Baillie Gifford™

Global Alpha
Q4 investment update

January 2024

Investment manager Helen Xiong and investment specialist Kirsty Potter give an update on the Global Alpha Strategy covering Q4 2023.

Your capital is at risk. Past performance is not a guide to future returns.

Kirsty Potter (KP): Hello everyone and welcome to this Global Alpha update. My name's Kirsty Potter, I'm an investment specialist for the Global Alpha Team, and I'm joined today by Helen Xiong. Helen is one of our three portfolio managers for the Global Alpha Strategy. Welcome, Helen.

Helen Xiong (HX): Thank you, Kirsty.

KP: So just a quick recap on Global Alpha before we start. Global Alpha is a really diverse portfolio of around 100 companies, and these companies represent opportunities right across the growth spectrum. So what we do is express these with our growth profiles. There are three. The first is the Capital Allocators. The second, the Compounders. And thirdly, the Disruptors.

So, without further ado, we're speaking today in early January and for many people, this is the time of year of reflection on the previous year and also a sense of renewed optimism for the year ahead. So, first of all, can I ask for your reflections on the market environment that we saw in 2023?

HX: Sure. Very happy to. Happy New Year to everyone watching. And indeed, thank you for watching. Reflections on the market environment in 2023, I'd say it was really a market of two parts. On the one hand, we had the Magnificent Seven and then we had everyone else. And it was very different market narratives that was driving both of them.

So, I think on the one hand we had a lot of macro uncertainty. The market narrative there was one of potential recession, so slower growth. It was one of higher interest rates where we saw the Fed rising interest rates at the fastest clip since the 1980s, and it was one of deglobalisation and rising geopolitical tensions between the two largest economies in the world.

Now, I'd have to say that the fundamentals of the portfolio – sorry, the companies in the portfolio – tell a very different story. There the delivered growth has been very strong, particularly the companies in the disruptive growth profile, which are also some of the companies that've been most impacted by this market narrative. And then I'd say you had the Magnificent Seven, on the other hand, which [are] Apple, Amazon Alphabet, Microsoft, Meta, NVIDIA and Tesla.

Now these are some of the largest constituents of the index, which collectively drove over half of the market returns. It's really difficult to generalise between these companies because they're all very different companies. But I'd say that perhaps one common theme is excitement around AI, where these companies are seen as either leaders in AI or companies that are most likely to capitalise on the AI wave. And so there you've also had strong delivered operational performance. But the share price in some cases has been above that.

So, it's really a market of two parts where, on the one hand, you've had strong fundamental performance, but a macro narrative dominating that and the share prices haven't completely reflected the fundamental performance. And then on the other hand, you've had the Magnificent Seven, the excitement around AI and the share prices have brushed off a lot of the macro concerns.

But we focus on the stories that are told by the fundamentals of the businesses, as you know, and you mentioned excitement about – or, optimism – about the year ahead. And I think what gives me optimism is really the delivered operational growth that we've seen across the companies in our portfolio, which has been very good. And it is the future earnings growth that drives value for share prices over the long term.

And you've probably heard us say this before, but the three-year forward earnings growth for the portfolio is two to three times that of the market.

Secondly, I'd say that I see a lot of resilience in the portfolio. There is no doubt that we are operating in a very different macroeconomic environment to what we had over the last decade with higher inflation and interest rates. But when I look at the portfolio, I see resilience and not fragility.

So, almost all of the companies in the portfolio are self-financing. The average gross margins in the portfolio is ten percentage points higher than that of the index. I can think of that as a proxy for pricing power in an inflationary world. And the debt-to-equity levels are less than half of the index.

And I'd say finally, my guess is that we're not going to see the same concentration of returns as we've seen in the last year going forward. And that's primarily what we talked about earlier, where, with the Magnificent Seven, the share price growth has perhaps exceeded the fundamental delivery, whereas for the rest of the portfolio, the opposite has been the case. So my guess is that we'll see a broader contribution from the market going forward.

KP: Thank you. There's been a real sense of momentum in the portfolio, and I was interested in your point there around improved outlook for many companies that we hold on behalf of clients. I wondered if you could expand a little bit on that and give us perhaps one or two examples of companies where growth’s actually getting easier, despite what has been quite a difficult macroeconomic environment?

HX: I don't think growth is getting easier but maybe I'll answer that question with respect to the three different growth profiles that we have. So I'd say with the disruptive companies – the disruptive growers – for the most part, their growth is underpinned by structural drivers. So it's better and new ways of doing things, taking share from the old ways of doing things. There I'd say growth is more a function of innovation and execution and less about economic growth.

Now, the share prices have been highly correlated with their interest rates. But the growth is not. So a good example would be Li Auto, which is one of the EV makers in China that is owned in the portfolio. They delivered over 100 per cent growth last year and they did it at very healthy and improving margins. And one of the main reasons for that is because EV penetration in China has gone from around 5 per cent when we were looking at the company in early 2021, to 50 per cent today. So it's [got] really strong structural underpinnings.

Similarly for companies like DoorDash or Trade Desk or Meta or Shopify, all of those companies have seen continued strong – and, in some cases, accelerating – growth, despite the difficult macroeconomic outlook. And I'd say a common theme there is, for the most part, growth is within their own control.

For the 'capital allocators'... These are the more mature companies that operate in cyclical industries. They are very much prone to macroeconomic cycles. We've been able to take advantage of the [share price] weakness to buy into what we think are world class companies with a very, very long growth runway who are also excellent stewards of capital. Now, there it's more about perhaps some of the headwinds easing and perhaps more of the tailwinds coming through.

Indeed, we've seen a record level of policy support in the US, but there has been a time lag between the policy announcements and that policy affecting the real industry and most of the policies are around encouraging companies to either upgrade their existing facilities or build new facilities within the US. Examples there would be... we bought Texas Instruments, a leading maker of analogue semiconductors, as well as Comfort Systems, which is one of the commercial installers of air conditioning systems.

And 'compounders' are the high-quality franchises that you would be happy to own in most economic environments because they're perceived as more resilient. And that resilience has been reflected in the prices of these companies, which have also held up relatively well. Certainly compared to what we see elsewhere. So we've been using that mostly as funding for the other opportunities that we see.

KP: Great. Some really good examples there, thank you. I wondered if we could have a short bite [of] 30 seconds on a portfolio company from each the three growth profiles that you're particularly excited about for the coming year ahead. Lots to choose from!

HX: I think it's probably hard to pick a [single] company that I'm very excited about because I'm excited about quite a lot of companies in the portfolio, but maybe I'll use this opportunity to talk about some of the newer holdings in the portfolio that we bought recently. So it's pure recency bias.

So, in the 'disruptors', I'd highlight Block, [which] used to be called Square. Block is a combination of two different ecosystems. One is a merchant ecosystem which started out selling payment dongles to small merchants to allow them to accept card payments but has since broadened out into a host of other merchant services. The other is a consumer ecosystem built around Cash App, which is a finance app that allows people to send, spend and invest money.

The share price is roughly the same level as what it was in 2018 even though the gross profit is over five times that level, so despite the very strong growth that we've seen. There's a lot of scepticism priced in here and I think one of the reasons for that is that Block has always had very good products, both for its merchants and consumers, but it hasn't always been a great business.

We believe that's starting to change. The company announced a very clear investment philosophy at the beginning of last year. We're starting to see a lot more cost discipline and we're starting to see a lot of the operating leverage come through.

The second company I'd highlight is CATL from the 'capital allocators' growth profile. CATL is the largest supplier of batteries in the world. It supplies companies like Tesla and Li Auto, which are holdings in the portfolio. We've been looking at the energy transition space for many years and batteries is, and will remain, the largest addressable opportunity within the energy transition space. Global battery demand is expected to grow over tenfold between now and 2050.

CATL is the global leader with a global market share of just shy of 40 per cent. It sells the best batteries at the lowest price because of its scale and because of its vertical integration and because of its relationships with a lot of the OEM makers. And that creates a virtuous circle where it's able to outspend everyone else on R&D and still make the highest margins in the industry. So it's very difficult for everyone else to catch up. But it is a cyclical industry and the industry is currently oversupplied, which has given us an opportunity to take a small holding in this company.

The final one I would highlight would be Sartorius from [the] 'compounders'. Sartorius is a company that sells bioprocessing consumables to the biopharma industry. So, think bags, filters and purification columns. Anything that's needed for the manufacturing of biologics drugs.

It's a company that we've admired for a very long time, but we've never been able to get comfortable with the valuation. But because of the challenges that the biopharma industry is facing at the moment, both with the inventory cycle, but also with the funding environment in biopharma, we've been able to pick this up at almost half the multiple than when we first started looking at it.

KP: Yes, really attractive valuations. Thank you very much. It's been so interesting talking to you today and thank you to everyone for watching. We will look forward to speaking to you again next quarter.

Global Alpha

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

	2019	2020	2021	2022	2023
Global Alpha Composite	32.7	36.4	7.3	-29.1	19.5
MSCI ACWI Index	27.3	16.8	19.0	-18.0	22.8

Annualised returns to 31 December 2023 (net%)

	1 year	5 years	10 years
Global Alpha Composite	19.5	10.5	8.3
MSCI ACWI Index	22.8	12.3	8.5

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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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com