Baillie Gifford™

Multi Asset investment update

October 2023

Even as inflation slows, central banks are maintaining high interest rates, leaving the global economy teetering between recession and a soft landing. Investment manager Scott Lothian discusses how the portfolio is adapting.

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Lindsey Knight (LK): Good morning, and welcome to this quarterly multi-asset update. My name is Lindsey Knight, and I am joined today by one of or multi-asset investment managers, Scott Lothian. In a moment, Scott will give, over the next ten minutes or so, an update on the portfolios, the performance, the drivers of that performance, our positioning and a bit about our macroeconomic outlook, and I shall share some slides to accompany those comments.

Before I hand over to Scott, though, there are a few small pieces of housekeeping I need to undertake. First of all, the fact that the comments and data that we will refer to will pertain to the Diversified Growth Fund, although those will broadly translate across all of our multi-asset funds. The second item is that this webinar is being recorded. And then, thirdly, please do ask your questions using the Q&A function at the bottom of the screen, and we will do our best to answer those live during the session. So without further ado, I shall hand over to Scott.

Scott Lothian (SL): Thanks very much, Lindsey. Hello, everybody, and thank you so much for joining us this morning. I'm going to come on to talk a bit about the macro background, also what we've been doing within your portfolio. So, the past three months have seen the global economy absorbing the lagged effects of those higher interest rates, and we've seen market views oscillating between a likely recession on one hand, and the better outcome of a softer landing on the other.

And really the ups and downs of that debate, around whether recession happens or not, are what we think will continue to drive markets over the coming months and year. And as a result, our overall outlook remains reasonably cautious. Still, as I'm going to come on to talk about, our longer-term outlook offers optimism across the wide range of asset classes that we can invest in within your portfolio.

So I'll cover those in more detail as we go through, but first I'll touch on the recent investment performance of the fund. It was another challenging quarter for many markets, although one in which our selective diversification benefits came through in offsetting what could have been an especially damaging set of events and outcomes. The third quarter of 2023 saw both global equities and global bonds both falling around 3 per cent. Developed market government bonds within that were down over 10 per cent over that short period. Against that backdrop, as we see on the page, the

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Diversified Growth Fund lost around 2 per cent.

Now, while we'd all rather have seen a positive figure there, and I thank you for your continued patience and understanding through these past few years, I'll go into a bit more detail about what I mean by that diversification working, both within and between the asset classes within the fund. Given the environment that we've seen, it's no surprise that the delivered volatility is still at the high end of its historic range, but comfortably below the 10 per cent upper limit, overall period that we're looking at. And again, those results are similar right across our range of multi-asset funds.

So, looking a bit deeper into performance, while within those numbers there are some clear contributors and detractors from performance, as we see here on this page, I'm going to focus mostly on the three-month numbers, which are those on the left-hand chart, but we show the 12-month here as well, to give a more medium-term context.

So, the two best performing asset classes in the portfolio were those which benefit from high spreads and floating rates, that's structured finance and insurance-linked securities. And over the course of the past 12 months, structured finance has added well over 1 per cent to total fund results, from allocation of around 10 per cent, and insurance-linked securities, or ILS, has also added a fair amount over that period, and there are still meaningful positions in the portfolio today.

Now, over the past year, you can see emerging market bonds have been the single-largest positive contributor to fund returns. They gave back a bit in the third quarter with those sharply rising rates, although somewhat offset by some strong gains, for example from our directly-held Ukrainian warrant investment.

The major detractors over the course of the past three months were those more duration-sensitive allocations, especially within our government bond exposure. Where we have long-duration exposures to the US, Canada, Australia and Sweden, those all reacted to rising US interest rates. Within the asset class, however, our short Japanese duration position did deliver a positive return as Japanese yields rose.

Finally, infrastructure, you see on the page, the bright blue colour there, was the worst hit of all of our asset classes. We tend to see infrastructure stocks as exhibiting positive duration over the short term, as investors tend to discount those future cash flows at higher interest rates. But they become broadly duration-neutral over the longer run, as the infrastructure companies are able to compensate for those higher rates with higher cash flows. But certainly over the near term, that proved to be the case again, and that rising yield environment of the third quarter, those holdings collectively detracting nearly 1 per cent from the total portfolio, and that was enough even to push the 12-month figure into negative territory for infrastructure.

Let me now share how we've been adapting the portfolio over the course of the past few months, to think about what might come next. With that in mind, I'm going to turn to a recent macro thinking, and then onto the portfolio. The chart that you see in front of you is our ten-year return expectations, this is as at the end of June, so a few months ago. We go through that formal updating exercise every six months, and showing the end-June figures here again as a precursor to going onto the portfolio, because it's this together with our near-term outlook that directly informs the shape of the portfolio, and those changes we'll be making over the course of the quarter.

On this chart, you can see the historic ranges of our asset class forecasts, our ten-year forecasts. Those are the blue bars. You can see the average, over the course of the past 15 years that we've been carrying out this exercise, that's the grey dots. And the end-June forecasts themselves are the green dots. And you'll see many asset classes with the green dots

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are up towards the upper end of those historic ranges, looking at areas such as developed market government bonds, structured finance, emerging market bonds, particularly hard currency, credit, property. All of those, up near the tops of their blue bars.

However, it's not just about that long-term story. In our multi-asset funds, we care about the journey as well as the destination. The part of our process that helps us to do that is our scenario analysis, where we consider the outcomes over the course of the next 12 to 18 months in a variety of different market environments. And again, this is from back in July. We're in the process of updating this this very week, so I'll have that to share with you very, very shortly. And please don't worry, I'm not going to go through each and everyone one of those plusses and minuses in the boxes.

What we see is that nearer-term outlook for growth and inflation, which has been a key factor in our investment process over the course of the past 15 years, and is evermore so the critical debate within the team at the moment and within investment markets more broadly, just how much are central banks prepared to endanger economic growth in order to get price increases down, to get inflation back under control?

Now, there are regional differences within this debate. For the main economies, the US is proving more resilient. Europe is weaker and arguably already into recession. And China is under significant financial stress, most notably in its real estate sector, that's been the case for much of the past couple of years. And how we think about the paths of markets, the path of asset prices at the macro level is very much informed by the paths for those three major economies.

We still expect that global growth, and US growth in particular, will continue to slow over the coming 12 to 18 months, with still a meaningful chance of a US recession. We still expect inflation to continue to fall in the near term, and policy therefore to be eased, a collective probability of inflation remaining higher than target until the end of next year, until the end of 2024, is meaningful. And this matters a lot for markets, as we simply don't see the Fed cutting rates while inflation remains so clearly and stubbornly above its target.

So, although we are cautious, on the more risky assets, given this near-term outlook, we saw a moment ago the opportunities where we've got the distinct possibilities of outsized returns over the longer term for many of our asset classes, and that's exactly what we're looking to be getting into your portfolio.

Again, coming on to what I hope is a familiar chart, you can see the portfolio, this is at the end of September, is very well diversified, with holdings across many different asset classes and, importantly, specially selected investments within each of those. And while we remain, as is said, cautious relative to our own history, you'll see that in the risk profile and so on, we've made some positive changes over the course of the quarter which can be categorised into three key areas.

Firstly, it's leaning into those long-term-return opportunities that I showed you before, and that includes increases to mezzanine structured finance. It's amongst the highest return opportunity over the course of the next decade, its good floating rate exposure. And here, we've added to some new and some existing externally managed funds.

It's into emerging markets government bonds, specifically hard currency emerging markets bonds, which, again, is one of the most attractive asset classes over the course of the next ten years, with current yields in excess of 9 per cent. And here, we invest in actively managed Baillie Gifford funds, managed by our colleagues here.

We added also to property. Again, you'll have seen the long-term returns, the ten-year outlook for real estate looking particularly strong relative to its history, and the other asset classes. And there, we've invested in a selection of real estate

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investment trusts across digital communications, logistics and healthcare to gain that exposure.

And in addition to emerging market equities, although you may have seen that ten-year outlook and thought the equity return doesn't look particularly outstanding, it's not terrible but it's not outstanding, what we've seen within that is that emerging markets is one area where cheaper starting valuations allow us to see better return prospects. And again, we're using an active Baillie Gifford managed fund to get that exposure.

Secondly, we took opportunities to focus more onto the best ideas within asset classes. And a good example of this is select additions within infrastructure, to names we like and have held in the portfolio which have been out of favour, such as many of the UK-listed infrastructure and investment trusts, which are now trading at heavy discounts to their underlying net asset value. And Danish renewable company, Ørsted, whose shares dropped almost 50 per cent during the quarter, after reporting some write-downs in US projects which we thought were overdone, and that gave us a good opportunity to boost our position there.

Some changes within developed market government bonds as well, we increased that short Japanese government bond duration position, seen positive movement from the Bank of Japan for the first time in a long while, and we diversified our long government bonds exposure, as you can see on the page, trimming some of the US treasuries holdings and adding exposure to both Canada and Sweden within that government bond exposure.

Thirdly, and finally, to fund some of those additions to the portfolio, we've excited two remaining third-party absolute return holdings over the course of the quarter. You can pencil that in here, even though that's now a zero allocation. With good diversification coming through from lots of other areas of the portfolio, we no longer saw the need to be maintaining those positions within the portfolio. There may come a time again, but we don't need them at the moment. And we also reduced our exposure to high yield by exiting one of our investments in externally-managed Asian high yield funds. Asian high yield no longer offers as compelling a yield pick-up as compared to other parts of the high yield market, although we do still maintain exposure to another Asian high yield within the portfolio.

And of course the portfolio, overall, still has exposure to those areas which we've consistently liked over the long term, opportunities in infrastructure, real estate, commodities, emerging market high yield credit and structured finance, to name just a few. And many of those can be sensitive to that short-term economic outlook and market direction, and so we're still looking to take advantage of price volatility, should we see it there presenting an opportunity.

All of this is a reflection that we are clearly approaching a juncture in investment markets. There may well come a time for wholesale investment in risky assets, but we don't think that's yet appropriate, given that more cautious near-term outlook. But based on the longer-term analysis, however, we stay very confident of being able to have the opportunities available to reach your targets and take advantage of the benefits that our strong, diversified portfolio can deliver, to put us in a good position, going forward. I'll end there, and pass across, for any questions, back to Lindsey.

LK: Great, thank you. Scott. I've got a few questions coming in, here. First of all, one of the biggest drivers that we think, of macroeconomic developments, is going to be this will-we-won't-we recessionary outcome. And as per our scenario analysis, we have a high probability attached to their being some kind of recession anyway. What happens if that doesn't come about and we do have a soft landing? And how will the portfolio respond to that?

SL: Thanks, Lindsey, it's a good question, and one that we're wrestling with this week, as we go through our scenario analysis exercise. In that case that we have a soft landing, and there are various different ways that may come about, we would expect many of the risky assets in the portfolio to do very well, and for the portfolio to then deliver a strong return. This is about having a balanced portfolio that would be resilient but also able to capture some of that upside. And if some of the more defensive positions in the portfolio may see losses or may not perform quite a strongly, the idea is that those core, long-term positions, that's when those will come through and fare well.

I think that the big question within that is how inflation is doing. If we do see it back near target, then perhaps central banks will have pulled off a very impressive coup and got us back on track. If it's still high, we might just be storing up further problems into 2025 and after.

LK: Okay. Actually, we've got a question here which is a little bit of a follow-on to that. If we are expecting that US recession in the next 12 to 18 months, say, why have we reduced our exposure to US treasuries?

SL: What we've done there is we've diversified that exposure, and the positions we've brought in alongside that, so Canada and Sweden, those markets are very sensitive to what happens within the US treasury market. Analysis that we've been working on, and looking at the dynamics within those markets, their situation's a little bit tighter actually, and we might expect those to perform more strongly in that type of environment, just given the pressures within those economies and the unemployment environment and so on, that means we would expect those to actually outperform treasuries in that exact environment. So it's been a diversification and, hopefully, an improvement in the prospects in that type of scenarios.

LK: Okay, good. I've got a question here about equity valuations. The impact of higher-for-longer inflation, thinking about the impact that that has on global companies in particular, of course, Baillie Gifford, we are a growth equity house, you mentioned within your talk there that we find equities less attractive as an asset class, so perhaps you could maybe expand a little bit about how that tallies with us as growth equity investors and our style that way, and what it is that we have within our equity allocation in the portfolio?

SL: Yes, certainly. So should we have that higher-for-longer scenario, if we have higher inflation, one might expect that to be something of a headwind for many companies, and we've seen some of that coming through over the course of the past few years. One of the things we've done within the equity part of the portfolio to try and build in a bit more resilience there is to diversify that. So within the equity part of the portfolio, not only do we still have exposure to some of the Baillie Gifford growth strategies, we've also added a value equity ETF over the course of the past quarter. It's just a modest position at the moment, but that's a position which holds a broad portfolio of those global developed-market stocks which look cheapest versus the market.

Now, our thinking there is that in the environment where traditional growth stocks are challenged, those value stocks look pretty cheap compared to the rest of the market, compared to their own history as well. So they've already suffered some of the pain of this higher-for-longer, but within that we're still keen to maintain positions to our colleagues, Baillie Gifford growth exposures, particularly the really deep growth, if you like, so our long-term global growth equity portfolio within Diversified Growth Fund, that's leaning into a fully concentrated portfolio of companies which, to some extent, are able to create their own growth.

Many of the companies that are ploughing their own fields are not heavily indebted, and so that prospect of higher rates doesn't lead them to substantial struggles in refinancing themselves. So we've got a nicely diversified book within the equity portfolio, but I would point out that, within listed equities, we're at about 11 per cent today compared to the long-run average of about 18 per cent or 19 per cent. So that recessionary concern is very much there over the near term.

LK: Okay, thank you. Shifting gear a little bit to multi-asset as a broader asset class, there's a question here about we're currently seeing banks which haven't, for a very long time, been offering returns of 5 per cent to 6 per cent, so the question is what is the attraction of holding multi-asset as an asset class, as an approach? Is there still virtue in holding multi-asset? And can you explain why that would still be a good investment for our clients to have?

SL: Yes, certainly, obviously very fundamental to our being here. We've also been disappointed by some of the performance outcomes over the course of the past few years, but I have strong belief in the concept of active multi-asset management with real-world target outcomes. We know it'll be very difficult at times, and relatively straightforward at other times, but I always think that having a good alignment of objectives between clients and managers is a key part. So we have that shared objective of strong, stable growth. I think that's one of the key parts for me.

We also see a lot of great opportunities to deliver substantial return in excess of cash. The long-term-returns chart that we showed a moment ago, the numbers on that are all in excess of cash. So if cash is 5 per cent, or if cash is 0.5 per cent, we expect to see those strong returns from those more tangible assets coming through, whether that's listed equity, that's real estate, that's infrastructure, that's government bonds, in these cases. So there are lots of great opportunities out there over the investment horizon that I think many of our clients and that we take for this portfolio.

LK: Okay. I've got a question here with regards sterling bonds. Now, we don't hold any gilts, for example, within the portfolio, but clearly the direction of travel of those is very important for particularly our pension fund clients, so what environment do you need to see before sterling bonds start to deliver positive returns, as they are down around about 20 per cent since rates started going up? Do you have a view on that?

SL: We don't have a very strong view, and hence we don't have that position in the portfolio. We've got a strong view on the US rates, we've got a fairly strong view on Japanese rates, where we have the short position, and so those are the areas that we're choosing to play at the moment. And within the UK, and from conversations with our specialist rates and currencies team, who're looking at this regularly, there are still concerns there. We still see the path for UK interest rates is lagging behind that of the US, possibly more in tune with Europe. As mentioned before, I think we're possibly seeing we're already in a recession or getting towards it, and so for us it's a wait-and-see.

Whether we then look into what we would need to see there, I think we'd want to be seeing clearer visibility of the end of rate hikes, we'd want to see some signs of positive economic growth coming through. I think this goes for broader Europe as well as the UK. And at this point, we're just not seeing enough of that, and there's a big tension that Europe and the UK gets caught between the US and China as the two superpowers of this century. And that's not necessarily a great place for the market to be, from the perspective of the broadly flexible global investor.

LK: You opened that answer by saying it's something that you don't, as a team, have a strong view on, so perhaps you could talk about any particular views where there's maybe discord within the team, where you've got opposing views? What sort of areas are those that are under discussion and debate?

SL: Yes, it's healthy to have disagreement within the team. And as I'm sure many people watching who've spoken to us before, we typically do have a good amount of healthy debate and disagreement within the team. I think the main one, and we've kind of touch on it a little bit but it's really important to tease it out a little bit more, is that difference between a recessionary outlook into 2024 and early 2025 and a soft landing. And really within the group, there have been two factions. And I think the soft landing team have been getting more of the upper hand, we've seen a bit more of that coming through, hence some of the additions, the opportunities to add to some of those risky assets that we mentioned on a fully opportunistic basis over the course of the past while.

But really, I'm going through our scenario analysis this week, we're still seeing reasonably high probabilities on both sides. So that disagreement, that argument, is going to carry on for some time to come. But that's definitely the main area of discussion and tension that we have within the team, if we put it that way.

LK: Okay. I've got a very specific one pertaining to infrastructure investment. This is specifically about HS2, which of course has been in the news quite a lot recently. Will the uncertainty around that particular project have any impact, do you think, on the broader, presumably UK, infrastructure market?

SL: That's a really interesting question, and we've certainly seen a lot of the infrastructure trusts that we like, those tend to be the more core infrastructure or renewable operators that are listed investment trusts in the UK market, trading at a deeper discount, so that's happened over the course of the past while. People that've watched webinars and spoken to us in the past may recall that we had far higher allocation to that, but had trimmed down when prices got very expensive. So we've recently had the opportunity to add back.

Now, to be absolutely honest, we attributed that to the fact that there were higher rates, that gives a bit of a headwind, there's that duration sensitivity, but I certainly wouldn't discount the fact that there have been problems within that area and there may be some cross-contamination. We don't have any exposure, directly or indirectly, within the portfolio to HS2 in particular, but there's certainly a narrative there that offers some contagion. I wouldn't want to overplay it, because I think the big features that are driving the types of infrastructure that you have within the portfolio, the Diversified Growth portfolio, is much more about the long-term outlook for renewables. It's about the medium-term outlook for global rates and economies and how much those underlying funds can pass on the impact of inflation, far more so than specific projects like HS2 and so on.

LK: Sure, thank you. We've got two minutes left on the clock, so one final, I think, ending on an upbeat note, what areas of the portfolio are you most excited about in terms of the prospects for them over the coming 12 to 24 months?

SL: I think a couple of the parts of the portfolio we really like, and those are the ones we've been adding to over the course of the past quarter, and adding to already meaningful positions in the portfolio, are those things like mezzanine structured finance. Again, it's floating rates but nice high discount margins to offer us good returns over the course of the next 12 to 18 months, and possibly beyond. Those discount margins may close, and we can recycle that into other asset classes. And those other asset classes could be things like emerging markets and emerging market bonds, particularly hard currency. We've seen that coming through really strongly in the ten-year outlook, but also in the nearer-term outlook. So you've got the opportunity again there to be delivering high, relative to other asset classes, and relatively resilient returns over the course of the next few years.

I also think, and we've got exposure within the Diversified Growth Fund, exposure to instruments like securities, again there's an area where we've essentially been far away from that asset class over the course of the past few years but have been building that back up. It was one of the highest contributors over the course of the past quarter and the past year. We're at a stage in the reinsurance cycle where we're getting paid very well to take those very well diversifying risks into the portfolio. So in terms of doing a lot of work both on return and diversification within the portfolio, I'm really excited by what we see from that, going forward.

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LK: Great. Well, that is us at 11:30, so all that's left to say is thank you to Scott for his time, thank you, all, for joining us. If you have any follow-up questions, please do just get in touch with your regular Baillie Gifford contact. Thank you, and have a good day.

SL: Thanks very much.

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Baillie Gifford Diversified Growth Fund Annual Past Performance To 30 September Each Year (net %)

	2019	2020	2021	2022	2023
Diversified Growth Fund	5.0	-1.0	10.3	-13.2	-1.3
Base rate +3.5%	0.8	0.4	0.1	0.8	4.1

Source: Revolution. Sterling.
Base Rate: UK Bank of England.

The manager believes that Base Rate (UK Bank of England) +3.5% is an appropriate target given the investment policy of the Fund and the approach taken by the manager when investing.
We have included past performance information for Diversified Growth as an example of our multi-asset approach. Please note that this is not a guide to future returns of our Multi Asset strategies. The investment universe of our Multi Asset strategies may differ slightly. The Baillie Gifford Diversified Growth strategy is not available in all jurisdictions.

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