



Keystone Positive Change

KPC offers high return potential from a portfolio aligned to key social goals...

Update

24 January 2024

Overview

The strategy behind Keystone Positive Change (KPC) is to maximise long-term growth potential by selecting companies which can have a real impact on resolving some of the world’s critical problems. Both elements are written into the formal objectives of the trust, and all holdings have to qualify on both grounds, with strong long-term growth potential and a clear potential impact.

In practice, looking at the market through this lens creates a highly active **Portfolio** versus a global index, which is highly differentiated from its peers. Companies involved in the net zero transition, the expansion of financial services across developing countries, and biotechnology innovation sit alongside each other. The portfolio has a highly different geographical exposure than the typical global fund, including significant exposure to emerging markets. It also contains a handful of unlisted companies which, while making up a small amount of the portfolio at present, the managers believe have explosive growth potential.

This strategy has delivered exceptional returns in the long run for the open-ended Baillie Gifford Positive Change fund (see **Performance**). However, the first two years KPC has been managed to this strategy have been tough, with a sharply rising interest rate environment leading to a rush out of growth stocks. Kate and Lee are extremely optimistic for their portfolio, pointing to very attractive earnings growth expectations from lower valuations. Overall, they report their portfolio has been performing well operationally but is not being rewarded by the market. The board, while backing the new strategy, has taken action to reassure shareholders, initiating buybacks, which demonstrate the value they see in the portfolio, and announcing a continuation vote will be held after the strategy has a five-year track record.

Kepler View

In our view, KPC is a stand-out option for investors who want to have a positive impact with their investments. While concepts like ESG and sustainability are bandied about widely, they are often poorly defined and investors are quite rightly concerned about ‘greenwashing’. When it comes to KPC, the Positive Change strategy is clearly defined, with the rationale for each company explained and progress discussed each year. We think it should appeal to the large number of investors who want their investments to have a positive impact.

The strategy also brings exposure to some secular growth themes with exciting potential. These include the expansion of services and the ability to start a business amongst the disadvantaged, the development of drugs for an aging world population, and the development of cleaner ways of generating energy and operating industry. A focus on long-term growth is out of fashion at the moment, as high interest rates see investors look to shorter-term returns, and we note stylistic factors tend to mean revert. Should we see rates start to come down in 2024, we think this could lead to a re-rating of many companies in KPC’s portfolio, and it could potentially lead to the **Discount** narrowing too.

Clearly the first two years under this strategy will have been disappointing for shareholders (and indeed the managers), but we think a highly active strategy like this needs to be judged over a longer timeframe, such as the five-year period used by the board for scheduling the continuation vote.

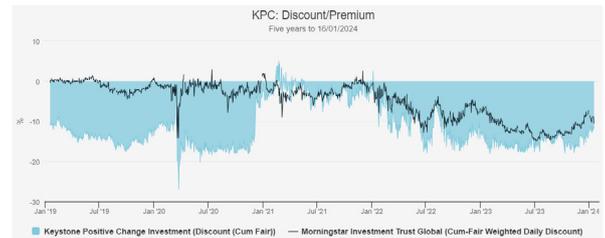
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Key Information:

Price (p)	233
Discount/Premium(%)	-11.8
OCF (%)	0.90
Gearing (%)	9
Yield (%)	0.2
Ticker	KPC
Market cap (£)	136,363,062



BULL

- Unquestionable commitment to affecting positive social change, in line with ESG themes
- High return potential from highly active approach
- Makes use of closed-ended funds’ advantages: gearing, unlisted investments and mid-cap companies

BEAR

- Volatility brings underperformance potential
- Exposure to growth factor and rising interest rates could lead to periods of underperformance
- All impact or ESG propositions bring with them some subjectivity and selectiveness in which goals to pursue



Portfolio

Keystone Positive Change (KPC) owns a portfolio of equities intended to deliver exceptional long-term growth by contributing to the resolution to key social problems. Both objectives are given equal weight, with each holding required to offer high returns and a significant potential impact on problems in one of four categories. These are: Social Inclusion and Education, Environment and Resource Needs, Healthcare and Quality of Life, and Base of the Pyramid. The basic idea behind this combination of objectives is that resolving key social issues, such as the need to transition to cleaner energy sources, or the need of a growing world population for access to financial services, is a potential source of high and persistent returns. It is important to note that while ESG can be hard to define and potentially involves fears of ‘greenwashing’, the Positive Change strategy is far more concrete and well-defined, with the trust publishing an annual impact report which details the rationale for each holding, reports on progress it has made, and is reviewed by KPMG, providing some third-party support that the information has been properly prepared and presented in accordance with the stated methodologies.

The portfolio is managed by Kate Fox and Lee Qian of the Baillie Gifford Positive Change team. They aim to look out further than the market, with an investment horizon of at least five years for each holding. They are willing to invest in early-stage, pre-profitable companies when they can see a path to profitability and growth, although the vast majority of the portfolio is in established businesses. The portfolio has a mix of household names spread across developed and developing markets, such as Tesla and TSMC, alongside little-known niche businesses the team think have huge potential. For example, the current portfolio includes Climeworks, a developer of carbon capture technology, and Boston Electrometallurgical Corporation, which is developing

Top Ten Holdings

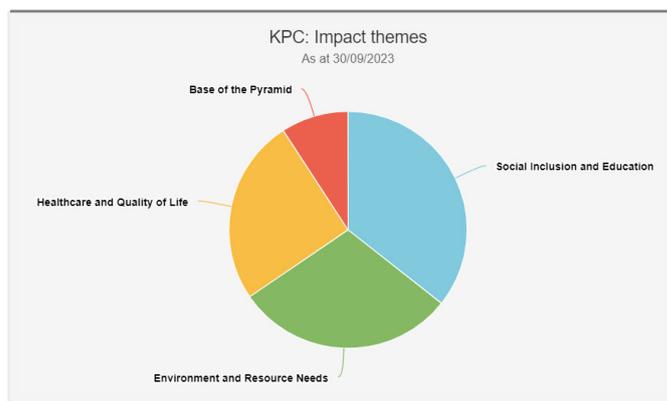
HOLDING	THEME	%
MercadoLibre	Social inclusion and education	8.1
ASML	Social inclusion and education	6.2
Remitly Global	Base of the pyramid	5.2
TSMC	Social inclusion and education	4.4
Deere & Co	Environment and resource needs	4.2
Bank Rakyat Indonesia	Base of the pyramid	4.1
Nu Holdings	Social inclusion and education	3.8
Shopify	Social inclusion and education	3.8
Xylem	Healthcare and quality of life	3.6
Dexcom	Healthcare and quality of life	3.5
TOTAL		46.9

Source: Baillie Gifford, as at 31/10/2023

a method of decarbonising steel production. These two are amongst five unlisted positions, alongside Spiber, a Japanese company developing fabric from biological material, PsiQuantum, which is developing quantum computing, and Northvolt, the Swedish electric vehicle battery manufacturer. Together they make up only 6.3% of the portfolio, but bring some exciting return potential. Northvolt is rumoured in the press to be considering an IPO this year, which could potentially lead to a significant gain for KPC, depending on the price achieved.

The chart below shows how the portfolio looks from an impact theme perspective. Social Inclusion and Education includes many companies which are helping to build a more inclusive society and improve accessibility to education. This includes MercadoLibre, Nu Holdings, and HDFC Bank, which are helping to improve access to financial services in Latin America and India respectively. ASML and TSMC, leaders in the semiconductor supply chain, also fit here, thanks to the huge contribution semiconductors make to tackling global challenges through enabling innovation and digital inclusion. Shopify is a platform that makes it easier for merchants of any size to sell online, allowing the growth of smaller businesses which bring people out of poverty. Meanwhile, the theme also captures the benefits Duolingo and Coursera bring in terms of spreading educational opportunity. The Base of the Pyramid has always made up a smaller part of the portfolio, but has some alignment with the social inclusion theme, with three companies operating to spread financial and telecommunications services across the poorer emerging markets. One is Remitly, which provides a cheaper and more efficient way for migrants to send money home.

Fig.1: Impact Theme



Source: Baillie Gifford

The Environment and Resources Needs theme is dominated by companies the team believe can help solve the climate crisis. We have highlighted a few of the more early-stage holdings above, but Tesla, Northvolt, Deere, the agricultural equipment manufacturer, and Xylem, the water solutions company, are more established,



and sit alongside companies working in metal recycling, aviation, and elsewhere. Finally, the Healthcare and Quality of Life theme has a tilt to biotech firms. Moderna is the best-known amongst the holdings, while there are other drug manufacturers too. Also included are adjacent companies. For example, Sartorius is a manufacturer of laboratory equipment, while WuXi Biologics partners with biotech companies to move their biological drug research from the desk to the lab and to the market, enabling innovation from multiple sources. Clearly there is risk in drug manufacturing, but models like these two are less dependent on the results of clinical trials, and offer the potential to benefit from the structural growth in demand for healthcare across the globe as populations age and become more wealthy.

To our mind, all four of these impact themes refer to clear secular trends which have momentum behind them and offer the potential for strong earnings growth to companies which can contribute to their resolution. Yet KPC's portfolio has largely struggled in share price terms over the past two years (see **Performance**). At least one underlying cause is clear: higher interest rates have led the market to look for lower duration equities, with more tangible earnings in the coming quarters and with a more direct link to inflation in their pricing (such as energy or basic materials producers). However, Kate and Lee argue that the long-term earnings outlook for their portfolio has not diminished, and they still expect very high earnings growth which should lead to rising prices over time. The team report they are very optimistic about the prospects for their portfolio, and their enthusiasm has only been increased by the lower valuations of their portfolio holdings versus a year ago. Market consensus estimates suggest the portfolio should deliver three times the benchmark's sales growth over the next three years, and earnings growth of 10.0% per annum versus 5.0% per annum for the index. Meanwhile, the net debt to equity of the portfolio is low, while companies are on average investing twice as much of their turnover in research and development than the market.

All this paints a picture of strong growth potential, which the managers argue is being overlooked thanks to stylistic and environmental factors. The sort of superior growth implied above should typically lead to a higher valuation rating, and KPC's rating is higher than the benchmark at the time of writing at 27x versus 17x (for the MSCI ACWI).

The Positive Change strategy has led to a very differentiated portfolio. We have already touched on the relatively rare exposure to unlisted companies. Additionally, the portfolio stands out from a geographical perspective. KPC has no exposure at all to UK-listed companies, while it has considerable exposure to emerging markets. Both are rare for trusts in the AIC Global sector, many of which exclude emerging markets. In fact, with around 30% in emerging markets, KPC is more

exposed to regions with fast-growing GDP than the typical global portfolio, and many of its key positions benefit directly from that GDP growth, such as the financials exposure. KPC is also underweight the US versus the MSCI ACWI, with 52% versus the index' 65%. We think the trust could therefore be held alongside a more conventional fund and offer diversification benefits and return potential from multiple sources.

Gearing

The gearing strategy is to maintain a modest level of structural gearing over the long run, in order to enhance shareholder returns. The trust has a £25m revolving credit facility of which £15m has been drawn down. This amount was unchanged through the 2023 financial year (ending 30/09/2023), and as the below chart shows, net gearing has been very stable after those drawings were made in 2021.

Fig.2: Net Gearing



Source: Morningstar

Performance

Events have conspired to create a poor environment for growth investing since Kate and Lee took over the portfolio in February 2021. That month almost perfectly coincided with the reflationary rally that followed the release of pandemic restrictions and led to a rebound in cyclical, value stocks over growth stocks. Then, in February 2022, Russia invaded Ukraine, which led to a surge in energy

Fig.3: Performance Under New Mandate



Source: Morningstar

Past performance is not a reliable indicator of future results.



prices and inflation. These events all helped push inflation to the highest levels for decades, leading to the highest interest rates for decades and a poor environment for growth stocks. Under the current new strategy, KPC has delivered a NAV total return of -15.4%, from 28/02/2021 to 16/01/2024. This compares to the sector's average NAV total return of -5% and a total return for the ETF of 26.9%.

All clearly defined strategies should be expected to have periods of being out of favour, but in our view they all have to be judged over a decent time period, not just a couple of years. It is unfortunate for shareholders that this poor period has come right at the start of Baillie Gifford's management tenure. However, the chart below, on the results to the open-ended Positive Change fund, shows that the strategy has been very powerful when the environment is in its favour. Since it launched in January 2017, the fund is up 217% compared to 86% for the index, despite it sharing in the tough period since 2021.

Fig.4: Performance Of Positive Change Fund



Source: Morningstar

Past performance is not a reliable indicator of future results.

Before we turn to the prospects for returns from here, it is worth considering performance in 2023 in a bit of detail. Kate and Lee stress that many of the portfolio companies performed very well operationally, and indeed some also saw good share-price performance too. An example is MercadoLibre, the largest position in the trust. This is an Argentinian ecommerce player and fintech service provider which is expanding across Latin America. It is seeing good growth in both sides of its business and the shares have rallied strongly. Duolingo, the education platform with a popular language learning app, has also seen remarkable share-price performance as its user base has grown. Nu Holdings, a Brazilian fintech, was another strong performer. All three serve the Social Inclusion and Education goal, from a positive change perspective.

However, the general trend against high duration growth stocks has weighed on the portfolio. This has led to poor performance on a number of companies. While the managers have reassessed their views on a handful of positions, in the main they think sentiment has shifted rather than fundamentals. For example, they remain big believers in the potential for Moderna's mRNA platform. In

particular, they note they have a treatment for skin cancer in phase three trials and have seen some positive results from their flu vaccine. In Kate and Lee's view, the market is overreacting to the fall in revenues from COVID-19 vaccines, leading to the significant decline in Moderna's share price over 2023. Alnylam Pharmaceuticals is another holding they think is suffering from general negative sentiment towards biotechnology, a high duration, high growth area. But the managers think there is huge potential in their RNAi therapies.

When it comes to stocks the managers have changed their views on, Orsted stands out. Orsted is one of the world's leading providers and operators of wind turbines. It has struggled under rising input costs and rising financing costs, as well as changes in tax credits in the USA. As a result it has withdrawn from two high profile projects and the CFO has left. The managers have recently chosen to sell the position.

Illumina is another position on which the team have seen their conviction tested. Illumina manufactures gene-sequencing devices, which Kate and Lee think are a crucial tool which will be increasingly used in medical science. However, a company acquisition has led to legal and regulatory challenges, while the CEO has been ousted by an activist investor campaign. The managers have engaged extensively with Illumina over the year and their view is that there is significant growth potential for the clinical use of sequencing technology. Illumina enjoys a near monopoly position and is investing heavily in research and development. The company has had a board re-refresh with a new CEO at the helm and given that Illumina is providing the infrastructure of the genomics revolution, the managers are willing to allow it some time to recover.

The managers also made a handful of sales last year, taking profits in Nibe, a manufacturer of heat pumps, which had been one of the most successful investments for the trust. They also sold Teladoc and Peloton on what they see as poor management and execution.

Overall, though, the managers argue their portfolio still has highly attractive growth prospects, and retain a high level of conviction in their picks. Sales and profit growth forecasts are high, as discussed in the **Portfolio section**, while the valuation premium has shrunk. Furthermore, they highlight the high levels of investment in R&D in their portfolio companies which holds out the prospect of maintaining of increasing growth rates over time. They argue that with interest rates looking to be on a more stable trajectory, long-term investments should be driven more by profits and cash flow growth than they were last year, and highlight that in 2023, many of their portfolio companies performed strongly in this respect, with market sentiment being against them.



For the record, over the past five years an investment in KPC (Keystone Investment Trust until February 2021) has generated -20.7% in NAV total return terms, although much of this period was under a previous manager with a very different strategy.

Fig.5: Five-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

Dividend

KPC's investment objective is to generate returns from predominantly capital growth. As such, any income received is a by-product and is unlikely to be substantial. The policy is to pay out dividends only to the extent required to maintain investment trust status, which is 85% of net income. One dividend is paid each year and for the 2023 financial year, 0.45p per share was paid, up from 0.4p the year before. This equates to a historical yield of 0.2% as of the time of writing. As such, KPC is unlikely to appeal to income-seekers.

Management

KPC is managed by Kate Fox and Lee Qian of the Baillie Gifford Positive Change team. They are supported on the Decision Making Group by investment manager Thaiha Nguyen and senior impact analysts Edward Whitten and Apricot Wilson. There are also three further investment analysts and two impact analysts on the team. The Positive Change team also draw on the work of other Baillie Gifford analysts, notably those on the Emerging Markets, Health Innovation, and International Equities teams. Research is shared internally, with the team having discussions and access to research produced by teams across the company. For KPC, the Positive Change team ensure that each stock has an investment proponent and an impact proponent, meaning that there is at least one team member who is willing to champion it for inclusion on each ground.

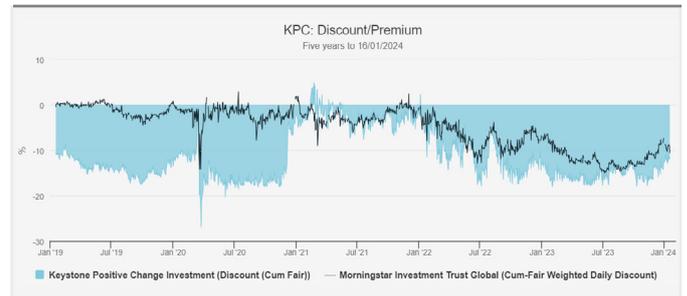
Kate joined Baillie Gifford over 20 years ago, after graduating with an MA in Economics and Maths from the University of Edinburgh. She is a partner at the firm. Lee joined Baillie Gifford over a decade ago and is an

investment manager, holding a BA (Hons) in Economics and Management from the University of Oxford. Kate and Lee are both CFA charterholders and co-manage the open-ended version of KPC Baillie Gifford Positive Change. In total, \$8.2bn, or c. £6.4bn, is managed under the Positive Change strategy across a global client base, as at 31/12/2023.

Discount

KPC's shares have traded on an average discount to NAV of 15% over the past year. The discount narrowed when Baillie Gifford was appointed, but when growth equities began to underperform in early 2021, the discount began to widen. The most likely reason for the discount to close is, in our opinion, a turnaround in performance. With rising interest rates creating the environment in which the discount has widened, it may be that rate cuts will create the environment for a reversal, and at the end of 2023 the discount did begin to narrow as rate expectations fell. The portfolio certainly has exposures to secular growth themes which look likely to drive earnings growth for years to come, such as healthcare and the drive to net zero.

Fig.6: Discount



Source: Morningstar

In the meantime, the board has committed to buybacks and a continuation vote to address the discount. Buybacks began in December 2023, having been eschewed since the change of manager. The continuation vote has been scheduled for the February 2027 AGM, representing five years under the Positive Change strategy. Five years aligns with the five-year investment horizon employed by the management team for their stock picks, and the board notes the open-ended Positive Change fund run by the team has a strong track record versus its peers over five years. We think this is a reasonable timeframe to assess the success of this strategy, rather than at present, after two years in which the environment has been pretty much as bad as it could be for this high-growth style with exposure to themes that were bid up to high valuations in 2020.

One area of concern in the market is unlisted companies, which it is anticipated might still have write-downs to



come, reflecting the falls in public markets. However, as we discuss in **Portfolio**, KPC's exposure is very small at just 6.3% of the portfolio, and we don't think this warrants a wider discount.

Charges

KPCs latest ongoing charges figure (OCF) is 0.9%. The average for the AIC Global sector is 0.49%, although KPC is one of the smaller trusts in the sector which means fixed costs are a larger percentage of NAV. However, KPC's OCF includes a tiered annual management fee structure, which should contribute to declining costs as the trust grows. The fee is 0.70% on market capitalisation up to £100m, 0.65% between £100m and £250m and 0.55% on the remaining balance. Charging on market capitalisation rather than net assets incentivises the manager to close the discount (although we note the convention is to present OCF as a percentage of NAV). The market capitalisation is c. £129m at the time of writing, which means the management fee is just below 0.7% of NAV on an ongoing basis. There is no performance fee.

The latest KID RIY is 1.29%, lower than the AIC Global peer group's simple average of 1.35%. However, we caution that calculation methodologies may vary.

ESG

We think KPC really is unique in terms of the commitment to impact being at the heart of every investment made and the commitment to transparency and accountability. One of KPC's two objectives is to "deliver positive change by contributing towards a more sustainable and inclusive world". Every single stock must have an impact hypothesis which explains how the team think it contributes to solving challenges in one of four areas : Social Inclusion and Education, Environment and Resource Needs, Healthcare and Quality of Life, and Base of the Pyramid.

In order to form an impact thesis, an impact assessment is carried out on each stock under consideration by a dedicated impact analyst, during which phase they consider the issues addressed by the product or service of a company rather than the financials. An impact score that ranges from 0-3 (where 3 is the highest, and 0 the lowest) is produced for each potential holding, with the three factors used to measure impact being: Intent, Product Impact, and Business Practices.

The Intent factor assesses the forward-looking strategy of a company to ensure that it is aligned with the stated goals and positive impact that the team see in the business and that the company's strategy can support the desired positive outcome. Furthermore, the team will evaluate

the level to which actions match verbalised commitments and the degree to which such processes can impact wider industry practices.

The Product Impact factor assesses the relationship that exists between a company's product or service and the problem, the breadth and depth of the impact, and the materiality of the product or service from a business perspective and in terms of the challenge. Impact is assessed on a forward-looking basis. Investments can be made in early-stage companies which have relatively low product impact currently if in future the team believe that the companies' impact will scale.

The Business Practices factor considers a company's environmental stance, treatment of key stakeholders and approach to governance. The analysis looks to identify good practice and clarity, with the team looking to identify industry leaders within this regard. Where business practices fall short of expectations the team will engage with the company to encourage improvement.

Each stock must have a champion on the team who is prepared to make the case for its positive impact as well as at least one champion for it as a financial investment. An annual impact report is published which explains the theses on the stocks, the progress the companies are making towards resolving the world's challenges, and is reviewed by KPMG who provide their assurance that the information has been properly prepared and presented in accordance with the stated methodologies. All impact theses are related to the UN's Sustainable Development Goals.



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