Baillie Gifford™

Sustainable Growth Q4 investment update

January 2024

Investment manager Katherine Davidson and investment specialist Alasdair McHugh give an update on the Sustainable Growth Strategy covering Q4 2023.

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Alasdair McHugh (AM): Welcome back to the fourth instalment in our quarterly video series. This time, we'll look back on 2023 and forward to 2024. Now, for those of you that are less familiar with our approach in Sustainable Growth, we're trying to build a portfolio that is sustainable in both senses of the word, capable of delivering enduring growth as well as enduring good.

Our fundamental belief is very much that those two things are mutually reinforcing, if your time horizons are long enough. So I'm Alasdair McHugh. I'm an investment specialist on the strategy, and I'm joined today by Katherine Davidson, who's one of our portfolio managers. Now in our investor letter, this time we talk about the Oxford English Dictionary's word of the year being 'rizz'.

But Katherine and I have agreed that both of us are nowhere near cool enough to use that in a sentence. So we're choosing our own word of the year and that's dislocation. That's something that we used a lot in the last 12 months to really describe the disconnect between companies' share prices and their fundamental operating performance, which at times have been quite distinct.

We've seen swings in sentiment and share prices fluctuating as a result of that. But the underlying progress for most companies has actually been pretty steady throughout the year and that came through in the final quarter of the year with good returns in absolute and relative terms. That helped us end the year in strong positive territory with double-digit returns in most currencies, roughly in line with our benchmark.

That's a welcome result after a couple of pretty bruising years for growth investors. But we are still aware that longer term numbers do remain disappointing. So there are dislocations that are persisting within our universe of companies and within our portfolio. And that's something that

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we've been trying to lean into in the course of this year. So, Katherine, I wondered if you could start with that point about leaning into these opportunities, please.

Katherine Davidson (KD): And I'll do it with maximum ’rizz’! So it’s actually quite good for us stock pickers when we see these kinds of dislocations in the market. So we've been able to take advantage of that both in our existing holdings, tinkering with position sizes and also in some of our new purchases. So within the portfolio, for example, we recently shifted a little bit of client capital from Watsco to Beijer Ref, both quite similar businesses, both in the sort of heating and air conditioning, heat pump kind of space, but vastly different performance over the course of the year.

And now we see they are much more attractively valued for its growth prospects versus Watsco. Another more substantive example would be Illumina, where we've recently added to a longstanding position as a culmination of what has been quite a long and painful engagement process. As many people will be aware, 2023 was, to put it mildly, a pretty bumpy year for Illumina.

They had an activist campaign, new CEO, new chair, and just at the end of the year the regulator ruled that they do need to divest a controversial acquisition that they had made. So it's been it's been certainly a rough time for shareholders, but we've been very closely engaged with the board throughout.

We have had them up to our offices in Edinburgh, we have spoken [with them] multiple times and we've also been lucky enough to have an audience with the new CEO. And I mean, through all of this, our conviction in the core business remains unshaken. So Illumina is the leader in gene sequencing. They're making the picks and shovels for all the really exciting stuff that's going on in healthcare innovation and we think it's undervalued relative to the growth potential in that very special, unique asset really. 2024 should be the year that they're able to refocus on the core.

An interesting observation is that there are obviously a few other people noticing these kind of dislocations, too. So a recent exit from the portfolio was Adevinta, the classifieds business. We're actually quite reluctant sellers here, but the company has recently accepted a bid from a private equity consortium who, like us, clearly thought that that asset was materially undervalued relative to the growth that will come from the secular economy.

AM: Okay. So I think those examples really neatly illustrate a tactical use of share price weakness for additions and new purchases, but an overwhelming focus on the company fundamentals. So that steadiness of operational performance throughout the year, has that surprised you at all?

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KD: Would it be cocky to say no? I think it's been gratifying, let's put it that way, because as you know, and as we've talked about in these videos, we've been really focused this year on improving the resilience of the portfolio and both at the individual company level and also the overall shape. So for example, we've talked about our number of double negatives.

So companies that are negative on both earnings and cash flow, the number of those has now come down from 18 to 5. And I actually think it's going to be lower once companies report their full year results. So that's one good sign. We've used some capital to start positions in really interesting, eclectic companies that are diversifying the sources of growth in the portfolio.

So The New York Times we've mentioned before and a more recent one, MSA Safety, the world leader in self-contained breathing apparatus for firefighters and 70 per cent global market share in hard hats. Who knew! And that's a really nice business because it's essentially a-cyclical because firefighting budgets don't change. It's much more driven by advances in regulation and technology. So that's a definite resilient stock.

And the other thing I would point to is that within our existing holdings, we've seen really encouraging operating performance this year. As you've pointed out, in particular, some of our larger names we've seen really impressive cost control and pricing power coming through. It's all very thesis confirming. So the likes of MercadoLibre, Shopify, Spotify, those are all really high conviction holdings where we're heading into 2024 with confidence that these are even leaner, fitter businesses.

AM: So lots of examples of companies that are learning, having adapted to a more competitive, a tougher environment broadly. So the obvious question then is, of course, what have we as portfolio managers learned in 2023?

KD: Yeah, well it's constantly humbling us this industry. You never stop learning - one of the things I like about the job - but we certainly took a few blows in 2023. For me personally 18 months since I've had a new country, a new firm, a new team, a new portfolio. So lots of learning points.

But probably the most formative moment from a stock point of view for me was the regional banking crisis in Q1. And I'm sure I'll be talking about that for years to come, because the biggest detractor in the portfolio last year was First Republic. And, you know, I started working in the financial crisis. So I've seen companies go under before.

I'm not naive about that, but this was probably the first time I felt quite so blindsided and where it happened quite so quickly as well. First Republic was fundamentally a solvent, well-managed,

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good-quality bank, which is why we owned it. But it was a reminder that the banks are a confidence game, essentially, that when you get a dislocation, normally you get a separation between the fundamentals and the share price.

You expect the share price to recover. But in the case of banks, the share price is so critical to the deposit flows that you can actually get the fundamentals rapidly deteriorate following the share price instead. So it can close in a way that hurts you rather than benefits you. That kind of reflexivity there and that's what we saw unwind very, very quickly.

And I'm quite pleased with the way we handled it. I would say it was one of our first big tests as a kind of partnership of portfolio managers, and we didn't make a knee-jerk response. Know, we weighed up the situation and we tried to be measured and rational about it, focus on fundamentals. But ultimately, when the writing was on the wall, especially after the credit rating downgrades, we were humble enough to exit and preserve client capital.

AM: Okay. So taking those lessons forward then into 2024, I'm interested in what excites you going forward and perhaps to build in a common client question, what are the potential triggers for improved sentiment towards growth stocks that we might see in the coming year?

KD: So 2023 wasn't a bad year for growth stocks, as you said, but it was really narrow. So the Magnificent Seven sounds like a marvel franchise. But, you know, the big seven tech stocks, that was what really drove outperformance last year. So what would be helpful would be a sort of broadening out of performance among great stocks, and there are probably two big things that would help with that at this point.

Firstly, would be the rates hiking cycle, especially in the States, has weighed a lot on growth stocks. We got a little taste in Q4 of what it could look like if we go into more dovish environment for interest rates, that would be very positive for all growth managers. And the second one would be the cessation of violence in Ukraine and the Middle East, which would obviously be a huge positive from a humanitarian point of view as well as for risk appetite in the market. But we are still seeing lots of attractive opportunities as you say.

The fact that the market was so narrow means that there's still 8000 plus companies of our universe that are pretty attractively valued and where we're finding lots of new ideas for our pipeline.

AM: Okay. Well, I think that's a positive note to end on. And thanks for your time today and thanks to our clients for your support over what has been a challenging but ultimately rewarding 2023. For

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performance, I think the summary is that it has been better, but we still think there is more to come as that improved sentiment towards a small number of growth stocks really broadens out to a wider number of companies in our universe. That's reflected in a very healthy pipeline of new ideas that are making their way into the portfolio, often at attractive valuation points.

So we're very happy with the portfolio’s positioning as we head into 2024 and we look forward to updating you on its progress throughout the year.

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Sustainable Growth

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

	2019	2020	2021	2022	2023
Sustainable Growth Composite	29.1	75.6	0.4	-42.3	22.5
MSCI ACWI Index	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
Sustainable Growth Composite*	22.5	10.0	N/A	10.4
MSCI ACWI Index	22.8	12.3	N/A	10.3

*Inception date: 31 December 2015.
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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