Baillie Gifford™

International Alpha
Q3 investment update

October 2023

Investment specialists Andrew Brown and Sachin Sharma give an update on the International Alpha Strategy covering Q3 2023.

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

Sachin Sharma (SS): Hello, and thank you for dialing into this International Alpha Q3 2023 quarterly video update. My name is Sachin Sharma and I'm an investment specialist on the strategy, and I'm pleased to be joined today by Andrew Brown, who is also an investment specialist on the strategy. Today, we're going to provide an update on the investment environment, how performance has been, and share some thoughts on what we've been doing during the quarter, and our outlook over the next five years and beyond.

So Andy, it's great to be joined by you today.

Andrew Brown (AB): Hi there, nice to chat to you.

SS: So in the most recent quarter, how has the investment environment been? What's the backdrop been and how has the strategy fared in that environment?

AB: Well, it's been a quarter where themes have dominated markets rather than company-specific factors. The turning point seemed to be some hawkish statements from the Federal Reserve and that underpinned a narrative of 'higher rates for longer'. When that happens, what we tend to see is those big sentiment swings. Growth stocks get hit particularly hard. Value stocks tend to do a lot better.

In many ways, what we saw in the most recent quarter echoed what we saw in 2022. Now, given that we are bottom-up stock pickers and we focus on quality growth companies, this is an extremely difficult environment for our style.

SS: Okay, and so in a difficult environment, what has attribution been like when you get into the specifics?

AB: Well, the strategy was well behind its benchmark during the quarter, and unfortunately now, over the year-to-date period, the strategy is also behind. So what this means is we've given up the gains that we made earlier in the year.

Earlier this year, there were some green shoots, there were some encouraging signs that markets were following company-specific factors, and in that environment, we did much better. Companies were continuing to perform well operationally, and that was being appreciated and rewarded by markets. But in the last few months, that's unwound and macro-driven sentiment really overwhelmed stock-specific factors. So now, unfortunately, we're behind year-to-date, which is very disappointing for our clients.

SS: Are there any particular examples that you'd highlight from a stock-specific basis?

AB: Well, there were a few themes that emerged as a result of what happened in markets. The first one I would highlight is Japan, where the underperformance of growth stocks was most pronounced. Any mild disappointments in earnings results, especially for stocks that trade on slightly higher-than-average earnings multiples have been hit very hard.

But at the same time, value stocks have enjoyed a very strong period. So, our Japanese names have struggled. When we look at the individual stocks there, one of the stocks that we bought last quarter called Nihon M&A, was very weak. This is a business that advises small- and medium-sized enterprises on succession planning. It's a structural growth stock that we believe it benefits from demographic tailwinds as a result of Japan's aging population. There's a very large number of deals each year as many companies are seeking replacement founders for companies that are run by individuals in their seventies or eighties. Nihon M&A reported weaker than expected results and the shares were extremely hard. Management have not changed their forecasts so this seems to be a temporary issue.

Another example is FANUC, which is an industrial automation business. Again, the results were a bit weaker than expected. FANUC is a business that also, we think, has secular growth tailwinds owing to demographics. Factory automation equipment is increasingly in demand. What's also helpful is that we're seeing increasing levels of investment and R&D spend, and that's driving more use of automation equipment.

But because the results were weak in the short run, in this case because China demand was a bit weaker than expected, the shares were out of favour.

The second thing I would highlight is stocks that face towards Chinese demand have been very out of favour. Now, to some extent, there's overlap with the Japanese names here. So for FANUC China is a big source of demand. But stepping out of Japan, we also have, for example, the luxury names like Richmond. The owner of the Cartier watch brand has been very weak during the quarter and we think [that's] because of Chinese demand being a bit weaker than expected. China is recovering, but the recovery has been much slower than many people expected.

So those are the two main themes I would draw out. The final one is companies that companies investing for future growth suffered Wee saw this in 2022 when companies that were choosing to invest and in doing so to compromising short-term profits in order to build out their competitive moat, were punished by the market. This is something that we generally support.

During the most recent quarter, there were two companies in particular that were hit very hard for that exact area. The first one is Adyen. This is the Dutch payment processing platform. In this case, Adyen has actually been investing consistently and they've been very open about that. But during the quarter, there was a slowdown in their US digital business. There were some signs of pricing pressure and some competitive pressures coming through from lower cost operators. This, coupled with Adyen making very steadfast announcements about continuing to hire people right into next year, resulted in the shares coming off very sharply.

When we look forward, Adyen has a great product offering. Not only are they a very reliable service, but they're able to deal with that complexity of operating across different payment platforms in different geographies. We think that if we step outside that US payment market they actually have a very strong position.

The second company in this ‘investing for future growth’ category is the Southeast Asian internet platform called Sea Ltd. Here I think the market was just a bit confused because earlier this year they made statements around cutting back investment, reining in some of the investments they'd made in peripheral markets and focusing just on the core markets, which we thought that was a very sensible move. The shares responded very positively to that.

But what's happened more recently is they've continued with that strategy, but within those core markets, where they do have a competitive edge and they are growing, they've made some noises around stepping up investment. We think that's quite a sensible thing to do, but because margins are coming off that in the short run the market has been a bit grumpy and the shares have been weak.

SS: Okay, great. So that's a good example of some themes that have been affecting some of the negative contributors to performance. What about some of the names that may be a bright spot in the portfolio recently?

AB: Yes, as always, there are names that that do well during the period. What's frustrating this quarter is that there were several companies that actually reported some really encouraging developments, but the market didn't really seem to pay a great deal of attention. So, of course there were positive contributors, but they didn't perform as well as they probably ought to have done, given the significance of what was going on.

So, for example, a couple of the holdings in the strategy demonstrated some really strong pricing power. Spotify, the music streaming platform, put their prices up for the subscription services by 10 per cent and that didn't harm volumes at all. And that's really encouraging, it demonstrates how much users value the service that they provide.

There's also a very different type of company, an Irish manufacturer of insulation panels called Kingspan which put prices up by some 25 per cent. Again, customers responded very well to that. and The shares were positive but they didn't go up by as much as we would have expected.
A second example to give is Scout 24. This is a German real estate platform. Germany is one of the countries in Europe that has actually moved into recession. The German real estate market has been very challenging, but Scout 24 actually reported very strong results, and this just demonstrates the value that they add to their customers. They make the whole process more efficient, and they take costs out of the system. So, they've proven what a resilient business model they have. So, yes, some encouraging examples, but the shares didn't move as much as we would perhaps have hoped.

SS: Yes.

AB: I guess now, having talked about performance, we should probably move on to what we've been doing in the portfolio. I know that you've written research on one of the holdings that we've taken during the quarter, so maybe you're best-placed to talk about what we've been up to.

SS: Yes, the team has been very busy during the quarter. We've had 120 meetings with management teams, predominantly on the road. It great to be out and about and meet management. Our stock discussions have ranged from everything from beer companies to healthcare businesses, through to discount retailers based here in the UK.

So, idea generation remains strong.

AB: There's clearly a wide variety of stocks being considered.

SS: And yes, exactly, lots of different names that we're considering. In terms of the new buys, there have been two new buys to note in the quarter. The name that you mentioned that I was fortunate enough to be able to write the research on was Reliance Industries, which is India's leading conglomerate.

It's got an incredibly strong track record of capital deployment. It's led by Mukesh Ambani. He's led the business successfully over the last 20-plus years after inheriting half of it from his father. Where we really focused on with Reliance was looking at the three areas that we think are going to be key to growth.

So, the history of Reliance is that it's an oil and gas major in India. That part of the business is essentially a cash cow for the company and that allows them to invest in several different verticals and deploy capital and disrupt markets and take market share. We've seen that within the digital space, they have the biggest mobile telecoms business, Reliance Jio If you went back to 2013, the sell side was attributing a negative valuation to that business. But the Ambanis had had the vision to disrupt the market and make it a success, initially by bringing average selling prices down, but through time, they've been able to take market share and actually increase the average selling price.

Recently, they won the 5G auctions in India. So, by the end of 2023, they plan to roll 5G out across the entirety of the country. So this is a really ambitious digital platform, and that's not to mention the streaming business, which again is following a similar disruptive pattern and challenging the incumbents.

AB: Incredible.

SS: They also have a retail business, with about 3 percent of the total retail market in India. But 12 percent of what is the organized market. The Indian retail market is predominantly unorganized. Here in the West we have supermarkets, we have big grocery stores, the likes of Costco, Walmart. That isn't really the case in India. There's unorganized markets of kirana (mom-and-pop) shops which are really vital to the local economy.

Reliance is the only business that's looking to partner with those kiranas. At the moment they have about 2 million partnerships and there's around about 20 million stores in India. o What they're looking to do is to use their ecommerce platform to then allow individuals to buy products from kirana stores, from their phone, from their tablet [or] laptop, pick them up or have them delivered from those stores.

And what that does is it appeals to the kirana owners because it means that they get more traffic through their stores, and then they are also able to open up Reliance's supply chain to these kirana stores, so that makes their inventory sourcing a lot more efficient and should improve margins in the long term.

When we look at the likes of Amazon, the likes of Flipkart in India, they're very strong in big metro cities like Mumbai and Delhi. But Reliance is the only business really operating in the rest of India, which is a really exciting place to be. So it's at a nascent stage, but there's a lot of growth we feel to come from the retail segments.

AB: Sounds very exciting, and I know we've done quite a lot of work looking for opportunities in India, so it's great to see this get into the portfolio.

SS: Yes, definitely.

The other name that we've added in the quarter is Demant, which is a European hearing aid business. It's one of the top three businesses in terms of hearing aid manufacturing and it's also got strengths in the retail side of things being a serial acquirer of retail audiology businesses.

We like the business because it's steadily increased its market share in recent years. It's been investing well, as I mentioned, buying up audiologists. In addition to that, it's got a very sticky customer base and that provides attractive recurring revenues, because once you have a Demant device, your audiologist is going to fall back to using the Demant product. And so it's quite easy for them to roll out new products, with incremental changes, that in turn require servicing and maintenance. So that's another name that we've added to the portfolio.

AB: It sounds like a classic quality compounder.

SS: Yes, exactly. So, a great name to add to the portfolio at this stage.

AB: And so what about the complete sales end, to fund these exciting new buys?

SS: Yes, so we've sold out of one name called Futu, which is a Hong Kong domiciled Chinese digital and savings platform. The growth trends behind it were that Chinese households are under-penetrated in terms of foreign equity ownership, being at circa 12 percent versus the US at around 50 percent.

However, there's been significant regulatory pressure which is going to make it much harder for them to gain any new mainland China users. Although the business is active in other geographies in Southeast Asia, our focus was really, in terms of the investment case, on the Chinese market, so we decided to sell out of our position in Futu.

The other name that we sold was Japan Exchanges, which we've held it for a decade. Over that timeframe, it's been a good investment, although our conviction in the growth opportunity over the next decade has waned.

AB: It sounds like we've upgraded the growth and the quality of the portfolio, which is really encouraging.

So moving on to the outlook then, Sachin, how are we thinking about the future?

SS: Yes, we're increasingly optimistic about the next five years and beyond. We feel that the portfolio benefits from several attractive tailwinds. We've spoken about some of these, whether it's facing into the rising consumer wealth in India and other emerging countries, or whether it's facing into things like the energy transition or the healthcare space.

So that, combined with the fact that the portfolio has demonstrated strong metrics in terms of forward earnings growth which is superior in the benchmark or quality metrics, which are significantly ahead. Although it's been a volatile period in terms of the markets, the portfolio looks very robust.

Once the market turns attention to fundamentals again, as we saw in the first half of the year, we believe we will be in a great position to be able to deliver for clients.

AB: And another factor that I would highlight is that great companies can navigate difficult times. It may be very frustrating for our clients to see that a lot of their holdings have suffered a draw down during this this macro driven environment, but actually, the examples that we gave earlier of Spotify and Kingspan putting up prices just really demonstrate that great companies can weather high inflation and more challenging macro environments.

So, we should feel confident because the holdings are good quality businesses that are run by exceptional management teams.

SS: Definitely.

AB: Great. Well thank you very much, Sachin, for your insights. And thank you very much, everyone, for listening to our quarterly call. We hope you found it useful.

International Alpha

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

	2019	2020	2021	2022	2023
International Alpha Composite	1.3	23.7	15.4	-38.3	18.7
MSCI ACWI ex US	-0.7	3.5	24.5	-24.8	21.0

Annualised returns to 30 September 2023 (net%)

	1 year	5 years	10 years
International Alpha Composite	18.7	1.1	3.9
MSCI ACWI ex US	21.0	3.1	3.8

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.

Risk factors

The views expressed should not be considered as advice or a recommendation to buy, sell or hold a particular investment. They reflect opinion and should not be taken as statements of fact nor should any reliance be placed on them when making investment decisions.

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

All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk. Past performance is not a guide to future returns.

This communication contains information on investments which does not constitute independent research. Accordingly, it is not subject to the protections afforded to independent research, but is classified as advertising under Art 68 of the Financial Services Act ('FinSA') and Baillie Gifford and its staff may have dealt in the investments concerned.

All information is sourced from Baillie Gifford & Co and is current unless otherwise stated.

Important information

Baillie Gifford & Co and Baillie Gifford & Co Limited are authorised and regulated by the Financial Conduct Authority (FCA). Baillie Gifford & Co Limited is an Authorised Corporate Director of OEICs.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

Baillie Gifford Overseas Limited provides investment management and advisory services to non-UK Professional/Institutional clients only. Baillie Gifford Overseas Limited is wholly owned by Baillie Gifford & Co. Baillie Gifford & Co and Baillie Gifford Overseas Limited are authorised and regulated by the FCA in the UK.

Persons resident or domiciled outside the UK should consult with their professional advisers as to whether they require any governmental or other consents in order to enable them to invest, and with their tax advisers for advice relevant to their own particular circumstances.

Financial Intermediaries

This communication is suitable for use of financial intermediaries. Financial intermediaries are solely responsible for any further distribution and Baillie Gifford takes no responsibility for the reliance on this document by any other person who did not receive this document directly from Baillie Gifford.

Europe

Baillie Gifford Investment Management (Europe) Limited provides investment management and advisory services to European (excluding UK) clients. It was incorporated in Ireland in May 2018. Baillie Gifford Investment Management (Europe) Limited is authorised by the Central Bank of Ireland as an AIFM under the AIFM Regulations and as a UCITS management company under the UCITS Regulation. Baillie Gifford Investment Management (Europe) Limited is also authorised in accordance with Regulation 7 of the AIFM Regulations, to provide management of portfolios of investments, including Individual Portfolio Management ('IPM') and Non-Core Services. Baillie Gifford Investment Management (Europe) Limited has been appointed as UCITS management company to the following UCITS umbrella company; Baillie Gifford Worldwide Funds plc. Through passporting it has established Baillie Gifford Investment Management (Europe) Limited (Frankfurt Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in Germany. Similarly, it has established Baillie Gifford Investment Management (Europe) Limited (Amsterdam Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in The Netherlands. Baillie Gifford Investment Management (Europe) Limited also has a representative office in Zurich, Switzerland pursuant to Art. 58 of the Federal Act on Financial Institutions ("FinIA"). The representative office is authorised by the Swiss Financial Market Supervisory Authority (FINMA). The representative office does not constitute a branch and therefore does not have authority to commit Baillie Gifford Investment Management (Europe) Limited. Baillie Gifford Investment Management (Europe) Limited is a wholly owned subsidiary of Baillie Gifford Overseas Limited, which is wholly owned by Baillie Gifford & Co. Baillie Gifford Overseas Limited and Baillie Gifford & Co are authorised and regulated in the UK by the Financial Conduct Authority.

South Korea

Baillie Gifford Overseas Limited is licensed with the Financial Services Commission in South Korea as a cross border Discretionary Investment Manager and Non-discretionary Investment Adviser.

Japan

Mitsubishi UFJ Baillie Gifford Asset Management Limited ('MUBGAM') is a joint venture company between Mitsubishi UFJ Trust & Banking Corporation and Baillie Gifford Overseas Limited. MUBGAM is authorised and regulated by the Financial Conduct Authority.

Australia

Baillie Gifford Overseas Limited (ARBN 118 567 178) is registered as a foreign company under the Corporations Act 2001 (Cth) and holds Foreign Australian Financial Services Licence No 528911. This material is provided to you on the basis that you are a "wholesale client" within the meaning of section 761G of the Corporations Act 2001 (Cth) ("Corporations Act"). Please advise Baillie Gifford Overseas Limited immediately if you are not a wholesale client. In no circumstances may this material be made available to a "retail client" within the meaning of section 761G of the Corporations Act.

This material contains general information only. It does not take into account any person's objectives, financial situation or needs.

South Africa

Baillie Gifford Overseas Limited is registered as a Foreign Financial Services Provider with the Financial Sector Conduct Authority in South Africa.

North America

Baillie Gifford International LLC is wholly owned by Baillie Gifford Overseas Limited; it was formed in Delaware in 2005 and is registered with the SEC. It is the legal entity through which Baillie Gifford Overseas Limited provides client service and marketing functions in North America. Baillie Gifford Overseas Limited is registered with the SEC in the United States of America.

The Manager is not resident in Canada, its head office and principal place of business is in Edinburgh, Scotland. Baillie Gifford Overseas Limited is regulated in Canada as a portfolio manager and exempt market dealer with the Ontario Securities Commission ('OSC'). Its portfolio manager licence is currently passported into Alberta, Quebec, Saskatchewan, Manitoba and Newfoundland & Labrador whereas the exempt market dealer licence is passported across all Canadian provinces and territories. Baillie Gifford International LLC is regulated by the OSC as an exempt market and its licence is passported across all Canadian provinces and territories. Baillie Gifford Investment Management (Europe) Limited ('BGE') relies on the International Investment Fund Manager Exemption in the provinces of Ontario and Quebec.

Israel

Baillie Gifford Overseas Limited is not licensed under Israel's Regulation of Investment Advising, Investment Marketing and Portfolio Management Law, 5755-1995 (the Advice Law) and does not carry insurance pursuant to the Advice Law. This material is only intended for those categories of Israeli residents who are qualified clients listed on the First Addendum to the Advice Law.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com