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investing ON THE go

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. From US political uncertainty to artificial intelligence and personalised cancer treatments, the forces shaping American businesses are evolving rapidly. Yet today's guest, tells us why investors may need to get comfortable being uncomfortable.

I'm Staci West and today I've been joined by Ben James, director on the US Growth Strategy at Baillie Gifford, which manages our Elite Rated Baillie Gifford American fund. Ben, thank you for joining me.

Ben James (BJ): Hi Staci, good to be here.

[INTERVIEW]

SW: So we do have to start with US midterms and this is not a political podcast by any means, but we do need to touch on it just because we have seen a pretty extraordinary result with the Democrats taking both the House and Senate. So from an investment perspective, what do you think that these results are actually going to change in terms of American businesses and markets from your point of view?

BJ: Yeah. So it was quite an interesting period of time after that result. Obviously, we're bottom-up stock pickers. We're not political analysts that try to invest on those sort of cycles. But if you look at the market reaction, I think in the days that followed, it's clear that on the day after there was a rally. On the Wednesday, there was a rally. And then on the Thursday, the NASDAQ fell more than 5.5%. And there's a general belief from what I've read that this was because people thought that with the Democrats owning or controlling both houses, they will be able to potentially slow the progress of AI in terms of data centre build-outs and so on. Now a lot of the pushback against data centres and the rise in electricity costs and so on was already happening before the midterms.

So my personal interpretation is that the victory for the Democrats meant that it was more likely that they could slow the progress of infrastructure build-out in the AI sort of CapEx picture that we're seeing.

Now, whatever happens, I think that AI is going to be in demand. I think that it could slow down some of the data centre build-outs, but that actually could play into the hands of some companies already. So those companies that have access to data centres with electricity, actually they'll be in a stronger position than they were beforehand. Those companies that are reliant on the actual infrastructure build-out will be weaker. Whatever happens though, we think that AI is going to be transformational in the economy, and everything that's already out there, the technology that's already out there, still has years' worth of runway ahead of it to be deployed into the real world. And so there's some significant investment opportunities still because of that. So we're not overly worried. I think commentators sometimes mistake a gridlocked, you know, House that's Democrats and White House that's Republican as good and stable, but actually, I think there'll still be lots of uncertainty to come.

So it's all about which companies can ride it out.

SW: And you mentioned data centres. There's lots of concerns about this AI regulation, what it's going to be like, data centres expanding, which you've touched on. But do you think that maybe, and I think you possibly are alluding to this, that people are just overestimating how much influence politics will have in this space. It is there. It is a transformational technology. It is something that is going to be around for a lot longer, and actually politics, who's in Congress, who's in the White House has very little influence over where technology and these businesses are going to be for their long-term growth potential?

BJ: Yeah, so it depends on your time horizon. On a one-, two-, three-, four-year basis, yeah, it does matter who's in the White House and who's controlling the House and the Senate, because they could slow things down or speed things up. And that does matter. And that does move share prices. So we shouldn't dismiss how important it is in the short term. And we saw that in those few days following the midterms, the volatility in markets. But yes, historically, on a 10- to 20-year view, it doesn't really matter. What matters is the deployment and diffusion of just a new technology through the economy. I do think that the political backdrop affects the pace of change. And, you know, it's like if the economic backdrop is weakening, so inflation rises and interest rates rise, then that will also temper, that will slow some of the economic activity. It's just going to. But because the demand, we think, the underlying demand for this new technology and the usefulness of it, its utility, is so powerful, it could actually accelerate it in some areas more than others. People might use a harder political backdrop or a more challenging economic backdrop to use this technology to do more with less and so on. So, trying to say that this is a sort of a killer or an accelerator for a technology is pretty futile. I've actually written a piece about it called "Fast Markets, Slow Forces", and it's an attempt to analyse the midterms through a 10-year view.

And if you think about which companies are becoming infrastructure, so whether that's Nvidia, and we can talk about that, but, you know, the companies that are essentially the new rail tracks for this new technology, and then the companies building on top of those rail tracks, those are the things that we're really excited about. And those who are reliant on lots of spending perhaps might be weaker.

SW: And given how much is being invested into that AI infrastructure and how much kind of just CapEx spend we're seeing on AI, do you think that we are kind of reaching a point where it is less about just the tech progress and more of "we've got to see financial returns from this"?

BJ: Yeah, so I split it into two. I think we're already seeing the positive effects of AI in the numbers of some of the companies using this. So if you look at a company like Snowflake, which, you know, is a data company that sits above an enterprise's store of data and helps you analyse it and bring new insights, when the agentic AI revolution, as it were, you know, in the beginning of the year, hit the headlines, a lot of software names sold off because the argument was AI is gonna do everything and software as a service companies are cooked, in layperson's terms. Actually, the operational metrics for Snowflake accelerated and it improved. It accelerated for three quarters in a row and it's growing 37%. Its revenue's at 37% year over year in the most recent quarter, and AI is deliberately driving that.

It's using its generative AI tools to help lay users get better access and better insights to their data and play with it, and we're doing that in-house here at Baillie Gifford, and we're getting lots of helpful insights out of it. That is a prime example of AI actually improving, you know, return on investment for Snowflake. I think there's still a debate though on the CapEx side of things. So the debate in the market is, you know, are the hyperscalers spending, you know, nearly 800 billion this year? Perhaps. Is that gonna get a good return on investment? And I think the jury's still out on that, and it depends. I think, you know, we're getting anecdotal evidence from some companies saying that they're getting a better return on investment on AI spend than they are on their, you know, spending on a developer, for example.

So imagine a software developer's 500K salary, and if you spend 500K on AI, they're actually getting a better ROI, return on investment, on the AI spend than the human developer. Now we can debate whether that's a good or a bad thing, but in terms of actual ROI, return on investment, that's positive for AI CapEx. I do think there's also a geopolitical backdrop to this where, yes, there might be some pushback culturally, from society about, you know, investment in data centres and slowing things down, but is the great game between the US and China actually going to supersede that, and it's in the US's national security interest to stay ahead of its peer?

SW: Leaving maybe a proper AI debate in the human interest side to a different side, it's probably not the time to unpack that entirely. When you're looking at these companies, and I'm not just talking about AI companies, but any company kind of in general, this strategy is very much looking for growth companies. It's what Baillie Gifford is, you know, known for. And when you're looking for these growth companies in particular, and you kind of mentioned it earlier, it depends on your time horizon, right? So I'm gonna pick 10 years, I'm gonna go long-term, how do you kind of invest through that period of companies where it might not be high growth, you might have to buy and hold and wait it out until you get that return on investment. And how are you then kind of battling through those challenges and seeing companies adapt to AI and all of the different kind of things that are happening? When do you say, "Actually, they've not adapted how we thought they would when we invested five years ago, and it's almost time to cut our losses, so to speak."

BJ: Well, I mean, how long have we got? [Laughs] Yeah. That's the job.

SW: Concise.

BJ: Yeah. So it's inherently difficult. Yeah. But what we have at Baillie Gifford is an advantage of operating in that five- to 10-year area. What will the world look like in five to 10 years? Which companies are driving that change or which companies are going to benefit from that change? And very few other managers operate there. So it's not a very crowded space. And the reason why it's not very crowded is because it's really hard. And the error ranges are really, really wide. Yeah. You know, you're thinking very probabilistically at that

time range. What we try to do is reduce those error ranges. So we're still gonna be massively wrong on some companies, and that's absolutely fine.

But if you're right on some of these companies, then they will more than offset the losers that you invest in. And so it's very much a venture capital-type mindset of finding these few outliers, more than the average investor, and you should in the long run outperform. It does mean that you have to accept a certain level of volatility because over one, two, three, four years, factors other than the company's fundamental operational progress drives its returns. So what we do is we look for three factors, really. A huge market opportunity relative to its current size. That's the first point. The second is that it has to have a sustainable competitive advantage, either technologically or to do with its business model. And that actually deepens and gets stronger as it grows. And then thirdly, and this is the critical one for managing change and uncertainty, is an effective culture.

So the leaders of the businesses that we invest in have to be long-term. And that can take different sort of shapes and sizes depending on what the company's trying to do. But the thing is that they have to maximise every short-term decision for the long run. So Shopify, for example, Tobi Lütke at Shopify. Shopify is the e-commerce operating system effectively. Now they, pre-COVID and pre sort of high interest rates or normalised interest rates, were investing heavily in logistics, very low margin, very expensive industry in which to operate. And they're trying to compete with Amazon effectively on same-day delivery and all that sort of stuff. However, once AI and agentic AI emerged in 2023, Tobi Lütke, who's a product specialist, who's a tech specialist, he's the founder, realised actually they need to double down on their core skillset, which is software and tech.

And so they sold the logistics business and he pivoted it. And the company has gone from strength to strength in terms of operational performance since then. Its share price has been very volatile, but it has delivered on fundamental progress. And that's what really matters over five to 10 years. Then it comes down to position sizing, right? So we believe that healthcare and biotech and so on is going to be transformed over the next 10 years, but it's an extremely uncertain industry, long time horizons, factors that we can't actually analyse come into play. And so you have to size these positions accordingly. So if it's very early-stage biotech, you know, you keep it very small, like less than 1%. But if it's already got proven drugs into the system and is generating significant revenues, it's de-risked and you can increase the size of the position.

So that's how we sort of bring it all together. Those three factors plus position sizing.

SW: And you mentioned healthcare. I did wanna touch on healthcare because I don't want people to think that this is a tech fund. We have focused a lot on tech, but another part of this fund and what I have seen people on the team talk about is this healthcare innovation, which is so incredibly interesting. However, healthcare is an area where it can take years to actually become commercially maybe viable. Especially biotech, as you said, you've got drug trials, you've got such a long runway of potential growth, as we talked about earlier. How do you balance what is that potential growth against the uncertainty of maybe where a company is today and saying, "Is this going to materialise in five years, 10 years?" Does it just come back to, as you said, position sizing? We've just got to start small and build as time goes on?

BJ: Yeah. So, you know, healthcare is a big sector actually. And we sort of split it into smaller categories. So you've got the therapeutics that are sort of pre-revenue or pre-commercial stage, so they're still discovering and trying their drugs. You've got ones who are established and actually are generating significant revenues. And then you've got tech meets healthcare. So using AI to improve treatments or analyse medical records to improve drug development and so on. And then you've got devices and health tech and med tech and so on. So actually there's quite a few different areas. So we try to have a well-diversified bucket of transformational

healthcare names across those sort of four areas. And then, yes, for the early-stage, the most transformational biotech names, so a name like Denali Therapeutics, which has got an incredible technology that allows large molecules to cross the blood-brain barrier.

So getting drugs into the brain to treat things like, you know, neurodegenerative diseases, so think Alzheimer's and Huntington's and so on. These are diseases which are going to be increasingly prevalent in our aging society. If they can crack that, huge opportunity, but it's still very, very early. Yeah. They haven't got a drug in the market yet. So it's kept at a very small position. But then you've got a company like Alnylam, which has a technology that can silence the genes that cause genetic diseases. And now it started off, when we first invested back in 2015, 2016, with no drugs on the market. Now it's got four or five, and it's generating billions of dollars of revenue. And so its position size has increased, but it's taken 12 years to get there.

Yeah. So the key sort of characteristic for biotech and drug companies for us is a platform technology. So we're not trying to identify a company that just will produce a blockbuster drug and make loads of money from it. What we want is repeatability. Interesting point about us being a tech fund. I think, tech or not being a tech fund, you know, tech is just such a broad term. Yeah. Every industry, whether you are, you know, Nvidia or IDEXX Laboratories, which looks after pets and things, or Knife River, which is an aggregates company, every company will utilise technology in varying ways and will improve their productivity and their margins because of it. Some will be more directly involved. So healthcare is going to be using AI and technological discoveries to improve their products and their results and so on.

And Moderna's a great example of that. It uses AI to, you know, in its most recent results for the personalised cancer vaccine for skin cancer, you know, it'll take a sample of an individual's skin cancer, refine the personalised cancer vaccine for that person's cancer, combine it with Keytruda, the chemotherapy, and the phase three trials have been incredible. Yeah. They've reduced mortality rates by about 50%. And that's just one cancer. And if it can do that for all these other cancers, that's a huge opportunity. So keeping the position size relative to its opportunity and the probability of success is key. And then you've got some bigger names like Medline, which produces gowns and PPE, and it's a distributor effectively. That's a more steady compounding growth company and you position it slightly larger.

So that's how we bring it into the portfolio.

SW: They have less of a focus on innovation and it's more practicality.

BJ: Yes, it is. And you become infrastructure and you're embedded and it's a different flavour of high growth. And because, you know, Moderna and Alnylam and Denali, these biotech names are very volatile and they move to a different sort of beat to the main market. Whereas Medline produces something more steady and reliable and they zig when others zag. Yeah. That's what we want in the portfolio.

SW: And we have talked quite a lot about innovation, for obvious reasons, but what about the American consumer? How important is the health of US domestic economy, interest rates, you know, consumer spending, when you are looking to invest in the businesses, a few of which that obviously we've already talked about? Is it something that you're really watching when you're looking at these companies? Or is it these companies, as again, we've talked about, we're planning to hold them five, 10-plus years, there's going to be cycles that we go through. And so it's more of, it's interesting, but it's not going to lead a decision.

BJ: Yeah. Well, the American consumer is not a homogenous bunch. There's very…

SW: They are not. [Laughs]

BJ: They are not a homogenous bunch. And we've actually been pleasingly surprised by the resilience of the 'consumer' to date. The economic backdrop is challenging. The affordability crisis and the cost of gas, the cost of electricity and so on. Part of which is to do with AI, but part of which is to do with geopolitics and so on. We are wary of that and we've been making sure that we're not overly exposed to the consumer too much, but there is still a lot of disruption and opportunity available in the US consumer space. So, you think about an insurance company like Lemonade, which uses AI to improve the speed with which people can get home insurance or pet insurance and improve the accuracy of their claims and prediction for premiums and so on.

That actually reduces cost for a consumer. And so in a tighter environment, people might go to a company like that. Wayfair, for example, in home furnishings and so on. People aren't buying that many sofas at the moment in general, but if they are gonna buy something, they might use Wayfair because it's more convenient and a better price. So there is some anti-fragile nature to some of the innovative companies that we own in that space, but they are vulnerable to the big moves in the market on sentiment. We deliberately try to diversify the portfolio across different types of high-growth companies in order to counterbalance that. So we talk about healthcare, talk about, you know, just technology in general. But we also have, you know, companies like IDEXX Laboratories, which is not really healthcare, but it's pet healthcare.

SW: It's pet healthcare. And I know, because I have a bill from them on my counter. [Laughs]

BJ: There you go. There you go. And what's quite interesting is people will spend money on their pets. Yeah. Even in tighter times.

SW: Absolutely.

BJ: And they offer longevity for the pets and people, you know, and more treatments and repeat bills for diagnostic tests that they're now bringing in. And this is an interesting diversifier in that space. So, you know, we're trying to make sure that we have the right balance of exposure to the best growth opportunities across America and obviously the world, because American companies drive a lot of global innovation, for the next five years, but conscious of the short-term buffets that we're gonna get.

SW: And there are so many interesting names. We've talked about a handful of them already. We would be here for hours if we went through every single one of them. But I am just going to kind of put you on the spot and name one or two more companies that you just think are an exceptional business for the next decade. When you put that really long time horizon on and where you think that transformational growth is going to be 10 years from now. Is there a company that sticks out in the portfolio that you think, "That's one that I'm watching"?

BJ: I mean, that's hard. We like all the 40-plus companies in the portfolio, but the one that's really in the front of my mind right now is Cloudflare. Okay. Cloudflare is born out of a sort of cybersecurity and edge computing. And, you know, six months ago, 20% of the internet goes through its system, its platform. You might have even seen it when you go to a website, there's a pause briefly to check that you're human. Yeah. And there's a little cloud, a sort of orange cloud, and it says, "Just checking you're human," and then it moves on. That's Cloudflare. Okay. That's one of the things it does. It has a different approach to cloud computing, in that instead of having large, big data centres and it's centralised and all the information comes

into these big data centres and goes back out again, it has smaller ones, lots more, located closer to the end user.

And so this means that latency, so the slowness of reaction or response from the data centre is less. So the latency is lower, which means it's quicker, which means for agentic AI, which is where AI agents go off and do multiple queries and use multiple loads of tokens, it's quicker and better for that. So the prospect for it is that it's becoming the cloud, the cloud for the agentic era. Okay. And the reason why it's so exciting is that on the recent earnings call, Matthew Prince, the CEO, said that in the quarter, 5% of the internet moved to its platform. Wow. So it went from 20 to 25% in three months. And because of its security aspects as well, given the threat from AI, from agentic AI to attack and find weaknesses, the importance of cybersecurity is skyrocketing.

So it's got that, it's got the edge computing, and it is effectively potentially the cloud for the AI agentic era. That means it could be as big as, if not bigger than, Google.

SW: You heard it here first. [Laughs]

BJ: But it's volatile, so it's not guaranteed.

SW: And we are running out of time, so I wanted to just ask one more question, which is, we are coming up to the end of the year, and it has been a bit of a rollercoaster of a year. We've had a lot of things happen, a lot of uncertainty. We've had geopolitics. We've had the midterms, as we talked about, and a whole handful of kind of events that we've had to ride out. Over the course of the year, has any one of those events kind of changed your thinking or evolved the portfolio in some meaningful way, or is riding out that volatility kind of part of this fund and your job and you've got to power through? And if that is the case, how are you feeling about next year? [Laughs]

BJ: Okay. In one minute, right.

SW: No pressure.

BJ: Yeah. The emergence of agentic AI at the end of last year and its unbelievable demand and effectiveness and utility did change our minds in the first sort of six months. And we're going to need more chips. And chips are going to get more complicated, no matter whether data centres are exploding or being restricted. So we've invested in more chip companies in the portfolio. We've tried to avoid the sort of what we call short-term bottlenecks with the memory boom, but instead we're looking for companies which are going to be enduring growers in this space. So we've invested in Arm, which designs CPUs. You know, any chip in an Apple phone has gone through Arm.

And we need chips to be more efficient, more power efficient and faster. This is what Arm does. And then KLA, they check effectively the chips that come out for being correct, you know, there's quality checks essentially. Quality control. And they can improve the yield for a chip maker. And so as chips become more complicated, they're going to be really important. But then elsewhere, we realised that, you know, Moderna has sort of proven that it's a platform company with its most recent results, but we've made sure that we've kept it in a size that is appropriate for its volatility and uncertainty. Whereas a mistake we made in the pandemic was we let it get too big and we didn't trim it. So after it doubled or more than doubled on results back in August, we halved it.

And then, you know, SpaceX and catching the Starship just recently. This is, you know, the large, fully reusable rocket system that they've got. That will be transformational. But again, it's gonna take a long time. So sizing it appropriately is the right thing to do. And then we've got the Anthropic IPO coming in. So there's a lot going on. The midterms are just adding more uncertainty to that fuel. But what's really reassuring is that the data show that companies that deliver the best fundamental growth in earnings or sales over a five-year period still outperform the market, even today. Even in this very concentrated AI-focused S&P 500 and NASDAQ. And we think it's a stock pickers' market for the long run. So that makes us very exciting.

But it's 'get comfortable being uncomfortable', I would say.

SW: Not necessarily what I wanted to hear going into the Christmas season. [Laughs]

BJ: Well, yeah. Get uncomfortable eating too much turkey, but AI is going to transform everything. You need to be long-term and comfortable with a lot of change happening. But realise that the systems that we've built around politics and society are pretty strong still and they'll counter back. And that's what I write about in my "Fast Markets, Slow Forces" thing. You know, the government and culture are still really powerful and things will overreact and be brought back and we just got to make our way through it.

SW: Well, on that note, Ben, thank you very much for joining me today. It's been incredibly interesting and a fund full of very interesting companies as well. So thank you for talking about so many, but also just your thinking behind everything and long-term growth potential. May it long live.

BJ: Thanks, Staci.

SW: This US equity fund is one of the purest examples of the Baillie Gifford growth philosophy. It is run by a team of four co-managers who focus on the small number of companies that create exceptional returns. The managers will also have conviction in these names, with the largest ten holdings usually accounting for over 50% of the portfolio. To learn more about the Baillie Gifford American fund, please visit fundcalibre.com and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.