INTERNATIONAL GROWTH Q2 INVESTMENT UPDATE

Investment specialist Hamish Maxwell and client relationship director Nick Thomas give an update on the International Growth strategy covering Q2 2023.

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

This communication was produced and approved in July 2023 and has not been updated subsequently. It represents views held at the time and may not reflect current thinking.

Hamish Maxwell (HM): Hello, and welcome to the Baillie Gifford International Growth Strategy update for Q2 2023. I am Hamish Maxwell, an investment specialist on International Growth, and I'm joined by Nick Thomas, who's been a member of the Portfolio Construction Group since inception 20 years ago.

Nick Thomas (NT): Hi, Hamish.

HM: Hi, Nick. International growth is all about long-term active growth investing. We're looking for 50 plus of the most exceptional growth companies in international markets. These are companies with rapid or robust growth potential that we can own for at least 5 to 10 years to allow competitive advantage to turn into growth. We typically have low turnover, between 10 and 20 per cent, and high active share, around 90 per cent.

And we think this is a really valuable way to invest because the evidence is clear that only a small number of companies create the majority of wealth in the stock market, which is a really powerful case for aiming to invest in just those biggest winners. If you want more detail on the asymmetry of stock market returns, there's some great work by Professor Henry Bessembinder, which we highly recommend.

Nick, thanks for joining us. Compared with this time last year, lots in the world has settled down, but lots also remains challenging. How do we think about performance in this context?

NT: Yeah, I think that's a good way of framing it, Hamish. I think the last few months have felt quite mixed. You could say that's an improvement on the previous period, which was downright hostile since the Covid pandemic started. And in performance terms, International Growth is ahead of the benchmark year to date, which is pleasing. A bit quieter in the second quarter, where we were roughly flat and the benchmark was up two and a half percent.

I think three factors have really been driving our returns in the last few quarters probably, discount rates, geopolitics and the progress of individual companies. You know, we would recognize as stock pickers that macro factors will always play a role in the short term. But we will always argue that it's the company factors that are the most important in the longer term.

So just to expand on that a little bit, you know, sharply rising discount rates have definitely been a strong headwind for our portfolio of long duration growth stocks. We have the sense now that we're somewhere near the peak of interest rates. We're not specialist enough to know exactly where that will be, but we think it must be fairly close. So that headwind dropping away I think will be helpful to us.

Geopolitics definitely remains stressful. There's a major war raging in continental Europe and a great power tension between the US and China is at a high level. So that's a worry. More positively on the change point, our portfolio is really built around companies that can benefit from a technological change. What we've seen from the companies and in some of the themes that we're investing in is this change is probably picking up.

So, you know, I'm really excited about that. And hopefully that will come to be the most important factor out of the three in the longer term. All of the news and excitement around artificial intelligence in recent months, I think, has probably just underlined that progress is still going on.

HM: Thanks for breaking that performance context down a bit. Can I ask you to expand on some of the stocks that have made notable contributions?

NT: So on the positive side, we had really good returns from Ferrari benefiting from the ongoing surge in luxury spending. Spotify also did really well coming off a weaker period and that's been picking up a bit. Latin American fintech company Nubank, which is a relatively new holding that we took from IPO last year, also reported blockbuster results growing its customer base by a third. So that performed really, really well.

Those ones are offset by some negative contributors, obviously, we had a couple of other European holdings that didn't do so well. Zalando, the fast fashion platform, its growth has been tepid or zero for a few quarters now, and we're concerned about how long that might continue for. Our luxury fashion holding Kering also had a weaker quarter. We think that's probably more passing and we have a lot of faith in Kering's leadership and its brand strength, as well. Our holding in MercadoLibre also pulled back a bit in Q2 after a really strong performance in Q1. But I don't think there's too much going on that's to be concerned about.

Interestingly, through the quarter, we've seen the continuation of a trend that we kind of first started picking up on in Q1, where quite a few of our holdings that had been racing to grow and burning through cash and reporting losses have switched their emphasis much more towards profitability. Now, sometimes this has been helped by competition dropping back, often because private equity funding is reduced. And sometimes I think it's just management teams responding to what investors and the market is asking them to do, which is deliver some positive earnings, sooner rather than later, please. So this has been quite good for the results and the share prices of quite a few of the holdings involved, like Spotify is the most obvious example. It's been coming up quite a lot in our discussions with management. It's nice when it happens, but we have to be very wary that companies are not sacrificing long-term growth to deliver shorter-term performance, so we've been talking to our holdings quite intensively about that dynamic.

HM: So, what we're really interested in is the drivers of long-term company success. Could I ask you to expand a bit on what the team has been up to, understanding this?

NT: Yeah, so there are some themes that have been shaping our research for quite a while now. The ongoing digitization of the economy, a lot of our holdings fit into that category. We've been learning a lot more and looking for ideas related to the energy transition, and that's come up quite a bit in the last quarter, and we've been trying to grow our position that's related to the revolution in healthcare, driven by biology and genetic sequencing. So, those are the three areas that I think are really been the focus of the research

In our weekly stock discussions, we typically look at two or three stocks each week. There's been a particular focus on ideas in the semiconductor value chain, which has been really interesting. We've already got big exposure there through ASML and TSMC, but we're trying to broaden that exposure out and think about how different bits of that value chain will perform in future years. And we've also looked at quite a few existing holdings and things like food delivery, online travel as well. So it's been a busy quarter for research.

HM: Great. When it comes to research and gathering insights, is it fair to say that our ability to travel more has been helpful?

NT: Oh, definitely, and I think that was what we really missed the most during the pandemic, and the restrictions have only really just lifted in some countries. So in the last quarter, we've been getting out on the road. We've had colleagues in Latin America and North America, right across Europe and also in China, which is particularly interesting. We've got some more trips planned to India and other parts of the Far East. So, that comes on top of the Zoom calls that we're still having with a lot of company management, so we're getting a really rich flow of insights and information from that source.

And partly driven by that, we've made some additions in the portfolio. We spent a really productive day with Adyen in Amsterdam, a payment company that's become quite a major holding in the portfolio. We've topped up our Asian insurance business, AIA. We've also added to MobileEye, the autonomous driving business that we bought when it IPO'd a few months ago. And we funded those purchases by trimming Spotify and Ferrari a little bit and carrying on with our reductions of Alibaba.

HM: Okay, so turnover remains low, but some trades based on relative conviction.

I'd love to touch a bit more on AI and I'm sure some of our clients would love us to touch on that as well. If we went back to the 1990s, a lot of people would have thought the futurist Ray Kurzweil was hopelessly optimistic in saying that by the 2030s we'd have these paradigm-shifting, world-changing moments in AI, "singularities" Kurzweil called them. But considering some of the recent developments the 2030s actually looks a little bit pessimistic. So I'm just wondering how International Growth thinks about these paradigm-shifting moments and how we also avoid the hype.

NT: Yeah, well, it's been building up steadily for a long time, we think, the importance of AI. But it is quite surprising how it sort of exploded into the public consciousness recently. I don't think anybody really predicted that. I mean, for quite some time now, the fourth question of our ten question stock research framework basically asks, what are the threats and opportunities to this company from AI? So we've been thinking about it for quite a long time and it's quite a big factor in our portfolio.

So, our semiconductor stocks like ASML and TSMC, they're really that sort of picks and shovels plays on AI and they're really powering it and they've been in the portfolio for a long time. And also some of the application cases of AI, you know, that's really what Spotify is, an AI company analysing how you listen to music and then making suggestions to you about what you might like to listen to next. That's all AI. And the same with Mobileye, it's autonomous driving technology, AI thinking about the driving situation around you.

It's been in the portfolio for quite a long time, so we do think it's very, very important. We've been looking at this quote from Arthur C. Clarke in here saying that technological developments like these sometimes can seem indistinguishable from magic. You know, that feels right, and I do sometimes have a sort of a sense of wonder when you look at what some of our companies are able to do.

But we're also wary not to get caught up in the hype cycle. We haven't been buying things because of the AI boom of excitement in recent months. It's just something that we're trying to learn about and build into all of our analysis over the long term.

HM: Yeah, I know the team has been busy and we've benefited from meetings with the management of Nvidia and likewise our holdings in Aixtron, VAT Group, ASML. So it's fair to say lots of learning, lots of insight?

NT: Yeah, definitely. And I think it actually highlights how we think about technology generally. We're never going to be technical experts in anything, and I'm sure everybody who's tried to read and understand a little bit about AI you realize how complex it is. But we've really privileged access to the people who really are the deep experts, whether it's the companies that you mentioned or also academics like IMEC, the Semiconductor Institute, or Brian Arthur in Santa Fe. What we've got to try and do is listen and learn to them and integrate what they're telling us into the portfolio.

HM: Okay. So another topic that I know is on clients' minds and is really, really relevant to us as international investors is China. And Lawrence Burns, the strategy's deputy chair, recently spent a fortnight there and Tom Coutts, the strategy's chair, is planning to go later in the year. So if we blend this knowledge with what we're getting from our Shanghai research office, from our other strategies as well in Baillie Gifford, is it fair to say that we've got lots of food for thought?

NT: Yeah, no question. I mean it's been one of the major topics right across the firm in the last couple of years, and I would probably add to your list actually, we've also been trying really hard to talk to and listen to our clients in North America to understand what it looks like from their perspective as well, because it's obviously a two-sided tension.

The picture is worrying at the moment. There is deep suspicion on both sides, and there's an obvious potential point of escalation around Taiwan. So we have to weigh up the risks, but also not forget the opportunities of investing in China while weighting in the funds has come down to around 10 per cent. That reflects what we think is currently the appropriate balance point.

As an international manager, the pace and the scale of the opportunities in China are too big to ignore. There's a few sectors, things like renewable energy and electric vehicles where China is rapidly emerging as a formidable competitor of global scale. And we already know and we've talked for many years about the domestic consumption opportunity that's powered by technology. We know how many amazing entrepreneurs there are in China. So, there's definitely a lot of positives, but there's also a very nasty tail risk that we have to be aware of that if you unpick it, you can trace back to the system of government and the concentration of power in a very small number of people. So, we weigh all these things up. We don't think zero is the appropriate weight, but we think 10 per cent is about right at the moment.

HM: Yeah, so lots of work, lots of thought, avoiding complacency and benefiting from some of those unique insights.

NT: That's right.

HM: Nick, thanks very much for those observations. I'll end with a quick summary on outlook. Our clients will know by now that we do not attempt to time markets. What we believe is that over the long term, share prices are driven by earnings growth and by cash flows.

And we also believe that International Growth is built with stocks that have rapid or robust growth potential that the market under appreciates. Of course, risks remain, and in the near-term they may be amplified by things like the US presidential election cycle, China-US relations and the conflict in Eastern Europe. But the underlying drivers of growth in the portfolio are not just intact, but what we're recognizing is an acceleration of the pace of change. As it's change that drives growth, we are really excited about the upside potential in the portfolio for the next 5 to 10 years.

So thank you very much for joining us, and we'll speak soon.

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Annual past performance to 30 June each year (net %)

	2019	2020	2021	2022	2023
International Growth Composite*	-3.3	30.5	44.1	-45.3	15.6
MSCI ACWI ex US	2.4	-4.4	36.3	-19.0	13.3

Annualised returns to 30 June 2023 (net %)

	1 year	5 years	10 years
International Growth Composite*	15.6	2.8	7.5
MSCI ACWI ex US	13.3	4.1	5.5

*MSCI EAFE prior to 30/09/18

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.
Past performance is not a guide to future returns.

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