PAYING THEIR DUES

INVESTING RESPONSIBLY FOR INCOME IN A TIME OF UNCERTAINTY

Toby Ross. Investment Manager, Responsible Global Equity Income Fund

BAILLIE GIFFORD

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Annual past performance to 30 June each year (net %)

	2016	2017	2018	2019	2020
Baillie Gifford Responsible Global Equity Income Fund (B Inc)	N/A	N/A	N/A	N/A	8.4
Baillie Gifford Global Income Growth Fund (B Inc)	13.7	23.8	5.7	12.6	7.2
FTSE All-World Index	14.0	23.0	9.4	10.1	5.7
IA Global Equity Income Sector Average	9.6	19.2	3.6	8.4	-2.6

Source: StatPro, FE, IA and FTSE. GBP. The Baillie Gifford Responsible Global Equity Income Fund launched on 06 December 2018 therefore no past performance is available before this date.

Past performance is not a guide to future returns.

The manager believes the FTSE All-World Index is an appropriate benchmark given the investment policy of the funds and the approach taken by the manager when investing. In addition, the manager believes an appropriate performance comparison for these funds 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 over shorter time periods.

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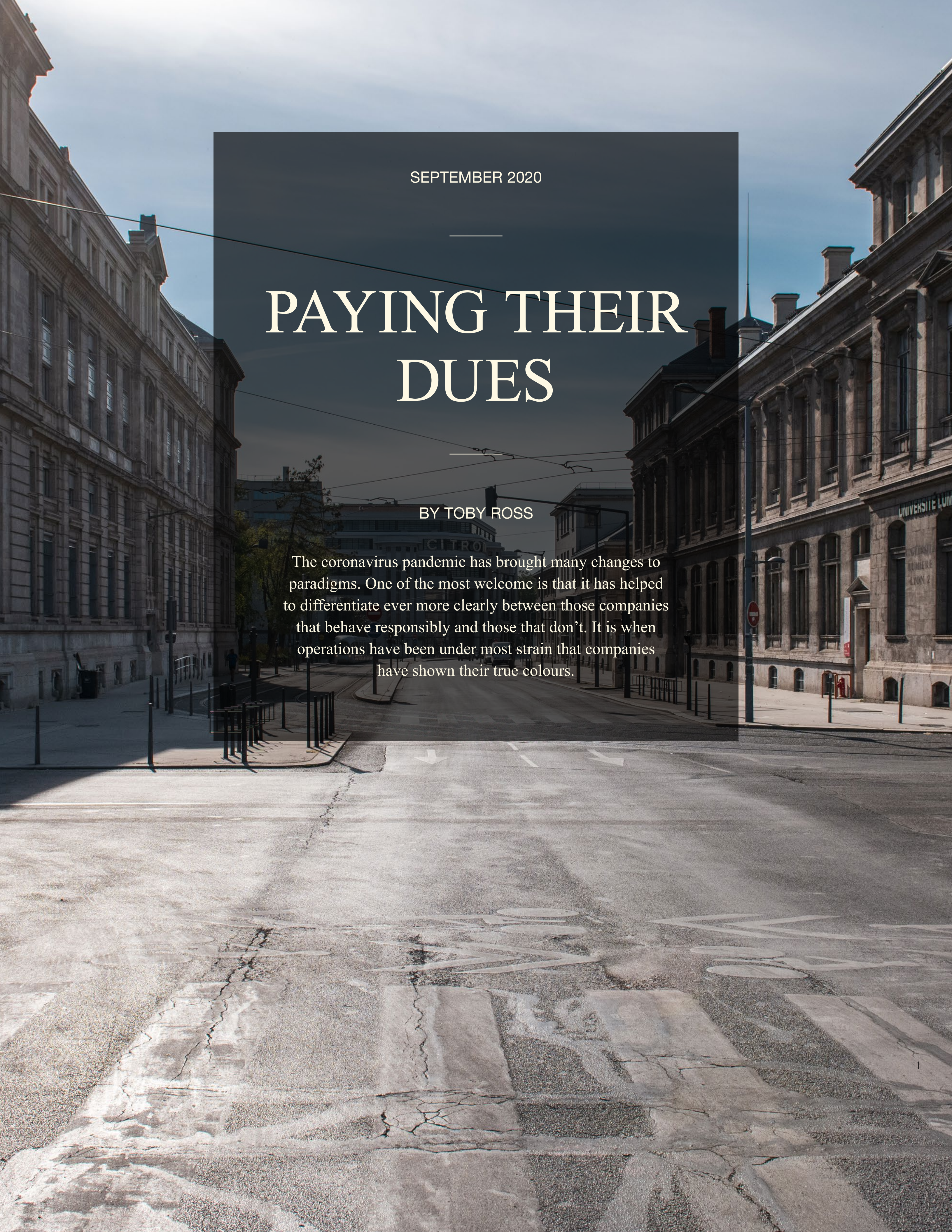
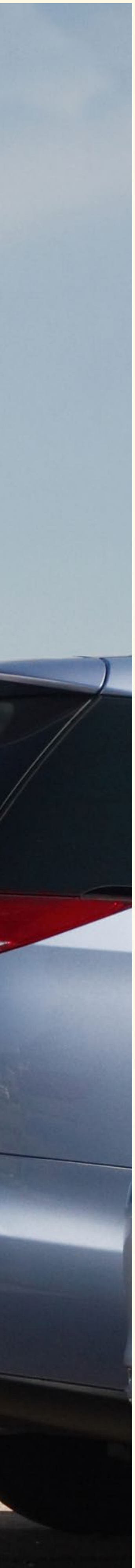


SEPTEMBER 2020

PAYING THEIR DUES

BY TOBY ROSS

The coronavirus pandemic has brought many changes to paradigms. One of the most welcome is that it has helped to differentiate ever more clearly between those companies that behave responsibly and those that don’t. It is when operations have been under most strain that companies have shown their true colours.



Over the last few months we've spent a lot of time talking to the management teams at companies in which we invest. This is partly to learn more about how they are responding in the current environment, and also to hear more about the trade-offs they are making between different imperatives. For instance, we want to know how they can continue to support customers if offices remain closed, or protect as much of the workforce as possible if volumes drop sharply, so that they remain able to serve customers.

In most of these conversations, we have been very encouraged by the ways that management teams were responding in real-time.

For instance, Wales-based car insurer Admiral didn't need a regulator to instruct it to 'treat customers fairly': when the company saw that fewer cars on the road would mean lower claims on insurance policies, it announced that it would give back £25 to each of its policyholders, to help cushion (in a small way) some of the financial impact of Covid-19. We spoke to management before this was announced, and they were adamant that "we will not profit from the pandemic – we will find a way to give it back."

On the other side of the world, Australian car listings business Carsales.com reduced subscription fees to zero in April because data about consumer behaviour showed that the car dealers to which it sells were about to see a sharp slowdown. Both Admiral and Carsales are now starting to reap the benefit in the form of greater loyalty from customers.

Similarly, the pharmaceuticals and diagnostics leader Roche has been ramping up its ability to run hundreds of millions of serology diagnostics tests to help governments know who has and has not already had Covid-19. It was obvious to management that these should be performed at cost, not for a profit margin, because they have a clear sense of what it means to be a responsible company.

Many of the management teams we've spoken to have also talked about the lengths they've been going to protect their employees. In some businesses it is just not possible to avoid redundancies when the demand environment changes drastically, but the message we've given to management teams and boards is to do what is right for the business over five or ten years, not what helps protect this quarter's margins. Often that means preserving the company's muscle for the rebound.

For most of the management at companies in which we invest, this is second nature, and the most common response we've heard is "we're glad to hear you say that – because we agree."

However, we still think it's important that we give them this encouragement. It has been depressing on many conference calls to hear management being questioned about the quarterly profile of costs, and asked to predict how profit margins will evolve in this uncertain year. Few questions were asked about the company's people or its customers. This all adds to the pressure on management to cut costs for short-term benefit. At times like this, the most valuable role that long-term investors can play is helping buttress management teams against this noise.

In the cases of a couple of businesses we had not yet invested in, observing management's actions has been very useful. Watching medical devices business Medtronic maintain its research investment and top up employees' pay, even as volumes dropped, assured us that it is a company which shares our long-term time horizon. This helped give us the confidence to invest in it for our clients.

IT'S NOT WHAT YOU DO, BUT WHAT YOU DO WITH IT?

However, we manage a responsible income strategy, and one of the biggest changes over the last few months has been a change in the emphasis not just on how companies make profits, but how they distribute them. Bruno Le Maire isn't the only person to draw a straight line between being a responsible corporate citizen, and dividend decisions.

This won't make us popular with many income managers, but we agree with Bruno – at least sometimes.

It's most obvious in sectors such as banking. The capital cushions that banks carry are a shock absorber between economic uncertainties and the real economy. Dividends paid by banks give those shock absorbers less cushioning. Banks may plead that they don't or won't need them, but they can't know what the future holds. What if they pay out the capital now, only to find they need it back in darker days six or 12 months down the line?

In the end, it usually falls back on the taxpayer – i.e. society at large. Taxpayers around the world have been very generous in providing liquidity to companies or supporting their payrolls. Many will ask why they should expect to see that cash going straight out the door in dividends to shareholders, who may be based on the other side of the globe. The quid pro quo here is obvious.

However, there's an extension of Bruno's argument that says: companies should reduce dividends out of a sense of solidarité. This leaves us scratching our heads. That's partly because we have a different view of what dividends are for.

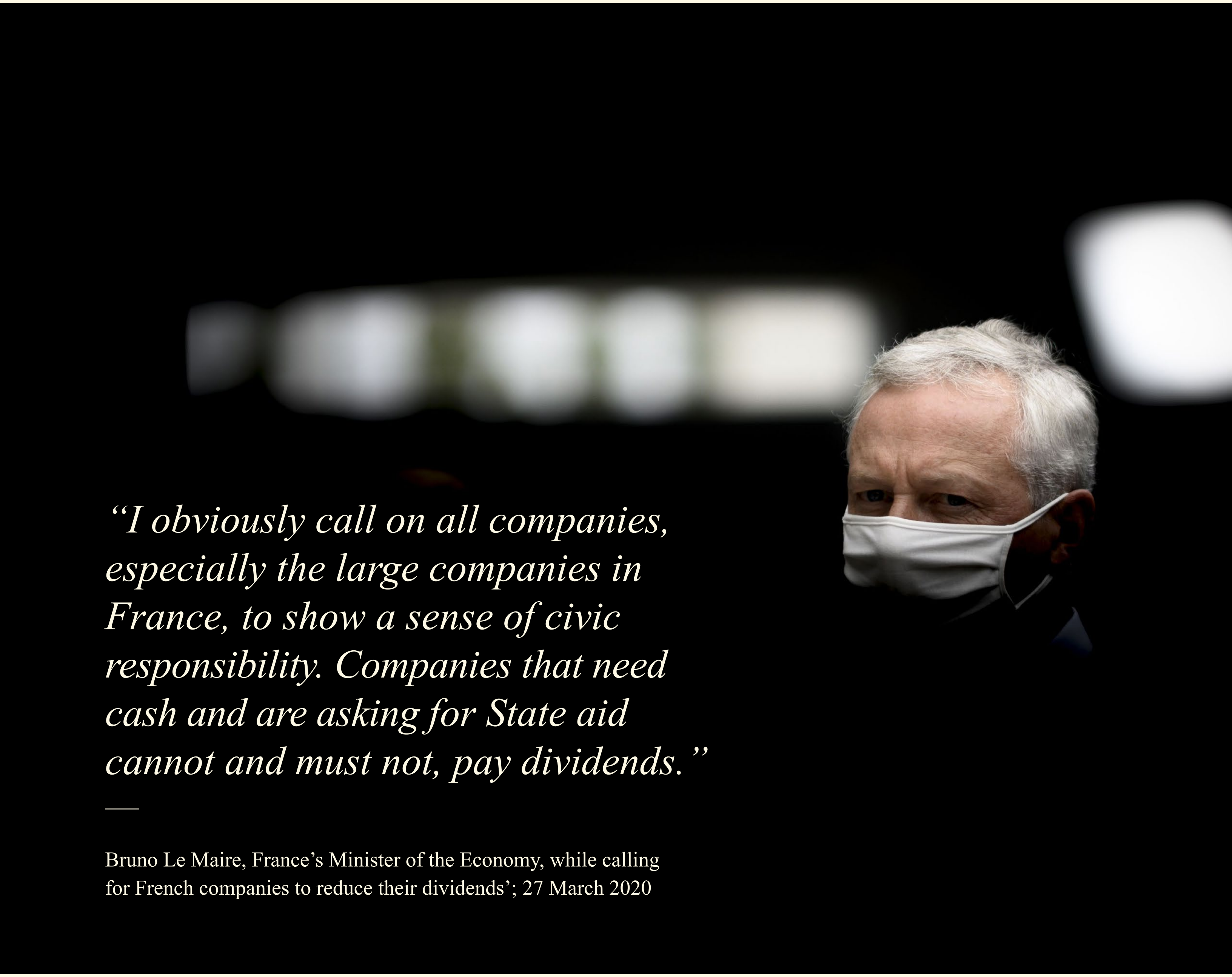
If dividends were simply a symbol, then maybe Bruno would have a point. But whatever management consultants may tell CEOs about the 'signalling power' of dividends, we disagree. The real, fundamental value of a dividend is in transferring cash out of the hands of companies that do not need it in order to support their customers or grow, and into the pockets of savers or investors, who need to spend it.

Our ideal business will need relatively low reinvestment to drive growth. It will be a matter of hiring people, adding lines of software, or opening a new distribution site. It won't be building new car factories, or setting aside significant capital for future loan losses.

This is one reason why we end up skewed so heavily away from capital-intensive businesses such as banking, utilities, or telecoms (which make up less than 5 per cent of our portfolio). These are often businesses where there's an ongoing tension between dividends today and the ability of the business to grow. It's a tug of war.

One beauty of these capital-light businesses for the income investor is that they have the potential to produce both growth and dividends. Over time, owning these has been one reason our Global Income Growth Fund has delivered much stronger returns than other dividend investing approaches.

During this crisis, we've seen another benefit. One pleasant surprise has been how many of the businesses we invest in have not seen a tension between dividends and doing the right thing for their stakeholders. Nor has that been the case between dividends today and growth tomorrow. They've been run with more conservative balance sheets than peers, their underlying growth has often been strong, and they are usually the leaders in their industry, with features such as higher margins. And they've been run along long-term lines in any case. When the going has got tougher, most have been able to do the right thing



"I obviously call on all companies, especially the large companies in France, to show a sense of civic responsibility. Companies that need cash and are asking for State aid cannot and must not, pay dividends."

Bruno Le Maire, France's Minister of the Economy, while calling for French companies to reduce their dividends'; 27 March 2020

for their broader stakeholders and their shareholders. Indeed, in most cases they've been able to increase their dividends. This is why all of our 10 largest holdings in the Responsible Global Equity Income Fund have grown their dividends in 2020 (data from 30 June 2020).

So, our current expectation is that our income this year will fall by only a mid-single digit amount – far less than if we'd been exposed to many companies where the choices around dividend payments have been tougher.

LOOKING FORWARD: A CHANGED CLIMATE

At the start of each year we set out our engagement priorities for the period ahead. The impact of the coronavirus made us reshuffle these priorities in the first half of the year. We felt that by far the most useful thing we could do for our clients and our holdings was to offer companies our support, and (where we can) make it easier for them to make socially responsible choices, even if that has a near-term financial cost.

But looking ahead, we think it's time to refocus on this plan, and especially on the challenge of climate change. Some commentators have said that the push to lower global emissions will weaken in a post-Covid-19 world, as governments and individuals worry about nearer-term issues.

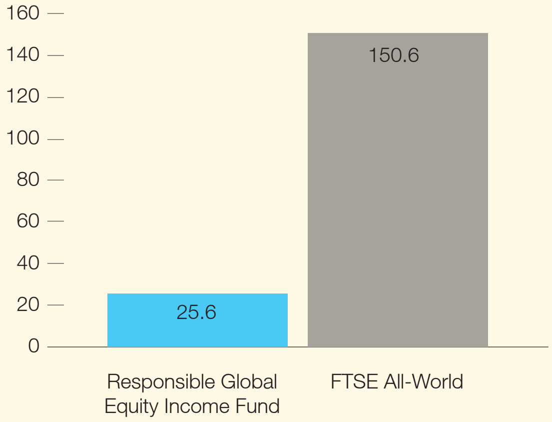
We disagree. The pandemic has graphically brought home the potential impact of tail risks – 'known knowns' – where it is still uncertain exactly where the impact will be felt. It has shown that resilience isn't always greatest where you may most expect it. But it has also shown that society is capable of changing radically when the threat is perceived as being 'immediate' enough. Chasms that seem impossibly deep can be crossed quickly.

Over the second half of the year and beyond, we will continue to support our holdings in managing the aftershocks of the pandemic; but we also think our civic and fiduciary duty is to be increasingly demanding of them around their climate change strategies. We are engaging with boards to seek aggressive, realistic goals, supported by better reporting.

Our carbon footprint may be dramatically lower than the wider market, not least because we exclude fossil fuel producers altogether. However, we don't see any room for complacency here: if our companies are going to still be robust dividend payers in five or ten years' time, we will need them to be on the front-foot when thinking about tomorrow's challenges.

Low Carbon Footprint

Relative Carbon Footprint (tCO2e/GBP Million Invested)



Source: YourSRI Platform and Baillie Gifford & Co.
As at 31 March 2020.

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Toby joined Baillie Gifford in 2006 and is Co-Head of the Global Income Growth Team and Joint Manager of The Scottish American Investment Company PLC (SAINTS). He has also been a member of the International Alpha Portfolio Construction Group since 2018. Since joining Baillie Gifford, Toby has also spent time as an Investment Analyst in the UK Equity Team and as a Global Sector Specialist. He graduated MA in English Literature from the University of Cambridge in 2006 and is a CFA Charterholder.

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