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always pays the best interest”*

Fund Manager Meeting Notes – Baillie Gifford Fund Manager Meetings



Baillie Gifford Funds and Investment Trusts have been part of the portfolios for some time. The Scottish Mortgage Investment Trust has had fantastic performance and remains a firm favorite. Two newer funds which we added are the American Fund and Emerging Market Debt Fund.

The meetings we had were a chance to get an update from the managers and provide direction going forward. In particular with Emerging Market Debt we were surprised by the extent of the sell-off in May despite the excellent fundamentals in many of the economies and we were looking for reassurance (as much as you can) that we would not face a similar sell-off when QE eventually stops.

On the equity side we are “concerned” with market highs and that these are reaching fair value and future returns will be considerably lower. We therefore wanted to get a feel from the managers whether the performance can continue going forward.

OVERVIEW OF FUNDS

Scottish Mortgage Trust

Overview

The fund invests globally with a focus on business disrupters. Currently there is a bias to technology businesses and consumer services.

Fund Manager		Fund Size			
James Anderson & Tom Slater		£2,982 m			
Performance					
YTD	2012	2011	2010	2009	2008
34.78%	30.05%	-15.15%	33.90%	52.87%	-44.77%

Source: Morningstar, on an bid to bid basis with net income reinvested. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. See note at end of document.

Key discussion points

James Anderson is currently on sabbatical and the fund has been managed by the co-manager, Tom Slater for the past six months. James is due to return to the management of the fund in January.

With Scottish Mortgage it is clear the managers are doing something right and investing in stocks which in recent years have done incredibly well. We wanted to know if the fund was vulnerable to periods of underperformance.

Tom explained that this was a concern for him and he had recently been to the US to see whether there was substance to some of the technology companies or whether it was frothy. His conclusion was that with the likes of, for example, Google and Amazon there is substance with growing businesses but there is frothiness with some technology businesses where the value is unclear. So the conclusion is that you need to pick carefully and we discussed this further.

As an example Amazon was bought at the same time as Ebay. Both are online retailers and both have the ability to be business disrupters. On paper Ebay appeared the stronger of the two however Amazon has actually been the winner. We talked about Amazon in some detail. Tom explained that if we were looking at a retailer growing at 20% a year then we would look at it in a different way. It doesn't have shops, the shop front is online and it uses warehouses to distribute goods cheaply.

This is Amazon; the key for any investor is patience and a focus on the long-term. Rather than focus on profit, it re-invests the profit for the long-term gains. Some of the ideas may be seen as gambles. Kindle is an example and this has transformed the way we engage with books, the success of this has led them into the tablet market. Cloud is another successful area. Of course we can see the success but they do have failures; for example expansion into other countries like China hasn't been as successful.

Amazon is a classic disrupter particularly in the way our shopping habits have changed. Apple is another business Tom likes. His argument is that this is not another RIM or Nokia, this is a business which takes half of the app download market and produces products which wow users. It won't launch for the sake of it, if it doesn't work it won't launch.

Other interesting companies we talked about are Alibaba who operate a platform similar to Ebay but the value of goods traded are twice that of Amazon and Ebay. And Baidu which is a Chinese Search Engine which is no 1 in China with a strong franchise.

He has recently invested in geomantic technology again using two companies, both small holdings and both

could succeed or just one. Myriad was an interesting company which does genetic profiling on Cancer. It assesses what drugs will and won't work.

For Tom this spread of ideas means that whilst some stocks have done incredibly well there are others ready to come through.

On the 'macro' side Tom feels the effects of QE are very complex and therefore difficult to assess the impact. The market however is forcing its own conclusion which leads to indiscriminate selling for example EM Debt where the fundamentals are right but it still appears to be wrong. But this can present opportunities. Tom is also very encouraged by China despite all the gloomy headlines and feels they are making significant headway on structural changes especially around the Financial and Healthcare Sectors.

In summary the fund has benefited from strong performance from some of the stocks; it is very hard to identify whether this can continue. However, clearly the fund is not about a small group of stocks and there are fresh ideas which still have to come to the front. Even with some of the existing stocks clearly Tom feels there is more value to be gained. Obviously we don't know how QE will play out and how indiscriminate selling will impact on markets but if the fundamentals are there then the fund can rebound from any negative sentiment.

Baillie Gifford American Fund

Overview

The fund looks to exploit market inefficiencies via active management.

Fund Manager		Fund Size			
Mick Brewis & Ian Tabberer		£409 m			
Performance					
YTD	2012	2011	2010	2009	2008
25.69%	4.44%	1.18%	23.94%	18.37%	-17.65%

Source: Morningstar, on an bid to bid basis with net income reinvested. You should note that past performance is not a reliable indicator of future returns

and the value of your investments can fall as well as rise. See note at end of document.

One thing I like about Baillie Gifford is that there is no house view. This certainly comes across with Ian. His views on China are different to Tom, our feeling from discussion with Ian is that he is less optimistic on China and its reforms. This is important because if demand falls from China this ripples out to Asia and Europe is one area that needs this growth to kick start a recovery and Ian just feels this is not coming.

The US and UK are able to print money and we are starting to see a growth in the housing market which then feeds across the markets. His feeling is that the US is a good place to be over the next three years and the markets haven't really priced in the opportunities.

The US is a different market to the global economy in that it is isolated from the global story where 80% of goods produced are internally consumed. Ian feels that GDP growth could potentially be as high as 4 to 5% next year, and again this is not priced in.

Generally the story coming out was that the market is indeed high but there is a lot the market is not pricing in. Companies he likes are Johnson and Johnson; where a new management team is in place and he feels after an awful period of underperformance it is in a position to grow. Pfizer is another company which is buying companies at phase 1 or 2 of development and then using its sales force to promote. Bristol Myers is similar.

He continues to like Berkshire Hathaway but also likes similar businesses like Markel and Fairfax.

Interestingly they are strict on their five reasons to hold or sell; these are industry background, competitive position, management, financial characteristics, and valuation. They don't hold banks, the only exception was that they considered AIG but it didn't fit in their criteria so it didn't become part of the portfolio. This means the fund has missed out on some of the growth from this sector but Ian seems happy focus on the fundamentals and allow others to take these opportunities. The performance long term has been strong and this is why we selected the fund, and this is a message that Ian was keen to focus on.

Over 5 years the fund has outperformed the S&P 500 95% of the time and over 3 years by 92% however, over 12 months this drops to 64% which reflects the patient investor rule.

One other stock he has recently sold is Apple which again is contrary to the holding in the Scottish Mortgage. He feels that it won't gain the same penetration in Asia and growth will slow. Therefore in his view it is no longer a good stock to hold.

We have always seen this as a more cautious play in the US market with strong long term performance. There will be periods when the style of investment is out of favour but we are prepared to wait for the long term rewards which we believe this fund can deliver.

In summary this is a more mid to large cap fund looking to deliver above average performance over the long term. This does mean short term the fund may underperform, but clearly over the long term it has consistently outperformed the S&P through active management.

Baillie Gifford Emerging Markets Bond Fund

Overview

The fund aims to deliver returns through investing in local emerging market currency bonds.

Fund Manager		Fund Size			
Steven Hay, Phil Annen and John Berry		£549 m			
Performance					
YTD	2012	2011	2010	2009	2008
-6.10%	13.08%	-1.85%	19.40%	7.32%	N/a

Source: Morningstar, on an bid to bid basis with net income reinvested. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. See note at end of document.

As we reduced our exposure to developed market debt we favoured emerging market debt because the fundamentals were very different. The sell-off in May showed that the market doesn't act rationally and

emerging market debt was treated as a homogenous group; taking no account of stronger regions.

What we really wanted to get from this meeting was a sense on whether we had seen the worst or whether worse could come when QE stops.

We have heard about the withdrawal of money; institutional money has not really gone from the market but about 50% of retail money has. We also saw investors move out in May and then slowly start to come back in. This doesn't really tell us a lot, but we can guess that some investors buy into the longer term story and are not scared off by short term noise, and those who have moved in are looking to capitalise on under-priced assets. So with this in mind it was good to meet Steven Hay and get his view.

Performance this year has been shocking; down over 6% this year following a strong 2012. Did they not foresee this, did they get it wrong, and is there more to come?

I genuinely feel that they could not have foreseen this reaction. The markets became nervous because of the Bernanke comments and in turn investors became nervous. They ignored the underlying fundamentals and ran for the exit.

There are countries which are not as strong such as India, Indonesia, Brazil and Turkey but the key to this fund is about getting the country bets right over the long term. This means avoiding countries with high inflation, political risk and high levels of indebtedness.

There are 16 countries that they focus on plus they can add in up to 10 from frontier markets, which is a vast number of countries.

The second strand is local currency which is growing, for example Brazil over a few years ago issued around 30% of debt in local currency, this is now 80 to 90%. This means there is more opportunities to choose from.

Thirdly many of the good economies are not weak, the balance sheets are stronger and credit significantly better than the developed market.

Although a country like Indonesia is seen as weak it has a low level of debt to GDP, it has a low current account deficit. It has raised rates to slow down the economy and is doing everything an economy should do. So it is an example of not taking everything at face value. Yes it is weak but there are a lot of positives and therefore opportunities.

Brazil is not liked by the markets and is seen as a weaker economy however there is value in the market. Mexico we hear is running out of steam however Steven feels that at 3% growth this could increase to around 5% plus.

So we have to scratch around to get a feel. Will this happen again, I think the simple answer is that we don't know and I don't think Steven knows although they can model different scenarios. However, Steven did feel that the worst has happened. We have seen this before, in 2011 when the markets were rattled and then once confidence returned the losses were quickly reversed.

With the stickiness of institutional money this is a good sign, they have seen people starting to invest in the market. Often when something is so disliked that is the time to invest.

One final thought and one we have heard before as QE stops, Japan is opening up its tap and so will Europe so the flow of money around the world will not suddenly stop when the US stops QE. You also have countries like Thailand and Brazil with significant reserves.

In summary the volatility of the fund hurt investors and the performance of the portfolios. This is a long term play and one which needs patience. We remain concerned about another short term correction, however if the last five years have taught us anything it is that often when the worst happens it doesn't happen again to the same extreme. We have made no decisions on what the next move will be at this stage.

Special note to performance data

The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced.

Conclusion

We remain happy with Baillie Gifford as an investment group and this is reflected in the use of the Emerging Market Debt Fund, American Fund, European Fund and Scottish Mortgage.

We accept returns across all equity markets may be challenged going forward. We believe Scottish Mortgage has other tools in its box to continue to deliver strong returns however this rate may not be at the same level as at present. The American Fund has delivered steady returns and we believe it can continue to do this albeit at a slightly lower level.

EM Debt remains a concern; in September and October we saw a strong bounce back however in November this fell away again. Clearly there is nervousness in the market and although the economies are strong the markets are voting with their feet even if this is plainly wrong. We could see a positive correction which would reflect this and we are hoping this will happen. Or we could see a period of underperformance. The jury remains out on this.

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