

A NEW ERA OF EXPLORATION

Joe Faraday, Director. Fourth Quarter 2018



RISK FACTORS

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A NEW ERA OF EXPLORATION

BY JOE FARADAY

Great explorers have been a Scottish speciality for centuries. Individuals whose wanderlust and sense of possibility has led them across the known world and beyond. In charting new territories and sharing their tales of adventure, they have widened all our horizons.

Our investors do not of course face the same hardships in their pursuit of the unknown, but there are parallels between them and these explorers as they seek new opportunities in international equities. They share the same passion to get to know people and places, and a willingness to share their insights to light the path for those who are to follow.

A TRADITION OF EXPLORATION

During her time as Writer-in-Residence at the Royal Scottish Geographical Society (RSGS), Jo Woolfe wrote the book *The Great Horizon: Fifty Tales of Exploration* (2017), using her unfettered access to their archival material. In the book, she celebrates the lives of many Scottish explorers from David Livingstone (1813–1873), the explorer and missionary to East Africa, to Isobel Wylie Hutchison (1889-1982), the Arctic explorer and botanist. It is an illuminating read, capturing a spirit for adventure that lives on in modern times through figures such as Sir Ranulph Fiennes (b.1944), the Polar explorer and mountaineer, who shares the great explorers' restless energy, fascination for uncharted territory, and perseverance.

Other contemporary explorers following in this tradition whom Baillie Gifford holds in high regard and whose efforts we support through sponsorship include: Craig Mathieson of the Polar Academy and Dr Beth Christie from the University of Edinburgh. Craig is the 'Explorer-in-Residence' with the RSGS. He takes youngsters from a variety of backgrounds on life-changing expeditions to the Arctic. The programme challenges the young people to redefine their physical and mental limits, and then supports them in sharing their experiences back home to inspire and motivate their peers. Dr Beth Christie has recently returned from an all-female expedition to Antarctica. Through her environmental work, she is a strong advocate for outdoor learning and teaching sustainability as a means by which to foster the values, attitudes, skills and confidence needed for people and the planet to flourish. We investors would do well to capture even a little of these attitudes.

Baillie Gifford's own exploratory record stretches back over a century. We were founded in Edinburgh in 1908 by Colonel Augustus Baillie and Mr Carlyle Gifford. These far-sighted men were excited by the opportunities they could see in the US, the emerging market of the day, and the achievements of innovators like Henry Ford and the first automated industrial production line. Messrs Baillie and Gifford understood the potential of his mass-market Model T car. But they also saw the opportunity on the other side of the world in the rubber plantations of Malaya (now Malaysia). To them, demand for cars meant demand for rubber, hence their first investments.



Rubber tree plantation.



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NEW TERRITORY FOR EXPLORERS

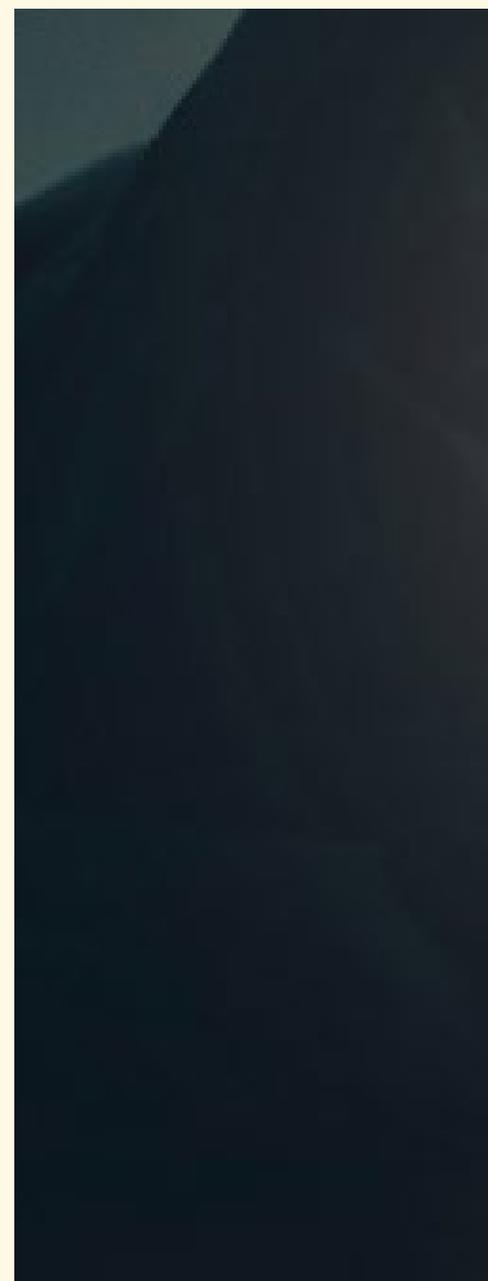
In a dynamic world, the nature of exploration changes, whether that be exploring the physical world or the world of investment opportunities. Our predecessors were excited by mineral discoveries like the 1848 Californian Gold Rush, by transport revolutions like the mid-19th century railroad boom, or by commodity surges like the one that inspired Baillie and Gifford's Malayan initiative. Nowadays, some of the most fertile areas for exploration can be grouped around three powerful drivers of structural growth: disruption, trust and technology. On their own, or, in some cases together, they create an array of remarkable international opportunities, which the right companies will be able to use to their advantage.

For example, in consumer stocks, we see a combination of structural trends – people, productivity and purchasing power. We are excited about a wide

range of consumer durable and discretionary stocks, many of which thrive on disruptive change and are bolstered by trust earned with their customers. We are fascinated by the rise of e-commerce the world over and believe it will thrive against a backdrop of disruptive technology.

Another promising area is financial services. Here, trust matters more than these other structural growth factors. What counts is business history and management. We like to probe how business leaders assign capital, and to assess their long-term thinking. We also care about that potential to disrupt. Savings platforms have this quality, but we are more concerned about their being good stewards of clients' capital.

Let's take a closer look at each of the three growth drivers.



A woman with long dark hair, wearing a dark hoodie, is looking down at a smartphone in her hands. The scene is dimly lit, with the primary light source being the screen of the phone, which casts a soft glow on her face. The background is a blurred teal or blue color. The overall mood is quiet and focused.

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DISRUPTION

Disruption is happening at an astonishing rate, as old industries – and entire economies – show themselves ripe for change.

Take China. Since 1990, the People’s Republic has seen a 28-fold increase in GDP per capita. No other country has come close. By comparison, India’s GDP has grown around five-fold. Most countries in the West have seen a rise of between two- and three-times. What does that mean for young Chinese? Experiencing such a rapid and life-altering increase in parental wealth over one generation certainly changes one’s perspective and frames your expectations for what is possible going forward. Whereas the West has become acclimatised to changes occurring gradually over a long period of steady growth, the Chinese people have adapted to a greater magnitude of change in a much shorter time-span. As a result, the young Chinese are bright, open-minded and expect their progress to continue.

Disruption can be seen most clearly in areas like mobile payments where the shift from cash to digital has leapfrogged the credit card stage. The Chinese mobile payment industry is growing far quicker than most of us in the West realise. The market is already fifty-times the level of that in the US. The Chinese now spend over US\$10 trillion via mobile payments every year. Importantly, it’s still growing far more quickly than it is in the West. This is taking place on the back of the rapid adoption of online retail, financial and on-demand services, such as ride-sharing activities, food delivery and the largest internet and smartphone market. Mobile payments giants Alipay and Tenpay are now bigger than Mastercard and Visa on most metrics.

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A second area of disruption is more structural: the global rise of the middle class has led to huge shifts in societal and consumer habits. The world's axis has shifted east. It will continue to do so and at an increasing rate. It took 10 years to add the last billion people to the emerging middle class. It will take seven years to add the next billion: of which, 380 million will be Indian, 350 million will come from China, and the remainder will mainly be residents of other Asian countries. As these people move from farm to factory, or factory to office, their incomes grow, their spending power improves, their appetite for buying goods increases, and this all feeds through to a wide range of big growth opportunities.



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TRUST

Disruption is happening at an astonishing rate, as old industries – and entire economies – show themselves ripe for change.

In an age of disruption and upheaval, trust has become a rarer and hence more-prized commodity. Against such a backdrop, we believe there are rich rewards to be gained from backing companies that have won the confidence of their customers. These are the companies that can grow and endure.

Trust and loyalty are intertwined. This is well understood by the Walt Disney Company, as explored in the 2004 book *If Disney Ran Your Hospital*. It captures the importance of building relationships, a rule that applies whether the ‘customer’ is a patient or a theme park visitor. Few companies get it right, but those that do can potentially reap rich rewards.

When applied to banking, the important thing is to keep it simple. A good example is Svenska Handelsbank, the 147-year-old Swedish bank where the individual branch is paramount, and each manager has the power to decide on how best to serve the customer. The bank’s reputation has helped it expand beyond Scandinavia into the UK and the Netherlands.

A further example is luxury brands, where heritage and glamour combine to promote trust. Cartier, part of the Richemont family of brands, is a good example. The company dates back to 1847 and has a formidable reputation for quality.

A final example involves trust in the more fundamental sense of the word – absolute reliability when it is needed or knowing exactly what it is you are getting. Here, the baby product sector is a good example. Parents are sensitive consumers who are prepared to pay a premium rather than take risks with their child’s safety. Japanese company Pigeon has a special bond with customers in its home market, and a growing position in China where trust in baby food safety has been a national issue.

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TECHNOLOGY

The rapid and continuing rise of new technology is a formidable driver of growth and, in our view, it is just getting started.

In the 1960s, US engineer Gordon Moore was first to raise awareness of the unprecedented growth trajectory which was to follow, with his ‘Law’ which predicted that processing power would double every two years. That is set to continue. There are currently only a few connected devices per person on the planet. It was just two in 2010. By 2035 that is expected to rise to 100 per person. Technology will become omnipresent, opening a wide range of opportunities.

The autonomous and electric vehicles (EVs) sector is an example of a potential growth area. Use of EVs is expected to increase a hundred-fold by 2035, offering major opportunities for the manufacturers of vehicles and components.

Other areas benefiting from technological advances include biologics or biopharmaceuticals: drug products derived from biological sources. These protein-based products are much more targeted, more complex and more effective than existing therapies. Currently they account for about a quarter of all drugs, but that proportion is set to grow. Combined with better diagnostics this new clinical frontier will have massive implications for healthcare spending, possibly causing it to fall.



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Another field of potential advance is robotics; currently in its infancy. Taiwan's Hon Hai, known internationally as Foxconn, is a giant assembly business that supplies Apple and many other household electronics brands. It is committed to replacing thousands of human workers with robots. Keyence, the Japanese factory automation company that provides high-end consultancy and design services is one of those that could potentially benefit. The expansion of robotics from the factory to the living environment is rich in opportunities.



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NOT EVERYONE CAN MAKE IT HAPPEN

It is not the case, however, that all companies working within robotics, for example, will benefit. Opportunity is one thing, execution another. The question for investors is who among these disruptors and innovators can deliver? And how best can we discover them?

Answering this question brings us back to our topic of explorers and our admiration for those pioneering individuals who have changed the world. Sir Ranulph Fiennes, arguably the UK's most famous contemporary explorer, has circumnavigated the world over three years, crossing both polar ice caps. But he never claims to have done it alone and attaches huge importance to the teams that made his quests possible. In the same way, we seek to work in partnership with the management teams that are both visionary in their outlook and able to execute upon that vision. Three of the other great explorer's qualities chime with Baillie Gifford's investment approach: curiosity, patience and bravery. We value these qualities in our investors and look to find the same attitudes in the management teams of the companies in which we invest on behalf of our clients. The degree and emphasis will of course vary.

For management, being curious is about being open-minded about the world and its opportunities – a willingness to give things a try. As the Canadian ice hockey legend Wayne Gretzky puts it: “You miss 100% of the shots you don't take”. We want company leaders who are willing to invest in growth and commit to R&D spend that will expand the business, sharpen their competitive edge and achieve long-term improvement. Curiosity is a predominant trait of China's Jack Ma, the teacher-turned-visionary who founded the internet behemoth Alibaba. His talent according to one admirer is to “come up with an idea, make it fun, and breathe something into it which otherwise is still just an idea.”

We want leaders to be patient. Outsized growth takes time. It is not about the latest quarterly growth figures. It's all about growth that endures. As Einstein said: “Compound interest is the eighth wonder of the world. He who understands it, earns it ... he who doesn't pays it”. We want to identify companies that can grow over very long timeframes. We think five-to-ten years out, and beyond.

Finally, there is the need to be brave. Having the hunger and determination to get up and keep going. A willingness to withstand short-term pressures and to be resilient. Serena Williams, the tennis champion put it: “I really think a champion is defined not by their wins but how they can recover when they fall.” Management must be willing to commit itself to long-term growth. This involves the need for research and development and not being complacent about the position of the business. Martin van den Brink of ASML – the Dutch technology company – is a good example. He has been a dominant force behind the advances made in lithography, the photographic process that imprints nanometric circuit patterns onto silicon wafers. The firm has been at the cutting edge of advancing Moore's Law, the main reason behind the rapid rise in the performance of semiconductors and processing speed, a world-changing shift, over the past few decades.

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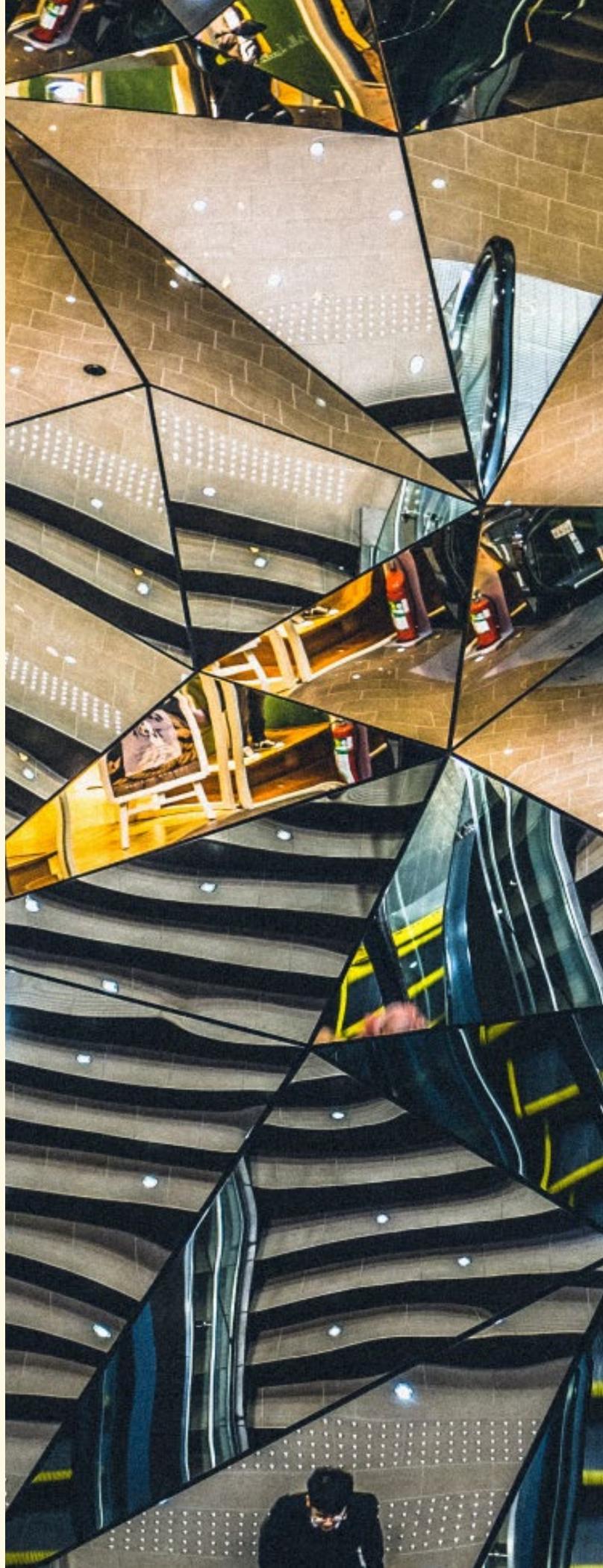
REFLECTING ON OURSELVES

So, what about Baillie Gifford? We aspire to emulate these great pioneers – whether it be the leaders of great businesses or the explorers who have conquered new frontiers. Our journey in investment as a firm began in Edinburgh and it continues there. Our location puts us far from the madding crowd but our perspective on the world is wide open. We are willing to learn and keen to back teams we trust.

We certainly believe in learning. Henry Ford once said: “Anyone who stops learning is old, whether at twenty or eighty. Anyone who keeps learning stays young. The greatest thing in life is to keep your mind young.”

We passionately believe in learning as investors and as an organisation.

We also believe in team work, in integrity, trustworthiness and sticking to our principles. As Sir Ranulph Fiennes said: “Whenever feasible, pick your team on character, not skill. You can teach skills; you can’t teach character.” For us, collaboration and team working are all-important.



LOOKING FORWARD

Recalling Jo Woolfe's study of explorers The Great Horizon, Baillie Gifford's own horizon is always shifting. From where we sit, we continue to be enthused by the views appearing through our telescope. We believe that international equities provide us with exciting new territories to explore, as we seek to find those companies that are seizing the opportunities created by disruption, trust and technology. We seek to harness those forces, and to partner with management teams that are curious, patient and brave. Investing is a form of exploration, one where you need the right people alongside.

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JOE FARADAY

Director

Joe graduated MEng in Chemical Engineering from the University of Cambridge in 2002, following an engineering scholarship with the Smallpeice Trust in his gap year. He also gained an MBA from the University of Edinburgh in 2009 and is a CFA charterholder. Joe joined Baillie Gifford's graduate scheme in September 2002 and has worked in our European, North American, Developed Asian, and Emerging Markets Equity teams. Joe transferred to the Clients Department as a Director in 2013 where he is responsible for servicing International Focus clients. Joe has been a member of the International Focus Portfolio Construction Group since 2007.

CURIOUS ABOUT THE WORLD

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