Ranfurly Strategic Limited and Baillie Gifford – Review of the Funds and Markets

Late last week the directors of Ranfurly Strategic Limited (Ranfurly) held a Zoom call with Kevin Mitchell (Director - Intermediary Clients) and Philip Scott (Investment Specialist) from Baillie Gifford, to discuss the recent performance of the Baillie Gifford fund invested by the Ranfurly Superannuation Scheme and the trends and drivers of the current financial market volatility. The call was attended by the Ranfurly team, Scheme members and advisors and we would like to thank all of you who took the opportunity to join. Our previous communications advised that this session would be recorded and made available for viewing through our website. However, unfortunately, due to UK privacy requirements, Baillie Gifford were not permitted to record the call without prior written consent of all those who joined the session. We were only advised of this after the fact. We apologise for any inconvenience this may cause and in lieu of a recording we asked Kevin Mitchell to prepare a written summary of the key observations from the live session. Kevin's summary is below.

Ranfurly's key take aways from the call were:

- It is understandable that Ranfurly and the scheme members are concerned with recent fund performance and Baillie Gifford are equally uncomfortable.
- Baillie Gifford have been actively reviewing the holdings in their funds from the bottom up to ensure the financials and investment fundamentals remain sound and the companies invested in remain focused on delivering the investment proposition that first led to Baillie Gifford's selection. In fact they said that many of the companies are more profitable now than at the time of initial investment, which means that the fundamentals remain sound.
- This review process, which is part of the usual investment process, has led to some minor portfolio changes (less than 15% turnover), however in general the portfolio companies have demonstrated good financial strength, with improved profitability and a focus on investing for the future.
- Baillie Gifford continue to hold true to the belief that has served them well for over 100 years, that identifying structural changes and investing for the long term (5 years plus), will generate returns over the longer term.
- As part of the investment process Baillie Gifford identify structural changes e.g. the innovations in healthcare technology and the transition from fossil fuels to renewable energy to select companies who show, over the long term, that they will increase in value by taking advantage of these changes. Baillie Gifford regularly review these trends/changes to ensure that they hold true, and the value proposition remains. It is an important part of their investment process and Baillie Gifford have increased the frequency of these reviews given the current market volatility. Despite the market sentiments they see nothing that has led them to believe that the structural changes will reverse, and the invested companies will benefit in the future.
- While not making wholesale changes to the investment holdings of their funds, Baillie Gifford have been busy reviewing all aspects of their investment holdings and their continued suitability to generate future growth in share price.

We apologise that we were unable to provide a recording of the 'Meet the Managers' call to members who could not attend the live session. If you have any questions relating to this article or the current market conditions, please let your advisor know and we will be happy to raise them with Baillie Gifford.

Additionally, if there is enough demand for a further session with Baillie Gifford, we will make arrangements for this at a future date. However, in the meantime you may find a previous Baillie Gifford webinar which was produced in early February 2022 useful in providing further information, by following this link:

RANFURLY
STRATEGIC

https://www.ranfurlysuperannuation.com/blog/2022/5/20/baillie-gifford-managed-fund-2021-and-beyond-webinar

Please note, neither Ranfurly nor Baillie Gifford are licensed to provide financial advice to scheme members. The information provided in this article is general in nature and should not be considered financial advice. Questions specific to your investment portfolio should be raised with your financial advisor.

Kind Regards,

Chris Wells
Director

Baillie Gifford – Kevin Mitchell – 'Meet the Managers' Additional Comments.

"It was great to speak with you yesterday and I hope it was a good experience for all attendees.

On the back of our later conversation, I have pulled together some additional comments which I hope you can use for your clients or add to your website.

Baillie Gifford was founded in 1908, to provide capital for Malaysian rubber plantations that were producing a key component to the fledgling motor car industry. Over our life span, we have experienced world wars, market crashes, terrorist atrocities, and most recently a global lockdown following the COVID 19 outbreak.

Each of the above environments are extremely uncomfortable to live through and they often feel unique, but our experience, which is adequately lengthy, has taught us to focus on our core belief that company share prices follow fundamental progress over long periods (five years plus). Over short periods on the other-hand, sentiment tends to prevail, and trying to second guess emotion and subsequent action is simply not a competency that we have. In fact, I would go as far as saying very few have the ability to foresee and manage market sentiment without incurring material trading costs and are effectively gambling with someone else's money. A flaw of the asset management industry is the sheer number of individuals who will try to convince you that they are smarter than everyone else. Although I am surrounded by many intelligent individuals, our acknowledgement that we are not smarter, sadly for the industry, is becoming one of our unique selling points.

Given our context of experience, what we have all seen in the last 24 months has been extreme and it has impacted our portfolios in both directions. The initial lockdown caused a material shock and markets declined before "lockdown" stocks took off, providing one of the most aggressive bull markets since the financial crisis and now retrenched back to pre-2020 levels. Did we foresee this? No.

It's a Revolution
We have long held the belief that there are some structural changes taking place, as a result of advancements in technology (driven by Moore's Law), which are affecting the broad economy and made up a number of the best performing companies in 2020. These changes will play out over decades rather than months and will be profound. More akin to the industrial revolution than simply a market advancement these structural changes will persist regardless of who is at war with whom, what the FED do, or indeed, where in the world you will be working from at any moment in time. We have seen industries change as a result, new industries develop, and incumbent businesses all but disappear if they do not act or react. During any revolution, there are some early adopters and in this case it was in retail, via Amazon, and advertising, via Facebook and Google, before change takes place in the broader economy. We are enthused as this revolution is broadening out rapidly and opportunities are vast.

The hardest phase of a revolution is that of adoption by the masses and thus taking the revolution to the next level. Making nascent concepts, technologies, business models mainstream is difficult, but 2020 provided the backdrop for mass adoption of technology and huge leaps were made, and our portfolios were incidentally well placed given our excitement for the underlying structural change that we were seeing.

Sentiment Shift
As the market re-adjusted in 2021, and continues through to today, sentiment has changed dramatically. Fear has replaced enthusiasm, and the share prices of many of our holdings have been cut dramatically causing a period of negative performance for our portfolios (some worse than others

depending on the growth style). As we have discussed previously, the markets fear is not misplaced, if your time horizon is short. The horrid scenario playing out in the Ukraine, Covid continuing to cause lockdowns, and inflation, and subsequent central bank reaction with interest rates, have caused growth stocks to de-rate materially. Unfortunately, when the market acts through fear, it reduces its ability to see ahead, and intently focusses on near-term issues further entrenching negative thoughts.

We have seen the effects of market fear and short termism in our portfolio holdings. Although many are fundamentally stronger now than they were 2 years ago, share prices do not reflect this, and a dislocation between company fundamentals, potential future innovation, and its current value has developed. Another key determinant for the market, at the moment, is a company's profitability. With sentiment at such negative levels, companies that are choosing to invest for the future, whether entrenching competitive moats or investing in R&D, and thus foregoing short-term profitability, the market is taking an extremely dim view.

Valuation – Roughly Right Rather Than Accurately Wrong

One of the key points raised in our call yesterday morning was regarding inflation and its impact on the valuations. I thought it would be best to reiterate our thoughts on valuation. Many market participants try to accurately assign a valuation to their investment case, which cannot possibly include all the potential outcomes a company may face. This often results in underestimating potential, not purchasing at all because it is too expensive, or selling far too early and not benefitting from the asymmetry of equity markets.

We seek to understand what the valuation of a company might look like in 10 years' time and why the market might not realize this. We think deeply about valuation, but in an unconventional manner. We do not wish to deny that there are many investors for whom deriving a fair value and target buy price works well. But it doesn't work for us.

Instead of seeking static precision, we focus on thinking about how a business could look over the course of our investment horizon of five to 10 years and beyond. In our view, valuation touches on every part of our research framework from top-line growth to margins, competitive advantage periods and management's culture and capital allocation – this will, of course, also entail a consideration of inflation if relevant to the investment case. These aspects of a company intermingle to answer the question of what the valuation might look like in five or ten years' time and why the market might not realise this. Rather than coming up with single point estimates, we try to imagine different scenarios to align our process with the reality that more things could happen than will happen.

Each of our investment teams will then benchmark a potential return profile against their own growth hurdles. For instance, our US equity team, will consider whether, from today's starting point, the potential return meets their aim of generating 2.5x over the next five years, whereas our European team considers a hurdle rate of 2x over the same period.

This approach doesn't provide us with a neat, single number at which to buy or sell a holding. But that's not the point. We think the purpose of our valuation work is two-fold. It forces us to quantify our qualitative assessment of the business – valuation work is a great tool to help us focus our attention and energy on identifying and thinking critically about the key assumptions of the investment case. In addition, it can give us a rough idea about the odds we are facing. We don't pretend to know the fair value of a business; all we hope is to get to a fairly accurate assessment of whether the odds are stacked in a company's favour or not. It is also an approach which could lead us to pay seemingly high near-term multiples for a holding where we are confident that the longer-term growth rate is sufficiently high.

As a specific example, our US equities team conducted some upside analysis on Moderna in December 2021. We believe the company will see an annuity-like vaccine revenue stream of $20bn p.a. from pan-respiratory and CMV vaccines alone, at 60% net margin. Based on this, we need only a 15x PE on this profit stream to deliver a 2.5x return over 5 years from the current market cap. There is also outlier potential in the >30 development assets. Vaccines alone could double this revenue stream. Other opportunities are early but offer additional potential upside from here. Since the end of December, the share price of Moderna has been weak, driven in large part by any news flow surrounding Covid-19. The upside case is therefore arguably easier to make from here on the basis that the investment case remains in-tact.

<u>Action In Investment Is Not All About Trading</u>

Being long-term sounds easy, and yet, during my 16 years at Baillie Gifford, I see less and less companies, asset managers, and other individual portfolio managers being able to actually act long-term. Poor performance is normally a catalyst to change your beliefs, chase short-term returns to massage personal ego, or to reduce the uncomfortable emotion of standing on the outside of the square. In fact, at Baillie Gifford, not only are we trained to think over 5 year horizons but we are also trained in being comfortable feeling uncomfortable.

When share prices move to the extremes (in either direction) the instant reaction is to do something about it. Whether that be sell, buy, add, or reduce. One option that is seldomly offered is to do nothing (on the face of it). Action has a consequence and often has a price. Acting perhaps provides a short-term comfort that a decision has been made and thus equates to an output, but in the long-term action is rarely additive if nothing fundamental has changed. We are no different to everyone out there when it comes to poor performance, and it is uncomfortable to see red figures on the Bloomberg screens every morning, but what you do next will define long-term outcomes.

Whether it is the Baillie Gifford Managed, Long-Term Global Growth, or Sterling Aggregate Bond Fund, there is always a lot of action, but that does not necessarily result in increased turnover within our portfolios. As bottom-up company / bond analysts, we revisit our investment cases, to ensure there is no deterioration in a company's long-term outlook. If I could provide a holistic "one liner" it would be that we are actively trying to find out if we are wrong. From a Managed Fund perspective, our Portfolio Construction Group, which meets quarterly, have met nearly monthly to see if any changes are necessary, and they have tweaked but nothing substantial.

<u>Have We Lost Our Minds?</u>

In short, no. I am pleased to say, when we analyse our companies, speak to our management teams, interview academics, without arrogance, we are more enthused in our beliefs and opportunities than less. Why is this? Do we believe the structural changes, driven by Moore's Law in technology, are going to reverse? Is the digitisation of the economy going to stop? Will the masses return to shopping on the high street, rather than continuing to move online? Will healthcare companies go back to generalised, slow medication that is hit or miss and take decades to come to market? Will the electrification of transport reverse back towards combustion engines? Will the renewable energy transition revert to fossil fuels? The answer to all these questions is, no.

We are cognisant that a revolution of this scale is not going to be a linear progression, and over short periods, any one of these trends could feel like they are going in reverse. Our role is to invest in the best growth companies, over the long-term and be supportive of them during difficult times. Although our performance in the short term hasn't been where we would like, nor do we know exactly when this complicated environment will end, we remain committed to our process, our style, and importantly our time horizon."