Positive Change in a new paradigm

Catherine Flockhart

Nothing has changed and yet everything is different

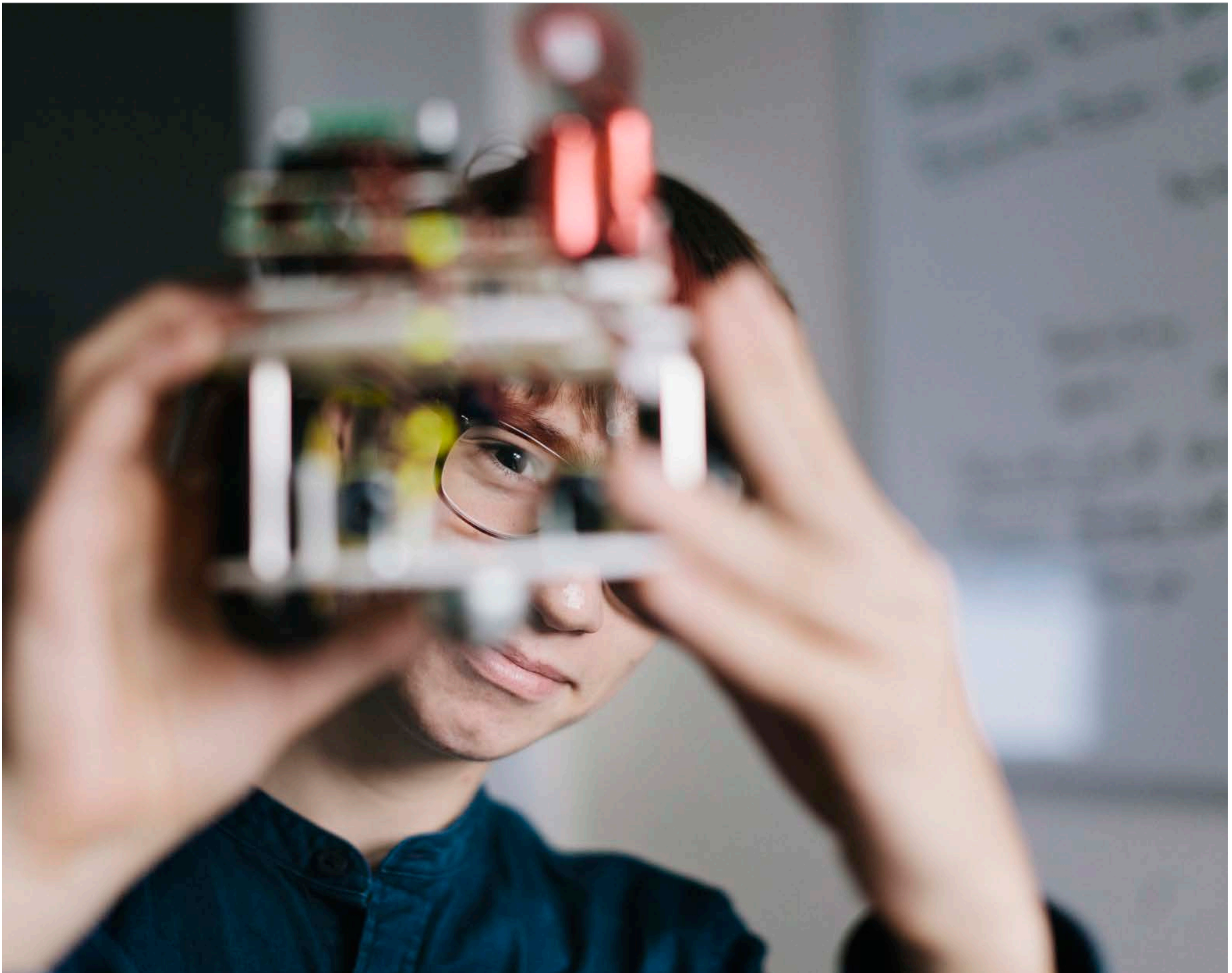
Jean-Paul Sartre, Nausea, 1938

Since launching Positive Change in January 2017, our mission has remained unchanged. We still seek to invest in growth companies that are addressing global sustainable development challenges. If anything, we have even greater conviction that businesses that can solve major challenges will deliver strong long-term returns. So, in essence, nothing has really changed.

All investment strategies have the potential for profit and loss, your or clients capital may be at risk. This paper is intended solely for the use of professional investors and should not be relied upon by any other person. It is not intended for use by retail clients.

And yet, as we stand in the post-pandemic world looking towards how we will fuel future global growth, everything is different. We are witnessing real change. Today, we are more excited than ever about the prospects for Positive Change in a new paradigm.

In fact, there are two potential paradigm shifts that we should examine. The first is the shift we've seen in financial markets with the end of quantitative easing. Does the post-pandemic world represent a fundamentally different environment, and what does that mean for growth? The second is the transformation that society will undergo as we reorient towards sustainable development and address climate change: we think this is far more significant.



Reflections on the recent, and not-so-recent past

As bottom-up stock pickers, we spend our time trying to find superior growth companies rather than predicting macroeconomics, but it would be wrong not to acknowledge that the last two years saw some big shifts that impacted short-term performance. As growth investors, we are often asked about the end of the age of easy money, and what this means for our companies, many of which promise exceptional cash flow growth, but a few years into the future.

As various countries emerged from lockdown in 2022, we saw a series of events collide to create a challenging backdrop. Supply chain dislocation, war, and growing geopolitical tensions, against relatively strong demand led to inflationary pressures and the end of quantitative easing. Central banks hiked rates faster and further than anticipated. The result in share price terms for our portfolio was significant as markets punished growth companies, whose future cashflows were deemed relatively less valuable. These are the first-order impacts of a rise in interest rates upon equities.

It would be easy to allow this post-Covid rollercoaster to throw us, to think this signals the beginning of a new paradigm where growth equities will no longer prosper. But the institutional knowledge Baillie Gifford has amassed as a stock picker for over a hundred years allows us to see this for what it is – the latest market cycle that we must look through in search of opportunities.

The 115-year track record of Baillie Gifford's longest-standing client provides evidence that periods of elevated inflation deliver short-term pain but fertilise the seeds of phenomenal long-term returns for growth stock pickers. The decade that followed the mid-1970s saw compound returns of over 1,100 per cent cumulative. We saw a similar phenomenon amidst another inflationary peak in 1980; a sharp drawdown before a compounded return of almost 800 per cent in the subsequent decade or so. The lesson is that throwing in the towel at the bottom tends to be catastrophically costly.

The graph below shows that companies that deliver the highest level of earnings growth reliably outperform in share-price terms on a five-year view. This data (ranging from 1992) covers periods of high interest rates, low interest rates and the global financial crisis.

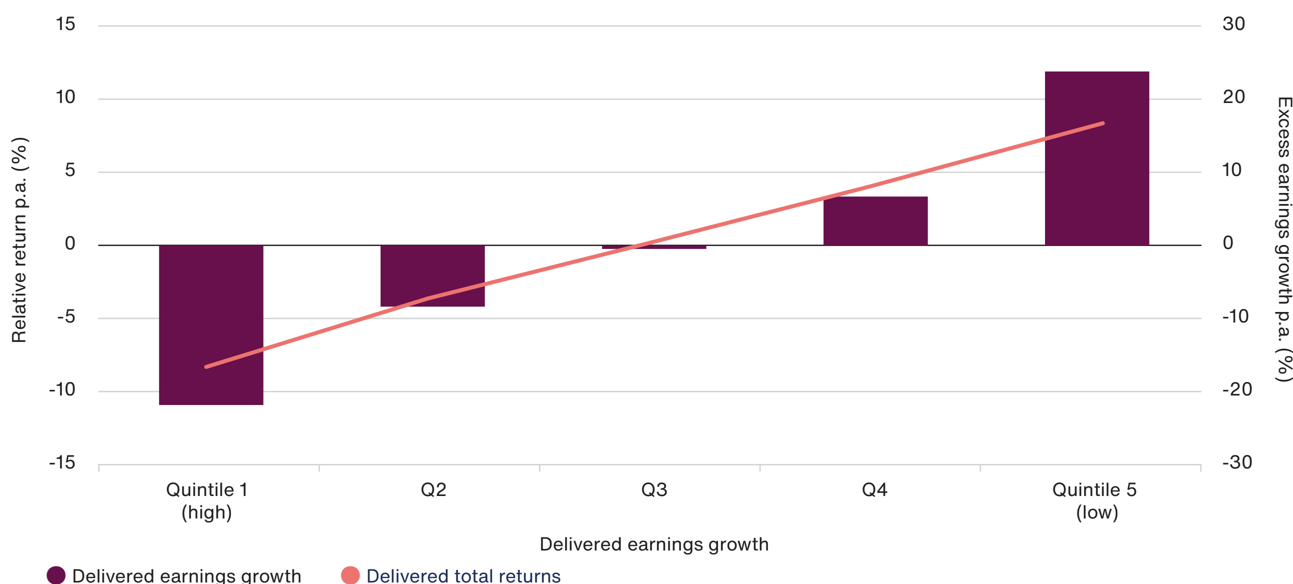
No matter what, over the long-term, share prices follow fundaments. This principle guides us when constructing a portfolio that can outperform over the next five years.

Sure, when interest rates rise, the first-order impact on growth equities is a reduction in share prices because future cash flows are discounted at a higher rate. We suspect the sharp correction is behind us. But more interesting to us as bottom-up stock pickers are company fundamentals and how cash flows might change in a higher interest rate environment. Who will be the winners that deliver top-quintile earnings growth?

Companies with a greater competitive advantage and pricing power will almost certainly be those that win. For example, our holding Ecolab, which offers water and hygiene solutions, has been able to implement price rises ahead of inflation while still providing good value to its customers by helping them to realise efficiencies. Elsewhere, we think holdings such as MercadoLibre, the Latin American ecommerce platform, may benefit from an environment that forces rational competition; those who can gain market share and grow profit sustainably should win.

Delivered median total returns on earnings growth quintiles

Rolling five year horizons (1992–2021)



Source: Baillie Gifford & Co.

Experience

Of course, as part of our bid for constant improvement, we have learned from experience. We have always recognised that pandemic consumption habits, which gave a huge boost to various portfolio companies in 2020, would not persist forever, but the reversal of fortunes for some was steeper than we anticipated. A few names in the portfolio faced greater barriers to adoption than we had expected and failed to navigate difficulty. Beyond Meat, Peloton and Teladoc were all companies in what could still be structural growth areas (plant-based protein, connected fitness and virtual medicine) but did not deliver, and so are no longer held in the portfolio. These companies all had the potential to deliver exceptional returns, but the probability we attached to that was too large. Put very simply, we were paying too much for the uncertain growth prospects they represented.

We have therefore challenged ourselves to think more carefully about the probability that highly valued companies can double over our five-year horizon. For example, we recently sold NIBE, the heat pump manufacturer owned since inception, which has re-rated significantly over our holding period and has been a strong contributor to performance. We spent 18 months following Remitly, which offers cross-border payments for immigrants, but held back from purchasing and monitored operating performance until the end of 2022; a more attractive entry point.

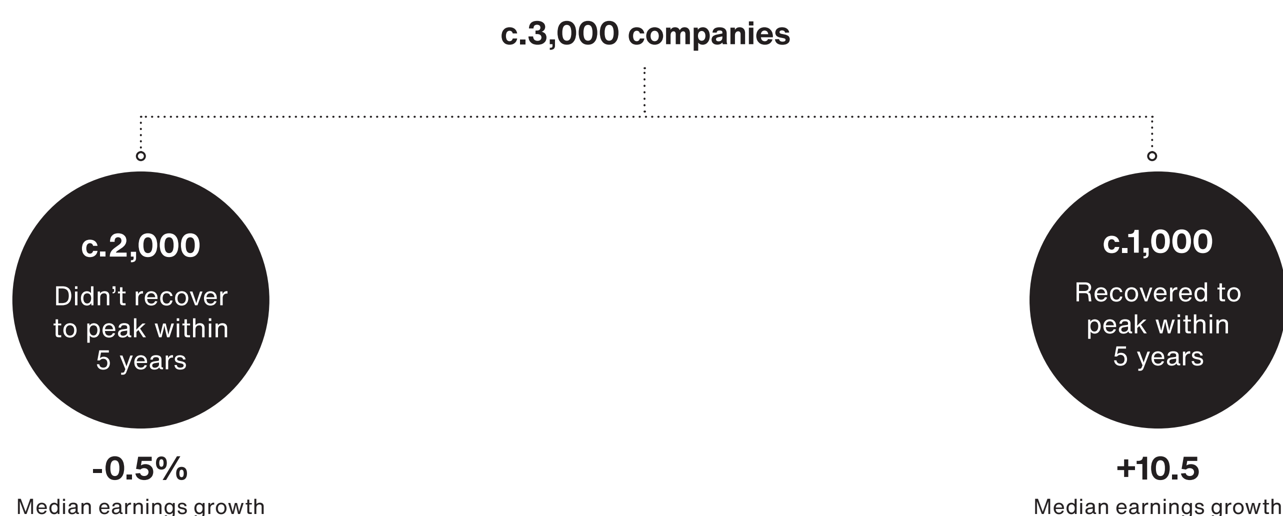
Confidence

But we must not overcorrect. Our long-term success has been down to our ability to seek out and understand exceptional businesses which the market underestimates, and back them in the face of uncertainty. Moderna, which we bought at IPO, had no revenues and an unproven technology when we took our first holding. Our fundamental research gave us conviction that the company did have an edge – by the end of December 2023, it generated a 330 per cent return for clients since purchase, more than compensating for smaller positions that did not work out. We still think Moderna has harnessed a powerful technology that will deliver tremendous value, and do tremendous good, despite the market's fixation with quarterly Covid vaccine volumes.

We know the backdrop has shifted, and companies now face a more constrained funding environment, and a more complex geopolitical one. We always come back to fundamental company analysis. Well-run companies, and well-capitalised companies, with long-term growth plans will be best placed to navigate the uncertainties of the future and bounce back strongly. The figure below illustrates this.

This period will sort the wheat from the chaff, and companies we hold may emerge in an even stronger competitive position. As in 2000, the weaker businesses fall away and those that survive can dominate the decades ahead.

Companies with strong earnings recover from drawdown* more quickly



Source: MSCI AC World.

* Data presented covers every company in the index that experienced a drawdown of over 50 per cent from December 1999 to April 2022.

Resilience

To ensure our portfolio is well positioned to prosper, we spent significant time last year reviewing our portfolio's resilience: testing revenue growth, pricing power, capital and cash requirements, quality indicators, and inflation sensitivity. At the start of this year, we looked again at cash balances and creditworthiness in light of tighter credit conditions.

Whilst Positive Change is invested in companies with disruptive technologies, it is not a portfolio of 'moonshots'. Outperformance since inception has been driven by revenue growth, not valuation expansion. More than 80 per cent of the portfolio is profitable and, of the remaining companies, all have more than two years of cash reserves. Companies within our portfolio currently trade at a price-to-earnings premium of approximately 1.5 times the market average. However, these companies have exhibited a remarkable five-year earnings growth rate, nearly double that of the index. Furthermore, the consensus forecast for their three-year earnings growth, which we believe to be a conservative estimate, is almost twice that of the index.

Fundamentally, the portfolio is on an incredibly strong footing, and we retain high conviction in the ability of great growth companies to generate strong long-term returns. Predicting short-term events has never been our aim, and our portfolio is volatile on a short-term view. Indeed, looking through that volatility is our edge.

The table below illustrates, at a stock level, the returns and maximum drawdowns of our 10 largest holdings to the end of September 2023.

As a result of turning volatility to our advantage, our five-year track record remains strong, both in absolute and relative terms. If you had invested £1 in Positive Change when we seeded the fund in 2017, today it would be worth £2.94, vs. £1.86 for the index.

In summary, whilst the backdrop undoubtedly looks different today, strong operational growth often drives share prices for those with the patience to hold on, and this relationship holds true regardless of market conditions. The future growth prospects for our companies look underappreciated today relative to the market and history tells us that bravery at this point could be richly rewarded. Finding and backing exceptional companies remains a constant pursuit. Our fundamental beliefs have not changed. So we look forward.

Stock	**Max drawdown**	**Holding period return**
Tesla	-68	1392
ASML	-48	559
Dexcom	-52	526
Alnylam	-50	367
NIBE	-50	361
Moderna	-80	334
TSMC	-46	303
Abiomed	-68	256
Kite Pharma*	-12	255
Alphabet	-19	185

Source: Baillie Gifford & Co. Data from 1 January 2017 to 31 December 2023.
* No longer held.

Imagining economic possibilities for... our generation

We are suffering just now from a bad attack of economic pessimism. It is common to hear people say that the epoch of enormous economic progress... is over; that rapid improvement in the standard of life is now going to slow down... that a decline in prosperity is more likely than an improvement in the decade which lies ahead. I believe that this is a wildly mistaken interpretation of what is happening to us.

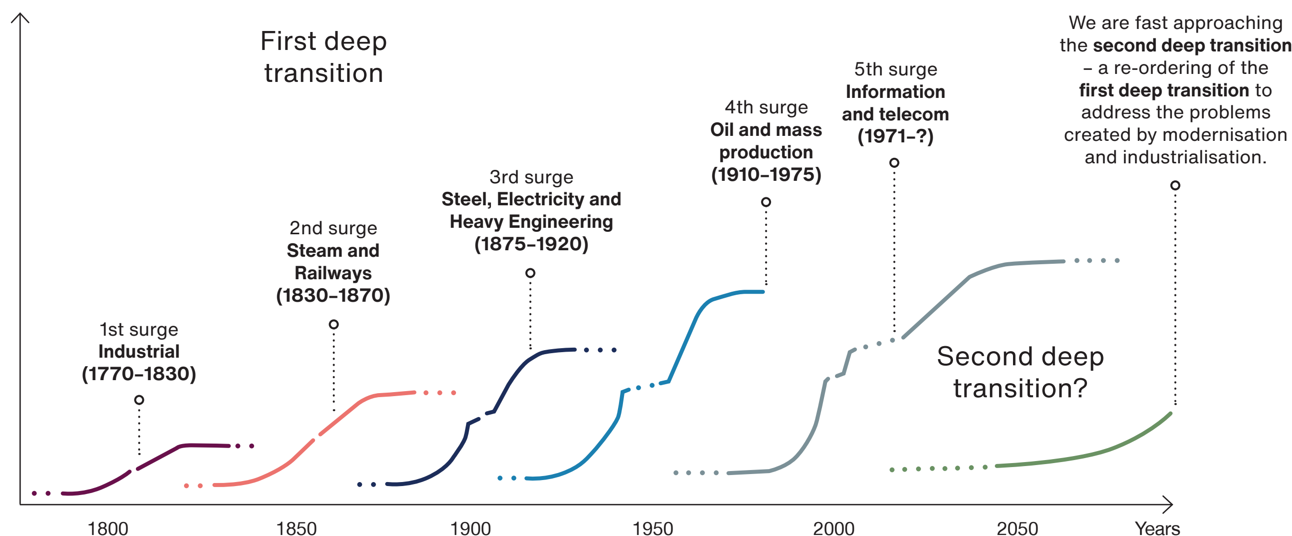
John Maynard Keynes

This quote comes from Economic Possibilities for our Grandchildren, which Keynes wrote in 1930. He muses on the massive technological improvements which he foresaw would improve efficiency and lift living standards for his grandchildren such that whole of society would become 'free from pressing economic cares'. Having first read this before we seeded Positive Change, I return to this book from time to time because the parallels with our mission are so stark.

But here's the thing: the pace of technological advancement has sped up such that we don't need to look out a century to see an advancing and necessary revolution in how we live. A sustainable transformation is needed within our lifetime, and we can see it is already afoot. This hugely excites us. This is the real paradigm shift.

Our work with Professor Johan Schot's *Deep Transitions Project* helps frame how we think about this long-term change and opportunity. The work of the Deep Transitions Project demonstrates that society has seen five surges in technological development since the 1700s. The first series of these surges created the first deep transition, which centred around industrialisation. We are now approaching a second deep transition, which could place society on a path towards a much more sustainable future.

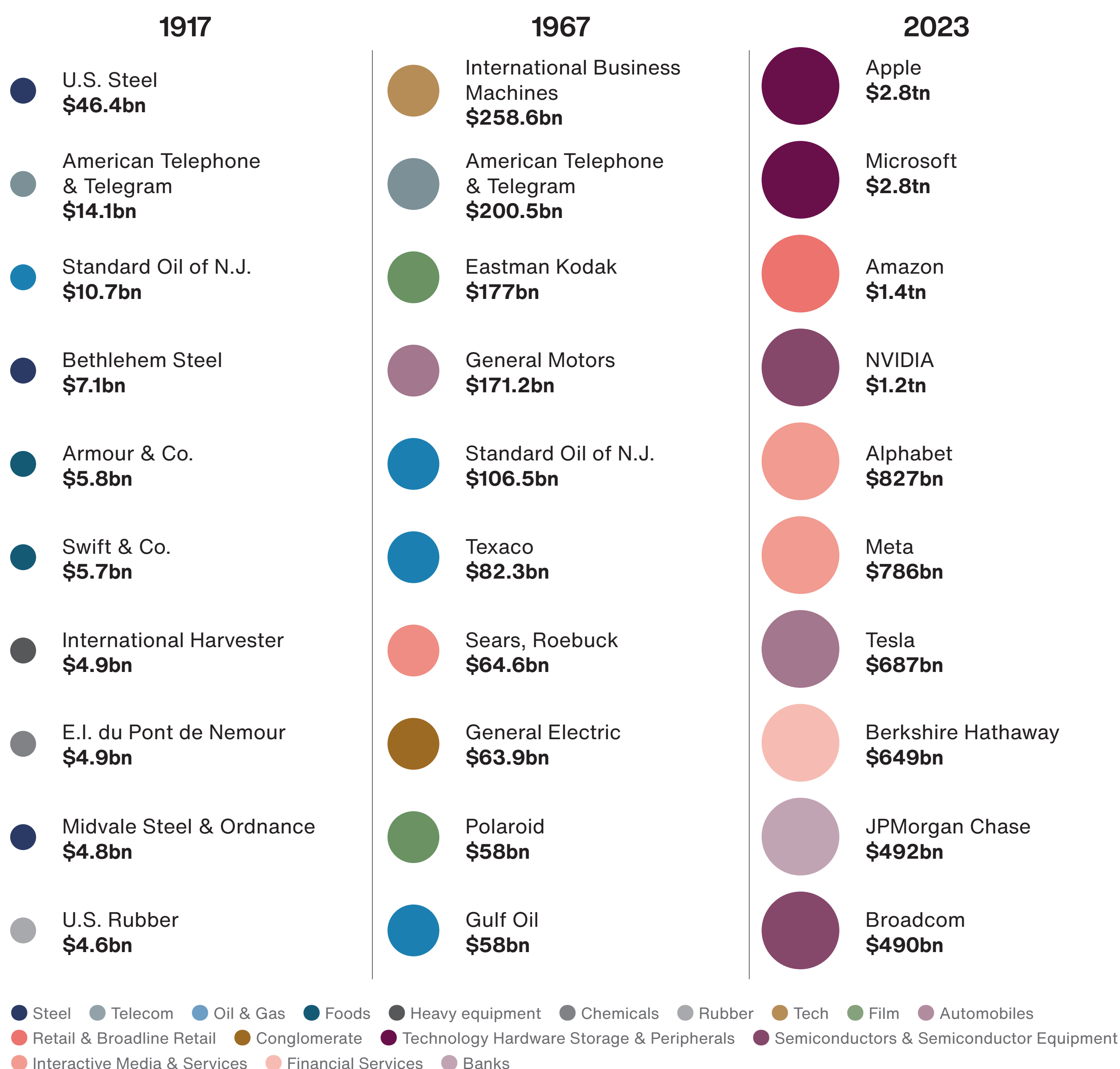
First and second deep transitions



Source: Johan Schot & Laur Kanger, Deep transitions: Emergence, acceleration, stabilization and directionality, 2018.

Our mission is to find exceptional individual companies to invest in, so when implementing the Deep Transitions Project framework we consider the companies behind these surges, and how they very much reflect the wants and needs of society of their time. If we look at the top companies in the US by market valuation a century ago, the list is dominated by U.S. Steel, American Telephone and Telegraph, and Standard Oil of New Jersey; this clearly displays the evolution from the 3rd Surge to the 4th. By the early 1970s, computing giants like IBM began to underpin the 5th Surge which continues to this day with Apple and Microsoft. What interests us is what the next 10 most profitable companies might look like as we approach the 'second deep transition'. Surely these will be companies that deliver the sustainable revolution that we need (as Tesla is already doing) and meet the needs and wants of society over the coming decade. The companies that can address sustainable development and reduce inequalities will not be fringe opportunities, they will surely become some of the world's most valuable companies.

Top ten companies in the US



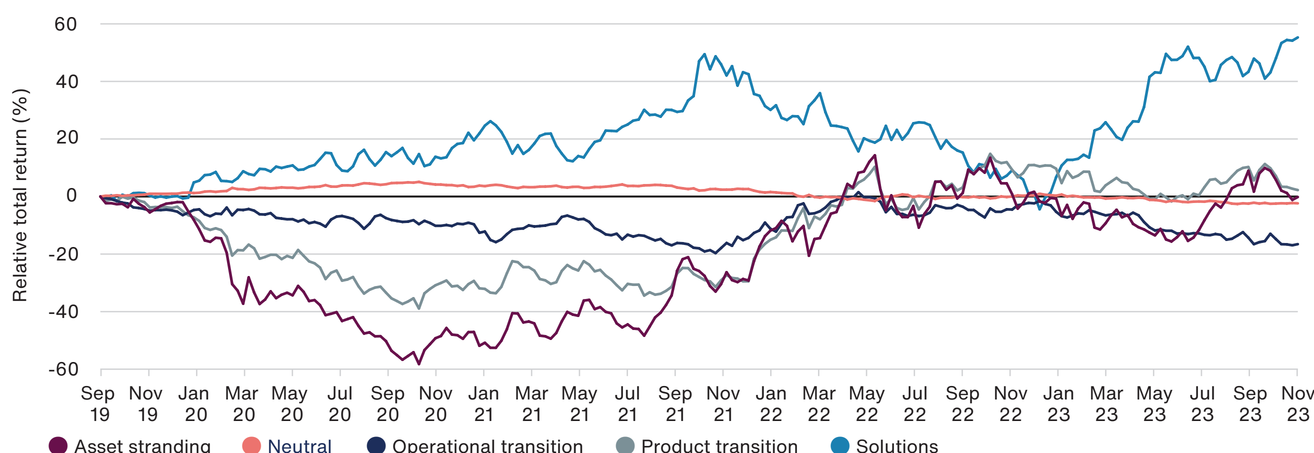
Source: Factset. Data as at 31 December 2023.

Debate around the energy transition has risen over the past year, but this is noise. Over the long term it seems clear to us that a transition (however messy and bumpy that might be) must happen, and most likely will happen.

Indeed, companies offering solutions for the transition are already outperforming in the long term, even before we see any decisive policy actions or detailed plans from countries committed to the Paris Agreement. The graph below demonstrates that companies with products or services addressing climate change have outperformed other categories, which possess more challenged business models and are gradually losing favour.

The innovator's dilemma – the idea that established businesses may struggle to sacrifice their existing revenue streams in order to capture future growth – is particularly interesting when we consider the energy revolution. How many major index incumbents who are tied to fossil fuels will be able to reorient their businesses to succeed in the new paradigm? We have businesses in our portfolio that we think can successfully transition, for example John Deere, but supernormal returns will surely accrue to the solutions providers in particular.

Total returns (%) relative to MSCI AC World Index by MSCI low carbon transition category



Source: MSCI. Data from 30 September 2019 to 30 November 2023.

Note: Asset stranding (score <2); transitions (2–5.7); neutral (5.7–7); solutions (>7). Operational transitions are defined by MSCI as those that need to retool current business, whereas product transitions need to change what they sell.

Estimates on the financing required for the net-zero transition are numerous and of course depend on the transition scenario. Bloomberg and McKinsey variously suggest financing for the energy transition will need to ramp up substantially, to between $7tn and $9tn annually. The International Energy Agency posits $4tn per year is needed in clean energy investment between now and 2050. All of these estimates will be wrong, but they are all vast, even if progress is slow and falls short of expectations.

Hopefully, all of these estimates are wrong. Indeed, Professor J Doyne Farmer, the Baillie Gifford Professor of Mathematics and Director of Complexity Economics at Oxford University, suggests that conventional forecasting of the costs associated with clean energy deployment likely underestimates the rapidity of technological advancement, the pace of cost reduction and the societal value that will accrue as the transition plays out. The economics of an energy system that relies on technology to synthesise endless sources of renewable energy could look quite different from a system that relies on digging up finite commodities and wasting much of its energy output through heat loss.

Nonetheless, more capital-intensive business models may well be some of the biggest winners in the energy transition. Sustainably sourcing the minerals and materials that we need for the transition, building an electrified energy infrastructure, and overhauling our agricultural system will all likely require investment in property, plant machinery and equipment beyond the servers that enabled tech giants to gain scale so quickly. History shows us that the companies that can deliver the greatest growth come in all shapes and sizes. Our portfolio has always invested across both transformational companies like Tesla and enduring growth businesses like Xylem, whose products help to save water.

The opportunity is quite simply massive and almost certainly far greater than we can conceive of. We already have c. 30 per cent of our portfolio invested in companies that are driving positive change in the area of environment and resource needs. We're also redoubling efforts by looking at all areas of the energy transition.

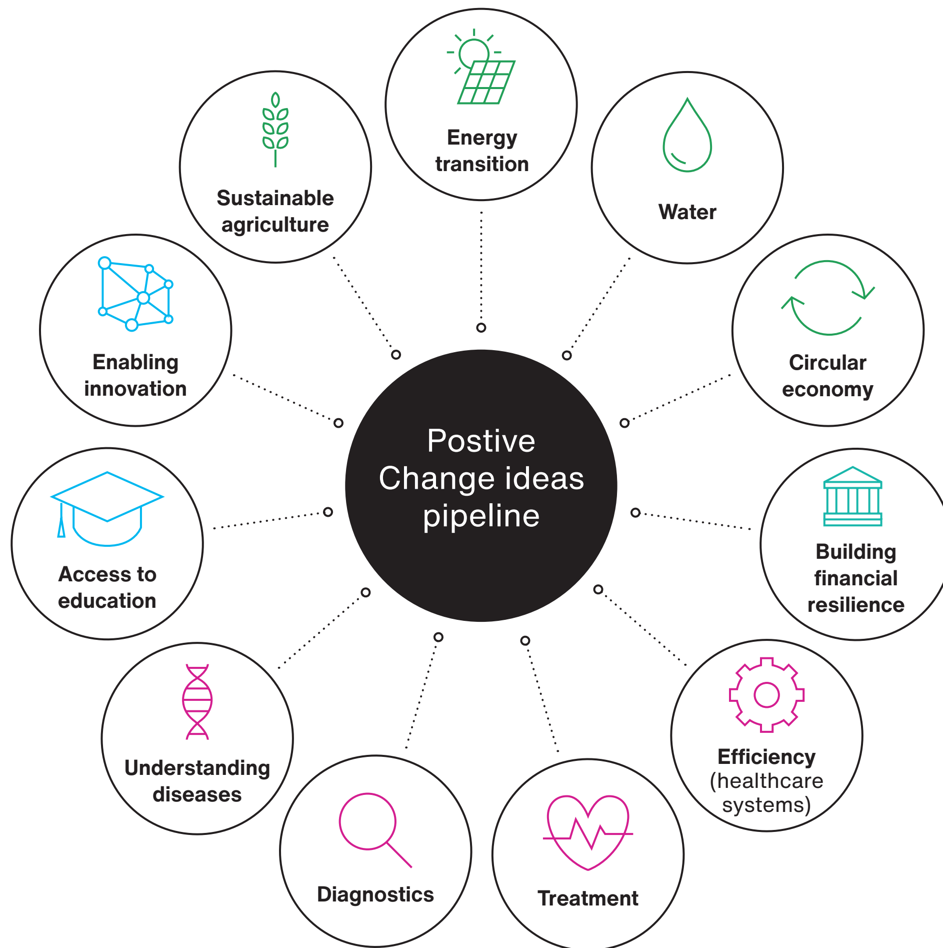
Our idea pipeline, depicted on the following page shows some of the areas we are investigating.

Of course, our portfolio will remain focused on finding ideas that meet all sustainable development challenges. We have previously expressed our enthusiasm for technological advancements, as they continue to support progress in healthcare and enhance access to essential services such as education and finance. This sentiment remains true today. Novel business models that can reduce inequalities will remain attractive. Our conviction in the business models of MercadoLibre, Duolingo and Nu Bank has grown thanks to stellar operating performance.

The deep transition towards a more sustainable society will touch each and every part of the economy. Tackling climate change will be critical for those living below the global poverty line.

A new paradigm is upon us. It is not a hundred years hence, it is in sight. It represents a possible and much more positive future. Our vision is not clouded by the fear in markets, in fact, we intend to use it to our advantage. Our patience allows us to see clearly and to seize the opportunity.

Inspiring solutions



- Social inclusion and education
- Environment and resource needs
- Healthcare and quality of life
- Base of the pyramid

Author biography

Catherine Flockhart

Catherine is a partner and Head of ESG at Baillie Gifford. She oversees our firmwide ESG function, which encompasses investment research, stewardship, voting and operations, and client communications. Prior to this, Catherine played an integral role in the launch and growth of our Positive Change impact strategy and has worked as a specialist on Baillie Gifford's established global and international equity strategies. Before joining Baillie Gifford in 2012, Catherine began her career at Goldman Sachs, and also has an MA in English Literature from The University of Edinburgh.

Performance

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

	2019	2020	2021	2022	2023
Positive Change Composite	30.1	86.0	9.7	-30.4	15.3
MSCI ACWI Index	27.3	16.8	19.0	-18.0	22.8

Annualised returns to 31 December 2023 (net%)

	1 year	5 years	10 years	Since inception
Positive Change Composite*	15.3	16.3	N/A	18.1
MSCI ACWI Index	22.8	12.3	N/A	10.3

*Inception date: 31 January 2017.

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.

Past performance is not a guide to future results.

Legal notice: MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indexes or any securities or financial products. This report is not approved, endorsed, reviewed or produced by MSCI. None of the MSCI data is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.

Risk factors

The views expressed should not be considered as advice or a recommendation to buy, sell or hold a particular investment. They reflect opinion and should not be taken as statements of fact nor should any reliance be placed on them when making investment decisions.

This communication was produced and approved in February 2024 and has not been updated subsequently. It represents views held at the time of writing and may not reflect current thinking.

All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk. Past performance is not a guide to future returns.

This communication contains information on investments which does not constitute independent research. Accordingly, it is not subject to the protections afforded to independent research, but is classified as advertising under Art 68 of the Financial Services Act ('FinSA') and Baillie Gifford and its staff may have dealt in the investments concerned.

All information is sourced from Baillie Gifford & Co and is current unless otherwise stated.

Important information

Baillie Gifford & Co and Baillie Gifford & Co Limited are authorised and regulated by the Financial Conduct Authority (FCA). Baillie Gifford & Co Limited is an Authorised Corporate Director of OEICs.

Baillie Gifford Overseas Limited provides investment management and advisory services to non-UK Professional/Institutional clients only. Baillie Gifford Overseas Limited is wholly owned by Baillie Gifford & Co. Baillie Gifford & Co and Baillie Gifford Overseas Limited are authorised and regulated by the FCA in the UK.

Persons resident or domiciled outside the UK should consult with their professional advisers as to whether they require any governmental or other consents in order to enable them to invest, and with their tax advisers for advice relevant to their own particular circumstances.

Financial Intermediaries

This communication is suitable for use of financial intermediaries. Financial intermediaries are solely responsible for any further distribution and Baillie Gifford takes no responsibility for the reliance on this document by any other person who did not receive this document directly from Baillie Gifford.

Europe

Baillie Gifford Investment Management (Europe) Limited provides investment management and advisory services to European (excluding UK) clients. It was incorporated in Ireland in May 2018. Baillie Gifford Investment Management (Europe) Limited is authorised by the Central Bank of Ireland as an AIFM under the AIFM Regulations and as a UCITS management company under the UCITS Regulation. Baillie Gifford Investment Management (Europe) Limited is also authorised in accordance with Regulation 7 of the AIFM Regulations, to provide management of portfolios of investments, including Individual Portfolio Management ('IPM') and Non-Core Services. Baillie Gifford Investment Management (Europe) Limited has been appointed as UCITS management company to the following UCITS umbrella company; Baillie Gifford Worldwide Funds plc. Through passporting it has established Baillie Gifford Investment Management (Europe) Limited (Frankfurt Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in Germany. Similarly, it has established Baillie Gifford Investment Management (Europe) Limited (Amsterdam Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in The Netherlands. Baillie Gifford Investment Management (Europe) Limited also has a representative office in Zurich, Switzerland pursuant to Art. 58 of the Federal Act on Financial Institutions ('FinIA'). The representative office is authorised by the Swiss Financial Market Supervisory Authority (FINMA). The representative office does not constitute a branch and therefore does not have authority to commit Baillie Gifford Investment Management (Europe) Limited. Baillie Gifford Investment Management (Europe) Limited is a wholly owned subsidiary of Baillie Gifford Overseas Limited, which is wholly owned by Baillie Gifford & Co. Baillie Gifford Overseas Limited and Baillie Gifford & Co are authorised and regulated in the UK by the Financial Conduct Authority.

Hong Kong

Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 is wholly owned by Baillie Gifford Overseas Limited and holds a Type 1 and a Type 2 license from the Securities & Futures Commission of Hong Kong to market and distribute Baillie Gifford's range of collective investment schemes to professional investors in Hong Kong. Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 can be contacted at Suites 2713–2715, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. Telephone +852 3756 5700.

South Korea

Baillie Gifford Overseas Limited is licensed with the Financial Services Commission in South Korea as a cross border Discretionary Investment Manager and Non-discretionary Investment Adviser.

Japan

Mitsubishi UFJ Baillie Gifford Asset Management Limited ('MUBGAM') is a joint venture company between Mitsubishi UFJ Trust & Banking Corporation and Baillie Gifford Overseas Limited. MUBGAM is authorised and regulated by the Financial Conduct Authority.

Australia

Baillie Gifford Overseas Limited (ARBN 118 567 178) is registered as a foreign company under the Corporations Act 2001 (Cth) and holds Foreign Australian Financial Services Licence No 528911. This material is provided to you on the basis that you are a 'wholesale client' within the meaning of section 761G of the Corporations Act 2001 (Cth) ('Corporations Act'). Please advise Baillie Gifford Overseas Limited immediately if you are not a wholesale client. In no circumstances may this material be made available to a 'retail client' within the meaning of section 761G of the Corporations Act.

This material contains general information only. It does not take into account any person's objectives, financial situation or needs.

South Africa

Baillie Gifford Overseas Limited is registered as a Foreign Financial Services Provider with the Financial Sector Conduct Authority in South Africa.

North America

Baillie Gifford International LLC is wholly owned by Baillie Gifford Overseas Limited; it was formed in Delaware in 2005 and is registered with the SEC. It is the legal entity through which Baillie Gifford Overseas Limited provides client service and marketing functions in North America. Baillie Gifford Overseas Limited is registered with the SEC in the United States of America.

The Manager is not resident in Canada, its head office and principal place of business is in Edinburgh, Scotland. Baillie Gifford Overseas Limited is regulated in Canada as a portfolio manager and exempt market dealer with the Ontario Securities Commission ('OSC'). Its portfolio manager licence is currently passported into Alberta, Quebec, Saskatchewan, Manitoba and Newfoundland & Labrador whereas the exempt market dealer licence is passported across all Canadian provinces and territories. Baillie Gifford International LLC is regulated by the OSC as an exempt market and its licence is passported across all Canadian provinces and territories. Baillie Gifford Investment Management (Europe) Limited ('BGE') relies on the International Investment Fund Manager Exemption in the provinces of Ontario and Quebec.

Israel

Baillie Gifford Overseas Limited is not licensed under Israel's Regulation of Investment Advising, Investment Marketing and Portfolio Management Law, 5755–1995 (the Advice Law) and does not carry insurance pursuant to the Advice Law. This material is only intended for those categories of Israeli residents who are qualified clients listed on the First Addendum to the Advice Law.

Baillie Gifford™

Copyright © Baillie Gifford & Co 2024. All rights reserved.
Authorised and regulated by the Financial Conduct Authority

CO1887404 Positive Change in a new paradigm 1223_WP_SC
Ref: 79711 10043582