UK Equity Stewardship Report

2020

Baillie Gifford

Investment managers

Risk Factors

The views expressed in this article are those of the UK Equity Team and should not be considered as advice or a recommendation to buy, sell or hold a particular investment. They reflect personal opinion and should not be taken as statements of fact nor should any reliance be placed on them when making investment decisions.

This communication was produced and approved in July 2020 and has not been updated subsequently. It represents views held at the time of writing and may not reflect current thinking.

Potential for Profit and Loss

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.

All of the stocks referred to in this note are held in at least one of our UK portfolios.

This article contains information on investments which does not constitute independent research. Accordingly, it is not subject to the protections afforded to independent research and Baillie Gifford and its staff may have dealt in the investments concerned.

All information is sourced from Baillie Gifford & Co and is current unless otherwise stated.

The images used in this article are for illustrative purposes only.

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Introduction

Welcome to the UK Equity Governance and Stewardship report. Our investment process at Baillie Gifford is founded on the long-term ownership of growing businesses. Our 'bottom-up' approach to stock selection leads us to focus on trying to understand the fundamental drivers behind individual businesses. We typically hold these investments for five to ten years – long enough for the fundamentals to emerge as the dominant influence on share prices. Cultivating conviction in corporate governance and sustainability in its broadest sense is a critical part of this process.

We also believe that our responsibilities go further. We want to help companies fulfil their potential by encouraging them to invest in growth opportunities and to eschew the short-term pressures of the stock market. With the support of our specialist Governance and Sustainability Team, our investors engage regularly with management, offering support and constructive challenge in pursuit of our mutual long-term interests. We strongly believe that stewardship is synonymous with responsibility, long-termism and sustainability.

The pages that follow set out the five key principles behind our stewardship framework. We include a case study and some engagement examples to help illustrate our efforts. You will also find an analysis of our investment strategy's carbon footprint. We hope you find these pages useful and look forward to having many more interesting conversations with you on these important matters.

Baillie Gifford's Stewardship Principles

Reclaiming Activism for Long-Term Growth Investors

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

Prioritisation of long-term value creation

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

A constructive and purposeful board

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

Long-term focused remuneration with stretching targets

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

Fair treatment of stakeholders

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

Sustainable business practices

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

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

Engagement Highlights

We are sometimes asked why we do not publicly shout from the rooftops about the extensive engagement activities that we undertake on our clients' behalf. It is suggested, for example, that we should be more vocal in the media – naming the companies we are engaging with and the matters that we are focusing on – as evidence of the work that we are doing.

While a higher public profile on our stewardship activity might seem appealing to some, our approach, as always, is determined solely by what's most likely to achieve the best outcome for our clients. To this end, our view is that directors are likely to be more comfortable speaking with us openly if they are confident that our exchanges will not subsequently be reported as headline news.

In a situation, for example, where we consider that management change may be required to drive long-term shareholder returns, we might meet with the chairman to explore the board's perspective and to share our thinking. Such an approach can lead to a smoothly-facilitated management transition without media coverage that might be hyped to generate headlines. In demonstrating the confidentiality of our discussions, we build relationships with directors that are characterised by trust, mutual respect and a sense of partnership. That in turn establishes a sound platform for us, as long-term investors, to monitor our clients' holdings over many years.

We are nonetheless acutely aware of client interest in our engagement activities, so we provide information and examples in quarterly reports and at client meetings. We cover our engagement process, and an example of how it informs our voting decisions, in greater detail in the Appendix (Quarter 3 and Quarter 4 Governance Letters).

Prioritising long-term value creation

Abcam is the leading supplier of antibodies for academic and biotechnology research. The UK Equity Team have been investing in Abcam for over 10 years and, as a significant shareholder, have enjoyed constructive engagement with the executive team and the broader board. For example, we engaged with the founder as he transitioned from Chief Executive Officer (CEO) to deputy chairman. The key focus for us was to ensure a smooth transition, with the founder's expertise remaining in the business and the new CEO being able to take control in an appropriate manner. More recent engagement has been focused on diversifying its product suite beyond stand-alone antibodies. In Q3 2019 it announced new investment plans to drive various strategic initiatives with a view to supporting medium- to longer-term revenue growth. Although these involve some additional upfront cost – possibly the reason for a nervous share-price reaction in the short term – we think this strategy is eminently sensible and we have conveyed our strong support for management's decision.

On 21 October 2019, **Prudential** completed the demerger of M&G plc from Prudential plc. As a result, Prudential has become an Asia-led Group focused on capturing opportunities in structural growth markets. We knew that the demerger would be a lengthy and complicated process, therefore we had a number of engagements with the board to review progress and timescales, and to discuss how it might impact on long-term value creation.

For example, in early 2019 we met Paul Manduca, chairman, and separately Philip Remnant, senior independent director (SID). We discussed with the chairman the recent turnover of long-serving senior management, succession planning, matters relating to regional divisions (including US, Indonesia, China), board structure, functioning and diversity. Following discussion with the SID, we expressed support for the proposed extension of the chairman's tenure until the 2021 AGM. This extension meant it would exceed the revised UK Corporate Governance Code's guidance of nine years from the date of appointment to the board. However, as the demerger was expected to complete in late 2019, we considered that the extension would provide appropriate continuity and accountability.

Anthony Nightingale, chairman of the remuneration committee, also engaged with us in relation to executive pay; we were supportive of his proposal that only limited changes be made pending the demerger. Later in the year, we met Mark Fitzpatrick, Chief Financial Officer (CFO). Our discussion included matters arising from the reported results and longer-term strategy for the two businesses that later became separately listed companies. While these engagements touched upon a number of our stewardship principles, our core focus throughout was to ensure long-term value creation for our clients amid a complex and significant organisational change.

Constructive and purposeful board

Our approach to investment requires us to think carefully about the board of each individual company. As active managers we invest in a wide range of selected companies from small early-stage firms to large mature businesses; they span different sectors of the economy and can have quite distinctive geographic footprints. This diversity of investments in client portfolios means we do not expect one type of board to suit all companies: what's right for one company may not be right for another. Our approach is to consider the suitability of the board at each individual company in the context of its business and strategy. While there is no fixed formula for the composition of a constructive and purposeful board, we expect each board to have the resources, cognitive diversity and information that is needed to effectively fulfil its responsibilities. The skills, experience, actions and behaviours of a board have a direct influence on the sustainability of a firm's long-term financial returns. We engage with the chairs, who steer the board, about succession planning and the future skills that will be needed in the boardroom as the company grows and strategy evolves. The following examples provide insight into how we assess boards:

Homeserve, the emergency insurance and repairs business, has an unusual board structure. It has a long-serving CEO, who founded the business, and a chairman, who has served on the board for nearly as long, having originally been appointed as a non-executive director. We were consulted on board succession following changes to the UK Corporate Governance Code in 2018. It moved the goal posts in terms of the maximum length of a chair's service, meaning the nine-year limit now refers to time spent on the board, rather than their tenure as chair. To comply with the new guidance Barry Gibson, chairman, would have been required to step down at the company's AGM. We were asked if we would support the chairman's re-election to provide continuity and stability to the board which, following significant change in recent years, has a number of relatively new non-executive directors. We thought this made sense under the circumstances, particularly in light of Barry's strong working relationship with the CEO, which enables him to facilitate candid boardroom discussions and constructive challenge to the CEO and other executives. We therefore supported his re-election.

We greatly value our access to company management and the ability to engage in open and honest dialogue with executives and board members. It is therefore incumbent on us to use this trust wisely and with respect, particularly when it comes to any assessment of operational underperformance and potential remedies. For this reason, we have anonymised the next engagement example: we engaged with a specialist engineer due to disappointing operational performance in its smaller, regional Asian business. Our objectives were to understand the challenges, the strategy for returning the business to a growth path, and to assess leadership capability. We met with the executive team, both the CEO and the relatively new finance director. We subsequently arranged a separate meeting with the chairman. At our meeting with the executive team we discussed the steps being taken to improve performance, which included divisional management changes, restructuring of business units, and a strengthening of financial controls. Our subsequent meeting with the chairman was also attended by the board's SID. We had previously engaged with the chairman in his capacity as chair of another company in which we are invested and had built a good and trusting relationship with him through constructive and confidential dialogue during a period when that company had encountered challenges. The strong relationship and mutual trust established during this earlier engagement provided a sound basis for open and candid discussion of sensitive matters in relation to board composition. A few months after our meeting we were contacted by the chairman following an announcement of significant senior management changes. We continue to engage with the new leadership team and believe that it is making sensible moves to address those historic operational problems.

Female Board Representation

The diagram below shows the proportion of companies that each of our UK portfolios invests in that have more than 30 per cent female representation on the board, plus those with any female representation. On both measures, all the UK portfolios are more favourably positioned than the benchmark.

Any Female Representation

≥30% Female Representation

*Excludes smaller company fund.

Long-term focused remuneration with stretching targets

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

We are consulted by many investee companies on executive pay proposals and vote on them at AGMs. There are several parts to a pay package; we analyse each element in the context of our expectations of the individual firm and consider how successful the overall pay structure is likely to be in aligning the reward outcome for executives with the interests of our clients as shareholders.

As long-term investors, we support meaningful share ownership requirements for directors, study the balance between short-term (annual bonus) and long-term reward opportunities and make informed judgements as to how challenging the targets for incentive plans are. For UK-listed companies the number of shares awarded to executives from long-term incentive plans is usually determined by performance achieved over a period of three years and we expect these shares to then be held for a further two years. This approach lengthens the period of alignment between executive reward and performance to five years and thereby strengthens alignment between the interests of directors and our clients. In a further effort to link reward with shareholder returns, executives that leave a company will, going forward, be required to retain a proportion of the shares they hold for a period of one-two years following departure.

Genus is an animal genetics company that helps farmers to be more sustainable, by producing higher-quality meat and milk. We cover our engagement with Genus in more detail in our Q4 2019 governance letter in the Appendix, however one aspect of our engagement was with the chair of the remuneration committee on revisions to the remuneration policy.

Genus' proposed amendments were considered in the first instance by a member of our specialist governance team and then discussed with our portfolio managers. This combination works well, with our governance specialists understanding best practice regarding the structure of executive pay, while the investors are best placed to judge whether the targets set for incentive schemes are challenging.

We initially indicated that we would not support Genus' policy amendments. This led to a further round of engagement, focusing on our reservations and suggested improvements. By engaging jointly, our portfolio managers and governance specialists delivered a unified message with conviction and provided clarity as to our voting intentions. In further revising its proposals, the remuneration committee fully addressed our concerns and we confirmed that we would support the remuneration policy resolution at the Annual General Meeting (AGM). However, in other instances where we consider the reward structure to be overly complex and generous we will oppose the remuneration policy as detailed in our voting activity report on page 16.

Fair treatment of stakeholders

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

Following revisions to the UK Corporate Governance Code in 2018, and thereafter to remuneration guidelines for UK-listed companies, there is now a clear expectation that executive pension contribution rates are aligned with the rate applicable to the majority of a company's UK workforce. The aim of this guidance is to encourage companies to develop a fairer approach to pensions, even though the actual value, and the form in which it is paid, may still vary from one individual to another. Companies are now expected to disclose their workforce rate (it will vary between firms) and to set out a credible plan to achieve alignment by the end of 2022.

Pension contribution rates are expressed as a percentage of salary and historically it was generally the case that the levels were significantly higher for executive directors compared to wider employees; **Rightmove** stands out, however, for its market-leading approach to pensions, with executives and staff offered six per cent of their salary.

During the 2019 voting season, several companies, including **Burberry**, made the commitment that any new executive would be appointed with a pension rate in line with the majority of the workforce. The adjustment for incumbent executives is trickier as their pension arrangements were agreed on appointment and are generally considered a contractual benefit.

However, **Standard Chartered** was a notable disappointment: 36 per cent of shareholders, including Baillie Gifford, voted against the remuneration policy when the method of calculating executive pensions was changed to give the impression of a significant reduction, while the reality was no change at all.

When participating in remuneration consultations, we have had the fair treatment of employees regarding pensions at the forefront of our mind. Revised proposals from remuneration committees have generally included a commitment to align the pension contribution of any new executive with the wider workforce rate but proposals for serving executives have varied. While some companies, including **Johnson Matthey**, set out a pathway for these directors to achieve alignment by end 2022, others including **Rolls Royce**, **Meggitt** and **St. James's Place** have committed to a phased reduction on our prompting. In our engagements we have urged remuneration committees to get ahead of the curve by seeking voluntary alignment by serving executives from 2020.

Sustainable business practices

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

Our investment approach requires us to think about all factors that might impact on the sustainability of a company's long-term financial returns. We recognise, for example, that how a company treats its workforce and suppliers and how it manages the external impact of its business activities can impact on the sustainability of shareholder returns. Our investors have the option of discussing business practices directly with company management teams, selectively participating in collaborative initiatives or combining both approaches.

For example, we attended **Unilever's** first sustainability event for investors. It was hosted by the CEO who, together with the CFO, attended every session. The chief sustainability officer, chief supply chain officer, chief research and design officer and the president of food and refreshment spoke at the event, which covered three key areas:

1. The importance of Unilever's brands having a strong purpose and the positive impact on Unilever's profitability, with examples of how social purpose has been driving sales.
2. The transition to making its portfolio of products as healthy as possible. Management acknowledged that further progress is needed, but stressed the work being done.
3. The environmental impact of palm oil sourcing, carbon and plastics. It was interesting to hear from the chief research and design officer on the innovative solutions being adopted to make packaging and materials completely reusable while having a cost benefit for the consumer. We are keen to follow up on progress regarding the transition and diversity of the portfolio with the president of food and refreshment this year.

In the mining sector, we are participants in the Mining and Tailings Safety Initiative (MTSI). This was established early in 2019, following the collapse of a tailings dam in Brazil with devasting humanitarian and environmental consequences. These dams store waste from the mining of resources that are required to meet global demand, including for consumer products.

The aim of the initiative is to put in place a governance framework to improve the safety and management of dams globally and provide transparency to stakeholders. This investor-led initiative has made good progress so far but there's more to do and the outcome will not eliminate the risk of future dam failures. We are pleased that both **Rio Tinto** and **BHP** are participating fully in the MTSI and are encouraging the setting of high safety and disclosure standards, rather than the setting of a low bar that would be readily achievable by all companies. The MTSI is a response to a specific long-term industry risk; our approach is to combine participating in the initiative with our one-on-one engagement with mining companies.

Boohoo Case Study

STOP PRESS

As we go to print, serious allegations have been made in the media about pay and working conditions in factories in Leicester that appeared to be used to supply Boohoo clothes. We are treating the allegations with the utmost seriousness. We engaged immediately with executive directors to understand their perspective, actions taken and proposed response. We then participated in a collective engagement with management, engaged with one of the company's industry peers and subsequently spoke with the Deputy Chairman, who is also the Senior Independent Director, to clarify specific issues and make known our particular concerns and expectations of the board. The allegations have arisen at a critical point in the company's development: its strategy has been delivering growth, the board has been strengthened and plans to enhance the auditing of suppliers and related disclosure were being progressed. The allegations have therefore presented us with a very significant dilemma; do we sell and walk away or continue to engage with a view to ensuring that the business is adhering to high social and ethical standards? After extensive discussion we have decided, on balance, to continue our engagement and to closely monitor over the next few months the delivery of information against milestones that the board has set and their responsiveness to matters that we have discussed.

We recognise that Boohoo is behind peers on some sustainability metrics but overall, we came away from the tour and time with management encouraged by the direction of travel.

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Reason for Engaging

Boohoo has quickly grown to become a major online fashion retailer in the UK. Its own-brand, online-only model, coupled with its innovative and agile 'test and repeat' inventory approach means that it has few limits on the volume, range and speed of distribution. As its success depends upon strong relationships with its supply chain and external stakeholders, we wanted to gain a better understanding of the sustainability of its business practices.

Objectives

To deepen our understanding of the supplier appointment process, workforce management and Boohoo's engagement with local external stakeholders.

Scope and Process

Our approach to engagement is to work together across our investment and governance teams. This keeps our thinking joined-up and ensures that we speak with one voice. Earlier this year, one of our UK portfolio managers and two of our governance and sustainability analysts travelled to Leicester to meet five manufacturers within Boohoo's supply chain. The five we met were among its largest producers, with the longest relationships, and the trip included visits to both new and old factories. Boohoo's co-founder, CEO, CFO, and sustainability director and head of Responsible Business also joined the tour.

During the tour, we had an open discussion with management regarding their perceptions of the company's sustainability and we were reassured that they recognise Boohoo is at the early stages of its journey with a lot to do. This sentiment was reinforced by the newly created role of sustainability director and head of Responsible Business last year, a position which should help to prioritise the sustainability agenda. We discussed the scope of management's pursuits and welcomed the following tangible sustainability goals that they have set themselves to deliver over the next 12 months:

— Mapping of the company's supply chain using a third-party vendor and disclosing this to shareholders;

— Disclosure of its environmental impact and forward-looking carbon reduction targets;

— Introduction and innovation of recycled materials into its product offering.

We also took this opportunity to engage directly with the suppliers. The consistent message from almost everyone was the benefits of Boohoo paying direct suppliers within 14 days. To put this into context, the industry average payment period is 75–100 days. One supplier explained that it helps the whole supply chain as the manufacturers then pay the fabric suppliers quickly, which means they often receive a discount, so it genuinely benefits a range of stakeholders.

We moved on to explore an issue that was raised by the Environmental Audit Committee in 2018/2019 into the sustainability of fast fashion. Specifically, we looked at the treatment of suppliers when they go to Boohoo's weekly buyer days to bid for orders. Factory owners travel to Manchester with garment ideas and pitch these ideas to buyers from Boohoo. We asked one supplier about the day and he explained that while it is competitive – you have multiple suppliers vying for orders – producers generally like the efficiency of it being on one day. He highlighted the example of being able to car share with other suppliers. The idea generation from the suppliers who attend the buyer day is an important part of Boohoo's ability to offer customers a wide range of products, so we were pleased to hear this feedback. We also confirmed that everyone who attends the buyer day must be an approved/audited producer for Boohoo and this is checked when orders are written.

Engagement Outcome

We recognise that Boohoo is behind its peers on some sustainability metrics but overall, we came away from the tour and time with management encouraged by the direction of travel. The desire to make progress was clear. The tour gave us a useful insight into Boohoo's supply chain and management's views on what the business is doing well and what they need to improve on. We committed to encouraging and monitoring progress in the following areas:

— The disclosure of the company's supply chain is expected in 2020. In addition, to setting out the breadth of its supply chain, we are interested in what it has learnt from the mapping process (industry competitors have reported cutting suppliers as a result of their mapping process);

— The introduction of third-party random audits to support the supply chain mapping process and reduce the risk of sub-contracted work;

— The disclosure of its environmental impact and forward-looking carbon reduction targets, expected in 2020;

— The introduction and innovation of recycled materials into product offering.

Shortly after our tour, the outbreak of Covid-19 unfolded. During these unprecedented times, we have been pleased to observe that Boohoo has retained its industry-leading payment terms and has also set up an emergency fund to help suppliers who may struggle.

Carbon Footprint Analysis

Climate change poses a serious threat to our environment, our society, and to economies and companies around the globe. If we are to address the underlying causes, then companies that are high emitters of carbon are likely to face greater societal and regulatory scrutiny, and higher costs to account for the true environmental impact of their activities. Understandably, our clients are also taking an increasing interest in the carbon footprint of their investments.

This section looks at the carbon footprint analysis of our three UK strategies. It illustrates the carbon footprint of each and highlights those companies which have the highest emissions. Analysing the carbon footprint of a business is complex and understanding the reasons for the results can be highly nuanced. However, an analysis, such as the one presented here, provides a starting point for discussion on this important issue.

We recognise that measuring the carbon emission levels of investment portfolios is far from an exact science. It is made difficult by a lack of disclosure, a lack of standardised reporting of emissions, and limitations in the universe of companies covered by data providers. However, tools are emerging which attempt to gather and verify available data, and also estimate carbon data where companies do not disclose it. This enables investors to gain a reasonable picture of carbon emissions at the overall portfolio level. The data presented here is provided by the third party provider, 'yourSRI', and covers Scope 1 and Scope 2 emissions. Scope 1 emissions are those that derive directly from company activities (i.e. fuel use). Scope 2 emissions arise from the use of purchased energy.

Clearly, there are limitations to this approach and it is appropriate to highlight them. Focusing on the Scope 1 and Scope 2 emissions ignores the carbon footprint of the supply chain, the use of products post production and any post-lifetime emissions. As an example, a car manufacturer relies on a long supply chain including metal extraction, plastic production and component manufacture, none of which would be captured in its Scope 1 and 2 emissions data. Post production, an internal combustion unit vehicle will be burning hydrocarbons throughout its lifetime and will require post-use processing. Although the supply chain and post-production usage have extremely high carbon costs, none of these would be captured within Scope 1 and 2 emissions data. Taking this a stage further, a manufacturing company that produces a component in-house will always have a higher carbon footprint than a competitor that chooses to outsource the component's production to a supplier. This applies irrespective of the efficiency (or not) of the supplier's manufacturing process, because the supplier's footprint is not captured in the calculation of the manufacturer's carbon footprint. Being aware of the obvious shortcomings and nuances within this analysis helps us to develop a fuller understanding of the information and how to interpret it.

The following charts show that all the UK strategies have a lower carbon footprint than their benchmarks by comparing what the carbon footprint would be if you invested £1 million into the fund versus £1 million into the FTSE All-Share index. We have also provided details of the carbon intensity of each strategy. This shows the total carbon emissions per £1 million of revenue generated by each strategy compared to that of the index and allows us to measure the efficiency of the strategy with regards to emissions per unit of financial output. What we can see is that all three portfolios also have a lower carbon intensity than the index.

Recognising the need to look beyond carbon footprinting, we have strengthened the climate expertise in the Governance and Sustainability Team...

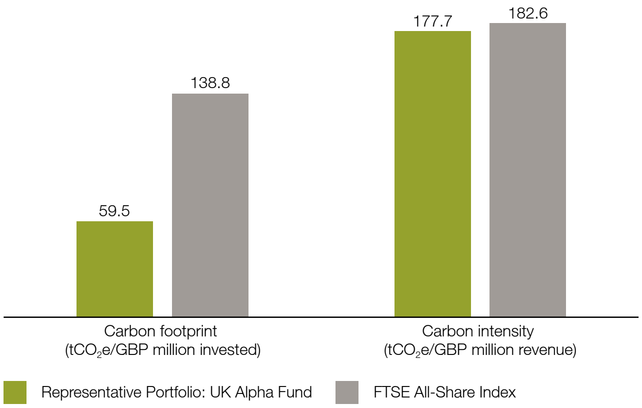
Looking Forward on Climate

A recognised limitation of carbon footprinting is that it is backward looking. It is limited to a snap-shot of the portfolio from a carbon perspective at a particular point in time. This is a useful starting point for holding the highest emitters to account, but it does not provide forward-looking insight into how companies are preparing for future risks and opportunities that may arise as a result of climate change. Recognising the need to look beyond carbon footprinting, we have strengthened the climate expertise in the Governance and Sustainability Team through new appointments and have set up a working group combining investment managers, governance and sustainability analysts and our Investment Risk Team to further develop our approach to climate change.

As part of this, Baillie Gifford is actively preparing a firmwide response to the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD). Published in 2017, the TCFD sets out for companies recommended climate change-related disclosures across four key areas: Governance, Strategy, Risk Management and Metrics, and Targets. The specific disclosures vary by industry so those relevant to Baillie Gifford as an asset manager may differ from the disclosures sought of our investee companies. While these disclosures are currently voluntary, we are conscious that mandatory requirements may evolve in the future. Our internal review and development of investment climate scenario analysis is in progress and Baillie Gifford has committed to respond publicly this year. In addition, we already report the relative carbon footprint (tCO_2e/GBP invested) and carbon intensity (tCO_2e/GBP revenue) of your UK Equity portfolios, in line with recommendations included in the TCFD framework.

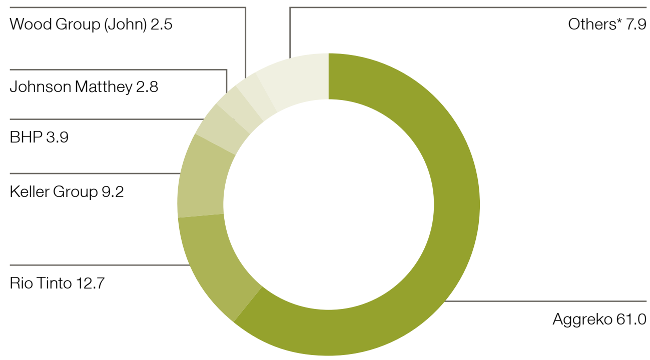
Alpha

Carbon Footprint and Carbon Intensity



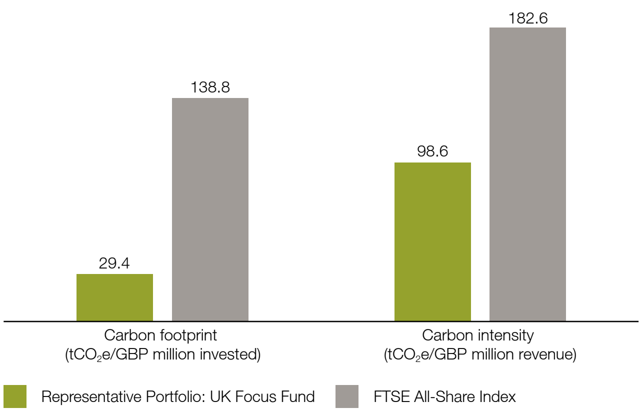
Largest Contributors to Carbon in the Portfolio (%)

(Function of Holding Size and Emissions)



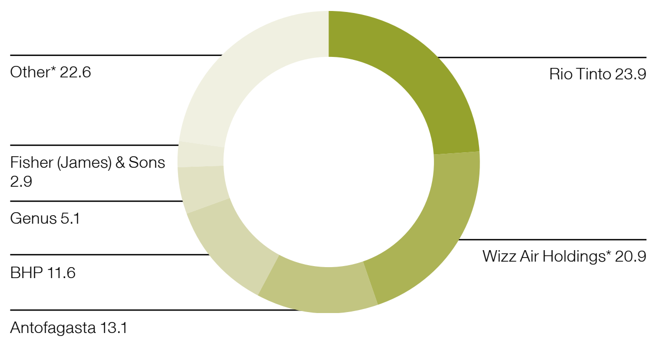
Focus

Carbon Footprint and Carbon Intensity



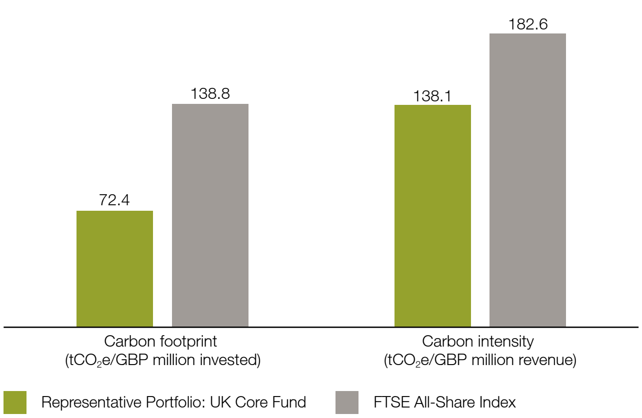
Largest Contributors to Carbon in the Portfolio (%)

(Function of Holding Size and Emissions)



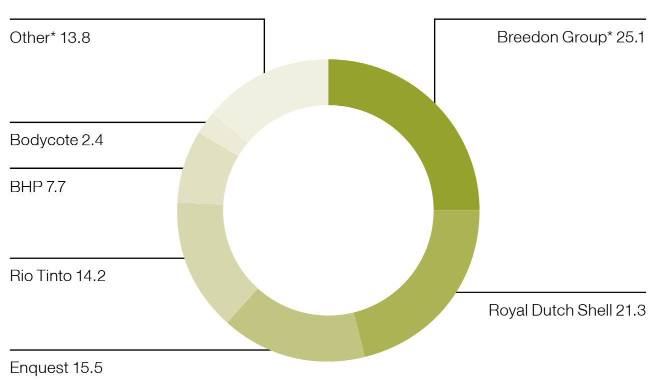
Core

Carbon Footprint and Carbon Intensity



Largest Contributors to Carbon in the Portfolio (%)

(Function of Holding Size and Emissions)



Data as at 31 March 2019.

*Denotes approximate value.

UK Alpha Emissions

Delving deeper into the intensity of the UK Alpha portfolio is informative. The data is markedly skewed by a single company, Aggreko, which makes up over 60 per cent of the strategy's emissions. Aggreko provides temporary power solutions to help meet short-term power outages in developing countries, caused by failures of local generation capacity, natural disasters and other exceptional events. It also supplies power to large public events in developed markets, such as concerts and sporting. The power is provided by a fleet of diesel generators housed in shipping containers.

As a company that burns diesel to generate electricity, it is not surprising that the carbon intensity is extremely high. Furthermore, almost all the carbon emissions associated with its activities are captured within Scope 1 and Scope 2 emissions. However, it is important to think about this activity in a broader context. The electricity that Aggreko produces is very much 'exceptional' and not a significant part of a country's energy mix. Usually its generators are deployed where there is no alternative because the infrastructure is not in place for a very short period of high demand, or where events such as natural disasters or temporary shutdowns curtail normal generation capacity. While we understand that the company has a high carbon intensity, we are also aware of the need for the service it offers and of the lack of alternatives.

In addition, we have observed that it is working hard to reduce the carbon intensity of its operations. In 2017 it signed its first diesel/solar hybrid contract in Eritrea, East Africa. This contract prioritised reliance on solar power to generate emergency electricity with the diesel generators only operating as a back-up when solar output was insufficient to meet demand. During 2018 Aggreko finalised its purchase of Younicos, a specialist in the integration of multiple sources of energy and energy storage, a business which will tilt the energy mix towards the cleanest sources available in complex situations utilising localised energy production.

UK Focus Emissions

Unsurprisingly, two of the largest contributors to emissions across both Focus and Core strategies are mining companies, Rio Tinto and BHP, which we have discussed in the 'Sustainable Business Practices' section of this report.

UK Core Emissions

In the Core strategy, oil and gas companies, EnQuest and Royal Dutch Shell are notable. However, since 31 March 2020, the Core portfolio has sold its holding in Royal Dutch Shell as we became increasingly concerned about both the short-term and long-term challenges facing the oil majors.

We have had several engagements with EnQuest since the beginning of 2020, including a video conference call between board members and our Investment and Governance and Sustainability teams. The outcome was a sense that the new chairman is keen to accelerate ESG awareness and action. We encouraged the company to progress disclosure of direct emissions and to engage with the Science Based Targets Initiative for verification purposes. We also communicated our view that the company needs to embed reducing carbon intensity into strategic thinking and will monitor progress.

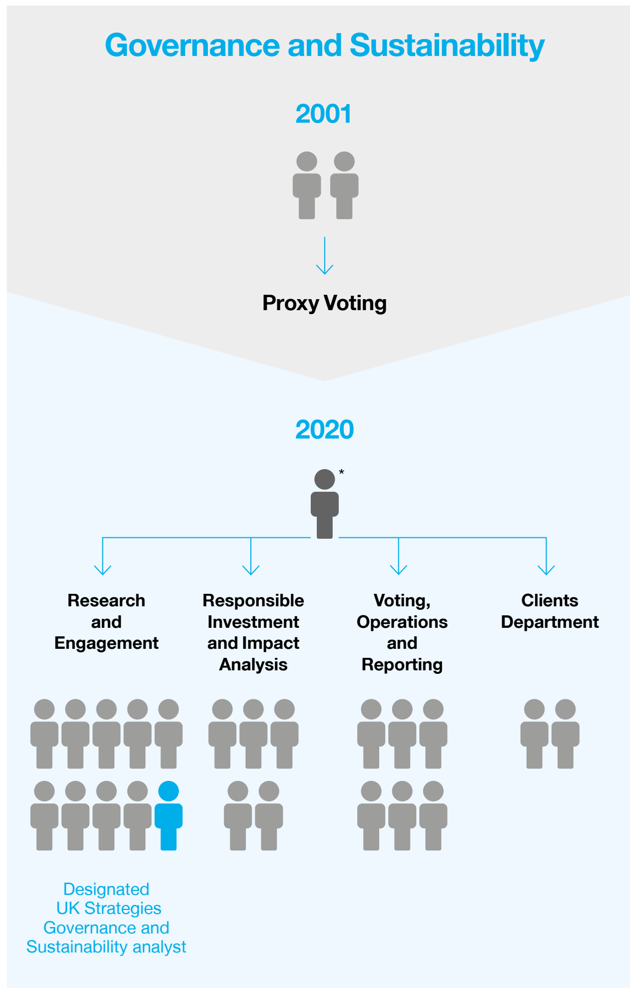
Overall, it is pleasing to see that all three strategies have a lower carbon footprint than the benchmarks and that the largest contributors are as we would expect. We do not target a low carbon footprint, and the measure will vary over time, but the results of this analysis hopefully aid your understanding, providing insight on some of the issues involved and on our approach.

Proxy Voting

Baillie Gifford's Governance and Sustainability Team has continued to grow and evolve to reflect the increasing sophistication of our research and engagement, and to help meet our reporting requirements. In 2019, the team was divided into two specialist groups: Research and Engagement; and Voting, Operations and Reporting. This enables the majority of our analysts to work on our research and engagement activities and a smaller group of analysts to take responsibility for our voting, operations and reporting. When all Governance and Sustainability colleagues are included, our total team now comprises 24 people.

The UK Strategy has a designated research and engagement analyst who can participate in engagements alongside the portfolio managers and works with them when we are consulted by investee companies. For UK portfolios, the designated research and engagement analyst manages the voting of the largest holdings in the portfolios and provides a point of contact in relation to the analysis and instruction of all other votes implemented by the Voting, Operations and Reporting Team.

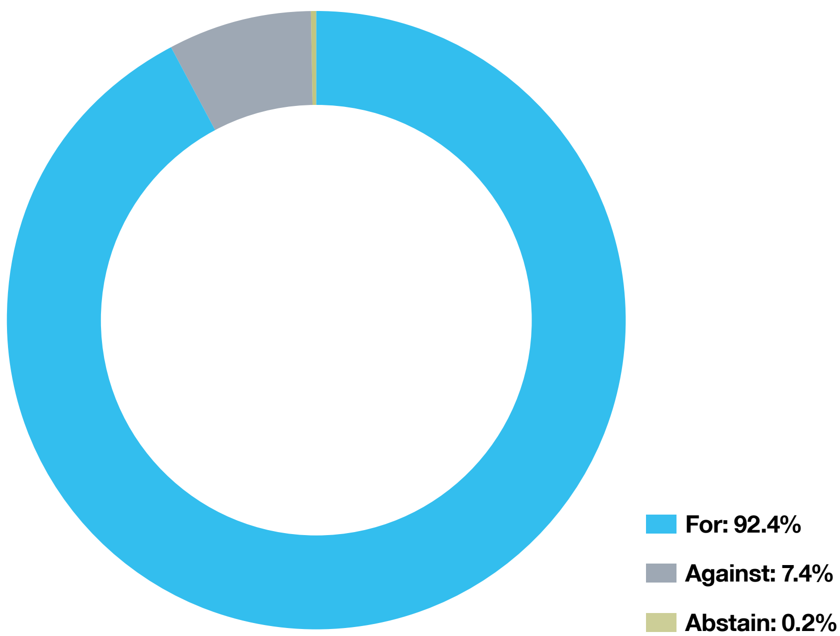
We are open-minded about the best framework to govern and manage a company and sceptical about the usefulness of a more prescriptive approach. While we consider the analysis provided by third-party proxy voting services, we do not follow their recommendations. All our voting decisions are made on a case-by-case basis that is grounded in our own company research and engagement. This rigour ensures a regular pattern whereby the governance arrangements of each holding are reviewed at least once a year. For each meeting, we take an active approach to voting and engage with companies where more information or discussion is required. When this is the case, the governance specialists often work alongside the portfolio manager to harness both investment and governance expertise with the aim of reaching a voting decision that reflects the nature of the individual business, its strategy and our expectations of it.



*The head of the Governance and Sustainability Team also acts directly for some of the investment teams.

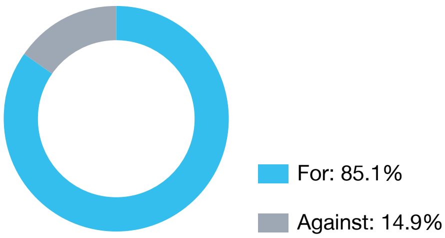
The following chart summarises the proxy voting activities of our three UK equity strategies for the one-year period to 31 March 2020. The data show that we supported most of resolutions proposed by management. This should not be a surprise as we seek to invest in management teams that we trust and respect and with whom we have a shared vision for the company's long-term future. A vote against a management resolution is not taken lightly and we will typically have a dialogue with management before, and sometimes also after, the general meeting to explain our thinking and share our view on how the matter of concern might be resolved.

UK Funds Proxy Voting Record



Examples of UK Equity Voting Activity

Remuneration



HSBC and Standard Chartered

We opposed both the remuneration report and the remuneration policy resolutions at each of the HSBC and Standard Chartered AGMs. By way of background, there are three differences between the vote on a company's remuneration report and the vote on its remuneration policy. First, the remuneration report must be proposed for approval by shareholders on an annual basis, while the policy vote must take place at least once every three years. Second, the vote on the remuneration report is backward looking, seeking shareholder approval for payments made to executive directors in respect of the year under review (in this case FY 2018-19), while the remuneration policy resolution is forward looking, seeking approval for the remuneration framework that those setting executive reward will have to work within when setting pay over the next three years. The final difference is that the vote on the remuneration report is advisory (because the payments will have been made), while the policy vote is binding; it should be noted however that the advisory vote is taken seriously because significant opposition can cause reputational damage to a company, the non-executives that set pay and to the executives that receive it. Given this risk, many investee companies consult us before making changes to remuneration and we commit considerable resource to this engagement with the aim of encouraging pay outcomes that are aligned with the long-term interests of our clients as shareholders.

In the case of both HSBC and Standard Chartered, we opposed the remuneration report due to the payment of fixed pay allowances to executive directors. The use of these allowances became widespread in the banking sector after the financial crisis because of EU legislation that capped the level of bankers' bonuses at 100% of salary or 200% with shareholder approval. The allowances have the effect of compensating executives for the lower bonus potential and, as such, breach the spirit of the legislation. In 2019, as both banks proposed new remuneration policies that involved the continued use of these allowances, we opposed the policy resolution in each case.

There is one notable respect, however, in which the remuneration practices of the two banks differ: executive pensions for current executives. Following a new expectation that executive pension rates should be aligned with those of their wider workforce by end 2022, both banks proposed that this would apply for new executive appointments. At HSBC, serving directors also volunteered to cut their pension benefit from 30% to 10% of salary, broadly in line with what is offered to all employees. By contrast, Standard Chartered proposed a smoke and mirrors change to its method of calculating the pensions of serving executives to give the impression of a halving of their pension benefit while the reality was unchanged. We were consulted beforehand by the remuneration committee of Standard Chartered and had made clear our opposition to its proposed approach to pensions and other changes.

Since 31 March 2020, the UK Team has sold out of HSBC as we fear the company is unlikely to generate attractive growth going forward.

2019 AGM Voting results:

HSBC:
Remuneration Report: For 96.8%; Oppose 3.2%
Remuneration Policy: For 97.4%; Oppose 2.6%

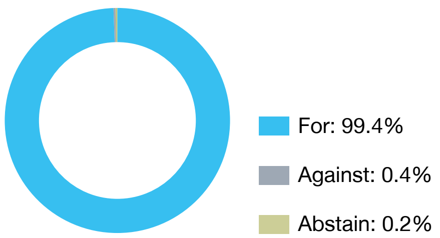
Standard Chartered:
Remuneration Report: For 89.2%; Oppose 10.8%
Remuneration Policy: For 63.8%; Oppose 36.2%

Just Group

The company, a provider of annuities, had a turbulent year during which it was required to strengthen its capital base through equity and debt issuance in response to regulatory change, a final dividend was not paid and the level from which future dividends would be calculated was rebased. The CFO and later the CEO resigned. Although the remuneration committee had adjusted downwards annual bonus outcomes for the year, we took the view that the payments made were generous in the context of performance and were not aligned with the experience of our clients as shareholders. We had engaged with the board throughout the challenging period and spoke with company again prior to instructing votes against the resolution to approve the remuneration report.

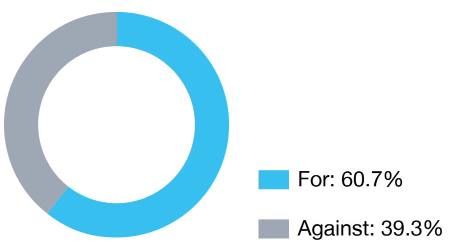
2019 AGM Voting Results: For 87.4% oppose 12.6%

Director Elections



Given our in-house research and extensive engagement activities, we do not expect to report many votes against director elections. From time-to-time, however, we may not support a director's election if a matter of concern has not been satisfactorily resolved. This might be the case, for example, where a non-executive director who chairs a board committee, such as the remuneration or audit committee, has not taken steps to address a matter over which the committee has a leadership role. We may abstain on a director's election if, following engagement, we are reassured that a credible plan is in place to resolve the situation within a reasonable timescale.

Equity Issuance With and Without Pre-emption Rights



When a company issues shares to raise new capital, the interests of existing shareholders are diluted unless they invest more capital to buy new shares. We believe that it is important that shareholders should have a say through a vote at a general meeting whether or not a company should raise new capital. To give companies some flexibility, it is usual for a limited level of share issuance to be pre-approved each year at the AGM in case it is needed. However, the level of share issuance that companies seek pre-approval for has increased in recent years to a level that we consider excessive. As a result, we typically vote against a large number of resolutions asking for pre-approval to issue new shares at company AGMs. Where this is the case, we make companies aware of our reasons prior to voting. During the 2020 voting season we have supported higher levels of issuance authority to provide companies with additional flexibility in the current market environment. We will review this approach at the beginning of 2021.

Appendix: Governance Letters

The following Governance Letters have been drawn from recent quarterly reports.

Q1 2019

Voting Season Ahead

The period between March and the end of June is the busiest period of the year for the Governance and Sustainability Team due to the seasonal peak in AGMs that take place. Voting is an important link in the chain of accountability between those that manage companies and their shareholders who provide capital for growth. The AGM is the opportunity for shareholders (or their agents) to register support, or otherwise, of resolutions proposed for approval by the company's board. As investment managers, we are responsible for exercising the voting rights of many clients at AGMs around the world, although some clients choose to vote their shares themselves.

For UK-listed companies, the voting process can be summarised as follows: details including the time, place and agenda items (or resolutions) are made known by the company and we are given a deadline by which to submit voting instructions on behalf of clients. In the intervening period, we analyse the resolutions, consult with our investors and review the outcome of any engagement we have had on matters relating to the AGM. When analysing resolutions, we pay close attention to any departure in a company's governance practices from the UK Corporate Governance Code (the Code). These departures might relate, for example, to the structure of the board or director tenure. As the Code is to be applied by companies on a 'comply or explain' basis, we need to understand why a company has chosen not to comply with best practice – and consider whether the explanation provided makes sense in the context of the company's stage of development. At this point, the views of our investment managers, who have deep insight into the company's strategy and performance, are particularly important. We may also engage with the company to clarify specific issues or intentions before our investor and governance personnel can, together, finalise voting decisions. Unusual resolutions, such as those proposed by a shareholder rather than management, are likely to require engagement with the proponents as well as the board before a decision is reached. We then instruct clients' votes electronically and record on our voting system notes about particular resolutions or matters on which we are expecting progress to be made. If required, we will also, on occasion, make recommendations to clients who vote their own shares.

From the above description, voting might sound like quite a clinical process that is quickly over and done with and then put to bed until the following year; you might even think the governance team could shut up shop. The reality is quite different. In fact, by the time we get to see an AGM agenda, there should be little, if anything, about it that surprises us. That's because the work towards a company's AGM often starts quite soon after the previous year's meeting. This will certainly be the case, for example, if there was a hefty vote against a resolution, or a commitment was given to review remuneration or appoint a new board member.

It used to be the case that boards could sometimes wave away sizeable opposition to an AGM resolution as long as it was passed. However, the Investment Association (an industry body) now maintains a public register that gives details of the AGMs of companies in the FTSE All-Share Index where there has been significant shareholder opposition (20% or more) to resolutions, or where a resolution has been withdrawn prior to a shareholder vote. When a company finds itself on this register, the board is expected to follow up with investors to discuss what the board is going to do to address their concerns. The register also records instances where a company appears for two consecutive years for the same resolution. This might be a flag that a company is not responding significantly to investor views, or the engagement process is not working effectively. In some cases, a company with an unusual structure (such as a dual listing) might face a strong polarisation of views on governance/voting issues and so could risk being categorised as a repeat offender.

Engagement activity between AGMs most often relates to remuneration or board succession planning. Consultations about changes to executive pay can take several months as a company's remuneration committee takes soundings on pay proposals from major investors (who may have different views on what's appropriate) and pieces together a remuneration structure that will command the support of a large body of investors. Ahead of the 2019 voting season we have participated in many such consultations from investee companies including: Prudential, Just Eat, British American Tobacco, Howden, Clinigen, Vectura, Hostelworld and Experian.

The publication of the revised UK Corporate Governance Code (the Code) in July 2018, has caused an increase in the number of consultations about board tenure and succession planning. Tenure consultations have mainly related to the new Code's provision that a chairman should not serve on a board for more than nine years from the date of his/her first appointment to the board, rather than from his/her appointment as chairman. This change is significant as it means that a chairman who was previously a non-executive director on the same board, might find themselves in breach of, or close to breaching, the revised tenure guidance. The Code allows for a limited extension to the nine years and we consider extension proposals on a case-by-case basis. We are mindful that a longer-serving chairman can have valuable corporate knowledge and experience and might be especially important on particular boards. So, while it would be easy to tick a voting box on a long-serving chairman's re-election, it is not our way of doing things: our instruction will reflect the engagement we have had on the matter prior to the AGM, and we are likely to support some chairmen well beyond the end of the nine year period if we believe it is in the interest of stakeholders.

Other topics that companies might consult us on outside AGM season include: changes to the board; the outcome of an audit tender, a director's external board appointments (given the sensitivity to the risk of having too many board appointments) and/or plans to progress boardroom diversity.

For boards, engaging long before an AGM ensures they have a good understanding of investors' views and expectations. As with any consultation, some participants may not support the outcome – but the board will understand their thinking and will be able to plan how best to respond. For us as investors, participation in consultations means we have done thorough due diligence well in advance of the AGM and know how we will vote. The process also helps to broaden the relationships we have with the board. While we engage with executive team members and chairmen during the year, consultations bring contact with non-executive directors on remuneration, nomination, audit, risk and governance committees. These board members stand for re-election at each AGM; understanding their work, manner and challenges informs our voting decisions.

In last year's voting season, we supported the majority of resolutions proposed by management at UK company AGMs. This should not be a surprise as we seek to invest in management teams that we trust and respect, and with whom we have a shared vision for the company's long-term future. It is also a reflection of our significant consultation work that helped non-executive directors shape proposals that we considered were aligned with our clients' interests. A vote against a management resolution is not taken lightly. We will typically have had dialogue with management before, and often after, the general meeting to explore how the matter of concern might be resolved.[1]

1 All companies mentioned are held by at least one of Baillie Gifford's UK strategies.

Q2 2019

The Sustainability Enlightenment

The first half of 2019 has seen a notable rise in the awareness of environmental challenges across the world. Although at the political level some countries continue to be singularly focused on particular projects or challenges, be that immigration, trade relationships or 'Brexit', at an individual and civil society level there is something akin to a contemporary enlightenment now beginning to take shape in earnest.

Swedish schoolgirl, Greta Thunberg, has taken the carbon transition challenge directly to governments around the world, inspiring the 'Fridays for Future' school protests outside parliaments. Sir David Attenborough's *Blue Planet* highlighted the fragility of our oceans and the existential threat to aquatic life from plastics, prompting an eight-fold increase in enquiries about single use plastics at one UK supermarket chain. Veganism is the fastest growing trend in food, and the IPO of the American plant-based food-tech company 'Beyond Meat' has been the most successful to date this year.

In a comprehensive and ground-breaking report published in May, the United Nations detailed the unprecedented rate of decline in biodiversity – tens to hundreds of times higher than in the past 10 million years. One million plant and animal species are now at risk of extinction.

Following on from Cape Town's recent brush with being the first 21st century city to run out of water, there is now much greater awareness of the scarcity of drinking water.

At a regulatory level, the EU is pressing on with the development of the Sustainable Finance Action Plan, which will include one of the most ambitious codification exercises ever undertaken, the 'Green Taxonomy'. This project is aiming to provide clear guidance as to which kinds of activities and products can be considered to qualify as suitably 'green' to obtain prioritised financial and regulatory support.

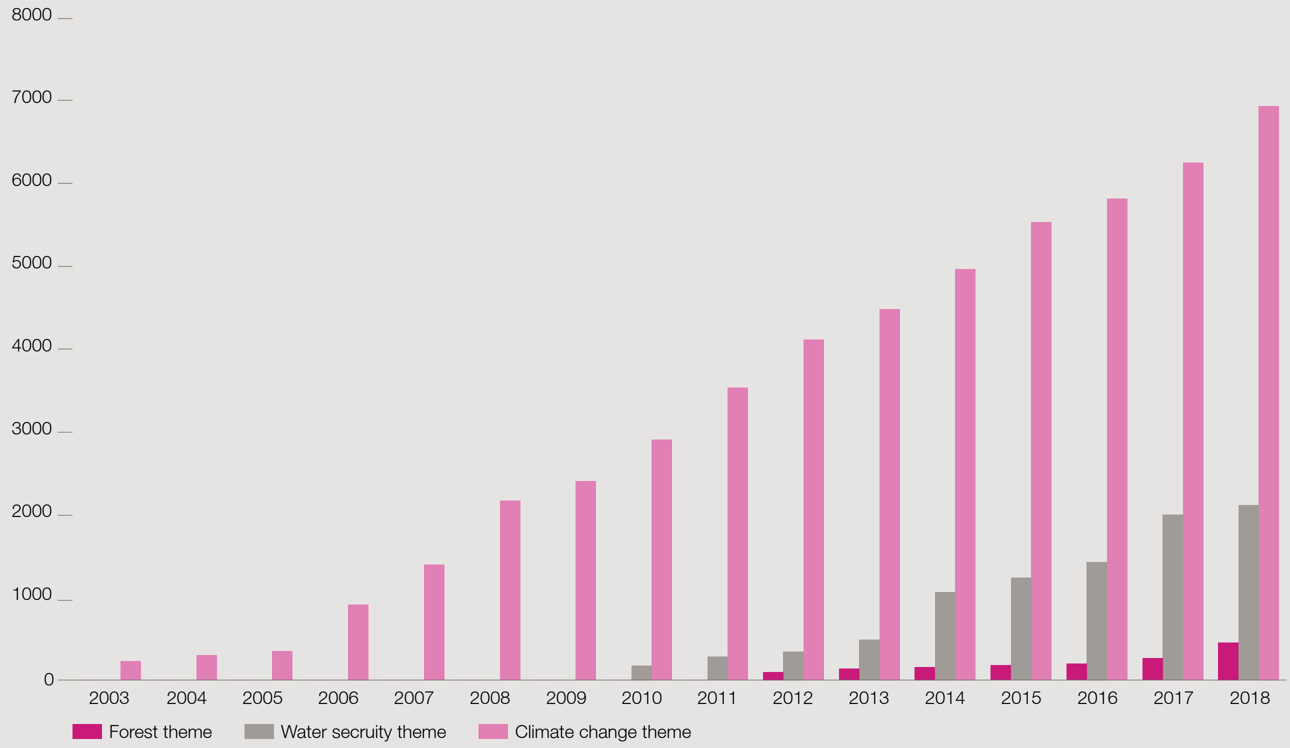
Whilst there are also countless examples of backsliding on environmental progress in different countries around the world, environmental activists are beginning to win the battle for hearts and minds even if the newfound awareness has yet to turn into resolute action. Sustainability has gone into the mainstream, and over the next decade, it will start to have an impact on all businesses – we may be rapidly approaching the limits of conventional economic growth.

Given this starting point, it would be easy to think that we have all the key information we need to start weighing environmental factors in the investment process, or indeed into individual consumer decisions. This couldn't be further from the truth. Despite two decades of corporate responsibility initiatives and growing interest in sustainable investment, our 'data map' of environmental impacts is surprisingly simplistic. In this sense, practitioners in the burgeoning field of ESG (Environmental, Social and Governance) have to more openly acknowledge that, like late medieval cartographers' knowledge of the earth, we actually know very little about the full lifecycle environmental impact of different products and services. Our sustainability data map today more closely resembles the very first enlightenment maps, which only showed the tiny sections of known coastlines – in this case, these are the most advanced businesses providing professionally collated and verified data. We can't begin to chart a safer course without better navigation tools.

The graph below shows the very recent increase in voluntary environmental disclosures to the internationally recognised Carbon Disclosure Project (CDP) database. The CDP is a UK-based organisation that encourages companies to disclose the environmental impact of their activities with the aim of making environmental reporting and risk management a business norm.

CDP Disclosure Growth

Number of companies per year of CDP disclosure cycle



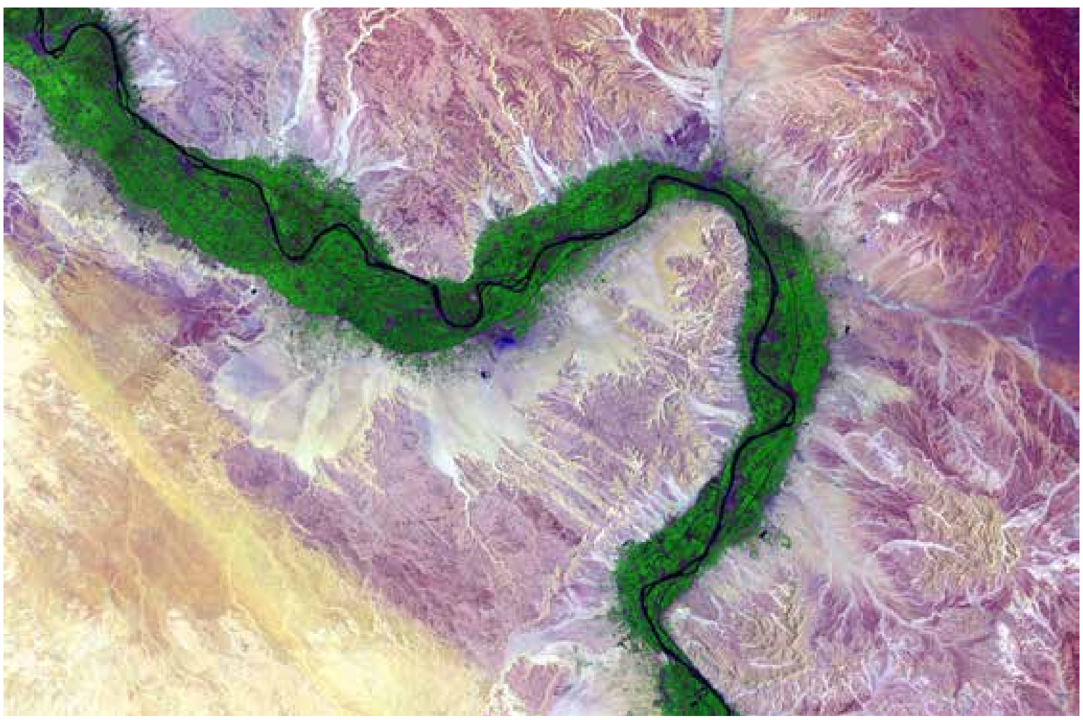
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total disclosing companies (across all themes)	228	300	349	915	1,395	2,166	2,403	2,906	3,536	4,140	4,539	5,001	5,624	5,863	6,316	7,018
Disclosure on climate change	228	300	349	915	1,395	2,166	2,403	2,903	3,531	4,112	4,482	4,968	5,532	5,815	6,251	6,937
Disclosure on water secruity	0	0	0	0	0	0	0	176	283	345	589	1,064	1,237	1,426	1,997	2,113
Disclosure on forests	0	0	0	0	0	0	0	0	0	100	138	159	179	199	264	455

Source: CDP.

Whilst the increase in reporting is impressive, the quality and coverage of data are much less encouraging, with estimated figures still common even for very large companies. In some emerging markets, robust data is almost non-existent. A secondary challenge is defining appropriate boundaries for environmental reporting: should online retailers, for example, take responsibility for the delivery emissions of third-party couriers?

Even bigger data challenges exist in certain sectors. We know very little about commercial fishing supply chains and stock provenance. Many products and services in food, fashion and other sectors cross the globe several times before reaching shelves, but this ‘hidden’ environmental footprint is currently undisclosed and invisible to consumers and investors. This quarter, we attended a conference at which companies in the apparel and textiles sectors discussed sustainability issues including environmental pollution, transport, recycling, labour practices and the balance of responsibilities between them.

Rather than leading to a collective shrug that ‘it is all too difficult’, the above data provides a starting point for discussion with companies on their approach to disclosure and the challenges that they face. It is also helpful when we are encouraging much better information from our service providers. If regulation and changing stakeholder expectations are going to disrupt business as usual in the 2020s (and we all need this to happen), we need to know where companies are starting from and how quickly they can change their business models to position themselves for long-term success in the age of sustainability.



Q3 2019

Engagement – What's it all About?

'Engagement' is used to describe the interactions we have with companies as part of our investment process. This engagement can start long before we decide to buy shares in a company. Once invested, we engage to deepen our understanding of the businesses, to provide feedback to boards and to encourage long-term thinking in the boardroom.

Abcam is a good example; we've been investors since its IPO in 2005 and have engaged with executive and non-executive directors, including the chairman, over the past 14 years. Our engagement has covered board changes and the evolution and implementation of Abcam's growth strategy – and we'll soon be visiting their brand new £46 million facility on the Cambridge Biomedical Campus. From time to time, when the Abcam board announces that investment in the business is to be increased, the share price dips because this spending can lower short-term results. To us, however, investment is the life-blood of long-term growth. Abcam generates cash, the executives are excited about new opportunities, they've demonstrated a disciplined approach to investment and have delivered good returns on it. Crucially, investing now will drive future growth and long-term sustainable returns to Abcam shareholders. That's why, in our recent meetings with the CEO, we re-iterated our support for management's investment plans.

Engagement helps us build relationships in the boardroom and beyond. In the case of Prudential, for example, this year we have engaged not just with executive directors (the CEO and CFO) but also with the chairman, the SID, the chair of the remuneration committee and senior management below the board. Board members each have specific responsibilities in addition to their collective duties for the development of strategy and long-term growth. The Prudential executives, for example, are responsible for the day-to-day management of the business, the chairman manages the board, the SID leads on matters such as succession planning for the chairman, and the remuneration committee chairman oversees the development of executive pay proposals. It is hardly a surprise then that, in our engagement with the Prudential this year, we have discussed strategy, board succession planning, regulation and remuneration – all of which are important to delivering long-term financial returns.

By meeting different members of the board – and wider employees – we can cover more ground than we would by meeting only the CEO and CFO. It is also a helpful check that everyone in a boardroom is thinking along similar lines in terms of the long-term growth drivers of the business and the implementation of strategy. Inconsistencies in the message from executive and non-executive directors would be a cause for concern and would prompt further discussion.

Over time, our engagement fosters an atmosphere of partnership and trust; this is important as we expect to be investors for many years. Our approach is about establishing a sound platform for discussion and making sure that doors are open on both sides if it would be good to talk.

We use the insights we get from this engagement activity to make sensible voting decisions – we're not box-tickers. All companies are different, so we think about what's right for each individual company in your portfolio before we vote. At Prudential, for example, the chairman, Paul Manduca, has now served nine years on the board. So, strictly speaking, to comply with the UK Corporate Governance Code, he should have stepped down at the May AGM. The board, though, want him to stay on until 2021 – this was something we'd covered in our engagement. The extension makes sense to us because the group is in the midst of a complex demerger. We want the chairman to stay on until it is completed, so we supported his re-election. A much more thoughtful approach than simply ticking the 'against' box. Other companies that have consulted on succession planning for their chairman include Genus, Homeserve and Enquest.

How engagement is conducted matters to companies and to clients. Different approaches are taken across the fund management industry. The method used will often reflect the investment strategy. For investment firms with tracker funds, for example, a governance specialist can end up leading engagement with both executive and non-executive directors and making investment as well as governance decisions. But is a governance analyst really best-suited to decide if, for example, Just Eat should merge with Takeaway.com on the current terms? A passive manager may, alternatively, delegate engagement to third parties by choosing to follow the recommendations of a voting agency. That's a particular risk when a shareholding is deemed small, or de minimis, in the context of the passive portfolio but represents a large proportion of the company's share capital. Companies do not like that delegation of responsibility at all, and are vocal about the disproportionate influence that it hands to proxy agencies. Investment firms with active mandates may choose to adopt a twin-track approach to engagement with companies. Where this is the case, investors meet with executive directors to focus on strategy and financial results, while the governance analyst meets non-executives on the same board to talk about ESG. There are, however, pitfalls in this approach too; companies express particular frustration when they get conflicting messages from the separate engagements, and they're often not quite sure who the final decision-taker will be when they consult. None of these approaches will deliver what clients expect or companies want.

Our own engagement approach is different for many reasons, but mainly because we're active investors, conviction investors and long-term investors. We only invest in companies that we want to hold, and we hold large positions in them for many years. This investment profile means we have to build relationships with boards that will enable us to monitor progress through effective dialogue over time. That requires us to earn the trust and respect of boards through our engagement activity. We describe our approach to this engagement as 'collaborative' because a UK portfolio manager and a governance analyst often conduct these meetings with board members together. It is a good way of keeping our thinking about companies joined-up and has worked well with, for example, Genus, Just Eat, Ted Baker, Bodycote, Rightmove, Homeserve and Johnson Matthey. Companies like it too because we speak with one voice when they consult us, and so we provide clarity about our thinking and voting intentions. There is only one situation where a board might not like our approach and that is if they try arm-twisting to get a vote instruction changed. Arm-twisting might work with the twin-track approach, but not with our joined-up method because the agenda item will have been considered jointly and the voting decision made jointly.

We value the access we have to boardrooms and we use it wisely and with respect, but we're not afraid to deliver tough messages to companies when it is necessary. That was the case, for example, with Keller Group. Keller provides specialist services to the construction industry; there have been a few disappointments in recent times that have come out of the blue and dented performance. Following a meeting with the executive team, we arranged to meet the chairman and had a candid discussion about leadership capability. This frank dialogue, and the constructive tone in which it took place, was helped by the trust and mutual respect built up through previous encounters. Since that meeting, the chairman has been in touch following management change.

Engagement is a two-way process: we may approach a company, or they may approach us. Who we engage with will depend on the topic of interest. The chairman will be our prime contact on board matters – that is particularly important if something unexpected happens. We spoke, for example, with the chairman of Genus when its highly-regarded CEO resigned, and with the chairman of Just Eat when its CEO left suddenly. In each case we were given an understanding of what had happened and what the succession plan was.

These are not one-off contacts: in Just Eat's case, for example, we had further discussion to monitor the succession management process and we recently met with the new CEO of Genus. If it is succession planning for the chairman's role, however, it is the SID we will engage with as he/she leads that process.

Of the other non-executives, our most frequent engagements are in relation to remuneration. Most, if not all, of our UK holdings consult us about pay. It is another area where our collaborative approach is important. A governance analyst can examine the proposed pay structure and bring knowledge of best practice, but the investors are the experts on the businesses and will know if the targets are sensible and tough enough. By working together, we can encourage pay arrangements that we think suit the individual company and provide a good alignment with your interests. We're always clear in our feedback if something is unacceptable to us – and that usually leads to change. If it doesn't – as was the case at Standard Chartered, Royal Dutch Shell, British American Tobacco and Vectura – then we vote against remuneration. We contact other non-executives from time to time on specific issues – audit committee members are a good source of information about non-audit fees, for example. And, beyond the board, we may engage with third parties in bid situations or if there's a shareholder resolution to be voted on. The purpose is, again, to gather information relevant to making sensible investment and voting decisions.

We make good use of the access we have to companies as part of our investment process, and our engagement is conducted in a constructive manner to build a platform for long-term dialogue with board members.

All of the stocks referred to in this note are held in at least one of our UK portfolios.

Q4 2019

An Engagement Timeline: Genus

Following the synopsis of our engagement approach in the quarter three report, our final governance communication of 2019 offers insight into our engagement this year with one holding in your portfolio, Genus. By way of background, Genus is an animal genetics company that helps farmers produce higher-quality meat and milk. We have been investors for several years and our total holding on behalf of clients puts Baillie Gifford at or near the top of the company's share register. We have built a good relationship with the board and from what follows it will be clear that our engagement goes beyond meetings to discuss strategy and financial performance with the CEO and CFO.

Our interactions with the Genus board have been led jointly by a portfolio manager and an analyst from our Governance and Sustainability Team. This is our preferred approach because it keeps our thinking about investment and governance matters joined up. It is noteworthy that, although the Genus AGM was in November, the engagement that shaped our voting decisions started back in March. Engaging throughout the year means that, by the time the AGM comes around, there should be no surprises in terms of the resolutions presented for shareholder approval. Although what follows is specific to Genus, a similar approach is taken with your other UK investments.

Overall, 2019 has been a busy year for the Genus board and an interesting one for our engagement activities. In the first quarter we had a call from the chairman, Bob Lawson, following an announcement that the CEO, who had led Genus for eight years, would be leaving in September. Our discussion focused on the background to this unexpected development (a new job opportunity) and the board's succession plan. The chairman assured us that the board had already appointed a search firm with a mandate to consider internal and external candidates (from the UK and beyond) for the CEO position. Later in the year, we discussed with him the process that led to the appointment of Stephen Wilson, the group's CFO, as CEO. Stephen has been known to our portfolio managers for several years; they were pleased with the news and met with Stephen shortly afterwards. The knock-on impact, of course, was that a new CFO would be required; this too was discussed with the chairman and, shortly after the November AGM, it was announced that Alison Henriksen will join as CFO in January.

And so it was that our engagement with the chairman in relation to the executive team started early in the year and extended almost to its end as we monitored succession management and provided feedback to him.

While the executive leadership changes were in progress, we were contacted by Lesley Knox, the SID. On a board, it is the SID who usually leads on matters to do with the chairman's succession. Lesley was keen to engage with us regarding the chairman's tenure. The UK Corporate Governance Code, following revision in 2018, recommends that a chairman serve on a board for a maximum period of nine years, albeit with some flexibility. Bob Lawson would reach the nine-year marker at the November AGM so strictly speaking, to comply with the Code, he should step down. Lesley was keen to know if we would support his re-election as chairman to provide stability to the board and support to the executives as they settled into their new roles. It is fair to say that we are not big fans of this nine-year limit; we think there are circumstances where it is important to have a longer-serving chairman with deep company, market and stakeholder knowledge. In the case of Genus, it made complete sense to us that Bob's tenure be extended, and we committed to support his re-election at the AGM.

In early June, we began engagement with the chair of the remuneration committee; she was reviewing the company's remuneration policy ahead of the AGM. A company is required to present its remuneration policy for approval by shareholders every three years. This vote on remuneration policy is different from the annual vote on the remuneration report in two respects. First, the policy is forward-looking while the remuneration report is backward-looking; the policy provides the framework and limits within which the committee must work when setting executive pay over the following three years, while the report provides detailed disclosure about what the executives received in the year under review. The second distinction is that the vote on the remuneration policy is binding, whereas the vote on the report is advisory. Boards are highly sensitive to reputational risk – to the company, the board and individual directors – if a high level of support is not achieved for either remuneration resolution. For this reason, most companies consult their largest investors on any changes they are thinking of making to remuneration before finalising them. The amendments that Genus was proposing were considered in the first instance by a governance analyst and then discussed with the portfolio manager. This approach works well because the governance analyst knows what is considered best practice in terms of the structure of executive pay while the investor is best placed to judge whether targets for bonus and other awards are tough enough. By putting their heads together, they can provide helpful feedback to the remuneration committee – even if the feedback is not what the committee is hoping to hear. In the case of Genus, for example, we were very clear that we would not support the amendments. This led to a further round of engagement where the focus was on our objections and what changes would have to be made to secure our support. By engaging jointly, our portfolio manager and governance analyst delivered a unified message with conviction and provided clarity as to our voting intentions – that put the ball back in the committee's court. Importantly, this engagement was conducted in confidence, in a constructive manner and in an atmosphere of partnership and trust. In revising its proposals, the remuneration committee fully addressed our concerns and we confirmed that we would support the remuneration policy resolution at the AGM.

In the autumn, as part of our investment research process, our portfolio manager visited a Genus bovine facility in Wisconsin. One of her most striking insights from this US visit was the support evident from employees for the appointment of Stephen Wilson as CEO. We fed this back to the chairman in a brief wrap-up call ahead of the AGM. He in turn confirmed that, from the board's perspective, Stephen was settling well into the CEO role.

When the Genus AGM finally came around in November, the governance analyst reviewed each resolution on the agenda and the outcomes of our engagement, then confirmed voting instructions with the portfolio manager. Votes were then instructed on behalf of clients and a courtesy email was sent to the company secretary summarising our voting authority and instructions. Communication, internally and externally, is an important part of our voting process. When the AGM results were released, we were pleased to see high levels of support for the election of directors (including the chairman) and the remuneration resolutions.

Engagement Example: Genus

Q1 2019	Q2 2019	Q3 2019	Q4 2019	November 2019
Engaged with chairman	Engaged with senior independent director	Engaged with non-executive who chairs remuneration committee	Site visit to the US and call with chairman; strong support evident for new CEO	AGM

Issues	Aims	Outcomes
Unexpected departure of CEO	Ensure we are comfortable with interim arrangements until new CEO is appointment	Confirmed our support for new CEO (previously CFO)
Chairman's tenure	Ensure stability and oversight during a period of executive changes	We supported chairman's re-election
Executive remuneration	Specific changes to executive remuneration policy	Required changes to remuneration were made so we supported remuneration resolutions

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