BAILLIE GIFFORD

Diversified Return US Dollar Quarterly Update

31 December 2022

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Past performance is not a guide to future returns. Changes in investment strategies, contributions or withdrawals may materially alter the performance and results of the portfolio.

Material market or economic conditions will have an impact on investment results. The returns presented in this document are gross of fees unless otherwise stated and reflect the reinvestment of dividends and interest.

Historical performance results for investment indexes and/or categories, generally do not reflect the deduction of transaction costs and/or custodial charges or the deduction of an investment management fee, the incurrence of which would have the effect of decreasing historical performance results.

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Potential for Profit and Loss

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Product Overview

Diversified Return invests across a broad range of asset classes with the aim of achieving dual objectives:

Return
Targeting attractive portfolio returns: 3.5% p.a. over cash*, net of fees, annualised over rolling five-year periods.

A positive return over rolling three-year periods.

Risk
With lower volatility than equity markets: annualised volatility of less than 10% over rolling five-year periods.

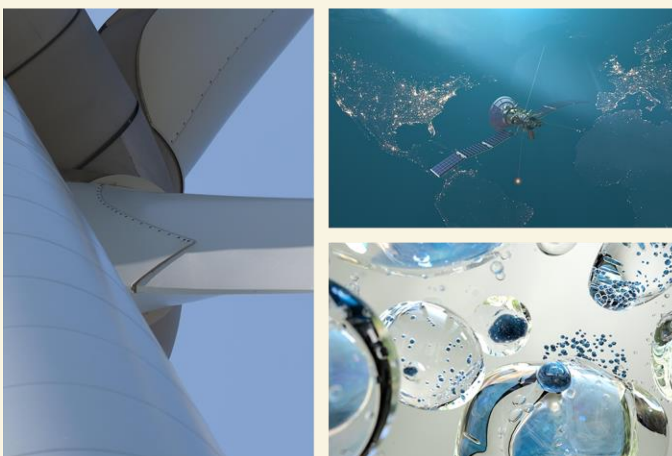
The performance objectives stated are not guaranteed.

*Cash rate applicable to base currency.

Markets closed 2022 much as they began: a sell-off in government bond markets weighing on most asset classes, with returns difficult to come by

The performance of the portfolio was approximately flat over the quarter, meaning that the full-year remained sharply negative

2023 is likely to remain challenging as central banks grapple to retain their credibility and force inflation back to target. However, we are confident in the prospects of good returns across a broad range of asset classes



Baillie Gifford Key Facts

Assets under management and advice	US$268.7bn
Number of clients	774
Number of employees	1839
Number of investment professionals	387

Market environment

Markets closed 2022 much as they began: a sell-off in government bonds weighing on most asset classes and returns difficult to come by. While the portfolio delivered a small positive return over the quarter, the full year remained sharply negative, meaning the longer-term numbers are behind their stated performance objectives.

As we look ahead, investment markets in 2023 will likely remain volatile as central banks grapple to retain their credibility and force inflation back to target. A recession in developed markets is a distinct possibility, and our view is that market estimates for corporate earnings are generally set too high.

While this basic assessment does not offer much cheer, we are confident there is more to get excited about. Whereas the first half of 2022 generally saw weakness across all asset classes and several of our investments performed poorly (particularly listed equities and property), the second half of the year has seen a number of asset classes start to show their diversification qualities. This, in combination with attractive valuations across many different asset classes, particularly fixed income and alternative forms of credit, gives us confidence as we look ahead, and we have been positioning the portfolio to take advantage of those opportunities.

Performance

In recent months we have seen some differentiation in performance across the portfolio's investments as asset classes' fundamental diversification qualities have begun to reassert themselves.

While equity markets have been a little more stable, the asset class as a whole has weighed on overall performance, albeit with a much-reduced allocation than where we started the year. Absolute Return also fell in value. The price of equity volatility protection (in the portfolio as VIX futures), which had performed well during September's LDI-prompted sell-off, fell in value over the fourth quarter as volatility remained generally subdued.

Some of the strongest performers in the portfolio over the last quarter include high yield credit, infrastructure and emerging market bonds. In China, a relaxation of strict Covid-19 rules, along with targeted support for otherwise struggling sectors (eg the property sector), has improved the economic outlook for the Chinese economy. This has proven to be particularly beneficial for the portfolio's investments in Asian high yield corporate bonds, given the relatively high weighting these investments have to domestic Chinese companies. Lastly, within developed market government bonds, 30-year US Treasury yields had been falling since data showed inflationary pressures starting to abate in November, albeit a brief year-end sell-off limited quarterly gains here.

Overall, with portfolio performance a small positive in Q4, we are starting 2023 with greater confidence that the market is finally coming around to a number of our key investment views.

Outlook

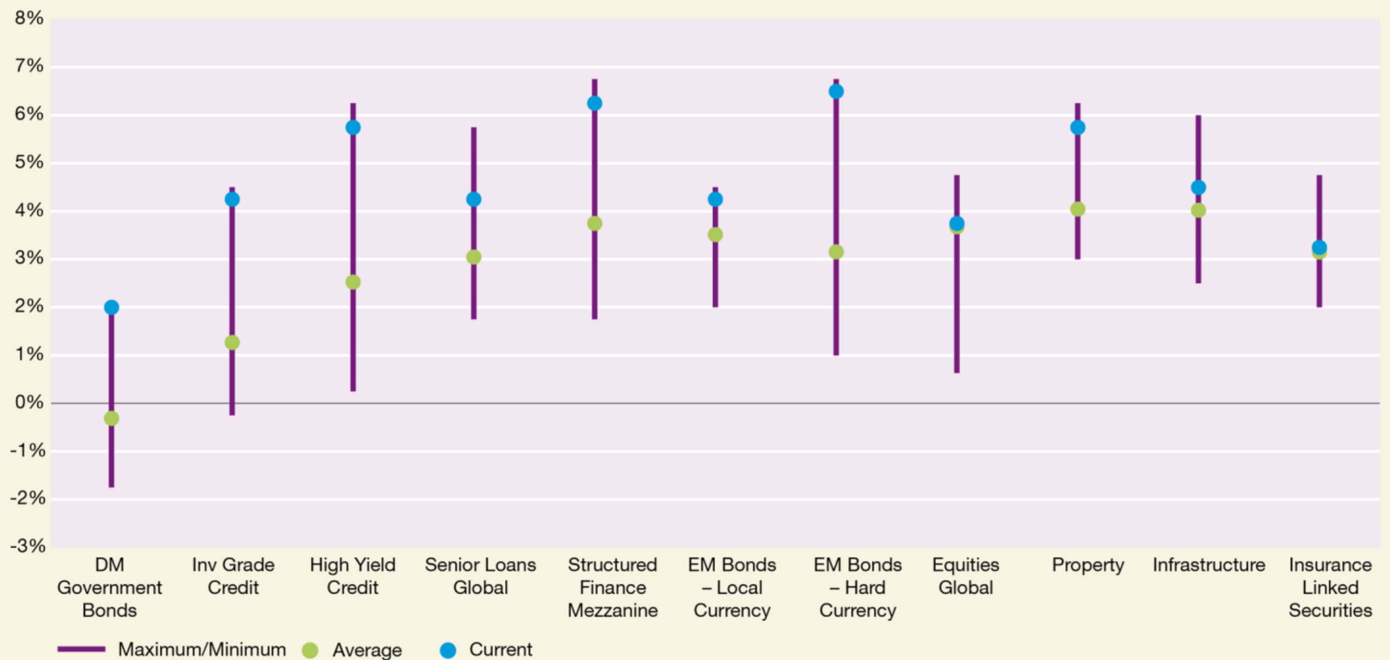
Choices made by central banks on policy and by governments on geopolitics will be significant in directing the global economy and investment markets in the shorter term. Monetary policy remains tight, and we expect policy rates to remain high until inflation is clearly on track to target. We believe that central banks are more likely to err on the side of caution, raising the chance of their inducing a recession in the US and Europe once excess savings have been drawn down upon. Therefore, as we look at the year ahead, we see more market volatility as likely.

However, we have much greater confidence in the medium and long term. Over that period, we expect a degree of normalisation, albeit with structural changes. We believe that demographics, inequality and high government debt levels are likely to combine to keep neutral interest rates (and long-term bond yields) low and that Asia will continue to be the centre of global economic growth. We also expect decarbonisation and technological innovation to remain important drivers of investment and productivity.

Against this backdrop and following a challenging year for investment markets in general, several asset classes appear to offer compelling value. Indeed, our 10-year asset class returns, as forecast by our long-term return expectations, are generally very close to their highest level since 2009.

Within our opportunity set, the fixed income asset classes generally offer attractive long-term opportunities benefiting from high starting yields. Structured finance and emerging market debt are also appealing, alongside the real asset classes of property and infrastructure. Essentially, we are seeing a broad range of compelling investment opportunities across the range of asset classes in which we can invest.

Long-term return expectations (%)



Note: Baillie Gifford estimates for asset class returns as at December 2022. Expected returns are passive and do not take account of potential alpha. We view these return estimates as broadly sensible indications of likely returns. They should not be interpreted as high precision forecasts nor are they likely to bear much resemblance to returns over shorter time horizons.

Positioning

Reflecting our outlook, more than half of the portfolio is invested in asset classes where fundamentals look likely to be more resilient than the market currently has priced or where valuations have already overshot to the downside, thus allowing us to express a high level of conviction in a wide range of high return opportunities.

This includes long-dated developed market government bonds and investment-grade credit. With 30-year US Treasuries trading at levels that are currently wider than our fair value estimate, our base case estimate is for good returns as yields begin to fall, although they should perform especially well in a recessionary environment. US and UK investment grade bonds are shorter duration than the Treasuries but benefit from being cheap relative to their long-run average, and at a time when maturities have been termed out, covenants are scarce, and interest coverage is high.

The portfolio also includes those assets closely associated with the decarbonisation push, particularly certain commodities such as aluminium and rare earths, where we see a scarcity of key materials necessary for an electrified future; logistics real estate, where space remains at a premium and contracted rents are well below market levels; Asian high yield, where Chinese property bonds are priced well below likely recovery levels, even in default; and mezzanine CLOs, where double-digit yields are available on these relatively safe structured finance assets.

The rest of the portfolio is invested in a broader set of attractive, diversifying positions, including infrastructure, where operational renewables and utilities generally offer stable returns; emerging market debt, primarily local currency bonds, which have proven to be diversifying through past crises and are likely to be a beneficiary of falling yields and China's reopening; and a combination of uncorrelated absolute return strategies and cash, the latter of these providing dry powder to take advantage of further near-term volatility.

Overall, the portfolio is relatively light on equity risk. While equities may not see further losses from here, the upside opportunity seems limited. As detailed above, we see a number of more exciting opportunities elsewhere across the asset class spectrum at our disposal. These opportunities offer both the potential of high returns and lesser risk. We are actively embracing these and believe that, by remaining true to our long-term, multi-asset philosophy, your portfolio can capitalise on these and look forward with confidence to 2023.

Performance Objective

To outperform the Federal Funds Rate by 3.5% per annum (net of fees) annualised over rolling five-year periods with an annualised volatility of less than 10% over rolling five-year periods.

The performance target stated is aspirational and in no way guaranteed, nor is it intended to be precise, and is not used for the purpose of determining or constraining the composition of the fund's portfolio. We believe it to be a reasonable estimate of the amount by which we can outperform the relevant benchmark in the long term through the consistent application of our investment process, taking into account the opportunity set and the characteristics of the markets in which the strategy invests. Performance may vary between segregated accounts and pooled funds in different jurisdictions as each structure will bear a different set of costs. A single performance target may not be appropriate for all vehicles in all jurisdictions and for this reason our fund specific materials will often refer to 'material' outperformance of a benchmark. Factors that may lead to Baillie Gifford failing to meet our investment performance objectives in future include a significant change in market characteristics such that our asset allocation approach is unrewarded for a period of time; or misjudgement of the prospects for long-term earnings growth for a significant of the asset classes in which we invest.

Periodic Performance

	Composite Net (%)	Federal Funds Rate (%)	Federal Funds Rate (%) +3.5%
3 Months*	1.5	0.9	1.8
1 Year*	-16.7	1.7	5.2
3 Years	-1.6	0.7	4.2
5 Years	0.9	1.2	4.7
Since Inception	1.7	1.2	4.7

Annualised periods ended 31 December 2022. *Not annualised.
Inception date: 30 April 2017.
Figures may not sum due to rounding.
Source: StatPro. US dollars.

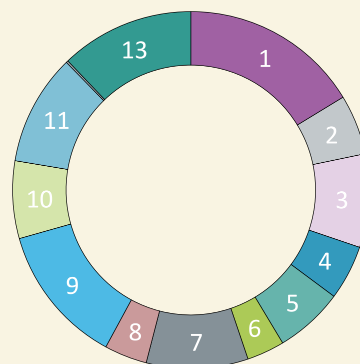
Discrete Performance

	31/12/17-31/12/18	31/12/18-31/12/19	31/12/19-31/12/20	31/12/20-31/12/21	31/12/21-31/12/22
Composite Net (%)	-3.8	14.5	6.1	7.7	-16.7
Benchmark (%)	1.9	2.2	0.4	0.1	1.7

Source: StatPro. US dollars.

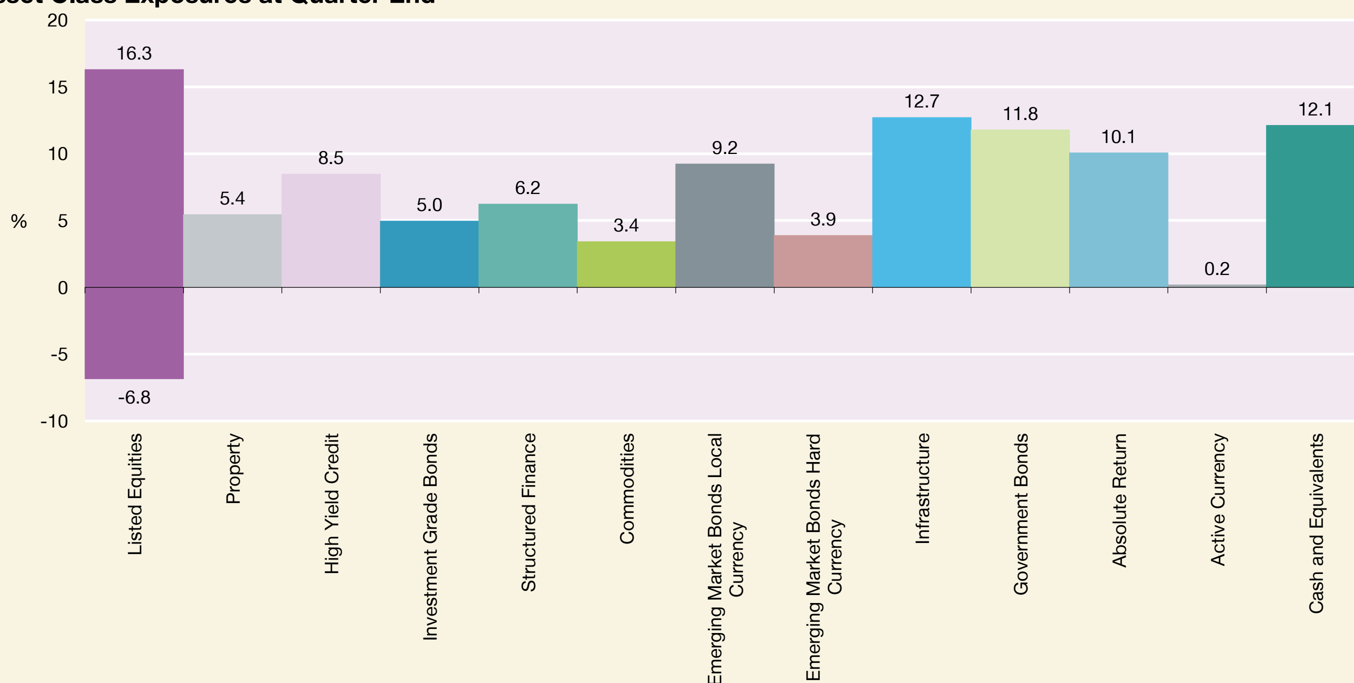
Asset Allocation at Quarter End

		(%)
1	Listed Equities	16.3
2	Property	5.4
3	High Yield Credit	8.5
4	Investment Grade Bonds	5.0
5	Structured Finance	6.2
6	Commodities	3.4
7	Emerging Market Bonds Local Currency	9.2
8	Emerging Market Bonds Hard Currency	3.9
9	Infrastructure	12.7
10	Government Bonds	7.0
11	Absolute Return	10.1
12	Active Currency	0.2
13	Cash and Equivalents	12.1
	Total	100.0



As at 31 December 2022. Total may not sum due to rounding.
When calculating the asset class weightings, all futures positions are included at 0% weight.
In addition to the asset class weightings shown, the Fund held short positions in government bond futures.
*Includes net active currency position.

Asset Class Exposures at Quarter End



As at 31 December 2022. Figures may not sum due to rounding
Futures positions are included at their net exposure weight and cash includes collateral held to back all long futures positions, therefore total portfolio exposure may not sum to 100%.
†The number shown against active currency reflects the net unrealised profit or loss of open positions in the Fund.

Predicted volatility is based on a snapshot of the portfolio at the end of the quarter, and provides a one-year prediction of the volatility of returns.

Risk Statistics (%)

Predicted Volatility	5.3

Source: Baillie Gifford & Co, Moody's Analytics UK Limited

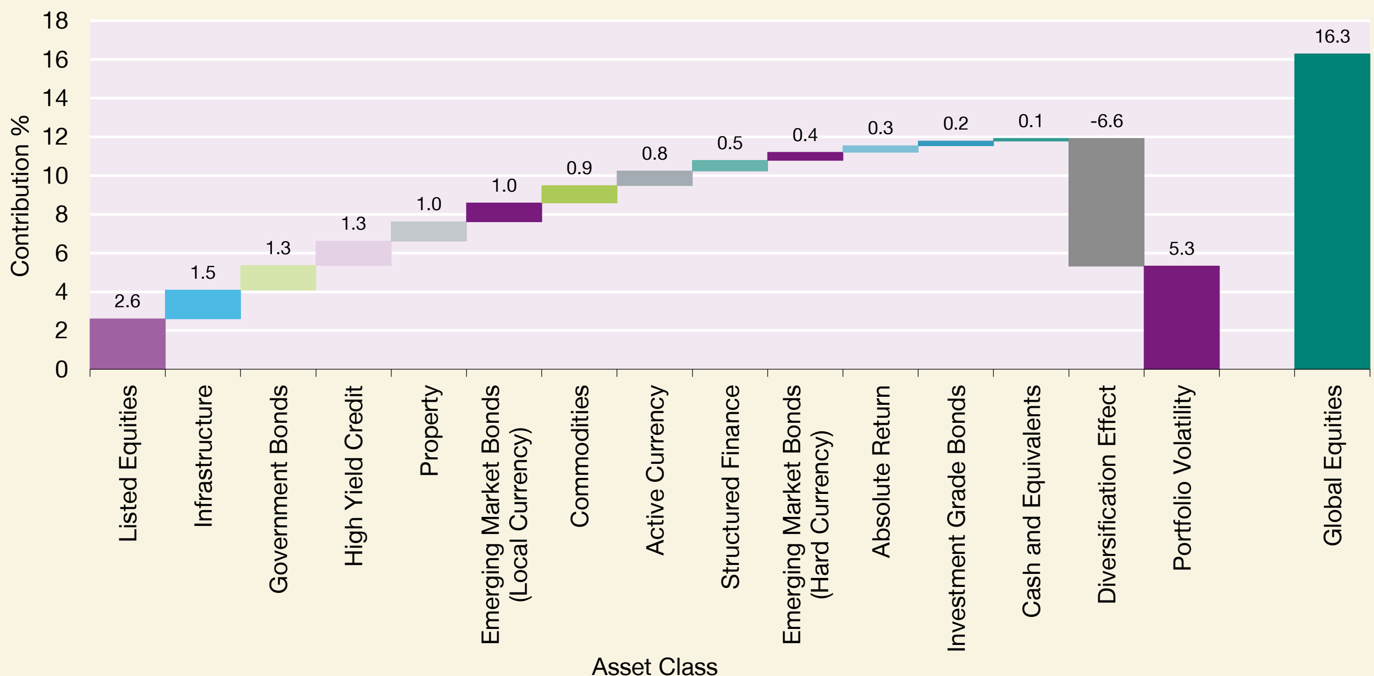
Monetary policy remains tight, and we expect interest rates to remain high until inflation is clearly on track to target. Central banks are likely to err on the side of caution, raising the chance of their inducing a recession

A variety of leading indicators are already showing weakness on a par with 2000 and 2008. This means that defaults should be expected to rise and earnings to fall in the near-term.

While we believe that current market levels, particularly in fixed income, offer more than adequate compensation for this, it raises the likelihood of volatility and further price weakness in the near-term

The risk attribution chart shows the contribution to predicted volatility of each asset class held in the portfolio at the end of the quarter. The diversification offset bar depicts the benefits of diversification, reflecting that asset classes are not perfectly correlated and therefore do not fluctuate in precisely the same manner over time. Therefore, the overall volatility of the portfolio is lower than the sum of the standalone volatility for each asset class. The blue bar shows the one year predicted volatility for global equities and is provided for context only.

Predicted Volatility – Attribution by Asset Class



Source: Baillie Gifford & Co, Moody's Analytics UK Limited and relevant underlying index provider(s).
Total may not sum due to rounding.
Global Equities: MSCI World Index.

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