BAILLIE GIFFORD

Baillie Gifford Strategic Bond Fund

Quarterly Update

31 March 2022

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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.

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Fund Objective

To produce monthly income. Opportunities for capital growth are also sought, subject to prevailing market conditions.

The manager believes an appropriate comparison for this Fund is the Investment Association Sterling Strategic Bond Sector average given the investment policy of the Fund and the approach taken by the manager when investing.

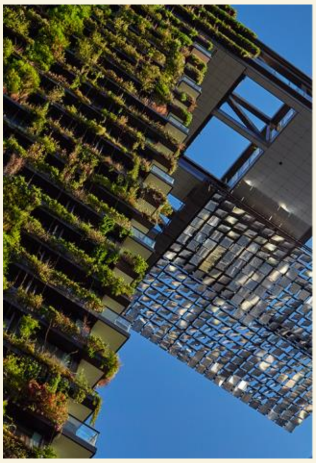
Risk Analysis

Key Statistics	
Number of Issuers	73
Typical Number of Issuers	60-85
Tracking Error	2.1%
Tracking error range	1-4%

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

Returns from the corporate bonds were negative this quarter. The market declined sharply in the first weeks of February as the Federal Reserve, Bank of England and European Central Bank's tone shifted to a more hawkish stance in response to rising inflation. Corporate bonds sold off further after Russia invaded Ukraine on 24th February. This move reflected the increased geopolitical risk and concerns that the war would lead to slower growth and higher inflation following a broad increase in commodity prices.

The portfolio performed in line with the benchmark in the first quarter of the year. Asset allocation added value as the portfolio's defensive positioning meant the portfolio was well placed to weather market volatility during the quarter.

At bond level, French hospitality company Accor added value as tourism and business travel continue to recover. American litigation finance company Burford Capital also performed strongly. With cash flows dependent on the outcome of litigation, Burford has proved to be lowly correlated to the market. Ozon Holdings was the main detractor. The company is an ecommerce platform serving Russian consumers on a first and third-party basis. The business is indirectly affected by the impact of sanctions on the Russian economy. Following the invasion, the bonds have been marked down to distressed levels costing the portfolio 0.35 per cent.

Over longer periods, asset allocation has made a meaningful contribution, in keeping with our strategic approach, with the portfolio profiting from a dynamic approach to allocation between investment grade and high yield bonds. Individual bond selection has continued to make a strong contribution to relative returns. Examples among the top performers in the past three years include American healthcare services company, IQVIA and American subscription streaming company, Netflix.

Portfolio positioning

We began 2022 cognisant of growing geopolitical risk and interest rate risk, with Central Banks signalling an increased willingness to unwind fiscal stimulus quickly to tame inflation. In this context, valuations in corporate bond markets ended 2021 high relative to history. Lower quality investment grade bonds (BBB rated debt), an area of the credit quality spectrum we typically favour, looked particularly expensive. As a result, we spent January reducing the portfolio's credit spread (the yield offered by corporate bonds over the risk-free rate) to bring it more closely in line with the benchmark. This was achieved by selling longer-duration corporate bonds in favour of shorter-duration corporate bonds, high quality supranational corporate bonds and US Treasuries. The portfolio ended January with close to neutral credit risk relative to the benchmark. Following the tragic events in Ukraine, the portfolio remains defensively positioned. We are concerned about elevated geopolitical risk and the potential impact of prolonged supply chain issues and inflation. These factors may dampen the recovery and raise the risk of a recession in Europe in the event of a misstep by central bankers.

New addition Shriram Transport Finance is an example of an attractive short-duration high yield bond we purchased this quarter. The company is a leading Indian lender financing used commercial vehicle purchases by small businesses. Shriram is prudently financed and has been tested through past economic and market cycles. It has diversified funding sources as well as strong liquidity and capital positions. We purchased this short-dated secured bond at an attractive yield of more than 4 per cent with less than 18 months to maturity.

Beyond risk reduction trades, we continued to identify new idiosyncratic opportunities for the portfolio this quarter, an example of which is Annington Funding. Annington owns a residential property estate leased to the UK's Ministry of Defence. The UK government wants to buy Annington's estate back, and the current owners were already looking to sell. It is likely that, by one means or another, the UK government will ultimately end up buying the estate, and in the vast majority of scenarios, that's a good thing for bondholders. The surprising and arcane legal tactic that the government's lawyers are using to try to engineer the repurchase has spooked the market and caused bonds to fall to prices which, in our view, all but eliminate downside risks with the potential for substantial capital upside for the patient investor.

Outlook

The financial and economic backdrop in 2022 will be distinctly different to 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 can 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, albeit we still expect small positive returns going forward.

Periodic Performance

	3 Months	1 Year	3 Years (p.a.)	5 Years (p.a.)
Class B-Inc (%)	-6.2	-5.2	1.8	2.7
Comparator (%)*	-4.1	-2.2	2.7	2.5

Performance source: FE, total return in sterling.
*Comparator refers to Comparator Benchmark: IA £ Strategic Bond 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 (%)	4.2	4.0	-4.2	16.3	-5.2
Comparator (%)*	2.3	2.1	-1.4	12.4	-2.2

Performance source: FE, total return in sterling.
*Comparator refers to Comparator Benchmark: IA £ Strategic Bond Sector.

Distribution of Portfolio by Asset Class

	Fund Weight* (%)
Sterling	
Conventional Sovereign	0.0
Conventional Non Sovereign	47.1
Index Linked	0.0
Total Sterling	47.1
Cash & Derivatives ***	
Cash	2.6
Cash	0.3
	5.7
Total Cash & Derivatives ***	8.7
Foreign Currency	
Conventional Sovereign	0.0
Conventional Non Sovereign	44.3
Index Linked	0.0
Total Foreign Currency	44.3
Total	100.0

*Shows exposure to bonds in the currency before any hedging is applied

Distribution of Portfolio by Sector

	Fund Weight (%)
Industrials	46.7
Financial	31.9
Quasi & Foreign Government	8.1
Securitized	5.7
Utility	4.9
Covered	0.0
Index Credit Default Swaps	-5.9
Cash & Derivatives	8.7
Total	100.0

Distribution of Portfolio by Credit Rating Band

	Fund Weight (%)
AAA	8.1
AA	3.7
A*	7.2
BBB*	33.8
High Yield*	38.5
Cash & Derivatives	8.7
Total	100.0

*Includes BG internally-rated bonds where there is no official rating.

Distribution of Portfolio by Region

	Fund Weight (%)
United Kingdom	32.1
Europe	26.4
North America	18.5
Emerging Markets	8.5
Supranational	3.6
Developed Asia	2.2
Cash & Derivatives	8.7
Total	100.0

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	None	Companies	None	Companies	None
Resolutions	None	Resolutions	None	Resolutions	None

Company Engagement

Engagement Type	Company
Corporate Governance	Burford Capital Limited, Marks and Spencer Group plc
Environmental/Social	Alibaba Group Holding Limited, EDP - Energias de Portugal, S.A., FirstCash Holdings, Inc, Nordstrom, Inc.
AGM or EGM Proposals	Ørsted A/S

Fund Name	Update
Baillie Gifford Strategic Bond Fund	Returns from the corporate bonds were negative this quarter. The market declined sharply in the first weeks of February as the Federal Reserve, Bank of England and European Central Bank's tone shifted to a more hawkish stance in response to rising inflation. Corporate bonds sold off further after Russia invaded Ukraine on the 24th of February. This move reflected the increased geopolitical risk and concerns that the war would lead to slower growth and higher inflation following a broad increase in commodity prices. We began 2022 cognisant of growing geopolitical risk and interest rate risk, with Central Banks signalling an increased willingness to unwind fiscal stimulus quickly to tame inflation. In this context, valuations in corporate bond markets ended 2021 high relative to history. Lower quality investment grade bonds (BBB rated debt), an area of the credit quality spectrum we typically favour, looked particularly expensive. As a result, we spent January reducing the portfolio's credit spread (the yield offered by corporate bonds over the risk-free rate) to bring risk more closely in line with the reference index. This was achieved by purchasing credit default swaps to reduce the portfolio's exposure to high yield bonds and by selling longer-duration investment grade bonds in favour of shorter-duration high yield bonds and high quality supranational corporate bonds. The portfolio ended January with a c. 32% position in high yield bonds and close to neutral credit risk relative to the reference index. Following the tragic events in Ukraine, the portfolio remains defensively positioned. We are concerned about elevated geopolitical risk and the potential impact of prolonged supply chain issues and inflation. These factors may dampen the recovery and raise the risk of a recession in Europe in the event of a misstep by central bankers. New addition Shriram Transport Finance is an example of an attractive short-duration high yield bond. The company is a leading Indian lender financing used commercial vehicle purchases by small businesses. Shriram is prudently financed and has been tested through past economic and market cycles. It has diversified funding sources as well as strong liquidity and capital positions. We purchased this short-dated secured bond at an attractive yield of more than 4% with less than 18 months to maturity. Beyond risk reduction trades, we continued to identify new idiosyncratic opportunities for the portfolio this quarter, an example of which is Annington Funding. Annington owns a residential property estate leased to the UK's Ministry of Defence. The UK government wants to buy Annington's estate back, and the current owners were already looking to sell. It is likely that, by one means or another, the UK government will ultimately end up buying the estate, and in the vast majority of scenarios, that's a good thing for bondholders. The surprising and arcane legal tactic that the government's lawyers are using to try to engineer the re-purchase has spooked the market and caused bonds to fall to prices which, in our view, all but eliminate downside risks with the potential for substantial capital upside for the patient investor.