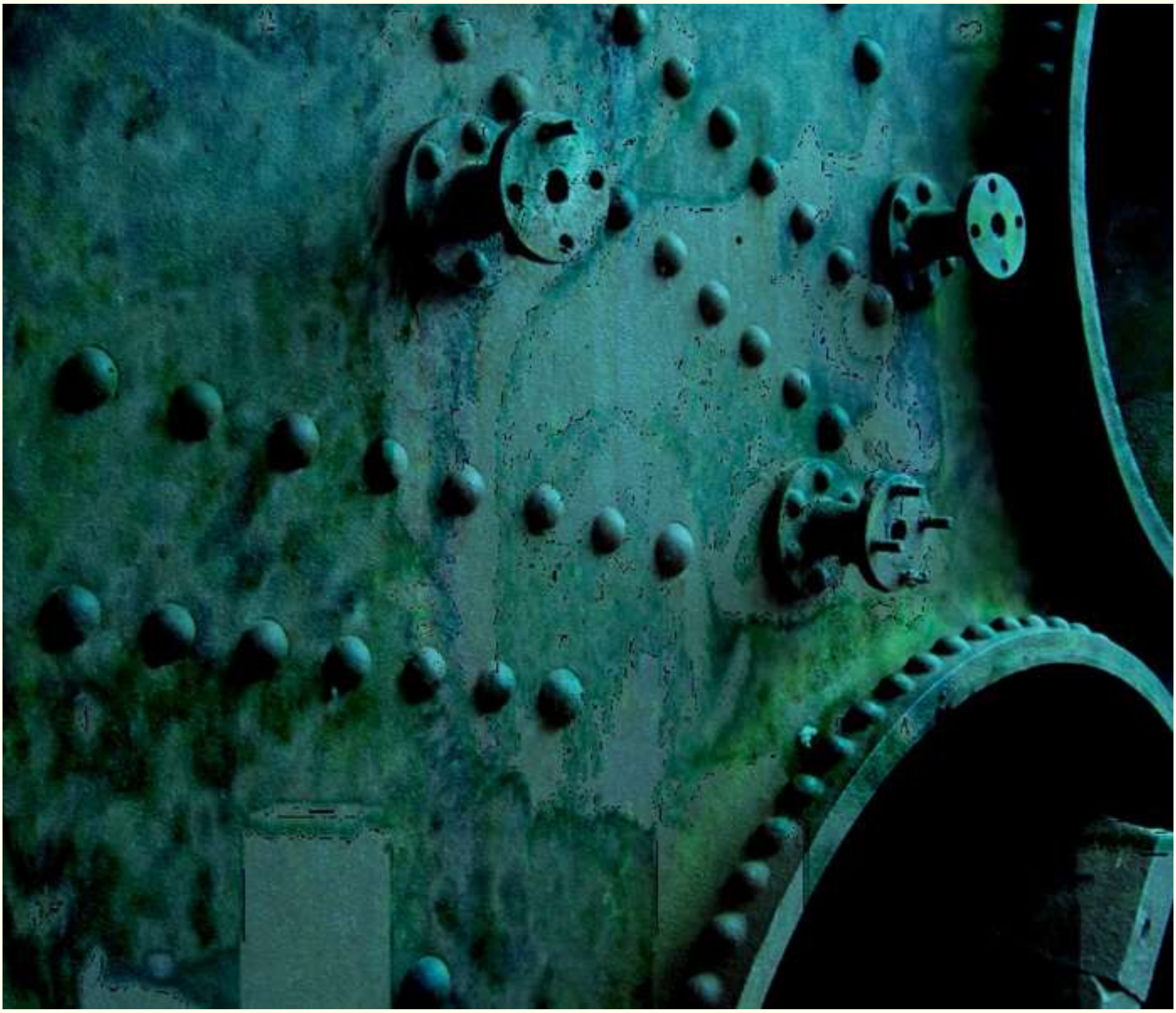
BAILLIE GIFFORD & CO

BCSSS BG Long-Term Global Growth Equity

Report for the quarter ended 30 September 2018



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A question of character

"The key is to always fall back on what's right. When in doubt, do the right thing. This always pays off in the end."

These words of advice were once imparted by a renowned CEO to university students at a graduation ceremony in Boulder, Colorado. His words implied that strong ethics are conducive to long-term success: after all, his company was riding high on a decade of colossal growth that had delivered an eight-fold rise in share price. This was an inspirational message for the new generation of young graduates. They would doubtless be reminded of it when, just two years later, that same business imploded and filed for bankruptcy. Investigations later revealed that management hadn't been doing 'the right thing'. Far from it. This was Lehman Brothers, and the CEO was Richard Fuld.

The rest is history.

As investors, we can learn at least two important lessons from Fuld's words, albeit not in the way he intended.

– Lesson 1
  Observing a company's integrity, its ethical considerations, and its sense of responsibility can help external shareholders to better understand how that company is run and how it may prosper in future.
– Lesson 2
  It's easy to be wrong about Lesson 1.

We know each of these lessons first-hand. However, in our experience, while smooth management platitudes can attempt to conceal impending catastrophes such as the example cited above, the more common challenge facing long-term investors is to detect what is often a gradual, subtle atrophy in a company's behaviour. For instance, we held the Brazilian oil company Petrobras on behalf of our clients from 2005 to 2011 – a period in which the company grew to become one of the largest positions in the portfolio. During our holding period, the company was listed on the Dow Jones Sustainability Index, received the Global Reporting Initiative's highest rating for transparency, and was ranked number one among the world's oil and gas companies for sustainability. There was no catastrophe, environmental or otherwise, that led us to sell the holding seven years ago. Instead we grew increasingly concerned by the gradual creep of the Brazilian government into Petrobras' affairs as the political backdrop changed.

Whether you call it corporate governance, corporate social responsibility, ESG, responsible business conduct, or sustainability, the underlying concept is the same and it is simple: a company's character matters. It matters to customers, employees, management, shareholders, stakeholders, society, and the planet. But it is also qualitative. It is non-financial, imprecise, subjective and variable over time. No company is invulnerable to potential behavioural failings and no investor is immune to missing the warning signs. But our odds of making better judgements about a company's character can be greatly enhanced, reducing – albeit never eliminating – the risk of mistakes. We do this by doing what we do best: examining company fundamentals. We seek to ask the right questions and get to know companies deeply. We don't apply simplistic ESG screens, rankings or elaborate quantitative models: we don't feel they provide the full picture, are dependent on the quality of their inputs and are inherently backward looking. Rather, our firm structure, our investment philosophy and our process are far more important to us. While not infallible, what follows is a set of characteristics we consider integral to our approach.

Our firm

Baillie Gifford is a private, unlimited liability partnership and has been since we were founded over a century ago. This rare structure underpins much of what we do today. Most crucially, it means we are not beholden to the often short-term interests of external shareholders. We take a truly long-term view, with a minimum investment horizon of five to 10 years. Our average holding period is eight years, and a number of companies in the portfolio have been held since the strategy began 15 years ago. We therefore seek to invest in companies that not only deliver compelling growth, but are poised to do so for many years, if not decades, to come. In our experience, the odds of a company achieving this successful combination of growth and longevity cannot be separated from its character. Good corporate behaviour can increase the probability of exceptional payoffs. In the words of Georg Kell, founder of the United Nations Global Compact, "a company's long-term financial success goes hand in hand with its record on social responsibility, environmental stewardship and corporate ethics". It's evident to us that we should seek this alignment.

Another important factor is the lack of a central Baillie Gifford 'view' on a company. Each investment team and each individual investor has the autonomy to voice their opinions and openly share their analyses, contributing to a culture of diverse thinking, healthy challenge and ongoing dialogue. We accept that one never has a full picture of a company, as they themselves are forever changing in terms of size, people, opportunity sets, and regulatory environments. But through our research and a learning process built upon interaction and iteration, we remain vigilant to ongoing shifts in company behaviour that may enhance or undermine our investment theses.

Our philosophy and process

The investment philosophy of the LTGG strategy is hinged on optimism, long-termism, a global outlook, and an obsession with growth. Our ambition is to find companies that have the opportunity to quintuple in value over our investment horizon. Business fundamentals – such as a company's market opportunity, returns, capital deployment, and sustainability of competitive advantage – are considered together with the intangible notions of culture, adaptability, and its role in society. In other words, an analysis of corporate character is intrinsically built-in to our investment process. This is because in our search for the best growth companies in the world, we recognise that corporate character matters just as much as operational performance.

Our lens for analysing companies in this manner is our 10 Question Stock Research Framework. This is designed to be a robust and repeatable framework for analysing a company not just before we invest, but also over time. But it is not inflexible. For instance, we recognise that many companies in the portfolio have grown to such scale and are driving technological change to such an extent that they have important societal consequences. As such, in 2016 we expanded Question 5 from simply "Why do your customers like you?" to also ask "Do you contribute to society?" In response to this question, our research typically considers factors such as the nature of the product or service, tax, environmental impact, and labour relations. This question is for instance, prominent in our research into Chinese electric vehicle company NIO, whose mission is to relieve China of its notorious air pollution (the company's Chinese name Weilai literally means 'blue sky coming'). It is also a relevant question for a company such as Dexcom, whose continuous glucose monitoring devices help enormously to improve the quality of life for sufferers of diabetes, or Alibaba, which is providing financial inclusion to a largely underserved population.

Questions
1. Is there room to at least double sales over the next five years?
2. What happens over ten years and beyond?
3. What is your competitive advantage?
4. Is your business culture clearly differentiated? Is it adaptable?
5. Why do your customers like you? Do you contribute to society?
6. Are your returns worthwhile?
7. Will they rise or fall?
8. How do you deploy capital?
9. How could it be worth five times as much, or more?
10. Why doesn't the market realise this?

While Question 5 is most obviously related to a company's sense of wider responsibility, considerations of a company's character are also embedded into other questions, such as Question 2 "What happens over ten years and beyond?" This was particularly relevant during Roche's attempted takeover of Illumina in 2012. Though the offer was at a significant premium to the prevailing share price we opposed the bid as we felt Roche's valuation of Illumina did not reflect the immense potential for Illumina's gene sequencing technology to transform the healthcare industry and improve the lives of hundreds of millions of people. We realised Illumina's share price would likely fall in the short term following the failed takeover, but safeguarding the company's independence was the correct action for a long-term investor. Question 2 therefore helps us to look beyond the market's short-term focus – such as considering not only Tesla's electric vehicles, but also the vast potential for its energy generation and storage business, and the possible implications for energy efficiency and the environment.

Question 4 asks "Is your business culture clearly differentiated? Is it adaptable?" This question was essential to considering whether to invest in Uber in 2014. Despite the company's tremendous market opportunity and dominant position in ride-sharing, we declined the opportunity to invest due to concerns about its culture. Put simply, we felt the company's attitude and corporate behaviour would be detrimental to its growth potential over the long term. In contrast, our holding in luxury brand stable Kering provides an example of how a company's response to this question can change positively over time. Kering's largest brand, Gucci, recently implemented a fur-free policy and has signed up to the Fur Free Alliance, an organisation that promises to end exploitation and killing of animals for fur.

This is not only laudable in its own right but demonstrates an aptitude to adapt and step-up its corporate responsibility. More broadly, Kering was the first company to publish an Environmental Profit and Loss statement, as the business seeks to positively influence every step of its supply chain from raw material production and processing to manufacturing.

Question 8 "How do you deploy capital?" can also reveal much about a company's character. For instance, we were encouraged by Atlassian co-founder CEO Mike Cannon- Brookes' careful consideration of any cultural impact following the company's acquisition of Trello last year. This conversation was continued at a meeting in Sydney earlier this year which discussed Atlassian's wider responsibilities to its employees and society: the company donates 1% of annual profits, 1% of employee time, and 1% of company equity to the Atlassian Foundation. This may sound minimal but equates to over $10 million in donations to education charities and over 22,000 hours of employee time volunteered in local communities. Interestingly, Cannon- Brookes identified the Foundation as a key motivator for applicants to Atlassian, bringing talent to the company as well as a broader societal benefit.

Gathering responses to our 10 Question Stock Research Framework over time helps us to understand the fundamentals of a company's behaviour. This built-up knowledge can be especially helpful during times when a company faces stress. While Facebook could undoubtedly have been quicker to react to the data security issues revealed in early 2018, it has demonstrated a willingness to engage with its critics and to improve itself, supported by a series of targeted actions. While we continue to monitor developments, we are encouraged by Mark Zuckerberg's approach: "I really think the biggest shift is around being more proactive, around finding and preventing abuse. The big learning is that we need to take a broader view of our responsibility."

Meanwhile Alphabet, having been heavily fined by the European Commission for the second consecutive year on antitrust grounds, continues to contest regulatory intervention. We are questioning whether the biggest risk to Alphabet in future might be the company's own behaviour.

Our research and insights

As we seek answers to our 10 Questions, we will meet with various members of company management in order to get to know a business better. As long-term investors, we do not rush investment decisions, and the research process – including management meetings – can often take several months, even years. These conversations are broad-ranging discussions about company strategy and thus provide a lens to assess aspects of company character, such as board composition, remuneration and incentive structures, capital allocation decisions, environmental performance, labour relations, health and safety, supply chain management, and stakeholder relationships. In a meeting with Splunk in 2017, for instance, we grew concerned about changes in the company's culture and focus on short-term incentive structures – worrying signals which contributed to our sale of the holding later that year. Similarly, in 2016, we sold Burberry after fruitless engagements on executive pay, and over our view that short-term sales growth was being prioritised at the expense of the exclusivity of the brand.

We also place much emphasis on deriving insights from beyond the narrow confines of the financial industry. We actively seek out experts, academics and other outside perspectives who can help us understand the world. For instance, in 2017 we commissioned one of our 'inquisitive researchers' to examine how social media was being used in the developing world. This helped us to understand how large companies in the portfolio, such as Facebook, are affecting lives in parts of the world that receive little coverage but make up the bulk of a company's users. Other examples of such external research have included the implications of nanotechnology, personalised medicine, Inditex's brands other than Zara, and online gaming. In addition to this, our relationships with academics helps us to access a range of different views and insights about topics relevant to companies in the portfolio. For instance, our relationship with the Leverhulme Centre for the Future of Intelligence is helping us to reflect upon not only the business opportunities associated with the rise of artificial intelligence (AI), but also the related issues of responsibility, trust, safety and ethics – factors which we consider seriously when analysing the AI efforts of companies such as Baidu or Alphabet.

Our influence

As owners of company shares on behalf of our clients, we have conferred upon us certain rights and responsibilities – in summary, to be good stewards of our clients' capital. We seek to do this not merely through proxy voting, but also through ongoing engagement between our investors and company management. We are also careful to avoid simply accepting conventional principles of 'best practice', instead recognising that the right governance structures for a company depend heavily on its age, stage and operating environment.

We recognise that shareholder proposals are a common way by which wider governance, environmental and social issues are brought to bear on a company, and thus proxy voting is an important mechanism by which to exert influence. Examples include proposals to increase disclosure on sustainability reporting, diversity, and wider employee rights. Every proposal is scrutinised by a member of our dedicated Governance and Sustainability team. Our decision not to outsource any of our decision-making allows us to assess every resolution on a pragmatic case- by-case basis, in conjunction with our investment teams. Earlier this year, for example, we opposed a compensation resolution at Under Armour's general meeting which we considered inappropriate. Our support for executive pay is based on the ability to provide appropriate pay-for- performance and alignment with shareholders over the long term.

Going a step beyond proxy voting, our low portfolio turnover and our patient ownership confer opportunities to exert further influence on a company by engaging in discussions with management. As long-term supportive shareholders, we seek to do this in a collaborative rather than activist manner. This involves working with management teams, gauging their receptiveness to our concerns and establishing whether improvements are on the horizon. This approach is welcomed by management. Facebook's Mark Zuckerberg invites us to join an annual discussion with half-a-dozen other long-term investors to openly discuss challenges facing the company, and Alibaba has called on our assistance to help improve its ESG reporting.

A healthy dose of humility

We believe this approach provides us with valuable advantages in understanding companies' attitudes and behaviour in order to better distinguish empty company rhetoric from sincere intent. But there's a final aspect of our approach worth stating: being honest about the difficulties we face. While we have never before had so much insight into aspects of company character, we face ever increasing complexity at significant scale. There will always be unknowns and grey areas. We will inevitably continue to make some investment mistakes. This may be because companies fail to execute as we thought, or due to negative behavioural shifts in their governance and stewardship, or more likely a blend of both. We accept that. That is being honest about our appetite for risk and reward. But going the extra mile to understand a company's character and embedding this into our fundamental analysis helps us to be broadly right about company behaviour most of the time. The asymmetric returns of doing so can be enormous – for our clients and for society alike.

Voting Activity

Votes Cast in Favour		Votes Cast Against		Votes Abstained/Withheld	
Companies	3	Companies	None	Companies	None
Resolutions	30	Resolutions	None	Resolutions	None

Governance and sustainability issues are deeply embedded in our investment philosophy and process

We don't apply simplistic screens, rankings or quantitative models, instead, we focus on the company fundamentals

There will always be unknowns and grey areas. But going the extra mile to understand a company's character is essential for long-term growth investing

Firmwide Company Engagement

Engagement Type	Company
Environmental/Social	Tesla, Inc.

Notes on company engagements highlighted in blue can be found in this report. Notes on other company engagements are available on request.

Company	Engagement Report
Tesla, Inc.	Employee health and safety is an important, high profile issue at Tesla. We met with the Head of Environmental, Health and Safety (EHS), Laurie Shelby, at the company's Fremont factory to develop our understanding of its policies and practices. Shelby was recruited in October 2017 and this was her first meeting with shareholders. Reporting directly to CEO Musk, Shelby is responsible for Tesla's initiative to become the safest car factory in the world. She explained that the company has over 200 EHS professionals globally. They meet bi-weekly to share ideas and alignment of practices. Shelby has also implemented an EHS centre of excellence, and employee engagement is facilitated through all-in-one reporting tools which record all incidents and enable staff to flag issues and make improvement suggestions. These provisions have led to improved working conditions and lower injury frequency rates. The company maintains a good relationship with the regulator, which recently completed an in-depth review of its injury reporting framework, concluding that the procedures in place are appropriate and accurate. This was a very useful meeting, providing assurance that the company's policies and practices are consistent with our expectations of a responsible operator.

Votes Cast in Favour

Companies	Voting Rationale
HDFC Corp, Inditex, NetEase.com ADR	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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