INCOME THROUGH A GROWTH LENS

Toby Ross, Investment Manager.

BAILLIE GIFFORD

IMPORTANT INFORMATION AND RISK FACTORS

The views expressed in this article are those of Toby Ross and should not be considered as advice or a recommendation to buy, sell or hold a particular investment. They reflect personal opinion and should not be taken as statements of fact nor should any reliance be placed on them when making investment decisions.

This communication was produced and approved on the stated date and has not been updated subsequently. It represents views held at the time of writing and may not reflect current thinking.

Potential for Profit and Loss

All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk.

Past Performance

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

Stock Examples

Any stock examples and images used in this article are not intended to represent recommendations to buy or sell, neither is it implied that they will prove profitable in the future. It is not known whether they will feature in any future portfolio produced by us. Any individual examples will represent only a small part of the overall portfolio and are inserted purely to help illustrate our investment style.

This article contains information on investments which does not constitute independent 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.

All information is sourced from Baillie Gifford & Co and is current unless otherwise stated.

The images used in this article are for illustrative purposes only.

Annual Past Performance to 31 December Each Year (net %)

	2015	2016	2017	2018	2019
Baillie Gifford Global Income Growth Composite	12.8	6.3	16.1	0.5	27.9
MSCI ACWI Index	10.4	9.0	15.4	1.2	27.5
eVestment Peer Group Average*	9.1	8.1	10.2	0.3	23.3

Source: Baillie Gifford & Co, MSCI and eVestment. Australian dollars. Based on a representative Global Income Growth portfolio.
*Based on the average return of strategies in the eVestment Global Dividend Focus Equity universe. Data is based on all strategies in the eVestment Global Dividend Focus Equity universe.

BAILLIE GIFFORD

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 www.bailliegifford.com

CM12757 Income Growth Lens 45285_AUD 0220.indd
Ref: 45285 PRO AR 0021

FEBRUARY 2020

INCOME THROUGH A GROWTH LENS

BY TOBY ROSS

We are long-term income growth investors, working in a well-known growth investment house. This seems to surprise some people. In fact, one of the questions we get asked most often is: but isn't income a 'value' strategy?

Our honest answer is that for us it isn't. Many income managers do describe themselves as value investors. For them, yield is a useful valuation prism. However, we view income investment in a very different way – for us, the goal is to maximise our clients' long-term income, rather than take advantage of a stock's near-term yield. As growth investors, Baillie Gifford has something quite different to offer clients looking for income from equities – and an approach which we think will deliver much better returns over the long run.

WHY INVEST IN EQUITIES FOR INCOME?

Underpinning the confusion about investment style is a common misconception about the value of equities for a long-term income investor. Many people think that the most attractive equity income investment is the one with the highest near-term level of income.

However, we think investors need to take a step back and ask themselves: why am I considering investing in equities for income? There are many types of asset that can deliver a stream of income; many flavours of bonds, or property, or infrastructure. In most of these cases the underlying income stream is contracted, so there is a legally-binding promise to pay cash to the investor.

Equities are different. Equity income comes from dividends, and dividends are the result of company board decisions. As times change, so can a company's commitment. Without a contract behind them, equities are intrinsically a more risky source of income than some of these other sources. Despite this risk, though, dividends have a significant attraction for income investors: their ability to grow.

To illustrate this point, let's imagine a retiree with $10,000 in annual income coming from bonds. After a year, inflation will have reduced the purchasing power of this income by, say, 2 per cent. That's the equivalent of about a week's worth of income that the retiree won't be able to spend next year. This may not sound like much. But after 20 years, inflation will have eaten away about one-third of this investor's income – the equivalent of four month's worth of spending. Of course, many retirees will live for more than 20 years. Long-term inflation therefore poses a significant risk to the income they will receive from bonds.

What is happening to the investor's income is also happening to the purchasing power of their capital. Because the face value of a bond does not increase over time, inflation is constantly eroding the bond's capital value. In the short term, the effect is not obvious, but over longer time periods the impact is drastic.

Equities have the potential to deliver a very different outcome. A share is a slice of ownership in a real business, whose managers are constantly trying to find ways to grow. Over time, a well-positioned company can grow its sales and profits, by developing new products or expanding into new markets. Rather than just keep up with inflation, this growth may significantly outpace it. If the profits are growing, then that usually means dividends are growing too – and so is the purchasing power of an investor's capital.

This ability to deliver real growth in both income and capital is a crucial difference when compared with, for example, bonds. The longer an investor's time horizon, the more important this ability to deliver real growth becomes. It is the ability to deliver real growth over a long period that makes income-generating equities a vital part of any income investment portfolio, in our view. For some people, such as those in retirement, the role of equities may be to offset the eroding effect of inflation on their other income-generating assets, by being the 'growth' part of the portfolio. For others, the prospect of getting both a growing stream of income and capital growth will mean equities give them greater flexibility over the course of their retirement.

However, to get these benefits, it is important to focus on long-term income, not short-term yield.

WHAT TYPE OF EQUITIES?

We have said that equities can deliver a very useful combination of both income today, and real growth in both income and capital for the future. But we don't believe that all dividend-paying equities are suitable for delivering these outcomes over the long run.

Firstly, we think the companies that can deliver both dependable dividends and real growth over the long term are usually those where growth doesn't require large up-front capital investments. In other words, they are cash-generative, 'capital-light' businesses.

For capital-intensive businesses such as telecoms companies, utilities, or real estate companies, delivering growth ahead of inflation usually requires big upfront investments in equipment, networks or buildings. Many of these businesses pay out a lot of their profits as dividends – but they also experience a natural tension between dividends on the one hand, and investment for growth on the other.

This is especially true when the overall profitability of a business is low, for example because its large up-front investments only generate a modest additional amount of cash. One temptation for the management of such businesses is to try and make up for low underlying levels of growth and low returns on capital by loading up their balance sheets with debt, or by taking on big acquisitions. These balance sheet manoeuvres can deliver a short-term boost to earnings, but they tend to increase the long-term riskiness of the business.

This relates to the second challenge. What income investors require is a dependable source of income that they can rely on during times of stress. Many dividend-paying companies are unlikely to meet this need. Take a marginally profitable business that has stressed its balance sheet in order to deliver some short-term growth. Such a company is likely to struggle to maintain its dividend when times get difficult. History shows that a surprisingly large number of companies struggle to maintain their dividend commitments through thick and thin. The equities that make sense for a long-term income investor are a sub-set of the dividend-paying equities on offer – companies that can reliably pay dividends through good and bad times. The companies that can do this will have better fundamental business characteristics, good underlying growth, and boards that are strongly committed to their shareholders.

– History shows that a surprisingly large number of companies struggle to maintain their dividend commitments through thick and thin.

FINDING LONG-TERM INCOME GROWTH

This is why our investment process focuses on finding businesses with significant long-term opportunities to grow, but not requiring large up-front capital investments. We think an investor can get both real long-term growth, and a dependable stream of dividends from these businesses.

In our experience, such companies are few and far between, and can't be identified by screening for specific characteristics. The opportunities tend to be stock-specific, and require judgement. Bottom-up stock selection is essential, in our view. Indeed, most of our time is spent looking for businesses that might be candidates for this, and putting them through our research framework. We think the best way to deliver real growth over time is to put it at the heart of the research process. One of the first questions we ask is therefore around the long-term opportunity to deliver real growth in profits.

Because these companies are rare, investors improve their odds significantly if they give themselves the widest possible opportunity set. We have a global universe of around 2,500 dividend-paying stocks. This allows us to be picky, and not rely too heavily on a small number of holdings for income. It also allows us to truly diversify the portfolio whilst investing in only a modest number of holdings overall. No stock contributes more than 5 per cent of the portfolio's income stream, no industry more than 10 per cent of the income, and no country more than 30 per cent of it. Our portfolio features eclectic growth opportunities from Europe, the US, Asia, and emerging markets, with many fundamentally different drivers of growth.

Indeed, we are always surprised that so many income investors restrict themselves to relatively narrow markets with a high degree of dividend concentration. For example, in the main indices in Canada, Brazil, or Australia, around half the dividends are paid by companies in just two or three industries. Typically these are mature, capital-intensive industries where there is tension between dividends and growth – for instance, banking, oil and gas, telecoms, or mining. In many cases, these largest dividend-payers have just got the balance wrong between cash returns and growth, encouraged by yield-hungry investors in their local markets. As a result, the overall dividend level of many of these large dividend payers has historically been volatile. We tend to own few of them.

So a global universe is very helpful for tilting the odds in an investor's favour.

We also think that we have two specific advantages in our search.

Firstly, Baillie Gifford as a firm has spent the last century developing expertise in investing in growth businesses. As the Global Income Growth team, we benefit hugely from the research of our colleagues on other teams, whether they are our global equity strategies, or those focusing on stocks listed in Japan, or emerging markets. In fact, 57 per cent of the investments in the Global Income Growth portfolio are owned in other Baillie Gifford growth equity strategies.

The sharing of ideas works because we are looking for many of the same things: a large growth opportunity, a differentiated business model, and a well-aligned, thoughtful management team. The biggest difference compared with our colleagues is that our team's investment process puts an additional focus on the ability of a business to seize these opportunities whilst also paying dependable dividends. We therefore think hard about questions like the capital intensity of growth, and board attitudes to dividends.

Secondly, we think Baillie Gifford's long-term investment horizon is very helpful – and well-aligned with our income growth clients' needs. We believe that compounded earnings and dividend growth over long periods can be very powerful, and is easily overlooked by investors focusing on near-term income or the pattern of quarterly earnings.

Our team therefore focuses all our research on the long-term level of a company's profits and dividends. When we have found a good idea, we like to hold the shares to allow this compounding to work. The turnover of our strategy is typically 15–20 per cent, consistent with our five-year plus investment time horizon.

Taking such long-term holdings is easier in a stable partnership, where our clients' interests are paramount. Baillie Gifford has that type of ownership structure.

– ONE OF THE FIRST QUESTIONS WE ASK IS AROUND THE LONG-TERM OPPORTUNITY TO DELIVER REAL GROWTH IN PROFITS.

INCOME GROWTH IN ACTION

We have already stated that our growth approach to income investing starts from a very different philosophical position compared with many of our peers. We think that growth is at least as important as today's income to a long-term income investor, and we construct our portfolios with this in mind. We therefore don't impose any minimum yield constraints on holdings, but we do demand that every stock in the portfolio will deliver a minimum level of real profit growth over time.

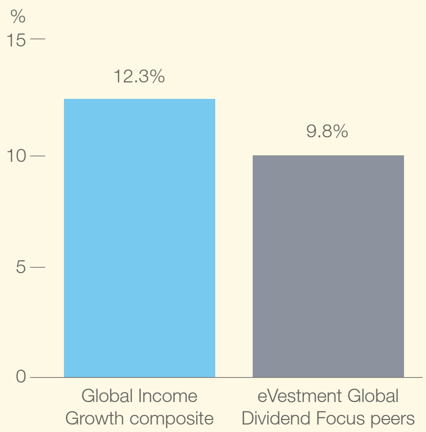
This means our portfolio looks very different from those of many of our peers. It has very little exposure to mature, capital-intensive businesses, such as utilities, or telecoms, or yield-generation vehicles such as REITs. It has lots of exposure to capital-light growth businesses from around the world. Because we think these businesses are growing in real terms, we expect them to deliver not just income today, but real growth in both income and capital – and strong total returns as a result.

Over time, the Global Income Growth strategy has done just that, with total returns that have, over the past five years, outpaced our peers who are more skewed towards 'traditional income'.

It has also delivered 29 per cent more income than a passive investment in global equities over the last five years, with lower volatility of capital along the way.

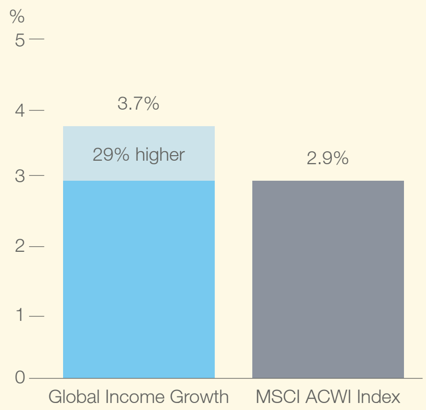
In summary, we like the fact that our 'growth' approach to income investment surprises people. We take it as a sign that we are looking at our clients' needs through a different lens, and so giving them something genuinely useful.

Total Returns



Net of fees, compared to other dividend strategies.
5 years p.a. to 31 December 2019, annualised.

Total Income



Relative to the global equity market.
5 years cumulative to end 2018.

Volatility

Average Beta: over 5 years to 31 December 2019.

Source: Baillie Gifford & Co, MSCI, eVestment. Data in Australian dollars.

IMPORTANT INFORMATION

This material is provided on the basis that you are a wholesale client as defined within s761G of the Corporations Act 2001 (Cth). Baillie Gifford Overseas Limited (ARBN 118 567 178) is registered as a foreign company under the Corporations Act 2001 (Cth). It is exempt from the requirement to hold an Australian Financial Services License under the Corporations Act 2001 (Cth) in respect of these financial services provided to Australian wholesale clients. Baillie Gifford Overseas Limited is authorised and regulated by the Financial Conduct Authority under UK laws which differ from those applicable in Australia.

Baillie Gifford Overseas Limited provides investment management and advisory services to non-UK Professional/Institutional clients only. Baillie Gifford Overseas Limited is wholly owned by Baillie Gifford & Co. Baillie Gifford & Co and Baillie Gifford Overseas Limited are authorised and regulated by the Financial Conduct Authority in the UK.

Persons resident or domiciled outwith the UK should consult with their professional advisers as to whether they require any governmental or other consents in order to enable them to invest, and with their tax advisers for advice relevant to their own particular circumstances.

Legal Notice – MSCI

Source: MSCI. The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an ‘as is’ basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the ‘MSCI Parties’) expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages. (www.msci.com)

ABOUT THE AUTHOR

TOBY ROSS

Investment Manager, Co-Head of Global Income Growth Team

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 ACWI ex US 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.

CURIOUS ABOUT THE WORLD

bailliegifford.com/thinking

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / www.bailliegifford.com