US EQUITIES STRATEGY Q1 UPDATE

Client Service Manager Patrick Stapleton and Investment Manager Gary Robinson give an update on the US Equities Strategy covering Q1 2023.

Patrick Stapleton (PS): Hello. My name is Patrick Stapleton. I'm an Investment Specialist at Baillie Gifford. I'm here today to talk with Gary Robinson, one of the Lead Managers for the US Equity Growth Strategy.

But first, as a reminder, our aim is to find and hold the most exceptional US growth businesses for the long term, so periods like five years and beyond. Long enough, so that those companies' operational performance can translate into their share prices. Today, we're going to talk to you about backdrop, portfolio positioning, and touch a little bit on outlook, as well.

So, Gary, it's been an eventful start to the year. Stresses have shown up in parts of the US banking system, and companies across the board are facing big changes to their operating and financing conditions. What's your take on this?

Gary Robinson (GR): Yes, it has been an eventful start to the year, and it's been an eventful three years since the start of the pandemic. It feels that we've been leaping from one crisis to the next. I think one of the interesting things about this period and these events is the linkages between them, so it might feel like these have been discrete events, but they're actually all connected to one another.

The pandemic, it triggered an avalanche, in my view, in the global economy, and that avalanche is still making its way downhill. The crisis started with COVID and lockdowns. And these lockdowns disrupted supply chains and caused demand to shift from offline to online.

And then, lots of people were put out of work, and so, we responded with very loose fiscal policy and very loose monetary policy, and then this combination of stimulus and supply shortages pushed inflation up to a level that we haven't seen in the last 40 years.

And then, after a period of calling that out as temporary, the Federal Reserve finally responded by raising interest rates at the fastest pace that we've seen for a very, very long time. And then that rapid rise in interest rates caused a huge sell-off in bonds, and in other long-duration assets, like equities. And then the sell-off in bonds resulted in stresses in certain segments of the banking sector. And then that culminated with the rescue of Silicon Valley Bank.

So, it's been a tumultuous few years. I think one of the interesting questions are where are we in this avalanche and when will it finally settle? The honest answer to that is that we simply don't know. The global economy is a complex adaptive system, and when a complex adaptive system becomes destabilised and shifts out of equilibrium, it's very difficult to predict outcomes.

But I think there are a couple of points that we can make on this that are worth nothing. The first point, or the first observation, is just that stocks outside of the banking sector have reacted in a relatively muted way to the stresses in the banking sector. I think that may partly reflect a judgement on the part of the market that this isn't going to become a systemic event.

But I also think it just reflects the fact that stocks are already very bombed out and there's a lot of bad news in the price. And so, when there's a lot of bad news in the price, when you have further bad news, it doesn't necessarily cause stocks to sell off further.

The second point I'd make on the avalanche is just that I think the US government has reduced the chances of a domino effect, here, by acting quickly, decisively, and proportionately to the stresses in the system. I think lessons have been learned from the global financial crisis when Lehman was allowed to go under in a pretty chaotic fashion. I think there's less of a chance of this becoming a broader systemic issue now.

However, that's not to say that there won't be any impact from this. I think it's quite likely that we'll see tighter credit conditions, particularly from the regional banks, where we've seen the biggest deposit outflows. And I think that's likely to act as a bit of a brake on the economy and drive some more slowing.

But I don't think that's necessarily a bad thing, when we've got unemployment near historic lows, and inflation still higher than where we'd ideally like it to be. I think it could, potentially, take a little bit of pressure off the Fed and enable them to pause their rate hikes, or even, maybe, cut rates a little bit quicker than expected.

Having said all of that, as you know, as we all know, we're not macroeconomists, we're bottom-up investors, and we are focused on finding the next generation of exceptional growth companies.

Whilst it's important that these growth companies are resilient in periods of macro stress, I don't think the macroeconomic conditions are going to be the primary determinant of outcomes for these companies. It's going to be much more about the structural growth opportunities that these companies are addressing and their ability to execute against those growth opportunities. And on that front, I feel very good about the stocks in the portfolio.

PS: With that I'm mind, how do you view the portfolio's positioning for now and for the long term?

GR: Yes, so we've spoken many times, we're long-term investors, and we're focused on where companies might be and what they might be able to achieve over a period of five to ten years. But we also have to bear in mind that companies have to be able to face current circumstances as they are today, not as they'll look in the future.

And so, as well as thinking about the long term, we also spend a lot of time thinking about resilience of companies in the portfolio, and whether they're well-placed to weather more volatile macro conditions. We feel very good about this right now.

The first line of defence against uncertainty is profitability because profitable companies don't have to rely on outside providers of capital to fund their businesses and to grow. And that might come as a surprise to people, given the high-growth bias of this portfolio, but two-thirds of the portfolio, by weight, is invested in companies that were free-cash-flow-positive over the last 12 months.

The second line of defence against uncertainty and volatility in the macro are balance sheets, and on this measure, the fund does well, too. The aggregate balance sheet for the portfolio is net cash, and the aggregate balance sheet for the market is net debt. So, in aggregate, the portfolio has a much stronger balance sheet than the market.

And just to put some numbers on that, again, by weight, 85 per cent of the portfolio is invested in companies which are net cash, so it's a very strong balance sheet, overall.

And then, two other lines of defence against uncertainty are culture and edge. Companies with distinctive cultures, in our view, they tend to be more adaptable than average, and they have a greater-than-average ability to navigate changing market circumstances. Companies with strong competitive advantages, they, also, are more resilient than average because they have the moats that enable them to weather these storms and to potentially pass inflationary pressures through to their customers through price increases.

As you know, culture and edge, these are two of the things that are absolutely central to what we look for in exceptional growth companies. Now, not every company that we own in the portfolio does well on all of these measures. There are a few companies in the portfolio which are not yet profitable, and which also have debt on their balance sheets. But these names make up a really small proportion of the portfolio, overall.

We also had some very limited exposure to the stresses in the banking sector, via holding in a regional bank. However, I think, most importantly, the current environment could end up being quite good for a lot of companies in the portfolio.

Most of the companies in the portfolio have only experienced one type of market environment, one of abundant and cheap capital, and one where investors were rewarding growth over profitability. But conditions have changed. We're in a different environment now. Many of the companies in the portfolio have responded rapidly to this change and have gently shifted their emphasis away from growing as quickly as possible to an approach which balances growth and efficiency.

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And I think as a result of this, we could see many of the companies in the portfolio come out of this period stronger and more profitable than they went in. I think the current period could also be useful for a number of the companies in our portfolio, in the sense that it will help to separate the wheat from the chaff.

We've been in a period of very loose capital, where capital has been very abundant and very cheap. Almost any company that wanted to access funding could access funding, and I think that resulted in a lot of lower-quality businesses having a lot of capital and entering markets.

I think what we could see on the back of the current period is retrenchment from these companies. Enabling the genuinely exceptional growth companies within these sectors to have a much clearer runway to execute on these structural growth opportunities and to build their competitive advantages.

We're already starting to see this in the portfolio today, and one example of that would be a company like DoorDash, the food delivery company, where a lot of the competition that sprung up during the pandemic is actually starting to pull back from that market now.

PS: I know the team has spent a lot of time on the ground in the US, so far, this year. How has this influenced your thinking?

GR: Yes, so we've spent a lot of time in the US, so far, this year. It's been great. There was one week last month, where I think five of the team were out in the US at the same time, all doing quite different things. Between the five of us, I think we saw 90 companies on those trips, and we saw a broad range of businesses.

We saw a lot of holdings. We saw Shopify, Workday, Affirm, Trade Desk, and Netflix. And then we saw a lot of new ideas in sectors ranging from Medtech to semiconductors, to EVs, to Internet of Things. Consumer products. Clean energy.

One of the things which struck me on my trip, I think, was just the extent to which it's mostly been business as usual for a lot of our holdings. Wall Street has become pretty obsessed with macro over the last couple of years, and the market is being driven by just a couple of macro statistics, to an extent that I don't think I've ever seen before in my career.

But for a lot of the companies in our portfolio, the focus is much less on the macro and on the here and now, and much more on continuing to execute on the long-term growth opportunities ahead of them.

So, one good example of that is Trade Desk. Trade Desk is a demand-side advertising platform. It allows advertisers to place advertising onto inventory around the internet and on Connected TV. And so, Trade Desk is exposed to a very cyclical industry, but Trade Desk is actually very geared into growth in the Connected TV market, and that's a segment within the advertising industry, which is in its infancy, and where there's huge structural growth potential.

And so, Trade Desk isn't worried about what's going on in the short term with the advertising market and that cyclicality because it's got this very long runway of growth ahead of it in this structural growth opportunity with Connected TV.

The management team there are much more focused on executing on that growth opportunity because that is going to be far more important to Trade Desk on a five to ten year view than what's happening in the broader advertising market in the here and now.

Another really important takeaway for me from my trip was just the importance of AI. This is something that I felt quite strongly about before I travelled out to the US, and I was thinking that ChatGPT could almost be akin to an iPhone moment.

But having had a chance to meet with experts in the field, including Sam Altman at OpenAI, I've come back from my trip thinking that generative AI could be even more important than the iPhone was when it was launched back in 2007.

Speaking of the iPhone, Steve Jobs, going back to the 1980s, when he was asked about what the impact of computers might be. Back then, it was very early on when people didn't really know what to think with computers starting to appear on desktops. He described the potential impact in a really eloquent and prescient way. He said that the best way to think about computers is, they're like a bicycle for the mind. And I love that.

I'm going to be much less eloquent when I try and translate that into AI, but if computers are a bicycle for the mind, I think AI is much more like a rocket ship for the mind. I think it could, potentially, be that impactful. I think it's going to have a huge impact on the economy, and I think it's going up-end a lot of sectors and create tremendous opportunities for companies that are willing to embrace it.

One company in the portfolio that's embracing it right now is the language-learning app Duolingo. So, Duolingo's been integrating generative AI into its app, and what it's using it for is a way to enable users of the app to have spontaneous conversations via a chatbot, which is one of the things that's really critical to improving proficiency.

Now, I met the founder of Duolingo about a year ago, and we were talking about how long he thought it might take for the app to reach parity with a human tutor, and he said that he thought it was probably going to be about 10 to 15 years.

I met him again on my recent trip, and now with the advent of generative AI, he thinks that the app could reach parity with human tutors in 3 to 5 years. So, this is just going to be absolutely transformational for Duolingo and for lots of other companies across the economy.

So, there's lots of exciting stuff going on. I think we're in a bit of a weird place right now, where we've simultaneously got some of the most uncertain and volatile short-term conditions that we've had for a long time. But also, we've got some of the most exciting long-term potential, in the form of tremendous underlying progress in a lot of fields like AI, like clean energy, like biotech, just to name a few different examples.

Given this rapid and exciting progress and taking that in combination with the fact that we've just seen a massive sell-off in growth stocks, pretty much across the board, very broad-based. The combination of the two things, I think is a really exciting and powerful combination. I think for investors who are willing to look through the short-term noise and who are willing to focus on the long-term, I don't think there have been many periods where the opportunities have been more exciting.

PS: Thank you very much, Gary. We hope you found this video insightful. Thank you for watching.

Annual Past Performance to 31 March Each Year (Net %)

	2019	2020	2021	2022	2023
American Equities Composite	16.5	1.8	144.2	-28.2	-29.3
S&P 500	9.5	-7.0	56.4	15.6	-7.7

Annualised returns to 31 March 2023 (Net %)

	1 Year	5 Years	10 Years
American Equities Composite	-29.3	8.0	12.4
S&P 500	-7.7	11.2	12.2

Source: Baillie Gifford & Co and S&P 500. USD.

Past performance is not a guide to future returns.

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