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Global Alpha
Q3 investment update

October 2023

Investment manager Spencer Adair and investment specialist Philip Rae give an update on the Global Alpha Strategy covering Q3 2023.

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Philip Rae (PR): Hello everyone, and welcome to this Global Alpha update. My name is Phillip Rae. I'm an investment specialist and part of the Global Alpha team. I'm joined today by Spencer Adair. Spencer is one of the three named portfolio managers on the Global Alpha Strategy. He's been part of the Global Alpha strategy since its inception back in 2005. So, Spencer, thanks very much for joining me and our clients today.

Spencer Adair (SA): It's a pleasure. Thank you, Phillip.

PR: We're going to talk about the portfolio's performance and recent positioning updates. Before we do that, it's just important to remind clients, we're doing this quarterly update with a view to the long term. That is how we invest.

We're thinking over [a] long-term investment horizon, typically three to five years and in many cases, companies have been held in this portfolio for far longer. We remain at its core a reward seeking approach. We're looking to invest in a diversified collection of growth businesses, high quality growth businesses across our three growth profiles.

Those are compounders: companies that deliver consistent and reliable growth and that we think can do that through any economic environment. Disruptors: companies that are reinvesting into their businesses to fuel future growth, where we think the opportunity for high growth rates is really attractive. And finally, Capital Allocators: companies that are investing counter-cyclically to entrench their positions in their markets and deliver attractive rates of growth over the long term.

Spencer as you know recent performance has been challenging and this extends a period of weaker performance. The market [has] been, just incredibly dominated by anything macro. What the latest view of the

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Fed is, what the latest inflation print [is]. Maybe you can just give us a sense for how you think about this current environment. And for the recent performance, set a context for our clients please.

SA: Yeah, thank you and thanks all. I think the last three years have been very much driven by external factors. So, this portfolio did very well during the pandemic and, then the last couple of years, as long-term interest rates have been going up, it's been more challenging. For me, the macro isn't just short term rates, the challenging bit is whenever your 10 and 30-year yields rise, because that's what's discounting the long term cash flows. [For] a lot of our holdings, the value is captured year ten onwards, not one year onwards.

So, although the market narrative is often about short term Fed rates or what's the Bank of England doing, really the thing which is driven, which is create a headwind, a big headwind for us is that long term yields have been going up.

And just as a reminder, over a third of the portfolio is being owned for ten years and over half the portfolio is being owned for more than five years, so we are we are really long term. So that's why it's the long bond yields, in particular. In the shorter term, in the last three months, there has been another shift in interest rate expectations.

People were hoping that we're closer to the peak and therefore we'd start to see a short term and therefore long term rates declined a bit, and that hasn't happened as quickly as people thought. So therefore, performance has continued to be a bit challenging.

This hurts long duration assets, it hurts long bonds. I don't need to tell some of our clients who have also got bond managers. It hurts long term equities and that can be in this portfolio that can either be captured in the disruptors where more of the values in year five onwards because they're trying to build and create something in the near term that only pays off in the long term or it also hurts the really long duration compounders.

Not all of the compounders, but some of them are the values in years ten, twenty, thirty and they they've been hurt pretty hard by that. So, we haven't had the diversification benefit which we might usually expect between the three growth buckets because of [the] resetting of long-term rate expectations. I appreciate that's been a very tough time for you, our clients. We've tested your patience and we're acutely aware of that. So thank you for your continued patience and indeed watching this video today.

But the good news is that whenever the market is dominated by one thing, so whenever the market becomes so fixated and dominated by one factor, which today is the macro, our rate expectations. It inevitably misses progress, it misses good news elsewhere. And we've seen that through a variety of cycles over the years, that whenever the market gets fixated by fears over housing, or fears over banking solvency or fears over China, it misses good news elsewhere.

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And so I think today the market is missing that our companies, the long term growth companies, are producing very significant long term fundamental growth and that we are beginning to see operationally exactly the kind of figures we hoped we'd see. We are seeing the companies making progress, releasing new products, putting their prices up, getting new customers, controlling their costs, all of those basic fundamental things are working and are going in the right direction.

So I could throw a whole lot of numbers to justify this, but just one number to simplify it. If I look at three-year forward revenue growth, so what are companies expected to grow their top line at over the next three years? Our rate of growth is three times faster, a little bit less, but roughly three times faster than the average company out there.

So our companies are growing materially faster with better profitability and with higher quality and all of those metrics. And yet, the valuation multiple is in line with long term average. [Now] in 18 years of running global Alpha, helping run global alpha [as] part of the team, I don't remember growth of three [times], or growth rates of three times faster being posted before.

So this is as an extreme relative operational performance that I've seen, and yet, the long term valuations are exactly in line where they've been in the past, which is a modest 20 to 25 per cent multiple [premium], richer PE multiple or EV to operating profit multiple. So I'm saying, valuations in exactly where they should be in the long term but operational, much, much better progress.

Now, that doesn't guarantee that we're just about to turn because I think that the market will turn when it wants to. But at some point, it's going to stop worrying about the macro and long term rates and start valuing companies, on their fundamental progress. We've seen that over every rolling five-year period, it's the companies with the best operational performance [that] do the best in share price terms.

That has not been happening the last couple of years and we think that [has] stored-up outperformance waiting to be released. I don't know when it's going to happen, but that's why I can look at you on a virtual environment on a webinar and say, I am not worried despite the underperformance.

Of course, some companies do a bit better. Some companies have operational hiccups. I get that, but that's what a portfolio is. But in aggregate, the companies are performing exactly as we hoped and valuations are supportive and it's just a matter of waiting for those fundamentals to really come through strongly.

PR: Yeah, it does feel like the market is really focused on the near term and very sensitive to any changes in interest rates. And there's, evidence of companies really continuing to invest through this environment and build on their competitive advantages. And that's coming through in the growth numbers that you just talked about. There are some companies that are facing more challenging backdrop too, maybe you could just talk through one of those and how you think about over a long-term horizon.

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SA: Absolutely. We're always going to have some things [we] do well and some things [we] do badly. That's why you have a portfolio to blend these things out. But let's pick on the worst performer of recent past, which is Adyen, which is a Dutch payments company. Adyen saw its share price halve within a couple of days back in August, which is no matter how long term you are, you feel that that hurts.

And so what happened with Adyen? Well, I think two things. The first is that three quarters of their businesses are performing exactly in line with expectations. So that would be primarily Europe being the largest part there – [that's] performing exactly where we hoped. But in the US, so online companies in America, we saw growth slow. Now the growth rate slowed to 25 per cent year over year. So I say slow, it didn't go backwards or it's not shrinking, but it definitely it's no longer growing at the 55 per cent it was growing previously.

So growth has slowed there and the market didn't like that. Because Adyen report only six monthly, it is now going to be a relatively long period that we don't really hear too much from the company. I know they've got an Investor Day in November, but they've actually got a relatively long time before they can evidence that things are turning around.

So why did growth slow in the US? It's primarily because they compete against PayPal as one of the companies they compete against. And PayPal bundled up their Braintree division, which competes directly with Adyen with the PayPal button. You click here to pay with PayPal and they essentially cut costs by doing that.

So in a more cost-conscious environment, online US companies said, I'll just go for the PayPal option thanks. And that's understandable, if we own any company for five or ten years, which is what we're planning to do, we're going to have times of tough competition and times of easier competition - Adyen has entered a period of tougher competition. So that's one thing that's happened.

The other thing that happened the market didn't like was that Adyen committed to continuing to recruit heavily and continuing to recruit engineers to make the product better. And that has got a high cost and that means they're going to temporarily squeeze what are currently very good margins. That is precisely what we want them to do. We want our companies, any of our companies to be investing for future growth. We want them to be ambitious. We want them to recruiting the best and the brightest, adding more and more functionality and value to its products for its clients.

So how I view this is that Adyen, like many of our companies, [it] has had a reset in its valuation, but that reset only happened once, so it's been reset. And yet we've got a stronger clue on its culture in terms of how it's thinking about growth, how it's being ambitious to continue to invest, which is a big tick. And we've also got a big tick because the starting valuations are now much more palatable and supportive, and it's trading on about 20 times earnings a couple of years out, albeit for structural growth, which high teens, low twenties for a long, long period of time.
So that would be one where, although it's been painful, and there are other examples of that, we understand why, and we think the response has been a good one. There's going to be a period of uncertainty in the

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market until they report a few more times. But actually, I suspect we'll look back at the PayPal versus Adyen competitive spat as a footnote in history rather than being anything terribly material.

PR: It does I think feel that we're in an environment where companies [that] are actually reinvesting for future growth, they're being sort of unfairly punished. When you look at this portfolio and, you know, in aggregate, companies are spending relative to sales a lot more on things like CapEx and R&D, so they are continuing to invest for that future growth, which is key.

Maybe just you could touch on the sort of volatility [we've seen] and how, we're sort of trying to take advantage of that, how you think about that volatility in a portfolio context and where it sort of throws up opportunity.

SA: Yeah, so I think it's been a bit too much volatility in the last couple of years. So I think although we were taking advantage of it, I think we could do with a little bit less volatility. What we're looking for are companies that have got, no matter what industry they're in, have got some sense of structural growth ahead of them, but have also got the means and capabilities to achieve that growth.

So over 95 per cent of the portfolio is self-funded in that they can achieve that growth through their balance sheets or through cash flow retention, and that's great, that's fantastic. I'd much rather have that being heavily biased towards self-funded growers and being dependent on the stock market reopening. Our companies tend to have very strong balance sheets, over twice as strong as their peers, which means they have not been hurt as much as rates have gone up.

But equally they've got lots of dry powder. So we're gently encouraging companies to say, look, if you're seeing your peers begin to retrench in whatever industry you're in, if you're seeing competitors withdraw, if you're seeing assets being put up for sale, don't be scared - go for it. This is your time to use that balance sheet counter-cyclically.

We have companies that are spending more in R&D, spending more on CapEx and really delivering that. So whenever I see the superior growth coming through, over a three and five year period, it's not a surprise, because it's a series of individual decisions being made at the company level that are able to really exploit that growth in the future. We are seeing pockets of companies that have invested an awful lot upfront and that that could be to develop an online tool, or a piece of technology code that they've written. It could be something as unsexy as a quarry.

So Martin Marietta were in the office a week ago, and then we went and had dinner together. And they've got stone in their quarries that are going to last 80 plus years, a very, very long period of time, a long duration asset. They've got demand and coming through from infrastructure Acts in the US, from repair and replace, from road building exercises etc, which are seemingly, building [growth] on top of growth, on top of growth – so a very rosy outlook there.

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But they were telling us that, I won't talk about the exact figures, but if you look at the average prices they put up over the last ten years, they know expect the next five to ten years to enter a period where pricing increases at about twice the rate it has done in the past.

So they should have a relatively rosy outlook on growth. They've done all their heavy CapEx spending, they've got all their quarries, and now it's a case of their overlap growth hump and now they can gently put prices up as long as they keep balance with competition etc, so there'll be puts and takes here. But we're entering a period of materially higher pricing growth to come through and that is a tremendous position to be in because that growth, if it's pricing, should fall predominantly to the bottom line.

So we should see accelerating growth, better margins, better returns on capital and that is not captured at all at current valuations. So there's a lot of other examples, but that's just one small example of heavy spending up front [that] has really allowed them to enter that a period of exploitation, if you like, of the of their assets and be able to grow profitably for a long period of time.

PR: Yeah. I think that there's lots of examples across the portfolio where they are, you know, navigating this environment very well, or indeed the competitive position may in many cases be strengthening as well. We've recently gone back looking at some of the upside cases for a lot of the companies in the portfolio. Maybe you could just share with our clients, you know, the value of that work, why it was done and how that features into the investment decision-making process.

SA: [Well] we're constantly reassessing the upside of all of our companies. Rather than do that purely on an ad hoc basis, we just periodically get together and say, look, let's take a slice of the portfolio. Now that could be compounders, or it could be companies in America or could be, in this case, our top 20 [to] 25 holdings, let's look at the largest positions in the portfolio.

The reason for examining those is that some of them have done very, very well. Some of them have performed very strongly. Can we still see an upside? But by definition, if you've got, you can either become a large holding because we've allocated capital to it or because your share price has done well. So [we just] want to check. We want to check the future growth of the portfolio and we were running everything through the 'what is the probability this will double again in the next five years?'.

So has everything got a 30 per cent chance of doubling in the next five years? And we did it publicly so that everybody can see the assumptions used, everybody can see the exit multiples, and therefore we could compare and contrast how hard did an analysts have to work in order to double [in share price terms] over the next five years.

Now, we've not yet made portfolio changes in the back of that, we are about to today in fact, so I won't front run those. But what I will say is that, there were of course tweaks here and there as always, some things we will take a little bit of capital out of [and] some things we want to add a little bit of capital to.

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But the big picture for me is that there was an imbalance between the companies where it's still very, very easy to double over the next five years, where it's become easier. And then a smaller group of companies where actually they've done well, it's time to start taking some capital and being countercyclical. So again, this backs up the kind of the enthusiasm in the portfolio in that independently doing this work where we're in a really pretty positive place in a whole lot of different holdings.

From incidentally all three of the growth profiles from all different geographies, it's a global thing whereby ambition and long term optionality has [not] been rewarded at all by the stock market. And that's what we're really excited about.

PR: Maybe give us an example of one that seems particularly underappreciated right now.

SA: Oh, you're putting me under pressure. One that I wrote on, which is all kind of biases there of course. One that I wrote on is Royalty Pharma, which provides funding to biotech and pharma companies and it does that by way of providing capital and having a royalty in exchange. So it provides the capital upfront and then it gets very, very high profit margin royalties coming in over the next five, ten, fifteen years. Depending on how long the patent has left to run.

This is a company where their ability to deploy capital has gone up, very sharply. So their growth opportunity has got much largerbecause guess what? If you're a biotech company and you raised cheap capital two years ago, you have burnt your way through it. You're now [thinking] how am I going to fund my last study before approval? You may have assumed that you could go back to equity markets and raise another $500 million or something. That's tough. That's really, really tough. So now these hundreds of biotech companies that have listed recently, are either are going to have to partner with large pharma or to go to royalty pharma in terms of getting this done, getting the drugs approved.

And so Royalty Pharma are, we think, deploying roughly twice the level of capital they were deploying three years ago. So the increment has gone up and it's hard to tell this with any certainty, but we think the returns they are making on incremental capital are also higher because there's a lot less competition for returns.

So this is a company which dominates its industry. We can measure [that] they're deploying twice as much as they were in the past, and we speculate or we have a thesis that they are they are going to make a higher return. This is trading on a low or high single digit PE. It's traded like a company in decline and yet we are very excited about that growth from here. That's just one example.

PR: Yeah, I mean [even] more broadly, actually, it does feel like growth is quite underappreciated by the market today and that's certainly been environment the last couple of years where growth has been quite out of favour.

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Thank you very much for your time, Spencer, and to the clients who joined to watch today [we] thank you very much. We appreciate the near-term performance continues to be challenging and we appreciate your ongoing support of the Global Alpha Strategy. We will continue to keep you updated with the latest developments around the portfolio and the portfolio's performance. And we'll speak to you again next quarter, thank you very much for joining us today.

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

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Global Alpha

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

	2019	2020	2021	2022	2023
Global Alpha Composite	7.2	21.5	26.9	-23.4	7.2
MSCI ACWI	8.7	2.9	29.4	-5.7	12.7

Annualised returns to 30 September 2023 (net%)

	1 year	5 years	10 years
Global Alpha Composite	7.2	6.3	10.4
MSCI ACWI	12.7	9.0	10.8

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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