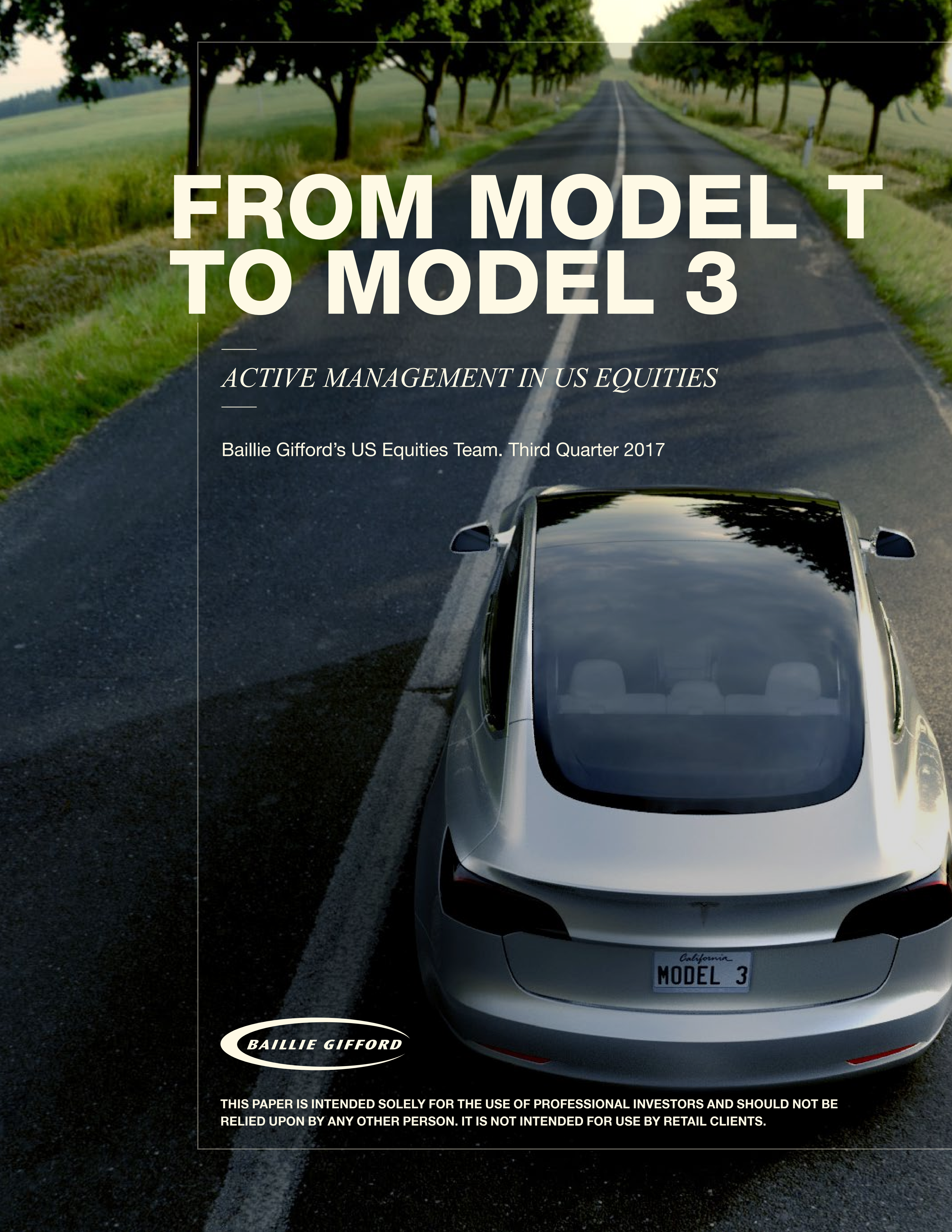

FROM MODEL T TO MODEL 3

ACTIVE MANAGEMENT IN US EQUITIES

Baillie Gifford's US Equities Team. Third Quarter 2017

BAILLIE GIFFORD

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Annual past performance to 30 June each year (%)

	2014	2015	2016	2017	2018
Baillie Gifford US Equities – Large/Medium Cap Bias	22.0	4.6	6.0	29.1	41.2
S&P 500 Index	24.6	7.4	4.0	17.9	14.4

Source: Baillie Gifford & Co, S&P 500. US dollars net of fees.

Past performance is not a guide to future results. Changes in the investment strategies, contributions or withdrawals may materially alter the performance and results of the portfolio. All investment strategies have the potential for profit and loss.

The Baillie Gifford US Equities Strategy is more concentrated than the S&P 500 Index.

FROM MODEL T TO MODEL 3

BY BAILLIE GIFFORD'S US EQUITIES TEAM

Baillie Gifford has been investing in US innovation for over 100 years. Our first investment was in the booming rubber industry, which grew on the back of increased demand for tyres as the Model T Ford took the US by storm in 1909.

Today we are excited by the next leap in mass market transport: Tesla's Model 3 electric car. US companies have been the bedrock of outperformance in the firm's largest asset class, global equities. This amazing country is the innovation capital of the world. As our US equity portfolio approaches its 20 year anniversary, we are more excited now than we have ever been about US companies. We will therefore take the opportunity to reflect upon what it means to be a truly active long-term US growth investor and why this matters. We will also discuss what will potentially drive outstanding long-term returns over the coming years.

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WHY ARE PEOPLE GIVING UP ON ACTIVE US EQUITIES?

Not everyone shares our optimism. US equities are witnessing significant flows away from active managers, a group which has struggled to make the case for its own existence. Generally-poor relative returns and high fees have drawn investors towards passive approaches. For example, over the past year, headlines have focused on the fact that roughly only 10% of large cap funds outperformed the S&P 500 over five years.

However, whilst painful for all concerned, this is not particularly unusual. There have been four times in the past 50 years when US active managers have had a similarly rough time – in the mid 70s, late 80s, during the tech-driven market fall around 2000 and over the past five years. The current period of underperformance has probably been caused by a combination of cash drag in strong markets, an allocation to non-US holdings (with the US outperforming other regions) and large caps doing well (with a lot of active managers being underweight large cap stocks). Given this cyclicality, we believe now is precisely the worst time to give up on active US equities.

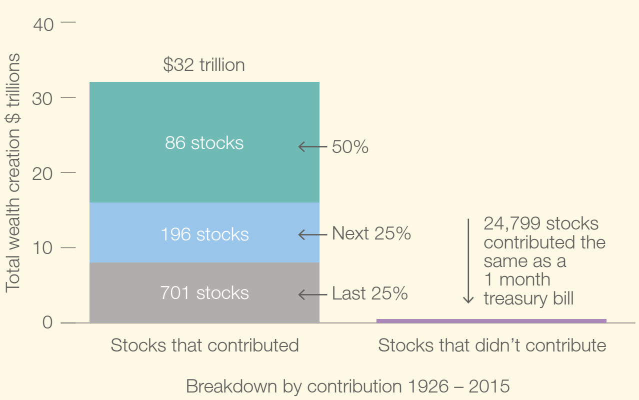
WHY YOU SHOULDN'T GIVE UP – SPECIFICALLY ON HIGH CONVICTION, BOTTOM-UP, PATIENT STRATEGIES

'Going passive' means giving up on the world's most abundant market for long-term active growth companies. The US produces over half of the world's fastest growing companies globally by market cap. We think this will continue given America's current generation of exceptional growth companies.

Importantly, long-term and highly active investment strategies work. These strategies are increasingly important as rapid technology-driven change is likely to create a clear divide between stock market winners and losers. There is academic evidence that patient, high-conviction investment strategies can beat the index. This is the style we employ and we are now among a minority of managers that have outperformed the S&P 500 over the last five years; relative performance across all other time periods is even stronger.

The key to delivering outstanding long-term performance is to focus all efforts on finding and owning these exceptional companies. It seems obvious, but owning the outliers in the skewed distribution of market returns matters. It is this asymmetry of returns that we want to capture in the portfolio. Why do we think these companies are so important? Well, over the past 90 years half of the wealth created by listed US stocks, approximately $32 trillion, was delivered by just 86 out of 25,782 listed companies – that's just 0.3%. The return distribution of all listed common stocks is positively skewed by these few outliers. This runs counter to mean-reversion theory and dedicated followers of the Capital Asset Pricing Model which assumes a normal distribution. The majority of stocks underperformed cash (T-Bills).

Contribution to wealth creation



Source: Bessembinder, Hendrik, *Do Stocks Outperform Treasury Bills?* (22 May 2017). The data includes all 25,782 CRSP common stocks from 1926 to 2015. In cases where stocks list or delist with a calendar period the return is computed for portion of the period where data is available. Beyond the best performing 983, an additional 9,853 stocks (38.2%) of stocks created positive wealth over their lifetimes. The wealth creation of these stocks was just offset by the wealth destruction of the remaining 14,946 (58.0% of total) stocks, so that the top 983 stocks created the same wealth as the overall market.

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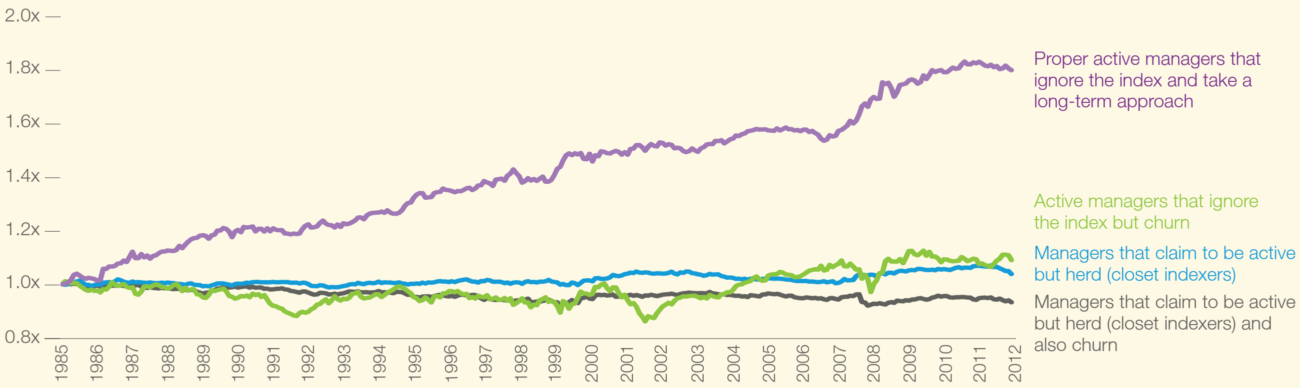
LONG-TERM ACTIVE MANAGERS OUTPERFORM

Outperformance relative to passive net of fees



Source: Cremers and Pareek 2015, Patient Capital Outperformance.

Yes, passive strategies capture all market returns, including the outliers. But we contend that this is a sub-optimal approach for long-term returns. The median return of stocks over the same period was negative; and you virtually guarantee below market returns after fees. Further academic evidence supports our contention – high active share, low turnover and bottom-up stock-picking are all good predictors for long-term outperformance.

The graph above shows why this is so important. Over a 27 year period (a more relevant time period for most of us), stocks held by high active share and patient institutional US equity portfolios accumulated an outperformance of 80% over closet index funds, high-turnover funds and passive funds. Adding real numbers brings home the reality. A closet index fund or passive strategy that delivered a $10,000 pot, could have instead been an $18,000 pot. A $40,000 pot could have been $72,000 pot. And so on. These numbers matter for investors.

THE PORTFOLIO REFLECTS OUR OPTIMISM

We don't have a particular view on the US economy or aggregate valuations; rather, we are excited because we think some of the best opportunities in the world are in the US market. These powerful growth franchises don't have peers in other stock markets. As they grow they are attacking many established industries. They are making life increasingly difficult for the big companies that comprise the major stock market indices and, in turn, making passive investment riskier.

Some of the major themes expressed in the portfolio illustrate this point.

BIG PLATFORMS

Amazon, Google and Facebook are some of the largest holdings. We apply a minimum return target of 2.5 times over five years for all stocks in the portfolio. So, for these large platforms we need to see a path towards trillion dollar market caps for each of them to justify holding them. This would be unprecedented in nominal terms. But we think these businesses are different both in terms of the size of the opportunities they address, their competitive advantages and how they scale.

For example, we think Amazon still has huge growth opportunities in both retail (only 15% of retail sales in the US are currently transacted online), and in Amazon Web Services, which is a tiny fraction of the overall IT market. A truly remarkable fact about Amazon is that it is taking over half of the incremental retail dollars that are flowing online. There has never been anything like this in the offline world. We see similar patterns of dominance in online advertising with Google and Facebook.

HEALTHCARE

Healthcare has been an increasing area of focus for the team. There is huge unmet need in healthcare, and there is lots of room for improvement. As part of our research efforts, one of the team, Gary Robinson, is spending a month in San Francisco over the summer meeting with a range of companies and thought leaders. We've also appointed an experienced healthcare journalist to help guide us through some of the big-picture topics.

There are some healthcare companies in the portfolio. There are names you'll be familiar with, such as Illumina, but also more recent additions such as cancer biotech Celgene, the maker of the world's smallest heart pump Abiomed, and cystic fibrosis company Vertex.

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FOUNDER-RUN COMPANIES

Founder-run businesses make up around 70% of the portfolio by weight. This compares to a weighting of around 12% in the S&P 500 that have founder CEOs. The characteristics that founders bring to companies are especially important given our return target and time horizon. Founder-run businesses are often managed with vision and ambition. They would rather invest than buy back shares. Having a founder still involved with a company is not a prerequisite for inclusion in the portfolio; ultimately, we're looking for businesses that grow faster, for longer and at higher rates of return – many businesses that aren't founder-run achieve this; however, we've found that founder-run businesses have a much higher chance than average of doing it.

Two recent additions to the portfolio, although from very different sectors, reveal our focus on finding companies with distinctive cultures, large growth opportunities and sustainable competitive advantages.

Activision Blizzard is the world's largest dedicated video game publisher. This founder-run company is benefiting from the shift to mobile gaming. With the recently established eSports and movies divisions, it will further leverage its existing intellectual property, giving its loyal fan base new media in which they can enjoy and consume more content.

HEICO is a disruptive force in the commercial aerospace industry. It is the global leader in the design, manufacture and distribution of approved 'generic' aircraft parts. These generic parts are significantly cheaper than those sold by the original equipment manufacturers. The generic parts market is currently only around 1%–2% of the total aerospace parts market; therefore, this family-controlled business has a huge opportunity to grow.

These purchases were in part funded by the sale of M&T Bank. While we believe that M&T is a well-run bank with a prudent lending culture, its modest growth prospects from here were not attractive enough for us.

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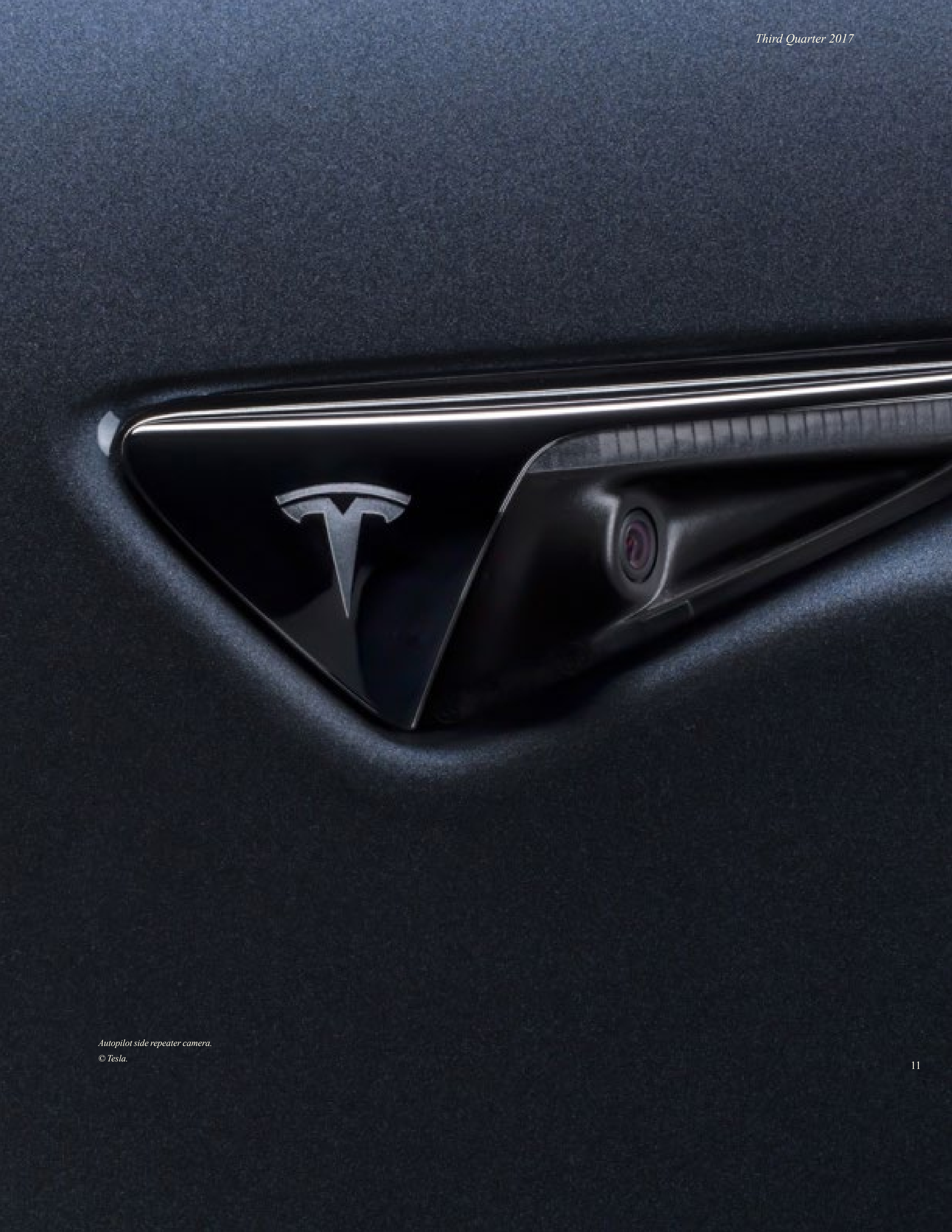
OUTLOOK

Finally, one other piece of research, Active Share and Mutual Fund Performance (2013) by Antti Petajisto, found that factor bets are not a good predictor of US equity fund performance. Prognosticating on politics and macroeconomics can be interesting, but transposing these opinions into sector allocations is not a reliable way to make money in the long run. So, despite the thoughts we may have on the current state of US politics and GDP figures, our focus is resolutely on the portfolio and patiently seeking out companies that could help deliver exceptional returns over the long term. We look forward to the next 20 years of investing in US innovation.



Autopilot side repeater camera.
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