WHY DO WE DO WHAT WE DO?

EMERGING MARKET INVESTING

Claire Gillies and Andrew Keiller. Third Quarter 2017

BAILLIE GIFFORD

IMPORTANT INFORMATION AND RISK FACTORS

The views expressed in this article are those of Claire Gillies and Andrew Keiller 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.

Baillie Gifford & Co and Baillie Gifford & Co Limited are authorised and regulated by the Financial Conduct Authority (FCA). Baillie Gifford & Co Limited is an Authorised Corporate Director of OEICs.

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 FCA in the UK.

Baillie Gifford Investment Management (Europe) Limited provides investment management and advisory services to European (excluding UK) clients. It was incorporated in Ireland in May 2018 and is authorised by the Central Bank of Ireland. Through its MiFID passport, it has established Baillie Gifford Investment Management (Europe) Limited (Frankfurt Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in Germany. Baillie Gifford Investment Management (Europe) Limited is a wholly owned subsidiary of Baillie Gifford Overseas Limited, which is wholly owned by Baillie Gifford & Co.

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.

Important Information South Africa

Baillie Gifford Overseas Limited is registered as a Foreign Financial Services Provider with the Financial Sector Conduct Authority in South Africa.

Important Information South Korea

Baillie Gifford Overseas Limited is licensed with the Financial Services Commission in South Korea as a cross border Discretionary Investment Manager and Non-discretionary Investment Adviser.

Important Information Japan

Mitsubishi UFJ Baillie Gifford Asset Management Limited (‘MUBGAM’) is a joint venture company between Mitsubishi UFJ Trust & Banking Corporation and Baillie Gifford Overseas Limited. MUBGAM is authorised and regulated by the Financial Conduct Authority.

Important Information Hong Kong

Baillie Gifford Asia (Hong Kong) Limited 百利亞洲(香港)有限公司 is wholly owned by Baillie Gifford Overseas Limited and holds a Type 1 licence from the Securities & Futures Commission of Hong Kong to market and distribute Baillie Gifford’s range of UCITS funds to professional investors in Hong Kong. Baillie Gifford Asia (Hong Kong) Limited 百利亞洲(香港)有限公司 can be contacted at 30/F, One International Finance Centre, 1 Harbour View Street, Central, Hong Kong. Telephone +852 3756 5700.

Important Information Australia

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.

EM Investing 41322 0717.indd
Ref: 41322 INS AR 0360

Important Information North America

Baillie Gifford International LLC is wholly owned by Baillie Gifford Overseas Limited; it was formed in Delaware in 2005. It is the legal entity through which Baillie Gifford Overseas Limited provides client service and marketing functions in America as well as some marketing functions in Canada. Baillie Gifford Overseas Limited is registered as an Investment Adviser with the Securities & Exchange Commission in the United States of America.

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 is not a guide to future returns.

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.

MSCI Legal Disclaimer

Source: MSCI. The MSCI information may only be used for your internal use, may not be reproduced or redisseminated 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).

FTSE Legal Disclaimer

Source: FTSE International Limited ("FTSE") © FTSE 2019. "FTSE®" is a trade mark of the London Stock Exchange Group companies and is used by FTSE International Limited under licence. All rights in the FTSE indices and / or FTSE ratings vest in FTSE and/ or its licensors. Neither FTSE nor its licensors accept any liability for any errors or omissions in the FTSE indices and / or FTSE ratings or underlying data and no party may rely on any FTSE indices, ratings and / or data underlying data contained in this communication. No further distribution of FTSE Data is permitted without FTSE's express written consent. FTSE does not promote, sponsor or endorse the content of this communication.

CLAIRE GILLIES

Claire graduated from the University of St Andrews with a BSc honours degree in Mathematics and Statistics in 2009. She joined Baillie Gifford the following year and spent six years as an analyst in the Investment Risk team before joining the Clients Department. Claire now works as a Client Service Manager and is a CFA Charterholder.

ANDREW KEILLER

Andrew graduated from the University of Edinburgh with a first class honours degree in Mathematics and Business Studies (BSc) in 2011. Upon graduation, he joined Baillie Gifford as a Graduate Trainee and completed a two year programme of secondments across the firm. He now works as a Client Service Manager in the Emerging Markets client team. Andrew is a CFA Charterholder.

EMERGING MARKET INVESTING – WHY DO WE DO WHAT WE DO?

BY CLAIRE GILLIES AND ANDREW KEILLER

Since we started running dedicated emerging markets (EM) portfolios in 1994, the philosophy underpinning what we do hasn't changed. We've always been active, always focused on growth and never allowed ourselves to get bogged down in short-term earnings estimates or price targets. This has resulted in portfolios which are considerably different from much of the market, and has afforded us the support of a number of long-standing clients. Here, we revisit the evidence backing our investment philosophy: why do we invest in EM equities in the way that we do?

SUMMARY

We need to be selective. We can't rest on the assumption that investing in a number of high-growth economies will certainly lead to high returns. Economies change and big swathes of business are under threat.

A focus on hard currency earnings growth works when your time horizon is sufficiently long. Companies which can sustainably grow their earnings will be rewarded.

Short-term discomfort comes with the territory, reinforcing the importance of a long-term approach.

EM equities have become an increasingly appealing opportunity set. The evidence is compelling that, in seeking the best returns globally, EM companies should not be overlooked.

BEING SELECTIVE

Active investment may have had a less than favourable press of late, but it will come as no surprise to those who know us that we remain confident in our active philosophy. We would strongly suggest that EM equity is an asset class where active management works best and where having a dedicated EM manager makes sense. InterSec research has shown that within the active manager universe, dedicated EM managers have added more value through active management than the EM portion of international equity portfolios has over the last ten years[1].

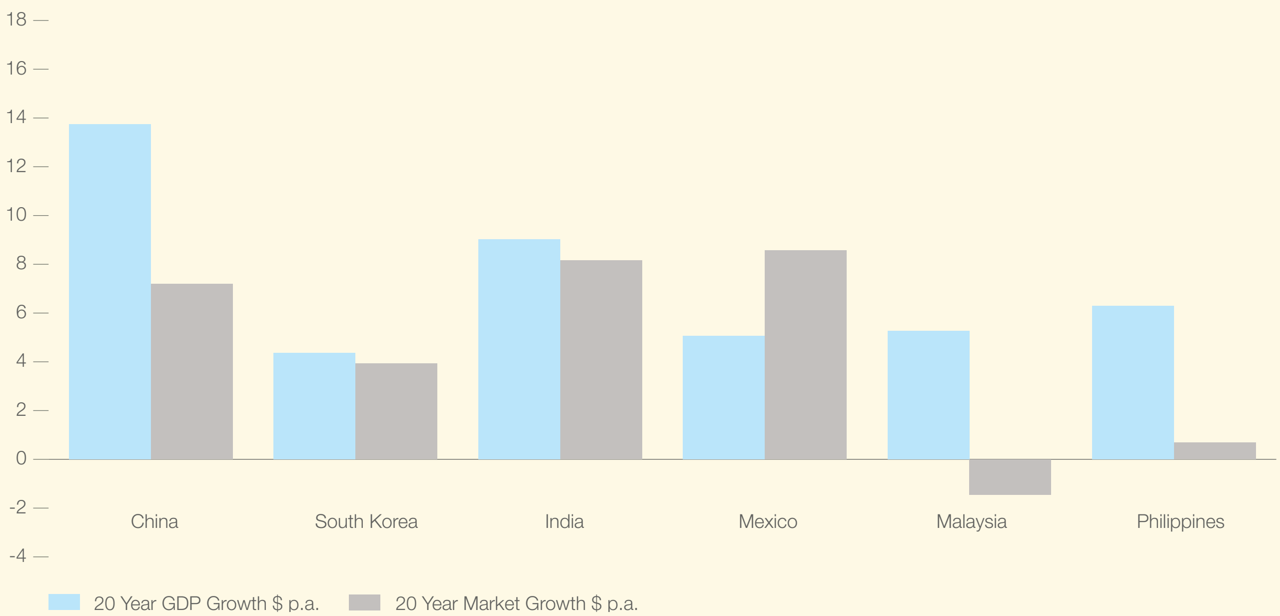
We warn against holding the index not just because passive investing forces investors to hold big companies which probably won't exist in 20 years' time, or because the EM index contains several state-controlled companies that do not have the dynamism that EM stocks are supposed to provide. In its simplest terms it's because most 'emerging markets' don't emerge. Being selective is critical, particularly now we are long past the China fuelled pan-EM boom.

By definition, investing in EM means you are gaining exposure to the world's fastest growth economies. But in truth, GDP growth doesn't always lead to high stock market returns. Several studies over the years have examined this in detail[2]. Perhaps it is because GDP is an outdated and increasingly useless measure, but this is also the strongest argument for active investment in EM; you can't hope that simply investing in a bunch of high growth economies will make you above average returns, in hard currency terms. Take Malaysia, for example, which has grown its GDP at an impressive 5.3% p.a. in US dollar terms over the last 20 years, and yet its stock market has contracted by 1.5% p.a.

[1] InterSec 2016 Year-End Investment Industry Report of the US Tax-Exempt Cross-Border Marketplace

[2] One of the most prominent examples comes from Jeremy Siegel, 1998 Stocks for the Long Run: http://www.riosmauricio.com/wp-content/uploads/2013/05/Siegel_Stocks-For-The-Long-Run.pdf

GDP Growth versus Market Return Over 20 Years



Source: IMF, Bloomberg and relevant underlying index provider(s). Data from 1996 – 2016.

Further to this, you only have to look at the evolution of the largest EM companies over time to see the importance of being active. An investment in the four largest index positions in 1994 may have been fruitful in the short term. However, today, one has been delisted, another has lost the majority of its value, and the others have gone nowhere in share price terms. Disruption of the telecommunications industry, and the inability of SOEs to adapt successfully, would have left investors disappointed in the long run.

Largest EM Companies by Market Cap

	1	2	3	4
1994	Telmex	Tenaga Nasional	Telekom Malaysia	Telebras

SOEs are still around 27% of the EM universe by index weight and today, we still see large swathes of the market under threat. It's true that emerging markets have a higher proportion of entrepreneur controlled companies versus developed markets, but SOEs have served to drag down the absolute returns investors have achieved through investing in EM as a whole. All the more reason to be selective. For those still unconvinced that active management is vital in EM, look at the make up of the index and its incumbents today. A number of long-term threats are apparent. Will internet finance eventually displace traditional banks? Can online networks (in both social and professional walks of life) leapfrog telcos? Will electric vehicle specialists and battery producers outdo traditional car companies?


MSCI Emerging Markets as at 31 March 2017
Long-term threats to incumbents
Telecommunication Services 5.6%
Utilities 2.8%
Consumer Discretionary 10.4%
Real Estate 2.6%
Materials 7.5%
Consumer Staples 6.9%
Energy 7.3%
Information Technology 24.5%
Financials 24.1%
Industrials 5.9%
Healthcare 2.4%
New communications route around telcos
Ecommerce and social networks leapfrog traditional shopping
Energy storage and renewables render the electricity grid redundant
Traditional banking disintermediated by mobile payments and peer-to-peer lending
Personalised medicine advances in the West reach the Emerging Markets

Source: MSCI.

RAISON D'ÊTRE

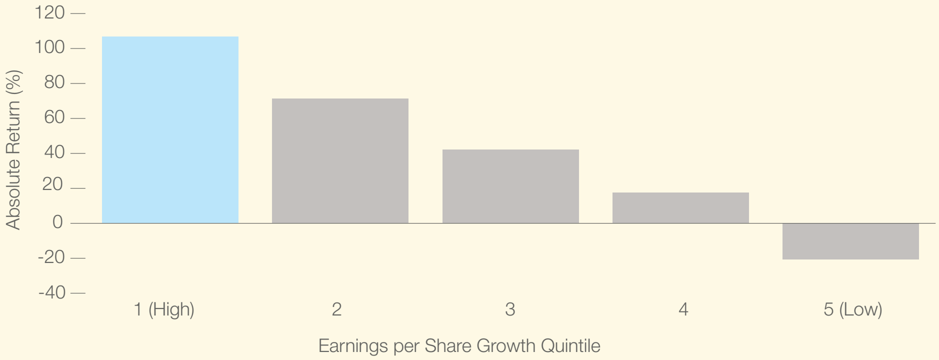
The whole raison d'être of EM investment is to capture the growth premium relative to developed markets. Is this true?, we hear our value peers exclaim; in a universe where hard currency growth is actually relatively uncommon, is value not the safer approach?

Underpinning our commitment to growth investing is the belief that, ultimately, those companies which can sustainably grow their earnings will be rewarded by the market. To evidence this we looked at different quintiles of earnings growth, in US dollars, over five-year periods in the EM universe. We found that in the last 20 years, the best quintile of earnings growers were rewarded, on a median basis, with a near doubling in share price.

The relationship is striking and demands our full attention. It underlines the importance of having a process with an unwavering focus on finding these companies that can grow their earnings over the long term at double digit rates. If we can find these companies, our clients will be handsomely rewarded.

But that's not to say that it's going to be a smooth ride. For the long-term EM investor focused primarily on individual companies, an active approach and resultant skewed portfolio, especially in a volatile market, certainly leads to periods of pain. We all know, over short time periods (by which we mean three years or less) share prices can readily detach themselves from operating fundamentals. A great example of this was in 2016. For instance, 86% of Brazilian companies outperformed the broader EM index, as did 77% of Russian companies. It didn't matter which company you were invested in: if you were in the market at all, the chances are you did well. These markets weren't driven by earnings; in this instance they were driven by economic and political factors.

Median Absolute 5 Year Return by 5 Year Earnings Per Share Growth Quintile

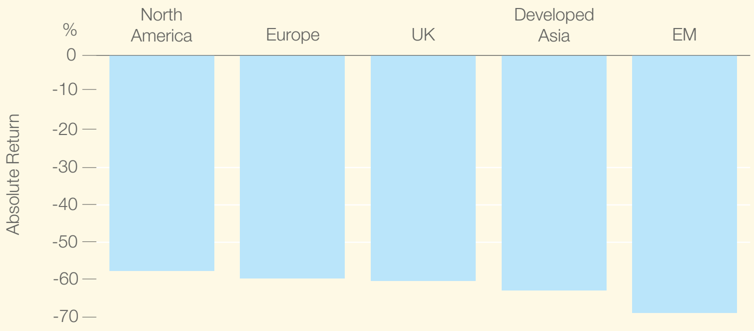


Source: Baillie Gifford & Co, Factset, Worldscope and relevant underlying index provider(s).
MSCI Emerging Market and FTSE Emerging Market Indices constituents as of the end of December of each year between 1997 and 2016 and with a market capitalisation larger than time-adjusted USD1bn. Earnings growth rates are based on previous fiscal year data, all in USD.

STAYING THE COURSE

At the individual company level, we took a look at 'big winners' in EM, defining those as companies which have delivered 20% p.a. total return in US dollar terms over a ten-year horizon; i.e. more than a six-fold return. We find that these highly successful companies were subject to rocky price trajectories, suffering an average maximum drawdown of 69% during the ten-year window. Clearly this is significant and gives some indication of the tolerance required of investors in order to access these substantial returns over the long term. Short-term discomfort comes with the territory. This figure, for EM winners, is also the most significant globally, on a regional basis.

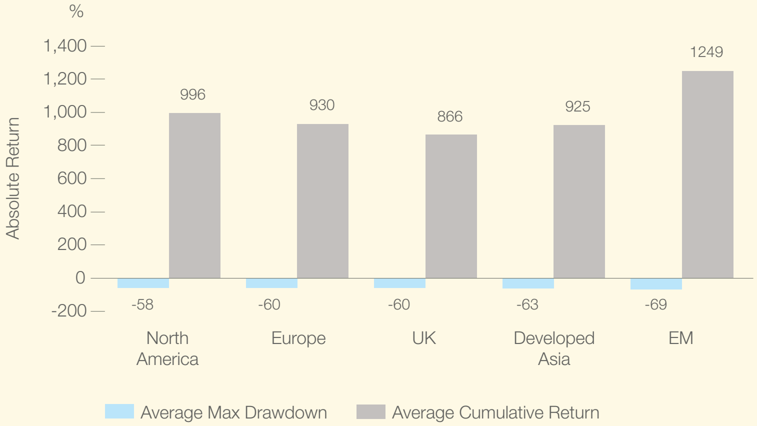
Average Maximum Drawdown During 10-Year Winning Period



Source: Baillie Gifford & Co, Factset, Worldscope, Datastream and relevant underlying index provider(s). Data from 31 December 1990 - 31 December 2016. Based on universe of global equities with market cap greater than $500m (historically adjusted) at start of period.

Perhaps this begs the question, why EM? Can we access the same big returns elsewhere without having to tolerate such unease along the way? First of all, we observe that in the context of the average cumulative returns of big winners over ten-year periods, i.e. more than 1,000% on average, compared to 69%, drawdown figures appear less significant. The second important observation is that the average cumulative return of an EM big winner is, by some way, the largest on a regional basis.

Asymmetry of Returns for Big Winners (10 Years)



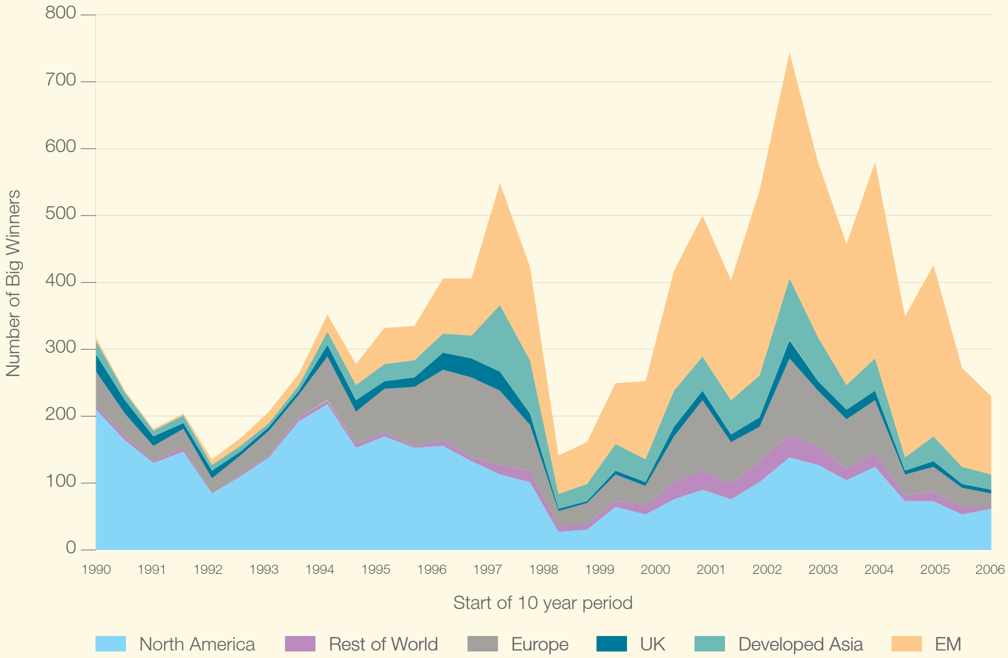
Source: Baillie Gifford & Co, Factset, Worldscope, Datastream and relevant underlying index provider(s). Data from 31 December 1990 - 31 December 2016. Based on universe of global equities with market cap greater than $500m (historically adjusted) at start of period.

Upside = total return, Downside = share price return

THE OPPORTUNITY SET

Staying on the topic of big winners for a moment longer, of course it's not just the magnitude of returns available that's important, but also the number of winners. Analysing big winners globally, we see that an increasing proportion can be attributed to EM. For periods beginning in the early to mid '90s, winners were dominated by North America, and less than 10% could be attributed to markets outside North America and Europe. Now EM contributes more than half of the best returning companies globally. The evidence is compelling, that in seeking the best investment returns globally, EM cannot be overlooked.

10 Year Big Winners by Region



Source: Baillie Gifford & Co, Factset, Worldscope and relevant underlying index provider(s). Based on universe of global equities with market cap greater than $500m (historically adjusted) at start of period.

CONCLUSION

In today's return environment, the need is as high as ever for equities to do the heavy portfolio lifting for our clients. EM equities specifically look very attractive, as long as the correct focus is maintained when investing in them. Our clients can be confident that in years to come we will still be working to the same principles that we do today. We will continue to invest in EM, we will be active, and we will be seeking to identify substantial growth opportunities with confidence that we, and our clients, will be rewarded over the long term.

We believe that the chance of strong absolute returns from EM is significant on a long-term view, thanks to a number of strong businesses and improving macroeconomics for many countries. This is about a lot more than just high GDP growth, favourable demographics and rising middle class incomes as many might suggest. Many companies are displacing established peers and monopolising relatively new industries, whilst still growing at a rate well in excess of the broader market. EM investors are being given the opportunity to invest in companies that we believe will dominate in years to come, not just in their home markets but globally, and in the process, generate world class returns.

CURIOUS ABOUT THE WORLD

bailliegifford.com/thinking

If you require further assistance or information, please contact
Baillie Gifford & Co Limited, Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone **0800 917 2112** for individual enquiries
Telephone **0800 917 4752** for intermediary enquiries
Or email us at **trustenquiries@bailliegifford.com**

Your call may be recorded for training or monitoring purposes.