INTERNATIONAL ALPHA Q2 INVESTMENT UPDATE

Investment specialist Andrew Brown and investment manager Steve Vaughan give an update on the International Alpha strategy covering Q2 2023.

As with any investment, capital is at risk. Past performance is not a guide to future returns.

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Andrew Brown (AB): Hello and welcome to the International Alpha Q2 Investment Update. My name is Andy Brown. I'm an investment specialist for the International Alpha Strategy. And I'm joined today by Steve Vaughan and one of the portfolio managers.

Steve Vaughan (SV): Hi, Andy.

AB: Hi, Steve. Before we start, just as a reminder, International Alpha is a portfolio of quality growth companies from around the world, excluding the US. It's a bottom-up constructed portfolio of our best ideas over the long term. And by long term we mean at least five years. And it's a highly differentiated strategy from the index.

Steve, let's start by talking about performance. Can you talk a bit about the most recent quarter? What's been going on?

SV: Sure. The direct answer to your question is that we are slightly behind the index over the quarter after a very strong first quarter. And so in a really good position year to date. If I look at sort of what's driving that, I think it's really pleasing to see that it's being driven by a diverse range of companies and investment cases. So, from the top contributors include companies like Denso, an auto supplier, right the way through to Shopify, which is providing software for merchants.

And the reason I mention that is because, after maybe two years of what felt like companies being judged in groups or sectors, it's now pleasing to see that those that are performing well operationally may be starting to get some recognition for that. So that's a great example, and something to look forward to it's a stock pickers.

Maybe to draw out one example, Edenred. This is a company that provides technology to companies to help them issue meal vouchers to their employees as a form of benefit or reward. It's obviously a beneficiary of tight labour markets as companies seek to keep their employees happy and that those tight, tight labour markets are obviously a big cause of inflation. On the other side, actually, Edenred is a beneficiary of high interest rates because the company pays it the money and it then holds on to that money before it has to hand it out to the merchant once the customer redeems the voucher, and during that time it's earning interest on that money. So obviously the higher the interest rate, the better for Edenred. A supportive backdrop for them, but they've just also executed really, really well. They've even just announced a really interesting looking acquisition into an adjacent area of employee rewards.

AB: Well, thanks. It's nice to bring one of the one of the companies to life. And it's also great to see that the individual stock-specific performance is being rewarded rather than the generalities of macro-related events like we saw last year.

So when we reflect on performance, are there any particular themes that you can draw as a result of the specific stocks?

SV: I guess if I had to draw out maybe one, it would be the continued, I guess, progression of some of the businesses that we saw be really badly impacted during the pandemic. So those in the travel industry, for example, would be a classic example. Some of our low cost airlines like Ryanair or COPA and also Amadeus, which is maybe a less well known business, providing software into the travel industry.

Ryanair has continued to see its market share expand since the pandemic. And that's driven primarily by what's, quite frankly, a superior operating model to some of its competitors. But they also made one or two really key decisions better than their peers. So, for example, during the shutdown, actually kept their pilots current so that when the market reopened, they were the first ones there with the supply. Likewise, Amadeus, Donald actually travelled to see them in Madrid earlier this month. That's another example of a business that continues to invest heavily during the pandemic when some of its peers were suffering and is now reaping the rewards of that. So, we'd cite both of those companies as examples of where really long-term capital allocation becomes a genuine competitive advantage for them.

AB: Yeah, it's great to see those companies come through a very challenging period during the pandemic stronger, and be rewarded for that more recently.

As always, there are stocks that do less well. Can you talk a bit about some of the detractors?

SV: So again, I think there's a range of businesses in the detractor column. Maybe if I drew out two in the health care space. Health care is a sector that has suffered certainly since the middle of last year. Part of that is just to unwind from the pandemic, but also a much tougher funding environment for the industry with higher interest rates.

Biontech and Sartorius are two companies that we own, very different companies, but they've both suffered a greater fall in revenue after the pandemic than was maybe expected. But equally for both of them, we see that as a short-term effect, a cyclical phenomenon, if you like, and we expect both to come through that and continue the structural growth that we're expecting for them over the longer term.

AB: Yes, I think the confidence is still there in the long-term case.

AB: This is a quarterly update, but of course, the strategy takes a five year perspective and has an objective of outperforming over five years. What do the numbers look like over more meaningful time periods?

SV: I'd start by using this time when recent performance does look a bit better to again reemphasize your point that that's not what we're focused on. We are very much focused on longer-term performance. So hopefully that message resonates a bit more when the short-term performance is better.

But equally on the longer-term five years numbers, they're still far from where we want them to be. We're disappointed in those. Again, a lot of it reflects a very difficult 2022, partly, obviously just our style being slightly out of favour last year. But again, as we've covered in previous updates, we will also very much hold our hands up and say that, you know, we compounded that backdrop with some stock-specific mistakes.

But I do think that the progress sort of year-to-date, albeit short-term, is a sign that the tide is beginning to turn. We may be much more optimistic. Again, some of the points I made before about stock picking may be coming to the fore. I think if you look at some of the uncertainties from last year, whether that's, you know, the situation in Ukraine or the continued rise of interest rates, you know, they're still there, but they're becoming a bit more normalized. People are sort of paying them a little bit to the background. Time horizons are starting to extend again, and that's really good for us as long-term growth investors.

AB: Yeah, that's good. Good to see. So, moving on to the portfolio itself, how are you thinking about the positioning?

SV: Sure. I think the most powerful thing I can say about how we view the current portfolio and how it's positioned is to say that, the long-term turnover remains kind of fully in line with where it's always been.

We've not made any more changes to the portfolio than normal, and that's despite actually an immense amount of new ideas coming through. We’ve been discussing an incredible depth and diversity of new businesses, right the way from some exciting project management software through to unbelievably branded bread. We've had so many ideas coming through that most weeks at the minute, we're having to schedule additional stock discussions to fit them in.

So the portfolio is constantly being tested and yet, it's a sign of the confidence that we've got in our existing names that we haven't made too many changes.

AB: So what changes have we made?

SV: We’ve made three changes this quarter. We've bought two really interesting and different Japanese businesses, which I know you'll know very well.

One would be Nihon M&A, which is a broker for small business founders or owners looking to sell to sell their business to, you know, to retire. And those owners that business represents their life's work and they're interested in finding a partner that can help them pass it to the right future owner. Obviously for that, Nihon is able to get the rewards and equally Recruit a very different business itself, made up of quite a few different businesses. But the key asset there have is Indeed.com, which is the world's number one jobs platform.

Then the third change moving away from Japan again, very, very different is a Italian family run semiconductor testing business called Technoprobe. This is a classic disruptor. It was literally founded in a garage and yet has grown to dominate the global market in this type of advanced MEMS probe cards. As the name suggests, those probe cards probe chips to test for defects and help optimize yields in the manufacturing process so are really critical to enabling some of the applications that we're seeing at the minute.

AB: Well, these all sound like very exciting structural growth stories that should do well regardless of the macro backdrop over the over the long run. I was certainly very fortunate to meet with the management of Technoprobe recently in Milan and find that a fascinating, fascinating company. So how have we funded these new buys?

SV: We made three complete sales over the quarter. As ever, our sales are driven by bottom-up considerations, progress of the investment case, essentially. We sold Ritchie Brothers Cochlear and Just Eat takeaway.

Ritchie Brothers, for example, we sold essentially because of a disagreement with management over capital allocation. At the end of last year, they went and did a very large transformational acquisition into an adjacent area that we think is not as good as the core auction business. And in a very different way, for example, Cochlear, we sold because actually, the investment case is fully on track, and is coming through as we expected, but we think it's more than reflected in the valuation.

So again, we are constantly testing our businesses, not just on the fundamentals but the valuation. And in Cochlear’s case, that was the catalyst for selling.

AB: That's great to see and it's great to see that we are long term investors, but when something in the investment case changes, then we of course react. We act to that.

Well, Steve, it's always good to end on a positive and I'm keen to hear just what you're most excited about at the moment.

AB: I'm most excited by the fact I'm excited and that it's actually quite hard to answer that question in a pleasing way. It's quite hard to pick a couple of things out.

But maybe if I give sort of one micro point and one macro point, the micro point would be what I talked about in the previous question around just the depth of ideas and range of ideas that we've got coming through. We’re stock pickers and it's ideas that drive us and when we're not sure of those and it's great that some of those are businesses that we know really, really well.

So Nihon and Recruit with B2B businesses that we've got a long history with across Baillie Gifford. But that we've looked at previously and just couldn't get there on the valuation and current markets are giving us the chance now to buy these great businesses at much more attractive valuations.

Then equally, Technoprobe is an example of a business that we couldn't have bought a couple of years ago and they've recently IPO'd and the products are new. So both sides of the coin coming through there in terms of the idea generation.

Technoprobe would link me to the to the macro point, which would be that after a very difficult couple of years, we really are now starting to see the re-emergence of the structural trends that we've been investing in on behalf of International Alpha clients over the past 20 years of the strategy. You know, all these great things that excite us. Those trends seem to be firmly in place, if not accelerating. We've made it through, I guess, like maybe quarter of an hour now without talking about AI quite an achievement. So I won't go there. But even if you just look at something much more mundane, like using technology to help people manage their personal finances, you know, we've got businesses in the portfolio like Fineco, like ICICI Lombard, you know, like Experian. These are companies that are applying technology to help their customers solve problems and in return for that, are rewarding investors.

So, after two years where it's felt like a lot of the big changes in society have maybe been kind of regressive, you know, looking back, back to conflict, back to inflation, back to the 1970s, oil prices, it's now great that a lot of the changes that we're seeing, are forward looking, it's towards a future that we haven't seen before, where we're all going to have a wide range of kind of technology to assist us.

So that kind of future looking future, is great for us as growth investors.

AB: Great. You're making me excited now. So just to summarize, so performance over the quarter, slightly behind year to date, we're ahead of the index and over a longer, more meaningful time periods. Performance isn't what we would like it to be. It's not what we would expect. But the tide seems to be turning, which is which is encouraging. And when you look at the portfolio, you're confident in existing positions, but there's lots of new ideas coming through which makes you very excited. So probably a good point to end on. Thank you very much, Steve.

SV: Thanks, Andy.

0723 International Alpha Q2 update
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Annual past performance to 30 June each year (net %)

	2019	2020	2021	2022	2023
International Alpha Composite	3.3	9.6	34.7	-34.5	17.7
MSCI ACWI ex US	1.8	-4.4	36.3	-19.0	13.3

Annualised returns to 30 June 2023 (net %)

	1 year	5 years	10 years
International Alpha Composite	17.7	3.3	6.1
MSCI ACWI ex US	13.3	4.0	5.2

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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0723 International Alpha Q2 update
48800 10030569

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0723 International Alpha Q2 update
48800 10030569

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