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.

AN ANNIVERSARY OF NOTE

On 23 December 1947, the first transistor was demonstrated at Bell Labs in New Jersey. As we write this note almost exactly 75 years later, the semiconductor industry is forecast to produce some two billion trillion transistors in the year 2022 alone. The numbers involved – the quantities produced, the size of the chips, and the wavelengths of light used in the lithographic process – are beyond comprehension.

Such are the secular miracles our modern world and its economic systems can produce. They allow for vaccines to be created at a speed not previously thought possible, vehicles to continue progressing towards autonomy, or last-minute Christmas gifts to be ordered.

We wanted to start this note with a reminder of the incredible power of technological progress, since last year was dominated by either geopolitical concerns or financial market turmoil, often at the same time. We will return to the topic of progress later.

Huge volume, small price

Price per trillion transistors, US $; transistors sold per year, trillions

Source: TechInsights.

Investors should carefully consider the objectives, risks, charges and expenses of the Fund before investing. This information and other information about the Fund can be found in the prospectus and summary prospectus. For a prospectus or summary prospectus please visit our website at https://usmutualfund.bailliegifford.com. Please carefully read the Fund’s prospectus and related documents before investing. Securities are offered through Baillie Gifford Funds Services LLC, an affiliate of Baillie Gifford Overseas Limited and a member of FINRA.
FROM CHIPS TO BIPS

It has been a year to recall the words of Sidney Homer and Richard Sylla in *A History of Interest Rates*: “Each generation tends to consider as normal the range of interest rates with which it grew up. […] Almost every generation is eventually shocked by the behaviour of interest rates because, in fact, market rates of interest in modern times have rarely been stable for long.”

The generation that had been anaesthetised by monetary policy over the last 14 years, particularly in the last three, was shocked by the behaviour of interest rates this year. That sharp rise in rates has been the dominant factor driving our poor investment returns this year. But beyond that obvious statement, what matters is whether we should have done anything differently in advance and what happens next.

On the former point, we are clear that there will be lessons for us to learn from recent extreme performance in both directions, but we are also clear that the best time to reflect deeply is not amid the storm but when calmer seas have returned. Otherwise, we risk learning the wrong lessons and distracting ourselves from our real task, which is ensuring that the portfolio today is in good shape for the next five to ten years. We are assessing some potential enhancements to our analytical and decision-making frameworks – around exit multiples, concentrations of risk and our judgement of company maturity – but will carry out a fuller analysis at an appropriate distance of time. The one thing we won’t do is change our investment approach, which is resolutely focused on the long term. And as long-duration growth investors, we need to acknowledge that short-term investment outcomes will always be subject to sharp changes in bond yields.

As for what next, we are not macroeconomic forecasters, but our central case is that we are close to the peak in interest rates and that the debate now is over half a point in either direction. A great deal of investment is about expectations, and market expectations today are radically different from where they were in late 2021. This inclines us to believe that the worst of the valuation hit has passed.

We’ve talked about the risk of a ‘triple whammy’:

1. A valuation hit as discount rates rise
2. An earnings hit as economic conditions weaken
3. A long-term growth hit

If we’re right about valuation, now it’s really about earnings and long-term growth. We are relatively relaxed about the former: economic cycles come and go, and we don’t try to predict their path or exactly how a company will trade through them from quarter to quarter. To borrow from Charlie Munger: “We’re emphasising the knowable by predicting how certain people and companies will swim against the current. We’re not predicting the fluctuation in the current.” Life is lived forwards, and long-term growth is the key question.

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1 A valuation method that bases the expected future value of a company as a multiple of forecast financial performance of the business; sales or earnings for example. The multiple applied is derived from observing business with similar characteristics in the market.
A COLLECTION OF REMARKABLE COMPANIES

Portfolio turnover remains low, typically around 10 per cent per year. Put differently, the fund today has around 60 per cent overlap with the portfolio three years ago, just as Covid-19 was starting. The companies we hold have endured sharply different market conditions over that period, and they face new challenges today. But what they have in common is a large growth opportunity, a strong competitive advantage – or a good chance of building one – and management we trust to navigate the storms.

It is rare for companies to thrive, let alone grow, for many years. Geoffrey West and colleagues at the Santa Fe Institute noted in a 2015 paper that “the typical half-life of a publicly traded company is about a decade”. Change and disruption are the norms.

The portfolio operates at both ends of the spectrum: we hold businesses that have been around for over a century and for whom the risk of disruptive change is low, and some that are yet to celebrate their 10th birthday and are attacking incumbents and creating new markets. Our bias over the last decade has been to emphasise the disruptive new entrants. However, there is still a place for exceptional franchises such as Ferrari, Kering, L’Oréal, Atlas Copco, AIA or SMC.

The chart below shows two things. The first is how the portfolio’s growth focus has increased over the last decade (the darker blue portion expanding from 2012), partly as the opportunity set increased and partly as our investment philosophy more deliberately emphasised the search for outliers. The second is how growth was accelerated by Covid-19 (the sharp increase, then reversal, in that blue section from mid-2020). The first 18 months of the pandemic were, overall, a remarkably good period for our companies. The next 15 months were remarkably poor. But the companies themselves haven’t changed, and the full story of this period has yet to be written.

Portfolio weights by 3-year forecast sales growth (% p.a.)

Source: Baillie Gifford.
STAYING (A BIT) ACTIVE

One of the greatest risks in times of poor investment performance is paralysis. The investor spends their time fretting about companies that are struggling, trying to make sense of the shifting external narrative, reassuring clients and worrying in the back of their mind whether the firm they work for is still sound. Maybe it’s time to dust off their résumé, just in case.

Having never worked at any other investment firm, I can’t claim real insight into the pressures other managers feel at times like this. We certainly haven’t always got it right ourselves. I remember the quarterly performance review process we used to endure some 15 years ago. It was probably quite mild and well-meaning by the standards of the profession, but it was still profoundly damaging to our prospects of doing a good job for clients in the long term. However, we have got a lot better. The role of a partnership, and of the partners within it, is to act as a countercyclical buffer in good times and bad, reminding ourselves when numbers are good that we’re not geniuses, and when times are bad that we’re not fools. Long-term returns are an output that sits outside our control. But creating an environment that gives us the best chance of generating those long-term returns is an input and is one we work hard to control, now more than ever. Times of stress are when cultures are reinforced, and values laid bare.

We continue to seek new ideas in areas where we already have investments, and in newer fields. The positive side of market weakness is that it allows us to build positions in new companies, as we have done in the likes of AutoStore, Mobileye, Prysmian and Wise, to name a few. All of these face large growth opportunities. While some explore familiar themes, others, such as Prysmian – which supplies cables to the energy industry – move us further into less familiar growth areas.

The best protection against volatile macroeconomic conditions is long-duration growth, and we believe we are well placed on this measure. We continue to turn over rocks in a deliberate and measured way and to seek new investment opportunities.
It’s inevitable that in a period of profound global shocks – the polycrisis – the amount of uncertainty in the world feels even greater than usual. But therein lies a paradox: risk can be lowest when uncertainty is greatest. Known unknowns are, by definition, more visible than unknown unknowns, but they may well be less dangerous.

As we navigate this environment, with geopolitical and macroeconomic factors at the forefront of people’s minds, we remain clear-sighted about the role we play in clients’ portfolios and their expectations of us. We invest in growth companies because we believe that share prices follow cash flows over time, and that the portfolios we construct will generate cash flows beyond those anticipated by the market. Good growth companies adapt, evolve and thrive over the long term regardless of the economic environment. Some will fail, of course, but others will succeed beyond our most optimistic scenarios.

In moments of pressure, time horizons shorten, and people focus on the recent past – ‘what just happened?’ – and the near future – ‘what next?’. It is precisely at times like this that the long-term perspective we have as a firm, stemming from our partnership structure, is more important than ever. We should focus on trends like those Doyne Farmer outlined: the next 25 years of semiconductor innovation will deliver products and services we can’t yet imagine.

**CHANGE, RISK, AND PROGRESS**

One of the most fascinating meetings we had in 2022 was with Doyne Farmer, a mathematics professor at Oxford University and formerly of the Santa Fe Institute – a place where many roads lead. The work of Doyne and his colleagues has led them to observe that learning curves such as Wright’s Law (which, crudely, is a more general version of Moore’s Law) are far more persistent than industry experts typically assume, notably in technologies that will enable the energy transition, such as wind, solar and batteries. They conclude that “a greener, healthier and safer global energy system is also likely to be cheaper”. It will take time for tipping points to be reached, but from an investment perspective we need to double down on our efforts to identify contributors to, and possible winners from, this transition.

But change is never easy, and with the energy transition will come continued geopolitical challenges. As Helen Thompson writes in **Disorder**: “If Britain were the power that climbed to dominance during the age of coal and the United States the power that ascended during the age of oil and coal, the spectre haunting Washington is that without a decisive American strategic turn to renewables and electrification, the new energy age that depends on metals and minerals will belong to China.” That strategic turn has now begun. But the longer-term challenges remain. We have spoken for some time about the chronic friction China’s re-emergence will cause as the world moves from unipolar to multipolar. To this, we must add the risk of autocratic hydrocarbon-based states raging against the dying of the light as the world moves to a cleaner future.
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Any stock examples, or images, used in this content 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.

As with all mutual funds, the value of an investment in the fund could decline, so you could lose money.

The most significant risks of an investment in the Baillie Gifford International Growth Fund are Investment Style Risk, Growth Stock Risk, Long-Term Investment Strategy Risk, and Non-U.S. Investment Risk. The Fund is managed on a bottom up basis and stock selection is likely to be the main driver of investment returns. Returns are unlikely to track the movements of the benchmark. The prices of growth stocks can be based largely on expectations of future earnings and can decline significantly in reaction to negative news.

The Fund is managed on a long-term outlook, meaning that the Fund managers look for investments that they think will make returns over a number of years, rather than over shorter time periods. Non-U.S. securities are subject to additional risks, including less liquidity, increased volatility, less transparency, withholding or other taxes and increased vulnerability to adverse changes in local and global economic conditions. There can be less regulation and possible fluctuation in value due to adverse political conditions. Other Fund risks include: Asia Risk, China Risk, Conflicts of Interest Risk, Currency Risk, Emerging Markets Risks, Equity Securities Risk, Environmental, Social and Governance Risk, Focused Investment Risk, Geographic Focus Risk, Government and Regulatory Risk, Information Technology Risk, Initial Public Offering Risk, Large-Capitalization Securities Risk, Liquidity Risk, Market Disruption and Geopolitical Risk, Market Risk, Service Provider Risk, Settlement Risk, Small-and Medium-Capitalization Securities Risk and Valuation Risk.

For more information about these and other risks of an investment in the fund, see “Principal Investment Risks” and “Additional Investment Strategies” in the prospectus. The Baillie Gifford International Growth Fund seeks capital appreciation. There can be no assurance, however, that the fund will achieve its investment objective.

The fund is distributed by Baillie Gifford Funds Services LLC. Baillie Gifford Funds Services LLC is registered as a broker-dealer with the SEC, a member of FINRA and is an affiliate of Baillie Gifford Overseas Limited.

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

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IMPORTANT INFORMATION

Standardised Past Performance to December 31, 2022 (%)

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<th>Fund/Index</th>
<th>1 Year</th>
<th>3 Years</th>
<th>5 Years</th>
<th>10 Years</th>
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<tr>
<td>The Baillie Gifford International Growth Fund (Share Class K)</td>
<td>-34.43</td>
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<td>MSCI ACWI ex US Index**</td>
<td>-15.57</td>
<td>0.53</td>
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Source: Bank of New York Mellon, MSCI. Net of fees, US dollars. Returns are based on the K share class from April 28, 2017. Prior to that date returns are calculated based on the oldest share class of the fund adjusted to reflect the K share class fees where these fees are higher. “MSCI EAFE until 22/11/2019, MSCI ACWI ex US thereafter. The above figures have been chain-linked for performance purposes.

Past performance is not a guide to future returns.

The performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end performance please visit our website at www.bailliegifford.com/usmutualfunds

The Baillie Gifford fund’s performance shown assumes the reinvestment of dividend and capital gain distributions and is net of management fees and expenses. Returns for periods less than one year are not annualised. From time to time, certain fees and/or expenses have been voluntarily or contractually waived or reimbursed, which has resulted in higher returns. Without these waivers or reimbursements, the returns would have been lower. Voluntary waivers or reimbursements may be applied or discontinued at any time without notice. Only the Board of Trustees may modify or terminate contractual fee waivers or expense reimbursements. Fees and expenses apply to a continued investment in the funds. All fees are described in each fund’s current prospectus.

Expense Ratios: All mutual funds have expense ratios which represent what shareholders pay for operating expenses and management fees. Expense ratios are expressed as an annualized percentage of a fund’s average net assets paid out in expenses. Expense ratio information is as of the fund’s current prospectus, as revised and supplemented from time to time.

The MSCI ACWI ex US Index is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance in the global developed and emerging markets, excluding the United States. This unmanaged index does not reflect fees and expenses and is not available for direct investment. The Fund is more concentrated than the MSCI ACWI ex US Index.

It should not be assumed that recommendations/transactions made in the future will be profitable or will equal performance of the securities mentioned. A full list of holdings is available on request. The composition of the Fund’s holdings is subject to change. Percentages are based on securities at market value.
IMPORTANT INFORMATION

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ABOUT THE AUTHOR

TOM COUTTS
Investment Manager

Tom has been a member of the International Growth Portfolio Construction Group since March 2008 and took over as chair in July 2019. He became a partner in 2014 and our chief of Investment Staff in 2018. Tom joined Baillie Gifford in 1999 and spent a number of years in our UK and European Equity teams before joining the dedicated International Growth research group full time in 2017. He graduated BA in Modern Languages in 1994.