HOW DO WE DO WHAT WE DO?

EMERGING MARKET INVESTING

Tim Campbell and Andrew Keiller

BAILLIE GIFFORD

RISK FACTORS

The views expressed in this article are those of the authors 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 in June 2020 and has not been updated subsequently. It represents views held at the time of writing and may not reflect current thinking.

Annual Past Performance (%) to 31 March Each Year

	2016	2017	2018	2019	2020
Baillie Gifford Emerging Markets – All Cap composite (Net)	-12.5	21.8	33.0	-3.3	-17.7
MSCI Emerging Markets	-11.7	17.7	25.4	-7.1	-17.4
FTSE Emerging Markets	-11.7	18.0	22.0	-5.3	-17.2

Source: Baillie Gifford & Co, MSCI, FTSE. US Dollars.

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.

Changes in the investment strategies, contributions or withdrawals may materially alter the performance and results of the portfolio. The Baillie Gifford Emerging Market strategies are more concentrated than the MSCI Emerging Markets index.

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 but is classified as advertising under Art 68 of the Financial Services Act ('FinSA') 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.

FTSE Legal Disclaimer

Source: London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group"). © LSE Group 2020. FTSE Russell is a trading name of certain of the LSE Group companies. ["FTSE","Russell"] are a trade mark(s) of the relevant LSE Group companies and are used by any other LSE Group company under license. "TMX®" is a trade mark of TSX, Inc. and used by the LSE Group under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.

MSCI Legal Disclaimer

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)

CM13649 How Do We Do 0620.indd
Ref: 47622 PRO AR 0017

This paper is a follow up to *'Why Do We Do What We Do? – Emerging Market Investing'* written in 2017.

JUNE 2020

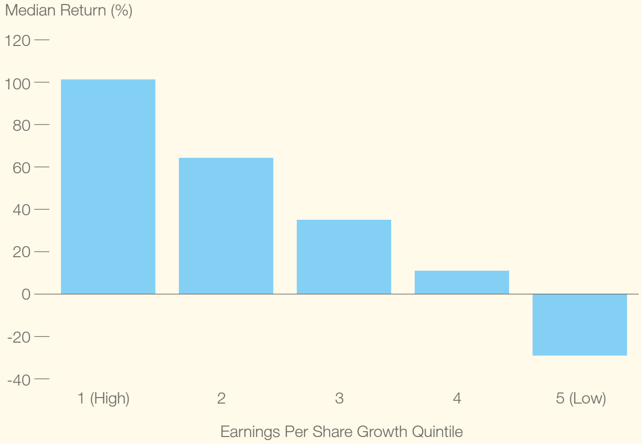
HOW DO WE DO WHAT WE DO? EMERGING MARKET INVESTING

BY TIM CAMPBELL AND ANDREW KEILLER

In the past we have written on 'Why Do We Do What We Do', exploring our growth philosophy in more detail, providing evidence to support our long-term, active approach. On reflection, we probably stopped short. The 'why', is of course important. Indeed, personalities like Simon Sinek, have made a career out of this single notion. However, some questions lead on from here. How do we go about implementing our philosophy in practice? How do we translate this 'why' into a portfolio that stands the best chance possible of delivering excess returns for our clients?

Our analysis showed the striking correlation between superior long-term earnings growth and stock price returns for the emerging markets (EM) universe.

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



Source: Baillie Gifford & Co, Factset, Worldscope and relevant underlying index providers. MSCI Emerging Market and FTSE Emerging Market Indices constituents as of end December each year between 1994 and 2019 and with a market capitalisation larger than time-adjusted USD1bn. Earnings growth rates are based on previous fiscal year data, all in US dollars.

Hence why our investment process is singularly focused on identifying those companies that can grow much faster than the market over prolonged periods of time. But distilling this process into something that fits neatly into a diagram is a challenge. By its nature, much of our process relies on the interplay of data, experience, educated creativity and probability. This does not lend itself to a matrix or a flowchart.

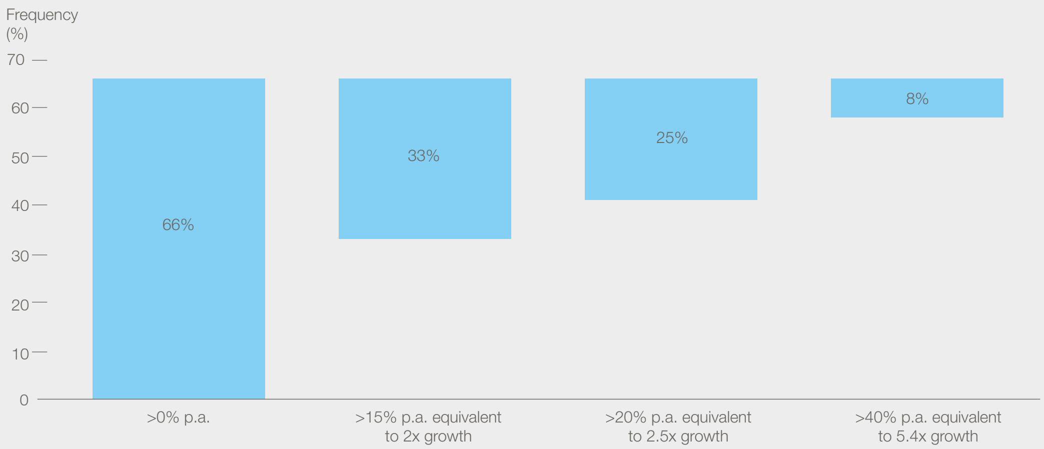
But, we do have a very clear view of the inefficiencies we are aiming to exploit.

IN SEARCH OF FAT TAILS

Our investment criteria dictates that any company put into client portfolios should be one where we can envisage at least a two-times total return in hard currency terms over five years. This doesn't mean 15 per cent per annum growth in a straight line, but we do look for it to come from underlying earnings growth rather than simply a re-rating of the shares. The cruel truth, however, is that only 33 per cent of stocks in our universe meet this criteria (based on a sample size of rolling five-year periods from 2002–2019). In fact, 34 per cent fail to generate a positive return at all. Our criteria is highly ambitious.

EM Stocks – Range of Rolling 5-Year Returns Per Annum

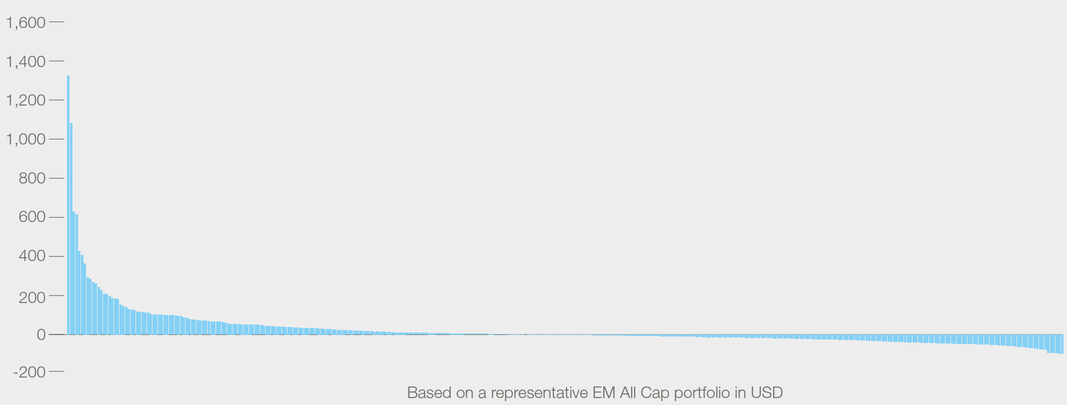
EM Stocks in MSCI EM Index or FTSE EM Index



This graph covers a 17-year period, split into rolling five-year periods rebalanced at the end of every year. It shows the proportion of EM stock observations that delivered five-year share price growth in each of the four different quantums. For instance, 66% of the stock observations grew positively and 33% exhibited growth of more than 15% per annum over five-year periods. Source: Factset and relevant underlying index providers. Data from end December 2002 to end December 2019 in US dollars.

Going further, it is evident that only a small selection of companies dominate EM returns over meaningful periods. Over the last 10 years or so, this pattern is clear. Between December 2009 and December 2019, there were nearly 2,000 companies in the MSCI EM index. Only 2 per cent of these drove all of the return. Of the other 98 per cent, although many obviously delivered a positive return, when added to those which were negative, they netted off to zero. Looking more specifically at our own client portfolios is also indicative of this pattern:

Stock returns, EM portfolio, 10 years to end January 2020



Source: Baillie Gifford & Co, Factset.

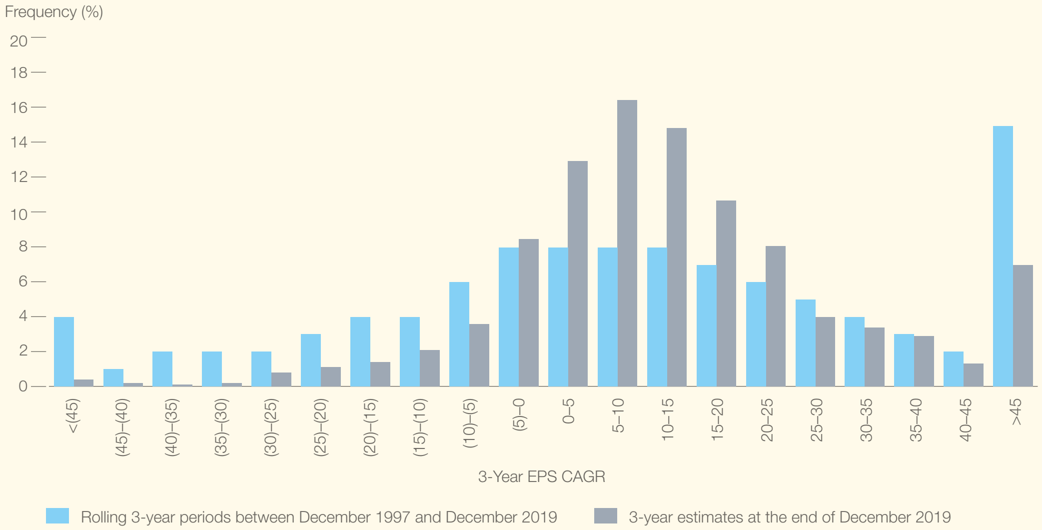
Clearly, finding the strongest performers requires us to be ambitious and demand a lot from the companies in which we invest.

How do we do this? We look for fat tails. Or to put this another way, we look to exploit the market's consistent refusal to accept the possibility of extreme outcomes. Consider the following chart which compares the average sell-side forecasts on earnings growth to the reality.

Looking at three-year forecasts[1], we immediately see that the majority of sell-side broker research predicts 0–20 per cent p.a. growth from companies in EM (grey bars). The reality (blue bars), is far more widely spread. We present this chart not as a dig at forecasting skill, as we would be the first to admit that forecasting precisely is impossible. It does, however, show a few interesting things. To begin with, the inherent bias in the sell-side means negative estimates are very uncommon compared to actuality (only 18 per cent of the forecasts predicted negative earnings versus the reality of 35 per cent). More importantly, there are a number of companies delivering very strong growth, as shown by the blue bars at the right-hand side of this chart.

EM Stocks – Range of EPS 3-Year Compound Annual Growth Rate (CAGR)

EM Stocks in MSCI EM Index or FTSE EM Index – All in USD – December 1997 to December 2019



Data from December 1997 – December 2019 in US dollars.
Source: Baillie Gifford & Co, Factset and relevant underlying index providers. As at 31 December 2019. The chart shows the range of 3-year earnings-per-share growth (per annum) delivered by EM stocks over the last 22 years (blue bars) with the 3-year earnings-per-share broker predictions (grey bars) at 31 December 2019.

These are the fat tails that we are targeting and it has proved to be a rich hunting ground, not least because the market consistently underestimates the likelihood of such growth occurring.

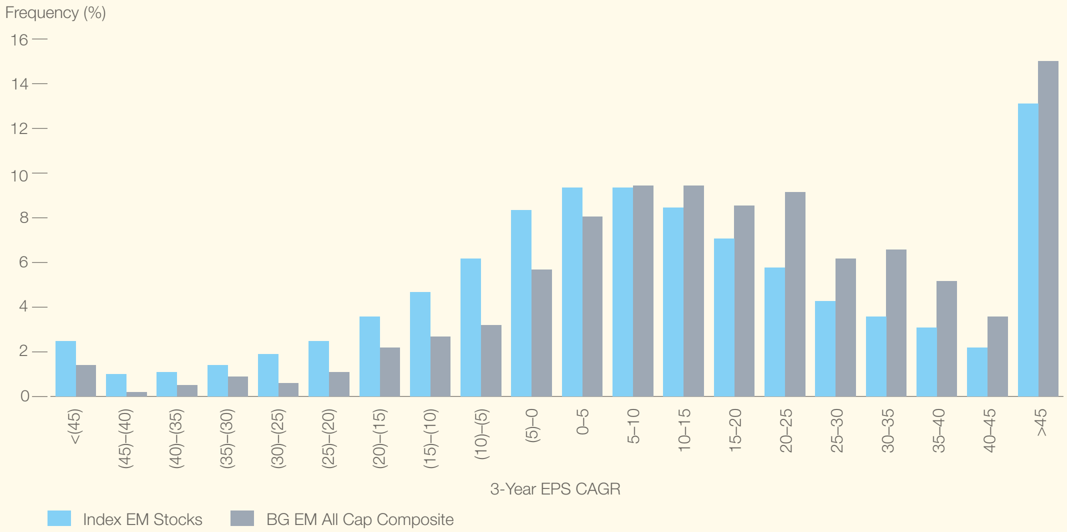
1. Ideally we'd have used five-year forecasts but unfortunately these are too far out for most sell-side analysts.

Time and again we see examples of where the market refuses to recognise the likelihood of rapid growth. It may be that this growth is lumpy, or represents a step change from a company's recent history or simply flies in the face of the law of big numbers, but our universe does present opportunities for those willing to break out of the confines of simply extrapolating recent history.

Just looking at our own client portfolios is instructive here:

Range of EPS 3-Year CAGR

EM Stocks in MSCI EM Index or FTSE EM Index vs Baillie Gifford EM All Cap



Source: Baillie Gifford & Co and Factset.
Rolling 3-year periods between December 2005 – December 2019, in US dollars. Source: BG Fund Reporting, Factset and relevant underlying index providers. As at 31 December 2019. Baillie Gifford Emerging Markets All Cap data based on a representative portfolio.

The skew of the grey bars to the right hand side of the chart demonstrates our commitment to finding superior growth companies. But identifying these names requires a number of particular disciplines.

First, it is far more profitable to spend time considering what could go right rather than what might go wrong. Portfolio returns will be overwhelmingly driven by a small number of companies that do extremely well, so making sure you invest in these companies is critical. It matters more than obsessively worrying about all the risks that are inevitably present in any investment decision. But this can be uncomfortable, indeed it requires a conscious rejection of our natural tendency to loss aversion.

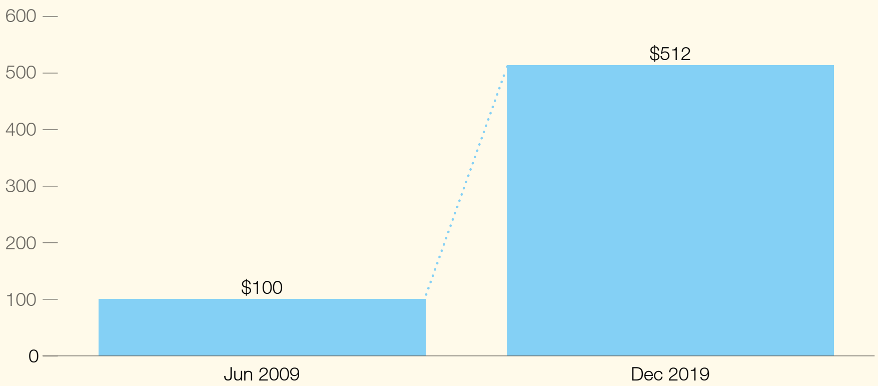
It necessitates that our analysis of companies is better than the extrapolation of most recent trends, that it correctly weights the possibility of extreme outcomes, of fat tails. And when we are faced with a small but credible chance of profits increasing by far more than the market expects, in a portfolio context, we should invest in size.

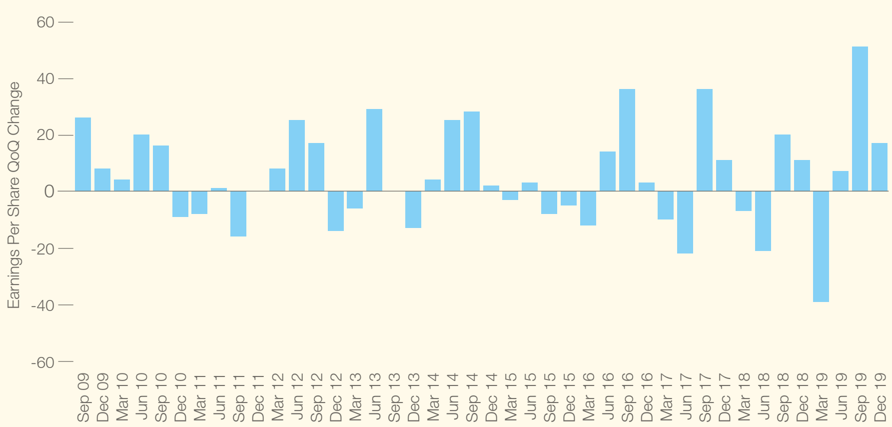
IGNORE THE IMMEDIATE

Experience has taught us that any attempt to forecast the near term with any level of precision can be seriously damaging to your wealth. Consider the following long-standing holding of our EM portfolios.

Taiwanese Semiconductor Foundry Company Earnings Per Share

Normalised to $100 as at 29 June 2009





Source: Bloomberg. As of 31 December 2019, USD.

The volatility of short-term earnings masks a significant rise in these companies' earnings power over the long term.

It would hardly be motivating or stimulating for an investor to be questioned every time a target was missed or there was a big short-term swing in earnings for one of these companies. Nor would this have been a profitable use of time. The volatility of short-term earnings masks a significant rise in these companies' earnings power over the long term. We spend all our efforts trying to understand the drivers of the latter, which requires a discipline in ignoring the former.

We would go further here, arguing that some of the greatest inefficiencies we encounter in EM are in companies where profits will be volatile from one quarter to the next, often as a result of investment or product cycles that are years in the planning. The market has shown a disdain for such companies, preferring the predictability of smooth profit generation even if the long-term growth rate turns out to be a fraction of that achieved by those more willing to reinvest in their business with greater ambition. This presents us with fantastic investment opportunities, but it requires an approach and culture that allows you to ignore near-term volatility.

You cannot invest in this way if you pay your investors for generating short-term performance. Quarterly or even annual earnings releases matter if you're paid on annual performance but ultimately, this is likely to be counterproductive. We pay our investors exclusively on rolling five-year performance. This ensures that we remain focused only on what really matters, bearing in mind the next year or two have very little bearing on the terminal value of a company.

INFLECTION POINTS MATTER

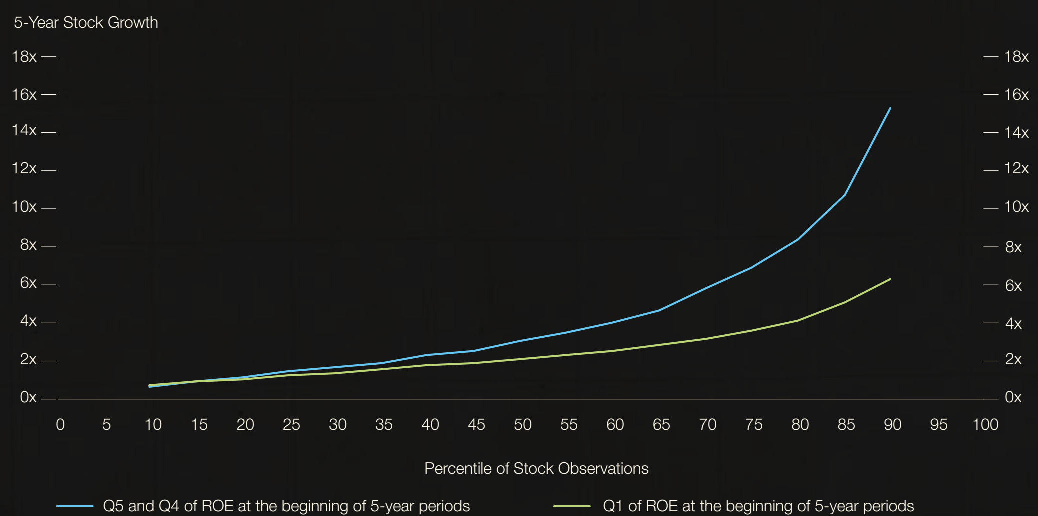
Another great inefficiency resides in the interaction between top-down and bottom-up investing.

EM investors do not have the luxury of ignoring the macro. Purely bottom-up investment is a path to ruin in a universe where industrial and economic cycles can dominate investment returns over multi-year periods. This also provides opportunities.

Our analysis shows that while it may pay to invest in those companies that display consistently high levels of profitability (as defined by those in the highest quintile of return on equity), the strongest returns are to be found in those companies that transition from poor levels of profitability to high (i.e. those that transition from the bottom two quintiles to the top quintile).

5-Year Stock Growth Percentiles by Quintile of ROE at the Beginning of the 5-Year Period

Stocks in Q1 of ROE at the end of the 5-Year Period



This graph shows the results of our analysis of EM returns data from 1996-2017. We split this into 5-year return periods, rebalanced annually, and we studied quintiles of 5-year US dollar ROE. It shows that stocks transitioning from low ROE quintiles to the top quintile have often displayed strong returns. For example, 20% of the observations grew more than eight times over 5-year periods, as shown by the blue line. Source: Factset. As at 29 September 2017. Based on equities defined as Emerging Markets by MSCI or FTSE.

This may seem obvious – rising levels of profitability are normally accompanied by a re-rating, thereby providing a two-fold kicker to share price performance – but identifying the drivers behind this change is the key and has been a significant source of excess return for our EM portfolios.

Over the last 20 years, broadly speaking, we can identify four separate inflection points that triggered significant changes to our EM portfolios.

1999	The transition from portfolios with a majority in tech to more diversified portfolios.
2003	The move to a much greater concentration in heavy industrial and commodity companies as China's huge infrastructure spend gripped EM economies.
2009–2012	Our divestment from commodity-based economies and a gradual increase to a significant overweight in IT companies.
2017	A return to broader and more diverse EM portfolios following a commodity country reset.

It is largely impossible to time these inflection points perfectly but when you have an investment horizon measured over many years, successfully anticipating the future direction of travel is hugely valuable. As one of our investors put it, we're not interested in the weather, but in climate change.

So how do we identify these inflection points? The first thing to say is that if you wait for all the evidence to be there that something has changed, you've already missed it. You will find very few estimates that assume a step change in return on equity. Dealing with incomplete information is the norm. Take the most recent transition, for example. Brazil and Russia were by no means out of the woods around 2017; their economies were (and are) still vulnerable to commodity shocks and volatile politics, but we believed there were reasons to suspect the balance of probabilities had shifted more in favour of hard currency growth than further retrenchment.

There is no silver bullet here but, by way of an example, factors we have looked at to inform our more positive view on oil and commodities include:

- the level of capex being spent on greenfield projects (many of the largest miners are scarcely covering maintenance capex let alone expansionary capex)
- changes in demand (beyond the obvious global growth, what does a marked increase in electric vehicles mean for nickel and platinum group metals?)
- changes in supply (shale oil may fill the need for light crude but what of the marked dearth of heavy crude, bearing in mind that most new sources of oil or materials require many years to come on stream?).

The ability to research these sizeable topics on a global scale, then join the dots and work back to the EM companies that stand the greatest chance of benefitting from these shifts in cycles has been one of the great strengths of our process. It is also why we would politely question those who argue EM investing can be purely bottom up or those who rely heavily on backward-looking quant models. EM cycles are frequently long duration, which in turn means they can overwhelm strong company fundamentals for multi-year periods. So our process explicitly encourages our investors to make time to understand and anticipate cyclical change. Portfolio management and pure stock picking are very different skills and experience has taught us that marrying the macro with the micro helps not just with idea generation but ultimately in maximising your chances of consistent outperformance.

CONCLUSION

To invest in emerging markets one has to be an optimist. Underpinning any allocation is the implicit belief that developing countries can emerge and that shareholders can benefit from this growth. But to make the most of that opportunity requires a clear understanding of how to take advantage of the inefficiencies that present themselves.

Our process actively seeks out the potential for extreme outcomes. The evidence supports the thesis that truly rapid growth is more frequent than the market expects and is consequently mispriced. To do this requires a relentless focus on the long term. Volatility of earnings, while behaviourally uncomfortable, is often a rich seam to be mined, and our long-term remuneration structure is key to allowing our investors to focus only on what matters.

Finally, we look for inflection points. We encourage our investors to travel, to think in terms of structural shifts and to assess the impact of prolonged imbalances of supply and demand. It is these inefficiencies that have driven our idea generation and informed our portfolio positioning for over twenty years. It has allowed us to generate excess returns through different market conditions and several cycles.

As we embark on another transition within emerging markets, the opportunities for active growth seem as plentiful as they ever have been.

ABOUT THE AUTHORS

TIM CAMPBELL
Client Service Director

Tim is a Director in the Clients Department and Chair of the Emerging Markets Product Group. He joined Baillie Gifford in 1999, initially working as an Investment Manager in the Emerging Markets Equity Team. He moved to the Clients Department in 2007 and became a Partner in 2012. Tim graduated BA in History from Trinity College, Dublin in 1997.

ANDREW KEILLER
Client Service Director

Andrew is a Client Service Director in the Emerging Markets Client Team and is a CFA Charterholder. He joined Baillie Gifford in 2011 as a Graduate Trainee and completed a two-year programme of secondments around the firm. Andrew graduated BSc (Hons) in Mathematics and Business Studies from The University of Edinburgh in 2011.

IMPORTANT INFORMATION

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.

Persons resident or domiciled outside 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.

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 also has a representative office in Zurich, Switzerland pursuant to Art. 58 of the Federal Act on Financial Institutions ("FinIA"). It does not constitute a branch and therefore does not have authority to commit Baillie Gifford Investment Management (Europe) Limited. It is the intention to ask for the authorisation by the Swiss Financial Market Supervisory Authority (FINMA) to maintain this representative office of a foreign asset manager of collective assets in Switzerland pursuant to the applicable transitional provisions of FinIA. Baillie Gifford Investment Management (Europe) Limited is a wholly owned subsidiary of Baillie Gifford Overseas Limited, which is wholly owned by Baillie Gifford & Co.

Hong Kong

Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(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 collective investment schemes to professional investors in Hong Kong. Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 can be contacted at Room 3009-3010, One International Finance Centre, 1 Harbour ViewStreet, Central, Hong Kong. Telephone +852 3756 5700.

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.

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.

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.

South Africa

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

North America

Baillie Gifford International LLC is wholly owned by Baillie Gifford Overseas Limited; it was formed in Delaware in 2005 and is registered with the SEC. It is the legal entity through which Baillie Gifford Overseas Limited provides client service and marketing functions in North America. Baillie Gifford Overseas Limited is registered with the SEC in the United States of America.

The Manager is not resident in Canada, its head office and principal place of business is in Edinburgh, Scotland. Baillie Gifford Overseas Limited is regulated in Canada as a portfolio manager and exempt market dealer with the Ontario Securities Commission. Its portfolio manager licence is currently passported into Alberta, Quebec, Saskatchewan, Manitoba and Newfoundland & Labrador whereas the exempt market dealer licence is passported across all Canadian provinces and territories. Baillie Gifford Investment Management (Europe) Limited ('BGE') relies on the International Investment Fund Manager Exemption in the provinces of Ontario and Quebec.

Oman

Baillie Gifford Overseas Limited ("BGO") neither has a registered business presence nor a representative office in Oman and does not undertake banking business or provide financial services in Oman. Consequently, BGO is not regulated by either the Central Bank of Oman or Oman's Capital Market Authority. No authorization, licence or approval has been received from the Capital Market Authority of Oman or any other regulatory authority in Oman, to provide such advice or service within Oman. BGO does not solicit business in Oman and does not market, offer, sell or distribute any financial or investment products or services in Oman and no subscription to any securities, products or financial services may or will be consummated within Oman. The recipient of this document represents that it is a financial institution or a sophisticated investor (as described in Article 139 of the Executive Regulations of the Capital Market Law) and that its officers/employees have such experience in business and financial matters that they are capable of evaluating the merits and risks of investments.

Qatar

This strategy is only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved. This does not constitute an offer to the public and is for the use only of the named addressee and should not be given or shown to any other person (other than employees, agents, or consultants in connection with the addressee's consideration thereof). Baillie Gifford Overseas Limited has not been and will not be registered with Qatar Central Bank or under any laws of the State of Qatar. No transactions will be concluded in your jurisdiction and any inquiries regarding the strategy should be made to Baillie Gifford.

Israel

Baillie Gifford Overseas is not licensed under Israel's Regulation of Investment Advising, Investment Marketing and Portfolio Management Law, 5755-1995 (the Advice Law) and does not carry insurance pursuant to the Advice Law. This document is only intended for those categories of Israeli residents who are qualified clients listed on the First Addendum to the Advice Law.

CURIOUS ABOUT THE WORLD

bailliegifford.com/thinking

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