Keystone Positive Change

KPC is a stand-out option for investors seeking to have an impact with their money...

Update
24 May 2023

Overview

Keystone Positive Change (KPC) has dual objectives of having a positive impact on society and generating high long-term investment returns. The investment strategy is a highly active, high-conviction approach, which sees the managers, Kate Fox and Lee Qian, identify companies with exceptional growth potential. Each company must also have a positive impact on society, which is analysed and interrogated as seriously as the investment opportunity.

The past 18 months has seen the fastest US rate hiking cycle in modern history, and this has led to a significant sell-off in many high-growth companies. Kate and Lee report that this is leading to some exciting opportunities opening up, with companies with exceptional growth potential trading at undemanding valuations. They argue that the discipline required by a weaker economic environment and higher funding costs should lead to the best companies being able to take market share and strengthen their competitive positions, and the managers expect the next few years to provide excellent opportunities for active stock-pickers.

An interesting distinguishing feature from many global equity portfolios is the ability to invest in unlisted companies, although these make up only 5% of the portfolio at the current time. This allows the managers to gain exposure to some exciting businesses when their fastest growth is still ahead of them, and opens up industries which are little represented in public markets (see **Portfolio**).

As growth strategies fell out of favour last year, KPC's shares fell onto a wide **Discount**, which is currently 16.2%. Notably, the discount has actually widened slightly this year, even though the NAV has outperformed global indices, with growth strategies outperforming as a peak in interest rates seems to have neared.

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Analyst's View

Many investors are concerned about the impact of their investments and want their money to contribute to achieving a better society. In our view, KPC has peerless credentials in this regard. Impact is written into every investment decision and given equal weight with investment outcomes. From an impact or ESG perspective, KPC would likely improve any portfolio.

From an investment perspective, we think it looks extremely interesting at this point in time. Buying assets when they are out of favour can lead to excellent returns, and growth stocks have seen a significant sell-off over the past 18 months which could represent an opportunity. In the case of KPC, the wide share price discount to NAV offers an extra potential source of returns.

Growth stocks could come back into favour, which would help KPC. However, the managers make a good case that this is not the only route to outperformance. Their strategy centres on identifying companies providing solutions to critical social and environmental problems, and critically those companies which are likely to prove successful in generating long-term profits from these solutions. In an environment of higher debt costs and a weak economy, the strongest companies stand to gain market share and consolidate their leading positions. As a result, if the team have picked the right stocks, this environment could provide the potential for alpha generation.

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

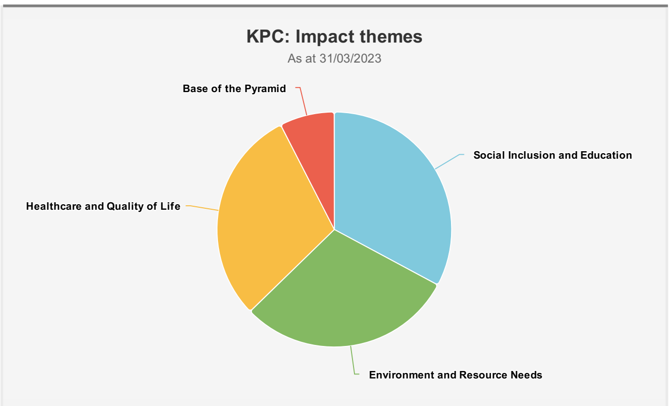
BEAR
Volatility brings underperformance potential
Exposure to growth factor and rising interest rates could lead to periods of underperformance
All impact or ESG propositions bring with them some subjectivity and selectiveness in which goals to pursue

Portfolio

Keystone Positive Change (KPC) aims to deliver long-term capital growth by investing in companies which are having a positive impact on society and helping to solve its key problems. Providing solutions to critical social issues should mean a company has excellent long-term growth prospects, provided that the right company with the right solution has been selected.

The portfolio is managed by Kate Fox and Lee Qian of the Positive Change team. As the name suggests, this team is focussed on delivering precisely this sort of strategy, being armed with impact analysts, resources and strategies designed to analyse, quantify and track which companies are providing likely solutions to key social problems. For KPC, these are: Social Inclusion and Education, Environment and Resource Needs, Healthcare and Quality of Life and Base of the Pyramid. Unlike most others, if not all, ESG or sustainable strategies, the impact thesis is as important as the investment thesis when it comes to a stock's inclusion in the portfolio. In other words, the two objectives are not weighed against one another, but the company must justify its inclusion on each ground, and to that end, there must be at least one team member who champions the stock from an impact angle, as well as one from an investment angle. Position sizing depends on the relative conviction in a stock on both grounds.

Fig.1: Impact Themes



Source: Baillie Gifford

This does not mean deprioritising growth, but Kate and Lee argue this way of thinking actually opens up some of the best long-term growth opportunities. Thinking about what the key social problems are and how they are likely to be solved is a fruitful angle for approaching stock selection. The managers have a global opportunity set and can invest into unlisted companies too (although the current allocation is low at just 5% of the portfolio). The impact objective often leads to the team investing in companies with products and business models at an early stage of their development, with all their growth ahead of them. This brings greater opportunity, as well as greater risk. Around 15% of the portfolio is in companies which have not yet earned a profit, meaning that they are potentially reliant on further equity or debt funding to continue to operate. Kate and Lee note that, generally, these companies are at breakeven on a cash basis, i.e. profits are negative thanks to capital investment, and have strong balance sheets with good cash positions. However, this element of the portfolio is vulnerable to rising funding costs such as those we have seen over the past 18 months. Meanwhile, the price investors are willing to pay for pre-profitable businesses has also come into question, with higher interest rates meaning that the return on safer assets has risen.

Most of the portfolio is in profitable, relatively mature businesses. Tesla is a good example of such a company. The team invested in it via the open-ended Baillie Gifford Positive Change fund when the latter launched in January 2017. It took a number of years for the company to turn a profit, but it has now recorded 12 consecutive quarters of positive net income, on a steeply increasing trend. The company remains in the portfolio, with Kate and Lee pointing to its relentless focus on reducing costs and improving manufacturing efficiency as a source of future success. The company is aiming to produce 2,000,000 cars this year, having produced just 10,000 only a decade ago, a remarkable growth rate which we think is indicative of the sort of result achievable when an innovative company is pushing on a door opened by a societal need – in this case, that of reducing emissions.

Tesla was very much unproven in 2017, during its pre-profit stage. KPC's portfolio contains numerous companies at that early stage now, which Kate and Lee hope will repeat its success. In the environmental space, one interesting early-stage company is Climeworks. This is an unlisted company which has developed a technology to remove carbon from the atmosphere and store it underground. The company's strategic goal is to remove 1% of the earth's annual carbon emissions from the atmosphere each year. Regarding the goals of social inclusion, a good example would be Remitly. This is a listed company, but still pre-profit, and it provides a more sophisticated alternative to Western Union, allowing cheap and quick cross-border money transfers. Remitly's shares have sold off over the last 18 months, as unprofitable stocks have come under pressure. However, Lee and Kate point out that revenue was up 40% over the year. In their eyes, this is an exciting growth opportunity and, having refrained from investing at IPO as the shares were too expensive, they have taken a position at these lower levels.

Another stock they have bought on weakness is Autodesk. Autodesk supplies the popular design software AutoCAD and it is providing new software products for the construction business, one of the least digitalised industries. Like Remitly, it has been admired for some time, but only after the growth stock sell-off in 2021 and

2022 have the managers been comfortable with the valuation. In general, they report the sell-off has thrown up many interesting opportunities and the managers believe that, in many cases, the baby has been thrown out with the bathwater. Kate and Lee look to pick the winners, i.e. those companies with the best solutions and the best competitive advantages. In their view, the more troubled funding and economic environment should lead to the winners forging ahead, and the next few years should be good for stock-pickers. They report seeing a number of companies cutting costs and laying off workers as unrealistic business models run aground.

Kate and Lee have been building a pipeline of possible new buys and argue that there may be more interesting opportunities in the unlisted space soon. They think valuations will show some pressure over the coming months, as they catch up with events in the public market, and this could provide opportunities to get the private allocation up to the c. 10% they intend to hit over the medium term, with an anticipated 30% maximum in the long run.

The portfolio is global in scope, with around 45% in North America, 24% in Europe ex UK and 25% in emerging markets. The emerging markets exposure has increased with the recent purchase of HDFC, a leading private-sector financial services provider in India. HDFC contributes to the 'Social Inclusion and Education' theme of expanding opportunity amongst the world's poorest. Whatever the geographical listing though, typically, portfolio businesses are operating in global markets, or at least are not constrained to their home economy. Similarly, there are some biases in sectors and industries – towards semiconductors, ecommerce and biotechnology – but, like the geographical allocation, this is a derivative of stock-selection. The top ten positions below show all these themes.

Top Ten Holdings

HOLDING	% OF TOTAL ASSETS
MercadoLibre	7.5
ASML	6.4
Shopify	4.8
Moderna	4.5
Dexcom	4.4
Bank Rakyat Indonesia	4.2
TSMC	3.9
Deere & Co	3.9
Alnylam Pharmaceuticals	3.8
Xylem	3.6
TOTAL	**46.9**

Source: Baillie Gifford, as at 30/04/2023

Shopify remains a large position and, indeed, Kate and Lee have added to it in recent months. It has sold off sharply to pre-pandemic levels, which the managers believe has led to an exciting opportunity. Ecommerce has grown substantially and looks set to grow further. Kate and Lee believe, from talking to customers, that Shopify is the best facilitator of online sales, with a strong competitive position. Similarly, they believe the drivers behind sales for semiconductor manufacturers, like TSMC and ASML, have grown in strength, with AI the latest use demanding more powerful computing power.

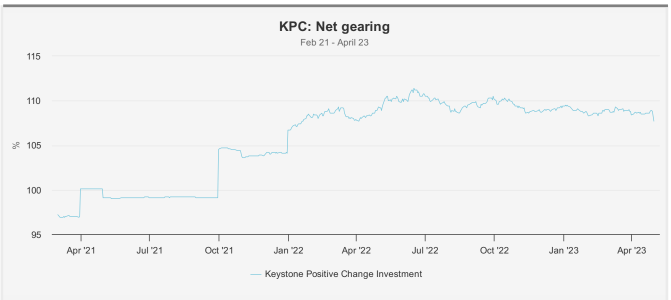
Turnover is expected to be low over the long term and even in the volatility of the past 18 months has remained muted, reflecting the fact the managers believe the case for their companies in the long run has largely strengthened, whatever the share prices have done. According to Morningstar data, turnover was just 13% over 2022. This is not to say the managers have held on to every stock; those that have been sold are those for which the managers believe the thesis no longer holds and do not see the potential for a long-term turnaround, for example Beyond Meat.

It is worth noting that KPC is not a blue-sky product: the team are looking for companies where they see a credible path to long-term sustainable growth, not just good ideas. To that end, having an understanding of early-stage unlisted companies – boosted by the resources Baillie Gifford applies there, across its funds – is helpful in steering the team away from impractical business models. For example, the team have steered clear of listed companies focussed on the hydrogen space. They have identified electrolysers as a key component in the process and being ripe for disruption. Electrolysers are expensive and making them cheaper could prove critical to making hydrogen viable. However, the team have identified companies in the private space which are developing much more efficient electrolysers, so Kate and Lee remain wary of the listed companies in this space.

Gearing

KPC's board expects the trust to maintain a modest level of structural gearing over the long run, in order to enhance shareholder returns. The trust has a multi-currency revolving credit facility worth £25m, which would amount to c. 16% of net assets at the time of writing, if fully drawn down. The managers drew down funds from this on two occasions during 2022, as markets sold off, which was a detractor to performance in a down year for the market, and net gearing stood at 8.4% at the end of March (according to Morningstar).

Fig.2: Net Gearing

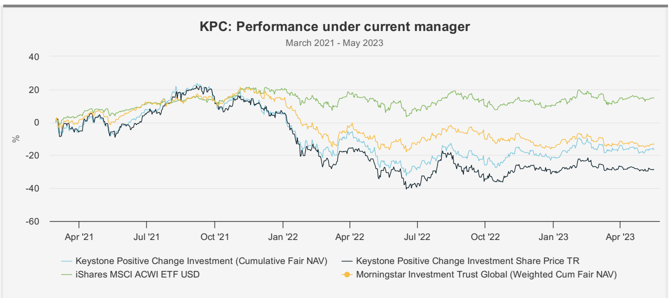


Source: Morningstar

Performance

Kate and Lee took over KPC in February 2021. Later that year, there was a significant sell-off of growth stocks, as the market began to expect higher interest rates for longer. This was compounded by the inflationary effect of Russia's invasion of Ukraine in February 2022, which led to a sharp rise in energy and food prices. Growth strategies like KPC have, therefore, underperformed over this period. As the chart below shows, it is not just KPC, but the global sector as a whole which has underperformed, thanks to the heavy growth bias of the latter. KPC's NAV total return has been -16.8%, as at 16/05/2023, compared to the sector's average NAV total return of -13.5% versus a total return for the ETF of 14.7%. However, as can be seen in the chart, performance has picked up in recent months.

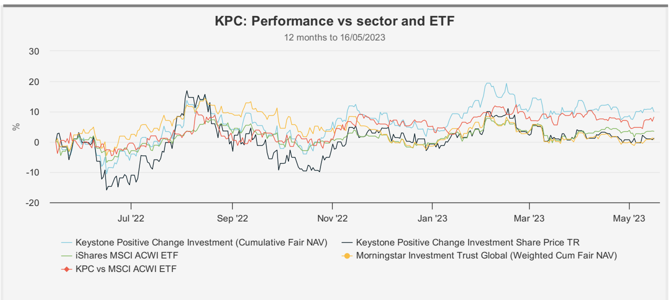
Fig.3: Performance Under New Mandate



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

The chart below shows one-year performance, with the cumulative relative performance of KPC versus the iShares ETF investing in the MSCI ACWI marked in red. This shows that KPC has outperformed since October and overall, generated 9.3 percentage points of outperformance for the year at the time of writing. We would interpret this as the market beginning to price in an end to the hiking cycle in the US, which has implications for the pricing of all financial assets. In our view, if we have indeed seen the peak, or if we are near, then there is a strong chance that growth strategies such as KPC could continue to outperform. In that light, the **Discount** looks particularly interesting.

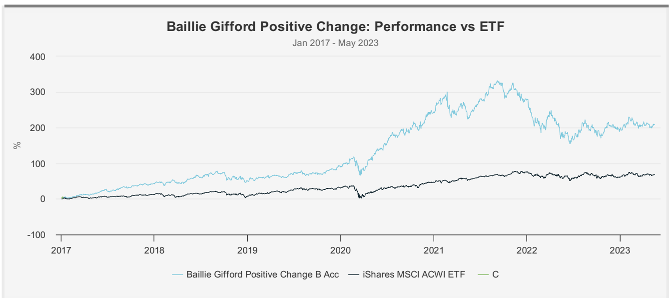
Fig.4: One-Year Performance



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

Over the long run, the positive change strategy, which KPC closely tracks, has generated huge excess returns for investors. Since its launch in January 2017, the open-ended fund has made 209.7% to 16/05/2023, compared to 67.6% for the iShares MSCI ACWI ETF. As the chart below shows, the best period in absolute and relative terms came during 2020, after the initial impact of the pandemic. There were a number of conducive trends: lockdowns led to a focus on new technology (TSMC was a holding to benefit from increasing demand for semiconductors), diagnostic and therapeutic healthcare companies benefitted (the positive change team held Moderna and Illumina, which were amongst their biggest contributors) and 'Build Back Better' plans led to an increased focus on green technology and EVs (Tesla was the top contributor to performance, from launch to December 2021). While the magnitude of outperformance may not be the same in future when growth is in favour, we do think this shows the strong potential in a highly active strategy such as KPC's.

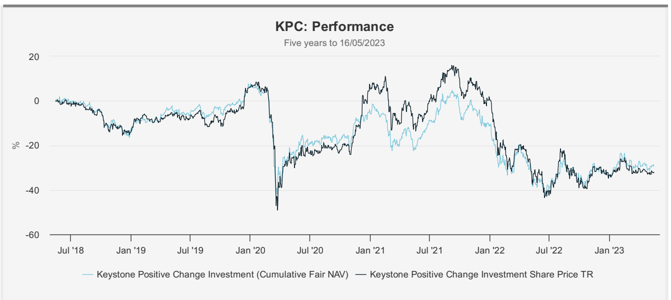
Fig.5: Performance Of Positive Change Fund



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

For the record, over the past five years an investment in KPC (Keystone Investment Trust until February 2021) has generated -29.5% in NAV total return terms, although much of this period was under a previous manager with a very different strategy.

Fig.6: 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. One dividend is paid each year and for the 2022 financial year, 0.4p per share was paid. This equates to a historical yield of 0.2%, as at the time of writing. We do not believe that KPC is a realistic option for income-seekers.

Management

KPC's Investment Managers are Kate Fox and Lee Qian, who are supported by the senior impact analysts of the Baillie Gifford Positive Change team.

The team are supported further by Thaiha Nguyen, an investment manager and decision-maker on the Positive Change Strategy, as well as six full-time analysts, comprising three investment analysts and three impact analysts. In addition, there are three portfolio advisors, with further support from Baillie Gifford's Emerging Markets, Health Innovation and International Equities teams. As per Baillie Gifford's company policy, 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.

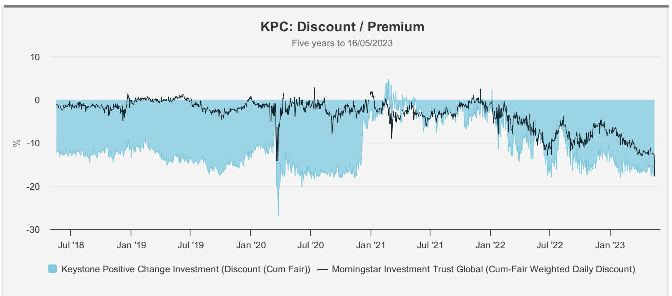
Kate joined Baillie Gifford 20 years ago, after graduating with an MA in Economics and Maths from the University of Edinburgh. She is a partner at the firm. Lee joined Baillie Gifford a decade ago and is an investment manager, holding a BA (Hons) in Economics and Management from the University of Oxford. Kate and Lee are both CFA charterholders and co-manage the open-ended version of KPC Baillie Gifford Positive Change. In total, $9.4bn, or c. £7.3bn, is managed under the Positive Change strategy across a global client base, as at 31/03/2023.

Discount

KPC's shares have drifted onto a wide discount to NAV as growth equities have fallen out of favour in light of a historically rapid interest rate-hiking cycle. In fact, the 16.2% discount, as at the time of writing, is almost the widest in the AIC Global sector. We think this is largely explained by stylistic factors: when Baillie Gifford took over the trust in January 2021, while growth was outperforming, it briefly traded at a premium. With that in mind, we think that the wide discount represents an opportunity for long-term investors. Predicting the future turns of the market is nigh on impossible, but we would expect growth to come back into favour at some point, and it could even be soon if central banks are forced to cut rates sooner rather than later. (We note pricing in some financial markets implies rate cuts in the USA before the end of 2023.) In the meantime, the hiking cycle appears to be near or at its peak, and so further pressure on valuations is likely to be limited in our view.

In 2023, KPC has performed well as growth has come back into favour, perhaps as market participants anticipate the end of the hiking cycle. Yet KPC's discount has not narrowed. In our view this represents an attractive opportunity. 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 5% of the portfolio, and we don't think this warrants a wider discount.

Fig.7: Discount



Source: Morningstar

The board has the ability to buy back shares (or issue new shares at a premium) but has stated that it does not believe repurchases will narrow the discount in periods in which market sentiment is universally negative, while it will reduce liquidity in the shares and increase costs. As such, it has not done so since Baillie Gifford took over management.

Charges

KPCs latest ongoing charges figure (OCF) is 0.9%. The average for the AIC Global sector is 0.48%. KPC's OCF includes a tiered annual management fee structure, with 0.70% charged on market capitalisation up to £100m, 0.65% between £100m and £250m and 0.55% on the remaining balance. The market capitalisation is c. £130m at the time of writing, which means the management fee is just below 0.7% 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

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, environment, healthcare and 'base of the pyramid'. 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 activities the companies are making towards resolving the world's challenges, and is read 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. We think KPC really is unique in terms of the commitment to impact being at the heart of every decision and the commitment to transparency and accountability. All fund managers will claim to integrate ESG issues, but KPC is very clear about the thesis for each stock and how this thesis might be achieved.

That said, here is a detailed look at how the impact theses are formed. An impact assessment is carried out on each stock under consideration by a dedicated impact analyst, during which phase the analyst looks at 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.

Considerations under the 'Intent' factor assess the forward-looking strategy and look to ensure that it is aligned with the stated goals and positive impact that the team see and that the strategy can support the desired positive outcome. Furthermore, the management will evaluate the level to which actions match verbalised commitments and the degree to which such processes can impact the wider industry practices.

A key differentiator as to whether companies will or will not make it into the portfolio is based on the product impact factor, with the assessment considering the relationship that exists between a product 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. No minimum impact score is required for an investment to be made, with Moderna invested in by the open-ended version of KPC on launch when it had a low product impact score. The product had not yet been developed: Kate and Lee considered the holding's future impact potential.

The final factor considered by an impact analyst is Business Practices, which comprises of a company's environmental stance, treatment of key stakeholders and personal approach to governance. The analysis looks to ensure good practice and clarity, with the team looking to identify industry leaders within this regard.

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