Reflections

Fourth Quarter 2022

"Buy the most exciting growth companies and hold them for longer than most investors would dare". That's the LTGG game plan, and a winning one for long periods. But in the last 12 months, this game plan has been a losing one. It's produced off-the-charts negative returns, absolute and relative, mainly in the first half of this dire 12-month period. Has something changed such that LTGG isn't a winner anymore? What should we do?

Form is temporary

The most memorable sporting image of 2022 was probably two men holding hands and crying. They happened to be two of the most revered sportsmen of all time – Roger Federer and Rafael Nadal. However, one period wasn't mentioned in all the outpourings of admiration celebrating the Swiss maestro's career. For two long seasons, Federer's forehand – the most sublimely destructive shot the tennis world has ever seen – stopped working. He kept hitting it slightly too long. It happened again and again, with the frustration culminating in the one racket smash of his career.

What did Federer do about his loss of form? He didn't change his swing. He didn't change his stance. He didn't change his attitude; no throttling back to play safe. Federer did something more important – he trusted it. He trusted that the laser guidance would click back in, while making a few small adjustments to help it on the way. In 2017 the fabled 'languid whiplash' returned to top form, and the Grand Slams.

Such is the pattern we see – for top sportspeople, Oscar-winning actors, Grammy-winning musicians – form comes and goes. When it goes, obituaries are hastily written. But the elite achievers quietly keep believing in what got them to the top, make some refresh adjustments, and, at some point, the magic returns.

Stock picking is no different. The LTGG philosophy and process is a proven winner. It has generated exceptional returns in the past, and it will do so again in the future. But LTGG represents an attacking, swashbuckling way of playing the investment game, and recently we've hit some big forehands long.

This is no wonder. In the last 12 months, the playing conditions for the investment game have changed in three major ways: via the interest rate cycle, China's zeitgeist, and the Covid-19 hangover.

So, why should we keep believing in our game and, in light of playing conditions, what adjustments are we implementing to make it a winner again?

Roger Federer (left) shakes hands with Rafael Nadal.

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Interest rates, inflation and read-throughs

The most important factor for the dramatic drop in LTGG's fortunes has been the change in interest rates and rate expectations. This meant the value of long-duration growth assets (even within this class, LTGG stocks are towards the extreme) was significantly reappraised downwards. All perfectly rational, especially if you believe higher interest rates will linger. And if you don't, it's still understandable that these valuations take a hit while we wait and see. Moreover, by autumn 2021, the valuations on go-go growth stocks demanded high growth for a long time, even at near-zero interest rates. This valuation extreme is clearer to us now than it was at the time, and its fall-out indicates an adjustment for us to make for the future – but not a change of philosophy.

We have long said that for new holdings we should be able to see 5x upside for a central bull case, and for existing holdings we should be able to see an upside of 2.5x in a central bull case, supplemented with a path to 5x or more when we paint a blue-sky scenario (ie, more bullish than the central bull case, what if everything goes right?).

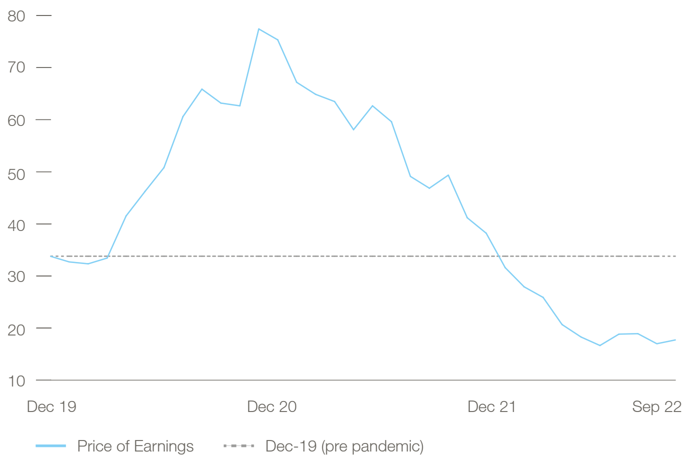
During 2021, after a strong run for years followed by a Covid-19 ramp-up in 2020, there were a number of stocks where we needed a blue-sky scenario just to get to our minimum return of 2.5x, never mind 5x or more. This was true of Netflix, NVIDIA, ASML and Amazon, for example.

This hard work to get to 2.5x scenario was a signal that valuations were too high. We took a bit out of Amazon and ASML, still our response was mainly to say, "maybe we're not being bullish enough in our scenarios", rather than to acknowledge that this was a moment – finally – to harvest some of the huge, accumulated gains. So, we would intend to respond differently to such a signal when there is a next time. If we need blue-sky scenarios to get to 2.5x, then we should review the holding size, even if the company is executing very, very well. This still means being brave and running winners for a long time, just not forever.

One of the two adjustments Federer made to his errant forehand was to move to a slightly larger head version of his racket. The larger sweet spot was more forgiving, so his contact point didn't require perfection to hit a winner. Our valuation adjustment will allow for a holding's progress to be a notch or two below perfection and still be a winner. It's our equivalent of Federer's larger sweet spot.

Valuations are certainly now in the larger sweet spot territory, being substantially below where they were pre-Covid. The chart suggests the price-earnings ratio is 50 per cent below where it was pre-Covid ramp-up, and exit multiples are undemanding (mid to high single digits in many cases).

This sounds encouraging for a turnaround in fortunes, but when will it happen?



Source: Baillie Gifford, Factset.

Are we nearly there yet?

With the interest rate cycle, the market travels in fear and feels relief on arrival. We are probably at the worst point in these travels – the Fed has hiked interest rates steeply, yet the increases don't seem to be doing that much. We all know there is a lag before rate rises bite, but the wait still causes disquiet, and in the meantime, the high-profile inflation numbers remain high.

Two factors are about to change this picture for the better.

First, the comparison numbers for inflation are about to help. In Q1 2023 we will see inflation annualised against a number that had already risen significantly in Q1 2022. All things being equal, this will bring down headline rates significantly over the next few months.

Second, the lag will have passed. Already some of our companies are seeing a response from their more sensitive cohorts of customers, be it Affirm in the 'buy now pay later' segment, Carvana in car sales, or Netflix on subscriptions. The impact will spread. By summer 2023, the market should feel confident that we are at or near the peak rates. This will hugely improve the chances of long-duration growth stocks returning to favour – assuming, of course, they are still around and still growing.

Note that there is a running assumption that inflation is bad for growth investors. Setting aside the discount rate hit to valuations, it's not true per se. In the past, we have generated very good returns during inflationary periods.

The end of free money sorts out the companies which have a true competitive advantage – and therefore pricing power – and stronger financial characteristics. At the end of Q4 2022, 80 per cent of the portfolio has positive earnings and/or cash flows, and two-thirds of the portfolio sits on net cash.

One or two of our companies may fall victim, too. Carvana is in a precarious financial position, but at 0.16 per cent of the fund (at 12/12/22), it can't hurt from here, and if it does pull through then the upside will be way more than 5x.

So, a backdrop from 2023 of some inflation and interest rates at a few per cent, but without the spectre of much higher rates, are playing conditions that may suit us.

China and common prosperity

We have long been significant shareholders in high-profile Chinese growth companies. Recently Chinese companies represented circa 30 per cent of the LTGG portfolio (versus 21 per cent at the end of 2022), and over the years we have lauded China's economic and entrepreneurial miracles.

China's investing environment has worsened over the last couple of years. The Ant IPO was a coal mine canary, as was the clampdown on the private education sector. We had seen 'tickings-off' in the past – Tencent had a year when it didn't get new games approved (for too pro-Western content plus the gaming addiction impact on education). It revised the content and policed teenage gaming time, and then its new titles started getting approved again.

But this time the tone change has been broader and deeper than towards one company or one sector. President Xi has become explicitly focused on the ultimate goal of "Common Prosperity" for the many, not insane riches for the few. This culminated recently in the latest five-year congress, which saw the politbureau stuffed with Xi followers at the expense of free market champions.

China's zero-Covid policy is also unsustainable. There has been some relaxation since the congress (in the face of significant social unrest) but emerging from Covid-19 lockdowns with half of the oldest age group unvaccinated will be a minefield. In the meantime, GDP growth will suffer. A challenging backdrop for investors.

So, investing successfully in China today requires an adjustment. The magic of transformational growth can still be found, but through a refined prism. That prism is one of alignment with government policies, and we have been scrutinising our Chinese holdings through it. The clearer the alignment the more comfortable we are to hold, and in size. Where there is less alignment, we are now assuming the profits accruing to shareholders will be capped.

This adjustment has led to several actions and a revised pecking order. We sold two holdings outright: KE Holdings (a real estate platform) a while ago, and more recently Bilibili, (a short-form video app) which remained a long way from monetisation. We have also reduced Tencent and Alibaba. They both have phenomenal market positions and have been impressive growth companies, but we believe their alignment is mixed (both are finding themselves shut out of cloud contracts for government agencies) and the chance of them being outliers from here is diminished. They will serve as a source of funds for new ideas in the coming months.

This will leave us with holdings where we have high conviction on alignment and, therefore, growth prospects. China will probably surpass alternative energy targets for the next 10 years and beyond – along with common prosperity, the government is very serious about net zero. Both NIO and CATL are well-aligned for net zero and have strong competitive positions from which to grow. Future Chinese holdings (we've looked closely at LONGi in wind turbines) may well reside in the alternative energy space.

Our holdings in Meituan and Pinduoduo seem well-aligned. Meituan employs five million drivers and has become a de facto food standards agency for China. Pinduoduo sees ordinary Chinese in lower-tier cities and rural areas benefiting from the wonder of ecommerce. And BeiGene is a national champion in oncology, with three approved drugs, improving outcomes for China's many cancer sufferers.

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Of course, we need to keep an eye on companies whose sales into China are significant and could be impacted by tensions and sanctions. So far, this is mainly Nvidia, whose sales of two top-end chips to China are banned, though Nvidia's lower-end chips sales are still to China. ASML was already impacted in 2019 by not being allowed to sell the highest-end EUV machines to Chinese-based facilities. Existing restrictions would need to go further to have an impact from here, but it's a possibility to keep in mind.

There are still exciting 'little giants' to invest in in China, and there are still years of strong growth to play there, but we've adjusted to the change of landscape and it will be tricky for Chinese holdings to be as big a part of the portfolio as before.

The hangover (parts 1 and 2)

Internet CEOs have not quite woken up with memory loss, a new tattoo and a tiger roaming their hotel suite, but the combination of ending Covid-19 restrictions and Apple's transparency tracking changes has left them with some hangover.

This nasty combination represents the third big problem for a number of LTGG's holdings in the last year. A few months ago, we sold Peloton for serious mismanagement due to the unrealistic extrapolation of the Covid-19 boom. It's now clear more companies have been caught out by this, with names from Netflix to Amazon, Carvana to Meta all suffering a loss of form and job cuts. Class companies adapt though, and we see Netflix's decision to have a cheaper ad-supported subscription tier – something they had long resisted – as a smart adjustment.

The Apple Tracking Transparency (ATT) changes have also hurt. A number of our companies lean on growth in digital advertising as a key revenue generator. If consumers elect not to be tracked across apps (80 per cent of us decline) then the ads pushed to consumers are less relevant and the value of these slots diminishes. Of our holdings, only The Trade Desk (a purely buy-side digital advertising platform) seems to be getting around this (with a clever algorithm) and is growing its advertising-derived revenues at more than 30 per cent. For most companies it's a clear negative for their business models.

These two changes – Apple's tracking change dates from January 2022 and Q1 2022 saw the biggest shedding of Covid-19 restrictions – mean we don't have visibility on underlying growth rates for a raft of companies. There is too much noise and not enough signal. But by the middle of 2023 we should see growth rates that better reflect a tenable tempo. If those rates are close to what we think they will be (at perhaps the hardest point of comparisons, Q3 2022, the portfolio is still exhibiting almost 20 per cent top-line growth year-over-year) then your companies will be due a positive reappraisal of prospects.

Our actions

We often talk about the importance of sitting on our hands, but in the turbulence of the last 18 months we've probably been a bit more active than clients think.

Since January 2020 there have been 17 new holdings in the portfolio (of which 14 are still in and have accelerated the growth of the portfolio) and 15 complete sales. In 2020 and 2021 we recycled 16 per cent of the portfolio out of Tesla alone and into other companies. Since the downturn in performance, we have sold out of Peloton, Beyond Meat, Bilibili, Delivery Hero, and KE Holdings. All were a long way from profitability and vulnerable to a more difficult playing field. Several of these weren't in the portfolio for long, though this isn't that unusual. Of the 133 complete sales we have made in 18 years of LTGG, 45 of them (about a third) were in the first two years of ownership. We've also sold where the growth prospects are unexciting even if the financials are strong – we have recently sold Meta, with the proceeds going into a new holding in Latin America which we will tell you more about soon.

Keep in mind that as a fully invested strategy we don't keep 10 per cent or more in cash to deploy tactically, so purchases need to come from sales. Given most of our stocks fell in unison the last year there haven't been as many relative valuation anomalies as one might think. To help navigate the stressful situation we organised the portfolio into three pillars of Early Days (6 per cent), On Track (78 per cent), and Outstanding Questions (15 per cent) and we've been moving stocks between the pillars according to developments. Additions tend to be in the Early Days (Ginkgo Bioworks) and reductions from the Outstanding Questions (Tencent, Alibaba).

However, so far, the transactions from the last 18 months haven't really worked – we recycled from our second generation of winners in LTGG into new holdings representing the third generation, namely Atlassian, Roblox, SEA, NIO, Shopify, Spotify, and Adyen. Most of these names have fallen significantly since we bought. Our newest buy, Ginkgo Bioworks, has fallen from $5bn market cap to $3bn since we bought it, and from $20bn when we first looked at it (but ruled it out on valuation!). Unusually, the weighted average market cap of LTGG is now less than that of the MSCI index.

The one 'action' that has already been satisfying is getting out to see the companies again face to face – in 2021 we met every holding bar one (Atlassian in Australia, whom we will meet in March 2023).

Engines of growth for the future

When the market's main worry turns from inflation to fears for growth, we would be relaxed. Very little of the growth in prospect for our holdings stems from macroeconomic factors. Much of it is replacement growth, or displacement growth as our companies provide better ways of doing the same thing – one of our US equity investors, Dave Bujnowski, explains this well in his excellent piece, The new engines of growth. Since the start of LTGG in 2004, the portfolio of growth stocks has done very well in a variety of economic scenarios. The growth themes we are most excited about remain intact or even strengthened: the move to alternative energy and the electrification of the grid, the intersection of deflationary technology with healthcare, and the inexorable rise of the internet of things.

Portfolio growth rates have slowed for now but from a very high starting point. CAGR five-year revenue growth is circa 30 per cent for the portfolio and over 20 per cent on a one-year view. On the most recent quarter of numbers, which includes the triple whammy of a Covid-19 hangover, Apple TT and supply disruption, the majority of the portfolio (20 of 36 stocks) would still double sales over the next five years.

The pipeline of new ideas is flowing nicely too. In recent weeks new ideas for holdings have included LONGi (Chinese wind turbines), BYD (a competitor to CATL and NIO), SolarEdge (photovoltaic inverters), Samsara (clever dashcams), Datadog (cloud optimisation), and MercadoLibre (arguably a surprising omission in recent years from the LTGG portfolio) to name a few. We are confident that we own companies that will grow strongly for years from here.

Eyeing a comeback

LTGG has had a sharp dip in form, but its attacking style of investing is a proven winner. Like other proven winners who've suffered a high-profile blip, we've done two things. We've made some postlapsarian adjustments to LTGG, notably on valuation scenarios and our assessment of China's prevailing narrative.

But, more importantly, we've continued to trust in our game style – one of brave, optimistic, high-growth investing. We are not in the business of predicting performance turnarounds, but there are good reasons to suspect that by next summer we'll be back on form. Then, when the market serves up opportunities to our forehand, we will let rip.

Important information and risk factors

Annual past performance to 30 December each year (net %)

	2018	2019	2020	2021	2022
LTGG Composite	-1.6	34.1	102.0	2.4	-46.4
MSCI ACWI Index	-8.9	27.3	16.8	19.0	-18.0

Annualised returns to 30 December 2022 (net %)

	1 Year	5 Years	10 Years
LTGG Composite	-46.4	7.9	13.2
MSCI ACWI Index	-18.0	5.8	8.5

Source: Baillie Gifford & Co and MSCI. Net of fees, USD. Changes in the investment strategies, contributions or withdrawals may materially alter the performance and results of the portfolio. All investment strategies have the potential for profit and loss.

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