

# Sustainable Growth Q3 investment update

October 2023

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**Investment manager Toby Ross and investment specialist Alasdair McHugh give an update on the Sustainable Growth Strategy covering Q3 2023.**

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**Alasdair McHugh (AM):** Welcome back for the third instalment in this quarterly video series. So these updates serve as a chance for us to share recent news on performance and transactions in the portfolio and also to answer any questions that you've sent us over the previous three months.

As a reminder, in Sustainable Growth, we're looking for companies that are sustainable in both senses of the word. So delivering both enduring growth and enduring good. And our philosophy is really that we believe those things are mutually reinforcing over the long term. I'm Alastair McHugh, I'm an investment specialist on the strategy, and I'm joined today by Toby Ross, one of our portfolio managers. Toby, welcome.

**Toby Ross (TR):** Thank you.

**AM:** Now Toby, it hasn't been a great quarter for growth investors, especially those with time horizons as long as hours.

I think in September, in the course of about 48 hours, 11 different central banks came out with the same message that rates aren't going to fall any time soon. Hugh Powell with the Bank of England likened that to Table Mountain and its flat top, rather than the Matterhorn and its triangular peak. So the markets very quickly factored that into its valuation models and growth stocks sold off.

Is it as simple, though, as interest rates up, growth stocks down, in your opinion?

**TR:** Well, that's definitely been the market's mental model recently. And it makes sense that if [a] company's growth is a long way into the future and interest rates go up, then there is an impact on the valuation in the near term. However, what really drives a company's value over the long term is the growth that it delivers rather than just how that's discounted.

And I think in these periods of dislocation, the market tends to focus much more on the discount rate rather than rather than the growth. And that's kind of where our opportunity is. So, it might surprise clients, but when we're sitting around the desk talking to each other about the portfolio, we're focused much more on the operational delivery of our companies.

So, are the results we're seeing confirming our hypothesis for why this company is going to be a great enduring growth company over the next decade or not. And we're looking for signals around that in the news rather than necessarily what central bankers are doing day to day. And when I come back to that operational news, I'd say by and large it's actually has been quite supportive of our thesis in most cases.

So you've had a number of companies putting up prices, as we've argued that they could. Starting to flex their pricing power. I think things like Shopify and Spotify, where that's been part of the case for a long time, it's really starting to come through. We've had many of our companies, whether it's Workday or Mercado Libre, producing really terrific growth numbers.

And actually, overall, we feel very good about the operational performance of most of our holdings. So from our perspective, it's actually been a pretty decent operational quarter even if we have been into this headwind that you referred to around the valuations of some names.

**AM:** Okay. So a bit of a disconnect then between the operating performance that we're seeing in company results and the share prices and the sentiment attached to what is still a pretty fearful market backdrop. So would you say that presents an opportunity to us then?

**TR:** Yes, in a word. And you can see that in different ways. One is just when I think about the valuations of some of the names, it just seems a bit wrong to me.

So one example that's front of mind [is] Workday, the software platform, [which] is one of our largest holdings. So that company's been taking market share hand over fist from the likes of Oracle over the last five years. Its revenues have tripled over that period, so really substantial growth. And I think that that can be sustained for the next decade. It will triple again over the next decade.

Meanwhile, Oracle is barely growing. But today those two companies are on the same multiples of sales because the market would much rather focus on a pay-out for the high near-term cash flows that you get from Oracle than the significant growth that you get from Workday, even though that will come with very significant cash flows over time.

So that's one reason we're so comfortable having something like Workday as a large holding. But we're also seeing that come up again and again in our new idea pipeline as well, which we'll maybe come onto later. But there's lots of examples of that dislocation working through both in the portfolio and in where we're hunting.

**AM:** Yeah, and I think Workday was one of the examples you used in a paper you wrote recently on the *Four traits of enduring growth companies*, which clients may have missed, is that right? So, for those of us who haven't read it - I, of course, have read it many, many times and enjoyed it - would you like to just quickly remind us of your conclusions in that paper, please?

**TR:** Yes. So, the purpose of that paper was, we say we're looking for enduring growth. So, the companies that are going to deliver the top quintile of earnings growth over a decade, which is basically double-digit earnings growth over that period.

We know that those companies have a very strong tendency to outperform, so they're a good place to look. But what does it take to be in that top quintile? And I think there are basically four features that you see in them.

One is cascades of opportunity, and Workday is an example that. There's lots of different dimensions that the company can grow in, that are going to give it many years of growth opportunity.

And another is resilience so that it can ride out those cycles. Because if you're investing over a decade, there are going to be periods of economic strain or geopolitical turbulence. So, what gives the company the ability to stay the course or be adaptable during those periods of change?

The third is power. So, what is it in the business model that competitors will find really difficult to compete against, and where are the really enduring sources of edge?

And then the final one is people with a clear sense of purpose. Because one trait I have noticed over time, when you look at the really successful companies, is [that] they've got a very strong idea of what their purpose is in life; how they add value for society, everyone knows why they come to work in the morning. And I think the longer your time period, the more important that last element is.

And I was thinking about that this week because at the start of the week I was visiting one of our holdings, the money transfer business, Wise, which is a fantastic little business. And I spent a day with a couple of colleagues, we saw six or seven members of the management team, talked about a really wide range of different topics. But the thing that came up again and again in every meeting was their sense of mission. You know, they know they're trying to reduce the cost of money transfer for everyone. Everyone in the organization gets why that's important. And it is one thing that makes the company strong.

So yeah, that's the paper in a nutshell.

**AM:** Okay. And I certainly saw those traits come through in our one new purchase this quarter, which was mining equipment business, Metso. Would you like to just give us a quick couple of seconds on that one? [A] couple minutes, maybe?

**TR:** You know me too well to say seconds. Metso's business, I'm really excited by. Actually, if you think through those four things, I think it exhibits all of them. So firstly, on the opportunity side, the long duration of opportunity, cascades of opportunity, side. So, there are two big drivers here. One is, if you think about the energy transition and the resources that will be needed for that, there is going to be a need for significant expansion in things like volumes of copper produced or lithium or other commodities.

Now that means lots of CapEx going into new mines. That's typically not great news for mining companies, but it's very good news for companies like Metso that make the kit. The second big driver there, though, is that all these mining companies are under a lot of pressure to reduce the energy intensity and water intensity of their processes.

Metso's process is one of the areas where they can really control and reduce that environmental footprint and Metso themselves have carved out the position of absolute technology leadership in that space. So they've taken on the job of saying, right, we're going to help you, miner, reduce the energy intensity of your process.

So there's a big demand driver that will come through, two big demand drivers, actually. On top of that, the industry's consolidated a lot. So it's going from four companies down to two over the last five years. So that's the power point. And then there's a management team who've come in four or five years ago who've instilled a really strong sense of purpose around the company, being clear about what the mission is and are helping to sort of focus on the most attractive, fastest growing parts of the market.

So there's quite a lot of different things that are going to be quite big tailwinds for that business over the next decade. But the thing that I find really interesting is that it's being valued as if this business isn't going to grow at some 15x earnings. So, I just think that's wrong. And it's a good example of one of those dislocations we're seeing.

**AM:** Yes, absolutely. And so that was funded by the sale of freelancing platform Upwork.

**TR:** Yes.

**AM:** And do you want to tell us about those, the four traits there and whether any of those have deteriorated?

**TR:** Well, we'll go into all four of those for there. So Upwork, yes, it's a freelancing platform, massive opportunity ahead of it. But I think the question we were asking ourselves is the resilience one. So, the way we frame that is, how much control does this business have over its own success? And I think in Upwork's case, they are still a business that's not yet at maturity and they haven't yet got necessarily that much control over their own success.

As we go into a more challenging economic environment, we just felt it didn't clear that hurdle. So we thought it was a good use of funding for something like that.

**AM:** Okay, so just one transaction this quarter, which I think shows the contentedness with the portfolio. But it also gives you lots of time to spend on the pipeline, lots of new ideas coming through. Do you want to give us a brief word on that?

**TR:** Yes. [Well] you've sat in most of the stock discussions where we've been talking about those. But the thing you'll have heard is how many ideas that our scouts and our team are bringing to the table at the moment. And lots of those are companies where we think the long term opportunities are really attractive, but the market is focusing on the short term at the moment, and it's quite hard to characterize them.

There's medical equipment businesses in there, there's safety equipment businesses, there's technology companies, there's software companies, there's a whole range of things. It's not just tech where you're seeing that contraction in time horizons. So, the idea hopper is pretty full at the moment and I'm hopeful that over the next quarter you'll see more of those coming through into the portfolio.

So we're happy with the shape the portfolio is in, but there's quite a lot of good ideas coming to the table at the moment.

**AM:** Yeah, and I think that's a lovely point to leave it on actually, real eclectic idea generation coming through into the portfolio. I think for our clients, the summary is that it has been a difficult quarter in performance terms and certainly we're seeing share prices being hit by poor sentiments in the market towards growth stocks. But at the operational performance level we're seeing a much more positive picture and we're very much trying to lean into that, and looking at some long-admired businesses and taking positions at what are now very attractive valuations.

So, thank you for listening today. If you have any questions you'd like to see us address in these going forward, please do send them in. And if you'd like to read that paper that we flagged several times in this conversation, then please do visit our microsite.

## Sustainable Growth

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

	2019	2020	2021	2022	2023
Sustainable Growth Composite	-7.3	66.9	21.7	-46.4	13.1
MSCI ACWI	2.0	11.0	28.0	-20.3	21.4

### Annualised returns to 30 September 2023 (net%)

	1 year	5 years	Since inception*
Sustainable Growth Composite	13.1	2.7	8.9
MSCI ACWI	21.4	7.0	9.2

\*Inception date: 31 December 2015.

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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