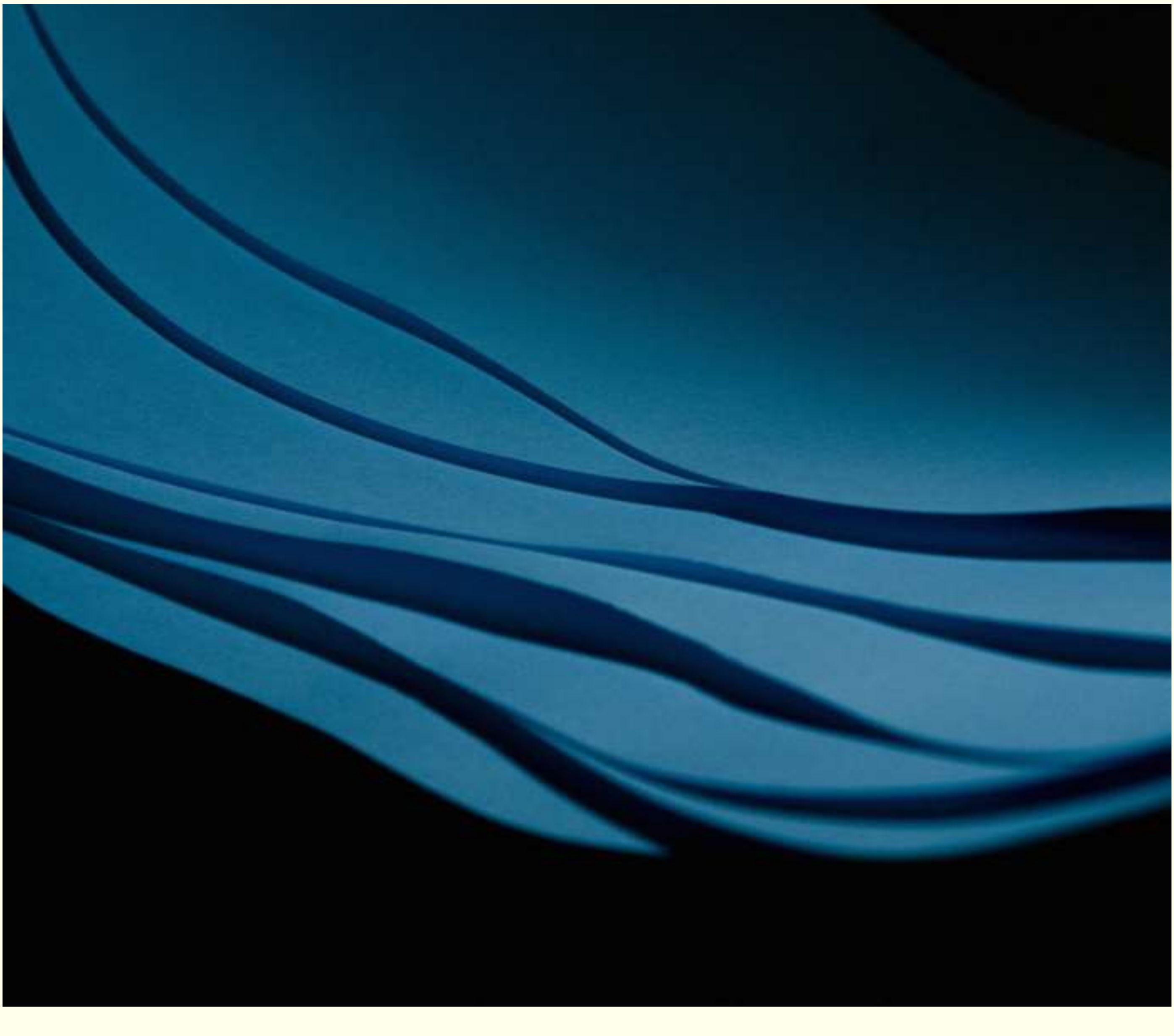
BAILLIE GIFFORD & CO

BCSSS BG Long-Term Global Growth Equity

Report for the quarter ended
30 September 2019



We have all become used to the increasingly mainstream public debate on corporate governance and responsible business issues. Phrases such as 'CEO pay ratio,' and 'carbon footprint' are now widely used in the media. For veterans working in the ESG field, this emergence from obscurity is still something of a welcome surprise. However, the levels of interest in what you might call stakeholder governance theory went up a whole level in August after the US Business Roundtable published a new statement of purpose, signed by over 180 of its corporate members.

The revolutionary semantic step taken by this usually lower key grouping of US corporations was to relegate shareholders to just one of several important stakeholder groups. In their own words from the accompanying press release:

> Since 1978, Business Roundtable has periodically issued Principles of Corporate Governance. Each version of the document since 1997 has endorsed principles of shareholder primacy – that corporations exist principally to serve shareholders. With today's announcement, the new statement supersedes previous statements and outlines a modern standard for corporate responsibility.
>
> "The American dream is alive, but fraying," said Jamie Dimon, Chairman and CEO of JPMorgan Chase & Co. and Chairman of Business Roundtable. "Major employers are investing in their workers and communities because they know it is the only way to be successful over the long term. These modernized principles reflect the business community's unwavering commitment to continue to push for an economy that serves all Americans."

What should we make of this significant change in tone from the top of corporate America? For some investors, the initial reaction might well echo that of the US Council of Institutional Investors (CII) (note: we are an associate member) which was clearly unimpressed: "The [Business Roundtable] statement undercuts notions of managerial accountability to shareholders… Accountability to everyone means accountability to no one."

However, in many parts of the world, stakeholder governance has always been business as usual. For example, in Japan, which has long championed an approach to business that is less directly beholden to investors, executives might understandably be wondering what all the fuss is about. Similarly, German companies, which have legally enshrined employee representation in their corporate governance, may have shrugged and wondered why it has taken so long for Anglo-Saxon capitalism to catch up with the programme.

In reality, the Business Roundtable statement is just the final nail in the coffin of the Chicago School of Economics inspired dogma of relentless focus on profit maximisation as an end in itself. The best companies – and the ones that we particularly like to invest in – have long understood that focusing on delighting their customers and enduring business excellence is the surest way to sustainable long-term profits. The recent changes to the UK Corporate Governance Code, which enshrine the importance of corporate purpose and director accountability to the workforce, signalled the change to a more multi-stakeholder approach to corporate decision making.

Taking the long view, it is the last 50 years that will come to be seen as the aberration. Corporations were originally set up and licensed to carry out a particular (socially useful) purpose. They have a distinct and separate legal form from ordinary businesses, and they enjoy legal personage and the right to own property and intellectual capital. Therefore, if well run, they enjoy a type of commercial immortality. The idea that corporations could take this special social licence to operate and use it only for short-term profit maximisation with no wider social purpose is out of step with the historical spirit of the joint stock corporation as well as the current zeitgeist.

Shareholder value theory served an important purpose at a time when many companies had lost their way and weren't necessarily delivering much value for anyone, but the philosophical pendulum swung too far. Either way, society's mood music has decidedly moved on, and right across the political spectrum. The Business Roundtable, for whatever reasons or motives, has recognised this and moved on too.

We do, of course, have sympathy with the CII's concerns about potentially less accountable corporations merely going through the motions of stakeholder-driven decision making. We also share the view that far too many companies struggle to set long-term growth targets that are aligned with investor interests, and instead resort to short-term measures to try and boost the share price to achieve executive compensation milestones. The CII is also absolutely right in that too many companies have been run for decades for the sole purpose of enriching their executives, and we need to collectively push back against this.

To conclude, we are very comfortable with the international convergence towards a more balanced approach to corporate decision making, and the idea of a wider set of goals for big business as a means to long-term value creation.

This may be a timely opportunity to introduce Baillie Gifford's own Stewardship Principles, which we published earlier this year. The principles very much focus on the themes discussed. They are included below for information, and will be incorporated in the next version of our Governance and Sustainability policy. Importantly, these are very much live principles, which we use in our ongoing engagement with your holdings as we push for best practice standards in corporate governance.

Baillie Gifford stewardship principles: reclaiming activism for long-term growth investors

We have a responsibility to behave as supportive and constructively engaged long-term shareholders. We invest in companies at different stages in their evolution, across vastly different industries and geographies, and we celebrate their uniqueness. Consequently, we are wary of prescriptive policies and rules, believing that these often run counter to thoughtful and beneficial corporate stewardship. Our approach favours a small number of simple principles which help shape our interactions with companies.

Prioritisation of long-term value creation

We encourage company management and their boards to be ambitious and focus their investments on long-term value creation. We understand that it is easy for businesses to be influenced by short-sighted demands for profit maximisation, but believe these often lead to sub-optimal long-term outcomes. We regard it as our responsibility to steer businesses away from destructive financial engineering towards activities that create genuine economic value over the long run. We are happy that our value will often be in supporting management when others don't.

A constructive and purposeful board

We believe that boards play a key role in supporting corporate success and representing the interests of minority shareholders. There is no fixed formula, but it is our expectation that boards have the resources, cognitive diversity and information they need to fulfil these responsibilities. We believe that a board works best when there is strong independent representation able to assist, advise and constructively test the thinking of management.

Long-term focused remuneration with stretching targets

We look for remuneration policies that are simple, transparent and reward superior strategic and operational endeavour. We believe incentive schemes can be important in driving behaviour, and we encourage policies which create alignment with genuine long-term shareholders. We are accepting of significant pay-outs to executives if these are commensurate with outstanding long-run value creation, but plans should not reward mediocre outcomes. We think that performance hurdles should be skewed towards long-term results and that remuneration plans should be subject to shareholder approval.

Fair treatment of stakeholders

We believe it is in the long-term interests of companies to maintain strong relationships with all stakeholders, treating employees, customers, suppliers, governments and regulators in a fair and transparent manner. We do not believe in one-size-fits-all governance and we recognise that different shareholder structures are appropriate for different businesses. However, regardless of structure, companies must always respect the rights of all equity owners.

Sustainable business practices

We look for companies to act as responsible corporate citizens, working within the spirit and not just the letter of the laws and regulations that govern them. We believe that corporate success will only be sustained if the long-run impact of a business on society and the environment is taken into account. Management and boards should, therefore, understand and regularly review this aspect of their activities, disclosing such information publicly alongside plans for ongoing improvement.

We take our responsibilities seriously. We will encourage focus on the building of lasting competitive advantage, and we will enthusiastically support those with a thoughtful approach, using voting to support our five core principles. At a time when the word ‘activism’ is synonymous with those targeting short-term gains, we would like to reclaim the term for the long-term growth investor.

Voting Activity

Votes Cast in Favour		Votes Cast Against		Votes Abstained/Withheld	
Companies	4	Companies	None	Companies	None
Resolutions	47	Resolutions	None	Resolutions	None

The US Business Roundtable published a new statement of purpose in August

Recent changes to the UK Corporate Governance Code signalled the move to a more multi-stakeholder approach to corporate decision making

We are very comfortable with the international convergence towards a more balanced approach to corporate decision making

Firm-Wide Company Engagement

Engagement Type	Company
Corporate Governance	Alibaba Group Holding Limited, Alphabet Inc., Amazon.com, Inc., Facebook Inc., Illumina, Inc., Kering SA, Peloton Interactive, Inc., Shopify Inc., Tesla, Inc., Workday Inc.
Environmental/Social	Hermes International SCA

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	Co-founder Joe Tsai wanted to discuss succession and culture at Alibaba. He remembers a conversation with us years ago on the advantages of partnerships, and still thinks that a partnership structure confers significant cultural differentiation. The market's preoccupation with co-founder and now former Chairman Jack Ma as the great leader of the company amuses Tsai. No insult implied to Ma - himself an advocate of group leadership - but Tsai has never supported the notion of a single great leader in the company. The ambition was to move leadership down the generations whilst keeping sage veteran advisors available. This increases corporate adaptability. Tsai believes that extended leadership tenure is generally detrimental, a notable exception being Amazon founder CEO Jeff Bezos given his endless curiosity and relentless reinvention.
Alphabet Inc.	We participated in Alphabet's quarterly call on environmental, social and governance (ESG) issues. The company provided an update on board oversight and operation, executive pay, privacy and user data, as well as sustainability. Whilst there appears to be progress across ESG issues, their approach to engagement remains restrained, with minimal time allotted to topics shareholders see as important. This level of interaction is not consistent with a business of its size and maturity. Consequently, insight to business practices was limited. As a long-term shareholder, we will continue to participate in such calls as part of monitoring the company's ESG practices, but we are realistic on the limited value they add. We also participated in the annual Alphabet seminar for long-term, large shareholders. This allowed us to hear from Chief Financial Officer Ruth Porat and Google CEO Sundar Pichai among others in the management team. Despite the seniority of the speakers, content was limited and certain parts of the business, such as Waymo, were not discussed - we will continue to engage on those aspects. We were encouraged to learn more about efforts to enhance user experience, such as a transformation of its targeted advertising approach thanks to machine learning, thereby avoiding the need for personal data (evidence of adapting to privacy concerns). Set against Alphabet's future growth is the prospect of regulatory intervention. Pichai's view was that regulatory scrutiny is nothing new. He takes comfort from Google's product development approach being focused on maximising helpfulness to users, while its search business cannot make money unless its partners are successful. Indeed, he suggested that regulatory intervention may be beneficial.
Amazon.com, Inc.	A session with founder CEO Jeff Bezos at the Sun Valley conference inevitably led to questions about media criticism and regulation. Bezos remarked that increasing media attention is evidence of Amazon's significance. Although this scrutiny is not new, it is more amplified than before. Amazon's readiness to engage with the issues is encouraging. Recent examples include the company's decision to raise the minimum wage for US workers to $15 per hour and its advocacy to raise the federal minimum wage, as well as a commitment to meet its obligations to the Paris Agreement on climate change a decade early. We continue to engage with Amazon to understand more about its attitudes and actions to addressing social and environmental concerns that may affect its long-term growth. Labour conditions remain an area for further research and we will again visit a fulfilment centre in the coming months.
Facebook Inc.	A meeting with founder CEO Mark Zuckerberg and Chief Operating Officer Sheryl Sandberg made clear that Facebook's acceptance of past errors has turned into action. With the company's operational performance still robust, Facebook is taking an increasingly proactive approach to addressing societal concerns. Indeed, Zuckerberg mentioned discussions with Bill Gates on how to simultaneously run a company and work with regulators. Whilst the advertising model and past errors may mean that being accepted as a force for corporate good in future is improbable, it is what Zuckerberg and Sandberg have in mind. The current modest reputational recovery might become societal forgiveness in the longer term, but we continue to engage with management on these issues.

Company	Engagement Report
Hermes International SCA	With around half of Hermès sales derived from leather products, environmental sustainability is a growing consideration in our investment thesis. An invitation to an event at the flagship Paris store provided an opportunity to discuss Hermès' approach to sustainability with Olivier Fournier, an executive committee member. He stressed that, as a brand that epitomises quality artisanry, it must use only the best raw materials - hence management's desire to strengthen control of its leather supply chains through more vertical integration. Beyond leather, Hermès is experimenting with alternative materials. We will continue this conversation with management in the coming months on the environmental and societal considerations facing the business.
Illumina, Inc.	Illumina's sequencing and array technologies drive advancements in life science research, translational and consumer genomics, and molecular diagnostics. We had a call with the company to discuss developments in its corporate governance. Recent changes include declassifying the board, annual elections for directors, and removing supermajority voting requirements to amend bylaws. These amendments increase board accountability and provide greater influence to shareholders. The board has been extensively refreshed in recent years, with the recruitment of experienced, high quality non-executive directors to provide oversight and support to management. International experience is the next area the board would like to strengthen. We are encouraged that Illumina's governance practices are evolving in a manner which supports its long-term strategy.
Kering SA	The potential for CEO François-Henri Pinault to reinforce the adaptability and longevity of Kering through his commitment to sustainability appears to be far more than just words. Leather alternatives are on the verge of serious commercial significance and it was clear from our discussion that Kering is positioning itself to reap the benefits. For those who market themselves on the basis of traditional leather, this could become a serious issue (hence our parallel discussions with Hermès).
Peloton Interactive, Inc.	Co-founder CEO John Foley thinks in decades. Even during our meeting just before Peloton's IPO in September, Foley was more interested in discussing how different Peloton would be 10 years from now. He shared his vision for ever greater personalisation, more opportunities for community engagement and potentially a 'fitness-as-a-service' platform. In contrast, he showed little interest in how metrics might look this year or next and he deferred to the CFO to respond to any near-term questions - behaviour we find encouraging. Among other positive cultural traits, Foley believes that the company can recruit top talent because Peloton unambiguously seeks to make the lives of its customers better by making them healthier. The greatest challenge in his view is how to continue nurturing this culture as the nascent company grows from hundreds of employees to thousands.
Shopify Inc.	A meeting with Chief Operating Officer Harvey Finkelstein highlighted that the company's culture is centred on entrepreneurs. This differs from Amazon, where customer-centricity is at the core of the business culture. Shopify does not consider the end customer as unimportant, but believes that reducing the frictions facing entrepreneurs is vital for customers to benefit from greater innovation and choice. Finkelstein combines his commercial oversight with the vision and product genius of founder CEO Tobias Lutke in their ambition to build a 100-year company. He underlined their eagerness to constantly improve culture, particularly as the company grows. Indeed, mentorship is hugely important internally. We were encouraged by Finkelstein's passionate engagement in company culture - a contrast to the lip service which many other executives pay to such questions.
Tesla, Inc.	Our discussion with CFO Zach Kirkhorn spanned a number of significant issues including: the various pricing adjustments earlier this year; the Shanghai factory; servicing; and the Model Y crossover vehicle. We also discussed a significant development over the past year - the departure of Chief Technology Officer JB Straubel. Credited with much of Tesla's battery prowess to date, Straubel had been a significant figure in the management team since the compny's early days. Kirkhorn informed us that Straubel's outside interests had been building for some time, but he stayed on until the Model 3 production levels were stable. This effectively allowed 6-12 months to prepeare for his successor Drew Baglino to step into the CTO role from the position of vice-president of technology. We pay close attention to succession planning and can take comfort that Baglino was recruited by Straubel back in 2006. We aim to meet Baglino in the coming months.

Company	Engagement Report
Workday Inc.	A meeting with co-founder CEO Aneel Bushri provided an opportunity to discuss management's approach to recent acquisitions. Faced with continued expansion of Microsoft and Amazon, the merging of specialist players may be the way for companies such as Workday to build more business verticals. Although there have been Workday bolt-ons in the past, Bushri sees the 2018 acquisition of the business planning software provider Adaptive Insights as being different in terms of its substantial scale and significance. His admiration of both products and culture at Adaptive Insights runs deep. As large acquisitions can often prove challenging for companies over the long term, Workday's attention to the alignment of corporate cultures is encouraging.

Votes Cast in Favour

Companies	Voting Rationale
Alibaba, 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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