

AN ERA FOR GROWTH INVESTORS

SCOTTISH MORTGAGE MANAGERS' REVIEW

James Anderson, Joint Manager of Scottish Mortgage Investment Trust PLC.
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BAILLIE GIFFORD

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Scottish Mortgage Annual Past Performance To 31 March each year

2014	2015	2016	2017	2018
28.9%	29.6%	-0.7%	40.9%	21.6%

Source: Morningstar, share price, total return.

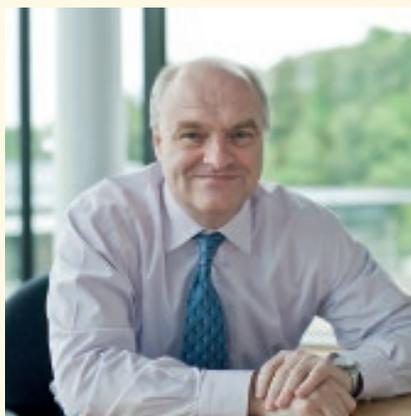
Past performance is not a guide to future returns.



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JAMES ANDERSON
Investment Manager

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 has Chaired the EAFE Alpha Portfolio Group since its inception in 2003 and has been the Manager and then Joint Manager of Scottish Mortgage Investment Trust since 2000. 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.



AN ERA FOR GROWTH INVESTORS

BY JAMES ANDERSON

As the late, great Hans Rosling wrote “It is not a question of intelligence. Everyone seems to get the world devastatingly wrong. Not only devastatingly wrong but systematically wrong.” We agree. Therefore highly educated but deluded human beings believe the world to be far worse than it is given the advances in global health, wealth and well-being that ‘are too slow, too fragmented, or too small one-by-one to ever qualify as news’. It’s this ‘secret silent miracle of human progress’ that convinces us to remain optimistic about the investment opportunities despite the understandably lurid headlines of our age.

But the investment world is devastatingly and systematically wrong in quite another manner. It does not understand the nature of investment returns, their origins or what may predict their occurrence. Investment returns are not generated by surveying the entire available field and adjusting correlations to the index by overweighting and underweighting according to marginal advantages and disadvantages, perceived risk of volatility, macroeconomic trends or comparative valuation.

Investment is a far more dramatic and extreme universe than that. It's not a well-behaved machine that cranks out returns to owners of all equities merely pausing to reflect the supposed laws of asset pricing relative to cash and bonds. Instead quite extraordinary returns flow to a tiny fraction of the companies in existence. This is articulated in more detail by Tom Slater in his mangers' review.

The companies that have the opportunity to deliver exceptional returns tend to share initial characteristics. They address potentially huge markets at early stages, they are run for the long term by founders or their descendants, and they zig and zag to adjust to developing circumstances rather than imposing a spread sheet on reality. It's these sort of companies that we need to identify.

The combination of digitalisation and globalisation has led to hitherto unimaginable opportunities for a cadre of founder led companies of the utmost ambition.

Moreover, great results are only attainable if patience is the mantra for investors as well as for founders. It's the persistent compounding of exponential returns that matters. So our task is not just to identify companies that possess extraordinary characteristics. It's to own them for a prolonged period. All too often excessive fear of events and headlines and a misguided desire to lock in past profits lead investors to chop down trees when they are but saplings. All great companies endure through periods of struggle. All great shares endure periods of dramatic underperformance. It is only in retrospect that success appears smooth and inevitable.

What is so remarkable about this era for growth investors is that we have been offered the chance to

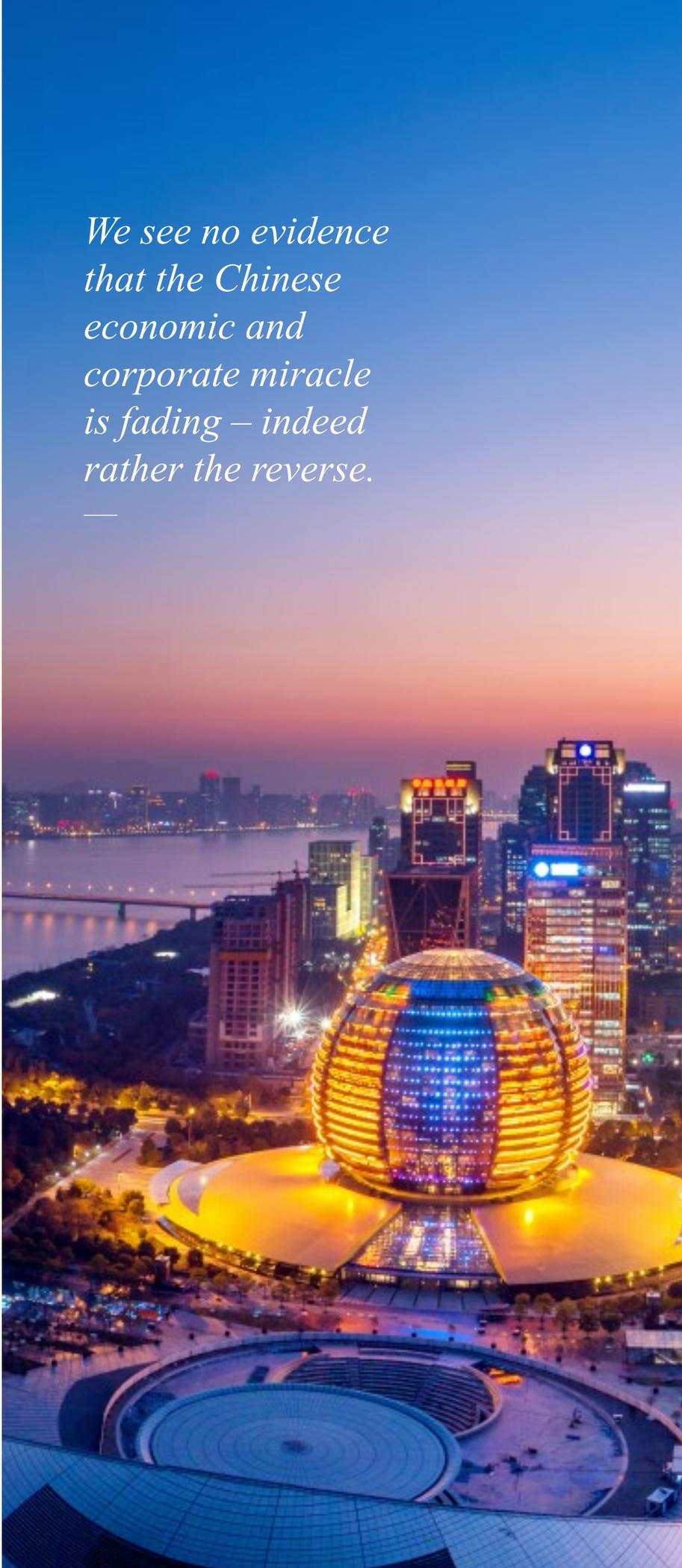
own a set of compelling companies that have the characteristics that denote the potential for greatness at extreme scale. The combination of digitalisation and globalisation has led to hitherto unimaginable opportunities for a cadre of founder-led companies of the utmost ambition. It's therefore natural enough that the corporate trees can continue to grow at previously incomprehensible scale. It's appropriate yet again to cite Amazon in all of these regards. It's not normal for a company of its size to achieve 43% sales growth in its cloud computing business, which has also hit a \$20 billion run rate, or to see the Prime subscription service exceed 100 million customers. These are all opportunities that Amazon invented.

NOT JUST SILICON VALLEY

Silicon Valley attracts headlines. Its companies have also contributed disproportionately to the returns enjoyed by global investors over recent years. But for Scottish Mortgage shareholders the focus on this area can become a little too intense. This isn't just a reference to the rather different culture nurtured by Seattle's Amazon or San Diego's Illumina but also to much wider considerations.

We should stress that our major investments are not confined to the West Coast of America – let alone to Silicon Valley. We go wherever any companies demonstrate the characteristics that offer the potential for greatness at scale. More often than not such companies herd together in clusters of mutual emulation.

We see no evidence that the Chinese economic and corporate miracle is fading – indeed rather the reverse.



EASTERN CHINA

Over the next twenty years we consider it likely that Chinese companies will create the most value. It seems equally likely that almost all of these will be found in the hubs of Eastern China. Shenzhen, Hangzhou (not Shanghai) and Beijing appear the epicentres of potential. As in America, the concentration of returns will be notable not just geographically but in the rise of a small number of remarkable companies.

This has certainly been the pattern of the last twelve months. During the period under review Alibaba and Tencent came to be recognised for what they are – dominant, thoughtful and highly sophisticated network companies with the technological and managerial abilities to extend their leadership into most segments of the Chinese economy and increasingly into international markets.

We think these two behemoths are at least the overall equal of their American peers in vision and abilities. They are both more at ease with their home society and government than is the case in America. Unlike most of their US counterparts both Alibaba and Tencent are prepared to reinvest in their businesses in order to redeploy their extraordinary cash flows. We far prefer this policy to the passive generation of vast cash piles. Only Amazon of the US internet giants has a similar attitude. Tencent and Alibaba share with Amazon the ability to grow at 40–50% over long periods of time. So this is no longer geographically confined to America but it is historically unprecedented.

As elsewhere, the recent pattern has been for the next generation of Chinese companies to grow up in private. But privacy should not be mistaken for lack of ambition. Given that funding at scale is available from Tencent, Alibaba and Baidu as well as a vigorous venture capital system, remaining unquoted is no obstacle to scale and, as elsewhere, allows investment to occur without the impatience of public markets. We can only reflect on the comparative appeal of the frequently hysterical and always opinionated daily news gauntlet that Tesla endures versus the quiet progress of its Chinese equivalent NIO (in which we now have a holding). We would expect our exposure to Chinese unquoted companies to grow over the coming year.

We see no evidence that the Chinese economic and corporate miracle is fading – indeed rather the reverse. The increasing scale, wealth, education and sophistication of the domestic market are likely to mean that the opportunities will become more, rather than less, alluring. Just as Scottish Mortgage 100 years ago had to confront America becoming the leading economy and the stock market with the most opportunities so we must acknowledge a similar transition today. It would be no surprise if China replaces the United States as the leading geographical location for Scottish Mortgage's assets. 100 years ago there was much murmuring in the Annual Reports that Canada or Argentina might be more appealing. We are more single minded.

SURPRISING SUCCESSSES

Our commitment to China and to the beneficiaries of exponential change has been consistent and frequently discussed by us. What may be less well-known to shareholders is that we've been fortunate enough to own a group of European companies that have delivered quite excellent business and share price performance over a prolonged period. Sometimes the degree of success has surprised the Managers.

Such is the case in our ownership of first Fiat Chrysler and then its Ferrari spin-off. Given the economics and maturity of the internal combustion engine this may seem unlikely territory for growth investors – so much so that we acknowledge that we may have been the beneficiaries of luck rather than good judgment. But we have believed for many years that Fiat Chrysler has outstanding leadership. It is prepared to be radical in thinking about the auto industry from first principles. This led to a preparedness to abandon the search for volumes to focus instead on a limited number of special brands. Ferrari itself is the lodestar of this approach with a mere 8,398 cars translating into operating earnings of €775m in 2017. Both figures have the potential to grow in the decades ahead.

Similar excellence in luxury brand development has been the driving force behind the progress of Kering. The growth of its Gucci division has been exceptional. But behind this rests a patient and thoughtful approach that has created a luxury clothing group that should endure into future generations. It is tribute to the sustained efforts of the Pinault family.

It is often assumed that whilst Europe retains historic brands, it lacks technology expertise and is bereft of businesses of the scale of America and China. This is an exaggeration. The most impressive European technological and commercial feat of the last thirty years has been the emergence of ASML, from a near bankrupt affiliate of Philips, to global leadership and now dominance of the lithography industry. Without ASML's achievements Moore's Law would have stumbled. Without Moore's Law the transformation of communications and the internet would have withered away.

But though ASML enabled the rise of the global platform companies, until now Europe could not boast such a company of its own. But it is possible that Spotify may fill this void. We have been investors in Spotify as a private company during a phase of intense and challenging work to establish music streaming with consumers and as a business model in the face of the entrenched interests of labels and competition from Apple, Amazon and Tencent. We suspect that Spotify would not have succeeded in becoming the global leader if it had been a quoted company during this period. But we are happy that it has now emerged into public markets. We have purchased more shares since the Scottish Mortgage year end.

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CURRENT CHALLENGES

We regard it as inevitable that there will always be major holdings in the portfolio that are topics of either popular concern or intense investment discussion in our own minds. Sometimes these categories overlap. In recent months, we have found that external questioning has been almost exclusively focussed on just two stocks – Facebook and Tesla – which have generated headline after headline. Thus far this attention has generated little reaction in stock prices but some comments on each may be worthwhile.

We have reduced our holding in Facebook. This was initially provoked by a concern dating to last summer that Facebook was too focussed on monetising its astonishing reach solely through advertising. We thought this was both unduly limiting and potentially mistaken. We did not expect this anxiety to be translated into public drama so rapidly. We continue to discuss the relevant ethical and financial issues with management but for now we are content to be shareholders but at a lower level.

Tesla is a rather different case. We need to be clear that the ‘production hell’ that Elon Musk spoke of entering has been both more persistent and at a lower circle of hell than we thought likely. But we do not believe that it is likely to fundamentally endanger the intense brand loyalty that has been built. We still believe that the business model is intact. We cannot be certain in these opinions but we think the rewards for shareholders if they prove to be justified considerably outweigh the risks. As ever we do not want to interrupt the potential for exponential compounding. We therefore believe it appropriate to resist the temptation to give into hysterical headlines and storm of hedge fund criticism that is the daily round at present. We intend to endure.

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FUTURE CHALLENGES

We are fully aware that Scottish Mortgage has enjoyed the rewards of an uncommonly long bull market. Although we remain delighted at the progress and prospects of our portfolio it would be unrealistic to exclude the possibility of market setbacks. Indeed it would be foolish to rule out such an occurrence at any time.

But beyond the compulsion to take profits that most shareholders exhibit we do not share the presumption that Scottish Mortgage is doomed to suffer unduly in a bear market. To us the underlying cause of the next market retreat is most likely to be the dawning realisation that broad swathes of the stock market that have been assumed to be strong and stable in difficult market conditions are instead acutely vulnerable to severe setbacks. From consumer staples, to traditional retailers to TV moguls to oil and utility behemoths to traditional pharmaceuticals and back to banks and insurance companies we see long-standing business models that are already showing signs of intense strain. In the next decade we fear that strain will morph into permanent collapse.

It seems to us that this is a far greater cause for concern than the perennial and excessive angst that the valuation of the great global growth companies that we are invested may be ahead of some traditional metrics. We believe that Scottish Mortgage is insurance against a world utterly changed just as much as it is the beneficiary of extraordinary corporate achievements.

CURIOUS ABOUT THE WORLD

If you require further assistance or information, please contact
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