

# US Equity Growth Q4 investment update

January 2024

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**Investment manager Kirsty Gibson and investment specialist Fraser Thomson give an update on the US Equity Growth Strategy covering Q4 2023.**

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**Fraser Thomson (FT):** Welcome to this US Equity Growth Strategy update. I'm Fraser Thomson, one of the strategy's investment specialists and I'm delighted to be joined by Kirsty Gibson who's one of our four investment managers. For those who are new to the strategy, Kirsty, how would you summarize the team's investment approach?

**Kirsty Gibson (KG):** So, we take a relatively concentrated and very long-term approach to investing. We're looking to invest in companies with enough growth potential to transform their market valuations over the next five plus years. And that'll be driven by the company's competitive positioning, the management team, and the culture of that business and the scale of the opportunity that they have in front of them.

Now, we look to select what we believe to be the very best of those businesses and to own them for long enough periods of time that that potential that they have is reflected in their share prices. And we can make a really strong return for our clients on that basis.

Now, we look at that growth potential and we compare that to what we've been asked to pay in the market today. And we therefore construct a highly ambitious growth portfolio of 30 to 50 names from there.

**FT:** A year ago, Kirsty, you said that if 2022 is a year of adaptation for the portfolio, then in 2023 you'd be looking to see companies execute on those changes. Looking back at that from now, how would you assess progress against that statement?

**KG:** I think it's important to put that 2022 comment into context. 2022 was a tough year for businesses. They'd come out of the pandemic – which ultimately was a really difficult period for them as well – and they were faced with a new reality. And that reality was higher interest rates, there was much more capital scarcity and there was an expectation of growth and profitability.

It wasn't just growth at all costs. And the consequence of that is, in order for companies to deliver on their long-run ambitions, they needed to take a new path. They had to adapt. They had to re-orientate. They could still achieve those long-run ambitions, but they might have to do it in a slightly different way. Now, for some, that reorientation was easier than for others.

You know, companies like Tesla, the electric vehicle manufacturer or CoStar, which is a commercial and residential real estate property platform, they were already profitable. So, for them, it was a relatively easy transition to make.

There were others which looked at trimming a little bit of fat, whether that be unfortunately having to lay off staff or mothballing projects that were no longer viable or transitioning from what we would call discretionary unprofitable to being profitable.

It was a task, but it wasn't such a difficult task. And I would put something like Shopify, which is a merchant commerce platform, or Amazon, that we all know very well for shopping online, into that category.

Then we had a category of companies that I would say were strong, they had resilience from a balance sheet perspective, but maybe you didn't see that in the [profit and loss statement] or the cash flow [statement].

And that's because they built up significant war chests of cash over the past few years and those war chests of cash are enabling those businesses to move towards the path of self-sustainability, but also make the investments that they need to be able to grow. And I would put something like Ginkgo Bioworks, which is a synthetic biology platform, into that category.

And then we have businesses which ultimately lacked resilience. So, Wayfair in online home furnishings, Affirm in Buy Now Pay Later, Carvana, which is a second-hand car marketplace, and Redfin, which is an online brokerage.

And these companies ultimately needed to make changes. And some have been more successful than others. So, Affirm and Wayfair... they've managed to transition, managed to take a new path.

Whereas we've not been able to gain the necessary conviction to believe that both Carvana and Redfin will be able to emerge from this environment stronger than they went in. And we've consequently sold those holdings.

So, I think what's most interesting is, as you say, this year has been about execution. And what's really positive is that the businesses that we own, for the most part, have been executing really, really strongly. And we believe that that is driven mainly by the cultures and the management teams that are behind these companies that we invest in.

Many have shifted their focus from growth at all costs to growth and profitability. Our biggest contributor to performance over the past year has done just that. And that's Shopify. Shopify has now delivered its fourth consecutive quarter of profitability. It's delivered a free cash flow margin of over 16 per cent and they've been

doing this whilst making significant investments in artificial intelligence and shifting their business model to make it more fit for the future.

I would also highlight Wayfair, so I mentioned them earlier, the online home furnishing website. They saw an unprecedented level of demand during the pandemic but as the economy started to slow, this was an unprofitable business and they started to lose market share.

Now they needed to make some really serious changes in order to be able to survive in the environment that they found themselves. Unfortunately, some of this meant letting go of staff from their company.

They made a number of layoffs, they've just announced their second quarter of adjusted EBITDA profitability and they've returned to revenue growth even in a declining home furnishing market. And finally, there was a leaked email in December this year from the CEO that was leaked to the press that said they've actually returned to full profitability as well.

**FT:** Great. Well, the final quarter of the year saw some quite big share price rises, generally a very rewarding period for the portfolio. But as well as the encouraging progress that you've mentioned, some of that market sentiment must surely be tied to the Federal Reserve comments around interest rate cuts in 2024.

So how do you, as a long-term investor, sort through that kind of dynamic?

**KG:** Yes, I mean, we invest in growth businesses, so we can't deny that they have benefited from easing concerns. But what gets us most excited is that fundamental progress that we've seen from these companies. And why is that the case? Because a fundamental part of our philosophy is the idea that fundamentals will drive share prices in the long run.

So, when you see the improvements in the fundamentals, you see these businesses getting stronger. They have the potential to emerge from this environment stronger than they went in. You can start to get excited and say, okay, this is a really interesting time for these businesses. And in the longer run, you know, the share price will begin to reflect even more of that fundamental progress.

I've mentioned a couple of examples there with Shopify and with Wayfair. But we can look at Duolingo, which is a gamified language learning app. They've grown their daily active users last quarter by 62 per cent year over year.

They have transitioned to a free cash flow margin of over 24 per cent. And yet they've done this [by] investing around 16 per cent of sales into marketing. So, it's not like they're spending loads and loads in order to generate that. And they've been raising their guidance each quarter as well.

CoStar, which I mentioned earlier, they've delivered double-digit revenue growth in one of the toughest housing markets that we've seen in decades, and they are countercyclically investing their over \$5 billion cash pile into new opportunities for future growth.

And finally, Meta, which we all know better, I guess, from thinking about some of their brands, whether that be Instagram or Facebook; they saw in the last quarter over 20 per cent revenue growth and an operating profit margin expansion of over 2,000 basis points.

And what's really exciting is even though we've seen all of that progress in the fundamentals – and share prices, we have seen them appreciate – I think it would be hard to say that valuations are stretched at the moment. We run a growth portfolio.

It historically and continues to trade at a premium to the broader benchmark, but it is trading at around 1.7 times EV to sales and that premium to the benchmark is actually lower than it was pre-pandemic.

And so, you've got a portfolio that's grown its EBITDA to the end of November by over 25 per cent, trading on what we believe to be a really great multiple for a group of businesses that have got some really exciting growth prospects in the future.

**FT:** I'd like to ask you about changes to the portfolio. So, annual turnover still below 20 per cent, but it has picked up a little bit since the start of the year. So, what's been driving that?

**KG:** Ultimately, opportunity drives turnover. That's how we run the portfolio. So, when new opportunities present themselves – and I mean both opportunities for existing holdings where we gain greater conviction or we see new opportunities from a valuation perspective to add to those holdings – but also purchasing new companies, adding new things to the portfolio as well. And I think we've had a good mix of both.

To give some examples, we've made three new additions to the portfolio in the healthcare sector. All of these three companies have experienced a greater than 30 per cent share price decline in the past year.

Some of that is driven by the fact that this industry as a whole, the healthcare sector, has been what can only be described as pummelled over this period of time, and that's partly a reflection of the interest rate environment that we find ourselves in. These are businesses that are much less likely to have even revenues, let alone profits.

And in a higher rate environment, there are concerns about their ability to raise capital for their future growth. And then also, the healthcare sector has faced some challenges when it comes to obesity drugs, GLP-1s. And there's been quite a broad sell off, and some of which is probably justified, some of which we think presents some opportunities.

So, we've made a purchase of a company called Insulet. Insulet makes small insulin pumps, which when combined with a continuous glucose monitor, basically creates a closed loop system, which is equivalent to an artificial pancreas. We've also taken hold in Guardant Health, which is a liquid biopsy testing business, and a sleep apnoea treatment company called Inspire.

We've also made some additions. So, one that I would highlight would be Pinterest. The newish CEO, he's been in the role for about a year and a half now, has had a number of different levers to pull in order to help this

discovery platform really achieve its potential. And he has definitely been pulling those hard in an attempt to make the Pinterest platform more shoppable.

And in doing so, in making it more shoppable, it makes it more appealing to advertisers, which ultimately helps to drive the revenue of Pinterest.

And we've been funding these new ideas with companies that have shown some quite strong share prices over the past year. So that would be Duolingo, CoStar which I mentioned earlier and also Watsco, which is an HVAC – [heating, ventilation and cooling] – distribution business.

**FT:** One final question for you, Kirsty. Sitting here right now, what do you think the greatest opportunities are for us, in growth investing from here?

**KG:** I think the greatest opportunity right now is that this is a stock pickers market. You know, we've been through an awful lot of change over the past few years. And I'm not just talking about change in share prices and valuations.

I'm talking about supply and demand, [about] new habits and old habits. And I think when you look at the S&P 500 and the performance of the S&P 500 at the moment, it would be easy to think, 'well, it's been very strong [and] how could this possibly be a stock pickers market?'

Well, actually, it's because seven companies that have been recently named the Magnificent Seven have been driving a lot of that return. So, if we look at the S&P 493, not that that's an index, but we'll say it is, actually has been relatively flat. And that suggests to me that the sentiment around growth investing and investing in companies for the long term that are changing industries is still quite negative.

And I think when we as a team look at companies, we treat them as individuals. I think the idea that you would choose not to invest in businesses because they are loss-making or because they're in a sector like the healthcare sector, it just doesn't sit very well with us.

Ultimately, the quick retreat of capital that we've seen across many industries is affording an opportunity for companies to really cement their competitive positions and their business models, and it's also enabling them to potentially unlock even more of the addressable market. As non-viable competitors are just removed from the area.

And I think the final note I would leave it on is, when you are focused on stock picking, it's really important to get out of your bubble. It's really important to be out there meeting companies, talking to management teams, talking to experts.

I was in in New York at the beginning of December and I did 16 management meetings and one 'investor day' in a four-day period. Was it tiring? Yes. Did my brain feel scrambled by the end of it? Yes. But that is how we are going to generate insight. Insight is not going to come from the latest broker upgrade.

**FT:** Fantastic that you've come back from your break feeling refreshed. Well, I think to summarize, we're seeing the portfolio holdings adapting really well to a changed environment.

With difficult choices around cost bases now being made and implemented we're seeing growth returning to the portfolio, and with it, strengthening profitability.

We think there is a lot more of this to come, because that growth is being driven by long-acting structural trends such as the implementation of AI or changing standards in healthcare and many more things besides that we think will play out over the next several years.

So, while the recent rise in share prices is certainly welcome, we think there is a lot of upside available to this portfolio, given the relatively undemanding starting point we find ourselves at in valuation terms.

You can find out more about these opportunities in our forthcoming article series, *The long view*, which will be published from mid-January. So please look out for that on our website.

The first article by Tom Slater is on AI and is well worth a read. But for now, from Kirsty and myself, thanks for watching this update. And we look forward to speaking to you again soon.

## US Equity Growth

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

	2019	2020	2021	2022	2023
American Equities Composite	30.5	128.3	-4.0	-55.5	46.6
S&P 500 Index	31.5	18.4	28.7	-18.1	26.3

### Annualised returns to 31 December 2023 (net%)

	1 year	5 years	10 years
American Equities Composite	46.6	13.3	13.3
S&P 500 Index	26.3	15.7	12.0

Source: Baillie Gifford & Co and S&P 500. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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