GLOBAL ALPHA
Q2 INVESTMENT UPDATE

Investment specialist Philip Rae and investment manager Helen Xiong give an update on the Global Alpha strategy covering Q2 2023.

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

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Philip Rae (PR): Hello and thank you for joining this Global Alpha Strategy update. My name is Philip Rae. I'm an investment specialist on the Global Alpha team and part of the wider Clients Department. I'm joined today by Helen Xiong. Helen, thanks for joining me. Helen is one of the three portfolio managers on the Global Alpha Strategy. Perhaps before we get started, just by way of recap, Global Alpha is a core diversified global growth strategy, and we use a three growth profile approach to investing in global equity markets, looking to capture a broad set of growth opportunities from around the world.

Those three growth profiles, by way of reminder, are compounders, disruptors and capital allocators. But at its core, Global Alpha is very much a reward seeking long-term investment approach that aims to deliver capital appreciation for our clients.

Helen, why don't we just jump right in? So 2022 was a challenging year for global stock markets. I think it's been pleasing this year to see signs of optimism begin to creep back in. I'm just interested to get your views on performance and how you're seeing the market environment today.

Helen Xiong (HX): Thank you, Phil. So, I think share prices are behaving more in line with the fundamentals, which is nice after a very turbulent period where they appeared to be moving in opposite directions. So, a lot of the increase in share prices, if you like, has been backed by fundamental delivered operational performance. Having said that, I think you're right in that we are starting to see some optimism creep back in. But that has been very narrowly directed towards the big technology platform companies that are seen to be the beneficiaries of AI, so Microsoft and NVIDIA, Meta, etc.

I think there is still a lot of uncertainty around global economic growth and around geopolitics, especially ahead of a US election year, next year.

PR: Thanks. And I guess, you know, obviously that sets the market environment. In terms of how that's influencing portfolio positioning – this year in Global Alpha, we've maybe seen a modest uptick in terms of trading, and that's, I would say, been a result of a lot of healthy idea flow coming through from the wider team.

I'm just interested to hear how you're thinking about that portfolio positioning, how that idea flow is influencing that, and your views on positioning as you look ahead to the remainder of the year and beyond.

HX: I think a distinguishing feature about Global Alpha is the breadth of the portfolio. So you mentioned in your opening remarks, Phil, that we have three different growth profiles in the compounders, disruptors and capital allocators. Now, all of those growth profiles exploit very different marketing efficiencies. So we have the opportunity to lean more heavily into one of those areas, depending on where we see the opportunities.

I think, as I mentioned, we've been through a very turbulent period where we've seen big shifts in valuation. And every time when there's a lot of uncertainty, a lot of volatility, a lot of fear, investors' time horizons tend to shrink and crowd around certainty. So, the compounders growth profile, that is the companies that you'd be happy to own in any economic environment, they've performed very well and we are seeing more opportunities in the disruptors and the capital allocators. So the disruptors being the newer upstarts where much of the value lies in the future. They've been out of favour, and the capital allocators [have] been the more economically sensitive companies. So we've been opportunistically taking some money away from compounders and redeploying it into the disruptors and capital allocators.

I think if I was to draw some common themes around the activity that we had, I'd probably categorise it into three different areas. The first would be the semiconductors. Now, semiconductors are the picks and shovels of pretty much any long-term secular trend you can think of, whether it is artificial intelligence (AI) or energy transition or the continued digitisation, I think over the last decade, we've seen a lot of consolidation around the semiconductor industries in various parts of the value chain. And with that consolidation, these companies have also become better businesses.

So, we've taken the opportunity to buy selectively into a couple of these companies. For example, Entegris, which makes consumables that are used in semiconductor manufacturing, or ASMI which is the market leader in the next generation deposition technology that we think will take share from the older technologies as we move down the different manufacturing nodes.

The second area I would highlight is the US infrastructure and housing-related names. I think a combination of energy transition, reshoring of manufacturing and electrification have led to a sort of inflection point in the investments that are being spent on US industrial and manufacturing capital expenditure (capex). And there is a chance that that trend could be sustained over the next decade.

So we've purchased companies like Eaton, which is a power management company, which historically has grown its organic growth at gross domestic product (GDP) plus rates. But that organic growth has really inflected upwards and it's much closer to the mid-teens level now, with very, very high incremental margins and where the shares are still trading at the low end of historic multiples. Other examples would be companies like Advanced Drainage Systems, which is a maker of plastic pipes, which is taking share from concrete.

And then the third area I would highlight is really the disruptors, the companies that are demonstrating very strong operational momentum, but where our conviction has been growing and we feel that the market is not yet in line with where and what our views are. So we've opportunistically added to some of those companies like Li Auto, The Trade Desk, DoorDash or Mercado Libre.

PR: Yeah. So I mean, seeing some new names coming into the portfolio in that semiconductor area, some new names coming in terms of the infrastructure beneficiaries, and then adding to some existing names, where we're seeing signs of execution [that] has been very strong or operational momentum continues to build.

Maybe just, can you say a bit more about that final category? You know, a name that we've been pretty impressed by how the company navigated what has been a more difficult operating environment for a lot of companies over the past 12 to 18 months?

HX: Yeah. So I think Mercado Libre is a good example of that. So Mercado Libre is the undisputed ecommerce winner in Latin America (LatAm). They have around 30 per cent market share across the region. It is a region where ecommerce penetration is still very, very low. It's around 10 per cent levels, and there is no reason why that can't double over the next five years.

Mercado Libre, a couple of years ago made the very difficult decision to invest heavily in logistics and distribution as it was moving away from a consumer to consumer (C2C) to a more professional business to consumer (B2C) marketplace. Now, with that investment, its margins were eroded and so people were really worried about the competitive dynamics. But fundamentally, that improved its long-term competitive position, and we're starting to see that play out now, where it's taking a lot of market share, it's growing despite the difficult and uncertain macroeconomic environment, and we're seeing the profitability come in very strongly. So that's an example of something that we've added to recently.

PR: I think in the earlier part of last year, the market got concerned that growth was particularly fragile. But in this environment, certain companies are actually strengthening the competitive position at the expense of their competitors.

One area that we can't avoid talking about today, I think a particular area of interest for stock markets over this year certainly, is artificial intelligence. You know, a very exciting area. And in fact, much more broader than the equity markets, is actually impacting a whole range of different areas. Just really interested to get your views, how you're thinking about it from [a] portfolio standpoint, how you're thinking about the technology and its potential impacts.

HX: Gosh, yes. I guess the first thing I'd say is that I think the excitement around AI is warranted. I think generative AI models have already delivered a lot of remarkable things and the pace of improvement is difficult to comprehend. And there is no sign that that rate of improvement is going to flatline any time soon. So it's difficult to overstate the impact and it's also difficult to almost make any long-term projections of what this might look like.

Having said that, I'm not entirely sure if AI is going to be a disruptive technology or a sustaining one. Now, sustaining technologies being ones that make incumbents stronger and disruptive technologies being ones that favour the new upstarts. So, for example, PC computers was a sustaining technology for media companies because it made them more efficient and took costs out, whereas the internet was a disruptive one because it completely changed the way we think about distribution.

I think when you look at generative AI, what's clear is that it improves the productivity of many white-collar workers, especially in software development. I think a lot of these models performed very well in many, many different tasks. But when you layer on proprietary data sets, it performs incredibly well. So a good example of that would be Bloomberg, where Bloomberg GPT trained with Bloomberg's own proprietary data set, just outperformed many other models by a very significant margin.

So I guess it seems likely to me that, in many industries, AI will be more of a sustaining technology that will benefit the incumbents, if the incumbents have large proprietary data sets that are relatively clean with large existing customer bases to which they can distribute that product. So, I'm quite optimistic when I look at our portfolio and not just in the obvious names like the Microsofts and the Metas of the world, but also in companies like CoStar, a commercial real estate company that is sitting on a wealth of information, of proprietary commercial real estate data, or companies like Moody's and S&P, they've got proprietary company financials data.

I think it's going to be very different to the pattern of disruption that we've seen over the last decade or two, where the value has accrued to a small handful of companies. I think it's quite likely in the case of AI that the value is more distributed. And I think the companies that we own are quite well-placed to capitalise on it.

PR: Yeah, that's fascinating, I guess, as well, it plays to our strengths of having bottom-up research, having an unconstrained approach to global equity market investing where we can actually try and go and discover those opportunities wherever they are rather than having constraints around our investment process.

Helen, it’s been fascinating talking to you and thanks for the update on the portfolio. And for those watching, thank you very much for joining us today and we look forward to talking to you again in [the] next quarter. Thanks for joining.

0723 Global Alpha Q2 update
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Annual past performance to 30 June each year (net %)

	2019	2020	2021	2022	2023
Global Alpha Composite	4.9	14.0	45.3	-32.8	17.1
MSCI ACWI	6.3	2.6	39.9	-15.4	17.1

Annualised returns to 30 June 2023 (net %)

	1 year	5 years	10 years
Global Alpha Composite	17.1	6.5	9.6
MSCI ACWI	17.1	8.6	9.3

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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0723 Global Alpha Q2 update
48202 10030536

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