ANALYSTS OF CHANGE

REFLECTIONS ON 20 YEARS OF INTERNATIONAL GROWTH

Nick Thomas, Client Service Director

BAILLIE GIFFORD | *Actual Investors*

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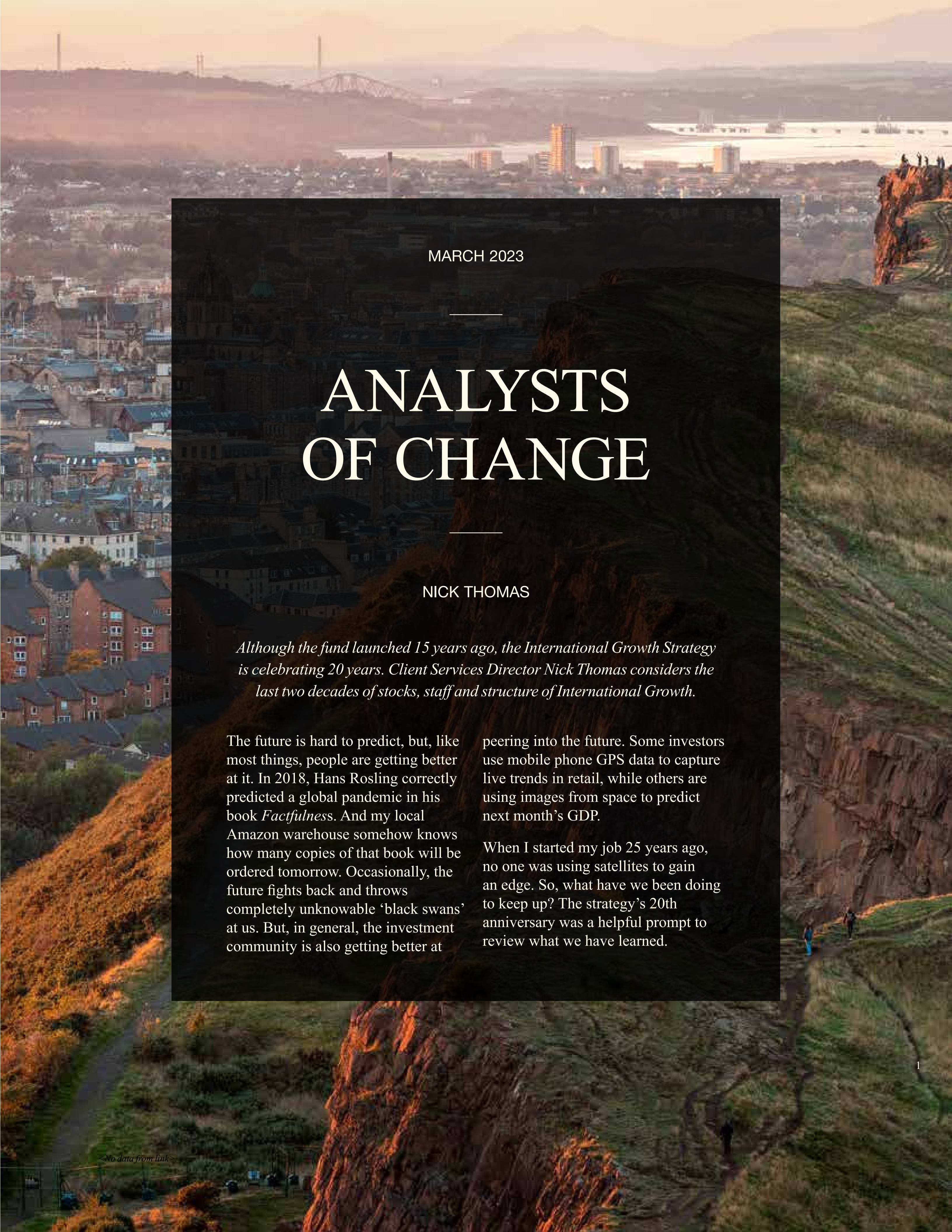

MARCH 2023

ANALYSTS OF CHANGE

NICK THOMAS

Although the fund launched 15 years ago, the International Growth Strategy is celebrating 20 years. Client Services Director Nick Thomas considers the last two decades of stocks, staff and structure of International Growth.

The future is hard to predict, but, like most things, people are getting better at it. In 2018, Hans Rosling correctly predicted a global pandemic in his book *Factfulness*. And my local Amazon warehouse somehow knows how many copies of that book will be ordered tomorrow. Occasionally, the future fights back and throws completely unknowable ‘black swans’ at us. But, in general, the investment community is also getting better at peering into the future. Some investors use mobile phone GPS data to capture live trends in retail, while others are using images from space to predict next month’s GDP.

When I started my job 25 years ago, no one was using satellites to gain an edge. So, what have we been doing to keep up? The strategy’s 20th anniversary was a helpful prompt to review what we have learned.

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HOW YOU THINK MATTERS MORE THAN WHAT YOU THINK

Listening to clients was the first and most important component. The International Growth Strategy was launched in 2003 in response to a request from Vanguard. The stability of our ownership structure and our stock-picking approach appealed, but they encouraged us to adopt a more joined-up approach to portfolio construction. This coincided with a shift that was already underway internally. Some of my former colleagues had become frustrated by how benchmark-based investing led to a lack of creativity, flexibility, and imagination and an apparent inability of investment managers to take significant risks. We wanted to deliver client objectives and maximise our edge by managing high-conviction portfolios and focusing on companies with higher growth potential.

Feedback from clients in the early years was twofold: as globalisation became more entrenched, our regional silos should disappear; and we should have greater courage of our convictions. We lost a client in 2005 on the grounds that the portfolio was too close to its benchmark and the team was not sufficiently integrated. We took this on board.

A 'joker' mechanism was introduced to make it easier for controversial stocks to become holdings, and we extended our timeframes and upside ambition. Our thesis was that individual conviction is more important than consensus when looking for outlier stocks. After discussing an idea, the colleague advocating a holding decides whether it deserves its place in the portfolio. This resulted in active share, a measure of how different a portfolio is from its benchmark, increasing. We started to see a shift in the balance between quality growth and rapid growth companies.

We were interested in different companies back then. A strong and persistent theme emerged as Chinese industrialisation and urbanisation gathered pace. Our portfolio was overweight energy, and the largest positions were in Vodafone, GlaxoSmithKline, and Total, and we were buying shares in Asian shipbuilders. A far cry from our technology-orientated portfolio of the last few years, in what was really a different world.

In 2010, as we exited the financial crisis, we acknowledged that our biggest opportunities should come from more controversial ideas and that these investments would be uncomfortable and complex. We wanted to focus on stocks that could make money regardless of whether a straightforward investment thesis supported them. "More grit in the oyster", as former partner Edward Hocknell put it.

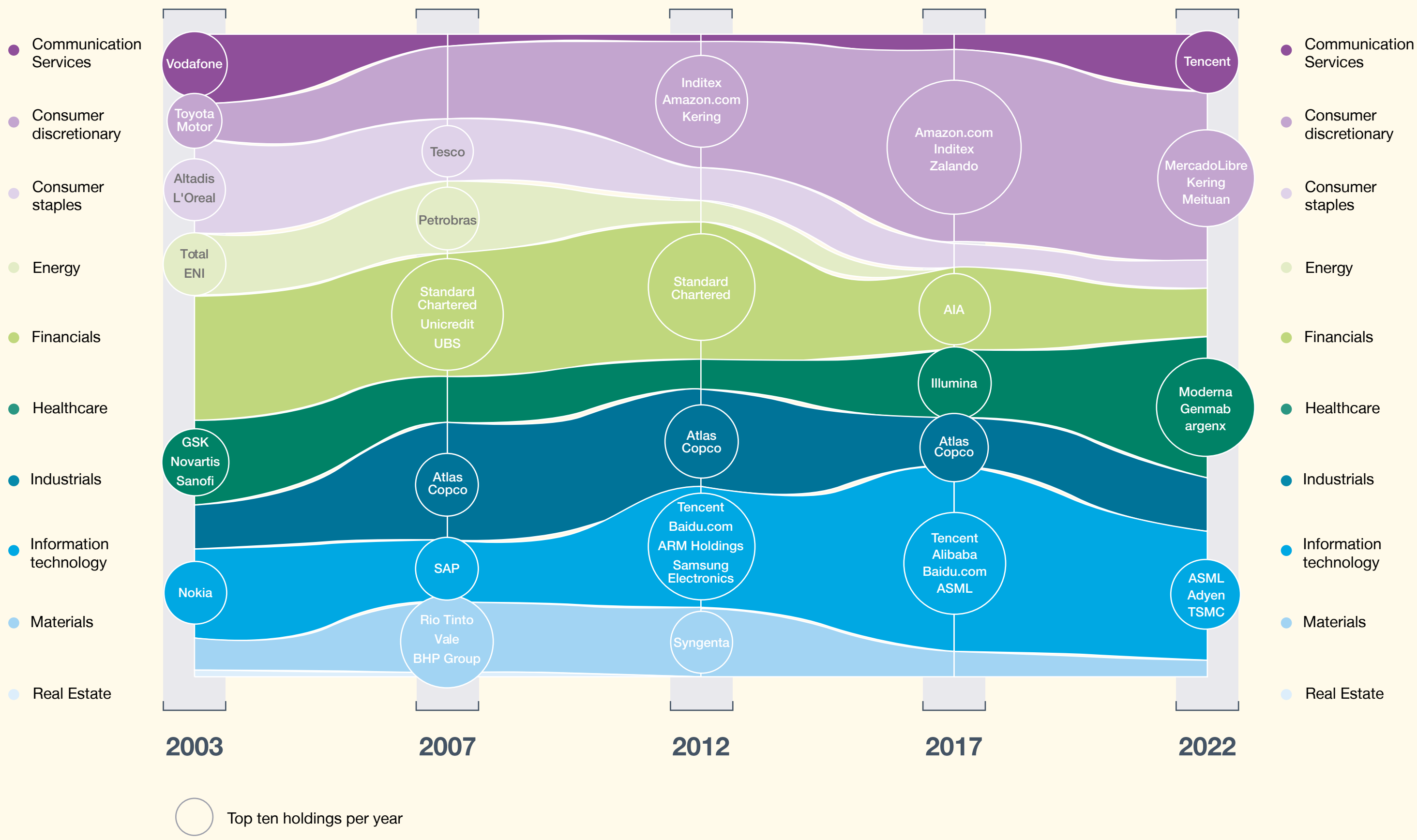
Around the same time, we started looking for ways to quantify risk based on the investment themes in the portfolio. We concluded that there was scope to tilt the portfolio further towards rapid growth, at the expense of stalwarts. We questioned the logic of holdings in large and straightforward companies that were less likely to be misunderstood by the market, and we tried to dispel the notion that we could only cope with risky stock ideas in small doses.

James Anderson articulated our upside ambition in his 2010 paper, 'Rational Optimism':

"Much fashionable attention has been paid to the depiction of malign shocks or Taleb's Black Swans. Too little has been said about upside surprises. Increasing the chance of capturing outsized winning potential is central to successful investing. Just one major success outweighs the demoralising impact of the (inevitable) mistakes on which so many like to concentrate."

It's been a constant effort to improve our approach to portfolio construction. In 2016 we started discussing the 'Kelly criterion', a formula to help weight holdings by a combination of upside and conviction, not simply riskiness. We had a working hypothesis that the upside from big winners would more than offset the losses from our mistakes. Then, in 2018, we spotted Professor Hendrik Bessembinder's paper explaining the incredible extent of skew in equity returns. Big winners really are the only thing that matters.

INTERNATIONAL GROWTH THROUGH THE DECADES



OUR TEAM

Likewise, the team dynamic has been under constant review. We're trying to optimise the balance between experience, continuity, trust, and new ideas. Younger minds can take us, and the portfolio, in new and interesting directions, as Julia Angeles, Brian Lum and Lawrence Burns have done.

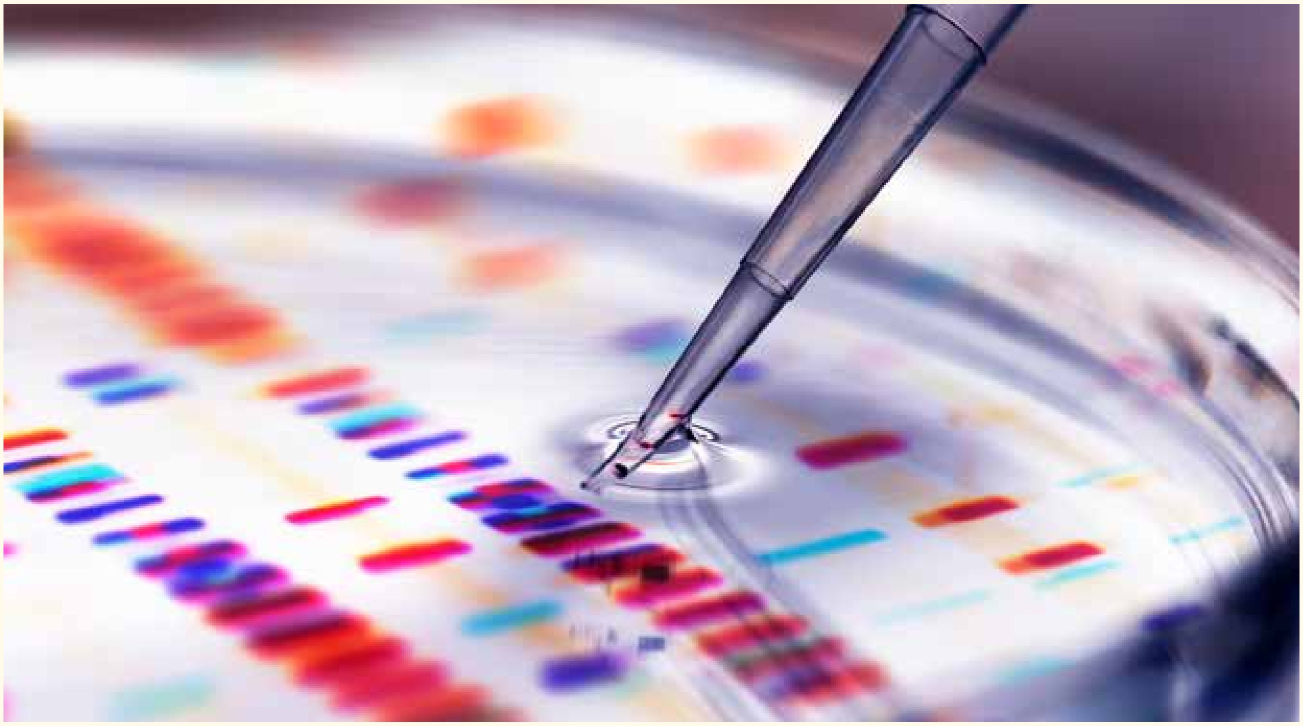
Some of Julia's early portfolio contributions included M3 (telehealth) and Sartorius (biopharmaceuticals). Her passion for healthcare has given us a clear vision for the future as science and technology converge in this field. This theme is coming into its own today, with new treatments taking us closer to personalised healthcare. The fund now has exposure to an exciting cohort of highly innovative healthcare companies. The Danish biotech company Genmab, which develops antibody treatments for cancer, was a top 10 holding at the end of 2022, along with the Dutch immunology company argenx, which targets autoimmune diseases.

Younger investors help us to spot new growth trends sooner, as they are not anchoring off previous investments. When Brian researched Xero, it was a young company offering cloud accounting software to 157,000 small and medium-sized enterprise (SME) users. Today, it has a subscriber base of around 3.5 million. Brian was quick to see the potential upside in 2013:

"Moving to the cloud goes much beyond simply getting rid of on-premise hosting and changing the pricing model – it can significantly change how small businesses and their accountants operate."

Reviewing the company again in 2016, it had lost none of its appeal.

"10-year-old Xero is one of the most fascinating (companies) that I have closely looked at. It can potentially serve tens of millions of SMEs globally as a leading provider of cloud-based accounting software."



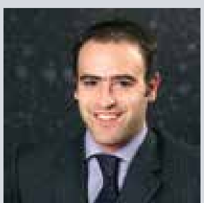
PORTFOLIO CONSTRUCTION GROUP

2003

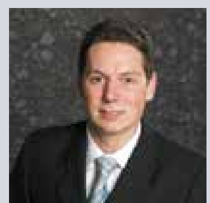

James Anderson


Nick Thomas

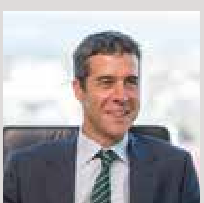

Sarah Whitley


Kave Sigaroudinia


Edward Hocknell


Tom Record

2023


Tom Coutts


Nick Thomas


Lawrence Burns


Julia Angeles


Brian Lum


David Salter

*Nick Thomas and David Salter are members of the Portfolio Construction group (PCG) for the International Growth Strategy; they are not members of the PCG for the International Growth Mutual Fund.

CULTURE IS CENTRAL

We spent much time considering company culture. Company meetings and open-ended questions are crucial inputs, and Tom Coutts has long advocated the value of the five-minute chat on the way out of a meeting.

"My own take, shot through with my own biases, is that there are common features in how the companies behave – a long-term vision, adaptability, client focus, ability to execute – and that when it comes to culture, the role of senior managers is to act in a way that illustrates and reinforces the culture they would like to encourage. But culture can't be created from on high. It evolves, and it emerges. And cultures don't exist in isolation, and they are not general. They need to fit the specific strategic ambitions and commercial realities of a particular organisation at a point in time."

Notable CEO-founders we have backed and learnt from over the years include Jack Ma (Alibaba and Ant Group), Hiroshi Mikitani (Rakuten) and Daniel Ek (Spotify). We have also spent a lot of time learning about the culture of outstanding companies with longer histories, such as Ferrari, Kering and Atlas Copco, which remain long-term holdings today.

OWNERS, NOT SPECULATORS

We learned through painful experience that even our most successful investments experience sharp drawdowns; ASML, MercadoLibre, and Stellantis are just a few examples of this. So, our bias is to be patient and supportive shareholders if the long-term investment case stacks up. As Lawrence remarked in 2021:

"In almost every client meeting, I am asked about our sell-discipline. No one has ever asked me about our hold discipline, which is a shame, as the greater cost to clients' returns comes from the inability to hold onto superstar companies when their returns are ticking upwards. Investment managers are usually very good at selling."

We sell holdings when the growth opportunity has diminished, the management team seems to be going off track, or we see better opportunities elsewhere.

MISTAKES ARE INEVITABLE

We're lucky to work in a culture where careers are not at risk for short-term underperformance and recommending things that do not work out is not a source of shame. We invested early into the renewable sector in 2009 but made analytical mistakes about competitive dynamics. We held onto UBS and Allied Irish Banks for too long as the financial crisis unfolded.

More recently, we were slow to appreciate the impact of new regulations in China. And it was a mistake to assume that changes in consumer habits during the Covid-19 pandemic would last.

Bessembinder taught us that the most damaging mistakes are the big winners we didn't invest in. Looking back, we should have realised more quickly that the luxury goods companies married long-term growth and outstanding competitive position to an unusual degree and that TSMC was a special company rather than just another option in our exposure to emerging markets.

We've just been through an experience where a large proportion of our holdings performed incredibly well, thanks to the effect of the pandemic, and then fell together equally sharply. There are lessons for us to learn from this experience, and we've been assessing potential enhancements to our process around exit multiples*, concentrations of risk, and our judgment of company maturity.

BEING STEADFAST WHEN CYCLES TURN DOWN

The last couple of years have shown the challenges of investing in different market environments. The advent of war and higher interest rates have been disastrous for long-duration equity valuations, but over the long term, the best defence against inflation and recession is growth. Entrepreneurs with ambition, and the ability to bring about change by solving meaningful problems, can thrive regardless of the environment. As Lawrence recently noted, the Argentinian company MercadoLibre is a poster child for this:

"Argentina has spent a devastating third of the last 70 years in recession. But my trip reminded me how exceptional growth companies could thrive in even the most inhospitable of macroeconomic environments by harnessing innovation.

*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 businesses with similar characteristics in the market.

"MercadoLibre is a great example. The Latin American commerce and finance pioneer's two largest markets are, after all, Brazil and Argentina. Since Baillie Gifford first invested in MercadoLibre in 2010, the Brazilian real has depreciated over 60 per cent against the US dollar. Brazilian GDP in US dollars has declined nearly 40 per cent. Over that period, despite this most punishing backdrop, MercadoLibre has returned twenty-fold in US dollars to its shareholders. Neither economic nor political stability are prerequisites for structural growth companies to deliver extraordinary long-term returns."

RATIONAL OPTIMISM

We are analysts of change, and we've had the fortune to invest through a period of remarkable progress. In the last 20 years, the cost of sequencing a human genome has fallen from $3bn to $200; the global middle class has almost doubled, and Moore's Law has transformed almost every industry. These secular trends are positive for society, easy to predict, and are likely to continue. And yet the market is relentlessly short-term in its outlook.

So, what else can we do to get better at prediction? The last word goes to Tom, Chairman of the group. As we came out of lockdown, Tom wrote a paper in which he summed up our hopes for the future and issued a rallying cry for how we should invest for the next 20 years:

"The world that emerges from this multidimensional process of change will, I believe, be better. And we are privileged as growth investors to talk to, and invest in, many of the companies that are driving change and shaping the new world as their innovations create new profit pools and destroy old ones. That requires of us analytical skills, of course, but even more important are imagination and a willingness not only to think about outliers but to ask, 'what if it really works?' and to commit our clients' money to investing in such possible outliers in the certain knowledge that some of them will fail… And we need to be radical, too, in the companies we invest in, the thinkers from whom we learn, and the possible futures we imagine." – Tom Coutts, *What Picasso teaches us about investing.*

Thank you for supporting us.

Nick Thomas

ABOUT THE AUTHOR

NICK THOMAS
Client Service Director

Nick joined Baillie Gifford in 1998 and became a Partner in 2010. Nick has been a member of the International Growth Portfolio Construction Group since 2003 and is a Director in the Clients Department with responsibility for North American Clients. Nick previously worked as an Investment Manager in the Developed Asia Equity Team before transferring to the Clients Department in 2009. He is a CFA Charterholder and graduated BA in Classics from the University of Cambridge in 1998.

IMPORTANT INFORMATION

The Baillie Gifford International Growth Fund
(Share Class K) as of March 31, 2023

Gross Expense Ratio	0.57%
Net Expense Ratio	0.57%

Source: Baillie Gifford & Co.

Annualised total return as of March 31, 2023 (%)

	1 Year	3 Years	5 Years	10 Years
The Baillie Gifford International Growth Fund	-5.07	8.45	3.30	7.50
MSCI All Country World ex US Index	-4.57	12.32	3.37	5.16

Source: Bank of New York Mellon and relevant underlying index provider(s). Net of fees, US dollars.

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/usmutualfund/internationalgrowthfund

Returns are based on the K share class from 28 April 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.

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.

Top Ten Holdings as at March 31, 2023

Holdings	Fund %
ASML	6.90
MercadoLibre	6.44
Kering 5.01	5.01
Ferrari 4.89	4.89
Adyen 4.65	4.65
Spotify 4.31	4.31
Tencent 3.95	3.95
Genmab 3.66	3.66
Meituan 3.44	3.44
L'Oréal 3.16	3.16

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.

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Principal Office: Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

780 Third Avenue, 43rd Floor, New York, NY 10017
Telephone +1 (212) 319 4633 / bailliegifford.com