Baillie Gifford™

US Alpha
Q4 investment update

January 2025

Investment manager Saad Malik and investment specialist Fraser Thomson give an update on the US Alpha Strategy covering Q4 2024.

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

Fraser Thomson (FT): Welcome to this update from our US Alpha strategy. I'm Fraser Thomson, one of the strategy's investment specialists, and I'm joined today by Saad Malik, who's one of the strategy's portfolio managers. By way of a very brief reminder, US Alpha is a diversified growth strategy. We seek to benefit from the outperformance that can come from investing in rapidly growing disruptive companies, steadily compounding businesses, and also those companies that can grow through the ups and downs of their market cycles. So it's a diversified but active and committed long-term US equity strategy. So Saad, welcome. The final quarter of the year was a strong one for the strategy and for returns overall. And that capped a good year overall for returns from the US Alpha strategy. But interestingly, one that didn't quite keep pace with even stronger returns from the wider S&P 500 index. So how do you put that kind of environment into context?

Saad Malik (SM): That's correct. 20 per cent returns in any given year is quite strong in the context of equity returns more generally, but we lagged the index. What's encouraging for us, nevertheless, is the source of our returns are different from the S&P 500. In our case, the portfolio's returns have been driven almost exclusively by fundamentals improving. That is, businesses generating more revenue, growing their profits. In contrast, the bulk of returns for the S&P 500 have come from revaluing of stocks. And so we feel generally quite positive about that setup. If you think about the attribution more specifically for the quarter, the stocks that really moved the needle for us include Shopify, the e-commerce platform, and DoorDash, the food delivery network. In both cases, these are businesses that have come out of a period of some challenge but have emerged much more strongly and are outperforming across the metrics that matter.

Of course, it's not all rosy. There are some businesses that haven't performed the way we like. Notably, there are businesses that are in the industrial sector. So Advanced Drainage Systems is an example. This sells plastic pipes to public and private infrastructure projects. In this case, we're

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seeing a business that is facing some cyclical pressures, which we think are short-term in nature. The same is true for Stella Jones. We think patience is rewarded here. We are long-term, we built conviction in these holdings. Patience was rewarded in the case of Shopify and DoorDash, and we think the same will hold true here as well.

FT: Great. Thanks, Saad. I guess staying with that valuation theme, clearly valuations have ticked up in the aggregate for the market in which you invest. And there must surely also be pockets of heat in valuation within the portfolio itself. So how are you dealing with that kind of environment?

SM: Absolutely. This is something we've spent a lot of time thinking about. And we've all seen the performance of the S&P 500, for instance. And you'll note that the valuation for the S&P 500 is roughly 20 per cent higher than it is on a decade average. I'm thinking about the price to earnings multiple in particular. We are bottom-up stock pickers and so as ever we are going to focus on valuation on a case-by-case basis. As a team we've gone through a valuation exercise where we reviewed roughly a dozen names over the course of a couple weeks and debated each of those vigorously. This was a decision useful exercise for us, and there are some notable decisions that have come out of this, and they include Watsco, which we've decided to sell. Watsco is a distributor of air conditioning units and heating units. It has an extraordinary track record as a capital allocator. Nonetheless, we've done the math and we think the case required to make our return hurdle over our holding period is quite unlikely, and hence the decision to sell. Similarly, we reviewed Fastenal, which is a business that distributes fasteners of various sorts. These are nuts, bolts, also adhesives. Once again, a great business. To meet our hurdle this business needs to combine an unlikely increase, acceleration in revenue rather, with growing profitability, which is unlikely for a mature business. And so in both cases, what this valuation exercise has taught us is that these are great businesses, but they may not be great investments at the moment.

FT: So I was interested to note from that valuation exercise that one name that's not on that list is Applovin. It's a recent purchase for the portfolio. But its share price has more than doubled since you first took a holding in it. So why does that one continue to justify its place in the portfolio?

SM: Yeah, I'm really enthusiastic about Applovin. It's a business in the advertising space. It connects roughly 1.4 billion daily active gaming users with various advertising content. When we first bought this business, it wasn't really considered a growth business by the market. It came out of a challenging period, which was challenging for a lot of the advertising sector. More recently, it's grown 40 per cent. It's an absolute powerhouse on roughly $4.5bn of revenue. And the market has taken notice. Their shares have repriced, as you've described. However, our enthusiasm remains for this business. What we've noticed, and through our conversations with the founder, even last month, actually, the business is expanding its addressable opportunity into e-commerce, which we think is a multiple of the gaming market. And therefore, the business continues to be really exciting for us. It's proven its value proposition, and now it's expanding where it can make that value proposition relevant. Hence, we continue to be excited about the upside.

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

FT: Well, there's one other new purchase I'm really interested to talk to you about, and that's e.l.f Beauty. It's a colour cosmetics company. The particular reason for interest is that you not so long ago sold Estée Lauder out of the portfolio. So what distinguishes these two companies that appear at first glance to operate in a very similar space?

SM: You're right, they do. And as bottom-up stock pickers, we're constantly reappraising our investment cases, and we're moving money to companies where we think there is the highest level of conviction. e.l.f is an example of that. e.l.f is a kind of new breed of business that we think is really well positioned to capitalize on the beauty market. It is exceptional across not just retailing and advertising. It has best in class advertising approach on TikTok. Which makes it relevant to users of demographics that legacy companies like Estee Lauder may not so easily address. And on a base of 1.2 billion in revenues, roughly, it's growing into a market that is probably in the tens of billions, if not more. We think that's a really attractive opportunity set.

FT: Great. Well, we couldn't let this update pass without mentioning the most important event in the US over the past quarter. And that's the emphatic victory for Donald Trump in the presidential election. Now, we've spoken in the past, and Mike's written a paper on why election outcomes often matter less to the long-term stock picker than commentators would have you believe. But just given how emphatic that victory has been, and the market reaction since, is there anything in there that's changing your thinking?

SM: Absolutely. It'll be really interesting to see how this new political regime will influence business. It's notable that Trump is a huge supporter of American business and the deregulation agenda he's putting in place is bold and will be interesting to observe. We've seen some big share price reactions as well, as you noted, since the election. And that's why we've done the valuation exercise that we did, looking at cases on a stock by stock basis to look for opportunities. That said, even if you look at the attribution in the last quarter, what we've noticed is, what's driving performance is not necessarily this political regime, but accelerating fundamentals. And what's driving accelerating fundamentals is a force that we think persists through the long term, and that we think is the source of the growth that we're observing in our portfolio. And that is innovation and entrepreneurship. That is individuals creating lots of change within their industries, solving large problems, and then benefiting from that change by capturing some of that value. I see this as a durable, long-term force for fundamental returns in this portfolio.

FT: Great. Well, thanks. I think that's an excellent point to pause the conversation. I hope through this discussion we've given you a sense for how the returns are being delivered in our US Alpha portfolio. And that's through the growth of revenue and earnings. And that stands in stark contrast to the wider stock market. So our premium has come down substantially over the past year. And we start 2025 with a portfolio that's well diversified across a wide range of growth drivers and styles. And we enter the year excited about the opportunities to come. So until our next conversation, thank you very much for watching.

US Alpha

Annual past performance to 31 December each year (net%)

	2020	2021	2022	2023	2024
US Alpha Composite	-	-	-	22.1	19.2
S&P 500 Index	-	-	-	26.3	25.0

Annualised returns to 31 December 2024 (net%)

	1 year	5 years	Since inception*
US Alpha Composite	19.2	-	20.6
S&P 500 Index	25.0	-	25.7

*Inception date: 31 December 2022.
Source: Revolution, S&P. US dollars. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite. 1 year figures are not annualised.

Past performance is not a guide to future returns.

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

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