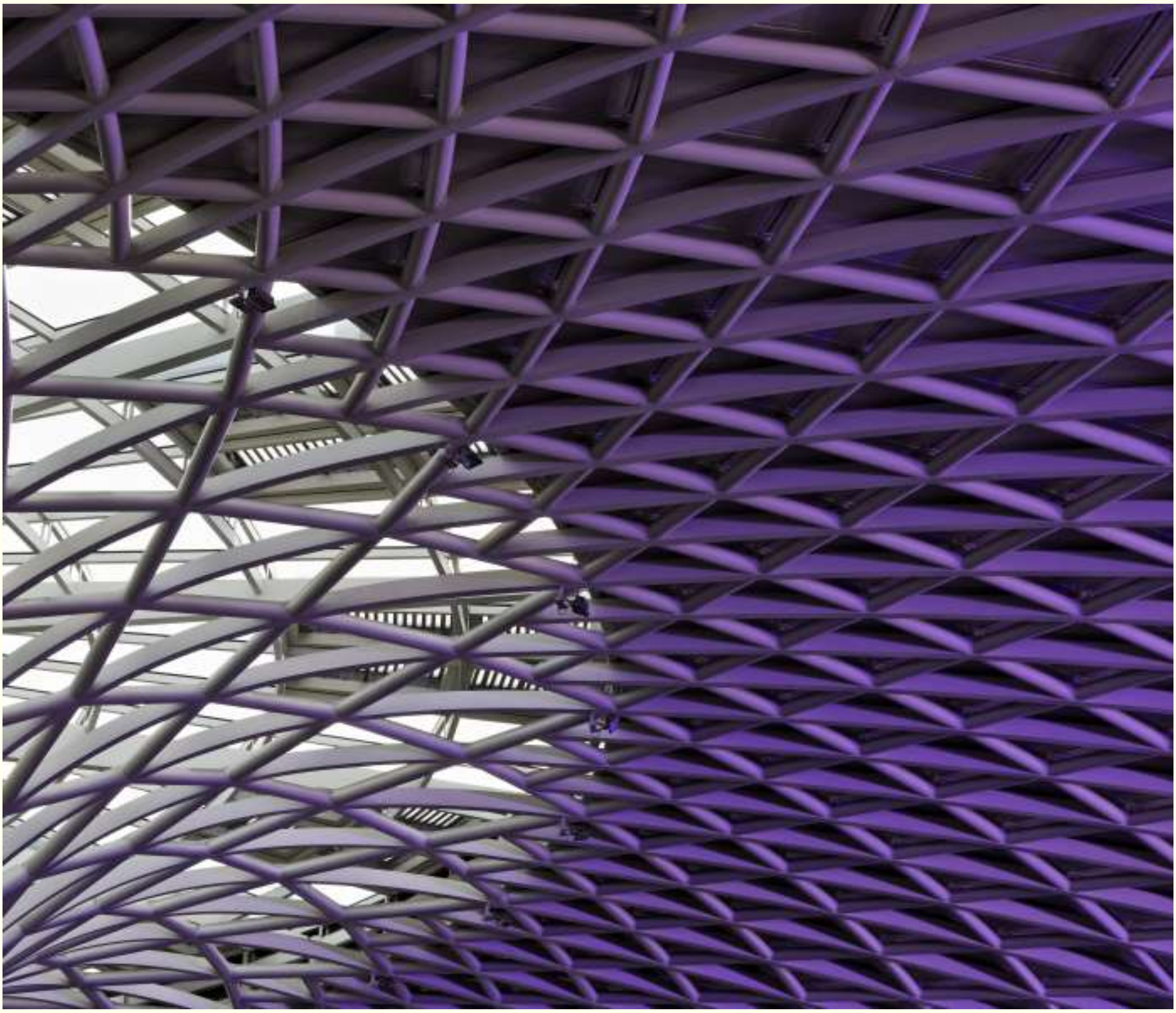
BAILLIE GIFFORD & CO

BCSSS BG Long-Term Global Growth Equity

Report for the quarter ended
31 December 2019



ESG and the importance of 'the bigger picture'

As we close out one decade and enter the new, it is worth a momentary pause to reflect on how far we have come with the integration of environmental, social and governance (ESG) factors into the investment process. A recently published Baillie Gifford booklet, *From Universal Rights to Global Goals* charted the evolution of ESG and responsible investing over the 75 years from the founding of the United Nations through to the present day. This long-view perspective highlights the fact that the recent surge of interest in ESG integration and responsible investment is a genuinely new chapter in the development of the asset management industry: whilst there is a long and venerable history of committed individuals and organisations taking principled and progressive stances on a range of different ethical issues, it is only in the past decade that institutional investors (and by extension asset managers) have begun to pay serious attention to ESG factors.

There are two powerful, compelling and interlinked reasons for this:

— First, there is an increasingly high-conviction view that, over the long term, ESG integration is rapidly becoming enlightened self-interest. As we enter what might be called 'the age of sustainability', when almost all countries will begin to step up to the unprecedented challenge of reducing environmental impact whilst continuing to improve the quality of life for all, well-governed companies with sustainable operations will have a better chance of commercial success in the long run.

— Second, there is a new-found sense of urgency and activism across a broad spectrum of investors, driven by the view that we now need to move very rapidly if we are to address climate change and a range of other pressing sustainability challenges.

These factors have led to the rapid mainstreaming of ESG and responsible investment that we have seen in 2019. However, the booklet also serves as a reminder of how recently the ESG discipline has emerged in asset management. The founding standards and principles, as well as the supporting industry bodies and service providers, all date from the last few decades. This relative youth is most apparent in the ESG ratings industry, where a number of competing providers attempt to give listed companies an overall score for their approach to sustainability. This is, of course, a very logical thing to do: if we are going to start allocating more capital to the most sustainable firms, we will surely need to rank their performance?

However, this is no easy feat, in part because of a lack of consistent disclosure from companies on ESG issues, but also because of the more daunting intellectual challenge of weighing up and aggregating a range of very different considerations – how do you compare workers' rights and environmental impact against governance arrangements or the social utility of a company's core products?

To date, most ESG ratings companies have taken the more limited approach of just assessing ESG risks in a cumulative way. All companies start in the same place, regardless of their core products, and are then marked down on a range of different headings. As mentioned above, disclosure from companies is still very limited, so companies that haven't invested in sustainability reporting also get marked down, regardless of their underlying performance. Those with the best reports and the least identified material ESG risks are the winners, regardless of their actual net impact on society. It is because of this deeply compromised approach that you can end up in a situation where companies making life-saving microscopic heart pumps or emission-free vehicles can be judged to be less sustainable than oil companies, fast food chains or even big tobacco. How would we even begin to explain this to someone outside of the ESG industry echo chamber?

Furthermore, even if we do just focus on ESG risks, there is no consensus on either the appropriate rating or the financial materiality of the range of risks assessed, with significant divergence across the various providers. How important is electricity consumption to Facebook, or combatting counterfeit goods to Alibaba? How risky (or otherwise) is a dual-class share structure or combined chairman and CEO role? Hidden beneath the comforting precision of a single consolidated ESG score, the seemingly objective is deeply subjective and built on limited disclosure.

The methodological limitations of the current ratings services cannot just be dismissed as the harmless teething pains of a nascent industry. As more and more investment products come to the market underpinned by such ratings, it really does matter whether they are funnelling money to the right companies. One of the logical downsides of a process that only looks at perceived risks is to discourage investment in innovative companies just at a time when we need innovation more than ever if we are to keep improving livelihoods whilst also transitioning to a net-zero carbon economy.

Major social advances are rarely incremental and cautiously controlled. Much of the remarkable progress in quality of life over the last few centuries was the result of calculated, innovative risk taking. Presumably, if they had been around at the time, the ESG ratings providers would have given a 'severe risk' warning to the Edison Electric Illuminating Company and its efforts to replace (explosive and flammable) gas lighting with electricity. The Ford Motor Company would have been slammed for ESG risks to motorists and pedestrians alike, and Merck & Co would have been excluded from all of the best ESG indexes for its pioneering efforts to commercialise the production of newly discovered penicillin. Indeed, in almost any walk of life, we would quickly encounter fundamental problems if we only thought about the risks, rather than weighing these up against the opportunities – investing, going to the doctor's surgery, or even commuting to work. ESG is no different.

To use a different analogy, rating companies on ESG risks but not ESG opportunities is akin to rating footballers on their track record of giving away penalties, whilst ignoring their goal scoring performance. We are not suggesting that any of this is easy, and to be fair the ESG ratings providers are clear about what their assessments cover – it is investors and other users of the data who need to very careful about making judgements based on partial information, or building sustainable investment products or fund-level assessments based on these ratings alone. There needs to be much more transparency in this respect if ESG integration and responsible investment are to keep growing in importance and stature.

Finally, disruptive innovation also requires genius and conviction, and personality traits that won't necessarily conform to the standard governance rulebook. For all of the above reasons, we do our own in-house research on ESG issues, and always try to look at the big picture for our holdings, weighing up the overall risks and opportunities in the context of the wider investment case.

To finish where we started, we are heading into a really important decade, when we will need all of entrepreneurial capitalism's creative energy to address climate change and a range of other sustainability challenges. We should be celebrating and supporting calculated risk taking by companies that are contributing to social and environmental progress, and renewing our efforts to back the most innovative companies that will be part of the solution rather than part of the problem. We also, of course, need to step up the pressure on genuine ESG laggards. It is therefore more important than ever that the ESG industry develops a more sophisticated approach to rating companies on sustainability to ensure that precious capital and energy is deployed in all of the right places.

Voting Activity

Votes Cast in Favour		Votes Cast Against		Votes Abstained/Withheld	
Companies	2	Companies	None	Companies	None
Resolutions	15	Resolutions	None	Resolutions	None

Institutional investors have begun to pay more serious attention to ESG factors in the past decade, but the ESG research industry is relatively new

Most ESG ratings companies only focus on assessing risks. Disclosure from companies is also still very limited, so those that don't invest in sustainability reporting are marked down, regardless of their underlying performance

Investors and other users of the data need to be very careful about making judgements based on such partial information

Firm-Wide Company Engagement

Engagement Type	Company
Corporate Governance	ASML Holding N.V., Alibaba Group Holding Limited, Alphabet Inc., Delivery Hero SE, Shopify Inc., Tesla, Inc., salesforce.com, inc.
Environmental/Social	Amazon.com, Inc., Illumina, Inc.
AGM or EGM Proposals	Kering SA
Executive Remuneration	Kering SA

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
Alibaba Group Holding Limited	The fact that Alibaba's partners took 18 months to agree on the company's six core values suggests that they are more than typical corporate speak. Daniel Zhang, chairman and CEO, believes these values codify the lessons and beliefs that Alibaba's co-founders historically passed on verbally to new employees - a sensible move as the company now has over 100,000 employees and aims to flourish into the next century. Values are disseminated widely as partners move between parts of the business. Zhang also spoke about the challenges caused by regulatory scrutiny. In addition to approaching regulators as early as possible ahead of new product announcements, the company is taking steps to build trust and understanding. For example, Ant Financial and AliCloud have built training tools to help regulators grasp the capabilities, implications and potential benefits of concepts such as the blockchain.
Amazon.com, Inc.	We visited Amazon's fulfilment centre in Dunfermline to learn more about employee pay and working conditions. Our tour walked us through the fulfilment process, from receiving an order to completion and dispatch. This was followed by a discussion with the general manager. In recent years, the company has raised wages of warehouse staff in the US and UK to $15 and £9.50 per hour, which is in line with living wage recommendations. Additional benefits including private healthcare, further education funding and subsidised travel, ensure that pay and conditions are competitive relative to industry peers for unskilled positions. We are supportive of the company's efforts to improve working conditions and encouraged managers to provide health and safety data to allow us to monitor progress in this area. We had a subsequent call with lead independent director, Jon Rubinstein, and Kara Hurst, the head of sustainability. We discussed Amazon's Climate Pledge and ambition to be a leader in meeting the Paris Agreement goals. Rubinstein provided insight on how the board operates, supports the management team, identifies and recruits new directors and thinks about succession planning. We are fortunate to have access to key individuals that can help us understand the company's operations and corporate governance.
ASML Holding N.V.	We met our investor relations contact at ASML. We discussed recent operational progress at the company and its prospects for the future, covering both the medium-term ramp up in manufacturing of its next generation extreme ultraviolet (EUV) machines and continued research efforts into the generation of equipment that will follow.
Delivery Hero SE	A conversation with co-founder CEO Niklas Östberg provided insights into the market opportunity, competitive advantage and potential upside for Delivery Hero, as well as shedding light on its corporate culture. This is a highly decentralised company whose international regional leaders have significant autonomy. Around half of logistics and delivery technology systems emanate from the Berlin HQ, but regional leaders can choose not to adopt them. Such decentralisation appears to help attract and conserve regional talent, enabling Delivery Hero to continue growing.
Illumina, Inc.	A discussion with CEO Francis deSouza helped us understand Illumina's operational progress and its contributions to society. He emphasised the significance of Illumina's collaboration with the UK National Health Service in sequencing genomes at vast scale. The opportunity is particularly significant from a societal perspective, as 95% of people have a gene variant that influences how they react to drugs, and billions of dollars are spent addressing adverse reactions. Large scale genome sequencing could deliver more personalised treatments, more efficiently. Uses vary from early diagnosis of genetic disease in children to pre-surgery checks for reactions to anaesthesia, and appropriate drug dosage based on a patient being able to metabolise drugs. We also discussed data privacy. Around 40% of customers store their genetic data in the Illumina cloud, but deSouza underlined Illumina's philosophy of acting as a good steward of customer data.

Company	Engagement Report
Kering SA	Kering has historically been something of a contradiction in terms of ESG. Its disclosure on environmental and social issues is second to none, but its remuneration practices have been contentious, and we have consistently voted against remuneration-related proposals at its AGM. This quarter, at Kering's first ESG-themed roadshow, we had the opportunity to speak directly with Sophie L'Hélias, lead independent director and remuneration committee chair, and Marie-Claire Daveu, head of sustainability. Ms. L'Hélias was keen to hear our assessment of Kering's remuneration practices, and indicated that she intends to make improvements. We will speak again as part of the remuneration consultation process in early 2020, but based on this meeting we are optimistic that long campaigned-for changes are coming. On sustainability, Ms. Daveu provided greater detail on how her team interacts with Kering's creative departments, how sustainability is governed throughout the company, and the process for dealing with the company hierarchy.
salesforce.com, inc.	The co-CEOs, Marc Benioff and Keith Block, strike us as different from each other and complementary in ways which can be useful to Salesforce's long-term growth. Benioff appears primarily concerned with taking a serious approach to conscious capitalism. A recent example is his introduction of an Office of Ethical and Human Use, whereby Salesforce will forego revenues by prohibiting products that don't align to core company values such as trust and equality. Meanwhile, Block appears mainly focused on operational performance, recognising the need for continued reinvestment and innovation in core products - another area we monitor. When asked about acquisitions, Benioff stressed that he pays little heed to per share dilution or even value accretion - instead, he looks at the quality of the brand, the product, the customer relationships and the company culture. On pricing, Block emphasised that Salesforce never wants to use pricing to grow, at the expense of doing what is best for Salesforce customers.
Shopify Inc.	Harley Finkelstein, the chief operating officer, stressed that Shopify should do whatever merchants require. The company has the potential to be the world's first retail operating system, comprising aggregated marketing, fulfilment, finance and more - whereby brands can maintain their direct-to-consumer relationships rather than passing through intermediated department stores or platforms. Finkelstein sees this as further democratisation of the internet. Commenting on the move into fulfilment this year, he noted that it is a distraction for brands which otherwise should focus on their products and marketing/positioning, and a problem Shopify can help to address.
Tesla, Inc.	We had a call with Chairwoman Robyn Denholm to discuss plans to develop Tesla's corporate governance and her views on the business more generally. Denholm explained that successful execution of strategy remains the number one priority and she has been impressed by accelerating operations in Shanghai. The senior management team was described as strong, working well together and using the board more regularly for advice and support. Denholm is focused on the role of board members as constructive stewards of the business and maintains regular one-to-one dialogue with management, including CEO Musk. Work is ongoing to refresh the board and implement changes to the bylaws and articles. Efforts to reform the latter were frustrated at the 2019 AGM due to low shareholder turnout, and plans are in place to address this in 2020. We believe she has had a positive influence since her appointment, and we are supportive of her work to facilitate Tesla's long-term mission.

Votes Cast in Favour

Companies	Voting Rationale
Atlassian Corp Plc, Trip.com Group	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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