The character of our companies

Long Term Global Growth ESG update

September 2022

Introduction

Faced with the frenzy of minute-by-minute news flow and the tyranny of quarterly earnings, it is tempting for hurried investors to resort to shortcuts and short-termism. Take ESG research[1], for example.

Despite well-known shortcomings in the quality and consistency of such ESG data and regardless of the complexities of the diverse ESG issues that companies face, what seems to matter most for time-pressured investment analysis is two things: speed and simplicity. Little wonder the most frequently used ways to incorporate ESG into equity valuations consist of relative rankings of companies and scorecards[2], not deep reflection. It's simpler to tick a box than to think outside of one.

The Long Term Global Growth (LTGG) team have a rather rare opportunity to do things differently. This largely comes down to how we think about one of the crucial ingredients in investing: time.

In the first of his series of works on geology in the early 1980s, John McPhee famously invited his readers to think of the Earth's past stretching across the length of the old measure of the English yard, ie the distance from the king's nose to the tip of his outstretched hand. "One stroke of a nail file on his middle finger erases human history", he wrote.

For long-term investors such as ourselves, this metaphor is humbling. It points to the importance of transcending the speculative distractions of short-term noise to focus on the more meaningful changes happening over longer periods.

[1] ESG refers to company analysis that considers environmental, social and corporate governance factors. This approach has been increasingly growing in significance.

[2] According to an ESG Global Survey in 2021 of over 350 institutional investors. https://bit.ly/3QQdP2g

In LTGG, this means undertaking fundamental analysis to enable us to identify and invest in companies for decades – businesses that are spearheading or disproportionately benefitting from multi-decade transformations – rather than making speculative bets on what might happen to share prices over the next few quarters. Such transformations include, for example, companies at the forefront of more personalised healthcare, rising incomes in emerging markets and the low-carbon transition. For the firms that demonstrate strong operational performance amid such profound changes, we believe this growth will translate into share price gains over time, providing superior long-term returns for our clients.

Of the few companies in which we invest, those that can align with ever-evolving societal and environmental expectations will likely have higher odds of success over our investment timeframe. Those that drag their heels or bury their heads in the sand are more likely to fossilise or fail. That is why we take our time to consider if and how the longer-term role of a company in society may materially affect our investment thesis, for better or worse. It is for this reason that LTGG has embedded ESG analysis (or whatever one calls it[3]) in our stock research framework since the inception of the strategy in 2004. If you'll excuse the use of a double negative, one can't not think about ESG if one is serious about long-term investing, regardless of whether one has an ESG objective.

The length of our investment horizon also gives us the requisite time to build relationships with the companies we invest in on behalf of our clients. For example, at Baillie Gifford, we have been engaging with:

- Kering since 1997
- Amazon since 1999
- Alibaba since 2012
- Moderna since 2017

In each case, this was several years before we took a holding for the LTGG portfolio. Being time-rich in this way lets us engage on an array of issues that may be material to our long-term investment theses. It also allows us to conduct proprietary research into companies' activities, monitor their progress over several years, support them in difficult times and challenge them if we feel they're losing their way.

While we believe our approach to ESG integration provides us with far greater insights than if we were to solely rely on overly simplified checkboxes and ratings, we fully acknowledge that we have ample room to improve. We don't have all the answers, nor do we pretend to. That is why we continue to deepen our in-house knowledge while drawing on external experts, associations and industry initiatives.

In recent months, for example, Baillie Gifford has joined the Taskforce on Nature-Related Financial Disclosures (TNFD), the Net Zero Asset Managers initiative (NZAM) and the Sustainability Accounting Standards Board (SASB). In addition, we have established a relationship with the China-UK Low Carbon College at Shanghai Jiaotong University, to help us deepen our knowledge about China's low-carbon transition, notably on opportunities in electric vehicles and energy storage. The firm has also commissioned leading human rights theorist Prof Jack Donnelly at the University of Denver to share his thinking on how we might navigate some of the complexities of international human rights in our company analysis. We will endeavour to challenge ourselves constantly and improve data quality and coverage.

In this 2022 report, we share insights from our LTGG company engagements and proxy voting, updates on the portfolio's climate fitness, as well as ESG developments across Baillie Gifford.

For more information on how we integrate ESG into our LTGG investment process, our collaborations, our views on ESG data, and more specifically how we think about ESG themes such as working conditions, diversity and inclusion, regulation and climate change, we invite you to **read our 2021 report**.

[3] You may have also heard of related terms such as CSR (corporate social responsibility), RBC (responsible business conduct) or sustainability. Regardless of the name, the underlying concept for us is the same: a company's character matters. It matters to its customers, employees, shareholders, society and the planet. It underpins a company's success or failure.

Notable LTGG engagements and proxy votes

One advantage of our 5–10 year investment horizon and concentrated LTGG portfolio is that we can build meaningful long-term relationships with management teams and boards. In doing so, we continuously refine and develop our answers to the 10 questions we use to analyse every company.

We don't believe there is a single formula for engagement. Just as we analyse companies in their own context and on their own merits, so too is our engagement specific to each situation. We do this because we are wary of prescriptive policies and rules. By their nature, they are reductive and blind to nuance.

Instead, we shape our interactions by drawing on a small number of principles we expect our holdings to respect:

- prioritisation of long-term value creation
- a constructive and purposeful board
- a long-term-focused remuneration with stretching targets
- fair treatment of stakeholders
- sustainable business practices.

With these ambitions, our goals for engagement fall into four categories:

1. fact-finding
2. monitoring
3. supporting
4. influencing

These are each of equal importance. Further details on how we undertake engagement can be found **in our 2021 report**. Clients can find notes of our engagements with portfolio holdings and our proxy voting activities[4] in our quarterly reports.

Some learnings and observations based on our recent engagements are as follows:

Reflection beyond ratings

According to one third-party ESG provider, **Cloudflare** has been subject to persistent allegations regarding the provision of website services to Myanmar's military-controlled Ministry of Home Affairs and the country's police force.

We used a conversation with founder/CEO Matthew Prince to delve into the issue more deeply. We learned that Cloudflare, in close cooperation with the US State Department, had already terminated its services in controversial regions in line with the department's sanctions and guidance. It continued to provide other services (such as for Myanmar's health service) upon the specific request of the State Department. Moreover, Cloudflare provided a vital way for Myanmar's citizens to access the global internet and communicate with each other despite the broad shutdowns that followed the military coup. Cloudflare has not made any revenue from the use of its services in the country, all of which have been free versions.

For us, this case illustrates the importance of looking beyond third-party ratings and reported controversies to dig deeper, engage and reflect on the issues. A low rating does not mean that a company has a below-average approach to ESG matters. It may reflect certain limits in the company's disclosures, but it would be erroneous to conflate such ratings with the company's actual culture and practices. Similarly, a reported controversy may signal a fundamental problem, but such information will remain incomplete unless there is engagement with the company – such as the discussion we had with Prince. Third-party data has a role to play insofar as it can help to corroborate or challenge our analysis, but we do not use it as a basis to divest first and then ask questions later.

Challenging ourselves

Ahead of the 2022 **Tesla** AGM, a shareholder resolution proposed that the company adopt a policy to respect freedom of association and collective bargaining. Currently, Tesla has no formal policy stating it is committed to freedom of association. The company has moreover been the subject of anti-union controversies.

Baillie Gifford's ESG team recommended supporting the shareholder resolution. It considered arguments that Tesla has a reputation for being anti-union. The team also felt that if Tesla genuinely intends for its human rights policy to allow for basic rights, such as freedom of association, then formalising this could help to ensure that employees' rights are protected.

[4] For clients for whom we retain voting rights.

However, we ultimately decided to oppose the resolution following a discussion between the ESG team and several of Baillie Gifford's investment teams (including LTGG's). To avoid doubt, Baillie Gifford expects all our investee companies to operate within the principles of the UN Global Compact, which encapsulates internationally proclaimed human rights such as freedom of association and collective bargaining. However, the investment team noted that the US National Labor Relations Act enshrines the right to association and collective bargaining. Like any US company, Tesla must comply with the law, and this is not simply a matter for company policy. In addition, Tesla's board has already adopted the UN Universal Declaration for Human Rights, which recognises the right to freedom of association and collective bargaining.

This case illustrates one of the many ways that our ESG team interacts with the LTGG investment team. We encourage internal challenge and debate. While there was disagreement on this specific resolution, there was agreement to support other shareholder resolutions requesting that Tesla provide a report on its efforts to prevent harassment and discrimination in the workplace[5], as well as a report on the impacts of employee arbitration[6].

Specifics matter

At the 2022 **Amazon** AGM, we supported a shareholder resolution requesting additional reporting on freedom of association. While Amazon claims its policies and practices protect employees' rights to freedom of association and collective bargaining, several high-profile controversies suggest that a more meaningful review would be helpful. Given the nature of complaints and allegations, our ESG team and LTGG investment team agreed that shareholders would benefit from a more thorough examination of Amazon's policies and practices regarding the topic.

Why did we support this resolution at the Amazon AGM but oppose a similar resolution at the 2022 Tesla AGM when we believe that companies should uphold the fundamental human rights to freedom of association and collective bargaining in all cases? As per our bottom-up approach to investing, where we examine the unique characteristics of each company, the ESG specifics matter too. The shareholder resolution at the Tesla AGM called on the company to develop a policy on freedom of association, which we felt was unnecessary given the legislative context and the steps already taken at board level. However, the resolution at the Amazon AGM called on the company to undertake additional reporting, which we encourage.

The resolution at the Amazon AGM failed to pass despite our support. But the issue remains a priority for our engagement with the company. In spring 2022, for example, we discussed the recent successful unionisation vote at a New York facility, as well as employee engagement efforts. On a related note, we spoke about the company's recently disclosed health and safety statistics – an area where we have been encouraging enhanced disclosure for several years. We are pleased Amazon has responded positively to our requests.

Picking our battles

A shareholder proposal was filed at the **Moderna** 2022 AGM requesting that the company commission a third-party report to analyse the feasibility of promptly transferring its intellectual property and know-how to facilitate the production of its Covid-19 vaccine in low- and middle-income countries. Prominent proxy advisors recommended supporting the proposal. Baillie Gifford held nearly 10 per cent of voting shares at the time, meaning our decision would be important for the result.

We first discussed the resolution with its proponent, Oxfam, to ensure we fully understood the charity's concerns and to help guide our further engagement with Moderna management. We then met with the chair of Moderna's board in Edinburgh and engaged with the firm's senior management to thoroughly explore the nuances of the situation before coming to our decision. We gained sufficient comfort that Moderna's leadership had deeply explored the feasibility of safely licensing its technology and to whom, in consultation with stakeholders, including the World Health Organization. We trusted management's view that further technology transfer to companies in low- and middle-income countries is not the best use of its limited resources in the immediate future. However, the firm will continue to consider this where appropriate. Furthermore, the main bottlenecks to ending the pandemic are no longer in vaccine supply but in last mile distribution.

We also trusted management's decision to take a cautious approach to enabling the proliferation of the mRNA platform around the world due to legitimate safety concerns. Moreover, we felt that the steps Moderna had announced to expand access to mRNA technologies in the future and ensure the world is better prepared for future pandemics are commendable. These include a commitment to never enforce its Spikevax patents in 92 low- and middle-income countries, to establish a manufacturing capability in Kenya, and to open up its platform to scientists through its mRNA Access programme.

[5] Our discussions with the company indicate that management is committed to addressing these issues and is investing in human capital management.

[6] Our discussions with Tesla have clarified that the company does not require mandatory arbitration, nor does it require outcomes of arbitration or litigation to remain confidential, but it does encourage employees to arbitrate.

We consider each portfolio company's unique characteristics and circumstances when determining which issues to prioritise in our engagements and voting. We care deeply about equitable access to vaccines. While we could have voted in favour of this proposal, our research and engagement ultimately led us to oppose it. We did not come to this decision lightly. But we felt that the company should instead focus its efforts on its commitments described above, as well as its extensive product pipeline, to ensure it realises the enormous potential of the mRNA platform over the long term.

Prompting change?

We hesitate to claim that our engagements have prompted change. Correlation does not necessarily imply causation. Moreover, we do not consider ourselves activist investors and do not seek to dictate microscopic details of strategy or culture to the companies we invest in. However, our investee companies can find our long-term view refreshing, leading some to seek our views and collaborate with us on ESG issues and their disclosures. There are, therefore, several cases where companies have made encouraging progress following our engagements. We highlight a few recent examples below.

Following our recent engagement with **Alibaba**, the company published its latest ESG report in September 2022. This was four years since its inaugural report. We note that the 2022 report discloses information on many of the issues that we had emphasised to the company in our recent written inputs and conversations. These included working conditions, diversity, inclusion, data protection, product accessibility and affordability for disadvantaged communities, and support for the development of small- and medium-sized businesses. Alibaba has, moreover, agreed to publish its ESG report on an annual basis from here on.

We engaged with **Cloudflare** in 2021 to gain insight into its energy sources and carbon footprint activities. We inquired about the company's carbon emissions disclosures, its approach to expanding low-carbon power for its data centres internationally and whether it could offer customers the choice to route their data according to the type of electricity source (optimising for renewables). After our meeting, Cloudflare released its Scope 1 and 2 emissions data[7] and set out its aspiration to be carbon neutral across its network from 2022. It also committed to accelerating the deployment of ARM energy-efficient chips to allow developers to choose the most energy-efficient data centres. And it launched a project to eliminate redundant web crawl that could generate carbon savings equivalent to planting 30 million acres of trees.

We have repeatedly engaged with **Kering** on executive remuneration over the past several years. We are pleased its response has been to increase target stringency in its Long-Term Incentive Plan (LTIP) for senior management. The company is also ratcheting up the target ambition on the ESG components of the LTIP. This includes a metric on the conversion of land linked to Kering's supply chain to more sustainable agricultural practices.

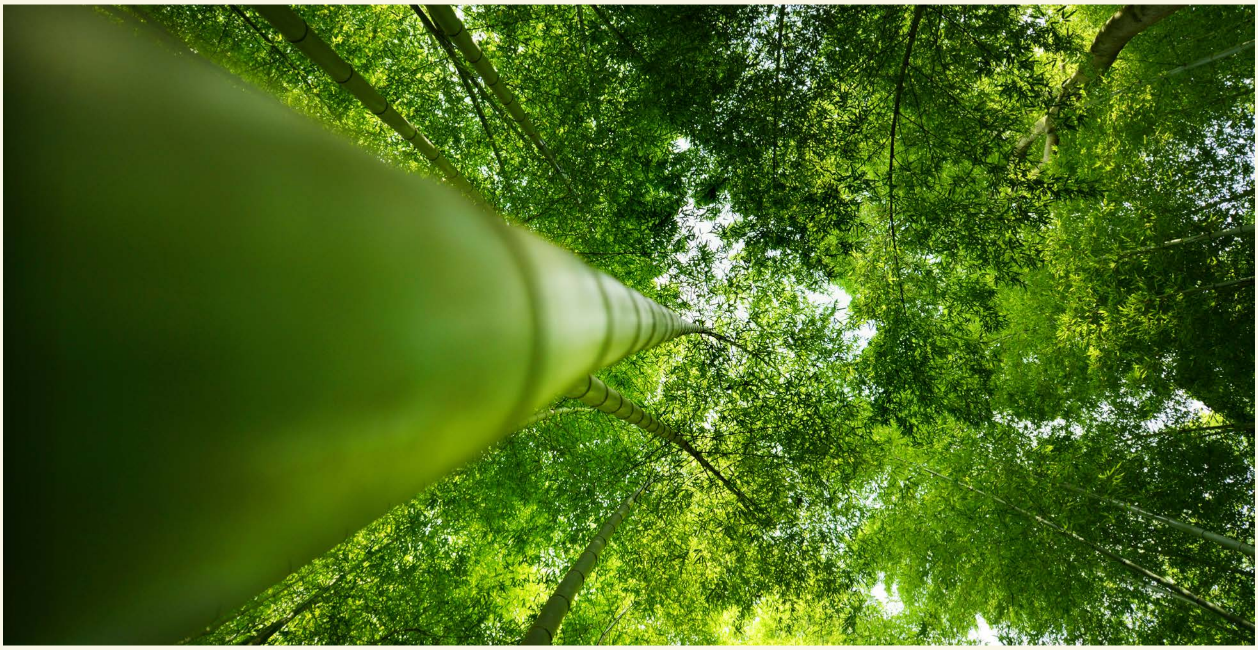
In our discussions with **Pinduoduo** about talent development and board structure, the company has recognised the importance of greater board diversity. For example, Pinduoduo has no female representation on its board at the time of writing. We have therefore suggested female candidates that the company may wish to consider. Pinduoduo's search for new board members is in progress, and we look forward to forthcoming announcements.

Tesla invited us to provide feedback on its 2020 Impact Report. We asked the company to disclose more about its environmental impacts and ambitions. For example, we requested that it provide further details about its 100 per cent renewable energy goal for its operations and the precise scope of its indirect emissions (including Scope 3[8]). In addition, we asked whether the company has any emissions reduction and battery recycling targets in place, whether it is considering setting a long-term science-based emissions target and if it can provide an annual figure for the total amount of emissions saved.

We also asked Tesla to disclose more about its societal impacts and activities. For example, we requested that it provide more detail on its supply chain's audit process, disclose company-wide health and safety statistics over time, and explain how Tesla employees benefit from the company's success, including how factory workers share in the value created by the business. Strikingly, Tesla included disclosures on all these requests in its 2021 Impact Report.

[7] Scope 1 covers direct emissions from owned or controlled sources. Scope 2 covers indirect emissions from the generation of purchased electricity, steam, heating and cooling consumed by the reporting company.

[8] Scope 3 includes all indirect emissions that occur in a company's value chain, whether upstream – purchased goods and services, employee commuting etc – or downstream – usage and disposal of a company's products or services.



Progress on our LTGG climate commitments

In 2021, we detailed our climate commitments, stating that:

- Currently, we commit that 100 per cent of our companies are aligned, or under engagement for alignment, with an appropriate net zero pathway.
- By the end of 2023, we expect most (90 per cent-plus) of the companies in the portfolio to report scope 1 and 2 emissions. If they do not, they will be on a specific engagement pathway for such disclosure. Any new companies entering the portfolio will have two additional years to meet this expectation.
- By 2025, we expect that at least two-thirds of the portfolio by number will be positively aligned with global net zero goals. For most, their preparedness, or indeed leadership, will be demonstrated through public net zero-aligned targets and strategies encompassing scope 1 and 2 and material scope 3 emissions. However, if we own an exceptional company that does not yet have net zero-aligned targets but already has or possesses the potential to be a transformative enabler of successful decarbonisation, we will provide specific research demonstrating this element of its alignment while we continue to work with it around the appropriate level of disclosure.
- By 2030, we commit that over 90 per cent of the portfolio will be net zero-aligned. Any new companies entering the portfolio will have two additional years to meet this commitment.

As things stand, none of the above expectations or commitments has impacted the shape or constituents of the LTGG portfolio. Indeed, we hope and anticipate that we will never be forced to sell a company because it failed to meet the expectations above. That is because we view positive climate alignment as a critical driver of competitive advantage over our investment time horizon.

To ensure that the portfolio holdings are on top of potential competitive, financial and regulatory risks around climate, our engagement in this domain has focused on some key areas. Some examples follow.

Raw material inputs

For some of our holdings, high-level climate targets are important. But their impacts on biodiversity and land use are more material and therefore critical to address.

In this regard, we are pleased with the climate progress of **Hermès**. We now class it as being a 'leader' among the companies we have assessed.

Given Hermès' ongoing reliance on leather, however, we're cognisant that the firm's ability to decarbonise is still tied to the agriculture supply chain. Hermès could play a role in shifting consumer perception of quality and durability away from a dependence on intensive raw materials, offering alternatives that don't compromise the brand's luxury appeal.

Disclosures and targets

We are following up on outstanding questions about the broad investment case for **Alibaba** and **Tencent**. But in the context of environmental initiatives over the last year, we're happy to see both companies have grasped the nettle around carbon disclosure and established sophisticated targets.

This progress provides a helpful engagement context for other online commerce holdings, such as **Coupang**, **Meituan** and **Pinduoduo**. The levers of influence for these companies pivot around securing green logistics and influencing the value chain, as both suppliers and customers.

Our role is to share the lessons and contacts we've made through our engagement with the leaders in this area, such as **Amazon**, **Shopify** and the global shipping companies we own on behalf of clients in other Baillie Gifford strategies.

Tensions between business models and climate considerations

Our conversations with **Amazon** have been less about the details of its operational decarbonisation – which we think it is doing well – and more about the broader climate issues that affect its business. How can a business model dependent on consumption continue to grow while remaining aligned with climate targets?

The bulk of Amazon's impacts is from the life-cycle emissions of the products it sells. How might the company adapt as consumers increasingly aim to buy less and think harder about their own footprints?

There is no easy answer to this question, and we continue to encourage and support Amazon's efforts to help us consume in a less extractive manner.

Energy efficiency

ASML is a lynchpin in the global semiconductor industry. All the major players use its lithography machines to produce chips.

As it continues to drive innovation, its impressive commitment to incorporating energy and material efficiency into its design process remains critical. That's true for its own competitive position and for its customers' decarbonisation efforts, including the semiconductors manufacturer TSMC, as well as their own clients, such as Apple.

Our engagement with ASML has provided us with helpful broader industry insight as its actions and targets have developed. We're encouraged that ASML is now targeting net zero across all scopes by 2040.

Influencing consumers

Within the sphere of advertising, we have previously highlighted that **Meta**'s most material impact on the pace of transition probably relates to its role in preventing the spread of climate-related misinformation and promoting access to good science. We'll discuss those topics further with Meta shortly.

The Trade Desk, meanwhile, occupies a slightly different space within the advertising ecosystem. It has been helpful to engage with the company to learn how it thinks about its influence.

The company is keen for its advertising clients to see it as a trusted partner. Premium brands do not want to be associated with misinformation. They care deeply about product placement and want to ensure their advertisements are kept distant from those of climate change laggards. The Trade Desk has a vital role to place in this regard.

The electrification of transport

The tailwinds behind the used car market are likely to be intensified by the shift towards electric vehicles (EVs). In the longer term, the online used-car dealership **Carvana** has an opportunity to act as the sales point for new EVs. Internal combustion engine-based dealerships, by contrast, will retreat without the profit line of frequent maintenance and servicing.

One risk to watch pertains to direct regulatory intervention to take old cars out of the market – compulsory scrappage or penalties for city driving, for example. Such measures could leave Carvana stock heavy.

Our engagement has explored the company's thinking about this point and how it might please customers by adding a fuel efficiency option into its search functions.

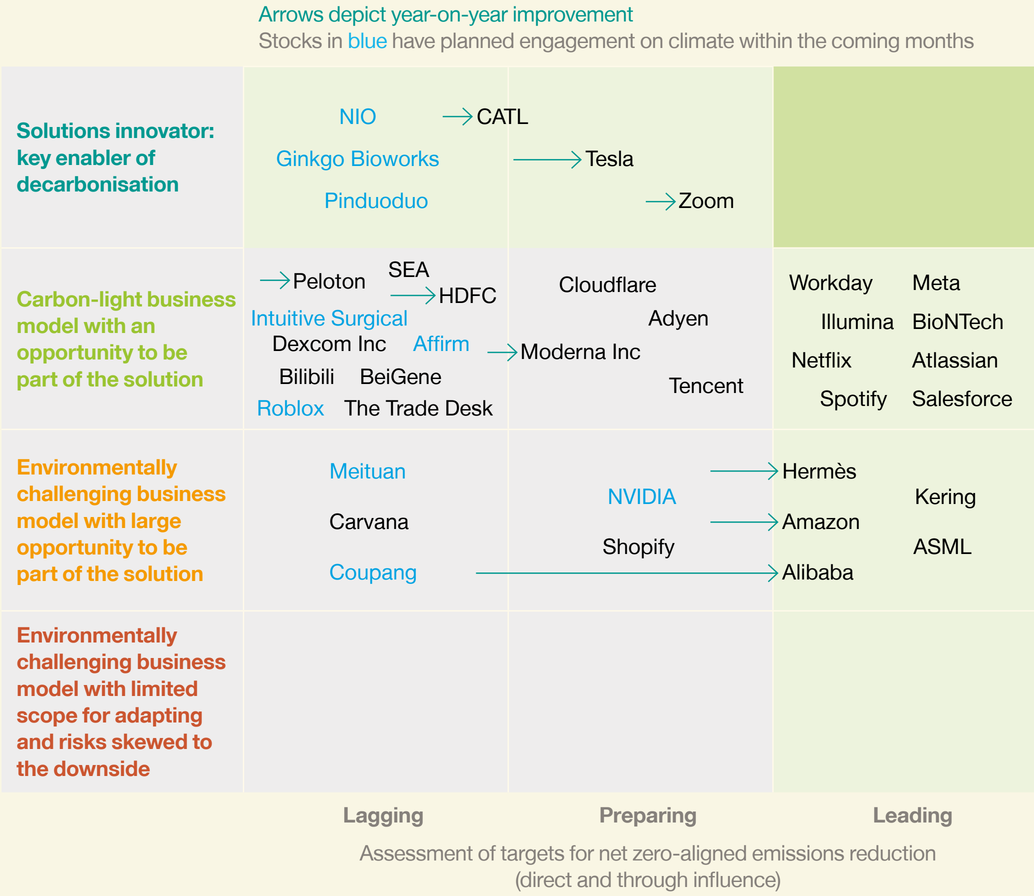
Exerting influence through finance

This is the second summer we have engaged with the banking and financial services provider **HDFC** on climate issues. We see a positive progression in reporting, board awareness and on-the-ground engagement with developers.

There's enormous potential for the firm to encourage its customers to adopt energy-efficient practices and address the physical risks posed by climate change.

The overall picture

The diagram below illustrates our current perspective of the portfolio's 'transition fitness'.



We're encouraged by the number of holdings showing year-on-year improvements, as depicted by the green arrows.

Our view remains that the portfolio is relatively well placed to navigate the transition, but there is no room for complacency. In the coming months, our engagements will continue.

We're keen, for example, to explore Affirm's potential to influence consumers through the carbon labelling of purchases within its buy-now-pay-later ecosystem. We also plan to discuss CATL's approach to sourcing raw materials for its batteries more sustainably.

Throughout the process, we're working to balance our climate engagements with other priorities. That will ensure we don't blindly push for a climate transition without considering the broader social implications.

Understanding supply chains is crucial, especially when the raw materials essential to the transition – such as cobalt and silicon – are sourced from regions with ethical supply chain questions we need to explore.

It is also important to stress that the holdings at the top of the diagram – the solutions innovators – won't enjoy any kind of lower hurdle around the demands of our LTGG research framework. Just as with other holdings, we require an enduring competitive position and a cultural advantage. We also need a compelling returns structure and scope for significant upside. A failure to meet those criteria will lead us to sell a 'climate positive' company, as was recently the case with Beyond Meat.

ESG updates at Baillie Gifford

Since the beginning of 2020, the number of ESG professionals working at Baillie Gifford has increased from 24 to more than 40. In June 2022, Catherine Flockhart, a partner in the firm, became Head of the ESG team[9].

In conjunction with Baillie Gifford's investment teams, the ESG team undertakes ESG research and engagement and coordinates the proxy voting process for all our clients' holdings where we retain the voting rights. The ESG team also highlights ESG risks and opportunities to the different investment strategies, monitors companies we have holdings in, engages with companies on ESG criteria and challenges them when appropriate.

An ESG Steering Group reports into the Baillie Gifford Management Committee. It also provides updates to our Equity Leadership Group and our Multi Asset and Income Leadership Group, which both include partners from investment and client-facing areas. These reporting lines help us to ensure that our research, ESG and stewardship activities are aligned with and remain of value and relevance to the firm and that they face the appropriate level of independent challenge and scrutiny.

The overarching purpose of the ESG Steering Group is to provide oversight and coordination for the firm's approach to ESG. It coordinates the multiple strands of ESG activity taking place across the firm. And it aims to ensure that we meet the rapidly evolving demands of ESG from an investment, client and regulatory perspective.

We also began a multi-year programme of work in 2021 to review and improve the provision of ESG data. As part of this, we recruited ESG data analysts to facilitate and enhance ESG data usage within Baillie Gifford, paying mind to data integrity and data availability. We continue to improve and expand the coverage of ESG data across different asset types and work to improve the flexibility of viewing and reporting data points for internal and external uses.

Further information about Baillie Gifford's approach to ESG is available on the ESG section of our website. You will also find our firm-wide Stewardship Principles, Investment Stewardship Activities Report, ESG Principles and Guidelines, Environmental Policy, and Principal Adverse Impact Policy, among other relevant ESG documents.

[9] Catherine Flockhart is a Partner and Head of ESG at Baillie Gifford. She oversees our firmwide ESG function, which encompasses investment research, stewardship, voting and operations, and client communications. Prior to this, Catherine played an integral role in the launch and growth of our Positive Change impact strategy and has worked as a specialist on Baillie Gifford's established global and international equity strategies. Before joining Baillie Gifford in 2012, Catherine began her career at Goldman Sachs, and also has an MA in English Literature from The University of Edinburgh.

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The Manager is not resident in Canada, its head office and principal place of business is in Edinburgh, Scotland. Baillie Gifford Overseas Limited is regulated in Canada as a portfolio manager and exempt market dealer with the Ontario Securities Commission ('OSC'). Its portfolio manager licence is currently passported into Alberta, Quebec, Saskatchewan, Manitoba and Newfoundland & Labrador whereas the exempt market dealer licence is passported across all Canadian provinces and territories. Baillie Gifford International LLC is regulated by the OSC as an exempt market and its licence is passported across all Canadian provinces and territories. Baillie Gifford Investment Management (Europe) Limited ('BGE') relies on the International Investment Fund Manager Exemption in the provinces of Ontario and Quebec.

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BAILLIE GIFFORD