon Paint in the portfolio as that's one of the companies we met on our recent trip to Japan. And how did we fund that new purchase?

IC: Well, part of the funding came from the complete sale of our holding in Suzuki Motor. Recent discussions with Suzuki have made us more concerned about its ability to compete in an auto sector that's moving more to electrified vehicles and EVs. Suzuki are making efforts to compete with these technologies, but we worry that the shift to EV drive trains will level the playing field and allow its competitors to take market share.

More broadly, there's been lots of activity among the portfolio construction group and lots of idea generation coming up from the regional equity teams. We continue to put a real emphasis on bringing uncorrelated ideas, growth ideas to the portfolio. And in the last month or so, we've discussed ideas in the testing and inspection industry, ideas in the materials industry, and we've also had long discussions about the risks and opportunities for some of our online businesses as they look to apply AI to their businesses.

KM: Great. You've spent the majority of your career covering Japanese and Developed Asia equities. The Japanese market has been doing a bit better recently, but as you said earlier, the results or the performance of our holdings have been a bit more mixed. What are you hearing and seeing from some of the individual companies?

IC: Yeah, well, it was interesting to see on my recent trip to Japan that as a country, it's really only now emerging from Covid restrictions. Mask-wearing was still a legal requirement up until the middle of March. And the country is really still in the process of returning to normal in terms of recreation and tourism. And if you put this together with rising raw material prices, this has been a bit of a headwind for the holdings we have in several Japanese consumer goods companies.

So companies like Shiseido in cosmetics or like Kao or Unicharm in the personal care industry. However, in the manufacturing and the automation industry and in exporting companies, which is an area that Japan has a traditional strength in, the weaker currency has really helped. Helped the competitiveness of these companies, as has the normalization of supply chains and investment by their customers. So, we've seen really good operational results from companies like Keyence in machine vision, SMC in pneumatics, Denso in auto parts.

Summing up on Japan, I think it's a market that will continue to be a fertile source for new ideas, particularly for those who are prepared to go beneath the big index constituents and seek out interesting midsized growth companies.

KM: Thanks, Iain. It sounds really similar to our approach in other regions and international markets. There's plenty of opportunities available for bottom-up stock pickers.

So to summarize, the investment backdrop remains challenging. However, we remain upbeat on the portfolio's holdings and the long-term growth prospects and growth drivers that underpin many of those holdings.

Thank you for listening to this update and we look forward to updating you again soon.

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

	2019	2020	2021	2022	2023
ACWI ex US All Cap Composite	-0.0	12.1	41.3	-36.4	14.0
MSCI ACWI ex US	1.8	-4.4	36.3	-19.0	13.3
EAFE Plus All Cap Composite	0.1	8.1	37.1	-35.1	16.1
Developed EAFE All Cap Composite	0.5	9.0	37.0	-35.0	17.0
MSCI EAFE Index	1.6	-4.7	32.9	-17.3	19.4

Annualised returns to 30 June 2023 (net %)

	1 year	5 years	10 years
ACWI ex US All Cap Composite	14.0	2.8	5.5
MSCI ACWI ex US	13.3	4.0	5.2
EAFE Plus All Cap Composite	16.1	2.3	5.2
Developed EAFE All Cap Composite	17.0	2.7	5.2
MSCI EAFE Index	19.4	4.9	5.9

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.

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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0723 Int All Cap Q2 update
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