Global Alpha Stewardship Report

2021

Baillie Gifford | *Investment managers*

Risk Factors

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Contents

Stewardship for Growth

Our core task as investors is to identify and nurture companies capable of delivering exceptional long-term returns. Only a select number of businesses have this potential and they are often those driving change across industries and the broader economy. Central to our approach is the desire to invest in companies with vast opportunities and to build lasting relationships with those driving their success. We aim to embolden ambition, focus attention on long-term value creation and help businesses to meet their full potential. We admire those following paths less travelled and believe that forced conformity can deeply damage a company's chances of success. To this end, we do not believe that rigid templates and rules should govern environmental, social and governance (ESG) engagements. However, we are equally strong in our belief that companies must be held to account when their standards fall short of those required to build truly lasting and admirable franchises.

Taking a long-horizon approach to investing helps embed the interests of society alongside those of asset owners. To be sustainable in the long term, companies must be run with consideration of all stakeholders in the broadest possible sense. Businesses which abuse the environment, treat staff poorly or damage the fabric of society will ultimately fall foul of regulation or find themselves abandoned by their customers. Prioritising sustainability will often require management to be brave and forgo short-term profit maximisation. Ultimately though, this behaviour will deliver greater franchise value and improved long-term financial returns.

While ESG has long been embedded within our investment thinking, there are reasons why we must further our efforts and integration. Societal pressures are increasing the materiality of ESG factors on long-term financial outcomes. Moreover, we understand that clients require enhanced reporting and clear evidence of where our engagements with companies have added value. Accordingly, we have made several process enhancements:

- We are being more explicit and have strengthened questions on ESG factors within our research framework. There is even greater focus on sustainability and stakeholder alignment.
- We have introduced enhanced ESG auditing across the portfolio, led by the Global Alpha team's full-time ESG analyst. These audits are materiality driven and focus on areas such as climate, biodiversity, the treatment of employees and the fair payment of tax. This work will help identify outliers and will guide aspects of our company engagement.
- Additionally, our central ESG team will conduct regular sustainability reviews of our portfolio, helping to identify areas for improvement and providing an independent overview.
- We will provide clients with enhanced ESG reporting metrics.

All of this means that ESG will be even more deeply integrated into our analysis, and that we will benefit from further external evaluation. Ultimately this will help us to evidence a deeply integrated ESG approach.

Research Agenda

Once a year we publish this Stewardship Report and a forward-looking Research Agenda. This section attempts to link the two publications. The Research Agenda is a collection of our known unknowns; topics and areas where we see the greatest potential for change. The aim is not to conclude, but to further our thinking. When looked at through a stewardship lens, what areas of the 2021 Research Agenda have we made progress on during the year?

We are pleased to report we have made considerable progress on three areas:

Growth and the value of disequilibrium	The imperative of social licence	The great energy transition

1. Growth and the value of disequilibrium

The idea of economic disequilibrium is the unsettling transformation or reshaping of an established industry. It is a disruptive but ultimately positive force. These periods require an open mindset, flexibility and ambition from management teams. Superior governance is one of the determining factors that separates the 'victims' from the 'victors'. For example, we supported the extension of a dual-class share structure at The Trade Desk, a cloud-based platform which is pioneering the future of online advertising. This unconventional governance practice provides a strong foundation for founder/CEO Jeff Green to ignore short-term market pressures as the company works to disrupt old advertising empires and establish a new advertising technology ecosystem. From a broader societal perspective, the disequilibrium is spreading from the relatively frivolous entertainment and retail parts of our economy to more critical areas such as healthcare, finance, education, property and energy. We concluded research and purchased holdings in several early disruptors in areas as diverse as biosimulation software (Cetara) and commercial real estate (CoStar). Technological disruption is accelerating.

2. The imperative of social licence

In the Research Agenda published at the beginning of 2021 we wrote:

"We sense that companies from Amazon and Facebook in the west, to Alibaba and Tencent in the east, must continue to prove their value to society at large, to innovate and to increasingly self-police […] As has so often been the case, we believe that we may be receiving valuable earning warning signals from China."

We are not usually that prophetic. We witnessed the troubling revelations of whistleblower Frances Haugen at Facebook (now known as Meta). Her claims that Meta routinely placed profits ahead of broader stakeholder interests are deeply disappointing and run counter to the company's narrative over recent years when we have engaged with them on these issues. Switching region, the magnitude, scope and frequency of regulatory changes from the Chinese authorities caused us to stop and reassess if our businesses in the country were operating with or against the grain of society. Our colleagues in our research office in China have been a great help in putting the new regulatory fervour into a longer-term context. We have, over the course of this year, reduced several of the largest technology platform businesses in both the US and China at least in part because of these issues. Our engagement with Rio Tinto following its destruction of the Juukan Gorge site in Western Australia is the most acute example from the portfolio of the importance of social licence. Our stewardship activities have sought to rectify serious governance failings which led to this disaster. We emphasised the need for a comprehensive overhaul of Rio's businesses practices, including the appointment of a new chairman, improved standards for cultural heritage and better corporate communication. We believe these changes are non-negotiable as the company looks to regain the trust of the traditional owners and build back a foundation which permits long-term value creation.

We are using your capital to shape the new world, not shore up the old one.

3. The great energy transition

The most tangible research and portfolio outputs have been in thinking through the implications of the great energy transition. At firm level, we organised a bi-weekly series of speakers on topics concerning climate change, such as science-based targets and carbon capture. At strategy level, we dedicated a month to reading independently around this topic and coming together to share the insights we gleaned from a broad variety of source material, from corporate strategy, politics, science fiction, and even climate scepticism. We commissioned independent work from Professor Mike Berners-Lee on some of our current holdings and their role in the great energy transition. Alongside a climate audit of the portfolio's climate strategies, these insights helped underpin some robust company engagement with our heaviest carbon emitters, such as the building materials company CRH, and the metals and mining business Rio Tinto. We believe we have encouraged more boldness and ambition in the senior teams. The impact on the portfolio can be seen with the sale of EOG, (not held in Global Alpha Paris-Aligned or Global Alpha Choice portfolios), the last of our traditional oil and gas extractors, which sharply contrasts with the new purchase of Li Auto, one of the next generation of electric vehicle manufactures from China. We are using your capital to shape the new world, not shore up the old one.

Let’s Talk Data

As avid proponents of analysing businesses through a qualitative lens, the above title might cause the odd raised eyebrow. Is this a case of the leopard changing its spots?

To be clear, we remain resolutely of the view that the sustainability of a company’s long-term operations can best be judged via a balanced qualitative assessment. Any attempt to distil an organisation down to a single ESG metric is fraught with peril. Nevertheless, we are living through the greatest information explosion in the last 500 years – since the printing presses began. Undeniably there is now a role for data to fulfil, not only to frame a company’s starting position but also to gauge the pace of change as organisations progress, or regress, on their journey to becoming better corporate entities.

Our ESG team has over recent months pulled together a data factsheet that groups together a range of metrics covering the E, the S and the G. It remains a work in progress. The challenge is sourcing accurate, robust numbers that provide insight and enable richer investment discussions. Nevertheless, we now have a template which we look forward to sharing with you over the course of 2022. Below are a few of the metrics which we think have utility as part of a broader discussion:

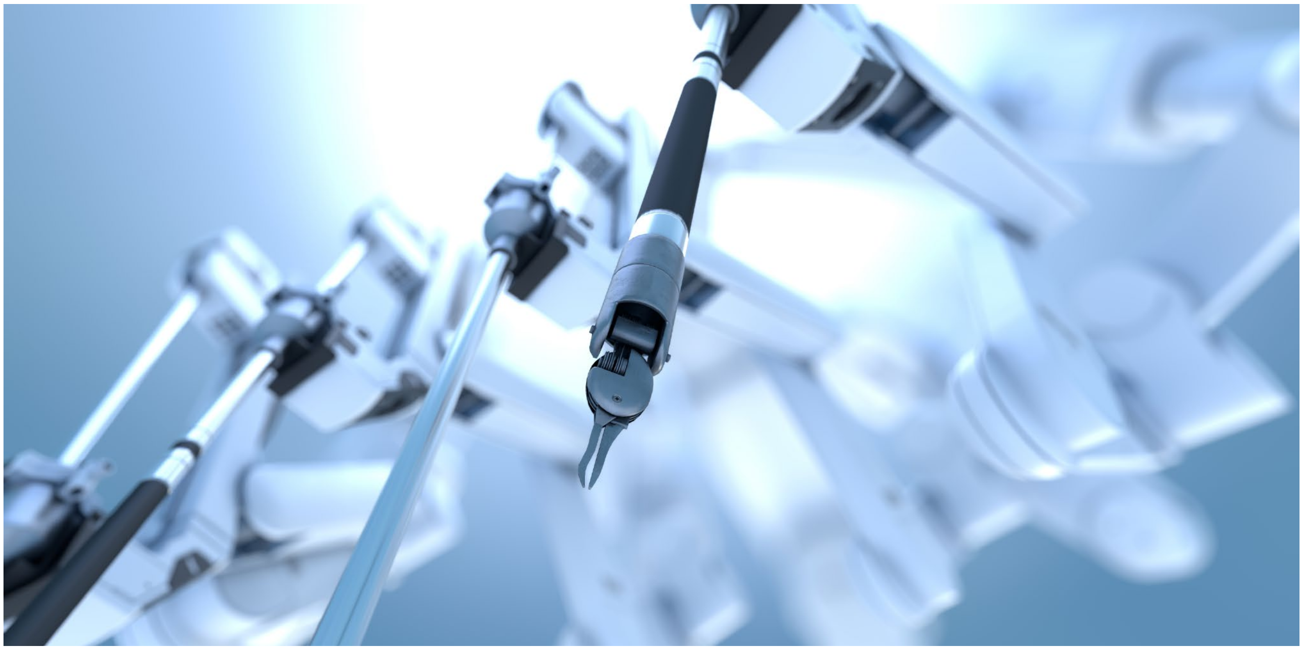
Ownership

Our preference for investing in founder-led growth businesses means our engagement with management is based on a mutual appreciation of perspectives. Founder-CEOs are experts in their businesses: individuals with a depth of knowledge that we can only aspire to achieve. A core tenet of our stewardship activities with non-founder led holdings is to encourage their leaders to act as principals of each business, not merely agents that shareholders have employed.

Owner Type	Index %	Fund %
Controlled (≥ 30%)	5.7	6.2
Principal (10–30%)	17.9	22.6
Founder Firm (CEO/Chair)	23.2	39.3
Family Firm (≥ 10% and Board)	7.2	5.7
Widely Held	45.8	25.7

Based on a representative portfolio as at 30 September 2021.

Controlled refers to a company where the largest shareholder owns the majority of the voting rights. Principal is defined as persons who own 10% or more of the share register and is not a founder or controlling shareholder.



Investing in innovation

Growth capital expenditure is expenditure on new assets that are intended to increase a company's productive capacity. This is different from maintenance capital expenditure, which is necessary for a business to operate in its current form. We believe this allocation multiple (defined as (Capital Expenditure + Research and Development) / (Dividends + Buybacks)) is important because it demonstrates a commitment to R&D, innovation, and calculated risk-taking. It evidences management's and the board's refusal to stand still and their willingness to grow the business in order to deliver long-term value creation. Consistent with our investment approach, the chart to the right shows that, on an aggregate basis, the portfolio's investment in growth capital expenditure exceeds the MSCI ACWI benchmark by approximately 25%.

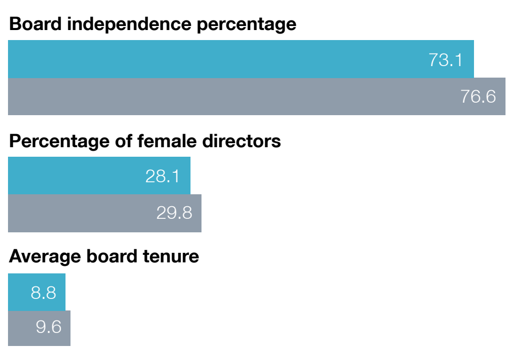
Allocation Multiple

Global Alpha MSCI ACWI Index

Based on a representative portfolio.

Board membership

We look to company boards to provide effective oversight. We believe a constructive and purposeful board is one consisting of strong independent representation, possessing the appropriate skills, experience and cognitive diversity to support management and guide the business. Standard datapoints on board composition are shown to the right. However, at an aggregate level we think they create more questions than answers; highlighting the importance of engaging with each company to understand board characteristics and their suitability for the age, stage and operating environment. One the one hand, shorter average tenure could signal unhelpful membership churn or instead a sensible practice of board refreshment focused on appropriate skills and experience as portfolio companies mature. While we tend to prefer there to be a majority of independent non-executive directors, is it material that portfolio companies on average have a slightly lower board independence ratio than that of the index? We are cognisant of ongoing work to improve management and board-level diversity across the portfolio and investment universe. A staple topic of our dialogue with companies is how their efforts to promote diversity and inclusion are supportive of the long-term business strategy.



Global Alpha MSCI ACWI Index

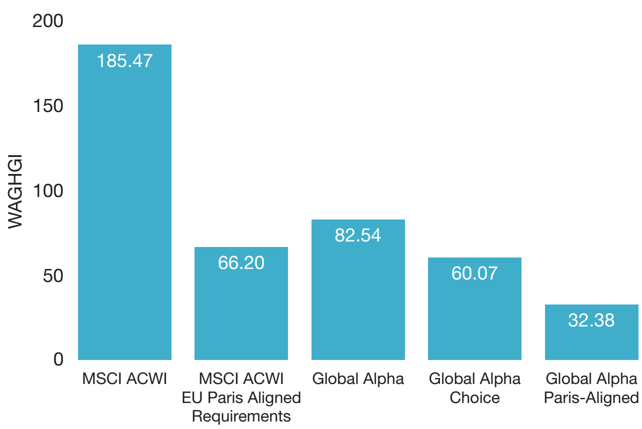
Based on a representative portfolio.

Carbon footprint

As with previous stewardship reports, the data below are a measure of the portfolio's carbon footprint. We are pleased to see that our efforts to deliver long-term value creation for our clients have been done in a manner which has a significantly lower climate impact than the benchmark.

Weighted Average Greenhouse Gas Intensity (WAGHGI) is a measure of a portfolio's exposure to greenhouse gas-intensive companies, defined as tCO_2e/$m EV. This metric, incorporating scope three emissions (upstream and downstream) on an incremental basis, has been recommended by the European Union's Technical Expert Group, a body which has been instrumental in both improving corporate disclosure of climate-related information and constructing methodologies for climate benchmarks.

MSCI Index/BG Portfolio



As at 30 September 2021.

The Global Alpha and Global Alpha Choice portfolios have a lower WAGHGI than the MSCI All Country World Index. Global Alpha Paris-Aligned has a WAGHGI materially lower than both the All Country World and EU Paris Aligned Indices.

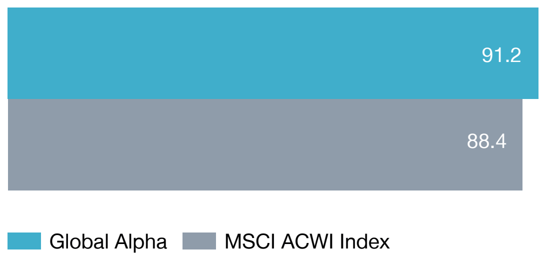
We continue to hold positions in higher emitting companies that we believe can deliver long-term value for our clients. Each business's approach to environmental stewardship will be an important determinant of this ambition and society's transition to a low carbon economy. As patient, thoughtful providers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

The building materials business, CRH, continues to be the portfolio's largest emitter, primarily due to its cement operations. We have continued our dialogue with senior management and the board about CRH's climate strategy. We are encouraged to learn that the company will meet its 2030 decarbonisation target five years early and look forward to the publication of new, more stringent commitments in the early part of 2022. Our conversations with CEO Albert Manifold reassure us that this is a strategic priority for CRH and an area where they intend to lead the industry.

UN Global Compact compliance

This indicator uses company compliance with the 10 UN Global Compact Principles as a proxy for social performance and exposure to corporate controversies. Amazon is on the 'watchlist' due to the well-documented challenges with regard to unions and working conditions – one of our longstanding engagement concerns. Two other holdings are excluded from the dataset. Many holdings that 'passed' can still do much better in our view; we are engaging with them on data governance, health and safety, sustainability and more.

Passed UN Global Compact Compliance



Based on a representative portfolio (%).

The above indicators represent a small snapshot of the numbers that we would like to provide to our clients over coming months and years. As data sets get better, we will focus on metrics such as tax gap, gender pay gap, CEO to median pay ratio and biodiversity/water intensity indicators. All of the above, and more, will increasingly play a role in being the inputs that go into forming a holistic view of the sustainability of a company's operations.

Climate Audit

In November 2021, the world's attention turned to Glasgow for the 26th United Nations Conference of the Parties (COP26), where global leaders met to discuss and accelerate efforts to deliver a more sustainable world. Within Global Alpha, our work to understand the portfolio's climate preparedness has continued apace, with the recent completion of a climate audit. In addition to more granularity on the portfolio's carbon footprint, the audit has provided company-level insight. We have outlined a summary of our findings below. This marks the next step in our stewardship work on climate and we look forward to discussing further developments with you over the coming months.

The objectives underpinning the audit were threefold:

Provide a snapshot of the portfolio's footprint, including the location of greenhouse gas emissions and proportion which are covered by reduction targets.

Gain a more comprehensive understanding of the underlying holdings' pace of change as we transition to a net-zero world.

Pull together a list of companies who are a priority for climate-related engagement.

Let us now take each of these in turn.

Portfolio emissions

Weighted Average Greenhouse Gas Intensity (WAGHGI), as mentioned above, is a measure of a portfolio's exposure to greenhouse gas-intensive companies. If your equity asset managers don't yet provide you with a portfolio-level WAGHGI, then prod them to do so. It is fast becoming industry standard.

The climate audit confirms previous carbon footprint work showing a carbon intensity and relative carbon footprint for the Global Alpha portfolio which is significantly and consistently below that of the MSCI All Country World Index. For clients invested in either of our Choice or Paris-Aligned variants, this intensity metric is lower again. While it is important not to conflate emissions intensity with climate risk, the audit clearly shows that the portfolio has significantly less exposure to carbon-intensive businesses than the broader market.

At a company level, the audit revealed two interesting outputs that warrant further work. First, 40 per cent of our holdings don't currently disclose scope one and two emissions – requiring estimates to be used in their place. This disclosure gap is much less severe when considered on a WAGHGI basis but it's a timely reminder that the challenges of climate change can only be addressed by first understanding one's starting point. Second, as expected, most of the portfolio's emissions are located either upstream or downstream of the company's operations. Scope three portfolio emissions are approximately five times larger than scope one and two emissions combined. While scope three emissions are based on estimated data, their materiality with regard to value chain emissions gives some indication of where the material climate risks are located. This portion of a company's emission profile is more difficult for them to influence. However, we have already started engaging with our holdings to encourage them to incorporate scope three emissions into their climate strategy and work towards reducing emissions across the value chain.

Pace of change

Beyond a snapshot of portfolio emissions exposure, we wanted to dig deeper and understand how the businesses we invest in on your behalf are embracing, or otherwise, the low carbon transition. To that end we used a simple but effective traffic light system to rate the climate commitments of portfolio companies. We believe it is important for our holdings to be ambitious and therefore we have set the bar high; an average rating was awarded for companies that target net zero by 2050 and are therefore aligned with a 1.5-degree scenario; the most ambitious objective under the Paris Agreement. Companies that target hitting net zero sooner and commit to addressing a broader range of value chain emissions were ranked better than average.

As a bottom-up stock picker, we judge companies on a case-by-case basis. This applies equally to climate change, where there is a recognition that companies, and indeed countries, will decarbonise at differing speeds. Those that can move fast must do so, while those that cannot must be afforded leeway and support. However, for the purposes of this analysis, a level playing field was used to ensure broad comparability, in the full knowledge that our follow-on engagement will be more nuanced.

Fifteen companies, representing over 22 per cent of the portfolio, were rated above average for their emissions targets. These include Alphabet, Farfetch, Microsoft and CBRE. A diverse group of businesses with a genuine desire by management to embrace the low carbon transition and make it a strategic imperative for the business.

Engagement

Among the cohort that fail to meet our, admittedly stretching, expectations are a few businesses that we have flagged as a priority for climate-related engagement. This is either because they fall down on basic disclosure (a vital requirement in our view and a starting point rather than an end goal), don’t have emission reduction targets in place or we don’t consider their targets sufficiently stretching. You might expect them to be heavy industrials with large carbon footprints. But this target list is very diverse, ranging from US health insurers to Asian-based ecommerce and gaming platforms. Our discussions with these businesses will be a shared initiative within the Global Alpha team, as well as a collaborative effort across the broader investment floor. Our ongoing dialogue with these companies will serve two primary purposes: to encourage climate strategies which align with the goals of the Paris Agreement and to deepen our understanding of these businesses. This information will be incorporated into our ongoing views on each business as part of integrating governance and sustainability within the investment process. We look forward to sharing progress with you on this topic over coming quarters.

TCFD – A Primer

Amid the acronym soup of modern financial markets (ABS, CAGR, ETF, NAV, REMIC – nope, me neither), there is one collection of letters that will have a profound impact on how asset owners, asset managers and companies understand and report on the climate-related risks posed by climate change. This acronym, gaining greater traction every day, is TCFD – the Task Force on Climate-related Financial Disclosure.

Background

There is clear scientific consensus that human activity is warming the planet. Financial markets, which have long been a part of the problem, now stand ready to be agents of positive change. They can pull forward future climate considerations by repricing those assets most at risk. They are also the means by which a transformational allocation of capital is channelled to solutions providers, who will lead the decarbonisation of our global economy. But for markets to fulfil their potential, there must be a great leap forward in reporting and disclosure – knowing our starting point is half the battle. This imperative led the Financial Stability Board to establish the TCFD in 2015. Its mission was to help identify the information needed by investors, lenders and insurance underwriters to appropriately assess and price climate-related risks and opportunities. Two years later, the Task Force published its financial disclosure recommendations, which set in stone a framework that was designed to be both stretching in its remit but also practical for near-term adoption. Companies, asset owners and asset managers are all now starting to use this framework to provide consistent, forward-looking information on the material financial impacts of climate change.

TCFD recommendations

The Task Force's recommendations are structured around four thematic areas that aim to capture the principal elements of how organisations operate – namely, governance, strategy, risk management and metrics. Let's take each of these in turn:

1	**Governance**	At the broadest level, this section should seek to provide clarity on both the oversight and day-to-day management of climate-related risk and opportunity, at both board and executive team level. From an asset manager's perspective, we would look to include detail on how climate factors are integrated into a strategy's philosophy and policies, and the extent to which these considerations are included in the responsibilities of the relevant portfolio managers.
2	**Strategy**	This is the key section of the report, where the actual and potential impacts of climate-related risks and opportunities on the organisation are disclosed. These impacts should cover all timeframes (short, medium and over the horizon) and a description should be included of the resilience of corporate strategy to various climate scenarios. From our perspective, we will look to include detail on climate risks and opportunities under various scenarios. Our analysis will look at whether these impacts are physical in nature and whether they are already having an impact.
3	**Risk management**	This section is about the identification, assessment and management of climate-related risk. We will examine how the strategy incorporates risk through research, investee company engagement and climate scenario analysis. You should expect us to include detail on how the materiality of these risks are assessed in relation to other portfolio risks and how they are incorporated into existing risk frameworks.
4	**Metrics and targets**	Disclosure is required of the metrics and targets used to assess and manage relevant climate-related risks and opportunities, where such information is material. The metrics and targets are grouped into the following categories: — Greenhouse gas emissions (includes scopes 1, 2 and 3) — Transition risks — Physical risks — Climate-related opportunities — Capital deployment — Internal carbon prices — Remuneration Targets should include time horizon, baseline and any interim targets, ideally incorporating 2030 and 5-year intervals.

But a word of caution. Metrics are absolutely part of the solution moving forwards. But the lack of granular data, combined with confusing overlap in some places and glaring gaps elsewhere (one organisation's scope three emissions are another's scope one emissions) mean that climate metrics in their current state should be treated with caution. In many ways this mirrors the broader industry-wide ESG problem of reductionism. Trying to boil down the stance taken by an intrinsically complex, organically evolving organisation, to a single metric is fraught with issues. Metrics have a role to play but they are one input amongst many and in no way a substitute for broader qualitative judgements.

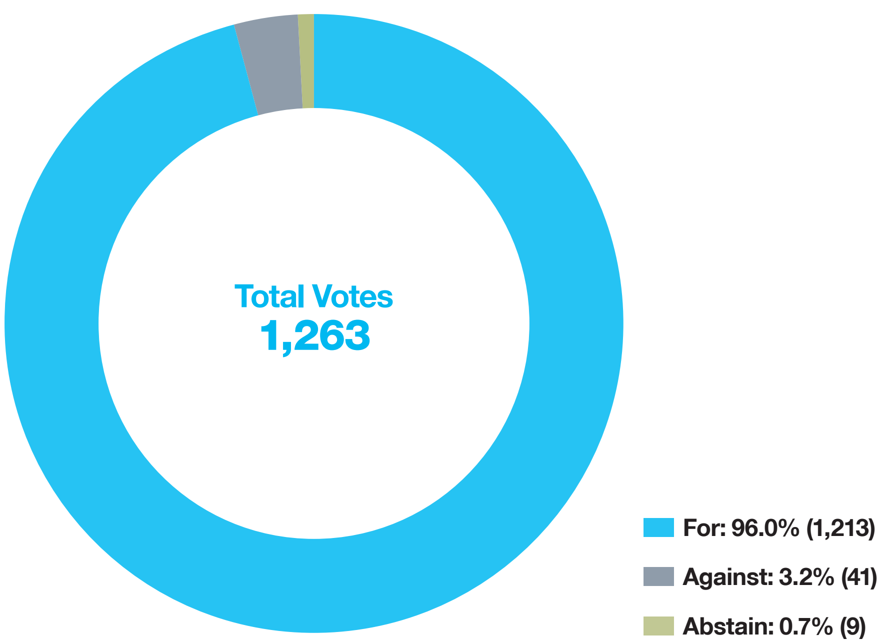
We started this short note with some acronym soup. But let us finish with a very clear rallying cry. The Task Force on Climate-related Financial Disclosure is a significant leap forward in how organisations report, with consistency, on climate-related risks and opportunities right across the globe. Inevitably it's not perfect but it does let us know our starting point, an action in and of itself that is so crucial to our broader net zero transition. We look forward to sharing our portfolio TCFD report with you in the coming months!

Proxy Voting

Exercising the voting rights attached to our clients' holdings is an integral part of our stewardship responsibilities. Coordinated internally by our dedicated ESG Services team, our voting decisions are investment-led, and focused on what we believe is in our clients' best interests. The portfolio's investment managers are actively involved in this process. We do not outsource any of our stewardship activities and routinely communicate any votes against management to the company as part of maintaining an ongoing dialogue. The ability to vote supports our ability to build long-term relationships with investee companies and strengthens our position when engaging with them. For this reason, we prefer that our clients delegate voting authority to us.

We invest in high quality management teams where we believe the governance structure is supportive of the long-term investment opportunity. We seek to avoid investments where corrective action is required to generate value. Accordingly, we support most 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 of abstentions when we think voting decisions are not black or white. We review the merits of each proposal on a case-by-case basis, considering the broader context in which companies operate. This approach enables us to maintain constructive relationships with management and the board as part of a gradual, long-term engagement process.

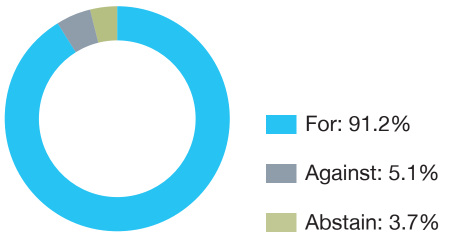
Global Alpha Proxy Voting Record



Source: Baillie Gifford. Data from 1 October 2020 to 30 September 2021.
Figures may not sum due to rounding.
Based on a representative Global Alpha portfolio.

Management Resolutions: Breakdown of Voting Activity

Remuneration

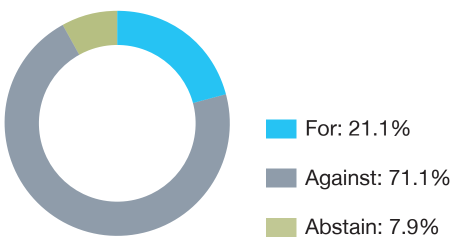


Example – Abiomed

We opposed executive compensation due to concerns with one-off equity awards granted during the year. We believed these awards undermined the integrity of the standard compensation policy and misaligned the experience of the senior management team and shareholders. We disagreed with the rationale provided by the company for granting these special payments, outlining our strong belief that we did not consider them to be appropriate. At the AGM, the pay proposal narrowly passed with 51 per cent support. Given this large oppose vote, we think it is important for the company to engage with shareholders and we look forward to encouraging better pay practices in the future.

Voting Result: For 91.2%; Against 5.1%

Shareholder Proposals

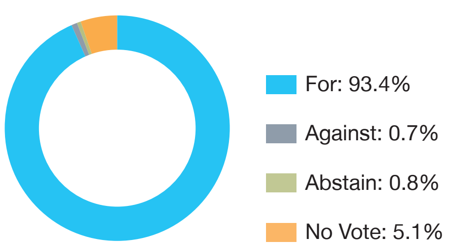


Example – Booking Holdings

We supported a shareholder resolution requesting the company produce a climate transition report. The climate audit of the portfolio completed during the year identified Booking Holdings as a laggard with regards to its climate strategy. Specifically, the company fails to provide sufficient disclosure of its emissions and does not outline reduction targets. We engaged with the company ahead of the AGM to encourage enhanced reporting and to explain our voting intention. We were pleased to see the resolution pass and look forward to the company improving its environmental disclosures.

Voting Result: For 21.1%; Against 71.1%

Director Elections



Example – Deutsche Börse

We opposed the election of the chair of the risk committee, Mr Andreas Gottschling. Subsequent to Mr Gottschling being put forward for re-election, he had to stand down from a similar position at Credit Suisse due to an ongoing investigation regarding the company's risk practices. While no evidence of wrongdoing has been found against Mr Gottschling specifically, the ongoing investigations made us feel unable to support his re-election to the same position at Deutsche Börse at this time.

Voting Result: For 93.4%; Against 0.7%

Source: Baillie Gifford. Data from 1 October 2020 to 30 September 2021.
Figures may not sum due to rounding.
Data based on the Global Alpha Growth Fund.

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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com