MULTI ASSET INVESTMENT UPDATE

James Squires, Head of Multi Asset, and Paul Morrison, Client Relationship Director, reflect on the recent drivers of performance and the current environment influencing Multi Asset portfolios.

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

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Paul Morrison (PM): Good morning, everyone. And may I extend a very warm welcome to this Multi Asset update. My name is Paul Morrison. I'm a member of the client team here at Baillie Gifford, and I'm absolutely delighted to be joined by a familiar face to many of you, on my right. James Squires, head of the Multi Asset Team. Over the course of the next half hour or so, James will be reflecting upon recent performance and the drivers thereof; how the current environment is influencing the shape of our multi-asset portfolios; and, also, our overall outlook addressing some of the key risks and the opportunities which we've identified.

That'll take about 10 minutes or so and then we want to open the floor to yourselves to give you as much opportunity to ask questions of James as we can, and in time honoured tradition will encourage you to ask your questions via the Q&A function at the foot of the Zoom screen. I'll put some slides on the screen in a moment. And, as usual, they reference the Diversified Growth Fund merely for simplicity. But all the key messages that you will hear apply to all of our multi-asset portfolios. So, without further ado, I'll pass to James and bring the slides up.

James Squires (JS): Great. Thank you very much, Paul. Good morning, everyone, nice to see you. I'll talk for about 10 minutes to set the scene, but then we can dive into questions, so please do let us have those questions.

The headlines from the last quarter: we see markets as having been in a holding pattern these last few months, oscillating between soft landing – that scenario where inflation comes down neatly and growth continues - and recession, where the inevitable impact of higher rates for longer is a collapse in growth.

In this environment and outwith of those few AI-themed stocks that have been on a tear these last few months, we've seen little to pick in terms of trends. That said, our belief is that the impact of monetary policy tightening - higher rates for longer - is clearly coming through in the United States. We see lending being pulled back, weaker new orders and a looser labour market.

And all of that makes sense if you think about it. Monetary policy usually acts with a 12 to 18 month lag. Twelve months ago, the Federal Reserve in the US was at one and a half percent interest rates and US mortgages were at 3 per cent. Today they're at five and seven and a half. Savings have increasingly been used up and that policy tightness is now being reflected in real time estimates of growth and inflation that are coming down.

Now in a quarter that oscillated between those two, but that finished with markets tilting towards soft landing, we saw a modest negative return: minus two percent for Diversified and Multi Asset Growth and minus one for our Sustainable Multi Asset Fund, which leaves them around flat for the year and marginally behind still over 12 months. Underlying those numbers, some investments such as emerging market debt and structured finance did very well and others such as high yield or the Japanese yen did more poorly.

But our outlook is positive. Our Long-Term Return Expectations remain high across a range of asset classes, and we've been finding exciting opportunities to add to across government bonds; structured finance, in particular, CLOs; insurance linked securities; and commodities, such as copper. So let's turn to the detail and I'll focus now exclusively on Diversified Growth.

Performance: as mentioned in my introduction, the Diversified Growth Fund performance was minus two per cent for the quarter and indeed for the last 12 months in total. We remain behind over longer periods, largely as a result of the first six months of last year. Fund volatility remains below its 10 per cent limit at 8.6 per cent per annum.

Breaking that performance down, we've seen a mixed set of results across asset classes. The next slide on the left-hand chart here shows the contribution of each asset class to Fund performance over the last three months and the right-hand side for 12. So, focusing on those last three months, on the left, you see it's our investments in emerging market debt and structured finance, both of which we added to over the last 12 months on the basis of high yields and long-term return expectations, that have delivered. However, on the right-hand side, in high yield, currency and government bonds we are needing a bit of patience.

Government bonds has been the biggest detractor as Treasury yields moved wider. At the end of March, at the height of the SVB concerns, long-bond yields were three and a half percent. They closed the quarter closer to four per cent as the market digested stubbornly-high employment and inflation data. But as I said, we retain a clear expectation that inflation and yields will fall over the next 12 months as those lagged effects of monetary policy come through on the real economy. And indeed, we've seen yields moving down again over the first couple of weeks of July. Let me give you a little bit more colour on a couple of those asset classes at either end of the spectrum.

Firstly, emerging market debt. This is as you'll just have seen, is our best-performing asset class over both three and 12 months. Here, we've made the observation that emerging market economies were generally ahead of the curve. Relative to central banks in the US and UK, their policy makers have typically raised rates sooner and faster. And, as they have done so their bond yields have risen and their currencies have weakened.

Latin America is a prime example here. Yields there had moved out from below 5 per cent to above 10. But what we have seen is that that early action has prompted a marked improvement in economic fundamentals. Where there are still questions on inflation in developed markets, it's clearly dropping in emerging markets, and that's seen yields falling across the board contributing to Fund returns. Importantly, we think there's much more to go for here. In Latin America, those yields are still around 9 per cent and as we look forward, we think the hard currency - the dollar - bonds issued by these countries - also start to present more attractive opportunities.

Elsewhere in emerging markets though, our Asian high yield investment has been more frustrating. There’s good value here - yields of 13 per cent across the index. But short-term performance is all about price action and this is a volatile area, particularly the Chinese property sector.

After a strong run over November, January, February, as the market got excited about China's reopening, we've seen bond prices fall back in the last three months. Investor enthusiasm has fizzled somewhat as economic growth has failed to come through strongly and the pace of restructuring has been slow. Property bond prices, which are distressed, have fallen back from 15 cents to 10 cents; a small change in price terms, but a larger change in percentage terms. Our view is that a lot of value remains there. Restructurings are happening. The delays are mostly procedural. Simply put, the courts which are required to sign off on restructurings are saturated and there's a long wait for a court date.

Evergrande is one of the most well-known property developers. It's agreed the terms of its restructuring in February, but the court date to put that into effect isn't until October, eight months later. And this is the story across the piece. The value is there - often agreed - but markets are impatient. We believe patience will bring rewards here.

Now, whilst these two are notable examples that have led short-term performance, these investments are part of a broader, well-diversified portfolio that is better placed to capture opportunities across the board over the medium term: a portfolio that has a significant exposure to bonds and duration assets to protect against and profit from economic slowdown; it has investment in a wide range of better-value economic assets; and holds a number of diversifies besides.

As I said earlier, our central economic view is still for a growth slowdown with a high probability of recession. In this scenario, we expect bond yields to fall. And, whilst it can provide positive returns in most mainstream scenarios, our holdings of investment grade bonds and developing and emerging market government bonds are there to express this clear macroeconomic view.

Long-duration assets make up around 35 per cent of the portfolio. Over the quarter, we added to them. We added to our holding of investment grade bonds by the Baillie Gifford Global Strategic Bond Fund, and we bought Canadian provincial government bonds.

Now, with our weak growth expectation, we maintain a low weighting in equities, the flagship economic asset. However, we are invested in a variety of economic assets that we see as offering better value, either because of a low starting price or a high yield that offers a good buffer against any capital loss that might be experienced. So on that theme, over the quarter, we added to Structured Finance - four o’clock on the wheel in front of you - introducing a new mezzanine

CLO fund managed by Accunia, a Danish specialist in the sector. The assets in that fund are yielding 12 per cent off a floating rate basis with high levels of default protection.

But we also made an initial investment into copper, five o'clock on the wheel. Copper is an essential commodity for electrification and the renewable transition. We bought at around $8,000 a tonne. That's well below the $12,000 price which we see as what is needed to bring new supply to the market and gives colour as to why we think the levels that we're buying in at are cheap. Adding to those examples, high-growth property, distressed Asian high yield and select equities and infrastructure, we have around 45 per cent of the portfolio in these better-value economic assets.

Finally, we maintain 20 per cent of the Fund in otherwise diversifying assets. Not directly sensitive to the path of growth, these include cash and T-bills; insurance linked securities; absolute return strategies, and our long yen investment. Over the last few months, we've taken advantage of the hardening of the insurance market to add to insurance linked securities with an investment in MetroCat, a specific bond that yields over 10% and insures New York's Transit Authority against severe flooding, and to Leadenhall, a diversified fund of insurance risks.

So our clear belief is that, with a bit of patience, this portfolio can deliver very strong returns for you. Our investments either bake in high, double-digit yields or benefit from a good asymmetry with more upside than down. In the short term, volatility is likely to continue to be the order of the day in markets and our modelling shows that we will be robust to that. But in the medium term, we're well placed to capture attractive return opportunities across the full suite of assets. And I think with that Paul, I'll hand back to you and happy to take whatever questions our viewers have.

PM: Thank you, James. Thank you to those of you that have submitted questions so far. Please, can I encourage everyone else on the webinar to submit their questions, their thoughts, their comments using that Q&A function on the screen?

James, I'll maybe try to combine a couple of questions that have come in already because I think they're getting to the same point. You've helpfully outlined the team's central expectation here: one of US-led slowdown, growth and inflation falling. I suppose that both of these questions are getting to the same point - what if you're wrong? What if the landing is actually a wee bit softer than you anticipated.

JS: A great question. And I think you have to be honest that this is a pretty difficult point - a number of outcomes are possible from here. And whilst we do hold the view that growth is likely to fall, inflation is likely to fall, and actually that's likely to lead to a recession over the next 12 to 18 months, it might not.

So I think what's important is the asymmetry of returns and where we see that asymmetry of returns. So, a soft landing as opposed to a recession, that's actually a good thing. That generally leads to good returns for those better-value economic assets. It still sees inflation coming down; it's good for those duration assets. The scenario that we would see as most troubling is one with low growth but very sticky inflation and where the Federal Reserve and other central banks have to continue to act to bring that inflation down.

We think that's probably worse for the less-good-value economic assets - for equities and for high yield. But really, when we look across the portfolio, what we're seeking to find is those investments that will do very well with high probability in those scenarios we think are most likely, and less poorly with lower probability in those scenarios that we think are less likely.

So to give you a kind of example of what I mean there, where we're invested in US Treasuries, we see yields coming down by as much as one and a half percentage points in our core scenario, and that would be a very good capital return. But in our risk scenarios, we see them only rising by about half a percent. So that kind of asymmetry, which we're trying to bake in across the portfolio, whether in duration or those of better-value economic assets that come with that buffer, is really important, we think, to delivering returns in that slightly uncertain environment going forward.

PM: Thank you, James. I've actually deliberately left the portfolio wheel on the screen; there's a comment up at the top on the economic outlook around emerging markets and Japan diverging. And that just picks up on another question that we've been asked, which is how have the team's views on Japan in particular been evolving over the last quarter and looking forward?

JS: Sure. I didn't speak to that specifically in my introductory comments, but I think it is an economy that we see as very interesting, one that has had a contribution to performance in the last quarter and one that we hope will have a contribution to performance coming on, say, and specifically what I'm thinking here is that Japan, as we know, has seen very low inflation for 20, 30 years, but that has changed. That is changing and we are seeing inflation picking up in Japan. If you look at Japanese core-core inflation, our preferred measure, that has been rising month on month on month on month over the last few quarters, it's now around four per cent.

We see an inflation impulse in Japan that is just as strong as it has been in the US, and we see it becoming more endemic in wage inflation and expectations. And that's interesting because the central bank in Japan policy makers have taken a completely different approach. The Bank of Japan continues to run ultra-easy monetary policy. It continues to run the yield curve control, which is effectively a version of QE. So we've got high inflation, but we've got ultra-easy monetary policy, which contrasts to the rest of the world where policy rates are very, very tight indeed. So, we think Japan as it is, is unsustainable and there needs to be a change in policy.

So how has that hit on performance in the last few months? Well, I mentioned the yen investment. So in that environment of rates remaining low and there being a high interest rate differential between Japan and countries like the US, the yen had got weaker. It finished the quarter close to 145 yen to the dollar, a weak level. That has already strengthened by three or four per cent over the quarter but it was a drag on performance in the three months to date.

We maintain that position because we expect to see that change in monetary policy, which will see the yen strengthen as rates are allowed to increase. And we've added to it by taking a position within government bonds that will benefit from Japanese interest rates rising from yield curve control being removed or at least amended and eased somewhat. So, it's been a bit of a drag in the last three months; we think it's a really interesting opportunity; and it's something that we really hope will add to portfolio returns going forward.

PM: Thank you, James. We have had a question from an audience member. What are you doing to strengthen risk management, especially with regard to protection strategies across equities and bonds? And there's a second part to the question around any hires in this area?

JS: Sure. So, I think the first thing to say to that is to acknowledge that we clearly could have done a better job of that in the first half of last year. And, there's an extent to which certainly long-term performance is still recovering from that. At that time, as the question alludes to, we were relying on a number of protection strategies, if you will, absolute return strategies to provide balance to a portfolio that had a wide range of economic assets.

We have moved away from that. We have a clearer expression of our current macro view in the portfolio. We have a broader set of better-value economic asset classes and without that, perhaps, uncertainty of those absolute return strategies, we have a number of assets where we have very clear confidence on how they will behave in a range of economic scenarios.

So, when we look at our risk models or indeed our scenario analysis, we have very good confidence that the portfolio will remain robust to a number of the things that could happen. I'd like to think that March-April was a good stress test of that, where we saw the banking concerns which started with SVB ended up with Credit Suisse. At that point in time, the Fund price remained very, very stable throughout that in a way that I think had we had the portfolio we had had 18 months ago, it would not have done so.

PM: Thank you, James. There are a couple of related questions that have come in around process and given recent performance being behind target, is anything being done or has anything been done to review the investment process? What are you doing to make up for the losses that we've seen recently?

JS: So, I guess actually this is the second half of the last question, which I didn't fully get to. What has changed for us in process because we have taken learnings from the last 12 to 24 months and we've introduced a number of developments.

Some of that is making sure that the research work we do feeds through directly to the portfolio and ensuring that there's no inertia. So making sure that our long-term return expectations actually get reflected more quickly, more thoroughly in the portfolio. Another part of that is working to build up our macroeconomic process across all of our relevant teams. That is led these days by James Carver within my team. And the outputs of that feed much more clearly into our asset allocation process. So, we think about asset allocation more in strategic terms, in terms of the long-term returns, in tactical terms, in terms of the macroeconomics. And linked to that is work to improve our risk process. So I talked more to that last question in terms of the risk outlook for the portfolio and the sorts of assets that we own at the moment.

What I didn't talk as much about was how we have added to our Multi Asset and Fixed Income Risk Team and how we, as an investment team, are working much more closely with, particularly Caspar and Livia, names you may have heard me talk about directly as our Risk Team's nominated people who work with us and come and sit with us on a more regular basis. And we have strengthened the process and the challenge that they can offer, and that has led to portfolio change. So, some of that explains or sits behind the removal of absolute return strategies or the reduction of absolute return strategies. A prompt from that team has seen us broaden out our bond duration and the addition of Canadian government bonds I mentioned partly was an attractive opportunity there but partly it's seeking to broaden the duration to hedge against, or at least have the portfolio prepared for, a broader range of outcomes, which would have included, for example, over the last quarter had we had a debt ceiling based default.

PM: We've had a question around structured finance observing that is has been a positive contributor to performance recently. And you mentioned that it's an area that you've been adding to. I wonder if you could talk about some of the work that you've been doing in that asset class.

JS: Yes. So, structured finance is an asset class that we've generally liked over the last 10 to15 years since the financial crisis, since authorities made it much more difficult for people to invest in the area and ultimate supply-demand balance in a way that meant that yields had moved up and were attractive relative to more conventional forms of fixed income. But, over the last two to three years, we've seen those yields move up higher again and, certainly, the differential between yields you can get in structured finance, which as I mentioned, will be 12, 13, 14 per cent off of a floating rate base, make them look very attractive relative to equivalently-rated corporate bonds where you're maybe only getting 7 to 8 per cent off a fixed rate base.

So it's an asset class that we have been doing a lot of work in over the last 12 months. We've been making investments at mezzanine CLO level, which is sort of triple-B rated tranches of collateralised loan obligations. So, pools of loans that sit behind them, corporate loans. Or at the very top end of those CLO structures in a levered format. And as we've done that, we've sought to find new ways of expressing that view, new managers with whom to work with. So, I mentioned to Accunia in my earlier comments. They are one of four or five managers who we have spent quite a lot of time doing due diligence on, going out and meeting, exploring their approach to investment, to ESG, their governance arrangements and so on. And we're pleased to say we've found two or three managers with whom we wish to put more money to extend an exposure to this asset class which continues to offer, we think, one of the highest long-term return expectations around.

PM: There are quite a lot of process questions coming in, but a process question relating to the long-term returns that you mentioned. I suppose the nub of the question was, from the most recent exercise that you undertook, what were the most attractive asset classes and are those ideas being reflected in the portfolio?

JS: Yes. Well, probably worth putting a slide up, if you don't mind Paul for that. There is a long-term return expectations slide, this will be familiar to you I think. It shows a range of asset classes across the bottom and then for each asset class, you can see a blue line which reflects the range of return expectations we've held for that asset class over the last 20 years; a grey dot which shows the average return expectation we've held over 20 years; and, a green dot which shows the return expectation we hold today.

So to the point I was just making in the last question, actually, mezzanine structured finance is the fifth asset class along from the left, and you can see from it's green dot is offering, we think, the highest possible return over the next 10 years across all of these asset classes, which is why we like it, why we have been adding to it, why we are likely to continue to add to it. To the question, what you can see is that most asset classes we see as delivering above-average returns. There's a couple of which are not: equities we think have fallen below average just a little. But, actually, where we see most attraction is in some of those more, more niche or less traditional asset classes. So, yes, structured finance, emerging market hard currency debt and ,actually increasingly, property. So those are both areas that we do plan to add to.

As I talked about emerging market local currency debt, as I said, we still see more opportunities in the hard currency debt. So, we had an asset allocation discussion last week, leading from this long-term returns, we are expecting to make an increased allocation into emerging market hard currency over the coming weeks.

Property is a little bit more nuanced. The opportunity in property is largely in areas like logistics, where we've already got an exposure and it's driven by rental growth. So, in logistics property, we see the rents that companies are paying for that property is sitting 30-40 per cent below open market rents. So, that's the opportunity as you don't have to make heroic assumptions about where rents are going. You should expect to see that return come through. However, property is an economic asset class. If we do see equities do poorly, it's likely that property will do poorly alongside it, at least initially. So, whilst we might make a small addition there with a macroeconomic view coming in alongside it, it's likely to be a small addition for now waiting for better opportunities. But you will see those long-term return expectations lead to portfolio changes.

PM: Thank you James. We are fast approaching 11 o'clock and we're maybe into dangerous territory here because it's a great question which maybe demands a one-minute answer around the benefits of active management. And I think you've you started to hint at it there with your last answer, but essentially the question is, are you able to explain how active management will help in the new higher-rate environment when for the last decade passive management has generally outperformed active? I think if you can, is there a simple one-minute answer?

JS: I think high yields indicate a level of stress and uncertainty in the economy, whereas low yields indicate low volatility and reasonably straightforward, everything is reasonably well priced. So, in an environment of higher uncertainty and wider dispersion amongst investments, that is when active managers can, and should, make the greatest returns both in asset class selection and in instrument selection within that. As I've hopefully given light to in the course of my comments, we think there's a number of asset classes that offer better value just now amongst economic asset classes. So, we believe the alpha we bring will be in selecting those and we have selected those. And within asset classes, as my property comment there just gave an allusion to, we see some really poor property opportunities, but we see some great property opportunities and I think it's really important that we're able to pick those in a time when there is that volatility and that uncertainty, those the number of opportunities increases in a way that when QE is pushing bond yields down and all prices to a premium, it is much harder to do.

So I do think that there is a lot of value here. It will require a bit of patience because that's what volatility does and that's what volatility requires. But we think with that patience, this portfolio as an active portfolio can deliver very strong returns over the medium term.

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PM: Great, thank you, James. Well, that half hour has passed very quickly. I think you have summarised very nicely there James, so I think without further ado, I will let you get on with your day. I will thank you for joining us this morning, taking the time out of your day to do so. We hope you have found the update to be useful and interesting. And should you have any further questions, please do not hesitate to get in touch with your regular contact at Baillie Gifford. Thank you and good morning.

JS: Thank you.

Baillie Gifford Diversified Growth Fund Annual Past Performance
To 30 June each year (net %)

	2019	2020	2021	2022	2023
Diversified Growth Fund	2.9	-3.0	13.9	-9.8	-2.1
Base rate +3.5%	4.2	4.1	3.6	3.9	6.7

Source: Revolution. Sterling.
Base Rate: UK Bank of England.
The manager believes that Base Rate (UK Bank of England) +3.5% is an appropriate target given the investment policy of the Fund and the approach taken by the manager when investing.
We have included past performance information for Diversified Growth as an example of our multi-asset approach. Please note that this is not a guide to future returns of our Multi Asset strategies. The investment universe of our Multi Asset strategies may differ slightly. The Baillie Gifford Diversified Growth strategy is not available in all jurisdictions.

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