Baillie Gifford

Health Innovation
Q4 investment update

January 2024

Investment manager Julia Angeles and investment specialist Diana Philip give an update on the Health Innovation Strategy covering Q4 2023.

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Diana Philip (DP): Hello and welcome to the Q4 2023 update for our Health Innovation Strategy. My name is Diana Philip. I'm an investment specialist on our health innovation team, and I'm joined by Julia Angeles, who is a partner at Baillie Gifford and one of the investment managers on the Health Innovation Strategy. Over the course of the next 10 minutes or so, we're going to provide you with an update on the investment landscape over 2023 and the performance drivers over the course of the last quarter.

We'll also touch on portfolio activity and most importantly, what's really galvanizing the team as we enter into 2024. Just as a very brief reminder, our Health Innovation Strategy seeks to invest in a very concentrated portfolio of companies that are really at the heart of the revolution that is taking place within the healthcare sector. And this is very much being driven by the convergence of technology into the sector.

So, Julia, perhaps we can begin with some reflections on 2023 and the landscape, which was very challenging for innovative health care companies and also touch on what drove the performance over the last quarter.

Julia Angeles (JA): Indeed, and 2023 continued to be a very challenging year for the life science industry as it was adjusting to the post-Covid environment. But also dealing with unfavourable macro conditions, rising interest rates, and also access to capital became very, very difficult. In addition to that, we also have anti-obesity drugs, GLP-1's that also added volatility to the companies that treat diseases that are caused by obesity.

However, despite that challenging backdrop, we still saw a lot of encouraging developments in the industry and a lot of progress. For example, we have the approval of the first gene editing therapy for patients with blood disorders based on CRISPR technology. And if you think about it, this technology has been discovered just [a little] more than 10 years ago and it’s already made to the patients.

So, we see a massive acceleration of their innovation from the academic lab to actual patients. We also see the increase in clinical trials, Phase one, which is also [an] indication of innovation to post-Covid levels. So that also tells us that innovation is not dead despite all the backdrop. It’s actually companies who continue investing and continue bringing new technology and solutions to patients.

And if you look at the portfolio level, we see also the same kind of level of progress and very encouraging developments. Take, for instance, Moderna. Before Covid, Moderna didn't have a single product on the market. Covid has accelerated Moderna's access to the market for the Covid vaccine. But now the company is very close to launching another several products.

So this is incredible progress also for a very young biotech company.

DP: Some really encouraging signs of innovation taking place, both within the broader sector and really importantly within the portfolio. And maybe you could touch on any areas of concern or any areas that weighed particularly negatively on the portfolio over the last quarter in the year.

JA: Overall, we still remain very encouraged by the health of our portfolio and that's why the turnover has been very, very low. However, if we see any significant developments to the investment case, we consider the stock and have a deep dive look, and we assess the investment opportunity. And a good example of this is Illumina.

Illumina is a company that produces genome sequencing tools that allow us to study human biology, and it's one of the industry leading players and it has been really transforming the entire field of life science. Unfortunately, Illumina has been challenged by regulators by making acquisition of that oncology diagnostic company GRAIL for competitive reasons. And on the back of it, there has been some management changes because management has been questioned for their decision making.

So those are kind of significant developments in the investment case and that's why we keep considering and reassessing the investment opportunities, but also beyond company specific developments. We also need to think about industrywide issues that are still impacting the portfolio. The Covid pandemic has been a massive distortion to the industry. So first it has accelerated the development of many different companies because of demand for pandemic driven products has been very, very large.

But now we have a reversal of that demand. And companies like Moderna, for example, suffered most because, their revenues obviously are not going to be the same as through the pandemic levels. And in addition to that, there is a need to make massive adjustments to their manufacturing capacity. In addition to the pandemic itself, we also had another layer, which compounded the impact on the sector, which is access to capital markets. And that has impacted younger buyers, the companies that had to restructure and reprioritize their pipelines and that had a spillover on the general R&D spending for the entire industry.

And in our portfolio, companies like WuXi, which is providing development tools for drug discovery and manufacturing and Sartorius, which is more geared towards those R&D budgets and they also have been impacted. We see some company specific issues, but most of it actually is still driven by industrywide shocks to the system.

And that's what has been impacting the performance.

DP: But overall, we continue to have confidence in those positions in the portfolio.

JA: Absolutely. But that's why I say we continue reassessing and the investment cases and we are very happy with portfolios at this stage.

DP: And Julia. Maybe I'll take you back to one of your earlier comments. You talked about the GLP-1 drugs, the anti-obesity drugs, which have really dominated headlines over 2023. What impact did they have on our portfolio and have we taken any action on the back of this?

JA: GLP-1 drugs are not new drugs, but over the past few years they've been increasing in their efficacy and also general awareness of these drugs. And there have been massive uptake but mostly on the private markets. The access to this drug is still limited for people who really need those drugs. But they do have impact on weight.

And we know that obesity is one of the major causes for diseases like diabetes and sleep apnea. Sleep apnea is a disease where patients can't sleep during the night, so their airways collapse and they cannot take the oxygen and as a result, they wake up. The way the market has approached it, they see a very straight correlation between, ok so now we can treat obesity, and that’s why it’s going to kill the market opportunity for all these companies.

But the way we see this is actually very different because, first of all, as I mentioned, those drugs are not new, however, they have been improving. Still, compliance remains very, very low. They're not going to really solve the problem at scale. But even if they do, we actually think it could potentially even expand the opportunity set for companies like that, that deal with sleep apnea or diabetes, or a company like Dexcom that provides continuous glucose monitoring. Because suddenly, people's awareness, there is something to do about first, you know, obesity is a source of problems.

You know, actually I want to be diagnosed also for diabetes, you know, and then actually everyone else would be better at managing my diabetes. And there is evidence suggesting that actually compliance with GLP-1 drugs increases as people are using continuous glucose monitors. So there is actually evidence of synergistic use of both technologies and doing better for patients, but also just because of the awareness.

But awareness actually could increase those market opportunities for both sleep apnea companies and diabetes.

DP: And perhaps we can shift gears and think about going into 2024. I understand the team are demonstrating incredible levels of enthusiasm for the opportunity ahead, and that's evidenced by new positions in the portfolio and all the trips that you've been on. Perhaps you can touch on some of the areas that you're particularly interested in as we head into 2024.

JA: Overall, while I was mentioning the challenging funding environment for us, for the companies getting access to capital, but also implications for R&D budgets, we see shifts on all fronts. First, we see a pick up on the secondary markets, primary capital markets, but also setting up new life science funds. There is a demand and there is awareness because technology and innovation doesn't disappear overnight and it's not going to disappear because of the unfavourable macro.

We see a revival of the capital markets and obviously still not at the levels we want them to be, but there are some healthy signs of recovery. This is one important development. But more important is if companies did made adjustments that they became a bit more rational in their approaches. But most importantly, they continued innovating. And I've just been in the U.S. and saw quite a few holdings and also those that have been impacted by Covid. Like Teladoc for example, the telemedicine company. Before Covid, they had one product, which is basically managing patients through triage, but now they have a much more complete suite of products managing mental health and chronic conditions.

The business actually became so much better. So we see that Covid has obviously has been a distortion to the investment case, but in addition, it's also been an accelerator to a certain degree, but also the business just became so much better and it's not reflected in the valuations. If you take just broader picture of our portfolio where we are, we also very, very much encouraged.

If you look, for example, at our portfolio companies' level of investment compared to the index, so R&D relative to sales is six times higher than the index level. The projected growth in sales and earnings is also three times higher than the index. And also our portfolio, even though we do invest in the early stage companies, 60 per cent of the portfolio is free cash flow positive or profitable.

So that is also a signal of a very high financial resilience of the portfolio. When you combine all that, so we are doing continued investing in the higher growth companies but also investing in the future that are healthy financially. But at the same time, you look at the valuations, and they are on a different spectrum. We are at the lowest point in history, it's the lowest in terms of sales to earnings, so price to earnings.

We think it's a very, very exciting entry point because as I say, innovation hasn't stopped. The companies continue making progress and we also try to take advantage of the current environment to look continuously for new opportunities. And we are looking at the spaces of synthetic biology and DNA synthesis, and we continue to look at the programable medicines. There are just so many exciting topics and that keeps us optimistic and encouraged about the future.

DP: Great. Thank you, Julia. Well, I think that's a great place to end. A note of real optimism, a portfolio that is very resilient, investing for its future and yet valuations that completely mask that. Thank you so much for listening. Hopefully, you found this a helpful update on the portfolio and we look forward to talking to you about the developments in the portfolio as the year progresses.

Health Innovation

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

	2019	2020	2021	2022	2023
Health Innovation Composite	28.0	81.4	-7.8	-32.7	-12.6
MSCI ACWI	27.3	16.8	19.0	-18.0	22.8

Annualised returns to 31 December 2023 (net%)

	1 year	5 years	10 years	Since inception
Health Innovation Composite*	-12.6	4.7	N/A	3.9
MSCI ACWI	22.8	12.3	N/A	10.6

*Inception date: 31 October 2018.

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.

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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

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