Baillie Gifford™

Upfront: episode six

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Financial journalist Cherry Reynard, intermediary client manager David Rolland, and investment managers Lawrence Burns and Praveen Kumar explore what the 'hero's journey' can teach us about risk in growth investing, how MercadoLibre is democratising finance in Latin America, and why now is the time for Japanese small cap investors to be brave.

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

Cherry Reynard (CR): Good morning. I'm Cherry Reynard, your host for Upfront, where we bring you the latest insights on Baillie Gifford's UK funds. Today I'm speaking with investment manager Praveen Kumar, who will be answering your questions live. So do send them in by clicking on the drop-down menu on your screen.

Before Praveen, we have investment manager Lawrence Burns talking on MercadoLibre, the eBay of Latin America. But first, client manager David Rolland is here to answer some of the questions that have been filtering into the team over the last few weeks. Welcome to Upfront.

So, hello and welcome to the show, David.

David Rolland (DR): Thanks, Cherry.

CR: Now, when I spoke with Megan earlier this year, she was pretty positive after a strong end to 2023. What have you seen since?

DR: I mean, I think that positivity has very much continued into 2024. If you take the MSCI All Country World Index from, say, the end of October last year, that's up about 20 per cent. And we've been having conversations with advisors for the past few years around the futility in trying to time markets. Now, they know this. We're not actually teaching them anything new. But they are probably having these conversations with some of their clients for the first time. So it's just another example of when markets turn positive, they tend to do so aggressively. And if you're underinvested, it can be very difficult to make up for that lost performance.

CR: OK, so the usual message: to stay invested.

Now, in the last episode, we also touched on the implications of central banks moving from rate hiking to rate cutting. How has that played out?

DR: It's playing out. I mean, inflation is falling, but it's perhaps doing that a bit slower than what the market thought at the start of the year. So, what you've seen is most central banks have kind of kicked the can down the road in terms of the first interest rate cut.

But markets have really just ignored that, they've pushed right on through. And some markets are at all-time highs, some have actually gone beyond all-time highs. So, I think it begs the question this year, will that macro narrative around Jerome Powell's comments or inflation prints be the key driver to markets this year? Or maybe it's that fundamentals are back in fashion. I mean, we certainly think in Q1 you started to see some good earnings come through, and more importantly, earnings that were more broad-base than just the MAG7.

And I think with the noise in financial news, sometimes we forget that the stock market is a market of stocks. But it's only really that micro-narrative that takes over four times a year and dominates the macro. But maybe this year will be the year when comments from NVIDIA CEO Jensen Huang have more effect on the market than those of Jerome Powell.

CR: Okay, yes, interesting. You mentioned the Magnificent Seven there, and there's been a huge amount of column inches devoted to their influence on market indices, particularly given their strong performance in 2023. What's your interpretation of that?

DR: Yes, I mean, I think they were, the MAG7 were the story of 2023. And I think at the end of that year, they made up about 28 per cent of the S&P 500. I think that figure is probably higher today, it's probably north of 30 per cent. But I think the bigger issue is looking at it in a world context. So, the MAG7 make up 20 per cent of the MSCI World Index now. And just to put that in further context, this is an index that's made up of 23 developed markets and has around about 1,500 stocks in it. So, if 7 out of 1,500 are making up 20 per cent, that's quite concentrated.

Now, this is testament to their, I suppose, their growth and their influence and their success. And I think it also highlights the importance of technology, and even more importantly still, how companies are using different types of technology to drive their growth. Now, on the flip side, obviously, you've got the concentration risk of having too many eggs in one basket. And it's something that investors will need to navigate carefully.

There's a film from 1960 called *The Magnificent Seven*. That's where the MAG7 took their moniker from, and I'm going to spoil it for people that haven't seen it, but only three of the seven survived to the end of the film.

CR: Oh, well, I don't need to watch it now so that's great. That concentration has fed into an ongoing debate on the merits of active versus passive. What's your take on that?

DR: I think it's further fuelled the debate on active v passive, but it also might make an argument for having a blend of both, the best of both worlds. If we take passive, for example, passive investing by its very definition will invest capital across an index like the S&P 500 or the MSCI World, like we've just discussed. It will invest capital across those indices without discriminating on the companies. So, some of that capital will be allocated to companies that are in terminal decline, so some of that capital will be destroyed.

Now this is not an anti-passive pitch by any stretch of the imagination. Passives are a huge part of our industry now. They're not going anywhere and, frankly, they provide broad market access at low cost. From the active investor's point of view, however, active can look at the company's fundamentals, can look at the company's fundamentals, can look at the company's market position and the future prospects. And, say, if an active manager likes some of the MAG7, they can take a big position and try to capitalise on their growth. But if they don't like that part of those companies, they can diversify away from them.

CR: OK, so we're saying that both have a place and active management is not a magic bullet?

DR: No, not by any stretch. I think most investors will have some form of passive strategy in their portfolio just now. At Baillie Gifford, we tend to run high active share portfolios. So, what that means is they're very, very different to the index, so it might be worth blending the two together. And actually, that would give you more diversification.

And it's coming back to this point around concentration, that's really what it's about. The US market grabs all the headlines, but it's not the only concentrated market in the world, there's quite a few of them. To take an example, [if] you look at the MSCI Europe now, I think it's the top 11 or 12 stocks in there that make up 22 per cent of that index. And they've got a snazzy moniker as well, the GRANOLAS. And even before the MAG7, you had the FAANGs, you had, if you go back to the 1970s, you had the Nifty 50. I've heard the AI 5 and the Fab Four being bandied around.

So, I think the overarching point here is that dominant industries and companies will change over time. But we're now in a position where if one or two of them struggle to maintain their dominance, they could drag passive funds down and take them on a bit of a hero's journey, which is something that has only really been attributed to active management in the past.

CR: OK, let's talk about that ‘hero's journey’ in a bit more detail, unpack that.

DR: Yes, so this is something I was at a conference recently, and the investing journey was described as a bit like the hero's journey, which I thought was a fantastic analogy for the last few years.

Now, this is something that's used in, say, children's storytelling, whether it's books or Disney movies. An example would be *The Lion King*. Another example would be *Finding Nemo*, which, by the way, has stood the test of time. My toddlers, if they were here, they would back me up on that and then probably just destroy the set. And even you don't need to look at Disney. *The Lion King*, for example - sorry, I would say the *Lord of the Rings* trilogy, sorry. That was three films, if you remember that, Cherry? That really draws out the hero's journey.

So, in essence, the hero will go on a trip. They will have ups, they will have downs, they will have challenges and triumphs in order to try to reach their goal. And I think that's actually just an excellent analogy for investing. Markets can be really difficult to navigate in the short term. But if you have a strategy in place, a robust strategy, you can see yourself through these ups and downs. And usually, usually the hero will walk off into the sunset happy because they've got one of these, a sound strategy in place, and they've stuck by it and persevered with it through some really difficult times.

Incidentally, we do actually own Disney, that is a new purchase in the Monks' Investment Trust and our Global Alpha Fund as of last month.

CR: Okay good. And what if somebody doesn't like or want that level of excitement, they don't want to do battle with the orcs, for example? Is there a kind of 'unheroic journey' equivalent?

DR: Yes, absolutely. Many advisors will have managed volatility multi-asset products in their portfolios for some clients, if they're looking to try to mitigate some of these ups and downs. And we have multi-asset and fixed-income products here at Baillie Gifford. But in the main, we're growth equity investors. And what we're saying is that it's very difficult to be able to manage that volatility with equities, get that predictability and smoothness, that's very, very difficult to do.

One of the key reasons for that is that progress itself is rarely linear. But this comes back to the hero's journey in that the hero's journey actually suggests that this is no bad thing, as in high volatility or extreme moves in share prices don't necessarily mean that investment cases themselves are broken. And actually, our Risk Team here at Baillie Gifford did some research recently which found over the last decade, if you look, you found that our highest returning stocks were actually [the] most volatile. So, and that correlation itself was almost perfectly linear.

CR: Okay that's interesting. Can you give some examples of that?

DR: I'll try to. So: NVIDIA, Tesla, Shopify, Tencent, Hermès, The Trade Desk, Amazon. Now I know that there'll be viewers going, well, he's mentioned quite a few of the MAG7, and I have, I've mentioned three. But this was a decade ago, so I would challenge that perhaps not many investors had heard of Tesla or NVIDIA a decade ago. And I think this comes back to our point here at Baillie Gifford, that we feel that the market struggles to really value transformational growth companies in the short term. I think we're about to hear about MercadoLibre, which is another one of those stories, we think.

CR: Yes, absolutely. And just before I let you go, David, anything advisors should be particularly mindful of at the moment, in your view?

DR: I think they're more than aware. They've just had the end of the tax year, which can be a very, very busy time. They've got Consumer Duty that's still bedding in from last year. I think the FCA have released some findings of their retirement advice review as of last month. And there's also complexities around the abolition of the lifetime allowance. So, there's a lot on advisors' plates, and I think that the overarching message from us is that we're here to help on the investment side. If we can lighten the load, please reach out.

CR: Okay, great. All right, brilliant. Thanks for joining us today, David.

Now, for those of you watching live, if you have any questions, simply click on the 'Ask a Question' tab. And as part of each programme, we feature an in-depth look at some of the transformational companies Baillie Gifford invests in. Today, we're learning about MercadoLibre, one of Latin America's most efficient ecommerce logistics networks.

Lawrence Burns (LB): In most countries in Latin America, you will find an oligopoly with three or four banks controlling 80 per cent of the market and charging some of the highest fees in the world. If you go to a bank branch, your experience is unlikely to be pleasant. You will probably have to pass through a security airlock, or a metal detector, and be seen as more of a threat than as a customer.

However, even that treatment isn't available for everyone. Because as many as 30 per cent of the people in Brazil, and as many as 60 per cent in Mexico, do not even have bank accounts. Even fewer have credit cards or access to investment opportunities and the ability to get insurance.

MercadoLibre is a company that is trying to change this through the application of technology. It started as an ecommerce platform and today is the largest in the region, shipping over 400 million packages a year, most of which are delivered through its own logistics network and arrive within just 48 hours.

The region's banks cannot offer financial services, such as credit, to many of these customers because they don't have data on them. After all, you need to know the likelihood someone will repay a loan before you give them that loan. However, because MercadoLibre has been serving millions of buyers and sellers for over two decades, it has accumulated a treasure trove of data through those ecommerce transactions.

Even if the traditional banks had data on these customers to help them lend, they would not be able to afford to serve many of them. Their cost structure, with thousands of branches, a hundred thousand employees, and an outdated technology stack, is simply too expensive to serve much of the population.

By contrast, MercadoLibre can serve its customers through an app at a fraction of the cost. So even if you don't need a large loan or have a lot of money to invest, MercadoLibre can profitably address your needs. In doing so it is ushering in a revolution, not just in ecommerce but in finance as well, providing payments, credit, savings and insurance to millions – broadening access, improving service and lowering the cost.

Latin America is a region of 650 million people with an economy worth $6tn. MercadoLibre is on a mission to democratise two of the largest and most important parts of that huge economy – retail and finance. And that journey is only just beginning.

CR: So that was Lawrence Burns, deputy manager of the Scottish Mortgage Investment Trust, introducing MercadoLibre. If you're interested in hearing more from Lawrence and about the Trust's other holdings, you can listen to their podcast, *Invest in Progress*, which is available on all the major podcast platforms.

Now to move on, we're joined by Praveen Kumar for a fund update.

So welcome, Praveen.

Praveen Kumar (PK): Hi, Cherry.

CR: Now, you're an investment manager in the Japanese Equities Team. You manage the Japanese Smaller Companies Fund and the Shin Nippon Investment Trust, and you're a deputy manager on the Baillie Gifford Japan Trust. So quite a full portfolio there, thanks for taking time out today.

Now, having been quiet for decades, Japan is all over the news with markets hitting new highs and price rises back in the mix. How important is all that for investors?

PK: I think it's potentially hugely significant and a lot of the reasons why we're seeing markets do what they have done in the last 12, 24 months. People have been waiting for these to materialise for decades, and the reason why we are seeing them finally take shape has been largely due to a combination of regulatory pressure, which has become more and more intense. And also a record level of involvement of activists who have the tacit support of the authorities, because obviously the authorities have the incentive to force companies to get better. So, things like improving shareholder returns, corporate governance reforms, finally companies are looking at [these], and being a bit braver in terms of putting through price increases as well.

So, a combination of all of these and not to forget the weak currency as well, which has proven to be a tailwind for some of the large cap exporting companies. So, a combination of all of these has created a perfect storm for large cap traditional manufacturing type businesses to drive the market higher, and that's what we've seen happen.

CR: And despite that strength in the large cap, growth stocks have continued to struggle and small caps in particular, which is kind of your part of the market. Can you talk a little bit about why that is and why it might change?

PK: Sure. So whilst all these changes and the stocks that have driven the market up in the last year, couple of years, whilst all this is good for the overall health of corporate Japan, unfortunately, what this has meant is that the real high quality businesses, the fast-growing, dynamic smaller companies, they've been left out.

Essentially what we've seen happen in the last three years, really, is people just not wanting to touch this asset class, which is the Japanese smaller companies asset class, with a barge pole. Virtually every single bit of capital has chased these types of large cap cyclical businesses, companies that have a very nice shareholder returns, improvement, corporate governance story. And unfortunately, in a perverse kind of a way, that's proven to be a significant headwind.

And again, coming back to the currency as well, the yen has blown past ¥150 to the dollar and that has also been a significant headwind. So, a combination of all of these investors just not being interested in growth small caps. Unfortunately, that's resulted in an environment where no one wants to buy this asset class anymore.

CR: And can you see that changing in the near term?

PK: Yes, so one way in which I would like to think about this is some of these headwinds could actually turn into tailwinds. So one example would be, as you know, the Bank of Japan has moved away from its negative interest rate policy to a more normalised interest rate environment. Typically, when interest rates rise, the currency tends to weaken. Interestingly, we've not seen that happen yet, presumably because people were expecting the Bank of Japan to be a bit more aggressive.

But for us, what's more important is not where we are, but where we eventually will get to. So, as this interest rate environment normalises, as we see slightly more interest rate hikes being put through, the currency should start to strengthen, and that's where we will start to see some of these domestic-focused small caps come into their own. Roughly about 60 per cent to 65 per cent of Shin Nippon's portfolio is invested in companies that are generating almost all of their revenues from the domestic market. So that could potentially be a tailwind.

And the other interesting and perhaps more important tailwind is just in terms of valuation. [If] you look at some of these large cap exporter type businesses that have driven the market to record highs, these have been re-rated quite significantly. And the gap between large cap and growth small cap has just widened significantly. The gap is at record levels. So, a combination of these and people focusing on fundamentals, again, should get investor interest back to Japanese growth small caps.

CR: And I'm interested, I mean, it must be something that lots of fund managers go through at some point in their career. But how do you stay optimistic when the market is running against you and clients are nervous, sort of understandably?

PK: Yes, that's always going to be a challenge as a fund manager, and there are, I suppose, a couple of things that we can hang our hat on in terms of trying to stay optimistic, stay resolute and focus on things that we can control. Rather than obsess and spend a lot of time on things that are outwith our control, things like macro factors or what investors prefer.

So, the couple of things. One is just working within a team environment. So as you know, Baillie Gifford has a very team-based culture. We don't have a staff-and-manager culture, we support each other. And pretty much the whole Japanese team is in a similar boat, because we have a similar style bias towards growth stocks. So for me, as a small cap manager, it's quite critical that I keep getting inputs from the broader team in terms of what they're seeing in other parts of the market, and I feed that into my analysis.

The second thing that actually gives me even more comfort is just where we are in terms of share prices and valuations. We've had such a massive de-rating that you're getting companies growing at 15 per cent, 20 per cent, 25 per cent on 11 times P/E, 12 times P/E. At least in my brief investing career I've not seen valuations reach these extremely low levels. So, the starting point for us is a very, very favourable one, and as and when the asset class comes back in favour I think these stocks should do phenomenally well.

CR: Okay, let's look at the portfolio now, if we can. Is AI a growth opportunity that you're considering at the moment, or that you find in the Japanese market?

PK: Yes, so interestingly, I would almost say AI has also been a bit of a headwind for Japanese small caps. And the reason for that is, you know, obviously we don't have an NVIDIA in Japan. So, people have been looking for a proxy to play the whole kind of NVIDIA, AI story. And the kind of companies they've zeroed in on are these semiconductor equipment manufacturers. So the big, big companies such as Tokyo Electron, which is one of the world's largest semi equipment manufacturers. So, there again, a combination of this AI theme, weak currency, these are big exporting companies, has resulted in these companies doing really, really well.

Within the small cap side of things, we do have a decent level of exposure to AI, so I'd like to segregate that into hardware and software. On the hardware side, we have companies that provide critical building blocks type of equipment, without which the whole AI theme wouldn't be possible. These companies have alarmingly large global market shares, already in some cases as extreme as 65, 70 per cent.

On the software side, we have a large number of companies that are using AI to develop services. One of the companies we own is using AI to automate the legal industry, for instance, where it manages the case load of lawyers, it helps lawyers analyse the past rulings of judges that they're going up against, for instance. A really interesting model. We also have companies that are using AI to improve the lifetime value of customers for ecommerce retailers, and to help them target customers even better. So, there's a whole range of ways in which we are playing the AI theme within the portfolio.

CR: Okay, so what else would you draw out on portfolio positioning? Are there any other themes that you'd highlight?

PK: Sure. We run a fairly diversified portfolio of 75-odd stocks, and there are various themes that are reflected in the portfolio. Artificial intelligence is one. Obviously, labour shortage is a problem that is only getting worse in Japan, so we have a decent exposure in terms of companies that are trying to solve this labour shortage issue.

We also have a decent level of exposure to companies within the semiconductor space, again, you know, a play on AI. But if you take a step back, and if you ask me, 'What have you been doing at a very high level of the portfolio?' If anything, given where we are, and what we've experienced in the last three years, we are trying to force ourselves to be a bit braver and almost increase the growth quotient of the portfolio. Because if we don't do that now then what's the point?

We are reaching a stage where we're not far off from maximum pessimism almost, and in that environment when valuations are so attractive, the asset class is completely out of favour, we are always trying to look for these really strong growth companies. When I say 'growth' I don't just mean in terms of sales, but also in terms of profits. And that is, at a very high level, what we're trying to do, trying to make the portfolio more and more growth-oriented. Because, personally, I don't think we would get another opportunity like this, in terms of when valuations have shrunk to such low levels, to buy a lot of these exciting high growth companies.

CR: Okay great thanks Praveen. We'll pause there and go to the Q&A to look at the questions that have been coming in over the programme.

Okay, so one thing we're seeing: what have you learnt from the poor performance of the Trust over the past three years? Is there anything that you are doing differently now, or you would have done differently?

PK: There are two main learnings for us from the underperformance that we've seen in the past three-odd years. I think the first one is definitely [that] we need to be a lot more decisive and ruthless, especially when it comes to selling companies. We have a very long-term investment horizon. Our turnover over long periods of time has averaged 10 to 15 per cent, so it's quite low.

But we should not conflate low turnover with laziness. So that's one big, big learning for us, where if we've seen stocks that have run really well where valuations, even for us as growth investors, seem a bit out of kilter. Although we have taken a fair bit of money away from such stocks, I feel looking back, with the benefit of hindsight, we could have been a lot more aggressive.

The second learning we've taken is to try and force ourselves to look in areas that we've historically not even considered, simply because we've just assumed that there aren't any growth companies here. So there is an element of just being a bit lazy in terms of analysis.

To give you an example, one of our recent holdings is a company called SWCC Group, which makes electrical wires and cables, an industry that traditionally we wouldn't even consider. But having seen an interview with the founder, having met her, and she's the first female president of the company since its founding, we saw a very, very clear turnaround growth story, margins expanding and valuations at single-digit P/Es. So that would be the second aspect where we're forcing ourselves to look in areas that we've traditionally not looked at.

CR: Okay, now next question. What are the common traits you look for in Japanese companies?

PK: I would highlight three broad characteristics that we look for in every single stock. The first one is just the growth opportunity. It needs to be large enough to sustain at least five-to-ten years' worth of really fast growth.

Secondly, we look at the business model quite closely. So I, personally, like companies that have a genuinely unique business model and not a business model that's maybe a wee bit different from what already exists. So a genuinely different business.

And thirdly, we spend a lot of time speaking with management, engaging with management, just to try and get a feel for how dynamic, how entrepreneurial these people are. What is their long-term vision? Do they really want to change an industry, scale the business to, you know, a level where it's no longer a small cap? So these would be the three core common characteristics that we look for in companies.

CR: Okay, great. And now I think we've got time for just one final one. What was the last stock you bought, and sold, and why?

PK: One of our recent purchases has been SWCC Group. So I saw an interview of the president in the *Nikkei* and thought it was quite interesting, the way she was turning around the business. First female president, first president from an R&D background. So I organised a call with her, met her in Tokyo during one of my visits, and then thought the story looked quite exciting. No one even knew about this company, you know, a company making electrical wires and cables, not that interesting. And it was at four or five times P/E. I came back, took a holding, and since we bought the holding last year, it's more than doubled. So, you know, at least some stocks in the portfolio are going up.

The last stock we sold was a company called Pigeon, which makes baby bottles and accessories. And this is a stock that we've owned for well over a decade, and they had a very strong position in China. But over the years, a lot of domestic Chinese brands have become much stronger and taken market share away from the company and management haven't really been able to respond to that competitive threat. So, we lost faith in management's abilities, and their dynamism really, and we just decided to sell the stock.

CR: Okay, great. All right, Praveen, thank you so much for your time today. We will wrap up there.

PK: Thanks, Cherry.

CR: And thank you all for joining us. To find out more about the topics we've discussed on the programme, please do go to the website, **bailliegifford.com**. The UK Intermediaries Team are here to help, so get in touch if you have any questions. So, until next time, goodbye.

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

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

	2020	2021	2022	2023	2024
Baillie Gifford Shin Nippon PLC	-21.2	68.8	-25.2	-14.0	-20.9
MSCI Japan Small Cap Index	-6.2	24.4	-7.7	5.4	12.4

Source: Morningstar, MSCI. Share price, total return in sterling.

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