ON TRACK FOR INCOME AND GROWTH

SAINTS QUARTERLY UPDATE

James Dow and Toby Ross, Investment Managers. First Quarter 2019

BAILLIE GIFFORD

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All data is current and source Baillie Gifford unless otherwise stated.

The images used in this document are for illustrative purposes only.

Past Performance

	2015	2016	2017	2018	2019
Scottish American Investment Company P.L.C. share price performance (%)	6.8	9.3	34.6	10.8	7.8

Source: Baillie Gifford & Co. Morningstar. To 31 March each year.

	2014	2015	2016	2017	2018
Scottish American Investment Company P.L.C. Total dividend per ordinary share (net) – (pence per share)	10.50	10.70	10.825	11.10	11.50

Source: Baillie Gifford & Co. Morningstar. To 31 December each year.

Past performance is not a guide to future returns.

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ON TRACK FOR INCOME AND GROWTH

BY JAMES DOW AND TOBY ROSS

Results season has been in full swing for the last few months. This is always an interesting time of year for us, because it's when we get some hard evidence around the extent to which the companies we invest in on our clients' behalf are delivering the outcomes that we expect.

Our investment cases are typically long-term in nature. We are seeking to identify whether a business will deliver good growth in earnings, ahead of inflation, over a five-year plus time period, and pay dependable dividends at the same time. For different businesses we will have a different expectation of what is likely to drive earnings growth, and what rate we might expect, though across the portfolio we typically think of earnings growth of at least 3 per cent ahead of inflation as the minimum long-term hurdle. If businesses are consistently growing above this sort of level, we are confident at the time of writing they will be able to deliver strong real dividend and capital growth.

At this time of year, we chalk up the scores, and compare them to our expectations. We aren't prescriptive spreadsheet addicts, and we rarely have a precise earnings expectation in mind. But let's say our hypothesis for an investment is that volume growth from new products and steady price increases should help deliver high single-digit earnings growth over many years. If the company then reports consecutive years of below-inflation earnings growth, it is a signal that we need to revisit our case. It might be that growth at that company has been deferred – and we are always willing to be patient with businesses we rate and management teams we trust. However, it might be a sign that we were wrong, and we need to re-consider the investment.

CHALKING UP THE SCORES

EARNINGS

So how have our holdings done? Broadly, the operating results from the portfolio have been strong. We estimate that for the companies which have reported at the time of writing (95 per cent of the holdings), the median growth in underlying earnings per share was around 8 per cent, or 6 per cent ahead of inflation (in the local currencies of the companies). The average, weighted by the size of the portfolio's holdings at the start of the year, was also around 7.5-8 per cent in nominal terms, or around 6 per cent in real terms.

As ever, averages of a diverse data set can hide a lot of variation, so it's important to look beneath the surface to understand what is driving this.

There are a few areas where earnings growth in the past year has been especially strong. Some of our high-growth consumer businesses, namely Anta Sports and Kering, delivered phenomenal like-for-like sales growth, as they attracted new consumers to their key growth brands (Fila and Gucci respectively). Earnings per share growth for both businesses was over 40 per cent. A number of our technology businesses delivered earnings growth of more than 15 per cent (for example Microsoft, Apple, Analog, National Instruments, Dolby), driven in each case by success in coming up with new products that excited customers. A number of our financials holdings delivered strong growth, especially our three stock exchanges (B3, Deutsche Boerse and Hong Kong Exchanges), and two of our banks which started to feel the benefit of rising interest rates on their bottom-line (UOB and Cullen/Frost). Finally, the portfolio does not have much exposure to the mining or oil & gas sectors, but earnings at Albemarle, Total and Apache all increased sharply thanks to volume growth and strengthening commodity prices.

The strong growth at these businesses was not a one-year blip – in most cases it has been sustained for several years, and we are optimistic that the drivers should continue for years to come, even if growth rates moderate.

Just as this growth has often been driven by exceptional execution by the specific companies we invest in, where we have been disappointed lately it has usually been for stock-specific reasons. SSE has suffered from challenges in its retail business, poor wind generation, and an expensive hedging mistake. We've been sufficiently disappointed by the company's performance to reduce the holding. Li & Fung is investing heavily to digitise the process of improving its customers' supply chains, but in the near-term the impact of destocking by retailers and store bankruptcies have weighed on its volumes and earnings. Lastly, AVI saw demand from South African consumers for its biscuits and shoes slow in the second half of 2018.

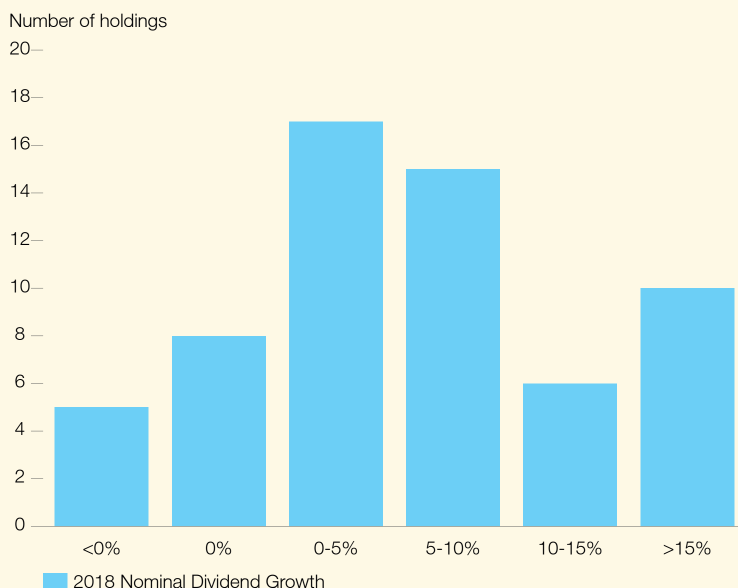
Stepping back and looking at the portfolio as a whole, over 70 per cent of the holdings exceeded our 3 per cent real earnings growth hurdle, and there were more examples of companies where we were pleasantly surprised than disappointed by the results.

AND DIVIDENDS

This earnings growth has largely been feeding through into healthy dividend announcements. Median dividend growth across the portfolio was 5 per cent, or 3 per cent in real terms. The average increase, weighted for SAINTS' holdings at the start of the year, was 7-8 per cent in nominal terms, or 5-6 per cent in real terms. Another way of viewing this is that some holdings delivered very strong dividend growth, and SAINTS typically had larger holdings in the names that delivered stronger growth.

We have shown the distribution of dividend growth rates in the SAINTS portfolio in the chart opposite:

Dividend growth rates in 2018

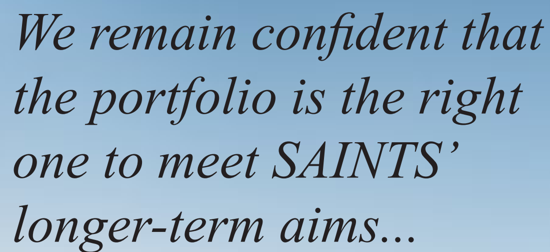


As we would expect, there was a high correlation between the earnings growth which companies delivered, and how confident they have felt in growing their dividends. Notable this year was the 75 per cent dividend increase announced by Kering, the 33 per cent increase from B3, and the 25 per cent increase from UOB (with a special dividend paid as well). Consistent with the earnings growth we saw from the portfolio, over three-quarters of the holdings delivered dividend increases ahead of inflation, in line with SAINTS' objectives.

We don't necessarily mind if some of our holdings don't raise their dividends *every* year, if that's not what is right for the business. For instance, we invested in GSK in full knowledge that the dividend would not increase for the next 2–3 years, as the new management team rebuilt dividend coverage. However, we are excited by the potential for accelerating long-term earnings growth here, led by the reinvigoration of the pharma research and development pipeline, and believe that in time this will feed through to dividend growth. And in the mean-time, the shares offer us a high level of income today. The important point to emphasise is that we are only willing to make this trade-off because of our confidence in the long-term earnings growth. Indeed, high near-term income combined with poor long-term real earnings growth is typically a worse combination the longer an investor's time horizon.

Five companies reduced their dividends this year, with reductions ranging from 2 per cent to 56 per cent. In some cases, this was for good reasons and from a position of strength. For instance, Anta reduced their interim dividend despite strong earnings growth. This temporarily reduced dividend is part of their plan to finance the acquisition of Amer Sports, which has the potential to be transformational for the business. We have reduced the holding, noting the level of debt the company is taking on, but are keen to remain invested through this period of transformation. On the other hand, Li & Fung and Man Wah traded weakly, and payout-ratio based dividend policies – where dividends are linked to a company's income – led automatically to dividend reductions.

This is a slightly generous view of our success in avoiding dividend cuts this year. During the course of 2018 we sold two holdings that had already reduced their dividends – Dia, and Pandora. The fact they were no longer in the portfolio at the end of 2018 means they are not included in the graphic on page 5. In both cases we thought it better to accept the fact that our investment case had broken, and reinvest the proceeds into businesses where we were more enthusiastic about the prospects for long-term dividend and capital growth. The same thing sometimes happens in reverse – there have been some occasions where



share prices have risen sharply, the contribution that a stock will make to the portfolio's income has reduced, and we have chosen to reduce the size of the holding, and reinvest some of the capital in an opportunity which we believe will deliver more long-term income. Decisions like these are one reason that dividend growth is not always the same number as the growth in the portfolio's income.

Another factor is currency moves. The dividend announcements noted are all in local currencies, and in most cases reflect what the companies are intending to pay over the coming year. If currencies move sharply, then that can have an effect on the portfolio's income. This is one reason why our focus is always on seeking to invest in companies with strong underlying growth, that will help them ride out the gyrations of currencies. And in SAINTS' case, it is one reason that the revenue reserves are so valuable.

Overall, we are pleased by the operational delivery of most of our holdings. As managers, we put a lot of effort into dissecting the cases where we've been disappointed – but stepping back and looking at the broader trend is also instructive, and reassuring. We remain confident that the portfolio is the right one to meet SAINTS' longer-term aims, though we are far from complacent.

PORTFOLIO UPDATE

Equity markets bounced back sharply at the start of the year, following a difficult end to 2018, and the equity portfolio has largely kept pace with this. A theme here has been a less gloomy view on the Chinese consumer, and Kering and Anta have performed very strongly. Several holdings which were particularly weak at the end of 2018 have bounced back quite strongly – Man Wah, BAT and Apache are all up by 30 per cent.

We have bought three new holdings since the start of the year. USS is a Japanese car auction business, with a dominant position in an industry where scale is the major driver of returns. We think its edge is enduring, but what particularly attracts us is the management team's relentless focus on improving the service, while finding new sources of growth.

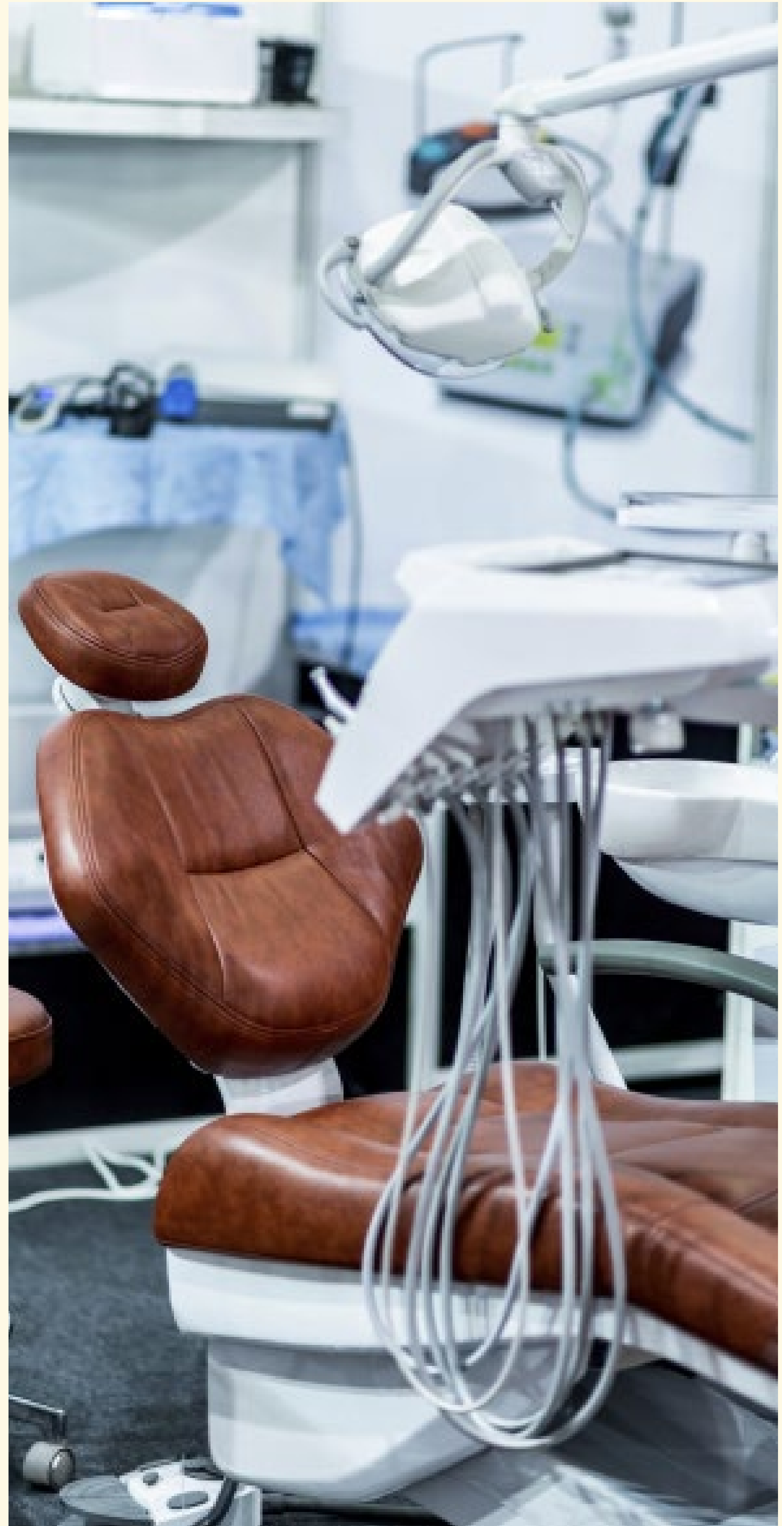
Kuehne + Nagel is a Swiss freight-forwarding and logistics business, majority owned by Klaus-Michael Kuehne. We think they are the technology leaders in their industry, and will benefit from a push towards more highly automated logistics services. They have a strong bias towards organic growth, and their capital-light business model allows them to return significant cash to shareholders as they grow.

Pernod Ricard is one of the two largest collections of global spirits brands. Our interest in this has been piqued by their success in building a valuable position in the emerging spirits-consuming markets of India and China, which have a long runway ahead of them. We are also encouraged by many of the changes which CEO Alexandre Ricard has been making to reinvigorate the core business, which we think could bear fruit for many years – he could potentially have decades at the helm.

We funded these purchases through the sale of Brambles, where we think the growth prospects have become both pedestrian and quite capital-intensive, and through a reduction to SSE. We also redeemed our holding in Athena Debt Opportunities, and we halved the holding in the Alibaba Convertible. For now, these bond sales have been reinvested into the equity portfolio, but we are also considering some new fixed income ideas.

Going through our holdings' results is a little like an annual check-up at the dentist.

OUTLOOK – OPEN WIDE



Going through our holdings' results is a little like an annual check-up at the dentist. It's important to do, and helps you spot what is and isn't working, as early as possible. However, what makes a difference between a perfect smile and a toothy grin is your daily habits – the inputs, rather than the annual session under the dentist's lamp. What are you eating, and how disciplined are you in brushing your teeth?

Most of what we do as managers is squarely focused on these inputs: it is the long-term, stock-specific research on new and existing holdings that helps us understand how they will perform over time. We continue to be ambitious for the new ideas we buy for the portfolio, and diligent when it comes to seeking resilient dividends. Any check-up always makes you think hard about what you can do better – but this year has left us feeling optimistic about the future prospects for SAINTS' holdings.

ABOUT THE AUTHORS

JAMES DOW

Investment Manager

James graduated MA (Hons) in Economics-Philosophy from the University of St Andrews in 2000, and an MSc in Development Studies at the London School of Economics in 2001. He spent three years working at The Scotsman newspaper, where he was the Economics Editor. James joined Baillie Gifford's graduate scheme in 2004 and became an Investment Manager in our US Equities Team. In 2017 James was appointed Co-Head of the Global Income Growth Team and Co-Manager of The Scottish American Investment Company P.L.C. (SAINTS). James is a CFA charterholder.

TOBY ROSS

Investment Manager

Toby graduated MA in English Literature from the University of Cambridge in June 2006 and joined Baillie Gifford in the same year. He spent some time as an Investment Analyst in the UK Equity Team and as a Global Sector Specialist. Toby became Co-Head of the Global Income Growth Team and Joint Manager of The Scottish American Investment Company P.L.C. (SAINTS) in 2017. Toby joined the ACWI ex US Alpha Portfolio Construction Group in September 2018. He is a CFA charterholder.

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