BAILLIE GIFFORD

Baillie Gifford Multi Asset Income Fund

Quarterly Update

31 March 2022

This document has been prepared for use by professional advisers and intermediaries only.
It is not intended for use by retail clients.

This document contains information on investments which does not constitute independent investment 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. Investment markets and conditions can change rapidly and as such the views expressed should not be taken as statements of fact nor should reliance be placed on these views when making investment decisions.

This document is issued by Baillie Gifford & Co Limited, Calton Square, 1 Greenside Row, Edinburgh EH1 3AN, a company which is authorised and regulated by the Financial Conduct Authority, Financial Services Register No. 119179, and is a member of The Investment Association. Baillie Gifford & Co Limited is wholly owned by Baillie Gifford & Co, which is authorised and regulated by the Financial Conduct Authority. Baillie Gifford Overseas Limited is wholly owned by Baillie Gifford & Co. Baillie Gifford Overseas Limited provides investment management and advisory services to non-UK clients. Both are authorised and regulated by the Financial Conduct Authority.

Additional Geographical Location Information
Israel: This Report, as well as investment in the Fund described herein, is directed at and intended for Investors that fall within at least one category in each of: (1) the First Schedule of the Israeli Securities Law, 1968 ("Sophisticated Investors"); and (2) the First Schedule of the Investment Advice Law ("Qualified Clients").

The Fund's share price can be volatile due to movements in the prices of the underlying holdings and the basis on which the Fund is priced.

As with any investment, the clients' capital is at risk. Past performance is not a guide to future returns.

Throughout the report all figures are rounded, so any totals may not sum. Not all stocks mentioned may be held by the portfolio.

All information as at 31 March 2022 and source is Baillie Gifford & Co unless otherwise stated.

Baillie Gifford & Co Limited
Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 bailliegifford.com

Ref: 18022 10009552

Fund Objective

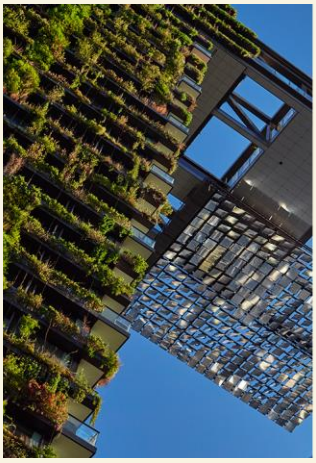
To produce monthly income, whilst seeking to maintain the value of that income and of capital in line with inflation (UK CPI) over five-year periods.

The Fund has no target. However, you may wish to assess performance of both income and capital against inflation (UK CPI) over five-year periods. In addition, the manager believes an appropriate performance comparison for this Fund is the Investment Association Flexible Investment Sector.

The crisis in Ukraine has exacerbated inflationary concerns by causing a further supply side shock

Central banks have responded with accelerated monetary tightening, further dampening growth but with the aim of supressing a structural rise in inflation

Fixed income asset classes are still at risk from further central bank tightening



Market background

The global economy was performing well, prior to the Ukraine invasion. The easing of Covid-related restrictions was improving confidence, causing consumers and companies to normalise their spending and use some of their accumulated cash piles. This surging demand further constrained supply, which raised global inflation rates considerably. Central banks had already taken note and were rapidly unwinding their monetary stimulus.

The crisis in Ukraine has exacerbated these inflationary concerns by causing a further supply-side shock, this time to a wide array of commodities. The direct impact from countries either not wanting to or not being able to buy Russian oil and gas has caused a surge in energy prices. Soft commodity prices have risen due to concerns that the vast grain fields in Ukraine might not be planted in time for the next growing season. Supplies of fertilisers and potash are concentrated in the region which means there are likely going to be long-term cost problems for farmers globally.

This supply shock is clearly detrimental to global growth and has raised the risk of higher inflation, creating the dreaded ‘stagflation’ environment, at least in the short term. Most central banks have responded with accelerated monetary tightening, further dampening growth but nipping a structural rise in inflation in the bud. This environment clearly puts pressure on almost all asset classes, but if inflation is successfully contained their actions should pave the way for stronger returns going forward.

Financial markets have suffered during the quarter because of a higher geopolitical risk premium and more hawkish central banks. The falls in equity markets have been relatively small overall because interest rates are still so much lower than inflation, meaning financial conditions are still broadly accommodative. Bond markets have suffered one of their largest quarterly drawdowns because bond yields had been at such exceptionally low levels ever since the pandemic and were certainly not priced for a period of high inflation. The US dollar has continued to strengthen as the Federal Reserve has sharply raised its projections for interest rates and it remains one of the better-insulated economies from high oil prices given its much-expanded domestic production of shale oil and gas.

Performance

As noted above, most investment markets were in negative territory in the first quarter of 2022 and the portfolio delivered a negative return of -3.0 per cent, net of fees. Equities were the main detractor, being the largest component of the portfolio, although the magnitude of return was similar for emerging market bonds, credit, and property. Special situations posted the largest negative return with our equity holdings exposed to Russia – mostly commodity-related companies – concentrated in this asset class, although the holding sizes were small in the context of the overall portfolio which limited the impact. We had positioned the portfolio to protect against a rise in government bond yields, so this asset allocation was helpful. Our infrastructure investments were resilient to the broad stresses in the markets and posted healthy returns during the quarter – with a meaningful allocation of close to 25 per cent of the portfolio, this made a material contribution in limiting losses over the period and demonstrates the benefits of our broad opportunity set.

Despite a tough quarter, total returns remain healthy over longer periods – a little over 7 per cent per annum over one and three years respectively. It is important for us to deliver capital growth to meet the portfolio's objective of keeping pace with inflation over the long term, and to support a growing income distribution over time. Equities and infrastructure have made the greatest contribution to returns but the diverse range of fixed income investments has also played a role.

Despite short-term weakness in capital values, the portfolio continued to generate a steady source of income – the forecast distribution to the end of the portfolio's financial year in June (when we must distribute all accrued income) is very marginally higher today than it was at the beginning of the year. This is a key feature of our approach, with a strong focus on seeking income resilience from a diverse set of investments. We do expect a small impact on future income due to the few holdings exposed to Russia but, having made some changes to the portfolio as noted below, forecast income for the full calendar year is barely changed from the start of this year.

Portfolio update

Asset allocation

At the start of 2022, the asset allocation of the portfolio was positioned for an environment in which equity markets have largely priced in the post-pandemic economic recovery and the world was facing the prospect of prolonged higher inflation and rising interest rates. Russia's war in Ukraine and the resulting concerns over supply shortages and higher commodity prices leading to a combination of slower growth and spiralling inflation only exacerbated the market trends that we were seeing. For the duration of the quarter, we maintained our position of focus on equity investments with a structural growth story and ability to withstand higher inflation, infrastructure investments and resilient high yield credit. All risk assets were indiscriminately punished by the markets and the next step for us in the second quarter of the year is to consider areas where the sell-off presents opportunities.

Security selection

We sold out of Russian local currency bonds on the day Russia invaded Ukraine and the associated underweight rouble position a couple of days later. We have also accelerated our exit from Norilsk Nickel. Nickel is a crucial component in the production of electric vehicles; however, we were increasingly concerned about the worsening environmental track record of the company's operations. While the company has not been sanctioned, we have sold the remaining position.

We have also introduced new ideas in the portfolio. Within property, we invested in Equinix, a company that develops and operates data centres. It has a diverse customer base and a global footprint and offers a range of value-add services to its tenants, giving it a better pricing power than its peers. We believe that combined with the long-term trend for increasing data processing needs, its competitive position and relatively better environmental footprint of its assets should allow it to grow dividend ahead of inflation.

In high yield credit, we invested in bonds of Coinbase. Coinbase is extremely well-positioned to benefit from the nascent growth of the crypto economy. With vertical integration, a strong 'regulatory-first' approach to operations and a dominant (and growing) market share in the US, we believe Coinbase will withstand increasing scrutiny towards the sector, helping to shape and develop regulations rather than falling foul of them. Bonds are very attractively priced relative to their BB+ rating, their highly cash-generative business model and large liquidity buffer.

Outlook

The financial and economic backdrop in 2022 will be distinctly different from anything witnessed over the last few decades. Inflation has become a major problem for governments and central banks and for the moment its control is the key priority. Unwinding the huge monetary support packages that central banks have undertaken since the pandemic is now front and centre of the battle against inflation, and we expect a rapid unwind of the Federal Reserve and Bank of England's balance sheets with continued regular rate hikes. High levels of excess savings from the combination of fiscal stimulus and restrained spending, during the pandemic, means consumers can keep spending despite higher prices. Therefore, we don't expect significant economic weakness, but growth will be much slower than had been initially expected for 2022. This means that inflation will continue to be elevated until central banks are able to tighten policy more significantly.

Fixed income asset classes are still at risk from further central bank tightening, but we believe most of the weakness has now occurred. Riskier asset markets still have to contend with the impact of rising rates and slowing growth, which limits our positivity on credit and equity markets, albeit we still expect small positive returns going forward. We have become more positive on emerging market bonds, especially their currencies where accelerated central bank tightening is likely to cause inflation to slow, which alongside a relatively strong balance of payments should lead to some currency appreciation.

Periodic Performance

	3 Months	1 Year	3 Years	Since Inception †
Class B-Inc (%)	-3.0	7.4	7.7	7.3
Sector Average (%)*	-3.6	5.0	7.5	5.5

Performance source: StatPro, FE, capital return in sterling.
Returns reflect the annual charges but exclude any initial charge paid.
†31 August 2018.
*IA Flexible Investment Sector.

Discrete Performance

	31/03/17-31/03/18	31/03/18-31/03/19	31/03/19-31/03/20	31/03/20-31/03/21	31/03/21-31/03/22
Class B-Inc (%)	N/A	N/A	-4.1	21.2	7.4
Sector Average (%)*	N/A	N/A	-8.1	29.1	5.0

Performance source: StatPro, FE, capital return in sterling.
Returns reflect the annual charges but exclude any initial charge paid.
*IA Flexible Investment Sector.

Do the tragic events unfolding in Ukraine pose a moment of reckoning for environmental, social and governance (ESG) investors? Can we continue to assert that ESG is a force for good or matters in the current environment? Amid the uncertainties playing out on the world stage, ESG may seem little more than a high-level sorting exercise, with its binary ‘good’ or ‘bad’ classifications.

Defence companies, to date banished from ESG portfolios with other so-called sin stocks such as tobacco, are suddenly rebadged as ESG investments. After all, what could be more ethical than the right of states to defend themselves against tyranny? And, by extension, with energy prices skyrocketing, it must surely be justifiable to pump money into oil and gas, and possibly coal, companies?

But this creates a dilemma for many. If oil and gas, coal and weapons are now ESG-friendly, even ethical, then perhaps it is time to admit that ESG investing has become redundant or meaningless. At least, so says a succession of opinion pieces in the media recently, calling upon the industry to clarify what purpose and relevance ESG has.

We have some sympathy with the instinct to challenge ESG investors and what they stand for. It’s hard to disagree with these rebuttals, although not entirely for the reasons suggested by some commentators.

As we see it, ESG is a process of change, constantly shifting – not a paint-by-numbers labelling exercise. As active, long-term investors, we understand there is no such thing as a perfect company. Being overly prescriptive from the outset about what good looks like – for example, by placing too much emphasis on a set of pre-determined metrics and scores or sectoral exclusions – ignores critical context, complexity and nuance. This is where many commentators have got it wrong.

It’s not how we go about ESG. The question we have always sought to answer through ESG is: ‘how does the company get better from this starting point?’ We believe that companies that are fundamentally misaligned with broader societal expectations and ignore their environmental impacts are unlikely to be successful over the long run. Investing in companies, not sectors nor themes, we analyse each company on its merits. We ascertain both its positive and negative impacts (and while we’re clarifying, creating jobs and contributing to a tax base can be positive impacts).

We consider ongoing engagement with company management as core to our investment activities and integral to our long-term investment framework. Sometimes, this engagement will involve reassuring management of our support during challenging periods; at other times, it entails pushing companies to ‘do and be better.’

What that entails rightly continues to change. Societal norms and expectations do not stand still, and our understanding of environmental issues, such as climate change, has become more acute. Likewise, you would expect the issues that we examine to determine the investment case and raise with company boards and management to adapt and grow with the times.

ESG resists easy classification. But that doesn’t make it meaningless. The consideration of ESG factors, by its nature, is a process of change. Yes, it involves assessing the current risks and opportunities, but the emphasis should be on ascertaining where the opportunities for improvement (and potentially transformation) lie.

And what ‘better’ looks like will depend on your starting point. If the starting point changes fundamentally (as the Russian invasion of Ukraine may prove), then it is both legitimate and necessary to re-examine the company and its credentials. We can establish how the company can improve and the pathways it will need to tread to get there.

As investors that believe fundamentally in the importance of due consideration of ESG matters and our responsibility as stewards of our clients’ capital, we need to grapple with this complexity. There are no easy answers – no neat boxes to tick, no simple metrics to apply. There is only detailed analysis and ongoing engagement, and a healthy dose of humility.

Voting Activity

Votes Cast in Favour		Votes Cast Against		Votes Abstained/Withheld	
Companies	9	Companies	5	Companies	2
Resolutions	104	Resolutions	7	Resolutions	5

When thinking about ESG, it is as important to understand where you are starting from, as where you are hoping to go.

ESG approaches have to accommodate complexity and nuance - these issues do not lend themselves to binary classifications.

Ultimately, effective ESG integration involves ongoing research and engagement, not simple solutions.

Company Engagement

Engagement Type	Company
Corporate Governance	Hargreaves Lansdown plc, Italgas S.p.A., Kering SA, LEG Immobilien SE
Environmental/Social	HICL Infrastructure PLC, Midea Group Co., Ltd., Rio Tinto Group
AGM or EGM Proposals	Apple Inc., Dolby Laboratories, Inc., Kering SA
Executive Remuneration	Amadeus IT Group, S.A., Edenred SA

Fund Name	Update
Baillie Gifford Multi Asset Income Fund	At the start of 2022, the asset allocation of the portfolio was positioned for an environment in which equity markets have largely priced in the post-pandemic economic recovery and the world was facing the prospect of prolonged higher inflation and rising interest rates. Russia's war in Ukraine and the resulting concerns over supply shortages and higher commodity prices leading to a combination of slower growth and spiralling inflation only exacerbated the market trends that we were seeing. For the duration of the quarter, we therefore maintained our position of focus on equity investments with a structural growth story and ability to withstand higher inflation, infrastructure investments, and resilient high yield credit. All risk assets were indiscriminately punished by the markets and the next step for us in the second quarter of the year is to consider areas where the sell-off presents opportunities. We sold out of Russian local currency bonds on the day Russia invaded Ukraine and the associated underweight rouble position a couple of days later. We have also accelerated our exit from Norilsk Nickel. Nickel is a crucial component for the production of electric vehicles, however, we were increasingly concerned about the worsening environmental track record of the company's operations. While the company has not been sanctioned, we have sold the remaining position. We have also introduced new ideas in the portfolio. Within property we invested in Equinix, a company that develops and operates data centres. It has a diverse customer base, a global footprint and offers a range of value-add services to its tenants, giving it a better pricing power than its peers. We believe that combined with the long-term trend for increasing data processing needs, its competitive position and relatively better environmental footprint of its assets should allow it to grow dividend ahead of inflation. In high yield credit, we invested in bonds of Coinbase. Coinbase is extremely well positioned to benefit from the nascent growth of the crypto-economy. With vertical integration, a strong 'regulatory-first' approach to operations and a dominant (and growing) market share in the USA, we believe Coinbase will withstand increasing scrutiny towards the sector, helping to shape and develop regulations rather than falling foul of them. Bonds are very attractively priced relative to their BB+ rating, their highly cash-generative business model and large liquidity buffer.