

An aerial photograph of a coastal landscape. The top half shows a large body of water with a curved shoreline. Below the water, a winding road or path cuts through a dense, green forest. The bottom half of the image shows a more developed area with buildings and infrastructure, possibly a resort or a small town. The overall color palette is dominated by greens, blues, and browns, with a dark, starry background at the bottom right.

GLOBAL ALPHA PARIS- ALIGNED

2020



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GLOBAL ALPHA PARIS-ALIGNED

The Global Alpha strategy will turn 15 years old this year. The product was launched in 2005 in response to a client need for an unconstrained and diversified global stock-picking portfolio, with a focus on superior long-term growth. Much has changed in the intervening decade and a half, but amid relentless change in the world and an evolution of our process, we have always been guided by our fiduciary duty to clients.

We understand that the issue of climate change is a key focus for an increasing number of investors. There is a clear scientific consensus that human activity is warming the planet and that we are facing a climate emergency. Urgent action is required to transition economies to a low-carbon future and reduce global emissions, ultimately to net zero.

The central aim of the Paris Agreement, adopted by 196 state parties in December 2015, is to limit the average temperature rise to well below 2 degrees above pre-industrial levels and to strive for 1.5 degrees by the end of this century.

For those seeking to incorporate climate change directly into their investment objectives, we propose a new variant model of Global Alpha.



PROPOSAL

Global Alpha Paris-Aligned will be consistent with the objectives of the Paris Agreement. The portfolio will be a variant of the core Global Alpha strategy. It will be managed by the same team and with the same investment philosophy and performance objective. However, there will be an additional process to screen out carbon intensive companies that do not or will not play a major role in our energy transition. This variant currently has an overlap of more than 90 per cent with the core strategy and is expected to closely track the performance of the main model over

time. At the time of writing, Global Alpha has a carbon footprint that is 60 per cent lower than the MSCI ACWI. Global Alpha Paris-Aligned will go further. We will use a more progressive measure, the MSCI ACWI Paris-Aligned benchmark, that is consistent with the carbon reduction requirements needed to achieve the objectives of the Paris Agreement. Global Alpha Paris-Aligned will commit to having a weighted average carbon intensity lower than that of the MSCI ACWI Paris-Aligned benchmark.

GLOBAL ALPHA PARIS-ALIGNED

OBJECTIVE

The objective of Global Alpha Paris-Aligned is to outperform the MSCI ACWI by 2–3 per cent* per annum over rolling five-year periods (gross of fees). In addition, and as stated above, we will commit to having a weighted average carbon intensity lower than that of the MSCI ACWI Paris-Aligned benchmark.

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We will track our carbon emissions against the more progressive ACWI Paris-Aligned benchmark. This starts with a carbon intensity that is 50 per cent lower than that of the standard ACWI. Furthermore, it incorporates a year-on-year decarbonisation target of at least 7 per cent, consistent with a trajectory for a 1.5-degree warming scenario outlined in the 2018 Intergovernmental Panel on Climate Change report.

*Before management fees. The performance target stated is in no way guaranteed, nor is it intended to be precise. We believe it to be a reasonable estimate of the amount by which we can outperform the relevant benchmark in the long term through the consistent application of our investment process, taking into account the opportunity set and the characteristics of the markets in which the strategy invests. Factors that may lead to Baillie Gifford failing to meet our investment performance objectives in future include a significant change in market characteristics such that our growth investment style is unrewarded for a period of time; or misjudgement of the prospects for long-term earnings growth for a significant number of individual stocks in which we invest.

SCREENING PROCESS

Global Alpha Paris-Aligned is an exclusions-based variant of the core Global Alpha portfolio. We will apply two screens to exclude high-emission companies that do not or will not have an important role to play in the economic transition to a low-carbon future.

Companies that generate more than 10 per cent of revenues from the extraction and production of coal, oil and gas.

Companies that generate more than 50 per cent of revenues from services provided to coal, oil and gas extraction and production.

In addition to the above, the highest emission companies will be subject to a proprietary framework designed to assess the risks they face in our low-carbon transition. This consists of three dimensions:

1. Does this company provide an essential product/service?

This question captures the idea of a carbon budget. We accept that not all emissions are equal. Some high emission industries produce products and services that are essential (e.g. agriculture), while others deliver products and services that are discretionary or only benefit a small group of people (e.g. aviation). Companies in the latter category are more exposed to climate risk.

2. Can emissions be mitigated in an economically viable way?

This question addresses whether products and services can be delivered in a better manner – specifically, if there are technologies which can significantly reduce the carbon intensity of a business in an economically viable way. Examples might include the use of renewable inputs (e.g. fuel and feedstock), improved product design (e.g. extending the life of products), the use of carbon capture techniques, or the adoption of radically different technology. Companies where green alternatives are readily available, feasible and economic are most at risk.

3. Is the company part of the problem or the solution?

If question 2 is about a company’s ability to mitigate, question 3 is about its willingness. Is there a desire and preparedness for a low-carbon transition? Here we assess company policy, emissions reporting and future targets. We consider how the company’s carbon performance now and in future might compare to others in the sector, as well as to the commitments made under the Paris Agreement. We seek evidence that carbon management is a part of the corporate culture, integrated into decision making. We use frameworks such as the Financial Stability Board (FSB) Taskforce on Climate-related Financial Disclosures (TCFD) and the Transition Pathway Initiative (TPI) to assist our assessment. Companies which score highly are those that take a leadership role in the low-carbon transition. They can help accelerate the transition for the whole industry.

Are there technologies which can significantly reduce the carbon intensity of a business in an economically viable way?

The highest emission companies are scored against this framework on a Red / Amber / Green basis. Those that fall beneath a set threshold (Red) are excluded from the portfolio, with the capital reallocated pro rata among the remaining (ex-Amber) holdings.

While it would be far easier to have a simple list of sector exclusions, such a blunt approach risks excluding many high emission companies that are solution providers and which will play a pivotal role in our low-carbon transition. For example, wind is one of the cleanest sources of energy with a very low carbon footprint over its full lifecycle. However, the manufacturing and installation of wind turbines are carbon intensive processes that rely on steel, concrete and advanced plastics, and consequently wind turbine manufacturers have high levels of emissions. Excluding companies based on their emissions alone risks advancing carbon reduction pathways that are inequitable or simply unviable. We believe that what this framework lacks in ease it makes up in thought.

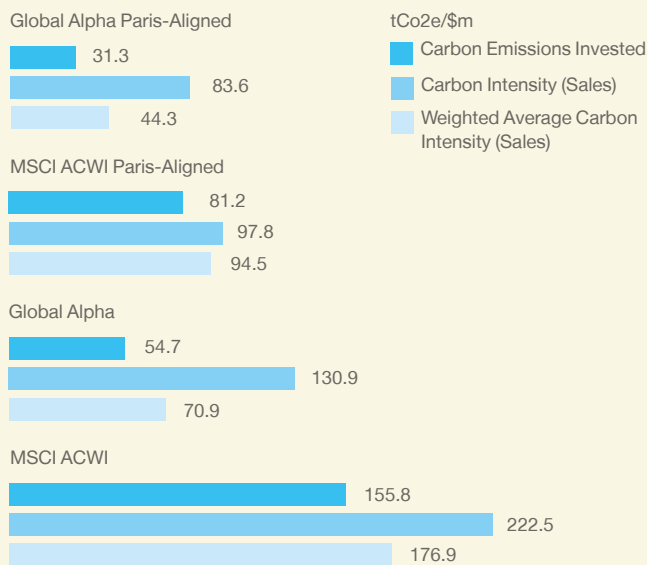


COMPARISON BETWEEN GLOBAL ALPHA VARIANTS

We have examined the portfolio characteristics and carbon analysis of Global Alpha Paris-Aligned and compared it with the core Global Alpha model, and the MSCI ACWI – see tables below. The overlap between the Paris-Aligned variant and the core model is currently around 94 per cent, and the portfolio characteristics are closely matched in terms of growth tilt and predicted risk.

The main difference lies in the carbon analysis, where the Paris-Aligned variant scores better.

Given the high degree of overlap between Global Alpha Paris-Aligned and the core model, we do not expect significant divergence in performance over time.



Source: MSCI. As at 27 April 2020.

	GA Paris-Aligned	Global Alpha	MSCI AC World
Risk			
Number of companies	94*	102	2956
Predicted Absolute Volatility (%)	13.5	13.3	10.5
Predicted Tracking Error (vs.ACWI) (%)	4.6	4.3	–
Predicted Beta (vs. ACWI)	1.23	1.22	–
Active Share (%)	87.6	87.3	–
Growth Tilt			
Leading PE	21.5	20.1	14.9
Yield (%)	1.4	1.5	2.8
Price/Book	2.2	2.1	2.1
EV/EBIT	23.2	20.3	15.4
Historic Earnings Growth (%)	11.3	9.1	5.9
1yr Forecast Return on Equity (%)	10.4	10.3	14.3
Debt/Equity Ratio	16	21	49
Average Market Cap (\$billion)	170.2	156.5	184.0

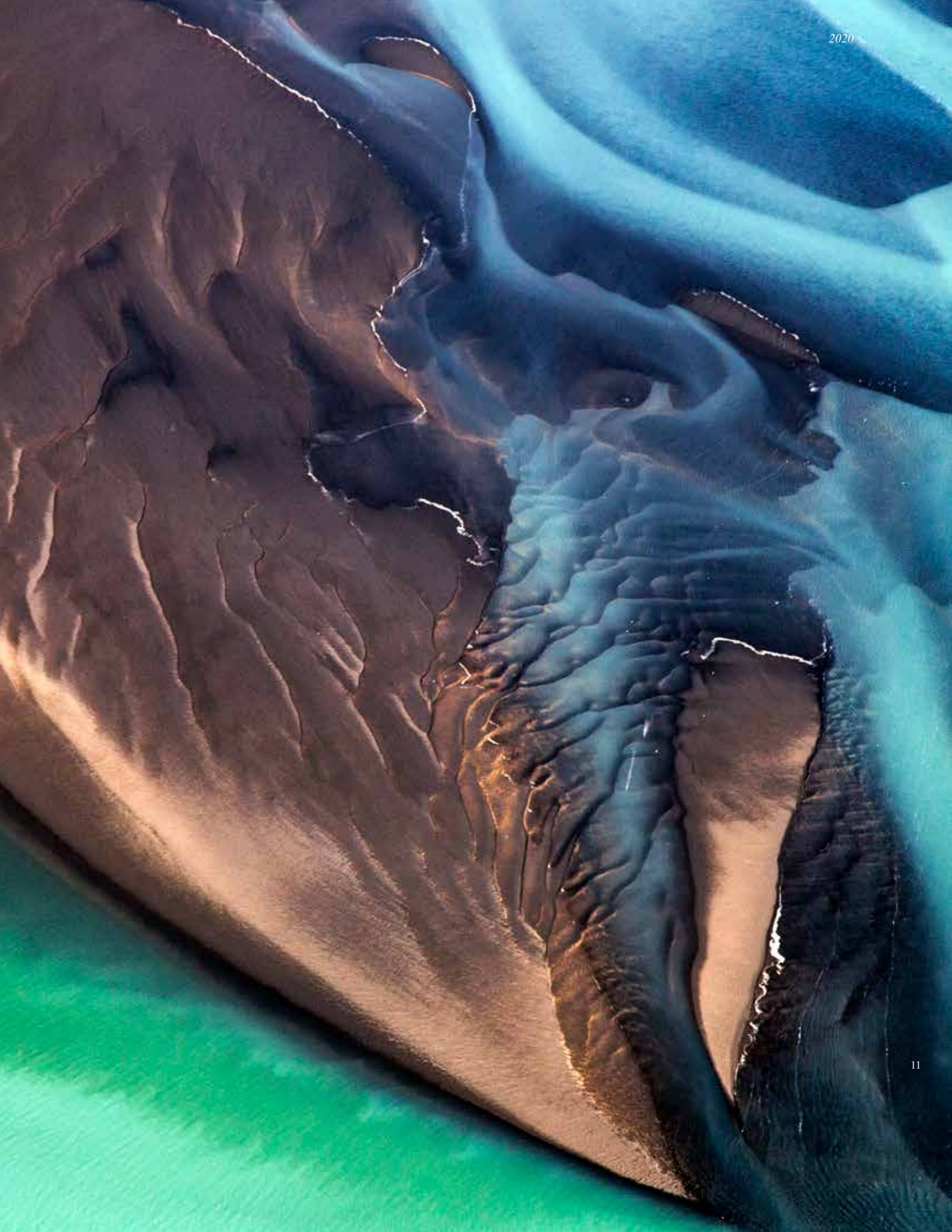
Source: UBS. As at 28 Feb 2020.

*Excluded companies: Albermarle, BHP, EOG, Kirby, Now Inc, Orica, Reliance, Ryanair.



CONCLUSION

We recognise that clients have different preferences, objectives, and time horizons. While our transition to a low-carbon future is well underway, it will take decades to fully wean our economy off fossil fuels. Many clients will continue to prefer our core product. Our duty is to manage your money in a manner that is consistent with your preferences. The choice is yours. We are grateful for your support over the years and remain eager to hear your thoughts on how we can continue to improve. For those that are interested in learning more about Global Alpha Paris-Aligned, we look forward to discussing this with you in the months ahead.



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