BAILLIE GIFFORD

Baillie Gifford Responsible Global Equity Income Fund

Quarterly Update

30 September 2021

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All information as at 30 September 2021 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: 12378 10004249

Objective

To achieve (after deduction of costs) growth in both income and capital over rolling five-year periods, whilst delivering a yield higher than that of the MSCI ACWI Index over rolling five-year periods. The manager believes this is an appropriate benchmark given the investment policy of the Fund and the approach taken by the manager when investing. In addition, the manager believes an appropriate performance comparison for this Fund is the Investment Association Global Equity Income Sector.

There is no guarantee that this objective will be achieved over any time period and actual investment returns may differ from this objective, particularly over shorter time periods.

Risk Analysis

Key Statistics	
Number of Holdings	55
Typical Number of Holdings	50-80
Active Share	89%*
Annual Turnover	15%

*Relative to MSCI ACWI Index. Source: Baillie Gifford & Co, MSCI.

Holdings have generally been reporting strong growth in earnings. We expect the portfolio's underlying income to grow 6-10 per cent this year

We are seeking attractive long-term opportunities in China, undeterred by short-term noise around regulation

Several new holdings with exciting prospects have been purchased

Earlier this year we updated our data on the dividend-paying universe of companies. As a reminder, we consider any company that pays a dividend and has a market capitalisation of over £1bn to be part of our universe. In principle we are happy to own companies that don't pay a dividend if we believe they will start one in the foreseeable future and make a contribution to our clients' long-term income, but we think the 'pays a dividend' criterion is a helpful starting point for sizing our hunting ground.

Today, there are over 5,300 such companies available globally. This is 25x more than if we restricted ourselves to just the narrower UK market. We think this broader set of potential investments remains the best argument for investing globally rather than regionally. However, what was more interesting to observe in the latest data is *where* the opportunity set is today. Around 1,100 dividend-paying companies are in the US and 900 are in Europe (including the UK). But the biggest single opportunity set is China, with over 1,200 dividend-paying companies.

Until a few years ago, these companies would have been beyond limits for most western investors. Like others we could only invest in the subset of Chinese companies that chose to list in Hong Kong (such as ANTA Sports) or New York. However, over recent years the Chinese government has been encouraging foreign investment into its domestic market, notably through the Connect programme offered through the Hong Kong Stock Exchange (a long-standing holding of our strategy). We are now able to invest directly in Chinese companies and did so for the first time this quarter, purchasing Midea Group: a manufacturer of air conditioners and other appliances.

Recently, China has been in the financial headlines repeatedly, and rarely in a good way. Regulatory moves have had a drastic impact on investor confidence in the education sector and some consumer-facing internet platforms. Some high-profile founders and managers have found themselves under scrutiny. More recently, the financial struggles of some property developers have come to the fore, with rumours of defaults by Evergrande. The Hang Seng index (a barometer of confidence in the Chinese economy) has notably underperformed other global markets this quarter.

Given these concerns, why are we now highlighting the opportunity in China? There are several facets of the opportunities for dividend investors in the Chinese market that are often misunderstood, and we think these are well worth considering and researching.

The first is the dynamism of many Chinese companies, many of which are still run by founders or by CEOs hand-picked by the founder. True, many of the 1,200 companies we highlighted above are state-owned enterprises, with capital intensive business models and poor governance – and we won't waste time looking at many of those. But there are many others with entrepreneurial management teams, that could be a great fit for our strategy. In a c.60-stock portfolio, we only need to find a handful of the most promising ones.

The second is the evolving nature of the Chinese economy, as the middle class expands rapidly, with a different set of needs and wishes. The speed with which Chinese consumers have adopted (for instance) ecommerce, or food delivery, or premium brands has often caught western observers by surprise over the last decade. It presents very big opportunities for the most dynamic companies, which take advantage of the shifts in what Chinese consumers or businesses want. This is a market where the successful can build businesses with billions of dollars of sales, faster than in almost any other part of the world. Increasingly, the successful companies are starting to look overseas.

The third is the emerging attitude towards dividends. Many international investors don't appreciate that the listing rules on the Shanghai and Shenzhen stock exchanges set minimum dividend pay-out ratios for companies, based on their profitability, level of maturity, and the capital intensity of growth. These minimum distribution levels rise from 10 per cent for the most immature companies, to 70 per cent for the most mature. The explanation for this is clear: the Chinese government does not want the most mature businesses to be hoarding cash and reinvesting it at poor returns. They would rather it was returned to shareholders (including the public and private pension funds which are big investors in the market), so that it can be used more usefully. Many founders take a similar view – we have observed in the past that many interesting founder-managed businesses listed in Hong Kong, such as ANTA Sports, have prioritised both growth *and* dividends as they grow. It is encouraging that paying dividends in China is both normal and welcomed.

This will matter more as time goes on, as China's government also appears to be keen that Chinese companies listed overseas 'come home', and list on the domestic stock exchanges. We expect that companies like Alibaba, Tencent, and NetEase, which originally listed in New York, and then set up dual listings in Hong Kong, are likely to pursue listings in China too – with dividends following.

We are stock pickers who seek to find a small number of outstanding companies from around the world. We typically have 50–80 holdings in our portfolio, and so our question is not "are there likely to be opportunities in China?", but rather "what are the handful of opportunities in this enormous pool of opportunities that are the best fit for our strategy?" We are looking for several things, including:

- Management teams we can trust
- A material growth opportunity
- A core business that is cash-generative, and which we think can support a resilient dividend, that is not going to be highly volatile
- Businesses that are operated in a sustainable way, that is in-line with the broad outlines of Chinese government policy

In searching for companies, we have been greatly helped by the input of Rio Tu, our Shanghai-based analyst who contributes ideas and research, along with four locally based colleagues. With his help there is a handful of names which we have been getting to know over the past several years. We also use third-party due diligence services for an alternative perspective on founders and to reduce the risk of fraud, for example.

The first locally listed company we have bought for the portfolio is Midea, one of the leading manufacturers and sellers of air conditioning equipment and other appliances. This is a company we have long admired, partly for their direct distribution model, and partly because of the entrepreneurial management team's success in entering new categories over time. We believe they will continue to grow via the same route, but over time we think their investments in robotics, building controls, and international expansion could also start to bear fruit. Midea offers both a similar level of income to the portfolio, and potentially very attractive long-term growth.

We have, of course, also been considering what implications there are from the recent regulatory events in China. In the main, our holdings have not been directly affected, because they do uncontroversial things like sell sportswear or rice crackers. NetEase, the videogame company, is the only holding where there has been an impact: the government has demanded that games companies limit the amount of time that children spend playing games, and there have been suggestions that the pace of approval of new games may slow for a period. NetEase has responded positively to these developments, and we are confident that they will make any adjustments necessary – and we believe that their own internal innovation will be the key driver of their long-term success.

Our overall portfolio remains very diversified geographically: our names are split roughly a third European, a third American, and a third from Asian or Emerging Markets (including Australia). We don't know how this allocation will evolve over time – we believe in following the opportunities, rather than making big top-down country allocations. However, in general we think that when people are worried about headlines, it is more important than ever to remain focused on the long-term opportunities.

Portfolio update

The portfolio showed a positive 2.4 per cent return last quarter, matching global equity markets. Investors oscillated between enthusiasm for the economic recovery gathering pace and fear about the undesired side effects of potential inflation (which we discussed in detail last quarter).

Summer months are typically an active reporting season for companies and the message we heard from most of the holdings was one of strength in their business and accelerating activity. While this was expected from companies which are more sensitive to the economic cycle like Swiss freight-forwarder Kuehne + Nagel, whose profits doubled in Q2 compared to the previous year, it was also true of a wide range of other businesses.

Leading semiconductor supplier, TSMC, recorded a 20 per cent increase in revenues in its second quarter compared to an already strong Q2 2020. Microsoft also had an active second quarter in 2020 but managed to boost earnings by close to 50 per cent. In another sector, food giant Nestlé recorded 9 per cent organic growth in revenues, an impressive number for a business with $100bn of revenues.

Several of the holdings performed well in the pandemic and capitalised on market share gained in the period, demonstrating the importance of a strong management in a crisis. US parts distributor Watsco, for instance, gained share in the pandemic while competitors were struggling and held onto these gains, leading revenues to be 37 per cent higher in Q2 2021 than they had been in Q2 2019.

The biggest contribution to returns in the quarter came from a diverse group of companies. Albemarle, the largest lithium miner in the world, rose on the back of strong lithium prices and guidance for revenue growth of 25 per cent per annum until 2026. Novo Nordisk, one of the largest holdings, highlighted a very strong start for their new drug against obesity, Wegovy. The diabetes business continues to grow but it is the potential of their obesity treatments which could extend Novo's growth by many years. Australian online platform carsales.com saw a rapid recovery in its activity and the acquisition of a US business will provide another engine of growth.

On the other side of the ledger, concerns about government intervention led some of our China-based holdings to weigh on performance.

The gaming company NetEase was affected by heightened scrutiny of the sector by the regulator. New rules were introduced to limit the time spent by children on games and regulate the content of these games. It is not the first time gaming has been in the spotlight and we believe that investors may be overstating the potential impact on companies like NetEase, who have been careful and proactive on this issue.

Shares in ANTA Sports, the leading sportswear company in China, were also weak in the quarter despite no obvious risk from regulation or link to real estate.

Shares in the Brazilian stock exchange B3 fell as investors turned negative on the short-term prospects for the Brazilian economy. Our investment thesis on B3 is built on the expansion and diversification of the capital markets in the next 10 years, a view which hasn't changed considering the recent noise around Brazilian politics.

Transactions

This has been a relatively busy quarter for new purchases, as several new ideas worked their way through our process. As well as Midea, discussed above, we bought new holdings in Starbucks, Valmet and Linea Directa.

We believe that a strong culture and the company's focus on customers will enable Starbucks to deliver strong growth over the next decade as it further embeds itself into its customers' daily routines. Our analysis suggests that there is room for significant growth in the number of stores in Starbucks' two most important markets of the US and China. The dividend has grown every year since it was introduced in 2011 and we expect that trend to continue in the coming decade.

Finnish engineering company Valmet is a leader in making and servicing much of the machinery used in the pulp and paper industry. It has a strong management team and a track record of returning cash to shareholders through its dividend. What really excites us is the potential earnings growth in the next 10 years as Valmet's customers supply a structurally growing market. Global pulp and paper use is rising as consumers shift to ecommerce and many companies are trying to reduce plastic use. Moreover, Valmet's customers need to invest substantially over the coming years to reduce their carbon emissions and Valmet is ideally positioned to supply and maintain more efficient machinery.

We also bought a new holding in Spanish motor and home insurer Linea Directa, which sells directly to consumers and is the equivalent of Direct Line in the UK. We believe that its differentiated direct-to-consumer approach allows it to deliver a better service at a lower price to consumers. We expect that its sensible approach to pricing should drive market share gains and, in turn, earnings growth for years to come. Linea Directa was recently spun out of its former parent, Bankinter, which should give it more freedom, but the main shareholder retains a 20 per cent stake, giving us confidence that the focus on the long-term will be maintained. The business is highly profitable and generates lots of cash, which will allow the company to pay dividends as well as reinvest to grow its business.

We funded these through the sale of McDonald's, Coca-Cola, and a reduction to ANTA Sports.

McDonald's is the world's largest fast-food company. While we admire many aspects of the business, we believe that growing the store base at an interesting rate over the next five to 10 years is increasingly challenging. We also believe that some of the sustainability challenges inherent in the business model, such as the significant emissions of their agricultural supply chain, or the nutrition impact of their products, are likely to become more pressing over the next decade. Having reviewed their strategy for managing these issues, we believe that the company has tended towards relatively narrow, unambitious responses. We have therefore used the holding as a source of funds for the new holding in Starbucks.

Coca-Cola is the world's largest soft drinks company. We have admired the strength of its brands, and the strong cash-flows generated by its business. However, the underlying growth in the business over recent years has been slower than we had hoped, and we deem Coca-Cola's ambition to address its large environmental impact not ambitious enough for such a large consumer-facing company. We have therefore used it as a source of funding.

Conclusion

One advantage of holding a diversified portfolio of resilient companies is that there is less need to make drastic changes when the wind blows in a different direction. Largely we can trust the managers of our holdings to make the right decisions in response to changes, whether that be rising input costs or a slowing Chinese property market. Our main focus is instead on assessing where the best opportunities for long-term growth may be. Although we've written about the opportunities in China in this letter, the pipeline of exciting new ideas spans all regions, and we see many reasons for optimism.

The views expressed reflect the personal opinion of the author and should not be considered as advice or a recommendation to buy, sell or hold a particular investment.

Performance

Periodic Performance

	3 Months	1 Year	3 Years (p.a.)	Since Inception (p.a.) †
Class B-Inc (%)	2.4	19.1	N/A	17.6
Benchmark (%)*	1.5	22.7	N/A	15.4
Sector Average (%)**	1.7	21.6	N/A	10.2

Performance source: FE, StatPro, MSCI, total return in sterling.
†06 December 2018.
*MSCI ACWI Index.
**IA Global Equity Income Sector.

Discrete Performance

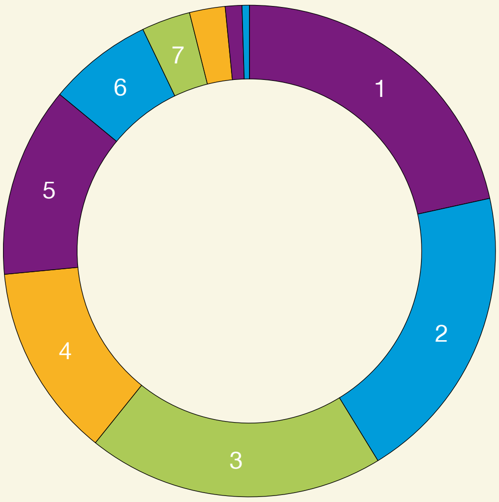
	30/09/16-30/09/17	30/09/17-30/09/18	30/09/18-30/09/19	30/09/19-30/09/20	30/09/20-30/09/21
Class B-Inc (%)	N/A	N/A	N/A	10.8	19.1
Benchmark (%)*	N/A	N/A	N/A	5.8	22.7
Sector Average (%)**	N/A	N/A	N/A	-3.9	21.6

Performance source: FE, StatPro, MSCI, total return in sterling.
*MSCI ACWI Index.
**IA Global Equity Income Sector.

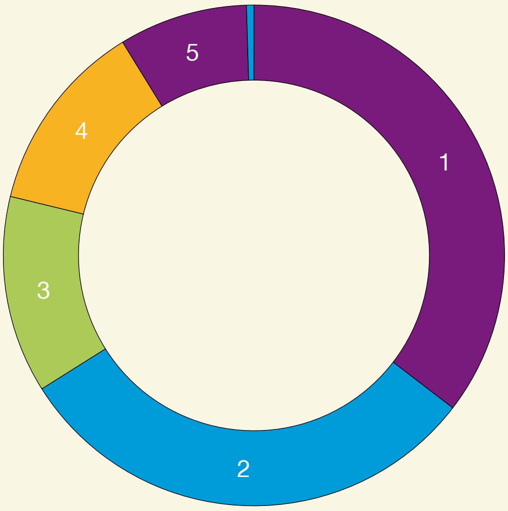
Top Ten Largest Holdings

Stock Name	Description of Business	% of Portfolio
Novo Nordisk	Pharmaceutical company	3.9
TSMC	Semiconductor manufacturer	3.5
Microsoft	Software company	3.4
Sonic Healthcare	Medical diagnostics company	3.2
Partners	Private markets asset management	3.2
United Parcel Service	Courier services	3.1
Fastenal	Distribution and sales of industrial supplies	3.0
Roche	Pharmaceuticals	3.0
Nestlé	Food and beverage producer	3.0
Procter & Gamble	Household product manufacturer	2.9
Total		32.3

Totals may not sum due to rounding.



Sector Weights		(%)
1	Industrials	21.6
2	Information Technology	19.7
3	Financials	19.5
4	Health Care	12.7
5	Consumer Staples	12.5
6	Consumer Discretionary	6.9
7	Communication Services	3.2
8	Materials	2.3
9	Utilities	1.1
10	Cash	0.5



Regional Weights		(%)
1	North America	35.4
2	Europe (ex UK)	30.6
3	Emerging Markets	12.7
4	Developed Asia Pacific	12.4
5	UK	8.3
6	Cash	0.5

A negative cash position may sometimes occur due to obligations awaiting settlement.

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Climate change is most often measured in decades but just one day can be notable. The Sixth Assessment Report by the Intergovernmental Panel on Climate Change (IPCC) was published on 9 August. The full 3,949-page report represents the most significant update to global understanding of the physical science of climate change. It has taken a full eight years to complete and its conclusions are unambiguous. They tell us that human-induced climate change is unequivocal and getting worse. Earth is now close to the 1.5°C threshold and more likely than not to be reached by 2040.

Climate change transition requires cooperation and international agreements among nations, and it needs innovation and entrepreneurship from businesses. Investors have a vital role to play too. Our responsibility as stewards of long-term capital is, we think, twofold. First, we need to understand how climate change can affect returns for our clients. The relationship between climate change and investment returns is currently focused on risk. The Taskforce for Climate-related Financial Disclosures (TCFD) is driving significantly better disclosure of potential financial costs of climate change. Conventional economic modelling can struggle to incorporate the type of unprecedented impacts that climate change might bring – such as large-scale crop failure, global sea level rise and collapse of ecosystems. So, TCFD has been a game changer in advancing our measurement of climate-related investment risk. We can point to the recent climate report published by Taiwan Semiconductor manufacturing Co (TSMC) as a highly comprehensive analysis of its risk and opportunities. It is a case example of how far the leading companies in the portfolio have come in responding to our request for granular climate-related reporting.

Our other core responsibility is to be supportive and constructive long-term owners of companies as they navigate the transition towards net-zero. All companies will need to get there eventually; for some it presents a near-term liability or opportunity, while for others it is less material to their core business, though still a feature of the regulatory space and customer environment they operate in. We try to ensure that our engagement with companies on climate-related issues is based on material risks and opportunities but is also supportive through significant periods of change. For example, we have engaged with United Overseas Bank (UOB) in Singapore to gain a clearer understanding of how it builds climate risk into its lending activity. For other holdings, such as Cisco, the global technology leader, our engagement is in support of its commitment to carbon neutrality across its operations by 2025 and a 2040 net-zero carbon emissions target for its full value chain.

For companies and investors to drive this climate transition effectively, the role of governments in helping to set the goalposts and rules of the game is vital. The Paris Agreement of 2015 was a huge step forward in this respect, and we now look to COP26 in Glasgow in November where, over just 13 days, more details must emerge on the regulatory and fiscal frameworks that will set the strategic course for the companies in the portfolio for the next decade and beyond.

New Purchases

Stock Name	Transaction Rationale
Línea Directa Aseguradora	Linea Directa is a Spanish motor and home insurer, which sells directly to consumers. We believe that the company has a very differentiated model in the Spanish market, with the most widely-recalled brand in Spain, and no reliance on expensive brokers or agents - which allows it to deliver a better service at a lower price to consumers. We expect that this differentiation will drive steady market share gains over the next 5-10 years. We are also excited by their plans in health insurance, and expect other product lines to follow over time. Like the best insurance management teams, they prioritise profitable underwriting over aggressive market share targets. The company was recently spun out of its former parent, Bankinter, and the Botin family have retained their 20% stake, helping to maintain the company's long-term focus. The business is highly profitable and terrifically cash-generative, and we expect material dividends over the coming years. We therefore bought an initial holding for the fund.
Midea Group 'A' - Stock Connect	Midea Group makes air conditioning units and other home appliances. It has a tremendous track record of growth in China, reminiscent of Japanese manufacturers in the 1980s who focused on excellent engineering at lower costs than incumbent companies. We have watched it grow for several years under the stewardship of longstanding CEO Paul Fang. We foresee continued growth in China in the years ahead, and the potential for excellent growth as it builds its business overseas. The dividend has been resilient and in the years to come we expect strong earnings, dividend and capital growth. The shares have weakened considerably in the past year as the market has fretted about short-term air conditioner sales in China. We are taking this an opportunity to start a holding. This is also the first purchase we have made of China 'A' shares in the domestic market.
Starbucks Corp	We took a new holding in the coffee retailer, Starbucks. We think the strong culture and focus on customer experience will enable Starbucks to deliver strong growth over the next decade as they further embed themselves into their customers' daily routines. Our analysis suggests that there is room for significant growth in the number of stores in their two most important markets of the US and China. The dividend has grown every year since it was introduced in 2011 and we expect the dividend growth to continue.
TSMC	We have moved the TSMC investment from the ADR to the local Taiwanese line. The ADR now trades at a 10% premium to the local line, and investing in the local line may help avoid double-taxation of dividends.
Valmet Oyj	This Finnish engineering company is a leader in making and servicing much of the machinery used in the pulp and paper industry. It has a strong management team and a track record of returning cash to shareholders through its dividend. We are excited by its potential earnings and dividend growth in the next five to ten years. Its customers are seeing structural growth in demand for pulp and paper, driven by reduced plastic use and the shift from physical retail to ecommerce. These same customers also need to invest substantially in reducing their carbon emissions. As customers expand and upgrade their machinery, we expect Valmet's revenue to benefit. We also foresee its profitability improving over time, as its business mix evolves. The prospect of strong earnings and dividend growth for several years to come prompted us to invest in the shares.

Complete Sales

Stock Name	Transaction Rationale
Coca Cola	Coca Cola is the world's largest soft drinks company. We have admired the strength of its brands, and the business model in which bottling companies around the world are responsible for most of the capital requirements of the business (making Coca Cola Company a very cash-generative business). However, we have had two questions. One is that underlying growth in the business over recent years has been slower than we had hoped; from our conversations with CEO James Quincey and others, it seems that the company is finding it hard to maintain growth at its current scale and level of complexity. The second is also partly related to scale: by virtue of its size, Coca Cola has a very large environmental footprint, and is (for instance) one of the largest producers of plastic packaging globally. We have been reviewing the sustainability efforts of all our consumer-facing holdings, and comparing the impact they have, and the level of ambition they have to address this. Our hurdle is that if a company's operations has a material negative impact on its communities, we want to see evidence of ambition to be best-in-class in how they manage that, with stretching goals. While Coca Cola has made some progress, we don't think it clears this bar - partly because of the complexity of its bottling operations. We therefore used it as a source of funding.
McDonald's	McDonald's is the world's largest fast food company. While we admire many aspects of the business, we believe that growing the store base at an interesting rate over the next 5-10 years is increasingly challenging (especially when compared to, say, Starbucks). We also believe that some of the sustainability challenges inherent in the business model, such as the very significant emissions of their agricultural supply chain, or the nutrition impact of their products, are likely to become more pressing over the next decade. Our assessment is that McDonald's is therefore a relatively high impact company. Having reviewed their strategy for managing these issues, we believe that in several areas, the company has tended towards relatively narrow, unambitious responses. We don't believe there is a route to improving this through engagement, and so decided that this should be a source of funding for new ideas.
TSMC ADR	Please see TSMC purchase note for explanation of the switch from ADRs to the local line.

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