Baillie Gifford European Growth

BGEU is a high-risk, high-potential return strategy looking cheap on a portfolio and share price level...

Update
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Overview

Baillie Gifford European Growth Trust (BGEU) is managed by Stephen Paice and Chris Davies, who start with a blank piece of paper and aim to identify the companies with the best long-term growth prospects in the European market.

The portfolio is highly active and differentiated from the benchmark. Positions in unlisted companies contribute to this, the weighting being currently at 10.6% of the portfolio, as does the significant mid-cap tilt. Overall, the trust is highly sensitive to the growth factor, which helps explain the swings in recent absolute and relative returns.

The last year has seen a significant fall in both the NAV and share price, following an equally extreme rise. As we discuss under **Performance**, this has been driven by macroeconomic conditions which we believe are unlikely to repeat and, in our view, long-term alpha is more likely to come from the managers' success in identifying companies which can deliver exceptional long-term earnings' growth.

The managers report an "extreme mismatch between the potential of our companies and their valuations" and that operational performance has largely been good, even as prices fall. In fact, some companies have performed extraordinarily well, yet been punished (see **Portfolio**).

BGEU's shares have moved onto a discount over the course of 2022 as risk aversion has risen and growth-investing has fallen out of favour. At the time of writing, the discount is 13.8% compared to an average of 9.8% for the AIC Europe sector.

The trust has structural **Gearing** which contributes to NAV volatility and amounted to 15% of NAV at last month end, following falls in the portfolio's value over the year. Helpfully, this debt has been locked in for the long term at very low rates.

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Analyst's View

The approach taken by Stephen and Chris is refreshingly optimistic. While the immediate outlook for the economy in the UK, in Europe and globally is poor, and the cost-of-living crisis bites, it is important to remember that there are still new markets and products being developed. Human ingenuity has a good track record of improving our standard of life and generating wealth. Stephen and Chris are looking for the outliers which will deliver the greatest returns, often by delivering the greatest change. This highly-active approach has the potential to generate high levels of outperformance, as it has done in the past, although active approaches also bring the potential for underperformance if the stock picks are wrong.

In our view, BGEU looks increasingly interesting after a period of underperformance. The longer record of the strategy has had a tendency to deliver alpha in cycles (see **Performance**). We would not, however, expect the extreme outperformance of 2020 and early 2021 or the extreme underperformance since, to repeat. This is because these seem reflective of extreme swings in economic conditions and valuations. In short, we would not expect growth stocks to be so indiscriminately bid up or down, but rather earnings' performance to be more crucial to performance.

After significant falls in the portfolio's value and with the trust on a discount of 13.8%, we think this looks potentially attractive as an entry point. It is particularly important for investors to take a long-term view though. This is due to the managers' own focus on the long-term, the immediate outlook being poor for short-term earnings, which often drives short-term share price performance and the potential for volatility, thanks to the high active share and structural debt.

BULL
Open-ended equivalent has a long-term track record of outperformance
Managers' compensation package is designed to incentivise long-term value creation
High-conviction approach to European growth-investing

BEAR
Gearing can enhance losses on the downside
Active approach also increases chance of underperformance
May underperform if interest rate expectations rise

Portfolio

The managers of Baillie Gifford European Growth (BGEU), Stephen Paice and Chris Davies, take the European markets as their hunting grounds. Their strategy is highly active and entirely benchmark-agnostic, with the aim being to generate substantial long-term outperformance of a passive investment by investing in a substantially different portfolio.

Stephen and Chris argue that European markets are unfairly associated with stodgy, large-cap companies in traditional industries, and the low growth rates in the region compared to some can lead investors to overlook its markets. They find many companies, largely at an earlier stage of development, which they believe can generate exceptional earnings and share price growth by developing new markets or growing to dominate existing ones with new strategies, technologies or other competitive advantages. They argue that the index of twenty years hence will be radically different from today's and aim to invest in those companies which will have a much larger weight in it, maybe even at the top of the index.

Themes and sectors are merely a by-product of the team's stock-selection process, however the portfolio has a clear bias towards growth stocks, particularly in the consumer discretionary, industrials and technology sectors. Growth stocks and technology stocks, in particular, have been under pressure over 2022 as interest rate expectations rise. Having contributed to exceptional returns versus the index, they have been detractors for the portfolio this year (see **Performance**). Stephen and Chris argue that the pendulum has now swung far too far the other way, with an "extreme mismatch between the potential of our companies and their valuations".

Below, we show the largest holdings in the portfolio and the companies with the largest weights in the FTSE Europe ex UK Index. There is no single name in common, while the largest holding in the trust is the unlisted battery manufacturer Northvolt. The ability to hold unlisted companies – 10.6% of the portfolio at the end of October – is a key differentiator from a typical European equity portfolio. The market capitalisation of Northvolt, €12bn, is also well shy of the c. €95bn needed to make it into the top ten companies in the FTSE Europe ex UK Index. This is illustrative of another key factor in the BGEU portfolio: its significant tilt towards mid caps. In fact, the trust has more in mid caps than any other trust in the AIC Europe sector (47.8% versus an average 25.8%) and the least in large caps, with an especially low weighting to the largest companies Morningstar dubs 'Giants' (12.6% versus an average 34.8%).

Largest Positions In Trust And Index

HOLDING	WEIGHT IN PORTFOLIO (%)	COMPANY	WEIGHT IN INDEX (%)
Northvolt*	6.7	Nestle	4.4
Prosus	5.9	ASML	3.2
Adyen	4.1	Roche	3.1
Topics.com	3.6	Novo-Nordisk	2.7
Richemont	3.6	LVMH	2.6
Ryanair	3.3	Novartis	2.5
Kering	3.1	Total Energies	2.0
Atlas Copco	3.0	SAP	1.7
IMCD	2.8	Siemens	1.4
Nexans	2.7	Sanofi	1.3
TOTAL	**38.6**	**TOTAL**	**24.9**

Source: BGEU, FTSE Russell, *denotes private company

The weighting to mid caps and the strong style bias contribute to a tendency for the portfolio to be more volatile than the index, along with the **Gearing**. Stephen and Chris accept that volatility and the possibility of loss in individual positions are risks worth taking and should be offset by the returns in their winners, if they have picked them right.

One of the ways companies can achieve exceptional growth is to open up and operate in the online space. This has been a key trend in the portfolio over the years. Spotify is a well-known operator in these fields and is still held in the portfolio outside the top ten. The company was owned, when private, by other funds run by the team. Another example is Prosus, an internet services conglomerate, which indirectly owns a large stake in Tencent.

Adyen, the Dutch online payments facilitator also fits this theme, and its fortunes over the past year illustrate what Stephen and Chris see as a dramatic divergence between sentiment and potential. The shares have halved since September 2021, yet revenues were up 37% in the first half of 2022 and Stephen and Chris believe that the company is capable of generating revenue growth beyond 20% over the next 20 years. Ultimately, the managers that believe the company could be Europe's first €100bn fintech. Unsurprisingly, the managers have held on through the bear market in the company shares.

In general, the managers argue that investors have become too focussed on share prices over the past year, rather than on the underlying competitive dynamics in industries. These are creating opportunities for the strongest businesses to take market share and consolidate their positions. They point to food delivery company Delivery Hero. The managers view this industry as ripe for rationalisation, which should lead to Delivery Hero consolidating its position. They note that Delivery hero has strengthened its position in the Korean market over 2022 as new-entrant rivals have been unable to compete. Another holding in this sector is Just Eat Takeaway.com and both companies have seen precipitous falls in share prices since late 2021. In the managers' view, these companies are 'discretionarily-unprofitable', still in a ramp-up phase in which they are reinvesting for growth, rather than attempting to generate short-term profits. In the long run, they think the growth in earnings will be the dominant influence over the share price, rather than valuation.

A similar dynamic is playing out in the airline industry, in which they expect Ryanair to consolidate its leading position and, to some extent, Wizz Air. The industry has seen SAS's bankruptcy in 2022 and Stephen and Chris expect companies which are cash generative and low cost to prosper, strengthening their position for when the market grows once more.

Another way companies can generate exceptional growth is through consolidation, rolling up competitors in fragmented industry. This is arguably a dynamic at play in airlines but has also been helping to drive exceptional growth in long-standing holding IMCD, a speciality chemicals distributor. In fact, the team describes its recent growth as 'unprecedented', with three quarters seeing c. 30% earnings' growth each. IMCD still only controls 5% of its industry, meaning that there is a huge potential runway for growth. The consolidation strategy is also critical to Topicus.com, a new purchase during 2020, which operates in the software field.

We imagine that Ryanair probably stands out to the average reader in the discussion above. This is a well-established industry and perhaps out of kilter with the earlier-stage, new-economy themes in many of the other positions discussed. It is an important reminder that Stephen and Chris are truly agnostic as to sector or theme and are trying to genuinely think independently, rather than being dragged along by trends. The recent purchase of EXOR is perhaps another interesting example of an older, well-established business which the BGEU team think has a strategy that can unlock exceptional growth. EXOR is a conglomerate owned by the Agnelli family, with interests in autos and consumer goods, amongst other things. Stephen and Chris like the long-term perspective often found in founder-led, or founding family-led, businesses and this is perhaps behind EXOR's c.€3bn cash pile, which places it in an excellent place to pounce on businesses after a severe sell-off in markets and while sentiment is poor. There is a similar dynamic in play at Kering, the owner of Gucci, which has c. €5bn cash to play with. The managers argue that at times of exceptional stress, the truly transformational investment decisions are made, hoping this is true for EXOR and Kering, as well as investors in BGEU.

Generally speaking, the managers have a tendency to own asset-light businesses whose value is in their intellectual property, software or human capital. The team's requirements for strong fundamentals, such as sustained earnings, as well as their bias towards capital-light business models, means their portfolio tends to demonstrate above-benchmark quality metrics. Prices and near-term earnings' expectations have been extremely volatile over the past year, making quantitative metrics volatile too, however we understand that the valuation premium over the market the trust typically trades at has shrunk, which could be potentially interesting for contrarians who expect mean-reversion.

BGEU's ability to invest in private companies opens up a larger pool of potential investments and means that the trust can, potentially, benefit from some of the fastest stages of growth. These positions are necessarily illiquid, which is easily managed in a closed-ended structure, and do create some near-term uncertainty on valuations as they are not traded daily. Stephen and Chris note this is the first test of the tech ecosystem since its explosion into life during the 2010s and they perceive optimism amongst management teams and investors. While there have been some down rounds so far, these have been relatively low. The team's view is it is time to watch and be cautious before deploying fresh capital, although the unlisted investments they do own have done well, operationally.

The financial year ending September 2022 saw higher turnover than usual in the portfolio. Much of this was due to the team taking advantage of market falls to add three companies in September which they had admired in the past but viewed as being too expensive. An example is Crispr Therapeutics, which developed gene therapy and is developing a treatment for cancer. The company has a strong cash position which will give it flexibility in the short term.

Gearing

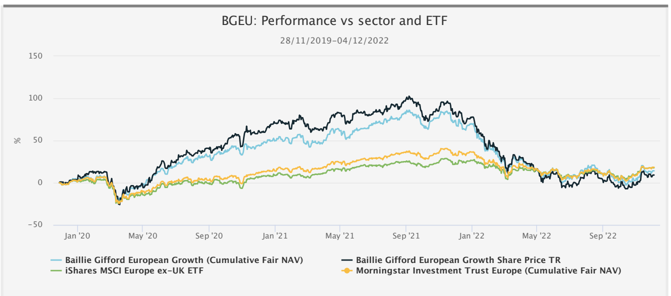
BGEU utilises structural gearing, which should enhance returns over the long run but also increases sensitivity of the NAV to falling markets. The trust has two long-term facilities which have locked in highly attractive rates. The trust pays just 1.57% on a 20-year €30m facility and 1.55% on a 15-year €30m facility. There is also an overdraft facility which facilitates short-term operations. This is worth €30m, although the board has agreed to cap its use at 15m for the time being. As at the end of September, this was all undrawn.

The board has restricted gearing to 20% of NAV, less the value of the unlisted equities. As at the end of October, unlisted equities made up 10.5% of the portfolio, so the maximum permitted gearing level was c. 17.9% of the whole portfolio. BGEU's net gearing stood at 15%, so reasonably close to the limit, especially given the volatility seen in markets in 2022. This is a result of the sharp falls in the portfolio value over the past year rather than a deliberate aim to increase gearing, which rose from 4% at the end of the 2020 financial year and 7% at the end of 2021 to the current level.

Performance

It has been a game of two halves since Baillie Gifford took over as manager of BGEU on 29 November 2019. In the first half, the new players swept all before them, racking up a considerable lead on the market. By 10/09/2021, in NAV total return-terms the trust was 60.3 points ahead of the index, or rather the iShares ETF tracking that index (see chart below). In the second half, the opposition, i.e. the market, fought back and BGEU has retraced all of the excess returns made. Under the current management team, the trust is up 14.1% in NAV total return-terms versus an average gain of 18.3% for the Morningstar Europe sector and 17.7% for the ETF. This extreme volatility in relative fortunes is due to an extreme shift in the economic and market environment. During the initial wave of the pandemic, rates were slashed and the economy was throttled by lockdowns, and growth stocks, particularly those in technology and ecommerce fields, were in favour. The rapid rebound in economic activity following the emergence of vaccines and the eventual pricing in by the market of higher expected interest rates led to a sharp reversal and preference for commodities, energy and low-duration assets.

Fig.1: Performance Since Change Of Manager

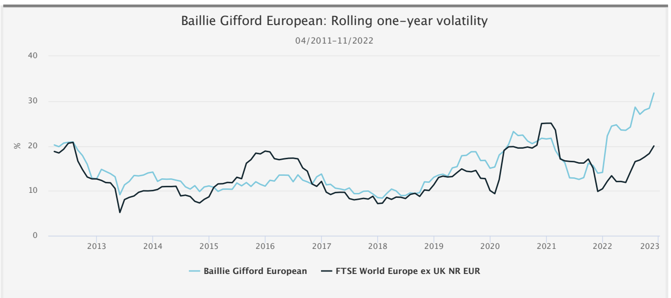


Source: Morningstar
Past performance is not a reliable indicator of future results.

It would seem prudent to us not to expect similar volatility during the rematch. Both periods were exceptional in different ways, but both saw extreme swings in expected earnings' growth and valuation multiples, the latter due largely to changing interest rate expectations. The core aim of the BGEU strategy is to identify companies which can at least double over five years, with the most important driver of this growth expected to be earnings' growth. As such, it is the outlook for long-term earnings which we think will be critical to the long-term success of the strategy. Given the long-term focus of stock selection, it is possible that some of the key holdings will remain under pressure in the short term as a recession moves across the European continent. However, if Stephen and Chris, have selected the right squad, their potential should lead to positive results over the long run. More stock-specific discussion can be found in the **Portfolio section**.

To underline how extraordinary the recent volatility has been, we show below the rolling one-year volatility of the open-ended Baillie Gifford European fund versus the FTSE World Europe ex UK Index. This is presented for the period since Stephen took over management in April 2011, since when he has managed it to the same strategy employed on BGEU. The volatility seen in the initial shock of the pandemic was notable and equivalent to that seen during the eurozone crisis. However, 2022's numbers blow even those away. We note the open-ended fund does not have any gearing.

Fig.2: Rolling One-Year Volatility



Source: Morningstar
Past performance is not a reliable indicator of future results.

Three years is a relatively short time to assess a strategy and the longer track record of the open-ended fund is interesting to consider. Notwithstanding the recent volatility, the open-ended fund has generated strong outperformance. Since Stephen took over as manager in 2011, the fund has generated outperformance of 2.27% a year, at the cost of a higher volatility, as shown in the table below.

Interestingly, we see some indication of alpha generation being cyclical in the rolling one-year numbers shown below. We note that this is alpha generated over the previous one-year period and so that alpha has not been 'paid back' when the line moves back to zero, but only declining when it is below 0. The cyclicality may indicate that this could be a good time to buy into this strategy, although there can be no guarantee past performance patterns will repeat.

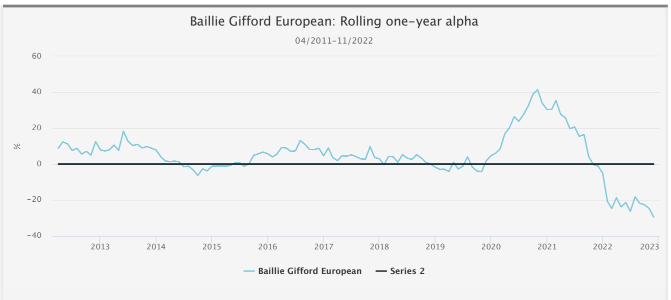
Long-Term Performance Of Open-Ended Fund

		01/04/2011 - 30/11/2022			
	Calculation Benchmark	**Return (Annualized)**	**Alpha (Annualized)**	**Sharpe Ratio (geo) (Annualized)**	**Std Dev (Annualized)**
Baillie Gifford European	FTSE World Europe ex UK NR EUR	8.96	2.66	0.32	17.16
FTSE World Europe ex UK	FTSE World Europe ex UK NR EUR	6.69	0.00	0.21	14.58

Source: Morningstar

Past performance is not a reliable indicator of future results

Fig.3: Rolling One-Year Alpha

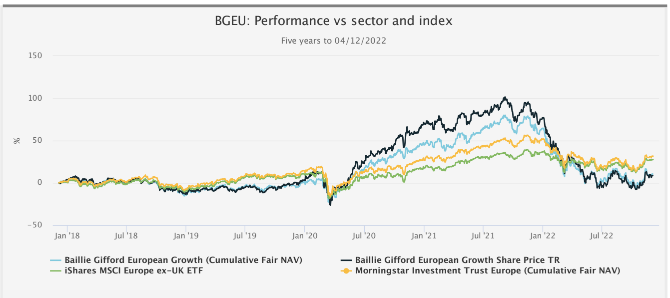


Source: Morningstar

Past performance is not a reliable indicator of future results.

For the record, we show below BGEU's five-year returns, although we note that around two years of this was generated under a different manager with a very different strategy.

Fig.4: Five-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

Dividend

Generating an income is not an objective of the board or manager and the dividend policy is to pay the minimum dividend necessary to maintain investment trust status, i.e. 85% of net income. One dividend is paid each year. In the 2022 financial year, net revenue was 0.79p per share, up from 0.44p a year earlier, and a dividend of 0.7p per share was paid, up from 0.35p. This amounts to a yield of 0.8%. Given the dividend policy and the fact the investment strategy is unlikely to lead to a high income on the portfolio, BGEU will not likely appeal to income-seeking investors.

Management

BGEU is co-managed by Stephen Paice and Chris Davies. In July 2022, Moritz Sitte left Baillie Gifford to take up a new opportunity. Stephen and Chris have spent their entire investment careers with Baillie Gifford. Stephen joined Baillie Gifford in 2005. He has also co-managed the open-ended Baillie Gifford European Fund since 2011 and is head of the European equity team. Chris Davies joined Baillie Gifford in 2012 and the strategy in 2019.

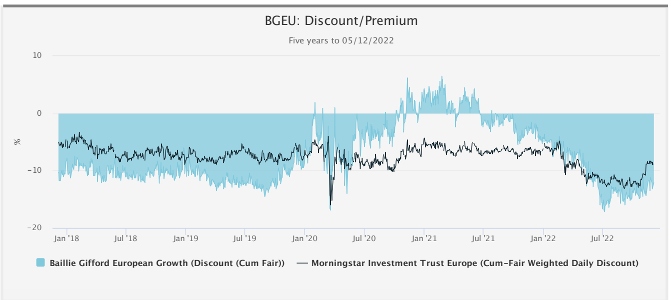
Across the European equity team at Baillie Gifford, there are an additional five equity analysts and one dedicated ESG analyst with whom Stephen and Chris work in order to generate further ideas and analysis on prospective holdings. Baillie Gifford's partnership structure, coupled with the managers' compensation scheme, based on rolling five-year outperformance of the benchmark, is designed to encourage a long-term perspective on investments.

Discount

BGEU's shares have moved onto a discount as risk aversion has risen in markets over 2022 and growth-investing has fallen out of favour. At the time of writing, the discount is 13.8% compared to an average of 9.8% for the AIC Europe sector. In our view, the discount looks attractive on a long-term view and we think the sharp rallies we have seen in the market over the course of the past year, which have seen discounts narrow in the short term, indicate there is a lot of cash on the sidelines waiting to get back in. The economic outlook remains cloudy and so we think investors need to be prepared for the possibility of widening discounts in the short term. However, it is also true that good returns can be made when buying assets that are out of favour, if investors have a sufficiently long-term investment horizon and the potential for a narrowing discount adds extra potential returns to those of the NAV.

The board has supported the shares with buybacks as the discount has widened. Over the course of the financial year, ending September 2022, c. 5.9m shares were bought back at a total cost of approximately £7,444,000 and an average discount of 7.9%. When buying back shares, the board does not have a formal discount target and is prepared to buy back shares opportunistically. The board has issued shares when the trust has traded on a premium (2.4m in the last financial year, or 1% of the pre-issue circulation) and the shares bought back are being held in treasury to be issued if, or when, the premium rating returns.

Fig.5: Discount



Source: Morningstar

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Charges

BGEU's latest ongoing charges figure (OCF), for the year ending September 2022, is 0.6%, which is lower than the AIC Europe sector's simple average of 0.86%, according to JP Cazenove. BGEU pays a management fee of 0.55% of the lower of NAV and market capitalisation. On any net assets above £500m, the management fee falls to 0.5%. Based on BGEU's current NAV of £621m, we estimate its current management fee to be 0.54% of the lower market capitalisation.

The latest KID RIY is 0.76%, which compares to an average of 1.23% for the Europe sector, according to Morningstar. However, we caution that calculation methodologies may vary between trusts.

ESG

ESG analysis is a key element of the team's process, with the alignment of interests between management and shareholders being seen as a key governance issue in the team's investment process. Additionally, the team have been increasing their focus on the net zero commitments and plans of prospective and existing investments in recent years as they believe that having a credible and workable pathway to this end will become a competitive advantage as governments commit to this agenda.

The team believe alignment is important for two reasons. On the one hand, the team will assess the alignment of a company's management with their shareholders to ensure that the actions of the managers are conducive to generating long-term value for shareholders. On the other hand, the team believe that each company needs to earn the social prerogative to operate, which requires the companies to positively contribute to society. As a result, Baillie Gifford aims to use its influence as an owner to promote sustainable long-term practices, with a focus on general principles as opposed to set rules. We note that the team ensure that BGEU remains in compliance with the UN's Global Compact principles and they also operate a sector-screen which excludes thermal coal, tobacco, tar sands and controversial weapons from the portfolio.

BGEU has received four out of five globes on Morningstar's sustainability rating when compared to its wider European equity peer group, which includes both open and closed-ended funds. We note that, as a region, Europe ranks strongly from an ESG perspective, with strategies in the region often having individually strong ESG metrics when compared to other regions. This is the result of European policymakers and management teams having long been aware of the need to follow sustainable business practices, thus forerunning other regions in their adoption of ESG practices. We also note that BGEU has received Morningstar's 'low carbon' designation, meaning it has met the rating agency's requirements for a sufficiently minimised carbon risk, plus it also has a lower carbon risk than its benchmark. In our view, BGEU is aligned with the aims of many ESG-conscious investors, even if it is not a sustainability strategy.

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