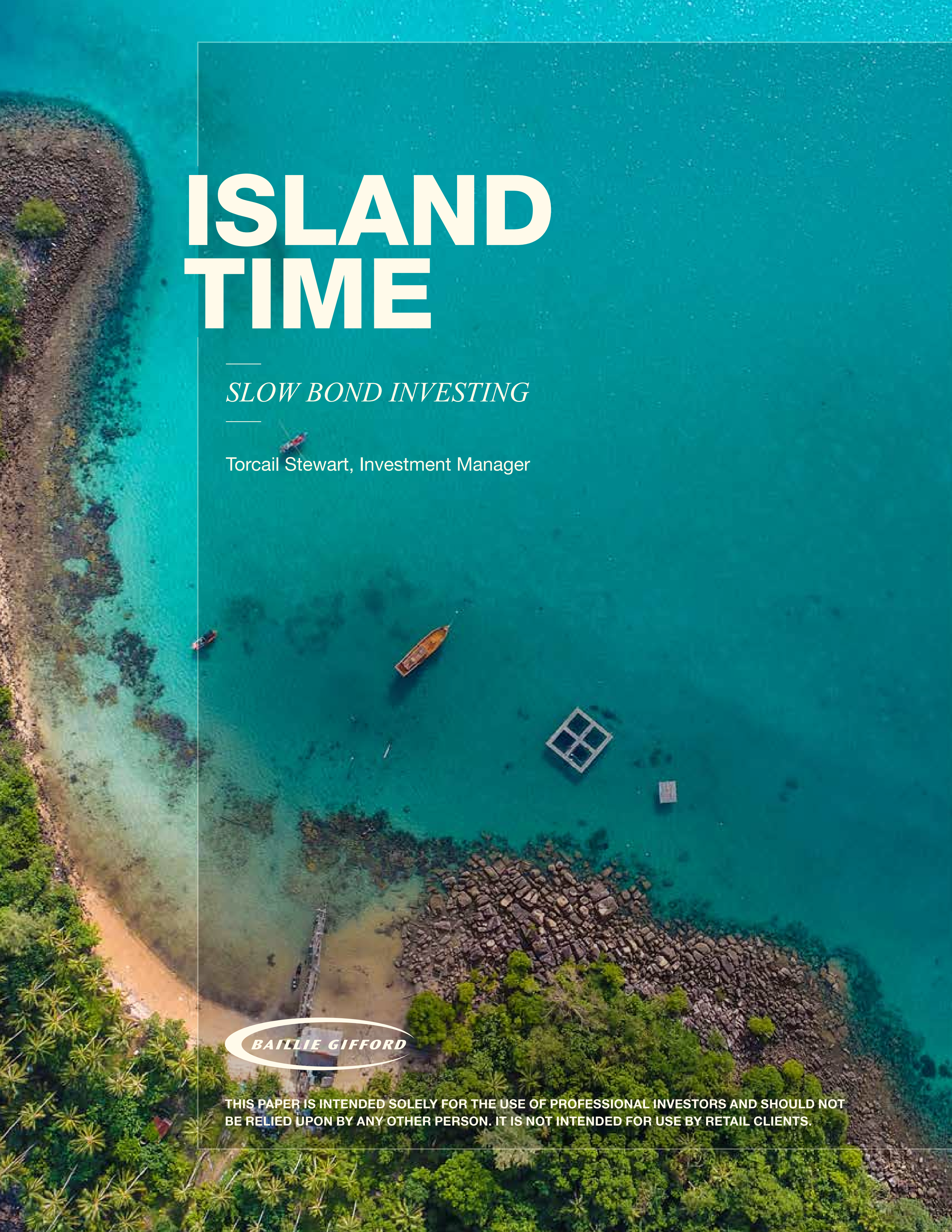

ISLAND TIME

SLOW BOND INVESTING

Torcail Stewart, Investment Manager

BAILLIE GIFFORD

RISK FACTORS

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All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk. Past performance is not a guide to future returns.

Stock Examples

Any stock examples and images used in this article are not intended to represent recommendations to buy or sell, neither is it implied that they will prove profitable in the future. It is not known whether they will feature in any future portfolio produced by us. Any individual examples will represent only a small part of the overall portfolio and are inserted purely to help illustrate our investment style.

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OCTOBER 2021

ISLAND TIME

BY TORCAIL STEWART

Isolation, by checking immigration and consequently competition, will give time for any new variety to be slowly improved; and this may sometimes be of importance in the production of new species.

CHARLES DARWIN, ON THE ORIGIN OF SPECIES

Islands have captivated the human imagination since time immemorial. In the 8th century BC, Homer related the epic journey of Odysseus with a tale populated with various magical beings, each living in its own unique island world.

Three millennia later, Charles Darwin, travelling on HMS Beagle, arrived in the Galapagos, a world of giant tortoises, marine iguanas and the bizarre blue-footed booby. At about the same time, the trip of another British naturalist, Alfred Russel Wallace, to the Malay Archipelago saw him encounter flying frogs, paradise kingfishers and the majestic red ape. Islands have acted as evolutionary laboratories of nature – and the imagination – for centuries. Building on their island experiences, Darwin and Wallace evolved similar theories of evolution through natural selection. Islands offer time for evolution to occur free from competitive distraction.

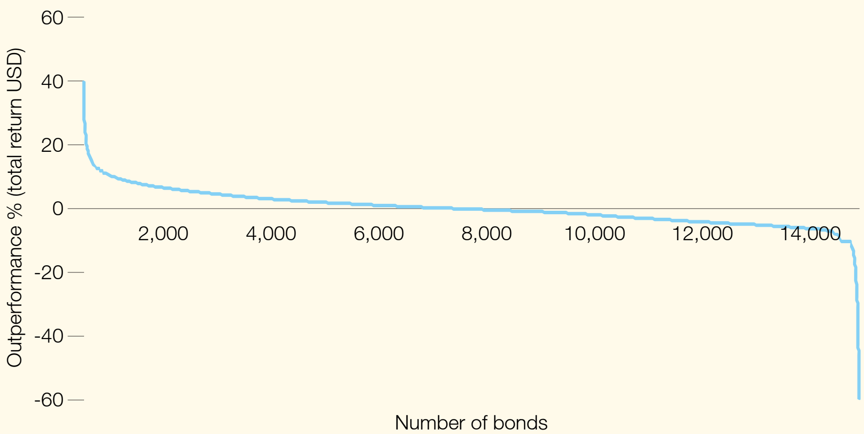
A similar principle applies in investment. While our fixed income approach is certainly neither exotic nor magical, it is nevertheless distinctive. Our approach to corporate bond investing has been incubated within the supportive 'island' environment of Baillie Gifford for more than two decades. The result is a unique methodology, focused on forward-looking research and bond selection. So, what are our tips for 'island-style' investing?

GO OFF GRID

Be free in your thought and action. Island Time implies thinking time. A well-considered decision is always better than a rushed one. Frenetic trading is not our style. We typically lend to companies for between three and five years. Therefore, choosing to whom to lend is not a decision that is taken lightly. The Baillie Gifford credit team undertakes deep, fundamentals-driven research on every investment. Our company research reports are typically 3,000 words long.

Getting off grid gives us the time to focus on what really matters, identifying winners and losers. Our research shows that only a handful of companies contribute to outperformance in global credit markets, as detailed in the chart below. Over the long term, it is the success of the companies in which we invest that ultimately delivers value for our clients. We design our portfolios so that bond selection can shine, without being overwhelmed by hard-to-diversify thematic factors.

Global investment grade and high yield index constituents
ranked by out/underperformance in 2020



Source: ICE BofA – Year 2020.

PLAN AHEAD

Fruitful island living requires you to think ahead and plan for forthcoming seasons. At Baillie Gifford, we believe that by undertaking forward-looking research we can identify winners and losers in advance. We follow a long-term approach both with individual bond selection and asset allocation. Our focus is upon companies' long-term fundamentals. We seek to lend to those businesses that are growing and have a sustainable competitive advantage.

Planning ahead also means you have to be aware of the global macroeconomic environment. We use our understanding of the broader macro context to shape portfolio asset allocation and thereby avoid areas of potential future market volatility. Our risk-budgeting approach considers various measures, including:

— asset class

— industry

— geography

— time to maturity

— cyclicality

— scenario testing

FIND YOUR NICHE

In an island community, everyone has a specific role and a specialism. Choosing the right role is likely to dictate your prosperity.

With the world as our oyster, to render such a broad bond universe manageable, our prospecting efforts target areas of bond inefficiency where we can maximise the value added through in-depth, fundamentals-driven research.

The credit quality of companies which issue bonds varies greatly. Intuitively, those companies operating at the low-quality CCC-end of the ratings scale may not be the most attractive investments. However, the same may also be true of those companies with high-quality AAA ratings. We believe that the most attractive investment opportunities are typically found between these two extremes, specifically those companies rated BBB and BB. This belief is based upon observation over the years that the rewards frequently overcompensate for the risks that these businesses present.

Other areas of inefficiency that we target include:

— out-of-favour sectors

— mis-rated bonds with upgrade potential

— new issuers to the market

— large unrated bonds

— management turnaround investments

— likely sector consolidation targets

— high-yielding convertible bonds

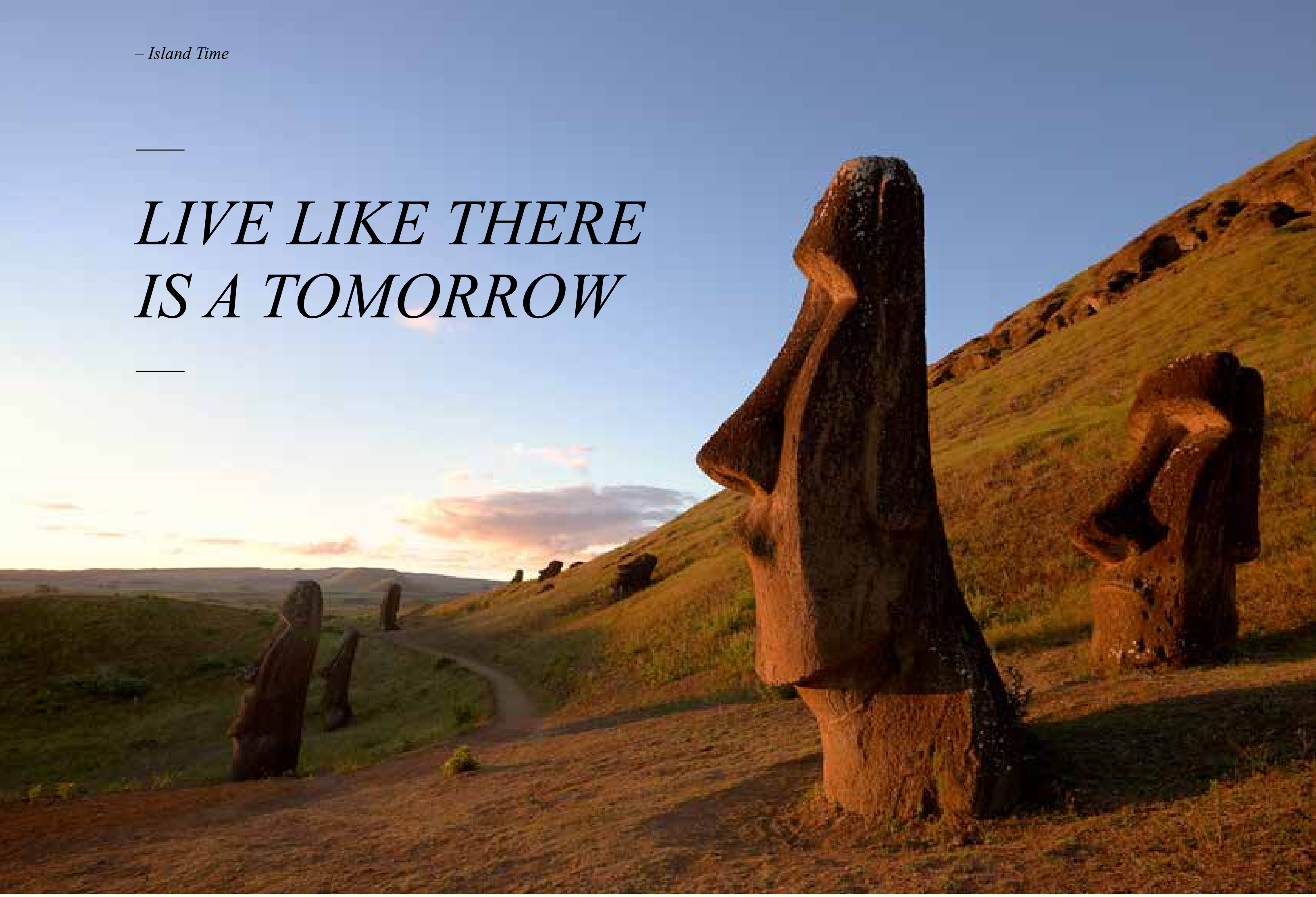
EAT WHAT IS IN SEASON

In bond markets, as with islands, it is usually good advice to tailor your gastronomical choices to what is in season. In other words, seek to lend to those companies that are structurally growing and avoid those in structural decline. A company that is structurally growing, in a time of cyclical weakness, is much more likely to receive capital support from its shareholders than one whose business model is increasingly obsolete. The latter variant carries the added risk that you never really know when growth may step-change downwards. Why take the risk?

Most companies that we lend to have strong long-term growth potential. Indeed, the weighted average sales growth of companies we lend to is greater than 10 per cent per annum.*

The other side of eating what is in season involves directing our prospecting efforts to those geographies and sectors where we see the best risk-adjusted returns. In times of fear, we often find that for out-of-favour sectors, strong companies' bonds sell off at the same time as the weak's. To the bond selector, focused upon long-term fundamentals, rich pickings can be made in such an environment.

*Source: Baillie Gifford & Co.



LIVE LIKE THERE IS A TOMORROW

Islands have finite resources. The original inhabitants of Rapa Nui (Easter Island) learned this too late. Thankfully, it is not too late for our generation. Harvesting resources sustainably is as essential for long-term island living as it is for modern-day investment.

The most material change to investment in the 21st century, we believe, will be the growing primacy of sustainable investment and the demand for low-carbon solutions. Environmental, social and governance (ESG) matters should be given equal primacy in the long-term investor's assessment of a business alongside its competitive positioning and its capital structure. Consideration of environmental, social and governance matters has enabled us to avoid defaulting or ultimately challenged businesses. Meanwhile, recently published research by Barclays* shows that even when you adjust for systemic factors, an ESG-orientated credit portfolio would have outperformed its non-ESG benchmarks in both the US and Europe between 2009 and 2020.

Getting on the right side of change clearly matters to portfolio returns. You should invest like there is a tomorrow.

*Source: Barclays, *Measuring ESG Returns in Credit*, April 2021.

APPRECIATE THE VIEW

Bonds don't have to be boring. The key differentiating feature of our approach is identifying companies whose balance sheets are likely to improve. Bond prices appreciate when yields reduce.

The stronger the balance sheet of an issuer, typically the lower the yield offered by its bonds. Consequently, seeking bonds issued by companies where you believe the balance sheet will improve is often a good strategy that can produce meaningful capital growth.

At Baillie Gifford we follow a distinctive approach to credit markets. Focused on long-term fundamentals, we seek to lend to growing companies that have sustainable or improving balance sheets and that will deliver a resilient income stream through the cycle.

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Torcail is an investment manager in the Credit Team and co-manager of our strategic bond funds. Torcail leads the Crossover Portfolio Group and is a member of the Multi Asset and Income Leadership Group. Before joining Baillie Gifford in 2008, he worked as an investment analyst for Alliance Trust's UK large-cap equity fund. Torcail gained a BA in Geography from the University of Cambridge in 2002 and an M.Phil in Management, Economics and International Relations from the University of St Andrews in 2005. He is a member of the CFA Society of the UK.

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