

# Sustainable Income Fund

## Q3 investment update

October 2024

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Investment manager Nicoleta Dumitru and investment specialist Tom Danaher give an update on the Sustainable Income Fund covering Q3 2024.

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

**Tom Danaher (TD):** Welcome to the Sustainable Income Fund update for the third quarter of 2024. My name is Tom Danaher. I'm an investment specialist here at Baillie Gifford, and I'm delighted to be joined today by one of our co-managers, Nicoleta Dumitru.

So for those new to the Sustainable Income Fund, it's really quite simple. It invests across listed equities, bonds and real assets, all with the aim of providing our clients with a resilient monthly income which grows with inflation over the long term, supported critically by capital which also maintains its real value.

So, Nicoleta, we'll start with the market backdrop. And three months ago, your co-manager Steven Hay sat in that very chair and confidently predicted that the Bank of England would start cutting interest rates in August, which proved correct.

That and other interest rate cuts have been largely positive for risk asset prices. So, first and foremost, how has the Sustainable Income Fund fared in performance terms?

**Nicoleta Dumitru (ND):** You're right, Tom. The market environment in the third quarter has been supportive for risk assets. Infrastructure, property, and equities, they have all performed strongly, especially relative to other safer investments like government bonds.

The Sustainable Income Fund has delivered a performance of roughly 4.5 per cent over the last quarter. And over the year, performance is roughly 14 per cent. More recently, one of the key drivers of that strong performance is infrastructure.

This is an asset class that I'm closest to. And as we all know, it has been struggling for the last couple of years with the increase in interest rates. More recently, it has been shining through in performance terms, but also fundamentally, because investors are now also interested in

infrastructure as an asset class, not just for the income yield that it offers, but also because of the dividend growth potential.

**TD:** So some of those headwinds have turned into tailwinds for infrastructure and we will come on to discuss that later on. Zooming out a bit, going into the third quarter, the fund had a fairly equal mix between equities, bonds and real assets. So can you touch on some of the asset allocation changes made during the third quarter?

**ND:** So balance is an excellent word to use to describe this portfolio. The exposure is remaining roughly the same. A third in equities, a third in fixed income, a third in real assets.

We have made a few changes, but they have been fairly minimal in terms of asset allocation changes. The real assets exposure is now slightly higher than the equity one, but it's only marginally so. And we have done this because we have observed a very interesting valuation gap opening up versus equities.

And with our view on interest rates and the fact that it would begin to fall, we expected that gap to begin to close. So infrastructure is roughly 22 per cent of the portfolio and property is roughly 10 per cent.

**TD:** So compelling valuation opportunities to add to both property and infrastructure. Thinking about those asset classes, let's turn to fixed income now. What have you and the team been doing in terms of the bond allocation during the quarter?

**ND:** I'll talk a bit more about corporate bonds, because that is an interesting part of the portfolio. It has been performing very strongly recently, so much so that valuations at this moment look elevated.

And in particular, it is the credit spreads, which are the additional yield that investors in corporate bonds should expect to earn on top of the government bond yield. Those corporate spreads have been tightening more recently. And that has happened across the board, both in terms of investment grade as well as high yield.

What we have done in the portfolio is we have introduced a credit default swap position. This is one of the tools at our availability that effectively allows us to lock in those attractive yields that we like on the underlying corporate bonds that we own, but also gives some protection should those corporate bond spreads increase from here.

Corporate bonds are still an attractive asset class. We continue to like it. It's 15 per cent of the portfolio. And we expect returns to be somewhere around 5 per cent to 7 per cent.

**TD:** The credit default swap is there as a simple derivative just designed to add a bit of extra protection in the event that corporate bonds sell off a little bit from their current high valuations.

Nicoleta, you are our infrastructure guru on the Portfolio Construction Group, so it would be remiss of me to not ask you some more about that. And that allocation is materially higher today than it was 12 or 18 months ago. Can you tell us what Sustainable Income's infrastructure portfolio looks like today?

**ND:** Sure. I should be clear from the beginning, the portfolio and infrastructure that we have today is virtually the same that we had a year ago when the allocation was lower. We simply have increased that overall position in the portfolio.

What we own is a bespoke portfolio, like you say, of listed, highly liquid holdings, roughly 20 to 25 of them, spread across different countries, roughly 10 different countries. The sectoral exposure is also varied. It includes things like international utilities, renewable generation, transportation infrastructure, telecommunication infra, all very broad.

What we are looking to deliver with the infrastructure portfolio is two main things. One is that resilient income yield, which infrastructure is really well placed to deliver because of the nature of the asset class and because we look for those particular holdings that have a monopoly or almost monopoly position with high barriers to entry in their markets.

And importantly, we also look for that dividend yield to also be accompanied by growth. So we're looking for exposure to structural themes. The energy transition is an interesting one for us. We have identified that as being one of the most interesting themes for the infrastructure asset class.

Terna, for example, is an Italian grid operator. They are spending billions of euros in upgrading the grid, and it's that regulatory capex growth that is going to deliver the dividend growth for the years to come.

**TD:** An interesting example there in Terna, which will benefit from that clean energy transition. Lots of diversified themes there in the infrastructure portfolio. And it's important to reiterate that each asset class is a bespoke portfolio just for the Sustainable Income Fund.

Looking beyond infrastructure now, if I may. Can you talk us through one other change in the portfolio during the past few months?

**ND:** Sure. Why don't we go closer to home? In equities, we have owned a position in Hargreaves Lansdown. This is the UK investment platform. It has been taken private last quarter. We have added a new position in CME Group, a US holding.

They have a very strong position in the financial infrastructure market. They are a derivative exchange business. The management team is strongly committed to the dividend and we expect the dividend to grow at high single digits for the years to come.

**TD:** An interesting new story in the portfolio there. We've touched on performance, positioning and what you've been up to. And I want you to get the crystal ball out and turn to the outlook. And for

many of those watching today, clients invested in the fund or those interested, those monthly income distributions are really, really important to make ends meet. So what's the outlook for income growth at the moment in the fund?

**ND:** The Sustainable Income portfolio is a bottom-up portfolio, and that is the defining feature of it. We forecast income on a monthly basis for the years to come. And for 2024, the income growth is going to be roughly 4 per cent.

For next year, 2025, the outlook is also favourable, and we would expect that income growth to be somewhere between 4 per cent to 5 per cent. Now, it's important to remember that this fund is trying to deliver an attractive monthly income to clients that keeps up with UK CPI over the long term.

It hasn't been an easy task to deliver over the last few years. As we know, inflation has been surprising to the upside. But importantly, as we were mentioning earlier, that is changing. And we are now firmly in real positive growth for income for our clients.

**TD:** A positive story there on income growth and we've touched on the fact that many risk asset classes have done really quite well of late. So broadening that out a bit beyond income, how do you see the outlook for total returns going forward?

**ND:** Sure. From my perspective, as an investor that looks at a range of asset classes, the fact that interest rates are beginning to fall is incredibly attractive. For a long time, equities have been the one asset class that has been shining through. And from here, we expect different asset classes to start to perform strongly, especially if the economy begins to weaken.

For this portfolio, our core task is to find the right mix of asset classes that helps to deliver attractive income and capital growth for our clients over the long run, and we have plenty of opportunities to do that today.

**TD:** So maybe now's the time for some of those diversification benefits to shine through. Nicoleta, thank you very much for taking the time to join us today.

Nicoleta has outlined there some of the drivers behind recent strong returns in the Sustainable Income Fund. Returns of around 4.5 per cent for the third quarter of 2024 and total returns of around 14 per cent over the past year to the 30th of September.

What do we have today? Well, the Sustainable Income Fund has a projected yield of around 4.2 per cent and we expect the monthly income distributions to grow at between 4 per cent and 5 per cent over the next 12 months.

Nicoleta has outlined some of the exciting opportunities in the portfolio, including in areas such as infrastructure and in equities too. That brings our quarterly update to an end. Thank you very much for joining us and please do get in touch if there are any questions we can answer.

## Baillie Gifford Sustainable Income Fund

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

	2020	2021	2022	2023	2024
Baillie Gifford Sustainable Income Fund B Inc	2.1	11.1	-9.4	5.9	14.2

Source: FE, Revolution. Net of fees, total return in sterling.

Past performance is not a guide to future returns.

The Fund has no target. However you may wish to assess the performance of both income and capital against inflation (UK CPI) over a five-year period. In addition, the manager believes an appropriate performance comparison for this Fund is the Investment Association Mixed Investment 40-85% Shares Sector.

### Important information and risk factors

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Derivatives may be used to obtain, increase or reduce exposure to assets and may result in the Fund being leveraged. This may result in greater movements (down or up) in the price of shares in the Fund. It is not our intention that the use of derivatives will significantly alter the overall risk profile of the Fund.

The Fund's share price can be volatile due to movements in the prices of the underlying holdings

and the basis on which the Fund is priced.

Further details of the risks associated with investing in the Fund can be found in the Key Investor Information Document or the Prospectus, copies of which are available at [bailliegifford.com](https://www.bailliegifford.com).