FROM CRISIS TO OPPORTUNITY

James Dow, co-head of Baillie Gifford's equity income strategies:

Global Income Growth Fund
Responsible Global Equity Income Fund
Scottish American Investment Company P.L.C.

BAILLIE GIFFORD

IMPORTANT INFORMATION AND RISK FACTORS

The following article has been written by James Dow, an investment manager for the Global Income Growth strategies, which include the Global Income Growth Fund, the Responsible Global Equity Income Fund and Scottish American Investment Company P.L.C.

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Annual Past Performance to 31 March each year

SAINTS	2016	2017	2018	2019	2020
Share Price	34.6	10.8	7.8	-4.1	36.7
NAV	31.7	7.2	10.6	-3.6	34.4
FTSE All World Index	33.1	2.9	10.7	-6.2	39.6

Performance source: Morningstar, FTSE, total return in sterling.

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Product details, including a Key Information Document, the possible effect of charges on an investment, are available on request.

Annual Past Performance to 31 March each year

	2016	2017	2018	2019	2020
Global Income Growth Fund (B Inc)	28.5	2.5	9.7	-1.8	33.4
Responsible Global Equity Income Fund (B Inc)*	n/a	n/a	n/a	0.0	32.4
MSCI ACWI Index	33.0	2.9	11.1	-6.2	39.6
Investment Association Global Equity Income Sector	25.4	-1.4	8.5	-9.8	32.0

Performance source: StatPro, FE, MSCI, total return in sterling. Returns reflect the annual charges but excludes any initial charge paid. *Please note as the fund's launch date was 6 December 2018, full historic performance is not available.

The manager believes MSCI ACWI Index is an appropriate target benchmark given the investment policy of these funds and the approach taken by the manager when investing. In addition the manager believes an appropriate performance comparison for these funds is the Investment Association Global Equity Income sector.

A NEW PARADIGM IN INCOME INVESTING AND HOW INVESTORS CAN EMBRACE IT

This is an exciting time to be an income investor. Never has it been clearer that a growth approach to income, as we have long advocated at Baillie Gifford, delivers better results than a high-yield approach. For too long investors have been advised to hold their noses and buy troubled companies with high dividend yields if they want income. In 2020 this paradigm was exposed as fatally flawed. Countless high-yielders, from high street retail chains to oil producers, were forced to cut or cancel their distributions. Meanwhile the growth approach fared considerably better, with our Global Income Growth portfolio income dipping only 3 per cent, despite a terrible year for dividends in the wider market.

The growth approach to income asks investors to look forwards, not backwards. It advocates embracing companies with bright futures – companies that are reinvesting appropriately in their business and paying lower but sustainable dividends. Our belief is that this approach to income will continue to bear fruit for many years to come. What's more exciting, income investors are currently spoiled for choice when it comes to picking stocks within this framework.

We call our methodology long-term income, not short-term yield. In this paper we share our experience of picking stocks using this growth-focused approach. We explain why we think the best is yet to come for this approach. And we highlight three simple questions we ask of any company when picking stocks for our income-growth portfolio.

LONG-TERM INCOME NOT SHORT-TERM YIELD

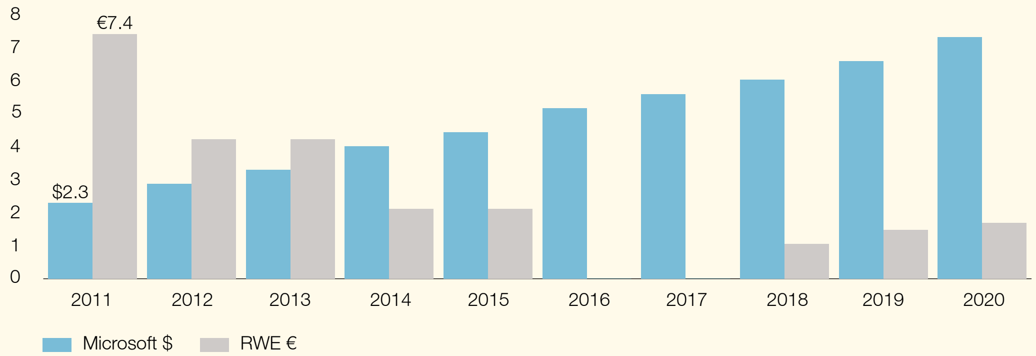
The simplest way to illustrate the way we invest for income is to look at a real-world example.

Cast your mind back 10 years to a time when the old paradigm would have asked you to buy shares in companies such as RWE, the German electricity company. At that time, it paid a large dividend yield of more than 7 per cent. As a utility business it had limited prospects for growth, but its dividends had grown steadily for several years. That was supposed to make it perfect for income investors.

Sadly, such an assumption proved wrong. RWE's business model was deeply troubled. Its electricity production was powered by dirty power stations burning brown coal, together with nuclear plants. Its future profits would be dictated by German regulators and wholesale electricity prices, neither of which are known for their stability. A forward-looking investor would have realised that the world was changing, and the German government was looking to phase out coal and nuclear electricity. RWE would soon face massive taxes on its production, and huge capital costs to replace its ageing fleet of plants. It was poorly placed to respond to this challenge with new investment: its debts were already twice its annual profit.

What transpired for income investors who owned RWE over the next decade was a disaster, as the accompanying chart shows. German regulations tightened, and electricity prices fell, resulting in RWE's profits collapsing. The share price tumbled. With high debts, declining cash flows and huge capital spending required, its dividend was terminated.

Income from 100 invested ten years ago



Total returns 2011–2020 (%)	Microsoft	RWE
Income return	47.6	24.2
Capital return	625.5	-35.9

Source: ThomsonReuters Eikon.

Here's the bottom line: an investment of €100 in RWE was worth only €63 a decade later. Total annual dividends were about €2.40 – a far cry from the 7.4 per cent yield offered in the first year.

The problem with this broken approach to income investing is that it places too much emphasis on a company's dividend yield. That 7 per cent yield looked appealing. But yield is a one-year number. It is not the same as long-term income.

As income investors, we have long time horizons. We are looking to help clients fund a 30-year retirement, or a charitable endowment, or some other financial goal which lasts for decades – not a single year. We need to align our mindset with this time horizon and find long-term income, not short-term yield.

Now observe the fortunes of Microsoft – another company that income investors might have purchased 10 years ago, if they had focused on future growth instead of high yield. A decade ago, Microsoft's Windows and Office franchises produced huge cash flows. But rather than paying out a big dividend yield, the company re-invested 70 per cent of its profits for future growth.

Some of those reinvestments went into technologies that would later be re-named cloud computing. Faster processing and internet speeds were opening up a lucrative opportunity for companies to store their data remotely, rather than on-premise. Microsoft was well-placed to cater for this brave new world. As we now know, 10 years on, this is a hugely profitable part of its business.

As Microsoft's profits have grown, so has its dividend. In 2010, the dividend yield on the shares was a little more than 2 per cent. Since then, the power of compounding has taken over. By the end of the decade, a $100 investment in Microsoft was yielding $10 – and the dividend continues to grow. The pay-out is also tremendously resilient, thanks to a fortress balance sheet and stable cash flows. This was true long-term income, not short-term yield.

Moving forward to where we are now, the new paradigm for income investing is about allocating capital to the Microsofts of the future. We purchased shares in Microsoft for our income strategy 10 years ago. Since then, each $100 invested has generated twice the income for our clients that they would have received had we followed the old routine and bought troubled high-yielder RWE. That's pretty extraordinary when you consider the difference in starting yield. But it demonstrates the superiority of this approach for generating long-term income.

Meanwhile, the capital value of RWE has fallen more than 30 per cent, while our investment in Microsoft has increased more than 600 per cent. This too is valuable to income investors, because it is tomorrow's capital that pays tomorrow's income.

WILL THIS APPROACH KEEP WORKING?

We like to illustrate our methodology by comparing our approach with owning a stable of racehorses, which will hopefully win prizes in the future. An investment in a troubled high-yield company is the equivalent of buying an old nag with only one or two races left in it. It might look 'cheap'. And who knows, it might bring home a medal in a race or two. But the clock is ticking, and you know it's only a matter of time before it needs to be put out to pasture, never to win again.

The new approach to income is the equivalent of investing in young, thoroughbred racehorses with years of prize-winning opportunities ahead of them. This will always be a better strategy for generating a lifetime of earnings.

What is most exciting for income investors is that we are living in a golden age of opportunity to buy companies with years of growth still ahead of them. Consider the following examples as sources of growth:

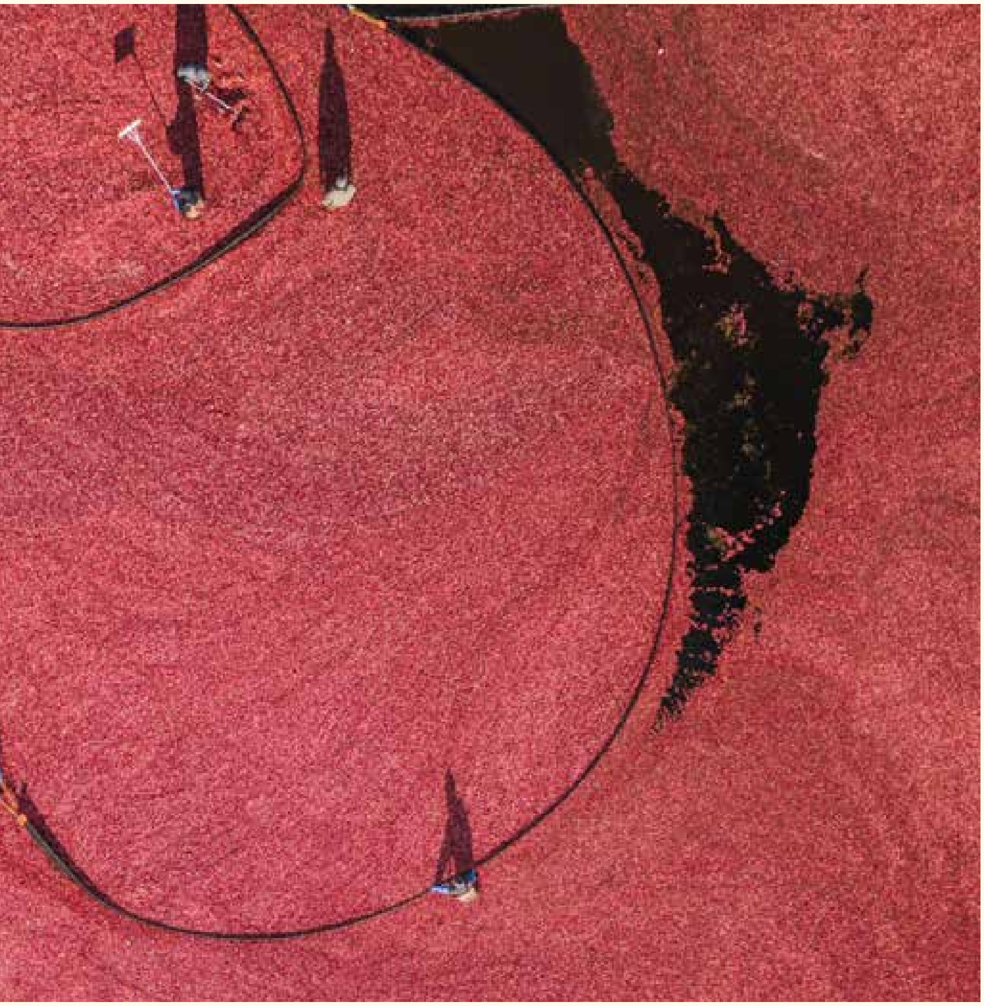
— Continued improvements in computing power and algorithms promise new ways to extract revenue and cost savings by learning from large datasets

— The fight against global warming is creating unimagined opportunities in many fields

— Homeworking through the Covid-19 pandemic has opened our eyes to new ways of communicating more efficiently

— Incomes could continue rising at a healthy pace for many years in China, a country with a population twice the size of Europe and the US combined

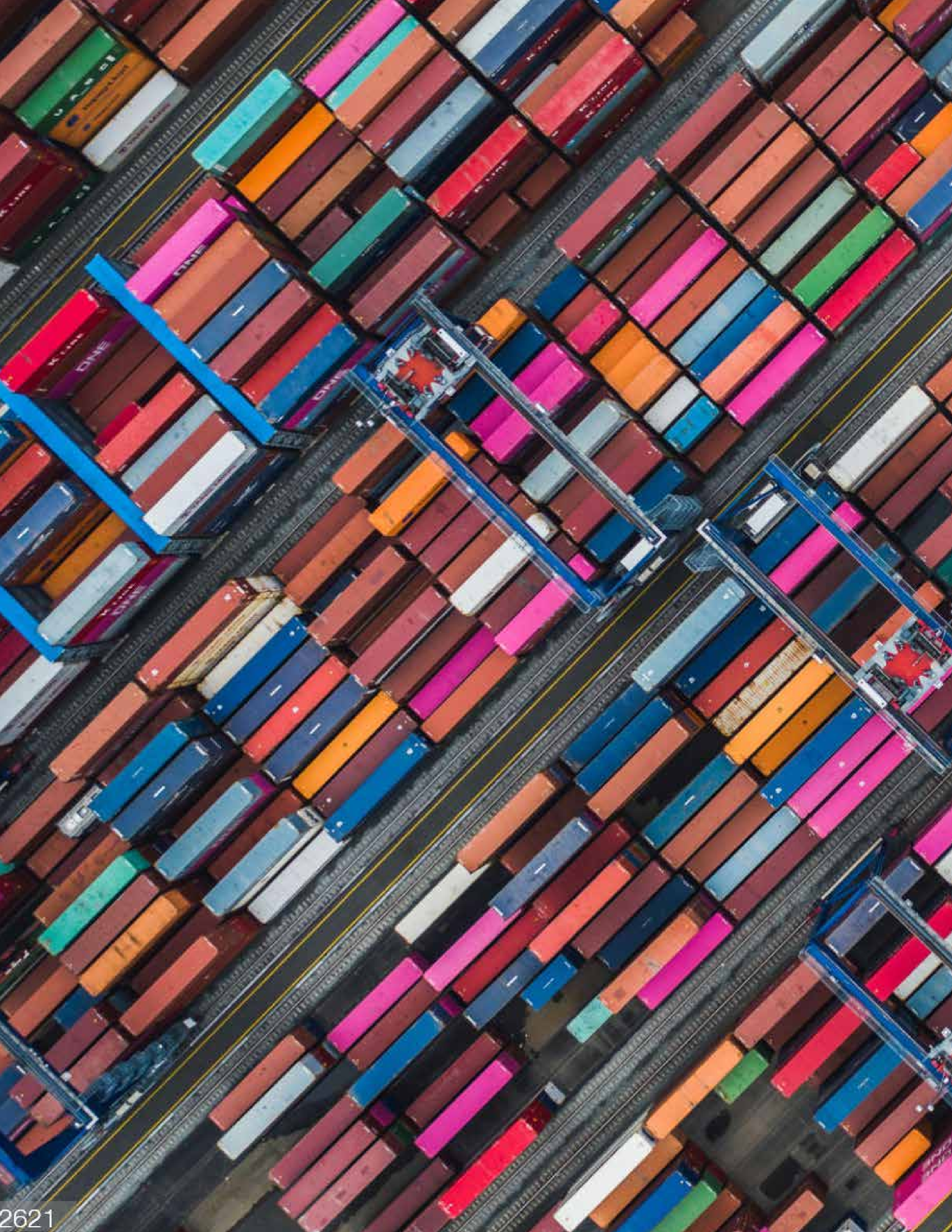
Our belief is that we can continue to reap the benefits of this approach for many years to come



Once an investor embraces the new paradigm for income, focusing on long-term dividend-growth by searching for companies like Microsoft rather than wasting their time on business models of yesterday like coal or big oil, a huge universe of opportunities opens before their eyes. Suddenly they can embrace opportunities such as package delivery businesses in an era of online shopping; healthcare companies in a time of biological discovery; semiconductor design firms in the age of Industry 4.0; and Chinese companies of all shapes and sizes in that vibrant economy.

Seizing these opportunities requires investors to look beyond the narrower confines of the UK market. On a global perspective, there are more than 4,000 dividend-paying companies of a size[1] that is suitable for the investor in search of the next Microsoft.

[1] Market cap above £1 billion.



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STOCK-PICKING WITHIN THE NEW FRAMEWORK

There is no magic recipe for finding dividend-growth companies with rising and resilient dividends. However, here are three high-level questions that we find useful.

Is the future exciting or problematic for the company?

This is a great question for separating the Microsofts from the RWEs. Looking forward for the next 10 years, we simply ask ourselves whether we see opportunities or threats. No surprise then, that within our Global Income Growth portfolio we hold companies including the following:

— Albemarle, the world's largest and lowest-cost owner of lithium for electric vehicle batteries

— Netease, owner of several of the most popular gaming, music and education franchises in China

— Novo Nordisk, the leading innovator in diabetes treatment

— Schneider Electric, manufacturer of efficient electrical equipment and automation software

— TSMC, the leading-edge producer of semiconductors globally

— UPS, the package delivery company with a global network serving online businesses

We believe these companies will see growing demand for their products. And we see unique competitive advantages, which will enable each of them to make healthy profits from their investments.

Does the company have a great management team embracing the opportunity?

It is one thing for a company to have an exciting growth opportunity, it is quite another to execute on that opportunity. Our experience has been that great management teams improve the odds of growing dividends immensely. Among the examples here are:

Admiral, the UK car insurance company, where the management team obsesses over customer and employee satisfaction.

Atlas Copco, the Swedish industrial tools manufacturer, whose unique management culture is built on empowering employees to find ways to grow the business.

Anta Sports, the Chinese sportswear company, whose young founder-owner has already built a brand to rival Nike in China.

Fastenal, the American industrial parts distributor, where the founder's mantra of "growth through customer service" still flows through the company.

Kering, the French luxury goods company, whose family has provided long-term focus and where management embrace the future.

Silicon Motion, a leading Taiwanese supplier of integrated circuits, whose founder is every bit as driven today as when he founded the company 25 years ago.

In a world where average CEO tenure is embarrassingly short, long-term investors are typically better off aligning themselves with great management teams who stick around for years.

Will the dividend be resilient, whatever the world throws at it?

Our experience has been that dividend resilience needs to be evaluated company-by-company. Dividends are ultimately board decisions, dependent on the unique circumstances at the company. Each one has a different cyclicality, pay-out ratio, and debt profile – all factors which influence dividend resilience in difficult years. As income investors, we don't look for short-cuts. We do our homework, stock-by-stock through the portfolio.

We spent years preparing our portfolio for a year like 2020. We had no idea that something called 'Covid' would strike, but we did know that the global economy experiences traumatic shocks every so often, and we want our dividends to be resilient through those times. We weren't perfect in 2020, but from around 60 holdings, more than 50 either held or grew their dividends in the midst of the worst ever year for pay-outs.

This stock-by-stock resilience, with companies such as Brazilian exchange B3 growing its dividend by 90 per cent, and distributor Fastenal paying out 12 per cent more, was key to our Global Income Growth portfolio delivering a dip in income of only 3 per cent, while global dividends were down nearly 15 per cent and the UK market slumped around 40 per cent. We continue to focus on careful stock selection, employing a range of tools including our Dividend Dependability Checklist, to ensure we are doing the best possible job for clients.

UK's top 10 dividend payers

	Past 5 years
Shell	Cut
Vodafone	Cut
Rio Tinto	Cut
BP	Cut
BHP	Cut
Lloyds	Suspended in 2020
HSBC	Suspended in 2020
Astrazeneca	Flat
GlaxoSmithKline	Flat
BATS	Grew

Source: Baillie Gifford & Co, Eikon content from Refinitiv.
Reflects dividend decisions as at 31 December 2020.

Global Income Growth top 10 dividend payers

	Past 5 years	2020 announcements
Coca Cola	Grew	Grew +2%
Procter&Gamble	Grew	Grew +6%
Roche	Grew	Grew +3%
Deutsche Boerse	Grew	Grew +7%
Sonic Healthcare	Grew	Grew +3%
Fastenal	Grew	Grew +12%
Microsoft	Grew	Grew +11%
Pepsico	Grew	Grew +5%
Edenred	Cut	Cut -19%
B3	Grew	Grew +91%

CONCLUSION

We believe that the old paradigm in income investing, which focused on troubled high-yielders, can now be cast into history. A new approach, based on growth and resilience, has demonstrated its benefits, and should continue to bear fruit in years to come.

There has never been a better time to embrace this approach: to invest in growing companies with bright prospects and resilient dividends and to seek long-term income, not short-term yield.

Globally, there are more than 4,000 dividend-paying stocks for the income investor to choose from. The right approach, driven by the right questions, can help identify the winners of tomorrow. This is an exciting time to be an income investor.

IMPORTANT INFORMATION

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ABOUT THE AUTHOR

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James was appointed co-head of the Global Income Growth Team and co-manager of The Scottish American Investment Company P.L.C. (SAINTS) in 2017. He joined Baillie Gifford in 2004 on the Graduate Scheme and became an investment manager in our US Equities Team. Previously, James spent three years working at The Scotsman newspaper, where he was the Economics Editor. He is a CFA Charterholder, graduated MA (Hons) in Economics-Philosophy from the University of St Andrews in 2000 and MSc in Development Studies from the London School of Economics in 2001.

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