Global Alpha Stewardship Report

To the year ended 30 September 2020

BAILLIE GIFFORD | *Investment managers*

Risk Factors

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This communication was produced in November 2020 and updated in January 2021. It represents views held at the time of writing and may not reflect current thinking.

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Stewardship for Growth

Our goal as investors is the identification and nurturing of companies capable of outstanding long-term returns. The excellent studies of Professor Hank Bessembinder and others make clear that long-run wealth creation is dominated by a remarkably small number of extraordinary companies, often powering technological or societal change. Core to our approach is the desire to invest in companies with vast opportunities and to build lasting relationships with those driving their success. We view our role as supporting ambition and helping special businesses to meet their full potential.

Importantly, taking a long-term approach to investing effectively embeds the interests of society alongside those of asset owners. For businesses to be sustainable over any meaningful time-horizon they must be run with consideration of all stakeholders in the broadest possible sense. Companies which abuse the environment, treat staff poorly or damage the fabric of society will ultimately fall foul of regulation or find themselves deserted by their customers. Let's be clear, prioritising the sustainability of a company in the long term will mean that certain short-term profit opportunities are foregone. This takes bravery and foresight from a CEO.

We do not believe that there can be a uniform or codified approach to stewardship or what is commonly labelled as Environmental, Social and Governance (ESG) considerations. We look for businesses which are willing to break the mould, to disrupt, and to drive change across industries. We must encourage them to protect and strengthen unique cultures rather than promoting conformity. We are delighted to support the thoughtful pay and governance structures of the likes of Netflix and Schibsted, and we celebrate the fact that these do not fit neatly with industry 'best practice'. We also understand that businesses evolve as they grow and will require different governance frameworks at each stage of their life cycle. We wish to help our investments on this journey.

A vast industry appears to be developing around ESG 'investing'. We greatly welcome the increased attention and any serious efforts to address issues such as climate change and the fair treatment of employees. Indeed, we have greatly strengthened both our team's and our firm's dedicated resource in this area to help provide serious thought leadership. However, we fear that the direction of travel is that of ESG 'washing', posterior-covering and the blunt encouragement of homogeneity. While standardisation may benefit those endlessly manufacturing indices, selling ratings and so-called passive ESG strategies, it does nothing to support actual long-term investing or those building the businesses of the future. Indeed, we believe that today's ESG 'industry' frequently focuses on inappropriate metrics which are insensitively applied. At its least harmful, this creates a deafening noise often misunderstood for signal. At its worst, it negatively influences the behaviours of stand-out businesses, drawing them closer to a sea of mediocrity, suffocating reward-seeking behaviour.

Our desire is to lead the conversation in a different direction – to focus attention on the benefits of patient relationship building, of long-sighted capital deployment and ambition for truly sustainable growth. We believe that this is a conversation with vital implications for innovation, the success of companies, the progress of society and long-term wealth creation for savers. This report provides three examples of what this looks like in practice. Each example illustrates a different way of how engagement comes about – Royal Caribbean where we sought to engage, Pernod Ricard where we were asked to engage, and Schibsted where quiet engagement has perhaps led to one of our most productive instances of stewardship for growth. This report is also a record of our voting and engagement activities on our clients' behalf. The discipline of disclosing our actions publicly helps hold us accountable. We are open to suggestions about how we can improve even further.

We will always take our stewardship responsibilities seriously, but we cannot promise to conform in our approach. Our efforts are focused on supporting radical ambition and helping special businesses to meet their full potential. Neither of those two outcomes can be easily reduced to a simple numerical score. Thoughtless shortcuts don't result in wealth creation.

Engagement Highlights

Schibsted

Schibsted has been one of Europe's most successful Media and Technology businesses over the past two decades. Its re-orientation from newspapers to digital marketplaces was visionary, brave and ultimately very rewarding. Key to this success has been a strong Board working with a talented and ambitious management team. We can be a little more confident than normal in ascribing success to these individuals as Spencer Adair has served as a member of the Board's Nomination Committee since 2015.

The purpose of these paragraphs is not to trumpet Schibsted's success. Rather, it is a reflection on the value of quiet engagement.

When we were conducting our initial analysis on Schibsted in 2012, a core tenet of our investment hypothesis was the presence, motivation and positive influence of the family Tinius Trust which was established by Tinius Nagell-Erichsen, the great-grandson of Schibsted's founder Christian Michael Schibsted. We believe Schibsted's willingness to take long-term risks can be directly linked to the quiet stewardship of the Trust, an approach that aligns well with our own.

"Its re-orientation from newspapers to digital marketplaces was visionary, brave and ultimately very rewarding."

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When the company came under increasing shareholder pressure due to the short-term losses from expansion into new markets, we were privately supportive and encouraged an even greater pace of investment. We backed the potential asymmetric skew to the rewards of success on the long-term. Similarly, when the company was criticised for spending heavily on an ultimately failed attempt to build a technology hub in London, we adopted a more sanguine approach. What was more important to us was the aspiration and motivation to become world-class coupled with any lessons learnt. Not every ambitious decision will work – we accept that the road to success will have inevitable potholes. Acknowledging this is one of the most important realisations a long-term investor can offer to companies. Indeed, the absence of mistakes tends to be indicative of a culture that is too risk averse.

There is an under-studied network effect in stewardship. By 2014 we had built very strong relationships at Schibsted and its peer Naspers. Both were competing head-to-head to build digital marketplaces in several exciting growth markets such as Brazil, Indonesia, Philippines, Thailand and Bangladesh. We believed that a more consolidated marketplace would be worth more than the sum of its parts. Our best guess was that the market ascribed negative value to many of these assets as years of marketing spend cast doubt on whether market leadership would ever be reached. On several occasions we quietly encouraged the senior teams at both companies to talk rather than fight. In 2015, Schibsted and Naspers entered a series of joint venture agreements and asset swaps. There was a substantial peace dividend as the leader in each market became clear.

To build genuine influence at any company, one must show serious commitment and engagement. It is no good to support companies when things are going well and walk away or criticise when things get tough. It is in the tough moments that we build repute. Often, engagement is little more than an understanding and tolerance for poor outcomes, and an occasional word of support. Quiet engagement doesn't result in headlines, but it is no less effective in influencing positive outcomes.

Pernod Ricard

Different market participants seek to make money in different ways. Not all prioritise long-term value creation. We first invested in the spirits company Pernod Ricard for Global Alpha clients in 2017. We were attracted by the company's opportunity to deliver accelerating organic growth, underpinned by the development of valuable drinks franchises across the vast Indian and Chinese markets. We had also been impressed by the ambition of the energetic Alexandre Ricard. Grandson of one of the founders, Alexandre took the helm as CEO in 2015 with plans to breathe life into the business through increased customer centricity, a drive towards operational efficiency and heavy investment in the Asian growth opportunity.

A year on from our initial investment, activist shareholders Elliott Advisors published a statement explaining they had bought an economic interest of 2.5 per cent in Pernod. Within the statement Elliott outlined suggested plans to improve share price performance. While there were aspects of Elliott's case which we agreed with, we had deep concerns that their focus on near-term margin improvement would be to the detriment of long-term organic growth and value creation. Although we were only entering the second year of our ownership of Pernod's shares, the company contacted us to seek our counsel. Over the prior 12 months we had spent time developing or relationship with management, including a trip to meet Alexandre Ricard in Paris.

During our conversations with Alexandre Ricard and subsequent interactions with the Senior Independent on the Board, we stressed our belief in the company's investment plans and that any scaling back of efforts in India, China and beyond would be to the detriment of long-term wealth creation. We also took time to explain our thinking to Elliott Advisors who have ultimately backed away from the company.

Too little time has passed for us to judge whether this continued path of investment will result in outsized value creation. Unlike Elliott Advisors, we have never taken a holding with a corporate agenda in mind. Our preference is for ambitious companies to be left alone to get on with their mission. In this case, we are pleased that our voice made a difference in preventing an ambitious management team from being blown off course.

"We have regular interaction with Baillie Gifford, relating to both our overall business performance and to governance matters. This was particularly true during a recent activist campaign. Baillie Gifford were prompt to engage with us to understand the requests being made by the activists and offer their view as a long-term holder. The feedback was extremely useful in helping us gauge different shareholder perspectives and it was very valuable to be assured of shareholder support at that time, with Baillie Gifford even offering to publicly back the Group's long-term strategy should the need arise."

Pernod Ricard management

Royal Caribbean

As with many cyclical industries, the single most important factor influencing profitability in the cruising industry is the balance between supply and demand. For many years, up until 2010, the industry followed a 'growth' strategy of rapidly increasing capacity, resulting in price discounting to fill the ships. Competition and personal ego ensured that irrational and unsustainable behaviours persisted even as the global financial crisis decimated demand. The final straw was the sinking of the Costa Concordia (operated by Carnival Cruises) in January 2012, with the loss of 32 lives. The industry was in trouble, with high levels of debt, depressed profits, a tarnished reputation and, as a result, rock-bottom valuations.

This was the situation when we invested in Royal Caribbean in April 2012. Our hypothesis was that while demand would recover along with the world economy, the 'arms race' was over and that there would be increased financial discipline, reduced supply of new ships and less price discounting. Stronger demand and slower supply would allow profits and return on capital to rise, justifying a rerating of the share price.

Royal Caribbean, the second largest operator (24% market share), had always been customer focused, while the leading player, Carnival Cruises (42%) had a reputation for putting its shareholders first. While in the short term this produced higher margins at Carnival, over longer periods it proved self-defeating: Carnival repeatedly suffered more operational problems, such as engine failures, because of structural underinvestment. In 2014–2015 Carnival had to spend an additional $700m on safety upgrades to meet new regulations while Royal Caribbean remained within normal budgets. Adhering to tighter environmental regulations also had a disproportionate cost for Carnival. By contrast, Royal Caribbean understood that if it focused on delighting its customers, over the long term the economics would follow.

Our reputation as patient providers of capital allowed us to build a relationship with the company. We opposed the renumeration packages in 2014 and 2015, pushed for improved disclosure of performance metrics and a move away from one-year targets. With our encouragement, the company introduced an explicit return on capital target in 2014 and extended the time horizon to 3-years in 2015, thereby strengthening alignment with long-term strategy and securing our support. In 2016 we identified Royal Caribbean as one of the portfolio's largest carbon contributors. Under shareholder pressure, including from Baillie Gifford, the company added annual fuel and emission reduction targets to its internal KPIs.

It's hard to say how much of the performance resulted from our engagements. We believe that our focus on stewardship for growth can increase the chance of success for companies. Stewardship for growth means thinking about the sustainability of the business well beyond our investment period. When we sold the last of our investment in Royal Caribbean in July 2019, we cited three growing concerns: increasing capacity, weakening pricing at their peers and rising environmental costs. All three of these undermined our conviction in the long-term sustainability of the investment case.

Engagement for Growth

Distinguishing the unconventional from the unacceptable

> *"A comfort zone is a beautiful place, but nothing ever grows there."*
>
> Unknown

To deliver outstanding long-term returns for our clients, we need to understand the businesses in which we invest. This includes the contextual circumstances that each company operates within, the management teams and boards to which we entrust our clients' capital and our role as responsible, thoughtful stewards. Advocating for the same governance practices for every business betrays this ambition. While we are supportive of initiatives to raise the floor of basic governance standards, we do not believe this elevates the ceiling for our investments to grow. For this reason, we do not seek comfort in conformity, but rather confidence in each company's governance practices to facilitate its long-term strategy. We wish to elevate the ceiling.

We engage to understand the merits of unconventional practices. Before passing judgement on the what¸ we first need to understand the how and the why of a company's corporate governance. For instance, in 2015 when Schibsted proposed a dual class share structure, our discussions focused on how this would enable the company to participate in value-accretive growth initiatives and why preserving the role of the Tinius Trust as Schibsted's primary steward was essential. We were less concerned by the departure from the one share, one vote standard.

Our ability to influence is not a simple function of how many votes we hold, but rather the type of relationship we have built with management and the board. We develop trust by acknowledging tough times and events occur. By demonstrating that we know failure is not the opposite of success, but part of the process, we gain respect from corporate leaders and gain additionality to our position on the share register. For example, following our support during Pernod Ricard's interactions with activist Elliot Advisors (as outlined earlier), the company sought our views about potential retrospective changes to its long-term incentive plan. We explained that these amendments would create a misalignment with employees and shareholders, and we were not supportive. Based on this feedback, the board decided not to go ahead with the changes.

Where we identify practices that do not meet our expectations, we will intervene. For instance, a core tenet of a constructive and purposeful board is independence and CyberAgent has been lacking in this regard over the course of our investment. Unsuccessful attempts to encourage more objective oversight compelled us to escalate our stewardship activities, abstaining on the re-election of founder and CEO Fujita-san at the 2019 AGM. Fujita-san received only 58 per cent support and the company has subsequently increased board independence.

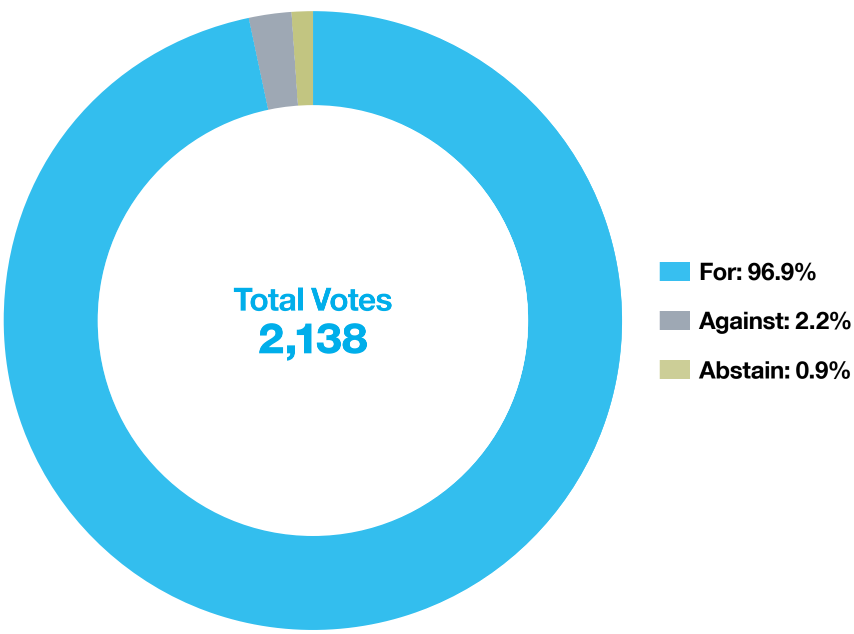
Support for the unconventional does not mean tolerance of the unacceptable. Accordingly, when allegations of sexual harassment and a toxic work culture at Ubisoft emerged earlier this year, we engaged immediately with the company. We signalled the seriousness with which Baillie Gifford views these issues and our support for the company to take all measures necessary to restore a safe, inclusive and diverse workplace environment. We have been encouraged by the actions taken so far, including the introduction of new communication channels and the removal of culprits, regardless of seniority. We continue to monitor developments and are ready to reengage if necessary.

We do not believe the barometer for successful stewardship is the amount of hours spent or the number of standardised practices adopted. We see our role as patient, committed shareholders as providing the support and latitude for companies to build differentiation and enduring competitive advantages. It matters little to us if this is done with a joint CEO/ Chair or a classified board structure. We are not motivated by a myopic fixation on governance best practices, but instead the creation of sustainable shareholder value. We believe this to be our duty as long-term stewards of clients' capital.

Proxy Voting

Exercising the voting rights attached to our holdings is a core component of our role as responsible stewards of our clients' capital. Coordinated internally by our dedicated Governance and Sustainability team and aligned with our bottom-up approach to research and engagement, we seek to make thoughtful voting decisions which are supportive of each company's long-term strategy. The portfolio's investment managers are actively involved in voting decisions and we routinely communicate any votes against management to the company, so they understand our rationale.

We invest in high quality management teams and in businesses where the governance structure is supportive of the investment opportunity. We seek to avoid investments where corrective action is required to generate long-term value. Accordingly, we support the vast majority of resolutions put forward by investee companies, voting against proposals on the few occasions where we disagree with decisions taken by management or where our ability to influence through engagement has either been unsuccessful or not possible. We understand the nuances of responsible stewardship and therefore make use abstentions when we think voting decisions are not black or white. Abstentions can be a useful way of taking account of the broader context in which companies operate, allowing us to maintain constructive relationships with management and the board as part of a gradual, long-term engagement process.

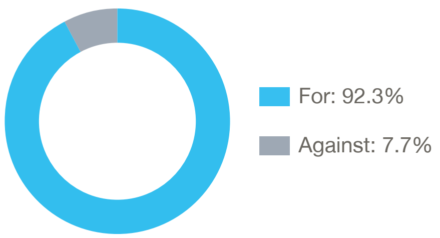


Source: Baillie Gifford. Data from 1 April 2019 to 30 September 2020.

Management Resolutions: Breakdown of Voting Activity

The graphics below provide a breakdown of Global Alpha's voting activity across different resolution categories, as well as some examples to illustrate our decision-making process.

Remuneration



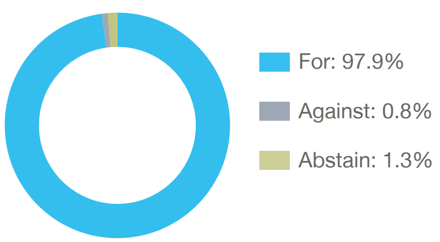
Example – Jefferies Financial

We opposed the executive remuneration because of the decision to grant discretionary bonuses to the President and CEO despite their failure to meet the threshold targets for the annual incentive plan. We had previously been supportive of the pay policy, which had an unconventional structure. However, we have been disappointed by Jefferies' overall performance and did not believe the decision to grant bonuses was justified. We considered this to be misaligned with the experience of our clients and did not think it was indicative of an independent, externally-aware Compensation Committee. Accordingly, we opposed the pay resolution and the re-election of the committee chairman.

Voting Result:

Executive remuneration: For 69.1%; Oppose 30.7%; Abstain 0.2%
Compensation Committee Chair: For 90.3%; Oppose 9.4%; Abstain 0.4%

Director Elections

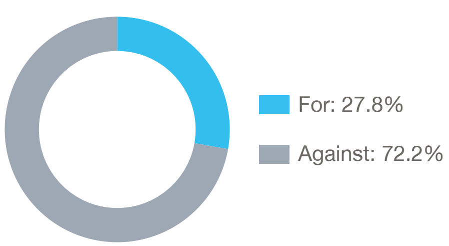


Example – SMC Corp

We abstained on the election of chair Yoshiyuki Takada and two new inside directors. SMC has long demonstrated a traditional Japanese approach to corporate governance, and we have regularly engaged with the company on our expectations in terms of an appropriately independent board to promote innovation and challenge. This year, when chair Takada's son became representative director, we took the opportunity of succession to write a letter encouraging SMC to improve its corporate governance as a matter of priority. If we don't see a suitably ambitious indication of change, we will continue to take voting action at the company's AGM.

Voting Result: For 76.28%; Oppose 18.25%; Abstain 5.47%

Shareholder Proposals



Example – Amazon

We voted in favour of two shareholder proposals related to gender pay and climate change disclosures. Amazon already provides some information on its gender pay gap, but the proposal requested median pay figures across the business. In our engagement we cited our experience in reporting these figures, and how we found them beneficial. Amazon has taken strong steps on climate change and the shareholder proposal requested formal commitments and targets, which we felt was consistent with management's intentions and our expectations.

Voting Result:

Climate Change proposal: For 29.75%; Against 66.55%; Abstain 3.70%
Gender Pay proposal: For 25.83%; Against 70.64%; Abstain 3.53%

Source: Baillie Gifford.
Data from 1 April 2019 to 30 September 2020.

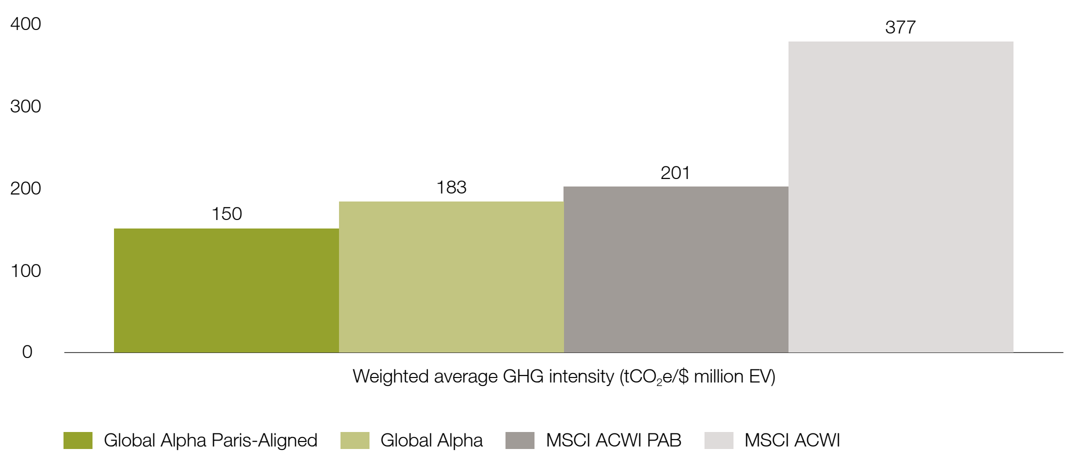
Climate Change

We assess the resiliency of the Global Alpha portfolio against environmental and social risks and opportunities. One tool we use is carbon footprint analysis, which identifies the largest emitters and helps to prioritise research and engagement activities.

This year, in line with MSCI's methodology for its Climate Paris Aligned Indexes, we have measured Greenhouse Gas (GHG) emissions intensity instead of carbon intensity for the portfolio. GHG intensity is a more comprehensive measurement of the portfolio's carbon footprint, including scope 3 emissions data as well as scopes 1 and 2. Scope 3 emissions data is the most complex to calculate and gathered data continues to be a combination of estimated and reported information. We expect this to improve over time. Understanding of scope 3 data is particularly relevant for the portfolio given its investment in technology and other businesses where most of their emissions are created in the upstream supply chain or the downstream usage of their products and services. By including scope 3 emissions data in our analysis we are striving to be better informed as to how holdings are managing their climate risks and opportunities.

As shown in the chart below, the Global Alpha portfolio has a lower weighted average GHG intensity than the MSCI All Country World Index. The weighted average GHG intensity (WAGHGI) measures the portfolio's exposure to GHG-intensive companies. Businesses with a higher GHG intensity are likely to be more exposed to carbon related market and regulatory risks. This metric is agnostic to ownership share and allows comparison of the portfolio's exposure relative to the index. It replaces previous measures which assessed the portfolio according to emissions per $ million invested and per $ million sales. The use of a weighted average intensity figure is consistent with recommendations from the EU Technical Expert Group and the Task Force on Climate-related Financial Disclosures (TCFD).

Carbon Footprint Analysis



Baillie Gifford & Co and MSCI ESG Research. Data representative of Global Alpha and Global Alpha Paris-Aligned portfolios. Benchmarks: MSCI All Country World Index and MSCI ACWI Paris-Aligned Benchmark. As at 30 September 2020.

The carbon footprint of the Global Alpha portfolio has improved over the past year. This is primarily attributed to three factors. First, we have sold high emitting holdings in Apache, AP Moller Maersk and Royal Caribbean Cruises and made a reduction to Kirby. These changes are offset to a certain degree by a new holding in Rio Tinto and an addition to Ryanair. Second, we have changed analysis providers from yourSRI to MSCI ESG Research. This decision was taken following a review of both providers and determination that MSCI can provide a more complete set of tools to help us monitor the environmental credentials of the portfolio. Finally, the reporting currency has changed from British sterling to US dollars. The latter is the default currency for MSCI, with sterling currently unavailable. We don't believe this is a material issue, as the primary comparison between the portfolio and the index is completed on the same basis.

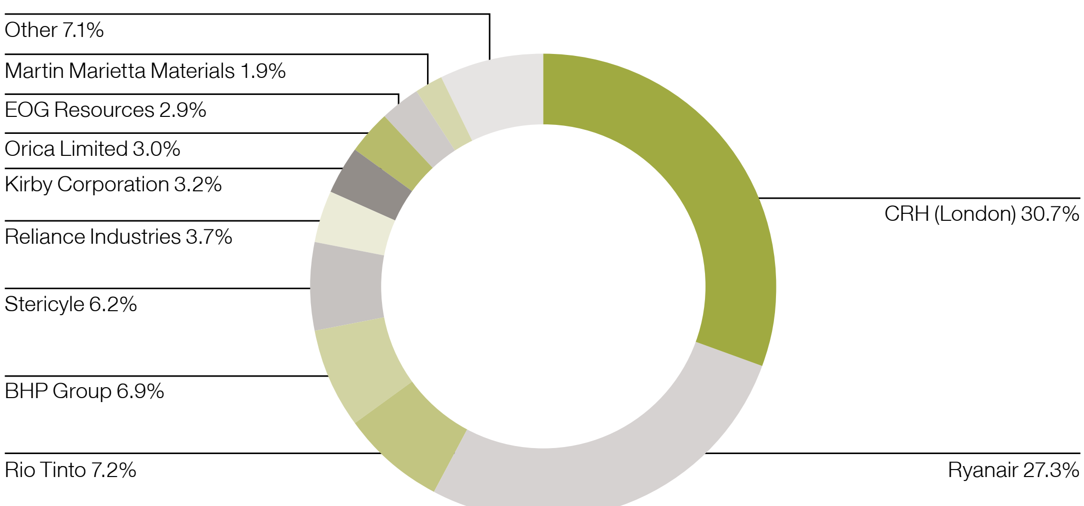
We continue to hold positions in high emitting companies that we believe can deliver long-term value for our clients. Each business's approach to environmental stewardship will be an important determinant of this ambition and society's transition to a low carbon economy. As patient, thoughtful providers of capital, we maintain an ongoing dialogue with these holdings to ensure continuous improvement.

For instance, CRH produces concrete which is the world's most widely used material and essential to social and economic development. As discussed in our 2018 Stewardship Report, we consider CRH to be an industry leader with regard to climate change. This is demonstrated by its recent announcement as part of the Global Cement and Concrete Association, to be carbon neutral by 2050.

Metals and minerals mined by Rio Tinto and BHP enable technological innovation, electrification of transport and renewable energy. They are also critical for wealth creation. To provide people in emerging markets with the same standard of living as we enjoy in developed markets, we will require a 370% increase in global steel and 248% increase in copper by 2050. Both businesses have ambitious plans to achieve net zero emissions from their operations and to support decarbonisation in the downstream usage of their products.

We understand that high-emitting industries have played a significant role in the climate situation we currently face. However, the leaders of these industries will also play an important part in how we transition to a more sustainable future. We remain committed to monitoring the preparedness of our holdings to risks associated with climate change and their impact on the environment. This is incumbent upon us a responsible investor and how we think we think about the long-term sustainability of each business.

Top 10 Contributors to Portfolio Emissions



Source: Baillie Gifford & Co. Total may not sum due to rounding.

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