SUSTAINABLE GROWTH STRATEGY Q1 UPDATE

Client Service Director Alasdair McHugh and Investment Manager Toby Ross give an update on the Sustainable Growth Strategy covering Q1 2023.

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Alistair McHugh (AM): Welcome to the first of our quarterly video updates on the Sustainable Growth Strategy.

These are designed to sit alongside the usual letters that we send to you in written form, and really just to give you a different medium with which to consume an update on the strategy.

As a reminder, or for those of you who haven't heard from us before, what we're trying to do with Sustainable Growth is look for those companies that are sustainable in both senses of the word.

So, enduring growth and enduring good. And what we mean by that is we're looking for those firms that are really long duration growth opportunities, and crucially, those that are leaving the world in a better state than they found it.

So, I'm Alistair McHugh. I'm an Investment Specialist on the Strategy. And I'm really pleased to be joined today by Toby Ross, a Portfolio Manager. And Toby's going to give us an update on the portfolio positioning.

Toby, I think the first quarter of the year is typically one where we see lots of updates from companies reporting their earnings, and generally, a pretty good indicator as to their fundamental health, we would say.

And I think particularly this year, really, we're starting to see a bit of distance between us and the pandemic now, and arguably, a bit more clarity out of some of those numbers that are being reported. What's been the big takeaway for you during the quarter and the results you've seen?

Toby Ross (TR): Yes, you're right. And it's certainly a busy time for hearing from companies. So, most of our companies have reported, and we've met many of them over the past few months.

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As you know, the first two questions in our process are around the long-term growth opportunities, so how much can this company grow over the next decade? And then resilience, so how much control does this company have over its own success?

Now, if you cast your mind back to the second half of last year, the prevailing thing going on in the market was that we were seeing growth decelerating for quite a few companies, as we went into a trickier economic environment, at the same time as interest rates were going up very sharply, which was making people worry quite a lot about the resilience of companies, how much control do they have over their own success?

And that combination was a pretty painful one for valuations of growth stocks. I think the big trend this quarter has been a bit of stabilisation in both of those inputs.

By which I mean generally, the growth numbers that our companies have been reporting have been very solid. So, many companies in the portfolio have been reporting double digit sales growth, really healthy levels.

Maybe not quite as high as during the pandemic, as you noted, but that deceleration feels like it's stabilised. And on the resilience point, I think last year, investors were really worrying about, is this company really in control of events? And what you've seen is companies now starting to pull some of the levers that are within their control, if they're stronger companies.

So, to give one example of that, is Shopify, which is quite a big holding for us. In January, they put through their first price increase on their basic subscription plans that they have for a decade.

So, they've added loads of value to their proposition for merchants, they've never put their prices up, until this year. Now, that took the market by surprise, but we think it's a sign of some of the latent pricing power and adaptability that many of the companies in the portfolio have.

So, overall, it's been a better environment. The results have been largely reassuring. And then there have been some pockets of real growth coming through.

So, I'm sure everyone watching this has seen lots of comments on generative AI and some of the advances there. Well, Nvidia is the key manufacturer of the chips that are being used in the data centres, that are being demanded by these new technologies.

Demand there has shot up, and that's been very positive for the results and the shares.

AM: Good. Well, I think clients will be very aware that it's been a pretty eventful start to the year. We've seen those lockdown restrictions falling away, and in China, supply chains easing up, as a result, oil prices falling.

All of that pointing to perhaps inflation peaking, and perhaps a better environment for growth equities, which of course, we’re very interested in. But then, wham, came out a banking crisis in the middle of that.

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Perhaps not on the scale of 2008, but certainly significant, nonetheless. You were around in 2008, so I'm just interested, and I'm sure our audience would be interested, in how this compares, over the last few months, to your experience back then.

TR: Yes. It was something that I was reflecting on earlier on in March. So, I was on our UK team during the 2007, 2008 financial crisis, and I remember then how surprising it was to see sometimes quite highly regarded institutions just melt away very quickly, because there was a collapse in trust in them.

Banks, and many financial businesses, are just confidence machines, and when that confidence evaporates, the business can be undermined really very quickly.

Now, as you know, we held First Republic Bank in this portfolio, and it has been one of the most highly regarded banks in America. You may not know this, but it had one of the best credit underwriting track records of any bank in the US.

And so, we regarded it as a very strong institution. But earlier this month, Silicon Valley Bank failed. People started to draw analogies between that and First Republic, and confidence just started to evaporate very quickly.

That was obviously a real shame. For me, one of the lessons, though, was when we saw the credit rating of First Republic being downgraded from investment grade, it was quite clear to us that the confidence in the bank had been irreparably lost, and there likely wasn't a way back.

And so, we took the decision to sell very quickly after that. And I guess the broader thing we're thinking about is what are might the second order consequences of that failure be?

And I guess the other thing that's on our minds is, this is a really highly regarded institution. It's very sad for all the employees there. We regard the people we worked with at First Republic, over many years, very, very highly. So, it's a very sad outcome for them.

AM: Yes, definitely. Our thoughts are with people who are contemplating their job and their employment, and very long careers, with the bank.

I think that resilience that you mentioned there is certainly reflected in the initial indications of what we're seeing in performance over a very short timeframe. We've seen a helpful uptick over the past three months, which, of course, you're not aware of, because you're entirely focused on the longer term and the fundamentals.

But certainly, the underweight in banks will have helped a little bit. I guess, more important than that is the fact that the market is arguably better reflecting those operating results that you've updated us on.

And I guess the dislocation between share prices and fundamentals is perhaps beginning to be realised by the broader market, and is perhaps tightening somewhat.

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You mentioned there the longer term implications, the second order effects. How are you thinking about the second order effects of these events, particularly on the portfolio's resilience?

I think, clearly, we've got a number of companies in the portfolio that are in the Silicon Valley area and related to that, and that may have exposure, for example, through deposits. So, do you want to give us a brief update on that?

TR: Yes. I guess the starting point is, when we're thinking about what might second order effects be, the starting point is always at the stock level. So, how resilient are the underlying companies?

And that's why we have that question there in our framework. I'm very glad that gearing across the portfolio is very, very low, and much lower than the wider market. So, by and large, actually, our companies, very often, have net cash balances, rather than having lots of debt.

And none of the companies we have, have had any issues, in terms of accessing their deposits, so we can put that worry to bed. I guess, longer term, the things we're thinking about are why do we have this banking crisis?

Well, it's really a knock-on effect of interest rates having gone up very sharply, indeed. And it's possible that that's going to lead to other pockets of stress elsewhere in the financial system.

We did actually take action in one other part of the portfolio. So, we used to own Sumitomo Mitsui Trust Bank, a Japanese bank, but we just decided look, this is another levered financial institution that if there is contagion in the financial system, it's likely not going to be immune.

And it wasn't a high conviction holding, so we moved on from that, to try and limit any exposure. And I guess the other longer term impact may actually be that, as you referred to earlier, it makes it more likely that we're reaching the end of this cycle of rising interest rates.

So, we're looking hard at gearing across the portfolio and pockets of stress, trying to avoid things that might be sensitive to contagion. But then also, I think it possibly does mark a bit of an end to the current phase of the market cycle that we've been in.

AM: So, a couple of names there that have exited the portfolio, First Republic and SMT, or Sumitomo Mitsui, arguably, because they became a little bit too exciting.

Now, I know that you've brought a couple of names into the portfolio that are perhaps a little bit more stable. Do you want to give us a bit of an update on what you've been doing to portfolio resilience in that regard, with the addition of those names?

TR: Yes. So, two new buys this quarter, and I was very offended earlier when you referred to them dull, because I don't think they're dull at all.

AM: I tried to avoid that word.

TR: You tried to avoid that word. So, the two names are Advanced Drainage Systems, which is one of the key providers of storm drainage infrastructure in the US.

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AM: Very exciting.

TR: Very exciting. And a company called Wabtec, which makes freight trains, and all the parts associated with them, in North America.

So, they might look like two very different businesses to you, and they're quite eclectic, they're very different from each other, very different from anything else we own in the portfolio. However, there are actually some big similarities within them and that draw us to them.

One is that they are both companies where we think they are poised to benefit from a massive wave of investment over the next decade, after having gone through a long period of underinvestment.

So, in the US, storm drainage infrastructure has been really underinvested in for a long period. As climate change has become more and more of a concern, you've seen more and more storms, there's a huge need for catch-up investment there.

And recent government interventions will accelerate that. That plays right into Advanced Drainage Systems' core sweet spot. For Wabtec, again, there's been huge underinvestment in the freight train fleet.

But what lots of the railroads are now starting to realise is they need to decarbonise their fleets, and Wabtec are the people who've got the technology that will help them to do that.

So, in both cases, they are companies that are helping to enable the transition. Either help adapt to climate change, in ADS's case, or helping to decarbonise quite a dirty industry, in Wabtec's case. So, big beneficiaries of underinvestment.

The second thing they share is fantastically strong competitive positions. So, Wabtec has something like 80 per cent of the active freight train fleet in America as their trains. Advanced Drainage Systems has got the majority of the plastic pipes market in the US.

Now, that competitive strength means they'll be the ones that benefit from the investment, but also, it gives them resilience. So, we think it gives them a lot of resilience in times of stress.

And I guess the third thing they've got in common is that we think returns and profitability in five, ten years' time could be much higher than today, and that's just not reflected in the valuations that we're paying.

So, they're good examples of uncorrelated different ideas, where we're actually really excited about the long term returns on offer.

AM: Yes, okay. I never thought I'd get excited about plastic pipes, but you've convinced me. I'm enthused, mark me up. Now, the other thing that's been going on, we often talk about the value of hitting the road doing primary research.

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And of course, you've been out, for a week or so, I think, of this quarter in the US, meeting companies. 25 companies in all?

TR: Something like that, yes.

AM: I know, you're just back, but do you want to give us a flavour of your takeaways from that trip?

TR: Yes. It's quite hard to give kind of a clean message, because the companies were very, very eclectic. I guess that's one of the nice things is we're seeing a really wide range of ideas.

And actually, one of them was Wabtec, so that was where the final stage of our research process was. To meet management, explore some of our contentions in more detail, and get a better feel for their beliefs, how they run the company. So, that's already had an impact on the portfolio.

But two higher level takeaways that struck me. One was actually around sustainability. So, there's lots of noise around ESG in the US today, but actually, talking to companies, I feel like there's a real change underway, in terms of how they think about it.

So, I think lots of companies have initially responded to ESG, by just disclosing lots of data in a very reactive way, setting targets for everything, and being quite unfocused.

Whereas in a number of conversations I was having with management teams in the US, it feels like we're moving to a much more thoughtful, focused approach, where companies are stepping back and saying: what is my real impact on society? Where's my point of leverage as a company? What's actually going to strengthen my business, if I really focus my efforts and go after it? Let's focus our efforts there.

I think that's exactly right. And it, it means that companies are focusing their efforts on areas that are going to make a difference, but also, going to make them better long term investments, help them grow faster.

So, I think that's one to watch, but it was definitely a theme I heard a few times. I guess the second one was just around valuation. So, valuations, in many parts of the market, have come back quite a way over the last year.

And for many of the companies we hold, we think they're starting to look much more attractive today.

But I was quite struck that quite a few of the newer companies I was meeting are still in quite high multiples, actually, and it's quite hard to see how we would make a lot of money for clients over the next decade from the current starting points.

So, I've come away with quite a few ideas that are on our watch list, but that we wouldn't yet be ready to add to the portfolio. And I think it's important that we stay quite disciplined. Focus on where there's long term upside, but don't get carried away.

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AM: Yes. And I'm sure clients will be pleased to hear that we've got that discipline around valuation, and certainly, pleased to hear that companies are more focused on the sustainability elements that matter to their businesses.

Of course, while you were away, the rest of the team were still here, doing research, and of course, the wider network of our investment scouts as well. Forward looking, is there anything in the pipeline you're particularly excited about? Anything you want to give us some colour on?

TR: There's lots. Actually, one of the nice things is that you can feel the pipeline filling up, as the scouts are understanding what we're looking for, and bringing forward some really interesting ideas.

I can't run through those, at this point, on this call, but I think there is a couple of names that I think are really interesting, both from the potential that they could be under earning today, and there's the potential for them to be much more profitable in five, ten years' time.

Really interesting growth stories. But also, really fitting that enduring good element of what we're looking for. So, one of them is a media organisation that people will have heard of. There's also a robotics organisation that we're looking at very closely, a testing business.

So, the pipeline is very eclectic, coming from all parts of the world, but it feels like there's quite a lot coming to the surface at the moment.

AM: Yes, so adding to the portfolio diversity over time.

TR: Yes.

AM: Thank you very much for that. I think it's fair to say it's been an interesting quarter. No shortage of challenges, no shortage of opportunities for us as well.

Possibly a bit odd to say this, in a period when we've had a banking crisis, but perhaps we're beginning to see a degree of rationality return to markets. So, let's check back in on that next time around. So, thank you, everyone, for joining us today. And thank you, Toby, for your time.

TR: Thank you.

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Annual Past Performance to 31 March Each Year (Net %)

	2018	2019	2020	2021	2022
Sustainable Growth Composite	1.7	-5.0	107.1	-19.0	-20.8
MSCI ACWI Index	3.2	-10.8	55.3	7.7	-7.0

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Annualised returns to 31 March 2022 (Net %)

	1 Year	5 Years	Since Inception*
Sustainable Growth Composite	-20.8	5.1	10.3
MSCI ACWI Index	-7.0	7.5	9.4

Source: Baillie Gifford & Co and MSCI. USD.
*Inception date: 31/12/2015

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