REFLECTIONS ON FIVE YEARS OF THE US GROWTH TRUST

Citywire's Richard Lander chats with co-manager Gary Robinson about lessons learned in recent years and the outlook for the trust.

The value of the trust's shares and any income from them can fall as well as rise. Capital is at risk. Past performance is not a guide to future returns.

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For a Key Information Document for the Baillie Gifford US Growth Trust please visit our website at www.bailliegifford.com

Richard Lander (RL): Hello, and welcome to this live programme from Baillie Gifford, the latest in a series of webinars where we talk to the managers of the business's different investment trusts. Today, we're speaking with Gary Robinson, who co-manages the Baillie Gifford US Growth Trust. My name is Richard Lander, of Citywire, and I'll be talking to Gary for about 25 minutes.

And it's such a good time to be doing this. In the first place, the trust has celebrated its fifth anniversary this year, and, of course, this is a pivotal point for the type of companies that the trust invests in. It's been a difficult environment for growth businesses over the past year, and that makes stock selection more important than ever. Now, following the discussion, we'll be taking your questions, and you can submit these at any time via the Q&A box in Zoom.

So, Gary, welcome. Thank you for joining us today. I'll start, as we inevitably must, looking back over the past three years and the COVID pandemic, an extraordinary time for the economy and for the markets. How did you navigate this difficult period, and what did you learn during it, and did it prompt you to make any changes to your philosophy and the investment process of the trust?

Gary Robinson (GR): Thank you, Richard, and thanks, everyone, for joining today. I wanted to start, first of all, with an apology. As you all know, outperformance has been very weak over the last two years, and this isn't the outcome that we were hoping for. So we're very sorry that you've had to experience this.

But I hope you'll take some comfort when I say that we've been managing through this challenging period the same way we've navigated through previous difficult periods, and that's by focusing on long-term fundamentals rather than short-term share price moves, and by sticking to our philosophy and process.

Now, the underperformance that we've experienced has been pretty broad-based, so share prices have been weak almost across the board for high-growth companies. So for example, in the American fund, our open-ended fund, only seven stocks were up in the last 12 months, and the median price change has been about minus 40 per cent.

However, despite the weak share prices, most of the companies in the portfolio have continued to execute reasonably well and are still growing at a decent rate. So by implication, the share price weakness that we've seen represents a significant derating for most of the stocks in the portfolio.

And I think this combination of much lower share prices and continuing good operating progress at our holdings bodes pretty well for future returns. So whilst things have been very tough over the last few years, I'm more optimistic now than I've been for quite some time.

In terms of our philosophy, we haven't made any major changes. We're still long-term. We're still running high-conviction, concentrated portfolios. We're still focused on finding those exceptional growth companies that we think will disproportionately contribute to market returns.

But there are always opportunities to learn. This is true during normal times and during volatile periods like the one we've just been through. The learning opportunities are arguably even more pronounced. And one topic that we've been discussing a lot around the team is the topic of resilience.

We are long-term investors and our focus is on the five- to ten-year potential for the businesses that we own, but we must also bear in mind that companies have to face their current circumstances as they are today, not as they'll look in the future, and so resilience is really important. And we've always placed a lot of weight on resilience and adaptability, but this is something that we're laser-focused on right now.

And the topic has become even more important recently, given the changes in the capital markets and the fact that capital has become scarcer and more expensive. So companies are having to face up to this new reality. They're having to assume that they won't be able to access cheap capital if they need to, and they're having to manage their cost bases and their balance sheets appropriately.

Now, fortunately for us, most of the companies in the portfolio are well capitalised, they've responded to this change in capital markets reasonably quickly, and they're gently shifting emphasis away from growing as quickly as possible to finding a more appropriate balance between growth and efficiency. And because of this, I think we could potentially see a lot of companies coming out of this period stronger and more profitable than when they went into it.

RL: Obviously, over such a turbulent period, different companies will behave in different ways. Which of your holdings have navigated this period best, and which face the biggest challenges?

GR: Yes. Almost any company that was a big beneficiary of COVID has been really challenged by this period, because they've had to deal with almost unprecedented demand volatility, which was disorientating and difficult to manage. And there are some companies that overinvested in their cost bases during the COVID boom, and they're having to readjust now as that reverts back to equilibrium.

So the companies that were most caught up in the COVID-related demand volatility are in e-commerce names, like Amazon, Shopify and Wayfair. We've also seen demand volatility at education companies like Chegg and Coursera, and then in enterprise software companies like Zoom. But we still have faith in these businesses. We think they're working through a short- to medium-term hangover from COVID, and we think that they'll come out on the other side of this.

Moderna was actually one which was a big beneficiary of COVID, but which has come out the other side of it stronger. So Moderna, obviously, everyone knows now the success that the company had during the pandemic with its vaccine. And what that's done for Moderna, not only has it proven that its new mRNA therapeutics technology works, but it's enabled Moderna to build this huge cash pile which its now using to reinvest in its platform and broaden out its drug pipeline into new and exciting therapeutic areas like cancer.

And then two other names that I'd call out that have navigated this period really well are Tesla, the EV company, and Duolingo, the language learning app. Both of these companies have grown really impressively through this period and are still growing at a really rapid rate and have executed almost flawlessly.

RL: Excellent. So let's just go back to the beginning of the trust. The motivation for launching it was to have a vehicle that wouldn't be affected by daily inflows and outflows, giving it the right structure to invest on public and private markets. And the background to that was companies were staying private for longer, and therefore, this private emphasis gave you a chance to get into exceptional growth companies before they came to the public markets. So looking back five years, how would you judge progress on investing in these private companies?

GR: Yes, sure. I think, so two of our key contentions at the time of launch were, number one, that there was a rich opportunity set in private companies, and number two, that we had the reputational strength to gain access to those opportunities, which is really important in private markets, because the best private companies pick their shareholders. And I think the results so far are broadly supportive of both of these contentions.

So just to put some numbers on this, at the end of January, we held 24 private companies in the trust, and these companies made up about 34 per cent of trust assets. And then we've invested in a further ten private companies since launch, which have subsequently gone public, and six of these are still held in the trust as public companies.

And we've been really pleased by the quality of the private companies that we've been able to gain access to. These are not small start-ups. The youngest companies that we own in the portfolio, I think, are now seven years old, and many are much older than that. These are large, innovative and, in our view, potentially generationally important companies.

RL: Sorry. Just to hone in on maybe a couple of the biggest private holdings, just tell us about those and what it is that excites you about some of these bigger companies in your portfolio.

GR: Yes. So I mentioned that we have 34, sorry, 24 private companies in the portfolio today, but actually, the exposure to private companies is relatively concentrated. So over half of our private company exposure is in the top five names, and so these are by far the most important part of our private company exposure.

And the biggest private company holding today is SpaceX, which is just over 6 per cent of the fund. We've held this one in the portfolio for a number of years now, still really excited about this one. So SpaceX, as I'm sure everyone knows, makes rockets and satellites, and it's been a hugely disruptive force in the launch market. It's managed to take about two thirds of market share in the launch market. And it's done that by dramatically lowering the cost of putting stuff into orbit.

And the reason why SpaceX has managed to build a launch service that's much cheaper than everyone else is because its rockets are actually reusable. So the company just relaunched one of its Falcon rockets for the 15th time. And this gives SpaceX an amazing cost advantage. There's no other company in the world that's even close to being able to do this at this sort of scale.

And SpaceX is using this cost advantage in launch and vertical integration to move into the communication sector. It's building a satellite internet service called Starlink, which is basically a low-earth orbit constellation of satellites that are designed to deliver fast broadband internet anywhere in the world.

Now, those of us who live in big cities in the West are quite spoiled with access to fast broadband, but a lot of the world still has slow or no internet, and Starlink is a big step towards solving that issue. And it's a relatively new service, but it's already got over 1 million customers. And so that's one of the reasons why we're so excited about SpaceX, and we think that Starlink has got the potential to grow many times over from here. So that's SpaceX.

The next biggest private holding in the fund is a company called Stripe, which made up about 3.5 per cent of the fund at the end of January. So Stripe is a software platform which makes it easy for businesses to send and accept payments globally. Before Stripe came along, it was a bit of a nightmare for businesses to build payments into the websites and apps.

The global payment system is really complex. Every country has got different banks, different credit cards, different mobile wallets, different regulations and regulators to contend with. And that complexity has made it almost impossible for small- and medium-sized companies to integrate directly with the financial systems globally and accept payments.

And what Stripe has done is it's built a software there that sits above the financial sector across the world, integrates with it on behalf of its customers and abstracts away that complexity. And so all you need to do as a customer of Stripe, if you want to send and accept payments, is integrate into Stripe's platform via a few lines of code, and then Stripe takes care of the rest.

And one of the reasons why we find Stripe so fascinating and exciting as an investment opportunity is that it's akin to infrastructure powering the digital economy. And it's this position as infrastructure that makes it so interesting.

Because when you invest in Stripe, you're not investing in a single company. You're not making a bet on a single company. You're getting exposure to growth of all of these start-ups and digital businesses that are building on top of the Stripe platform. So in a way, it's almost like a royalty on growth of the digital economy.

RL: Excellent. Talking about Stripe takes us nicely into the question of private company valuation, because I know Stripe had another fundraising quite recently at a lower valuation. So just tell us a bit about the process for valuing private companies and why you think it passes the test, that people should have confidence in the values that you put on these companies.

GR: Yes. No, happy to chat about that, and this is something that I think there's maybe been a little bit of a misunderstanding around, because we are very confident in our valuation process. And we published a note on the US Growth Trust website, outlining the valuation approach, so if anyone is interested in really getting into the detail on that, I'd encourage you to go onto the website and have a look at that.

But to briefly describe the approach, the valuation process is overseen by an internal valuation committee at Baillie Gifford that's staffed by qualified accountants. For each holding that they look at, they commission a report from an external valuation provider called S&P Global.

Now, the investment managers do feed into the process, but the valuation committee, they're independent, they own the process and the final decision on valuation rests with them. Fund managers like me only get to find out final decisions on valuation once those valuation decisions have been applied. Now, the aim of the process is to get to what we would describe as being fair value, the price that would be paid for one of these assets in an open market transaction.

One of the things that I think is quite important to note is frequency. So our valuations are updated regularly, at least quarterly. So on a rolling monthly basis, all of the stocks in the portfolio will be reviewed, a third each month. But valuations are also updated in response to events, so if there's been a big move in the peer group, if there's been a change in fundamentals, if there's been a takeover approach.

And given the volatility in markets recently, the valuations have been updated far more frequently than quarterly. So, for example, 80 per cent of the names in the US Growth Trust have been revalued five times or more in the last 12 months, and a third of them have been revalued eight times or more in the last 12 months.

And in terms of what gives us confidence in the process, it's the external input from S&P Global, the fact that the committee at Baillie Gifford is independent from the fund managers. Over and above that, the valuations are scrutinised by the Board of Directors twice a year, and also, the valuations are scrutinised by our external auditor.

And another important point to make on that one is just that because a lot of the private companies that we own in the US Growth Trust are also held in other Baillie Gifford investment trusts, many of the holdings are scrutinised by different external auditors at multiple points throughout the year. So SpaceX, for example, has been reviewed by three auditors a total of five times in the last 12 months.

RL: Excellent. I suppose one indicator… You said earlier you're confident in the holdings. Obviously, the valuations have gone down in quite a lot of them over the past year, for obvious reasons. But your turnover is low, and you said, last November, it was low even by your standards. Is it remaining that way? And what changes have you made to the portfolio lately?

GR: Yes. So turnover is still low. It's actually lower than it was when we last spoke, Richard. So it's sitting at about 5 per cent right now, which I think is as low as it's been since we launched the trust. And I think this mainly reflects the fact that a lot of the stocks that we own today are very cheap, and that's set a very high bar for new ideas getting into the portfolio, frankly. So it reflects the fact that we're confident in what we own.

And in terms of what changes we've made, well, based on that 5 per cent turnover, not many. On the public market side of the portfolio, we added two new names over the last 12 months, so gaming company, Roblox, which we've been getting to know since before it IPO'd, and restaurant chain, Sweetgreen, which we've also been getting to know since before it IPO'd. And then on the private side, it's mainly been small additions to existing holdings.

So the overall picture is one very much of consistency. The biggest holdings in the portfolio today, a lot of them are the same holdings that we had prior to the pandemic. We're still confident in them. They're still early in their growth trajectory, and we think their best opportunity is ahead for them.

RL: Excellent. I suppose another angle on that is companies coming to your attention, particularly on the private markets. Is there less of a parade of companies wanting your money? Has that been slowed down by the developments in the market?

GR: It has been pretty quiet over the last 12 months. The level of activity has been much lower than it was in the 2020 to 2021 period.

RL: Excellent. So let's go back to the beginning. You started with an apology that the trust has lagged the performance of the S&P 500. And you went into some detail earlier, but just let's recap on the lag against your benchmark index, and without prognosticating too much, because you can't do that. Where do you think the fund is now in terms of overall valuation and at a level where you'd like to see it?

GR: Yes. It's been five years since launch now, and it's really been a period of two halves. So the first two and a half years were very, very strong, and then the latter two and a half years have been very, very weak.

One thing to note is that although we have lagged the S&P over the five-year period, the NAV has risen quite strongly. So it was up just over 80 per cent, I think, in the five-year period, although the S&P was up just over 90 per cent in that period. But the share price has risen much less than the NAV over the five-year period, so the trust is now trading on quite a significant discount to NAV.

The underperformance that we've seen, particularly in the last two and a half years, has been really a function of a sharp devaluation of the portfolio, so price to sales multiples have fallen pretty sharply across the board. And I think that's been, to a quite significant extent, driven by the change in the interest rate environment.

So as you know, we own high-growth stocks. And for those high-growth stocks, the cash flows of those businesses are weighted towards the outer years, and that means that they're more sensitive than average to changes in the real discount rate. And so they've been particularly sensitive to the rising interest rates.

And interest rates seem to have stabilised now. So if you think interest rates are going to be stable from here, then from this point on, the outcome should be driven much more by fundamentals rather than changes in valuation, but any further rise, or indeed fall, in interest rates could influence valuations either way from here.

RL: Yes. And you mentioned the discount to NAV there. Do you think that tells you something about investor appetite for growth stocks, and your trust in particular?

GR: Yes. Well, I think you've seen your discounts widen across the whole investment trust sector. So I think it's a function of where we are in the market cycle right now and the fact that we're very much in a risk-off environment. And I think if we were to see a stronger period for markets, then that would probably help with the discount. But it's very difficult to predict with these things.

RL: Exactly. Some things are beyond your control. Let's take a look at the longer-term investment outlook now. And we're probably in for a period of higher interest rates. The age of free capital has gone. So what keeps you so motivated about finding great growth stocks? Are we still in a good era for the growth companies that you want to hold in the trust?

GR: Yes. My view on the long-term outlook hasn't changed. I'm a bit of a broken record on this. I've said it many times before. But I think we're in the middle of a once-in-a-generation shift in the global economy, and that's being driven by these new technology modalities like internet and mobile and AI.

And I think we're closer to the beginning of this shift than we are to the end, and I stand by this. I think the structural megatrends that were underway before the pandemic and that were accelerated by the pandemic will continue post-pandemic. It's just some companies are facing difficult comps right now, and we're in a period of adjustment.

And although I think the macro conditions could temporarily affect the pace of growth for some of these companies, I don't think the economic backdrop will be a major impediment to long-term growth for these companies.

Now, I'm actually finding the period that we're in right now very odd, because we simultaneously have some of the most volatile and uncertain short-term macro conditions that we've faced in ages and some of the most exciting and significant technology-led changes that we've seen in our careers.

For example, I think what we're witnessing right now in the field of AI is at least on a par with the iPhone in terms of its potential impact on the world, and it might actually be even greater than that. AI is progressing at an absolutely blistering pace. It's going to have a profound impact on how humans and machines interact with each other. It's going to have a massive impact on how we work. It'll make us more efficient. It will drive productivity growth, create new industries, help us solve problems and drive progress.

And Steve Jobs famously, I think it was back in the 1980s, he described the computer as a bicycle for the mind, which I thought was a really nice and elegant way to describe it. And I'll be far less eloquent in describing AI, but I think AI is the equivalent of a rocket ship for the mind. And I don't say that lightly. I think it genuinely could have that sort of impact on productivity by augmenting humans in their jobs.

And one example from the portfolio that's using AI to its advantage right now is Duolingo, which is a language learning app. Now, I spoke to the founder last year, and we were having a discussion about when he thought the company might be able to converge with human tutors in terms of its abilities. And he said he thought it would be somewhere between ten and 15 years.

Duolingo has now integrated generative AI into its app. It's just rolling out right now, and the founder now thinks it will take them three to five years to reach parity with human tutors. And that's just in the space of a year, which is just amazing. So it's a weird world we're in. There's lots of volatility, there's lots of uncertainty, but we're also witnessing some of the most important breakthroughs I think of the last 100 years. And I think that provides a really exciting backdrop for growth investors and for growth stocks.

RL: Right. You describe AI as the rocket ship. Every day, we wake up, and another company is implementing AI. And it reminds me of the first wave of the internet in the late 90s, where you just put dot-com after your name and your share price trebled.

So to put it crudely, there's a lot of hucksters out there and people saying we've got AI when they really haven't. How does a professional investor like you sort out the wheat from the chaff, find the companies, other companies like Duolingo that are really going to make the most of AI for its shareholders and its customers?

GR: Yes. One of the debates that we've been having is where are the benefits of this likely to accrue in the value chain? You've got the hardware providers like Nvidia, which is a big holding in the fund, and we think that they stand to be a very significant beneficiary of this as a provider of picks and shovels to the AI goldrush. There are the cloud infrastructure providers like AWS and Azure and Google Cloud, and we think that they stand to do pretty well. I think the providers of the large language models like OpenAI potentially stand to do really well in this.

And then, in terms of the application layer that's being built on top of those large models, I think it remains to be seen. I think there are probably quite a lot of companies out there that are building what amount to thin client layers over the top of GPT-4's API, and I don't know how sustainable those business models will be.

But then you have other companies which do benefit from competitive advantages, like Duolingo with its branding and its expertise in education, which can use that AI to augment its service. And I'm much more excited about those ones. And actually, Duolingo is one where I think their chances of leveraging AI successfully are enhanced by the culture. So the founder is a guy called Luis von Ahn. And he was previously a Professor of Computer Science at Carnegie Mellon, and he taught the AI course.

RL: Okay. I'm going to turn to questions now from the audience, and a couple of them, in fact, more than a few, would like to know more about AI, particularly one. What are your views on the concerns raised by the likes of Elon Musk about AI, and it's going to go too far too fast, small chance of wiping us all out, and we've got to put the brakes on? Is he right? Is it possible?

GR: I think we should take these concerns seriously, because the people who are most concerned also seem to be the people who are most expert in this field. So it's almost the opposite of some other areas of innovation, like vaccines, for example, where the people who were most concerned were the people who had least expertise. But this time around, it's people like Elon Musk, and even someone like a Sam Altman at OpenAI said he believes that this industry ought to be regulated.

And I think one of the potential compromises between just ploughing ahead at full speed and pausing… Because I think one of the risks with pausing is also that there are always potential problems with any new technological innovation. There are potentially massive benefits that would accrue very broadly across society from getting this right.

So I think one of the potential compromises in between just going really quickly and doing nothing at all is to potentially slow down the pace of progress. Because I think if we continue to see 100 per cent-plus gains in the capability of these models year over year, year after year, then one of the issues is just that the socioeconomic infrastructure is not going to be able to keep up. The regulators who are regulating society are going to be left in the dust by this.

And so is there a way that we could throttle progress but not stop progress to enable society to better cope with what's coming? But that's something that's going to require the coordination between and collaboration between not only different companies but also different countries around the world in order to make that happen. So it's going to require a lot of work, but I totally buy into the arguments that we ought to be regulating this industry and taking the risk seriously.

RL: Right, okay. Another Elon Musk-related question. You did talk about how confident you are in SpaceX, and this is a topical one. In the light of Virgin Galactic's troubles, the company went into liquidation today, does that do anything to deter you from your enthusiasm for SpaceX, or do you think it really is in a different category?

GR: SpaceX is in a different category. There is no other company that even comes close at the moment in launch. And other companies that are chasing this market opportunity, their aspiration is then to be number two to SpaceX. I think SpaceX is just so far ahead that the chances of anyone else catching up with them are pretty slim right now.

So as I mentioned, they accounted for two thirds of all of the masts put into orbit globally last year, so they really are in a different league in terms of the frequency of launches, in terms of the scale and in terms of their capabilities. And I think that, if anything, the chances are that they're only going to pull further ahead with the Starship that they're working on, which will massively increase the amount of masts that they're able to put into orbit.

RL: Okay. Another question, turning to private portfolios. How, and are you, participating in new funding rounds within the private portfolio? Are you getting a lot of demand for more money, and what are these companies using it for?

GR: Yes, we're not getting a lot of demand at the moment. There have been one or two fundraising rounds here and there from our existing holdings, the one or two companies that have wanted to get out on the front foot and raise a bit of money proactively.

And then there was the Stripe fundraising which was publicly announced, where they were looking to raise money to help their employees realise liquidity so that they could pay tax liabilities that were crystallising on restricted stock they'd been issued a number of years ago.

So it's been pretty quiet on the fundraising front. A lot of companies in the portfolio raised quite a lot of money back in the 2020-2021 period and are sitting on a reasonable amount of runway, and so they're under no pressure to raise money. And if you don't have a reason to raise money right now, then you probably wouldn't raise money right now, because the conditions are quite challenging.

I think there's always going to be funding available for exceptional companies, but it is more difficult to raise. The terms are less favourable, and it's taking a lot longer to raise money now than it was back in the 2020-2021 period.

RL: Right. So there's no real pressure to raise your self-imposed limit on private participation.

GR: No. And that percentage is in the 30s right now, and we can go all the way up to 50 per cent too, if we feel that that would be in the interests of shareholders.

RL: Okay. I'm going to end with one more question about AI. I think, again, it's one that comes round from the first round of the internet. Do you think AI is profoundly deflationary in terms of cutting costs for companies?

GR: Yes, I think it's going to be massively deflationary, and I actually think, if you believe, if you buy into some of the arguments that are being made by Sam Altman and other people about the pace of progress with AI, then inflation is not going to be a major issue. I think the shift that we've seen in the global economy away from tangible products towards intangibles and technology has made it much more difficult for economists to actually measure underlying productivity growth and inflation.

And there's a really interesting paper published by an academic at the Philly Fed, a person called Leonard Nakamura. And he estimates that we've been overstating inflation to the tune of about 2 per cent per annum, and that figure has been growing year after year because it's just so difficult to incorporate intangibles and free products into our productivity statistics. And I think that's just going to become more pronounced in a world where we're using lots and lots of AI.

RL: Well, given what we're all dealing with in inflation at the moment, that's a piece of good news to end on. So thank you very much, Gary. That is all the time we've got for it, and really value your expertise and joining us today. And thank you all who have tuned in. I think it's been a fascinating discussion. Thank you for your questions. We had far more than I could come up with or get time for. We've got more sessions like this coming up, so do please keep an eye out for those, if you've found them useful. And all I've got to say is thank you very much, and goodbye.

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

	2018	2019	2020	2021	2022
Baillie Gifford US Growth Trust	*N/A*	*30.0*	*133.5*	*-4.7*	*-52.8*
S&P 500 Index	*1.6*	*26.4*	*14.7*	*29.9*	*-7.8*

Source: Morningstar, S&P, total return in sterling. The US Growth Trust was launched on 23 March 2018.

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- *The Trust can borrow money to make further investments (sometimes known as "gearing" or "leverage"). The risk is that when this money is repaid by the Trust, the value of the investments may not be enough to cover the borrowing and interest costs, and the Trust will make a loss. If the Trust's investments fall in value, any invested borrowings will increase the amount of this loss.*
- *The Trust has a significant investment in private companies. The Trust's risk could be increased as these assets may be more difficult to sell, so changes in their prices may be greater.*

- *The Trust can buy back its own shares. The risks from borrowing, referred to above, are increased when a trust buys back its own shares.*

- *Market values for securities which have become difficult to trade may not be readily available and there can be no assurance that any value assigned to such securities will accurately reflect the price the Trust might receive upon their sale.*

- *Investment in smaller companies is generally considered higher risk as changes in their share prices may be greater and the shares may be harder to sell. Smaller companies may do less well in periods of unfavourable economic conditions.*

- *The Trust can make use of derivatives which may impact on its performance.*

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