UPFRONT: EPISODE SEVEN

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Financial journalist Cherry Reynard, client relationship manager David Rolland, and investment managers Spencer Adair and Luke Ward explore the companies driving growth, how PsiQuantum is using quantum computing to solve society's challenges, and the long-term growth opportunities within diversified portfolios.

Your capital is at risk.

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, Spencer Adair, who'll be answering your questions live. So do send them in by clicking on the dropdown menu on your screen.

Before Spencer, we have Investment Manager, Luke Ward, talking about PsiQuantum, whose mission is to build the first commercially useful quantum computer, with the aim of solving humanity's greatest challenges. 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 welcome back, David. Now, we last chatted in April, and I know two months is just a nanosecond in financial market terms, but are there any highlights to report since we last caught up?

David Rolland (DR): Yes, nothing huge, Cherry. Markets have remained fairly resilient in the face of a number of challenges. And China, which is one of the key engines of global growth, is starting to show signs of a recovery. I think year to date, most equity markets have progressed. And that's in the face of rates remaining on hold for the most part.

And I suppose the other thing I'd touch on is the MAG7 that we had a chat about in the last episode. So I think it's encouraging from a market point of view to have seen some broadening out, or at least you can argue that they're not all charging as a pack. I think NVIDIA's the star performer of this year. I think the share price is up around 150 per cent or

maybe more. Tesla's share price has been negative this year, and Apple only recently moved into positive territory, I think in the last couple of weeks. So there is some more dispersion there, I guess.

And I think it's maybe indicative of investors' appetite, investors' confidence to move into areas that aren't just AI or tech or labelled as growth or value. And I think it speaks to what we believe, that growth is driven by individual companies and comes in many different flavours, which is quite literally the case when you look at Sweetgreen, which is a fast food US salads business, and Greggs in the UK, which is a slightly different type of fast food business, but both compelling growth opportunities in our mind.

CR: Okay, great. Now, last time, we chatted through the active versus passive debate, but you mentioned value and growth there. That debate goes back decades. What's the difference in your mind?

DR: Timescales, I think. We don't actually think we're that far apart from value investors. And I actually think the labels of growth and value can be quite misleading and limiting. I think a value investor is looking at a business right now, it's looking at the business, the current assets, the current earnings, in its current form, whereas I think growth investors are looking at a slightly different timescale. They're looking at businesses that can rapidly grow their earnings over, say, a five-year timescale. So it's a slightly different mindset. Value is looking at current earnings, growth is looking at future earnings.

CR: Yes, absolutely. One pushback you hear from clients is that Baillie Gifford will buy a growth company at any price, so they're willing to buy growth companies at high multiples. What's your take on that?

DR: So I think the lines become a little bit blurred here again, because growth and value investors are both trying to find undervalued opportunities. They're just maybe looking at it with a slightly different lens. So a value investor may have seen a thing or a few things go wrong at a company, but they think that the market is wrong to sell off the stock as much as they have, i.e. there's more value in the company than the market is giving it credit for.

From a growth investing point of view, or certainly our approach, we're looking at what could go right. So we're looking at perhaps a structural driver to the company's growth that the market is underappreciating, or there might be a revenue stream within the business that we think can grow exponentially but the market is not even paying any attention to. So I think that's probably the key thing for me. But I suppose you're talking... On valuation, do you mean more on a PE multiple side of things?

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CR: Yes, I suspect that's what people are looking at when they make those assumptions.

DR: Yes. So I'll use the posterchild, NVIDIA, as an example again, because it's a household name now. We don't mind buying growth at an unreasonable price if we expect vast earnings to come through. And when they do come through, the PE multiple actually tends to fall.

Look, we want to own businesses, we don't want to rent them. And we know from academic studies that it will be this small number of outliers that drives your portfolio returns over the longer term. So for us, it's really just maximising the chances of finding these companies and then holding them for long enough that they can compound and they can deliver those outsized returns for our clients.

CR: Okay. Can you unpack that idea of owning versus renting?

DR: Yes, sure. I think it's around trading. So if you're trading a lot or turning it over, as we call it in industry speak, so say if you have 100 per cent turnover and you have a 100-stock portfolio, well, then you need to find 100 new ideas every year. If you have a slightly longer holding period of, say, five years plus, it might be that you only need to find a handful of ideas every year, so you can really focus in on the areas that are most exciting.

From the way that we look at the world, it's those missed opportunities that can be far more detrimental to performance rather than the investment cases that don't work out. So our research process is designed to find companies that can multiply their earnings, because we know, over the long term, that is what matters, that is what delivers outsized returns, not whether or not you're growth or value or macro or inflation or rates.

CR: So that idea of asymmetric returns, where something can go up indefinitely.

DR: Spot on.

CR: Now, we've talked a lot about what's happened and where we are now, in the last couple of programmes. But I wonder if we can talk about what's next. Have you done any analysis on what could help or hinder the Baillie Gifford approach from here?

DR: Yes, of course, Cherry. We are resolutely long-term in our approach, but we do concede there's a number of scenarios that could play out in the short term that could affect things. So I think if you had a repeat of 2022, where you had an unexpected and rapid rise in interest rates, now, that would be unhelpful. That would be a headwind

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scenario, and we would likely underperform in that scenario. Now, I don't think you'll find too many market participants who think that that is a realistic case at the moment, but

with heightened geopolitical risks, it's not a zero per cent chance, I guess.

Our portfolios are a lot more resilient to deal with that scenario if it was to transpire. I think this new normal that we're now experiencing, with rates at a slightly more relatively elevated level, our companies have adapted. It used to be, just gain market share at all costs, underwritten by cheap cash, but now the market wants to see profitability and wants to see free cash flow. So our companies have adapted and are a lot more profitable than they were in 2022, and actually carry a lot less debt than the benchmark in aggregate as well, which I think is really important in an environment where you've got slightly raised rates.

Another scenario would be that we just go on as we are today, so you have more static rates or rates have effectively stabilised. So to be clear, we don't need interest rates to fall for our portfolio companies to continue with their progress. The rapid rise in rates in 2022 obviously made it a very uncomfortable place to be a growth investor. But if they do settle at the rates that they're at today, that shouldn't be a problem going forward. In that scenario, it'll be the earnings growth that drive the share price returns.

So our risk team did a bit of work on this and found, from 1992 to 2021, that the fastest-growing quintile of companies actually delivered the top quintile of share price returns. So they correlated together. And that was true of any five-year rolling period within that period. So what does that tell us? It tells us we've got to try to find as many of these companies as possible and hold them. And I think, in aggregate, if you look across our equity fund range just now, they are growing earnings much faster than the market.

And I think the final thing I'd say on that, it's a bit of a kicker, would be around research and development. So our companies are allocating much more than the market to research and development. And again, there are academic studies to show that if you do allocate to research and development, these companies have, and continue to deliver, superior equity returns.

CR: And much of the market talk is still focused on falling rates.

DR: Yes.

CR: And you've not touched on that, so can you just talk through that a little?

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DR: Yes. I think, if we're being honest, that would be a tailwind scenario. So here, you get the earnings growth driving the share price returns, but you get a nice little boost from the

valuation rerating. And I think the other thing to say would be that even after a strong 2023, the valuation premium that our portfolios are on is not particularly challenging, so you're not actually having to pay up hugely for that growth. So I think just to sum it up, we don't need rates to fall for the portfolios to perform, but yes, concede that would probably help rather than hinder.

CR: Yes, absolutely. Okay, that's great. Thanks for joining us today, David.

DR: Thanks, Cherry.

CR: It was a pleasure to have you.

Now, for those of you watching live, if you have any questions, please do click on the Ask-a-Question tab. Now, 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 PsiQuantum, the next step in computing technology.

Luke Ward (LW): Imagine a world where we could solve complex scientific problems in a week rather than a decade, and for a fraction of the cost. While most eyes are focused on AI, there's another superpower in the making, quantum computing. Unlike traditional computing, which operates in binary bits, on or off, quantum computing uses qubits, which can exist in multiple states simultaneously. This allows them to simulate the world around us in far greater detail than ever before. As a result, things which are considered impossible today could very soon become a reality, thanks to these devices.

For example, in the energy space, quantum computers could model exactly how individual electrons and ions move through materials, and use this to develop much more powerful batteries and solar panels. In healthcare, they could reveal precisely how proteins fold and combine into lifesaving drugs. In agriculture, we could reverse engineer the catalysts bacteria use to make their own fertiliser or reveal the secrets of efficient carbon capture behind photosynthesis.

The historic challenge, however, has been that qubits are very hard to make and control. They're sensitive to even the slightest disturbance, and so researchers have been restricted to using exotic materials and small systems much more suited to scientific demonstration than commercial application. Progress towards transformational use cases has been limited as a result. This is where PsiQuantum comes in.

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PsiQuantum is a company on a mission to build and deploy the world's first useful quantum

computer. It was founded on the premise that scalability, not just science, is the key to success here. Whilst there are many ways to make one qubit, there's probably only one way to make the millions of qubits needed for quantum computing to change the world.

PsiQuantum's innovation is having designed its chips and qubits to fit in with traditional silicon manufacturing processes. This is allowing it to leverage the billions of dollars and decades of experience already accumulated by the semiconductor industry to help mass-produce its quantum hardware.

On the strength of this approach, the company has attracted significant funding and is now getting ready to build its first facility in Australia. The plan is for this to be operational within the next five years, far sooner than competitors, and become one of the most important tools for innovation that has ever existed.

CR: So that was Investment Manager, Luke Ward, introducing PsiQuantum. It seems clear that quantum computing has the potential to positively affect the world we live in. We'll be looking at how it progresses in the future. Now, to move on, we're joined by Spencer Adair for a fund update.

So, welcome, Spencer. Now, a quick introduction for anyone who may not be familiar with Spencer. You've been a partner in the firm since 2013, and you're an Investment Manager in the Global Alpha Team, which manages the Monks Investment Trust. So perhaps we could kick off with an overview of what Monks is all about.

Spencer Adair (SA): Absolutely. Thank you. So Monks is a diversified, long-term growth trust, with low cost. So the low cost we can measure. That's 44 basis points of recurring fees. The diversified growth is we can go anywhere in the world. So we can invest in all four corners of the globe and across all industries or sectors. So, currently, we've got 33 different industries that we invest in, so it really is very broad-based.

And we make money for our clients by the growth, the fundamental growth of those businesses. And the good news is that those businesses are in great shape. So they've got rock-solid balance sheets, they're growing mid-teens rates on forecast earnings, they're all self-funded, and they're investing a lot in R&D and Capex, so they're developing their own growth market. So that's what Monks is all about.

CR: Okay, great. And with that broad palette, can you tell me a bit more about how you are defining growth?

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SA: Absolutely. So we've got three definitions of growth.

One is our growth stalwarts. So these are our get-rich-slowly, compounding companies. So in there today would be the likes of Microsoft or Novo Nordisk. They are companies you're prepared to own for decades, and they can churn away and grow. Second up would be more immature companies, the rapid growers. The next five years looks very bright, but they're doing something radical, something different. So the likes of NVIDIA are in there, PsiQuantum, which we just saw about, would be in there, part of our Schiehallion holding. So it's really cutting-edge things.

And then the third type would be cyclical growth. And these are more established industries, they've got a bit of a cycle to them, but they're run by people that have done this before. So they're run by people that lean in when everyone else is leaning out, and they take a step back when everyone else gets excited, so that countercyclical capital allocation. So that's how we think about growth.

CR: Okay. Let's start at that grittier end, because I think those are the type of companies people wouldn't necessarily associate with Baillie Gifford. Can you talk through some of those underappreciated opportunities?

SA: Yes. So what Monks is really trying to do, we're trying to combine some of the glitz and glamour, if you like, of Silicon Valley and that growth, but also some of the grit of the real-world businesses. And we've owned some of these companies for decades. So that may include the likes of Ryanair, CRH, Martin Marietta, companies that are airlines or aggregate companies. So I get excited about gravel and that kind of thing, which not everyone can say that.

Look, one recent example. I was in Canada last week, and one of our new holdings in Canada is a company called Stella-Jones. Now, that sounds a little bit like a Welsh performer, but Stella-Jones is actually North America's largest electrical pole company. So it takes very long, straight trees, it strips them, treats them and stores them. And these poles literally support the whole grid, the electric grid, in North America.

Now, Stella-Jones has a terrific record. Over the last 25 years, it's been consolidating the market, and it's up a hundredfold. So you can get excited about boring things like poles, and you can make a lot of money out of them. But for us, the exciting thing is that the growth, we think actually over the next 25 years, could be equally bright. And that's because of a couple of things.

Whenever a lot of the infrastructure was put in place, it was in that 1945 to 1960 period.

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Now, these are wooden poles. They have beetles, they have rot, they last a certain amount of time, and they're getting on a bit, so they need to be replaced. So next time there's a big windstorm, it'll be very good for Stella-Jones. So we've got a replacement cycle going on, which means we're in for a pretty ripe or pretty strong 25 years of growth.

But on top of that, you've got all the extra needs for electricity. That could be powering electric cars, it could be the new solar and wind turbines. So you're generating the electricity in different places and you're also consuming it a lot more in other areas. So the grid investment is going to have to go up a lot. And so that's what excites us about the likes of that company.

Finally, there are significant barriers to entry. There are some biological barriers. You cannot just grow really tall trees straight away. You have to wait 40 years before these are ready. And so the supply side can't just respond quickly. But also, you've got to treat these poles, you've got to store them. There's a lot of working capital, a lot of quite harsh chemicals. So these things, we're really excited about that kind of strong growth, underappreciated, strong track record, and yet trading on a well below market multiple of earnings.

CR: Is there any vulnerability to a change in US administration?

SA: There always might be, because you never know. US politics is never 100 per cent forecastable. But what we're talking about in these kind of infrastructure investments, there's bipartisan support. There's also lots of local support. If your grid goes down and you don't have local power or you don't have bridges or your roads are terrible, and potholes, that annoys the local voters. And so you tend to have both local activism plus bipartisan support.

And then on top of that, you've got this element of geopolitical will to bring more high-end manufacturing back into the US and to deal with some of the more greener ways to produce electricity. So actually, of course, any one politician could interfere for a little bit, but we think, structurally, there's going to have to be significant long-term investment in some of these infrastructure-type investments.

CR: Okay, great. Now, so you talked about the glitzier side.

SA: Yes.

CR: You have some exposure to AI and tech more broadly. Can you talk me through a couple of those?

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SA: Yes, of course. So I'm not going to repeat the NVIDIA or the Novo Nordisk cases because they've been done. They've been done to death, I'm sure. But whenever we speak to all of our high growth companies, we're looking for two things. We're looking for what's changing in the world and what's the bottleneck.
And the bottleneck, whenever I speak to battery companies or chip companies, hi-tech biotech manufacturing, electric cars, the big bottleneck is skilled labour to actually build these plants. So this is the thing which is holding them back. It used to be equipment, maybe a couple of years ago, but the supply chains got resolved. But now it's actually people to build. ChatGPT is fantastic, but it can't build your factory, it can't do your wiring for you. And that's the real bottleneck.

So a company I met last week that's from Texas is called Comfort Systems, which we own in Monks. And it has got 16,000 employees, and they're either electrical engineers, contractors, or they're air conditioning contractors. And they're in huge demand at the moment. In 2020, their backlog was about six months and about $1.5bn worth of work they had on their books. Today, they're booked out until 2026, you can't put them in your diary, and the backlog's about $6bn. So it's risen fourfold in the last few years. So it's the type of growth where, if you can identify that bottleneck, you can identify where growth's going to accrue.

CR: Yes, that's quite a pipeline. And then just finally, with such a diversified portfolio, is there anything that unites these examples?

SA: Well, so the two things I talked about were change and bottlenecks. And if you can identify those two things, it doesn't matter if you're the latest AI chip, it doesn't matter if you're someone making utility poles, those are the things which, if those two are in place, those are the precursors for growth.

And then afterwards, we then say, if you've got change and a bottleneck, can we see a plausible chance that any individual holding will double over the next five years? That's not necessarily a central case, but it's a possibility of doubling. And everything has to pass that test, and it does so. So that's both the drivers of what we're looking for, but also, there's a valuation driver or an upside driver that we also put in place.

CR: Brilliant. Okay. Thanks, Spencer. Stick with us. We're now going to move to the questions that have been coming in over the programme.

Okay. So, first question. Can you talk a little bit about gearings and buybacks within the trust?

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SA: Of course. So gearing is at 7 per cent. Our long-run gearing is going to be about 10 per cent. So we've been using that opportunity the last couple of years, as markets have weakened, and we've been buying back stock. We will continue to increase the gearing gradually, slowly. In terms of buybacks, I also run an open-ended vehicle, and one of the things I love about Monks and closed-end vehicles is I have the opportunity to issue shares when we trading at a premium to NAV and buy back when we're trading at a discount. And we've both issued shares quite aggressively and bought back aggressively.

So the board and I regard it as our duty to allocate capital countercyclically. We're trading at a discount today, and we've bought back, I think, 7 per cent of the trust in the last year. And that's without any activists or anything like that. It's just it's the right thing for us to do. So we're very happy to be buying back stock aggressively at a discount.

And the other important, critical advantage for us is that we took advantage of the low-rate period and we locked in long-term borrowings at very low rates. So our total debt is locked in at 2.7 per cent. And that goes out 30-40 years in some cases. And so that's a great advantage today.

CR: Okay. Now, next one. I've noticed your turnover has ticked up to 20 per cent recently. That doesn't sound very high. But why are you trading more of late?

SA: So not too much has changed. So, technically, that is correct. Turnover was about 15 per cent, and now it's about 20 per cent. But I wouldn't read too much into any one single year's numbers. Long term, we are a five-year holding period. 20 per cent is in line with that, so nothing unusual. But I don't manage it on a rolling 12-month basis, so it's perfectly possible that my turnover is 10 per cent in one 12-month period or 30 per cent. It's going to average 20 per cent over the long run, so don't read too much into short-term numbers. The reason why turnover is a little bit higher is we've had lots of change, lots of new opportunities, and so it's driven by those new ideas coming into the portfolio.

CR: Okay. One more. Can we have some examples of growth companies that have adapted to this environment of elevated rates?

SA: Absolutely. So about 20 per cent of the portfolio is in companies that we would call capital-advantaged, in that they've got a big beneficiary, or they've got a big benefit of having raised a lot of capital and are now really proving their profitability. This was probably most visible by the likes of Meta, formerly called Facebook, who, if I go back two years, they could not spend enough money, quickly enough, on augmented reality and virtual reality. And today, they have really pivoted to, well, let's just show a bit of growth, let's just show some profitable growth, and the share price was rewarded with a very, very

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strong run in the markets the last couple of years.

And a number of the smaller tech companies are doing exactly the same. They're saying, before I can go and become go-go growth again, I'll prove it to you. It's like doubting Thomas. They're saying, look, I can grow, I'm valuable, my business model works. And so there is everything from, even the big companies, like Amazon, are beginning to do it, but some of the smaller ones, like Block, are doing it. And so it's a really common theme among many of the rapid growers. And then the other bucket we have are these stocks which have got a lot of spare capital, and they're deploying it, they're using it, they're taking advantage of the bargain prices out there.

CR: Great. Okay, thank you. And then I guess we've got about 30 seconds for this one.

SA: Okay.

CR: But what's your overall outlook from here?

SA: Okay. Very enthusiastic. Growth is broadening, which we like. It's not just about seven stocks anymore. That plays into our hands. And our companies have got great balance sheets, structurally faster growth, they're doing the right things, and they're all self-funding. So I'm very excited.

CR: Brilliant. Okay, thank you so much, Spencer, for your time today.

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 do get in touch if you have any questions. So, until next time, goodbye.

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