STREAKY

PERIODS OF UNDERPERFORMANCE ARE INEVITABLE

ACWI Alpha Team. Second Quarter 2018

BAILLIE GIFFORD

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Even though the Premier League, the top flight of English club soccer, now attracts bigger television audiences in the States than in the UK, it's very unlikely that more than perhaps one or two of our clients have ever heard of Jamie Vardy. Yet at the end of 2015 the striker was for a few weeks one of the most talked about sportsmen on this side of the pond.

Part of the interest in Vardy stems from his classic rags-to-riches story. Cut by his home town club aged just 16, partly because he was thought too small to play professionally, he drifted into what's called non-league soccer (think bush league), worked in a factory and was convicted of assault. While on probation he played wearing an electronic tag, occasionally being substituted early in road games so that he could jump in his parents' car, still in his kit, and make it home in time for his curfew. After that slow start his progress has been meteoric: within four years he was a full-time professional player; a year later he moved to the major leagues; two years later he was playing in the Premier League; a year after that he made his debut for England; and for much of the 2015/16 season his unglamorous, unstoried club, Leicester City, have been at the top of the League. As he's said in more than one interview, "I pinch myself most days".

Yet Vardy's back-story hardly justifies the degree of media attention he has attracted. That was all about the streak. Starting at the end of August 2015 he scored a goal in eleven consecutive Premier League games, a new record for the competition which was set up in 1992, and the best run in the top flight for over 60 years.

Each year the number of "Will Bill pull it off again?" stories increased.

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If Vardy's story is new to you, it's unlikely that the idea of the sporting streak is. American sport seems just as fascinated by such streaks as we are here – Wilt Chamberlin's 18 consecutive field goals made; Wayne Gretzky's 51 consecutive scoring games; and, perhaps most famously, Joe DiMaggio's 56 consecutive games with a hit. In 2015, running almost in parallel with Vardy's scoring streak, the Golden State Warriors enjoyed the best ever start to an NBA season, winning their first 24 games as part of a 28 game streak, the second longest in history.

Mercifully, investment streaks attract less interest, but there is still a degree of fascination, which seems to be connected to our ingrained human desire to detect patterns. Most famously, Bill Miller's Legg Mason Value Trust beat the market for 15 consecutive years between 1991 and 2005. While still well short of 15 years, we have been on a bit of a streak ourselves. The Baillie Gifford International Equity Fund has now outperformed the benchmark over a number of years.[1]

As Miller's streak extended, media interest grew. In 2002 Janet Lowe, Warren Buffett's favourite financial journalist and Charlie Munger's biographer, published a book about him entitled *The Man Who Beats the S&P*. Each year the number of "Will Bill pull it off again?" stories increased. Early in 2005, with the 14th year in the bag, the *Wall Street Journal* reported that "after a furious finish last year, Bill Miller's streak lives" following "a late December surge".

Thankfully, institutional investment managers attract less media attention. We've even had the equivalent of the Journal's 'furious finish' or 'late surge' on occasion, when we 'pulled it out of the bag' in the fourth quarter.

This is surely where the linkage between sports and investment streaks becomes unhelpful. In sports, time is not continuous: there are individual games and discrete seasons which end with clear winners. In investment, however, as in life, time is continuous, a fact that is not changed by our habit of dividing it up into quarters and years for reporting purposes.

The late surges of media commentary make investment sound like a sprint where the last 10 metres are often crucial, or at best, a middle distance race where carefully timing your kick for home is a vital skill. Indeed, colleagues at Legg Mason apparently used to compare Mr Miller to Silky Sullivan, a racehorse in the 1950s who was famous for shocking come-from behind victories.

1. Benchmark: MSCI ACWI ex US index. For the most recent month-end performance please visit our website at www.bailliegifford.com/usmutualfund/internationalequityfund

Past performance is no guarantee of future results.

But in reality investment isn't a horse race with a fixed finishing line. If we have to pursue the sporting comparisons, it is more like a marathon, perhaps even one of those Depression era dance marathons immortalised in the Sydney Pollack-Jane Fonda film, *They Shoot Horses, Don't They?* For, to borrow a phrase from motor racing, "To finish first, first you must finish." In researching potential investments, picking stocks and constructing portfolios we look out at least three to five years. Consequently we think that is the sort of timeframe over which our performance should be assessed.

In the nearer term what matters is the consistency not of our performance, but of our people, philosophy, process and portfolio. Is there continuity of personnel on the strategy? Is the philosophy consistent? Has the process changed? Have the broad quality growth characteristics of the portfolio shifted?

Bill Ackman recently noted that "stocks can trade at any price in the short term, [but] it is rare for companies to trade at material discounts to intrinsic value for extended periods". Ben Graham, widely regarded as the father of serious investment analysis, said much the same thing more succinctly a long time ago: "In the short run, the market is a voting machine but in the long run, it is a weighing machine."

Our process is focused on finding companies with sustainably superior earnings prospects in the long term, stocks with real weight. We remain confident that a well diversified portfolio of carefully chosen companies with strong competitive advantages and the management and financial strength necessary to make the most of those advantages will outperform the market averages over the long run.

The Baillie Gifford International Equity Fund (Share Class K) As at 31 March 2018

Gross Expense Ratio	0.61%
Net Expense Ratio	0.61%

Source: Baillie Gifford & Co.

Annualised total returns as of month end 31 March 2018 (%)

	1 Year	3 Years	5 Years	10 Years
The Baillie Gifford International Equity Fund (Share Class K)	22.68	10.23	8.67	5.30
MSCI AC World ex US Index	17.05	6.68	6.36	3.17

Source: Bank of New York Mellon and relevant underlying index provider(s). Net of fees, US dollars. Returns are based on the K share class from 28 April 2017. Prior to that date returns are calculated based on the oldest share class of the Fund adjusted to reflect the K share class fees where these fees are higher. The MSCI All Country World ex US Index is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance in the global developed and emerging markets, excluding the United States. This unmanaged index does not reflect fees and expenses and is not available for direct investment.

The performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end performance please visit our website at www.bailliegifford.com/usmutualfund/internationalequityfund

The Baillie Gifford fund's performance shown assumes the reinvestment of dividend and capital gain distributions and is net of management fees and expenses. Returns for periods less than one year are not annualised. From time to time, certain fees and/or expenses have been voluntarily or contractually waived or reimbursed, which has resulted in higher returns. Without these waivers or reimbursements, the returns would have been lower. Voluntary waivers or reimbursements may be applied or discontinued at any time without notice. Only the Board of Trustees may modify or terminate contractual fee waivers or expense reimbursements. Fees and expenses apply to a continued investment in the funds. All fees are described in each fund's current prospectus.

Expense Ratios: All mutual funds have expense ratios which represent what shareholders pay for operating expenses and management fees. Expense ratios are expressed as an annualized percentage of a fund's average net assets paid out in expenses. Expense ratio information is as of the Fund's current prospectus, as revised and supplemented from time to time.

But at times our approach will be out of favour, attracting few votes, and we will underperform. Indeed within our history, there have already been several such 12-month periods. It just happens that none of them has coincided with a calendar year. And, given the behaviour of the market in its voting phases, that is pure luck. Bill Miller himself noted something similar even as his record was drawing increasing attention, calling the streak “an accident of the calendar”. Investors Business Daily calculated that over the fifteen years, the Value Trust underperformed the market in around a quarter of the rolling 12-month periods. It’s no coincidence that in British English streaky means lucky.

So sooner or later our streak will inevitably end. Indeed it will be surprising if the period of underperformance that ends it is as short as a year, calendar or not. There are a number of good studies of the performance records of successful long-term investors and all of them point to a pattern where even the best long-term records include significant periods of underperformance. In 1986 Eugene Shahan reviewed the spectacular records of seven investors identified by Warren Buffett as “The Super investors of Graham-and-Doddsville.” Shahan found, amongst other things, that, with the exception of Buffett himself, “these managers underperformed generally in 30–40 percent of the years covered.”

More recently, in 2013, Vanguard published *The Bumpy Road to Outperformance*, a paper that examined the record of all 1,540 actively managed US domestic equity mutual funds available to investors at the beginning of 1998. Only 55 per cent of those funds were still in existence at the end of the 15-year period and only roughly a third of the

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survivors had outperformed their style benchmarks. But for our purposes the most interesting findings were that of those that had outperformed 97% experienced at least five individual calendar years of underperformance; over 60% had underperformed in seven or more individual calendar years; and two thirds experienced a run of at least three consecutive years of underperformance.

When Vardy scored in the eleventh game, a local company brought out a special limited edition of their “ready salted” potato chips, renamed “Vardy salted”, and bagged in Leicester City colours. At Legg Mason it became a tradition to hold gatherings for some after-work champagne on the first day back into the office in the New Year after the streak had been extended. We had a night out, not to celebrate the streak, but to mark the first decade of the Portfolio Construction Group. Expect us to raise a glass to consistency – of people, philosophy and process, but not (or, at least, not necessarily) of performance.

CURIOUS ABOUT THE WORLD

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