Baillie Gifford™

International Smaller Companies Q4 investment update

January 2024

Investment manager Brian Lum and investment specialist Eoin Anderson give an update on the International Smaller Companies Strategy covering Q4 2023.

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Eoin Anderson (EA): Hi and welcome to the International Smaller Companies investment update for Q4 2023. My name is Eoin Anderson. I'm an investment specialist on the strategy, and I'm joined today by Brian Lum, a portfolio manager who has headed the strategy since its inception.

International Smaller Companies is a small cap portfolio that looks to invest in small, exciting, growing businesses from within the international equity universe. It will invest in companies that are less than 2 billion market cap and hold them up to a market cap of $10 billion.

Brian, it's been a really tough couple of years for growth investors in international equity markets. How was Q4 2023? How has the year been and how are you feeling at the moment?

Brian Lum (BL): It has been a very tough two years for us. The past quarter is much better in relative and absolute terms. Overall, I'd say 2023 as a whole is very much up – ups and downs, depending on where interest rate expectations evolve, that often has a big bearing on how we perform. There's still a lot of fear in the market. Small cap is very much an out-of-favour asset class, and there's a strong preference for predictability in the markets.

EA: It sounds like things have looked a little better. Any themes or any stocks in particular that you would draw out that have been performing?

BL: There are always stock-specific factors, but I want to highlight two themes. The first one would be semiconductors and AI. The top contributor for the past year would be Global Unichip, which is a Taiwanese semiconductor company. They design custom chips, called ASICS to their customers, which tend to be technology companies. As AI applications emerge, many of these tech companies are looking to custom chips to maximize performance for their specific AI application.

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So, for example, Global Unichip is one of the partners for Microsoft's AI program. Now TSMC is Global Unichip's leading shareholder, and this affiliation really helps in terms of reputation as well as technology knowhow.

Two other AI beneficiaries that featured in the top contributors list would be ASPEED, which is a Taiwanese semiconductor company and MegaChips, which is also an ASICs custom chips company based in Japan. Japan occupies a very interesting space in the semiconductor industry, given where geopolitics are at the moment and MegaChips will have a role to play in the Japan semiconductor industry.

The second theme would be M&A. Just before the end of the year, it was announced that Outsourcing, which is a Japanese staffing company, as well as Volpara, which is a medtech company, they do AI software for breast cancer screening. Both of these will be acquired. And early in the year we had ESI, which is a French software company that was acquired. So all of these deals came with some of the healthy premia and that boosts fund performance a bit.

EA: So it seems there's certainly been a trend for M&A. Is that something you expect to continue? How does M&A fit into your thinking when managing this portfolio?

BL: I think occasionally one of our companies being acquired is a fact of investing. I would say that with mixed feelings over M&A and in general, of course, we prefer to hold companies for the long term and get the full upside if our investment case works out as we expect. In these specific cases, we have [been] reasonably satisfied by the size of the premia and we can understand the rationale of these deals, so mixed feelings.

EA: And moving away from some things that have been performing well or, receiving a premium for, to underperformance. Are there been any companies that are that are struggling at the moment? Inevitably, there will be some, I'm sure.

BL: Yes, there are stocks specifics. For example, Victoria, which is a UK flooring materials company, they had a bit of an accounting issue and I guess Japanese names also feature quite heavily in the top detractors list. It's worth remembering that the Japanese yen has depreciated against the dollar substantially over the past two years. It's gone from just over ¥100 to a dollar from 2020-2022 to something like ¥140 per dollar in 2023. So, it has really hurt the more domestic companies in our portfolio and the high growth companies in that space. So, things like Raksul, which is an internet company, if you will, and also Kamakura Shinsho, which is another internet company.

EA: Perhaps on that theme, but broadening it to the portfolio, we know that share prices will be dictated, to some extent, by macro factors, be it currency or interest rates or even geopolitics, as we've seen a lot in the last the last year or two. How do these factors, which are out of your control, but also out of the control of the companies that we invest in, how do they fit into your thinking?

BL: For us, it's very clear. We know where we may have insights and where we don't. And it is about focusing on bottom-up stock picking for us, and learning our lessons, and making sure that there's a baseline level of diversification in the portfolio. For companies, that's a very interesting one at least in the short term – we've just been talking about interest rates and currency – it seems that companies don't have control over their destiny, but I don't think that's correct.

Companies do have agency just over longer more sensible time periods because good management, they do respond to external environments, adapt the strategies. So, we mentioned Raksul as an example. It's really a portfolio of B2B internet platform companies. And over the past 18 months they have adapted their portfolio quite significantly, focusing more on the more profitable companies and being able to be more selective in what they acquire. So, we are seeing changes there. They're also changing the management responsibilities at the top. So, the impact of these changes will come through in the coming years. And so sometimes you just need to be patient and to recognise that changes take time.

And there are other examples such as Hypoport, which is a German mortgage lending platform. The German mortgage market is dire at the moment. From, Hypoport, we're reassured to see that they have really cut back on their cost base, but at the same time really navigating through this difficult period by gaining share of what's left of it. So, as it emerges on the other side, it will hopefully become a much stronger business.

EA: And how about the shape of the portfolio and portfolio changes? Tell us what's been happening during the year.

BL: So, we remain true to our investment style. Our investment horizon is 5 to 10 years and this year we added ten new names to the portfolio and exited eight. There's real diversity in the new names that we've added. We've got a gene sequencing company, we've got a semiconductor equipment company, we've got a Korean tour operator, we have the leading Indian cinema chain in our portfolio now. We have a Japanese AI software company in the portfolio. Real diversity.

I would that's a one pleasing development for me. The observation that over the past year – actually two years - that half of our new ideas were initially flagged by us by colleagues outside of our team. And this is pleasing to see. We often get asked by clients, 'how do you cover such a vast investment universe?' And so, we are getting help from many colleagues, and this is the network effect of investing, if you will. And of course, it's worth saying, in a Baillie Gifford context, we're still a very young team, so this is encouraging to see.

EA: So, it sounds like that's encouraging. Lots to be excited about. So, I'd love to hear your priorities for 2024. But perhaps first, before moving on to that, any parting thoughts or reflections on the year gone by?

BL: One company interaction that really stuck with me was a video call with Nayax, a payments company. So, think about the payment terminals on vending machines or parking meters, and so on. That's what Nayax does. So, I was discussing a recent acquisition that they did with the founder

CEO, and halfway through the discussion, he just stopped, quickly apologized and just disappeared. We were staring at his chair for 5 minutes. And after that, he came back and finished off his sentence. And carried on as if nothing happened. Now Nayax is an Israeli company. For them, disappearing to their company bunker is a routine occurrence now. And despite the disruption of this horrendous war, the company managed to grow at least 35% for 2023, as it did in 2022.

This is not a huge holding for us, but I think it encapsulates some of the themes very neatly in that. We should expect the rest of the 2020s, this decade, to be a volatile one. We need our companies to show adaptability and resilience. And that's what we're looking for. We're still looking for high growth companies. We're looking for companies that are resilient beyond just balance sheets and where their assets are. We're looking for aligned management teams. And in Nayax's case, the share price is a third down from its IPO price back in 2021. So, we are looking for the disconnect between share price and reality, as well. That's really the opportunity.

Moving on to 2024, we are very optimistic about the companies in our portfolio. Most of them are in good shape. The portfolio balance sheets in aggregate are healthy and, also, we've got a very rich pipeline, as rich as ever really. And last Thursday was my first day back in the office and, in that single day alone, I had three new ideas mentioned to me by three different colleagues. And this is great to see. And so, 2024 is off to a good start.

EA: Great**.** Thanks very much, Brian, and thank you all for watching. We very much look forward to talking to you next time.

International Smaller Companies

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

	2019	2020	2021	2022	2023
International Smaller Companies Composite*	N/A	46.1	9.1	-38.8	16.2
MSCI ACWI ex US Small Cap Index	N/A	14.7	13.4	-19.6	16.2

Annualised returns to 31 December 2023 (net%)

	1 year	5 years	10 years	Since inception
International Smaller Companies Composite*	16.2	N/A	N/A	5.1
MSCI ACWI ex US Small Cap Index	16.2	N/A	N/A	6.5

*Inception date: 28 February 2019.

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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