GLOBAL DISCOVERY FUND – MANAGER UPDATE

DOUGLAS BRODIE, PORTFOLIO MANAGER OF THE BAILLIE GIFFORD GLOBAL DISCOVERY FUND, DISCUSSES THE PHILOSOPHY THAT UNDERPINS THE STRATEGY AND THE WAYS IN WHICH THE TEAM IDENTIFIES SMALL COMPANIES WITH GROWTH POTENTIAL.

Investment markets can go down as well as up and market conditions can change rapidly. The value of an investment in the fund, and any income from it, can fall as well as rise and investors may not get back the amount invested.

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Anzelm Cydzik (AC): I'm joined today by Douglas Brodie, portfolio manager of the Baillie Gifford Global Discovery Fund. Douglas, welcome.

Douglas Brodie (DG): Thank you.

AC: Douglas, could you maybe start by outlining the philosophy that underpins the strategy?

DB: Sure. We set out our stall to find out what we think are the most interesting, innovative, entrepreneurial companies. Really, at their core, these companies are problem-solving in nature, often that problem has a global relevance. And that, therefore, means that if these businesses execute upon that, that the growth avenues really are very substantial.

We seek to find those businesses when they are small, when they are immature, and we look to retain ownership of those businesses as they grow and as they thrive. So, I think, while some people may look at what we do as smaller companies, small cap investing, we think it's actually much, much more than that. Yes, we are finding these businesses when they are small, but we ultimately want to own them as they become much, much larger and become the dominant businesses of the future.

So, we look for, I think, what I would classify as, businesses doing something novel. That they have an element of disruptive flair to how they seek to do it. They are looking to reshape their industries, they have huge ambition. And we are attracted to those businesses, really, because of the extreme investment asymmetry that they offer us as long-term shareholders.

AC: So, Douglas, how do you assess whether a small immature company can become a large successful one? You've touched upon some of the traits, is there anything else you're looking for?

DB: Yes, if I expand on it a little bit more. So, if you think about that problem-solving element to what these companies are seeking to do, we spend a lot of time thinking about the nature of that problem. How big is it; how real is it; who else out there is trying to solve that problem as well; how might that problem evolve; and, really, why now? Why is this problem solvable now, where, perhaps, it wasn't five years or so, ten years ago?

I would say we often also focus on the fact that we’re conscious that many of our younger businesses, they are quite raw, and they can have great ideas, they can be extremely high in terms of potential. But, ultimately, they have a lot to prove. And really, that transition between being a high-potential business and a business that's executed and really delivered is probably the management team at that business. Ultimately, people build these businesses.

So, we spend a lot of time thinking about the management, really, the alignment structures, the incentives that are in place, the motivations. It’s probably no coincidence that about two-thirds of our companies have a founder attached in some capacity to those businesses. And I think that can be very instrumental in really providing that drive, some of that entrepreneurial flair, and, quite possibly, sets a cultural advantage in some of these businesses.

But, I'd say, ultimately, we’re looking for businesses that, over time, will develop a robust, competitive edge to what they do. So, it’s really hard for others to replicate, it’s hard for others to follow. And really, that can capture many kinds of examples, but we’re really looking for having those ingredients in place and seeing them, hopefully, develop over time.

And, ultimately, if businesses develop that edge, that can really manifest itself through what we think is a real inherent scalable advantage for some of these businesses. Effectively, allowing them to grow; and as they grow, become stronger, perhaps even accelerate growth, and improve their profitability.

And that's, ultimately, very rare. If you think about how most businesses grow, they tend to develop diseconomies of scale as they grow, the bureaucracy builds, the mentality changes. And, I think, often, interesting smaller businesses, particularly those founder-led ones, can push through that

And that scalability can really manifest in many ways. You think in terms of some of the network effects that underpin many of our online businesses. You think about the technology platforms that would be at work in many of our companies, particularly in terms of some of our healthcare companies. So, it can take many forms, but really tying all those things together is how we would describe the traits of the companies that we look for.

AC: Could you maybe bring the process to life with a stock example?

DB: Yes, sure. I think there's numerous examples I could use. But, maybe one that would bring it to life very interestingly would be Ocado, a business that, I guess, some of our UK audience base might be quite familiar with. So, Ocado is an online grocer. It’s been listed in the UK for a number of years now, pioneering, really, how to do online grocery at scale. And if you think about how consumers have embraced online commerce, you see that in multiple areas now, they appreciate the choice, they appreciate the flexibility.

And, ultimately, grocery, to our minds, felt no different, and we sensed that the demand was there, but the supply side was struggling to adapt. This was the crux of the problem. The incumbent retailers couldn't really adapt very easily to an online world, at least in a way that they could do it at scale and they could do it in a profitable fashion.

And we sensed that Ocado, without that incumbent legacy, starting with a blank sheet of paper, could really better define the problem and better come up with a solution to address it.

And the more we looked into the business, you saw tantalising glimpses that they could both achieve that ability to do this as scale and to do it better. And, ultimately, to do it more cost-effectively.

You think back to some of the comments I was making about management and founder-led businesses. In Tim Steiner, you have the founder of Ocado. Still very active in that business; really setting that tone, setting that vision that permeates, I think, very deeply through that business, so you have that alignment element that's right. And I think the thing that attracted us to Ocado, also, was that very experimental culture to what they were doing. They were very keen to run their initial warehouses, really, as great big experiments, to iterate, and to improve... And, ultimately, those experiments, we think, yielded a very interesting automation proposition that is, itself, now very deployable. And actually, as we're seeing with Ocado, licensing that technology all around the world, actually very scalable.

So, multiple licenses, probably the largest of which would be with Kroger in the US.

AC: Now, my understanding is that you've lost a number of holdings in the portfolio over the past year, due to M&A activity? How happy are you about this?

DB: I certainly wouldn't use the word happy. I mean, to give a little bit of context around it, we've lost about six businesses, six holdings to M&A, over around an 18-month period, which would represent quite a marked acceleration versus previous periods.

And that's in the context of a portfolio that's about 100 holdings. It's not something we relish, we don't look forward to it, we don't expect it, we don't build our investment cases around it. But there's probably a sort of reluctant acceptance that, in a way, it's how the world works. Big businesses struggle to innovate, the bureaucracy has built up, they don't have that innovative mindset. And so often what you see is the more nimble, smaller businesses that can grab these new technology tools, innovate, and iterate with them that... They're the ones that come up with the problem-solving element. And the way that bigger businesses deal with that is often to buy the smaller business that solved the problem for them.

We don't like that, we don't hope that happens, but we accept it does in various cases.

There's interesting dynamics around that. As I've alluded to earlier, some of the tools that now allow businesses to scale, quite possibly helped some of these small businesses get to a point and scale quite so quick that they escape that risk they get acquired by some of these bigger businesses. But, ultimately, we'll learn more about that over the coming decades.

AC: Now, last quarter of 2018, markets underwent a notable period of volatility. Did you do anything notable with the portfolio during this period?

DB: Yes, I guess we're conscious that in the short term, markets can be in this constant, sort of, tussle between fear and opportunity and the catalysts that tip that one way. I wouldn't say we pay too much attention to that. The catalysts tend to be fairly short term in nature, and actually very removed from what we think are some of the longer-term structural arguments that are at work, either in the economy at large or perhaps more relevantly in some of the industries, in the businesses that we invest in.

But occasionally you are sort of gifted opportunities in that regard, so we added to a few of our larger holdings in that sense, some of our newer holdings, I think we were almost gifted opportunities to do that. We made an addition to Yext, which I think is a very interesting data knowledge management tool for various businesses around the world. We added to Zillow, a marketplace for real estate in the US, and interesting avenues for how they're looking to grow that business. We actually took a new holding in a business called Axon Enterprise, which people may know, it's the manufacturer of Taser devices and body cameras worn by various police forces around the world.

That side of it is an interesting business, but there's an awful lot of technology and software development that is being used and developed by the police forces to kind of archive and make sense of all that data that's being developed in the field, so we think that's a very interesting area. It's nice to be given those opportunities, and around the edges we do seek to exploit them when we can, but ultimately, we are a low turnover portfolio, but it's nice to have those opportunities when we can.

AC: So, how excited are you about the current opportunity set?

DB: Oh, hugely, when you think about what's going on the world, just that innovation cycle that we're in, that toolkit of technologies that companies now have access to, everything that we're seeing for those frontiers of innovation moving so fast in so many different areas. And the companies that I think are best positioned to exploit that tend to be the smaller, more nimble businesses, the ones that can grab these new technologies and really work with them, and iterate them, and really push them.

And you're starting to see that come through now, I think, with some of these interesting, very scalable businesses, tools that now allow companies to have different revenue models, different avenues for growth. And some of those assumptions of the past about how companies must grow, I think are beginning to be challenged.

So, as an investor in these interesting up and coming small, high-potential businesses, that's the backdrop we love, and it's a challenge we relish.

AC: Douglas, thank you.

Annual Past Performance to 31 March Each Year (%)

	2015	2016	2017	2018	2019
Baillie Gifford Global Discovery B Acc	16.8	-1.8	24.3	25.3	19.9

Source: Morningstar. Share price, total return. Sterling.
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The fund invests in overseas securities and changes in the rates of exchange may also cause the value of your investment (and any income it may pay) to go down or up.

Investment in smaller, immature companies is generally considered higher risk as changes in their share prices may be greater and the shares may be harder to sell. Smaller, immature companies may do less well in periods of unfavourable economic conditions.

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