

Some Suspicions About the Coming Years

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BAILLIE GIFFORD

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Annual Past Performance to 31 March Each Year (%)

	2016	2017	2018	2019	2020
International Growth Composite Net	-11.7	18.4	35.7	-5.4	-1.1
MSCI AC World ex US	-8.8	13.7	17.0	-3.7	-15.1
LTGG Composite Net	0.7	19.1	40.7	8.4	10.7
MSCI World AC	-3.8	15.7	15.4	3.2	-10.8

Source: Baillie Gifford & Co. US Dollars.

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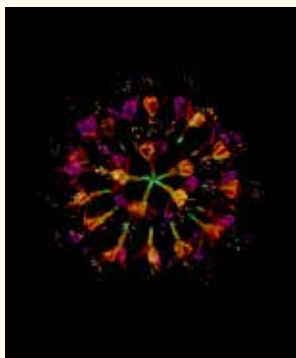
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SEEKING GUIDANCE

At times of stress we need anchors. Pontification is not good. But it's expected in almost every video and podcast. Let's look instead at some of the guidance that true experts and greater minds might be giving us before we rush to vainglorious judgment of the right course of action. We're trying to glean clues from deep expertise. I apologise if this piece therefore occasionally seems reluctant to draw definitive investment conclusions.

HANS ROSLING ON SCARY STATISTICS AND RATIONALITY

We've often cited Hans Rosling in the past. He spoke at two of our conferences. Sadly, Professor Rosling is no longer with us but his lessons seem ever more relevant amidst the coronavirus of 2020. He cited a pandemic as the first on his list of fears that might interrupt quiet progress. He spent much of his career as an epidemiologist. He grasped the mathematics of exponential growth. Moreover he translated theoretical knowledge into action in a remarkable manner.

“Statistics can be terrifying ... I saw a line on a graph that gripped me with fear. I had been concerned about the Ebola outbreak ... But in my work, I often heard about sudden outbreaks of deadly diseases, and I had assumed it was like most others and would soon be contained. The graph in the World Health Organization research shocked me into fear and then action...



Liberian Red Cross team in Monrovia, Liberia.
© NurPhoto/Getty Images.



*Rosling was no
academic theoretician.
He cancelled all his
assignments and flew
to Liberia.*

They showed, for the first time, that the number of cases was not just increasing along a straight line: 1, 2, 3, 4, 5. Instead the number was doubling like this: 1, 2, 4, 8, 16. Each infected person was infecting, on average, two more people before dying. As a result, the number of new cases per day was doubling every three weeks ... Within only nine weeks (the time needed for three doublings) the situation would be eight times as desperate. Every three-week delay in dealing with the problem would mean twice as many people infected and twice as many resources needed.” (*Factfulness* p74–6).

But Rosling was no academic theoretician. He cancelled all his assignments and flew to Liberia. He stayed over Christmas and the New Year. It’s possible his actions shortened his life. They certainly shortened the Ebola outbreak.

LESSONS

Apart from inspiration, what can we take from this as investors? We've spent much of the last decade trying to understand the dynamics and repercussions of exponential growth in a corporate setting. It's been worthwhile. Yet we have been aware enough of the potential for malign viral growth that we think it is indulgent to label Covid-19 as a Black Swan. Sadly, it was always all too conceivable to be that.

But the central point remains. For both growth and decay we need to understand the power of doubling. We don't see markets as being at all comfortable in handling this in either direction. One striking illustration comes from Max Levchin, co-founder of PayPal and now CEO of Affirm, a

consumer finance start-up in which Baillie Gifford has a holding. He was endeavouring to explain Elon Musk's misjudged outburst claiming the virus was unthreatening. He said "I think it is a great illustration of how it is really, really hard for human beings to understand exponential growth. Even if you've been in Silicon Valley your entire life ... it's still incredibly difficult to internalise this idea that we saw one or two infections and today we are seeing hundreds." If Musk can't do this then however much the pandemic seems instructive then I very much doubt markets will be able to digest this lesson.

In this context we have become increasingly concerned that negative exponential change might be the best

way of thinking about climate change. It carries its own analogous, if distinct, self-reinforcing logic. Just as the more a virus spreads the more dangerous it becomes so too the more the climate changes the still worse it gets. It may not be doubling as with Ebola but it is certainly likely to be accelerating in pace and consequences. If you like it is scary progression intermediated by the hard-to-track feedback loops that complexity science describes. This means we need early information and ideas that are transformative if possible rather than just limiting damage. We're not sure that standard ESG metrics grasp this. As with pandemics what we require is the ability to do far more than we assume to be necessary initially. Getting ahead of the curves is hard but essential.

BUT BE RESOLUTE

Yet before leaving Hans Rosling, we believe he would have asked us to raise our eyes. The virus is a matter of deep seriousness. But it is also an event that captures our minds to an inevitable, traumatic, personal and immediate extent. It is the very paradigm of what Rosling termed the “negativity instinct” and the “fear instinct”. He was an observer, a rational observer, not an optimist.

But he warned us that unusual and negative events warp our minds: “if we are not extremely careful, we come to believe that the unusual is usual: that this is what the world looks like.” The investing analogy is that when dramatic, negative events occur that our time frame contracts even more than is normal. That 2020 will see disastrous earnings tests our minds but if balance sheets can cope then the value of a company is still the value of the long-term free cash flows into eternity. Without wishing to be complacent that resilience ought to be present in our holdings. Of course shocks are inevitable yet for true growth companies the appealing underlying prospects ought to survive the challenge. After all the normalised annual increase in sales, earnings and cash flows should exceed the rate at which we discount those outputs. The out years matter more not less to our portfolios than 2020.

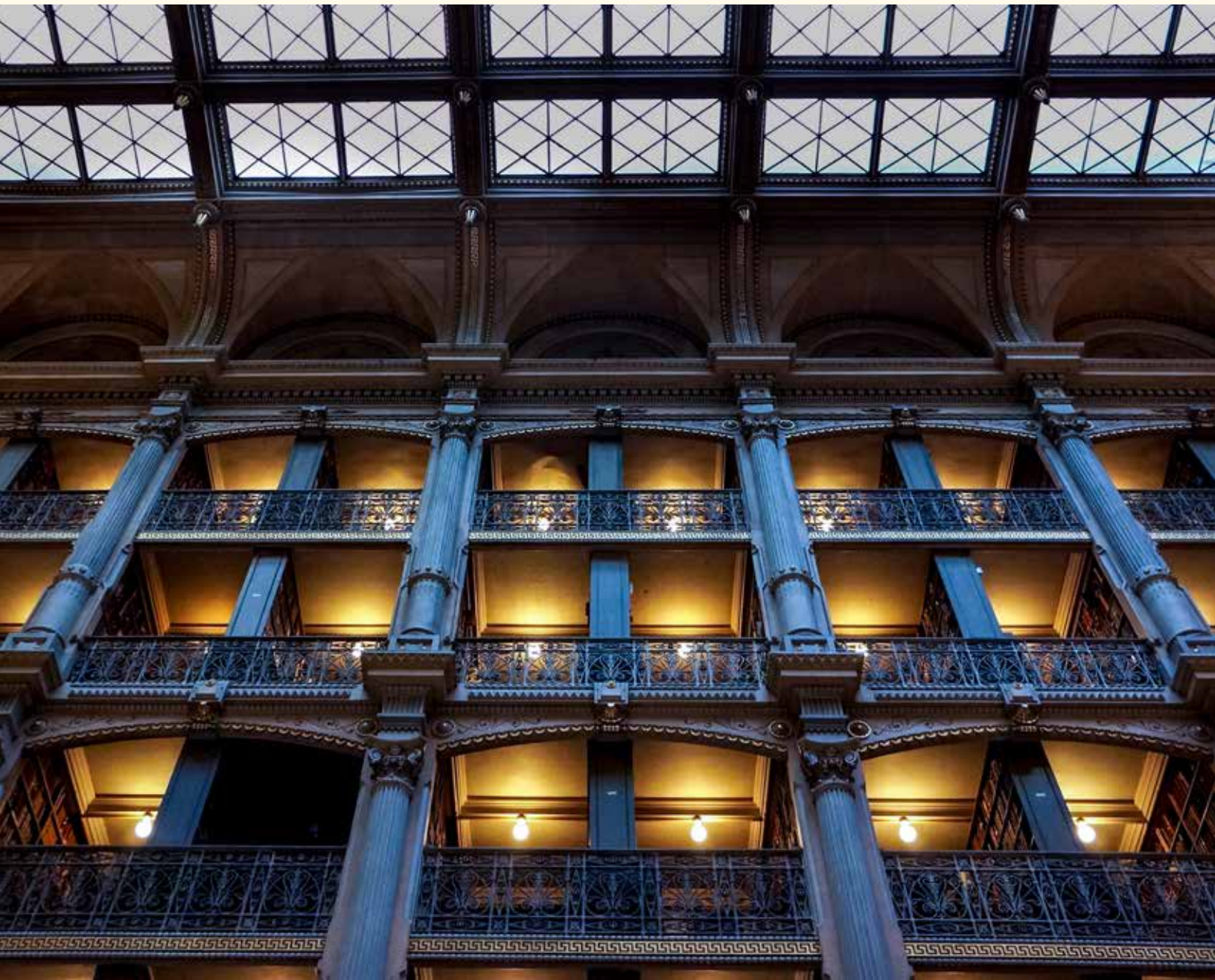
JOHNS HOPKINS

Before moving onto slightly more direct investment observations there's another source that I should mention. I'm a Trustee of Johns Hopkins University and it's been a privilege to see their response in a public health emergency. I don't normally write about Hopkins but it seems relevant now.

The central point I want to make is that the underlying thought process at Hopkins is a long way away from that demonstrated by the investment industry. It eschews prediction. Data comes first. It is followed not by projection and forecasts but by identification and enumeration of the challenges – should circumstances move in directions plausible or

improbable. It's data-dependent not in the sense of slavishly following the most recent numbers but in the deeper meaning of willingly subjecting opinion to facts rather than imposing a thesis. It's about thinking of the challenges and opportunities set up by this path dependence. I'd hope that we already endeavour to follow suit to some degree by thinking in terms of probabilities and outcomes rather than one central prediction. But at a time of crisis I still feel we need to try harder to observe and simultaneously be less confident in making judgments. We'll almost certainly need to revise our presumptions in the coming months. We mustn't make it hard to do so out of mistaken overconfidence and ego.

*At a time of crisis I still feel we
need to try harder to observe*



George Peabody Library at Johns Hopkins University.
© Archive Photos/Getty Images.

A STARTING POINT



At times of crisis there's plenty of evidence that we become preoccupied with the short term but what seems equally dangerous is that our brains are overwhelmed by angst and severe pressures so that we seek refuge in prior contentions. I'd suggest that this is particularly prevalent at present. Be it face-to-face (on Zoom), in traditional or on online media or in responding to clients there's a real temptation to see the crisis as reinforcing whichever prior worldview is our preferred narrative. I confess to doing so – in my version Covid-19 is bound to increase the chance of Universal Healthcare finally coming to America but that's because I want that to be the case not because it's evidentially likely. I want it to bring more attention to inequality and climate change. People I look to for advice, such as Carlota Perez, see glimmers of hope in this direction. But she would admit that's deep optimism speaking as much as analysis.

I would advocate that the best introductory question to ask at present is “what has the pandemic changed your mind about?” Given that it is early in the crisis and still earlier in the economic and societal reaction, let alone in the pauses needed to reflect, there should be no embarrassment in answering tentatively.



*In my version Covid-19 is
bound to increase the chance
of Universal Healthcare finally
coming to America*

MONETARY AND FISCAL TRANSFORMATION

My initial attempted answer is already so palpable, so almost universal that I'm not sure that it will disappear though it will evolve in unexpected directions. It is that for practical, if not political, purposes the illusion of a small state, of Reagan, of Thatcher, of neo-liberalism or almost whatever you want to name this slippery creature that has dominated the last 40 years is definitively over.

By the end of March 2020 every Western government opted for fiscal support at scale. Was austerity but a dream? What happened to Reinhart and Rogoff? In America, with the prior assistance of Mr Trump contributing, it will now be virtually impossible for its totemic 90 per cent debt to GDP redline not to be shattered with World War II levels above 100 per cent within sight.

No democratic government, however free market in rhetoric such as the UK or however financially conservative such as Germany or the Netherlands, has advocated a different path. Is there the ideology or the will or even the ability to row back from this position? There seems little sign that such exists. Is there any party that is going to campaign for election on the back of restoring public finances? The CDU might be the closest to this position to watch but even in Germany this seems a hazardous proposition to test.

If the fiscal support has been immediate and pervasive the reaction of the Federal Reserve has been quite extraordinary. The idea – fashionable in markets but a month ago that central banks had no more ammunition approaching the zero bound – has been destroyed. In the second half

of March, Federal Reserve assets expanded by \$1.14 trillion. Or \$1 million a second. At the same time restrictions on lending policies have been evaded via agreement with the Treasury Department using Special Purpose Vehicles. I thought these had disappeared with Enron.

Arguably it's been even more remarkable to see the Fed rush to rescue stressed international dollar borrowers. Swap lines were opened and expanded and collateral rules sharply relaxed. Or as the financial historian Adam Tooze writes "There is a real sense that in 2020 we are seeing a concerted and self-conscious deployment of Fed resources in a global lender of last resort capacity that is even more prompt, larger in scale and more wide-ranging than what emerged in 2007–8. In 2007–8 it was improvisation. Today it seems extremely deliberate." This has certainly changed my perception. It is not how I thought the Fed would respond in an era of MAGA. Thus far there hasn't even been a tweet of complaint. This is more, not less, globalisation.

Outside America there are two dogs that haven't barked. Their silence may be of great future significance if not reversed. The first is that as yet [9 April 2020] the ECB and associated bodies such as the Eurogroup, pressured by German and Dutch politicians, have refused to issue Euro or Corona Bonds on a unified basis. If this does not change then for the first time in my career I would observe that the endless and tiresome predictions of imminent European disintegration, so beloved of the British media, might have some truth to them. The feeling of betrayal in Italy and Spain is intense. This needs to change.

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Federal Reserve has
been quite extraordinary.*



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The second silence has come from the Chinese authorities. The decisive turning point in the Global Financial Crisis probably came when China injected huge amounts of liquidity and state spending. This time there is nothing similar. The main deposit rate is unchanged. There's been mention of regulatory forbearance. China is an outlier in opting for restraint. This may be appropriate given existing debt concerns but the contrast is striking.

What does all this mean for a humble equity investor? Should we even be interested or just burrow down and assess companies? Normally that is the responsible and prudent approach. But every 15 years or so it is irresponsible not to respond. At some point we needed to acknowledge that China mattered. At some point we had to recognise that a set of technology-driven platform companies inverted traditional economics.

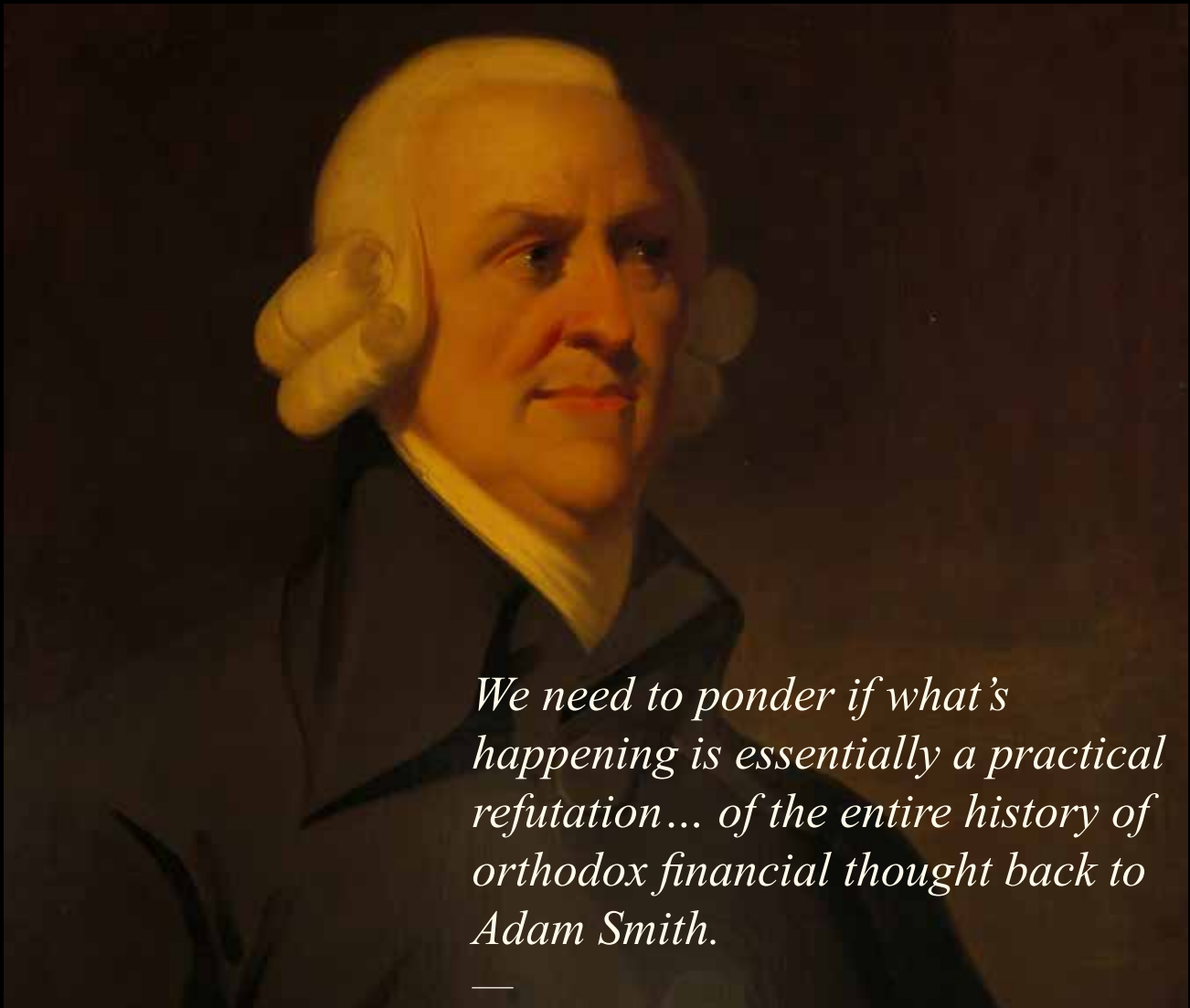
So now we need to ponder if what's happening is essentially a practical refutation of the doctrines of the last 40 years but also, if this doesn't seem too bold, of the entire history of orthodox financial thought back to Adam Smith. It's sometimes said that when a crisis occurs people pick up the ideas that simply happen

to be lying around and haven't yet been tried. That may be right but in monetary policy the chain seems to be more that a severe human and economic fracture has led to the closest emergency tools being seized on as a first step but then and only then are the theoretical justifications being cited. So we have a QE4 of unlimited scale, we have a commitment to underpin interest rates at near zero and we have collusion with the Treasury to pay for government activity. How is this not Modern Monetary Theory (MMT)? Or as Stephanie Kelton says on Twitter "We have Covert Monetary Financing now. Primary dealers take up all newly-issued Treasuries, and the Fed backstops primary dealers. Ergo, the Fed is *already* directly coordinating with fiscal, all day, every day."

Now I'm sure that lots of critics will emerge from the woodsheds as the virus slackens to demand renewed austerity but will that have sufficient credibility? I doubt it given the experience of last time and the near global, across-party experiment we are currently seeing. How can the austerity gospel take back control when the *Financial Times* can write in one of its supremely self-confident leaders that "Radical reforms reversing the

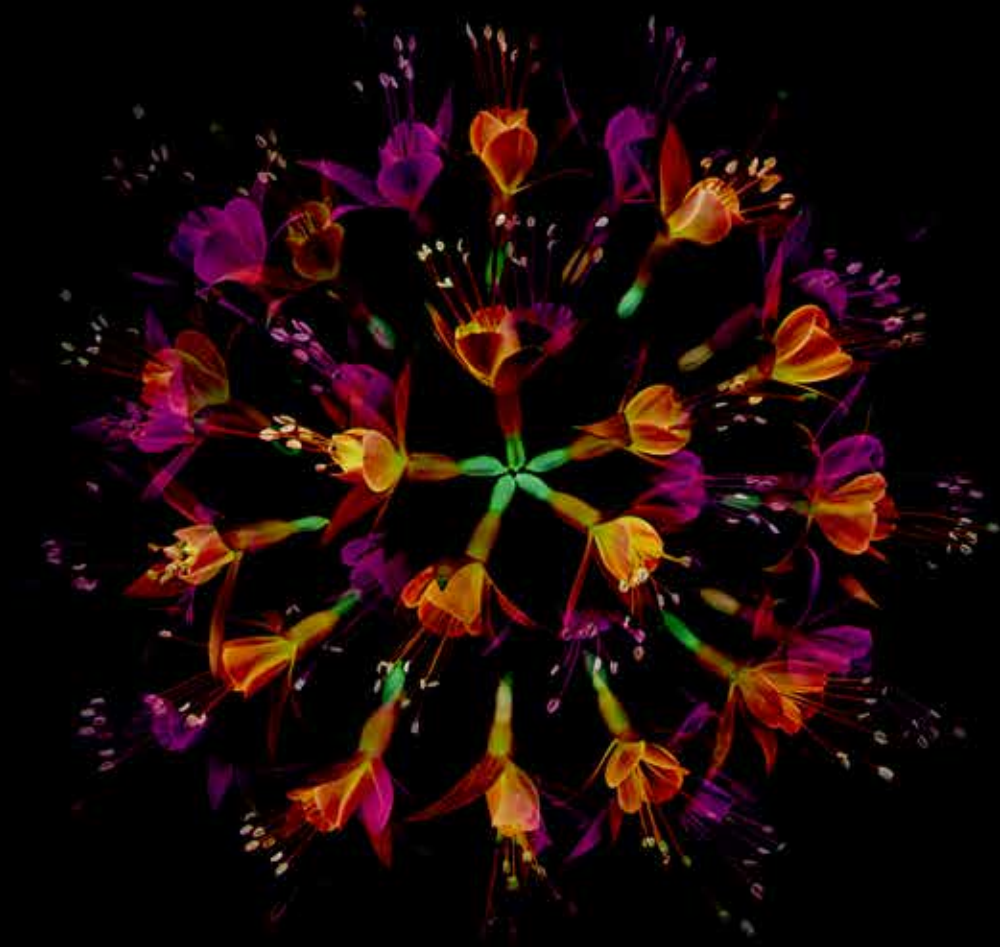
prevailing policy direction of the last four decades will need to be put on the table. Governments will have to accept a more active role in the economy. They must see public services as investments rather than liabilities, and look for ways to make labour markets less insecure. Redistribution will again be on the agenda, the privileges of the elderly and wealthy in question. Policies until recently considered eccentric, such as basic income and wealth taxes, will have to be in the mix." On 5 April the new Governor of the Bank of England announced that he was still committed to the old tenets of prudence. By 9 April he changed his mind and pronounced that the Bank would finance government borrowing.

If this is the considered opinion of the heart of the financial establishment then it's hard to rule out dramatic change. Or more precisely at the very least somebody, somewhere is going to run an experiment with continued, formal or otherwise, MMT. The immediate candidate is Spain. There immediate Universal Basic Income is in the works – there's already a plan to make this permanent. I'd guess that the success of Portugal in resisting austerity has been enviously spotted in its much larger neighbour.



Adam Smith.
© Hulton Archive/Getty Images.

WHAT DOES THIS MEAN FOR US?



To start with it equates to the financial system being run intentionally as a zombie. It is nationalised in all but official status. This has been a fair approximation of Japan since 1990. Since Europe and the UK moved to forbid bank dividends in early April it's already happened in Europe. We've been sceptical about investing in banks and insurers for a long time. Financials are arguably just a sub-section of that huge realm of companies that have been run for near-term income generation in the last decade to little evident corporate or investor benefit. We now think this mentality is simply pointless. All this will, of course, make lots of hedge funds extremely angry. But that's their preferred state.

At the same time the revisionist vision offered by the *Financial Times* and currently being tried out during the crisis isn't as clearly hostile to capital as might at first be supposed. For sure the notion of wealth taxes won't appeal to the editorial columns of its American cousin but what this fundamental approach implies is that it will be the state that pays to support the precarious, the sufferers of inequality and younger generations. Financial security would be the remit of the State not the Company. The model looks more like Sweden rather than the Soviet Union. Moreover the contention is that this requires only modest tax increases. It can be funded by far higher debt levels in the central bank and treasury nexus. I'm not making a prediction as to the success of this policy nor to the risk of inflation but simply observing the current dynamics.

THE GEOGRAPHY OF CRISIS

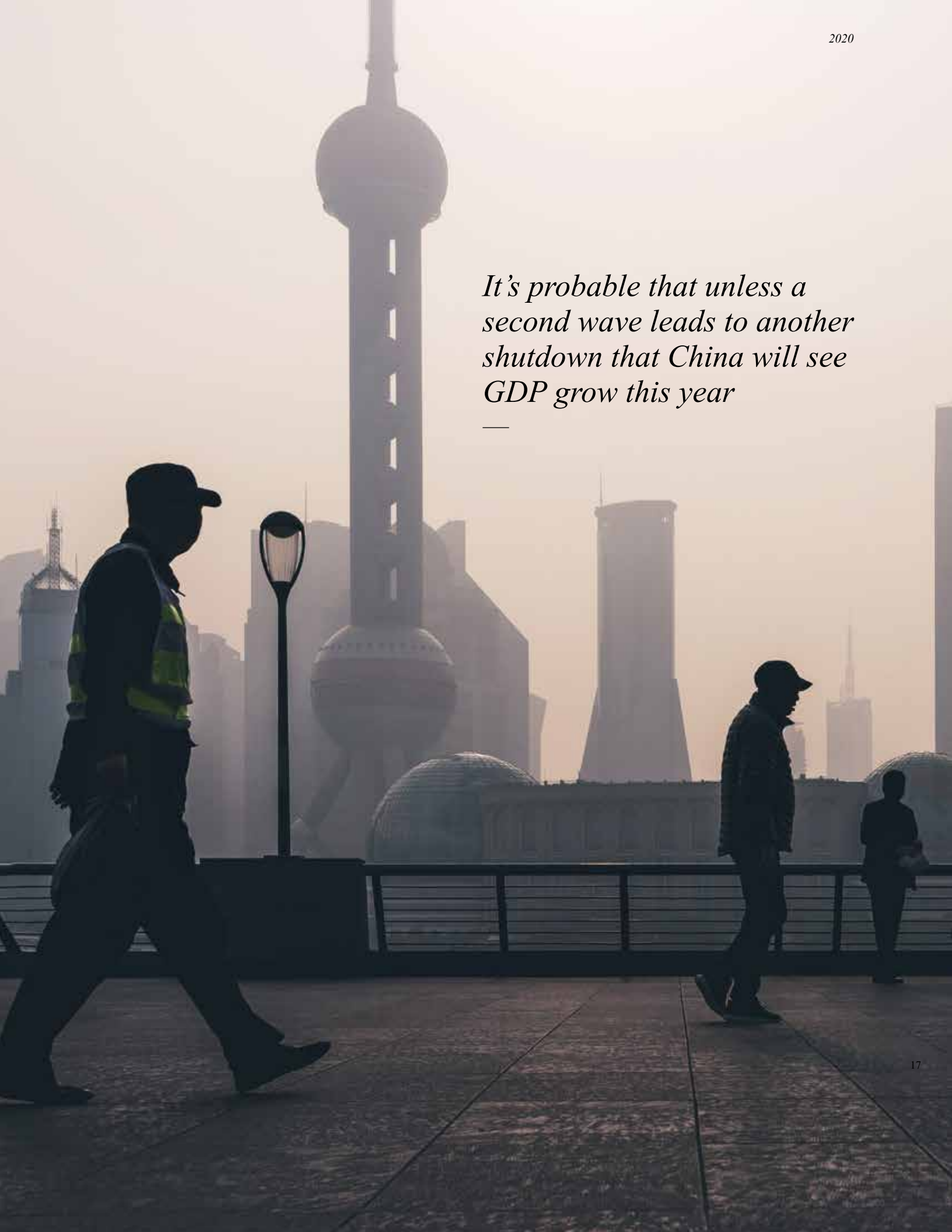
It's probable that this crisis tilts the heart of the global economy further towards Asia. That includes towards China. I don't think this should be taken as advocacy of the Chinese model in all its facets. There are many democracies in Asia that have met the challenges of a health emergency in equally impressive style but from the start and without obfuscation or procrastination.

Covid-19 is thereby acting as an accelerant of processes already underway. It's probable that unless a second wave leads to another shutdown that China will see GDP grow this year; its improbable that even with a contained death toll that this will be true of the US. It's close to impossible that Europe will grow even if the pandemic miraculously ceases from today. That's deeply depressing. Europe takes pride in its healthcare provision but with the possible exception of Germany it has not proven itself successful in the moment of crisis. That demographics have been a crucial factor has not assisted the task but that's no more an excuse than the terrible economic and racial divergences within American fatalities are for the US.

Prior to the pandemic we had already been shifting our highest enthusiasm towards Asian, and especially Chinese, growth opportunities. In the online world it seemed to us that there was a danger that the once so fertile (Western) American corporate scene was stagnating in all too many cases. It's perhaps emblematic that Facebook has moved from wishing to enter China to begging Congress to provide assistance against ByteDance's TikTok. At the same time the basic business models in emergent fields of Asia, or even Europe and Latin America, appear more anchored in reality and more likely to be sustainably profitable. Why bother with the travails of Grubhub and Uber when Meituan-Dianping is turning profitable? Why has Blue Apron collapsed whilst HelloFresh steals the US market from under it? Why are Ant Financial, Tencent and even MercadoLibre transforming finance so much more dramatically apparently than any peer in America? Perhaps these will all prove illusions but it's been enough to catch our attention.

But in truth for several years much of our geographic attention has been less focussed on continents and nations than on specific cities and regions. So far this has held up to market testing. For all the muttering of discontent above, an index of Northern Californian and Washington State companies has been greatly rewarding relative to the rest of the country. The hypothesis that cities matter to business models has even survived the frequently problematic European environment. Companies from Berlin may not have reached the heights of capitalisation of Seattle or Hangzhou but compared to Frankfurt or Munich the dynamism of Zalando, Delivery Hero and HelloFresh is deeply refreshing.

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WHAT INVESTMENTS ARE NOW MORE VALUABLE?

Although it's temporarily natural but blinding to look at short-term relative performance I would argue that we should already have enough evidence, enough observations that we ought to move onwards to contemplating the future. It may even be that it's now the ideal time to do this. We know enough. But we are still bewitched by the human toll of the virus and associated short-termism. For now at least this has moved from the panic of past weeks to an exaggerated focus on the immediate beneficiaries of current conditions and government action.

From hour to hour and day to day it's possible to make and lose very high percentage returns according to the latest virus and bail-out headlines in airlines, cruise ships and struggling retailers. For sure, if the markets rally, such a search for high beta can offer short-term rewards but it seems to us to be pushing investors in a profoundly misguided direction in the long term.

Instead if we ask which companies do we have greater confidence in the long-term free cash flows and



Tencent We Exhibition in Shanghai, China.

© Barcroft Media/Getty Images.



in the probabilities of success, it appears to me that, by normal investment standards which force us into decisions where the edge is only teetering above 50:50 bets, we are being offered a selection of unusually favourable odds.

What I am saying is not at all that I believe that behaviours exhibited during the pandemic are bound to persist. It seems to me just as probable that we will desperately want to go to a restaurant rather than order delivery or meal kit foods. The very idea of another Zoom meeting might be enough to tip us all into being emotional wrecks. I might even want to meet my colleagues for a while.

But there is another category of experience that seems likely to be built in to future attitudes. One of the most frequent lines of argument in recent years has been that technology is evil and platform technology companies and their leaders should be restrained. It's hard to argue that this hasn't had a depressing impact on share prices. One of the noisier advocates of such a view has been Anand Giridharadas.

But by April he was admitting "the crisis has made me realise that I have undervalued the tools made by Silicon Valley. Which are, yes, prone to abuse, monopoly, foreign meddling, and all the rest. But which right now feel like pillars of civilisation while so many other pillars crumble." Giridharadas is more honest in his introspection than many but he is not alone.

We can then add a more severely practical argument. Do we think the long-term free cash flows of, say, Amazon, Tencent and Alibaba are higher or lower than you thought at the start of 2020? There's always room for discussion but I suspect the likelihood is higher. Yet we also know that the discount rate is substantially lower for now and conceivably for as far forward as we can see. So the relative outperformance that we have enjoyed is pleasant but we would argue still understates the improvement in absolute prospects and value.

ANOTHER CRISIS – AND A BENEFICIAL TRANSFORMATION

Whilst the human toll and immediate economic consequences of the virus are justifiably preoccupying all of us it may mean that we underestimate quite distinct developments or subsume them in the pandemic narrative.

It's tribute to the power of the virus that it's overshadowed the end of the age of carbon. Indeed the collapse of the oil price is frequently portrayed as an episode in the saga of the virus. This seems chronologically and conceptually flawed. Share prices are a useful guide. The all-time highs of Exxon and Schlumberger were in 2014. The dramas of March 2020 came after a prolonged slide – indeed in market capitalisation most of the 2020 decline in absolute dollars came in the first two months of the year or in other words before Covid-19 affected Western markets and prior to the Saudi-Russian breakdown. It's a parallel with the Global Financial Crisis. Headlines screamed when Northern Rock and RBS went under but the market capitalisation declines were most acute well before their ultimate fates became apparent. Drama not index impact catches our attention.





*Drama not index impact
catches our attention.*

THE POWER OF RENEWABLES

So what was the market grasping at before the drama? It seems to us that the month by month, year by year, decade by decade efficiency improvements and cost declines in renewable energy are responsible. Or what Hans Rosling described as the “secret, silent miracle of human progress”. Or as Gregor Macdonald writes in *Oil Fall*, “The pivotal moment for the oil industry – indeed for all capital-intensive industry – is not the decline, but rather, the transition from positive annual growth to zero growth.” The stock market had spotted that this is where we are before the pandemic struck.

I don’t want to be boastful but this was forecastable. We did forecast it leaning on the perceptions of those with far greater expertise than our own. Two years ago we wrote (in *Aberration or Premonition*) that “the pricing of renewables is continuing to fall so convincingly and the increase in the installed base is rising so sharply that this is becoming acutely embarrassing for traditional forecasters”. We cited the Santa Fe Institute on the predictability of innovation in energy costs. We even ventured to cite Ray Kurzweil pointing out that this eventually all matters: seven doublings from 0.01 per cent take us to 1 per cent and seven more to 100 per cent. We were then around 1 per cent. As of the first quarter of 2020 52 per cent of German electricity came from renewable sources according to the BDEW federal body. In the UK the government reported that over the same period renewables provided 45 per cent of electricity. Under the current lockdown fossil fuels have fallen to less than 15 per cent of generation.

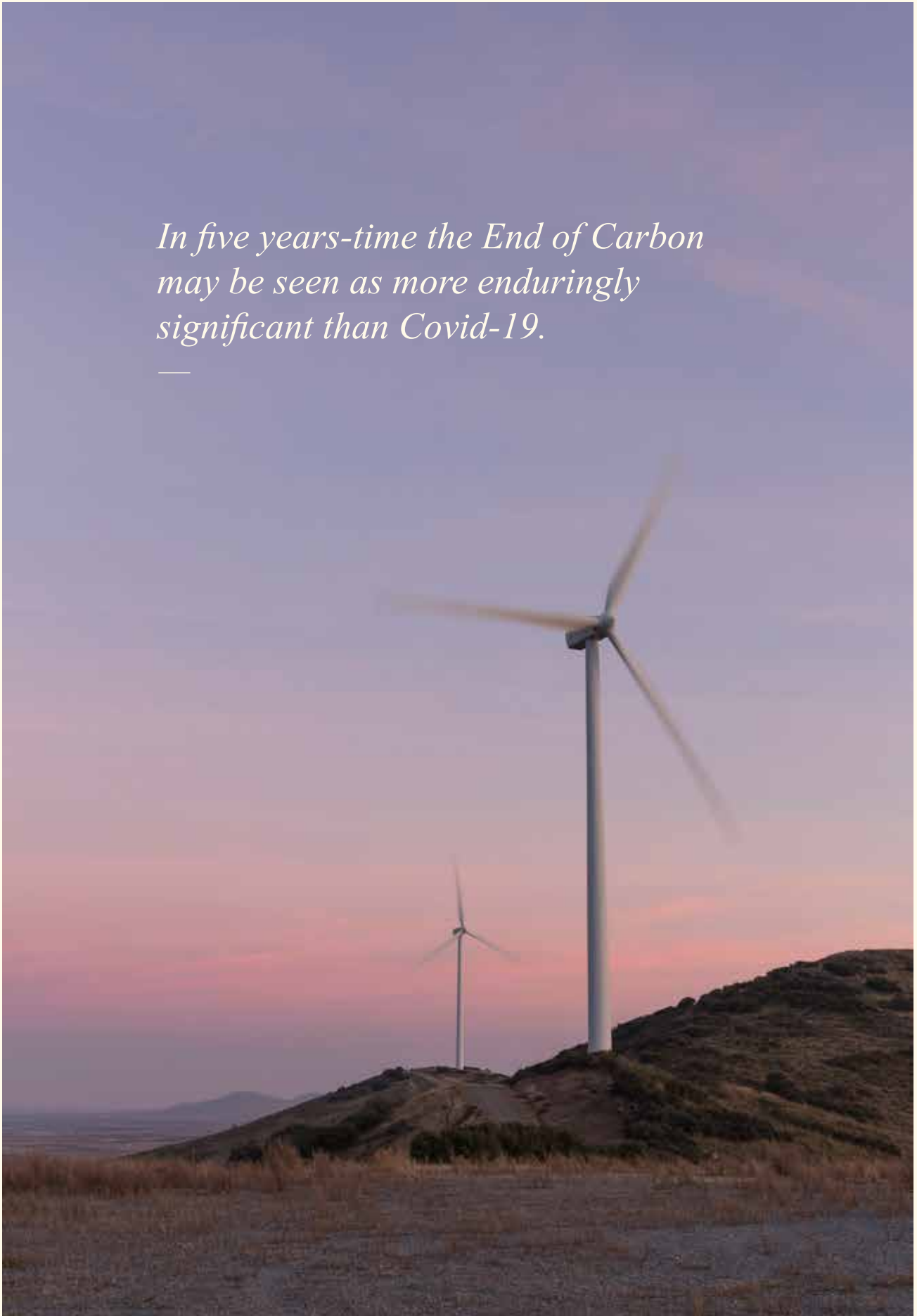
Such a pattern is both encouraging and vital as the next task is to convert transportation to electricity. What’s been most striking in our conversations with Tesla this year

has been its intense focus on this challenge. The current degree of success barely registers. As our ever-perceptive colleague Spencer Adair put it there’s “restless paranoia and a desire to improve” as in Musk’s view they haven’t yet moved the dial in the task of “changing the energy equation”. The frustration for us is that Tesla still seems pretty much alone in this ambition.

It’s possible that in five years-time the End of Carbon may be seen as more enduringly significant than Covid-19. This is in no way meant to minimise the human and societal disaster of the pandemic. Ironically the lockdowns and casualties are providing additional insight into the daily health damage that pollution exacts in a less dramatic but depressingly severe manner.

But, sadly, pandemics are far more frequent and recurrent than energy revolutions. Or as Ian Morris puts it “When we look at the entire planet across the last twenty thousand years, I argue, we see three broadly successive systems of human values. Each is associated with a particular way of organizing society, and each form of organization is dictated by a particular way of capturing energy from the world around us.” (*Foragers, Farmers and Fossil Fuels* p4). Twenty thousand years is a proper time frame. We shouldn’t forget it as analysts rush to upgrade oil equities over the next weeks because the virus death toll might slacken or President Trump barter a deal with his Saudi and Russian friends.

*In five years-time the End of Carbon
may be seen as more enduringly
significant than Covid-19.*





© Corbis Historical/Getty Images.



FINAL OBSERVATIONS

In the Palazzo Pubblico in Siena there are frescoes depicting the effects of Good and Bad Government. They were painted in 1338–9 to remind the city government of their responsibilities. The contrast between them could hardly have been more marked. They seem appropriate to our age. Decisions taken and habits formed at this time of crisis will mark our societies for decades to come and arguably the earth forever. The perils of short-termism, generational fights, excess inequality and nationalism are all too obvious. I suggested that the economic centre of the world is moving to Asia but frankly if this provokes continued mutual antagonism between the US and China then the world will be in no fit condition to inherit.

All this is far outside the remit or abilities of Edinburgh. We have no Adam Smith or David Hume these days. Is there anything that we can do though? We can at least invest. By that I mean that the worst policy at all levels would be to give in to our fearful instincts. There's far too great a temptation in the investment world to yearn for safety and imagine stability. That rarely occurs. Stability is most improbable at present. It's our form of Bad Government. We need to play our own small part in nurturing the set of transforming possibilities. It's a time to back the companies that we believe in with commitment and for the long term. We've improved at this with the disciplines we have learnt in private markets in recent years. It's now time to adopt such an approach to enduring and building in public markets.

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James graduated BA in History from Oxford University and after postgraduate study in Italy and Canada he gained an MA in International Affairs in 1982. He is a Trustee of the Johns Hopkins University. He joined Baillie Gifford in 1983 and became a Partner in 1987. He headed our European Equity team until 2003 when he co-founded our Long Term Global Growth strategy. He Chaired the International Growth Portfolio Group from its inception in 2003 until 2019 and has been the Manager and then Joint Manager of Scottish Mortgage Investment Trust since 2000. James is a co-manager of the Vanguard International Growth Fund where Baillie Gifford serves as a sub advisor. He has also served as a member of the Advisory Board of the government sponsored Kay Review and as Chair of the subsequent industry working group that set up the UK Investor Forum. James is a member of the Firm's Strategic Leadership Group.

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