THE RETURN OF THE TARTAN ARMY

The Tartan Army has woken up.
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The merry band that follows Scotland's national football team is affectionately known as the Tartan Army. It hadn't got out much recently – since 1998 Scotland failed to qualify for any major tournament, so the kilted hedonists found themselves stuck at home, watching DVDs from Blockbuster, then series on Netflix. The seasons came and went as they waited for another big day out.

Scotland's qualification for the Euro 2020 (played in 2021) freed the Tartan Army's foot soldiers to burst forth like long-term inmates on day release. The paparazzi were ready to capture the debauchery. Yet the day after Scotland vs England in London, the papers printed a photo none of us ever expected to see, of the Tartan Army, the morning after, voluntarily cleaning up Leicester Square.

The stooping blue shirted, beer-stained-kilted figures resembled creatures emerging from hibernation, different beasts from the rogues that went to sleep: ones with a social conscience. A Scottish fan arriving at the scene after 23 years on Mars (courtesy of SpaceX) would wonder what had happened to their dependably reckless and inebriated pals.

At the same moment, an equity investor – stirring from a similar length slumber and returning to the hamster-wheel of news flow – could have experienced the same ambivalent epiphany: 'OK, I know it's not the '80s anymore, but with all this lovey-dovey tree-hugging ethos, do my companies still dare make a profit?'

Purpose and profits

Broader corporate purpose has become ubiquitous, and in many cases as important as shareholder returns. Some investors will assume a contradictory tension between these two forces, but we now believe a sense of purpose is more likely to be a driver of shareholder returns, not a detractor from them. Our Question 5 in the 10 Question Stock Research Framework has evolved over the years to reflect this. Its newest wording is "What societal considerations are most likely to prove material to the long-term growth of the company?"

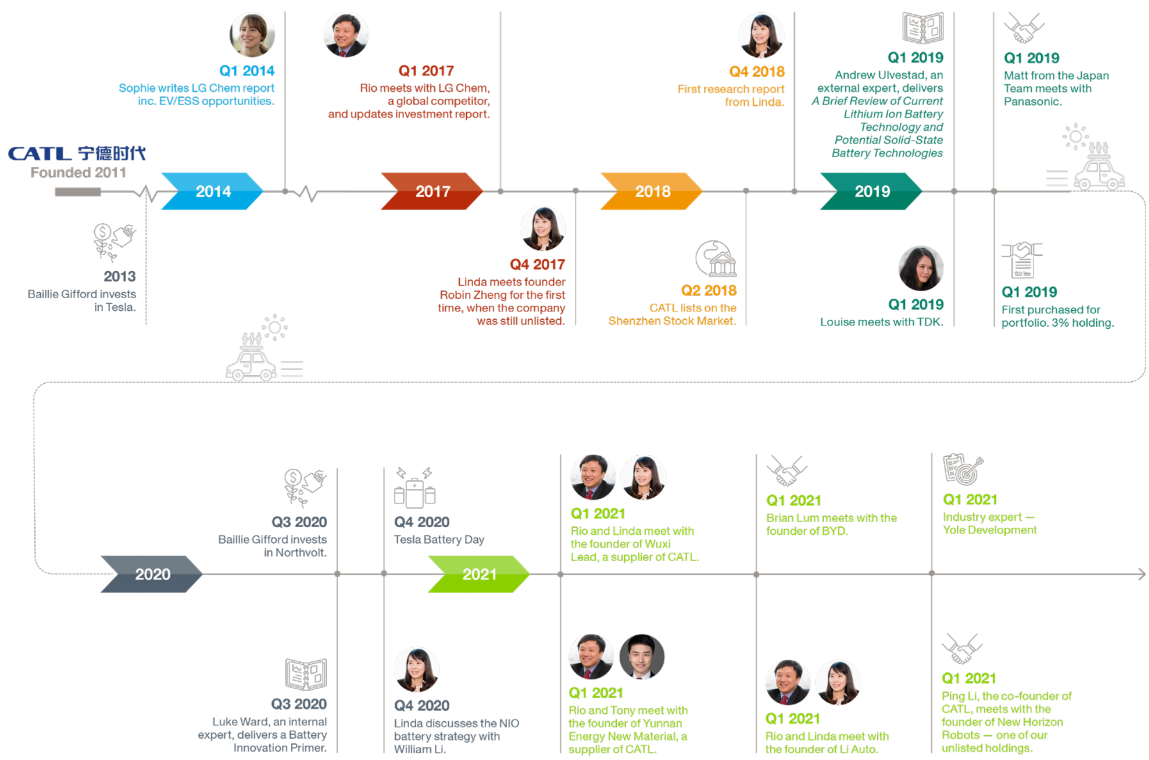
For those who worry that ESG factors are taking over – what about returns? – then LTGG is the strategy for you. The reason is simple: we demand a huge return – five times the current valuation please – of every company we invest in. There is no compromise on this, whatever the company's raison d'etre. But logically, if enough effort is deployed (for example) on reducing CO2 emissions over the next couple of decades, then those companies that facilitate this are more likely than most to produce the strongest returns.

Perhaps the most emblematic example of that (apart from Tesla) is new LTGG holding CATL, the Chinese battery maker. It's a good example of the Baillie Gifford ecosystem at work. We first met the founder in 2017 when CATL was unlisted and have owned it in our China A Share fund since 2019 (CATL has produced a 10-times return since then. We've not made our A Share fund generally available yet) and this led to the purchase by LTGG.

CATL's market cap is now just over \$200bn, which means our bull case needs to see it as a \$1tn company by 2030 or so, regardless of how 'good' it is for the planet. Our bull case sees exactly such an outcome, though our assumptions (80 per cent electric vehicles by 2030, 1.4 terawatt-hour per annum demand for electrical energy storage systems, 40 per cent global share for CATL in both businesses, 15 per cent margins gives... \$35bn operating profit on a 30-times multiple... over \$1tn value) will make some smile at our cheerful optimism.

But if we are right, our bull case will fall short of what CATL achieves. Long-standing clients will recognise exactly such a pattern from our early blue-sky cases on some of today's household names.

CATL and the Baillie Gifford Ecosystem



The worry list

However, broader purpose also includes the duty of 'national service', and its impact on business models and shareholders was most acutely highlighted in China in the last year.

Our experience tells us that clients spend too much time worrying about subjects they shouldn't. Here are two favourites to put to bed first

What about Inflation?

This sound and fury comes round every few years and signifies nothing – our well-rehearsed thesis on ASML and Moore's Law will hold firm. But if that seems too flippant, then consider the following points which rarely get mentioned:

- Five-year historic LTGG earnings growth (USD) is circa 29 per cent, circa 3x the index, so low single-digit inflation is not going to have an impact – and we're not relying on high exit multiples to meet our five-times cases.
- The period 2005–2007 which was a more inflationary environment than we're seeing now (CPI was running 3–4 per cent pa) was a period of strong returns for LTGG, delivering circa 19 per cent (USD) absolute returns pa.
- The effect of $100/t carbon will be much more inflationary than central bank moves. This will be bad for most index incumbents and a tailwind for many LTGG holdings (why is no one talking about this?).
- LTGG is on net cash and has not been gorging on cheap debt to buy back stock.
- A number of our holdings have huge latent pricing power (Netflix, Cloudflare, Hermes).

What about valuations?

Note all the previous points, and also consider this: in the last 17 years of LTGG, we cannot remember a single time – not one – when 'senior management' at our clients were bullish about equity valuations. We have plenty of evidence from our own analysis that companies on the highest multiples go on to post the best shareholder returns. Examples? Netflix: a five bagger from starting multiple of 150 times. Atlassian: a 15 bagger from starting multiple of 70 times. Moreover, 'market' valuations are meaningless (and always 'worrying' to some). The valuations of the companies we own are the only thing we pay attention to – they are either ludicrously high or absurdly low, depending on whether our growth thesis pans out. But the asymmetry of returns biases this game in our favour, and enough of these Panglossian fantasies keep panning out such that LTGG has returned 30 per cent pa over the last five years, versus 13 per cent for world equities.

Having said all that, Chinese regulation is a proper, sensible, serious threat to consider, and one that we are pondering in depth.

National Service – a serious consideration

Global equity observers should remember two points of context: the same theme is playing out across the world, not just in China; second, this isn't a new theme in China either. In the past we've seen Baidu have its knuckles rapped for a fatal healthcare advert, Tencent frozen out of new game approvals, and further back we sold China Mobile on regulatory concerns.

The current sequence of regulatory change that began with the last-minute pulling of the Ant Group IPO does have a serious feel to it. To best understand what the Chinese Government is doing, we need to start with what Marcus Aurelius called 'first principles'; then consider our response.

Marcus Aurelius

The one child policy in China lasted from 1980 to 2015. In the six years since, nothing much changed in birth rates. The Chinese Government does not want the population to fall and was puzzled. It asked parents 'why are you still only having one child?' 'The cost of education' came the reply (an answer that rings true to many around the world). The difference with China is the subsequent action with immediate effect – in order that parents will have more than one child again, the private education providers were no longer going to be allowed to make profits. With this turn of events we ended up selling Tal Education for a loss.

The democratisation of education – an admirable goal in itself – is part of the broader government push in China for 'common prosperity'. Again, most governments would like to see something akin to this in an era where wealth polarisation has become such a high profile issue. We see western governments through the OECD trying to make global champions pay a fair rate of tax in more of the countries they do business in, with varying success. But in China it is simple – companies fall into line.

Where does this leave us on our other Chinese investments? We also sold NetEase, the games maker, though this was as much due to a drift in corporate culture as it was for being the target of serious regulation. All the companies will need to do some 'national service' and most have announced large donations of revenues to the common prosperity goal. It's also true that the business models of Pinduoduo and Meituan have long been aligned with spreading out prosperity, and we are even more bullish about them than before. We are also very glad to have our research office in Shanghai providing first-hand insights. We spend time speaking to government officials around the country about their five-year plans, to academic institutions (Tsinghua, Jiaotong) and we now have a dedicated Chinese ESG analyst in our office in Shanghai. We think this increases our chances of understanding the first principles when picking winners.

Not the same old story: Daniel Craig has reinvented James Bond.

Investment performance

Understandably, we've fielded many questions about the Chinese holdings in the last year. But the level of concern has been disproportionate to impact, so it's worth putting portfolio performance into context.

With the Chinese holdings having a rough time, the LTGG portfolio is down roughly 15 per cent relative over the last 12 months, and just up in absolute terms with other winners – Moderna, Cloudflare – coming to the fore. This 2021 underperformance is dwarfed by the 90 per cent outperformance in 2020. As with 2008 and 2009, it only makes sense to look at 2020 and 2021 as a pair of years and say 'did you come out on top?' (Emphatically yes both times.)

Over five years LTGG is up about 30 per cent pa absolute and plus 15 per cent pa relative (and that's after this year's minus 15 per cent relative). If that's what our portfolio 'gives back' after outperformance of many times the magnitude, our clients should be very happy.

Of course, there is a scenario where more, even all, Chinese companies delist from the US stock exchange. The worst-case scenario here – extremely unlikely – is a rushed delisting (companies are supposed to get two years' warning) before they have time to relist. That would mean, for a few weeks or months, holding a company privately before it relisted. Awkward, but not the end of the world. It is far more likely that Chinese companies (we are finding lots of interesting 'A's) continue to increase as a portion of the LTGG portfolio over the next 10 years. And talking of the end of the world…

The actual end of the world

In any James Bond film, it is almost the end of the world before Bond saves us with seconds to spare. And so it is the latest movie No Time to Die, but with a crucial read-through for your portfolio.

We wrote in the summer of 2021 about how growth companies chase the elixir of youth, and a few manage to find the magic formula. Time catches up with human beings too – even Daniel Craig – and the moment had come to pass the world's most famous action role on.

But the Bond franchise is emblematic of what we look for in a great growth company – a special formula, but one that can reinvent itself and continue to thrive. When Craig took on the role back in 2005 the Bond franchise was struggling to stay relevant. Craig moved Bond on, from a "sexist misogynist dinosaur", as M described him, to an increasingly rounded protagonist, surrounded by three-dimensional female characters, but still a hero whose last act in saving the world is to pick up a child's teddy bear.

Our best holdings change with the times but keep something magic along the way. Amazon Prime reinvented Amazon which was already a good 'reinventing retail' story, and non-retail business AWS may well be the new dominant narrative for profits in years to come, Tesla has reinvented (among other things) the decades-old manufacturing fable of Toyota, but it may be about to revolutionise the car insurance chronicle to boot. Moderna is reinventing the great 20th century disease-prevention story of vaccines and will at some stage personalise medicine.

How can we tell which companies will get closest to the elixir of youth, to reinvention? There is a shorthand we use, from a number we don't think the market pays nearly enough attention to, and that is research and development (R&D). R&D is long termism in action. It is open-mindedness. It is the marshmallow test. We like to invest in companies whose R&D budget is twice the nearest competitor's, and who have a culture of being prepared to rip up well-received stories.

The bar chart shows just how much our companies stand out from an R&D point of view, investing on average more than 18 per cent of sales in R&D versus 8.5 per cent for the index, so more than double the market. This is long termism in action, and open mindedness – the bigger the R&D spend, the more likely you are to find something that surpasses what you've got. Far better that you find it than someone else. When Baillie Gifford first invested in Moderna, the company needed capital to keep its R&D into mRNA going – there was no giant revenue generator on the horizon. But what the great Gary Player said of his right-place-right-time golfing form applies to the felicitous happenstance of company R&D: "the harder I practise, the luckier I get".

What clients should really worry about is if these graphs change. Not volatility of share prices or investment performance, not inflation, not valuations – just: are LTGG's companies still investing for the future? If they aren't, they might stop getting so lucky. (Peloton is a company that has had to pull back investment – of all the speed bumps Peloton has hit, this is the one we will be monitoring most).

So, in the last year we've reset the portfolio, but kept what we think is the magic sauce – a group of the world's most exciting growth companies based on an optimistic long-term blue-sky focused process. Headline differences you should notice:

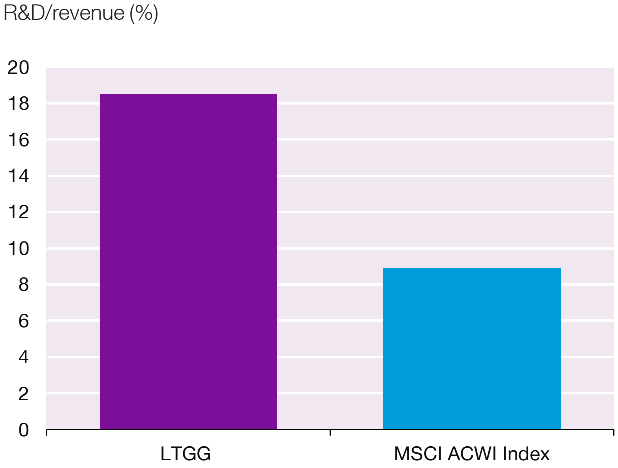
– We've slaughtered some sacred cows (Baidu a while ago, Alphabet more recently) and made substantial reductions to Meta (formerly Facebook) where the renewing of growth momentum looked less plausible.

– There are no giant holdings at 9 per cent or 10 per cent, a size where we have often had two or three stocks in the past. The largest holdings are in the 5–6 per cent range. These are high conviction names of course, but in the cases of Tesla or Amazon the upside from here while still high is a notch down from the no-brainers of recent years.

– The idea is that from 5 per cent onwards holdings grow organically to hit the 10 per cent ceiling. We'll see whether it's the same names that percolate to the top again through more stunning growth or a newer one such as Moderna or Cloudflare.

– There are lots of new names in the portfolio (the most in a 12–18 month period in the last 17 years). You will see them typically come in as 1-2 per cent holdings. These include CATL, Bilibili, The Trade Desk, Beyond Meat, Coupang, Carvana, and Affirm. If any of them turn out to be home runs, they'll end up as 5 per cent plus holdings (and household names).

– Clients don't necessarily see the competition for capital that goes on behind the scenes. There is a welcome generational span in the LTGG Team and lots of enthusiasm for new ideas – only a subset of them makes it through (especially initially) but the pipeline has been flowing abundantly.



Source: FactSet, MSCI.
Based on a representative portfolio as at 31 October 2021.

Conclusion: more than a Quantum of Solace

Before he agreed to become Bond, a dubious Daniel Craig wanted to read the script for Casino Royale (being the most famous actor in the world for one often lampooned role has its downsides). One surprising line in the carefully guarded screenplay convinced him: having lost the poker game, 007 takes refuge in the bar and is asked the old vodka-martini question for which we all know the cliched reply. Except this time we don't. "Do I look like I give a damn?" snarls Bond. Craig thought "if they're prepared to rip up this old line, I'm in".

We love backing companies that are prepared to rip up successful business models to keep the magic of their franchise going. We have reset the portfolio to allow a third generation of new holdings to come through, while keeping the long-standing ones which have, like Daniel Craig with James Bond, taken a compelling narrative and reinvented it to stay relevant.

For clients of LTGG looking to the future, this is no time to di[vest].

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Annual Past Performance to 31 December Each Year (Net %)

	2017	2018	2019	2020	2021
LTGG Composite	54.0	-1.6	34.1	102.0	2.4
MSCI ACWI Index	24.6	-8.9	27.3	16.8	19.0

Annualised returns to 31 December 2021 (%)

	1 Year	5 Years	10 years
LTGG Composite	2.4	33.3	22.9
MSCI ACWI Index	19.0	15.0	12.4

Source: Baillie Gifford & Co and underlying index provider. USD.
Past performance is not a guide to future results. Changes in the investment strategies, contributions or withdrawals may materially alter the performance and results of the portfolio. All investment strategies have the potential for profit and loss.

Past performance is not a guide to future returns.

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