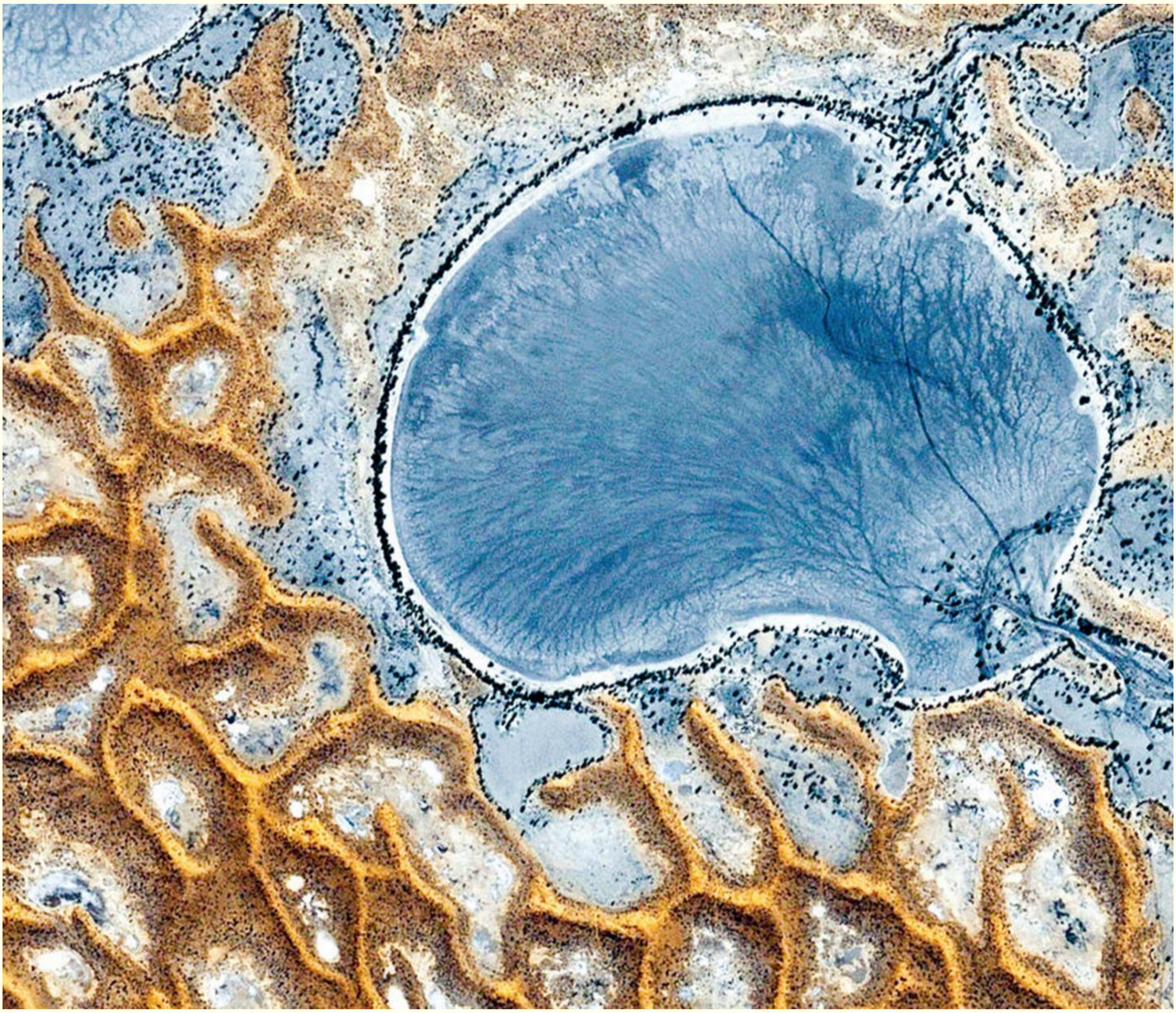
BAILLIE GIFFORD

BCSSS BG Long-Term Global Growth Equity

Report for the quarter ended
30 September 2017

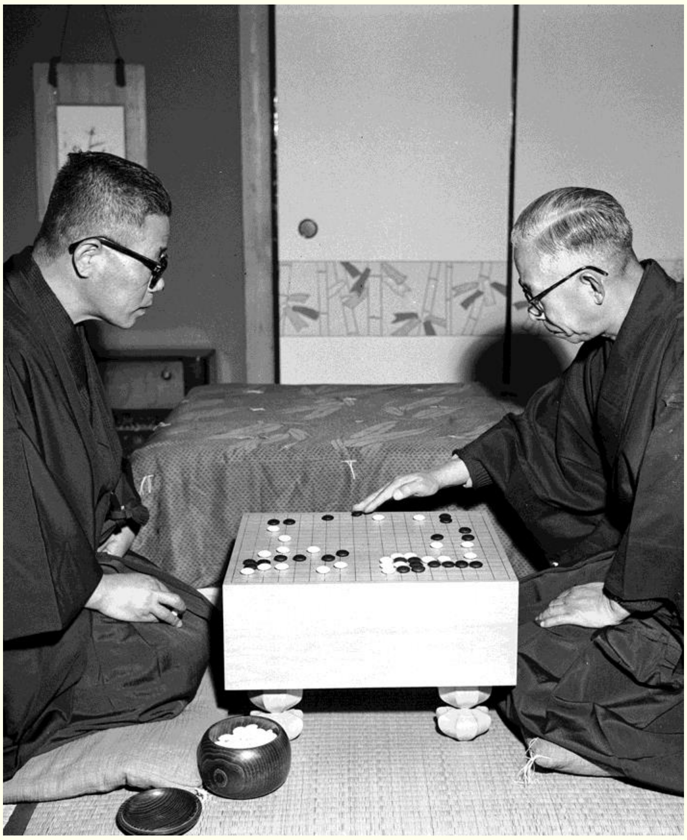


James Anderson recently penned some thoughts about our engagement with companies in your portfolio…

I've been asked a few times about our approach to corporate engagement. What follows is mostly personal experience and reflections from a Long Term Global Growth perspective. These are by no means a set of rules for Baillie Gifford as a whole, it is for each strategy to decide their own approach. What is important is that we are all clear in the direction and in the significance of our own approach.

Origins of engagements

The LTGG team has always been adamant that stewardship is part of our ethos. However, we have never taken a holding with the intent of advancing a corporate agenda. We buy because we believe that the companies are already concerned with being long-term in approach. We believe the portfolio companies concentrate on building a competitive moat and flourish by having a purpose beyond shareholder value. This is our focus. We don't search for problems to solve; this cuts against the processes of LTGG.



This attitude means we are committed to the individual companies in which we invest. So, for us, engagement is a combination of confidence in the company and in our processes, but also an admission that bad things happen in the natural course of events. We strive to get to know our investments well enough that problems are neither a surprise nor so destructive of former hypotheses that exit is the only response.

Implications

I'd make two further claims stemming from this notion that bad things happen. First, simply acknowledging that tough times and events occur is the single most important realisation a long-term investor can offer to companies and to clients. Of course, realisation is but the first step towards serious ownership, but without it I don't believe you can actually be a long-term investor. Denial that sometimes things aren't perfect is part of the childishness of financial markets. If we throw a tantrum each time the complexity of corporate life becomes apparent then companies won't admit to issues. This is what happens to most companies in most public markets. Challenges aren't discussed. Problems are reduced to getting quarterly earnings back on track (often by adopting stupid moat reducing policies). In my view, there is no easier or better path to gaining respect from corporate leaders than demonstrating that we know that hard stuff happens.

Second, in most cases of turbulence, engagement is nothing more than tolerance. Since corporate life and share performance isn't a straight line, most market fusses are best ignored with a quiet word of support. Many of our most productive instances of stewardship have stemmed from consciously doing nothing at all or at most murmuring support. Facebook is an historic example. We bought the shares in the IPO and held on during the turbulent aftermath. Even a company as large and influential as this noticed.

From tolerance to action

When does support need to be more voluble? When does it need to come with substantial provisos or even requests for change? Often this is a reflection of little more than noise levels surrounding our shareholding. Will we push Under Armour far enough in addressing its problems? Or try to engage Alphabet on matters of tax? I think perhaps we are potentially more influential and more visible in some cases than others.

What is common in these cases is that we explicitly decided that there was a growth opportunity and a competitive moat worth investing in for the long term and hence worthy of time and effort. This isn't always popular.

I'd advocate more open discussion of whether we think avid engagement is justified. It isn't always so. Being willing to admit that there have been disappointments relative to the earlier hypotheses is healthy. Again it's an acceptance that bad stuff, both events and managerial, happens. Engagement beats rage, head in the sand denial or exit when there is a business worth saving.

Occasionally, engagement is forced upon us by takeover activity. Two instances stand out in my memory. First SoftBank's successful acquisition of ARM last year and the second, Roche's failed bid for Illumina.

With ARM, it was with great sadness that we voted in favour of SoftBank's proposed acquisition of ARM. We were inclined to resist the deal. We felt it undervalued the future growth in demand for ARM's products. But after conversations with the Chairman, the CEO, the Finance Director, the Senior Independent Director and mostly critically, the Chief Technology Officer, we came to the view that acceptance was the right course of action. ARM did not possess the willpower, nor the resource to turn its potential into actuality over the next decade. ARM, sadly, were nervous about the scale of the investment required, the risks that needed to be embraced and the patience that would be required of markets. SoftBank, however, had the ambition and the confidence to address these challenges.

The outcome of the attempted hostile takeover of Illumina by Roche was different. Here, the time frame of returns and the probabilities related to the outcomes were the central issues. Roche management, we felt, were only looking out quarters ahead. Our time frame was decades. This engagement proved a real step forward for us. By fighting against Roche to secure Illumina's independence, we obtained traction in a challenging sector by gaining access to smart management teams and potentially transformational companies.

Moreover, we ought to be able to make our views heard before issues we care about arise. An example would be Atlas Copco. Atlas Copco derives a substantial portion of revenue from making machinery energy efficient. We have been speaking to them about the long-run impact of near free energy on their business. This is an example of quiet engagement being preferable. But that cannot be an excuse for inaction or shying from inevitable public moments.

Some tentative conclusions

I don't think it's entirely appropriate to look for general messages in engagement beyond a few fundamental principles. The specifics of the situation and company are paramount – perhaps unhappy companies are different in unique ways. This is why a rules-based approach makes me nervous.

Outstanding companies are not nails to be hammered down because they dare to dissent from normalised mechanisms. Or, to put it another way: culture and organisation should be reflections and reinforcements of business models that favour radicalism, innovation, deep competitive moats. Rewarding convention isn't our role, we should avoid thinking one size fits all. You don't build differentiation and enduring competitive advantage by imitating others or obeying sacred texts.

But these cautions aside, I'm convinced that serious commitment and engagement have extraordinary benefits for our investing skills and for companies. These are a set of fly-wheels that mesh unusually well – if we treat companies more thoughtfully then they will treat us more seriously and thus we become better investors – engagement requires long-term perspective.

It's absolutely no good talking about support and then rushing away at the first sign of trouble. We can all support companies doing well and going up in a straight line. That proves little. You earn respect at the tough moments. We should acknowledge when there are discouraging and problematic events but be emboldened when we think that with time, effort and thought we can help improve the situation. There is nothing like going through hard experiences to build muscle and repute. This includes an acceptance that abrupt falls in price are frequently the immediate fruit of stewardship – turning down takeover offers isn't always popular.

Lastly, we should be blunt about acknowledging our limitations. By trying to do too much we go beyond our skills and we distract ourselves from what we can contribute. I'd advocate that we have but two guidelines. We should only be interested in making companies longer-term and in helping dig better moats. The rest is noise.

Voting Activity

Votes Cast in Favour	
Companies	3
Resolutions	18

Votes Cast Against	
Companies	None
Resolutions	None

Votes Abstained/Withheld	
Companies	None
Resolutions	None

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Serious commitment and engagement can have extraordinary benefits for the long-term value of the companies in your portfolio

Votes Cast in Favour

Companies	Voting Rationale
HDFC Corp, Inditex, Intuitive Surgical	We voted in favour of routine proposals at the aforementioned meeting(s).

Votes Cast Against

We did not vote against any resolutions during the period.

Votes Abstained

We did not abstain on any resolutions during the period.

Votes Withheld

We did not withhold on any resolutions during the period.

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