BAILLIE GIFFORD

Scottish Mortgage Investment Trust PLC

Manager's Portfolio Review May 2012

BAILLIE GIFFORD

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This is an extract from the Scottish Mortgage Investment Trust Annual Report and Financial Statements as at 31 March 2012, a copy of which can be obtained from our Client Relations Team on the telephone number above.

Manager's Review

Each year the Amazon Annual Report incorporates the original shareholder letter from 1997. Although the origins of Scottish Mortgage are more distant and our thoughts are far less profound than those of Jeff Bezos we think this is an admirable discipline. What follows is therefore a summary of how our investment approach has evolved over the last decade. We should be prepared to be judged by it in the years ahead.

Our Core Investment Beliefs

Whilst fund managers claim to spend much of their careers assessing the competitive advantage of companies they are notoriously reluctant to perform any such analysis on themselves. The tendency is to cite recent performance as evidence of skill despite the luck, randomness and mean-reverting characteristics of most such data. If this does not suffice then attention turns to a discussion of the high educational qualifications, hard work and exotic remuneration packages that the fund manager enjoys. Sometimes the procedural details of the investment process are outlined with heavy emphasis on risk controls. Little attention is given to either the distinctiveness of the approach or the strategic advantages the manager might enjoy in order to make imitation improbable. We think we should try to do better than this.

We are long term in our investment decisions. It is only over periods of at least five years that the competitive advantages and managerial excellence of companies becomes apparent. It is these characteristics that we want to identify and support. We own companies rather than rent shares. We do not regard ourselves as experts in forecasting the oscillations of economies or the mood swings of markets. Indeed we think that it is hard to excel in such areas as this is where so many market participants focus and where so little of the value of companies lies. Equally Baillie Gifford is more likely to possess competitive advantages for the good of shareholders when it adopts a long term perspective. We are a 100 year old Scottish partnership. We think about our own business over decades not quarters. Such stability may not be exciting but it does encourage patience in this most impatient of industries. We only judge our investment performance over five year plus time horizons. In truth it takes at least a decade to provide adequate evidence of investment skill.

The investment management industry is ill-equipped to deal with the behavioural and emotional challenges inherent in today's capital markets. Our time frame and ownership structure help us to fight these dangers. We are besieged by news, data and opinion. The bulk of this information is of little significance but it implores you to rapid and usually futile action. This can be particularly damaging at times of stress. Academic research argues that most individuals dislike financial losses twice as much as they take pleasure in gains. We fear that for fund managers this relationship is close to tenfold. Internal and external pressures make the avoidance of loss dominant. This is damaging in a portfolio context. We need to be willing to accept loss if there is an equal or greater chance of (almost) unlimited gain.

We are very dubious about the value of routine information. We have little confidence in quarterly earnings and none in the views of investment banks. We try to screen out rather than incorporate their noise. In contrast we think that the world offers joyous opportunities to hear views, perspectives and visions that are barely noticed by the markets. From our office in Shanghai to futurists in California there is more in the investment world than the *Financial Times* or *Wall Street Journal* describe.

We are global in stock selection, asset allocation and attribution. We are active not passive – or far worse – index plus in stock selection. Holding sizes reflect the potential upside and its probability (or otherwise) rather than the combination of the market capitalization and geographical location of the company and its headquarters. We do not have sufficient confidence in our top-down asset allocation skills to wish to override stock selection. We do not have enough confidence in our market timing abilities to wish to add or remove gearing

at frequent intervals. We do, however, have strong conviction that our portfolio should be comparatively concentrated, and that it is of little use to shareholders to tinker around the edges of indices. We think this eventually produces better investment results and it certainly makes us more committed shareholders in companies. We suspect that selecting stocks on the basis of the past (their current market capitalization) is a policy designed to protect the security of tenure of asset managers rather than to build the wealth of shareholders. Companies that are large and established tend to be internally complacent and inflexible. They are often vulnerable to assault by more ambitious and vibrant newcomers.

We are Growth stock investors. Such has been the preference for Value and the search to arbitrage away minor rating differentials that investors find it very hard to acknowledge the extraordinary growth rates and returns that can be found today. The growth that we are particularly interested in is of an explosive nature and often requires minimal fixed assets or indeed capital. We think of it as 'Growth at Unreasonable Prices' rather than the traditional discipline of 'Growth at a Reasonable Price'. We need to be willing to pay high multiples of immediate earnings because the scale of future potential and returns can be so dramatic. On the stocks that flourish the valuation will have turned out to be derisorily low. On the others we will lose money.

We believe that it is our first duty to shareholders to limit fees. Both the investment management fee (equivalent to 0.32%) and the TER (0.51%)* are low by comparative standards but at least adequate in absolute terms. We think that the malign impact of high fees is frequently underestimated. The difference between a TER of 0.5% and one of 1.5% may not appear great but if the perspective is altered to think of costs as a percentage of expected annual returns then the contrast becomes obvious. If annual returns average 10% (sadly they have not in recent years) then this is the difference between removing 5% of your returns or 15% each year. Nor do we believe in a performance fee. Usually it undermines investment performance. It increases pressure and narrows perspective.

*Total expense ratio as at 31 March 2012.

Portfolio Comments

The three contentions that we have outlined in the past remain intact. To repeat the formulation of 2010:

— The rise of China (and to a lesser extent other emerging economies) is transforming the global economic scene.
— Stockmarkets underestimate the power of technological change in exaggerated revulsion to the bubble of 1998-2000.
— The Western financial systems are dangerously flawed.

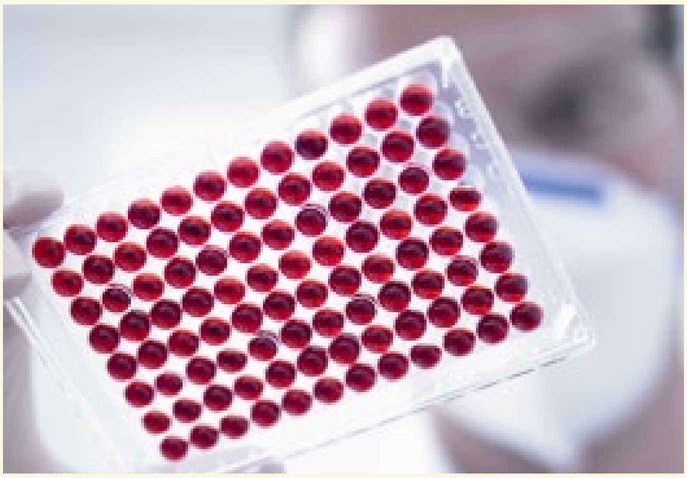
Technological Innovation

We have seriously underestimated this force. It is more powerful than we thought and far broader in its application than we suspected. We now believe it to be the most important influence on the investment world. The opportunities in front of us are likely to be even more dramatic than in the recent past. This is because the very pace of change is in itself accelerating. It is very hard to grasp the implications of this. The minds of normal human beings, let alone those of fund managers with their preoccupation with the immediate, have difficulty in coping with change that is exponential rather than linear and where the guidance offered by the past is so modest.

Apple is perhaps the simplest example of this process as its devices are so dominant and as so much of its story is visible. In product terms this has taken us from the original Apple computer retailing at the equivalent of US$2,500 in today's prices without a monitor, power supply or even a casing to an iPad with at least 10,000x as much processing power for a fifth the price. In 2001 it took 91 weeks to sell one million iPods. In 2011 it took 24 hours to sell one million iPhone 4Ss. For the company this will translate into sales of over US$150bn this fiscal year (with China now running at 20% of sales) with near 40% operating margins and US$110bn in cash. From the share price lows before the return of Steve Jobs in 1997 a market value of below US$1.5bn has become US$550bn. Identifying and holding such extraordinary companies is our primary task. Doing so holds far greater rewards than any amount of market prognostication. Whilst we have owned Apple since early 2009 we feel that we deserve more criticism than praise for our actions. Not just did it take us several years to buy the shares but we were also quick to take profits in 2011. Our holding and our profits should have been significantly larger.

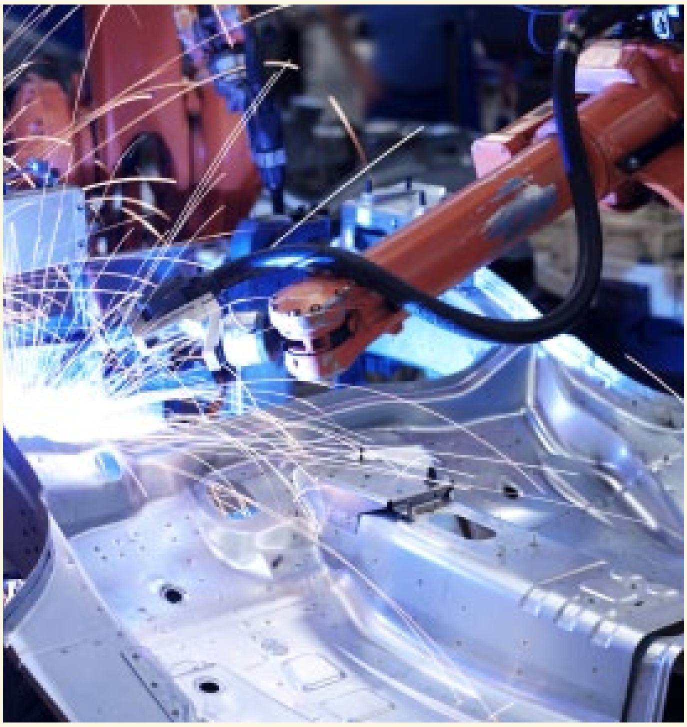
We hope that we own several companies that can follow the same path as Apple but are at a much earlier stage of development. As suggested earlier they are businesses with substantial growth opportunities, minimal or negative capital requirements from a young age and what we think are sustainable competitive advantages. This often translates into formidable margins and return on capital. Their advantages lie in network effects or in more traditional dominance by scale but the lack of capital intensity is in common. We think that such companies are extremely unusual in the history of capitalism. The markets are very uncomfortable in dealing with their existence and characteristics. They are hard to fit into the established valuation frameworks – particularly those that stress the relationship between the capitalization of a company and the value of its fixed assets. Although most of these companies are American (or specifically West Coast American) there is little theoretical reason that this need be so. The main exceptions are currently Chinese which is intriguing.

Our two largest holdings continue to be Baidu and Amazon. Both fit into the description above. They also reflect our strong preference for companies that are led by their share-owning founders. Baidu has continued to grow dramatically but the room to expand still seems open-ended. It has only 321,000 paying customers. There are approximately 40 million small businesses in China. Mobile search is growing very rapidly and advertising is becoming critical to the Chinese consumption surge. Amazon may be an even less mature business. Unlike Apple or Baidu it currently operates on very low margins. It has so many opportunities to invest that despite very favourable cash-flow dynamics it can consume all the cash it generates. As long as it is investing in activities where its competitive position ought to be powerful and returns improving then we are content to be very patient investors in such a vision for all the resultant volatility in the share price.



Alternative Energy and Healthcare

We have grown accustomed to the extraordinary pace of change in the electronics and telecommunications industries. As we noted last year similar developments are now working their way into industries in which innovation has previously been blocked by the self-interest of established players. Whilst opposition can still slow progress it is unlikely to be able to do more than delay transformation once the relevant technologies acquire sufficient momentum. We have applied this idea to the alternative energy and healthcare sectors. So far this has proven a significant error in the first case and seems quite promising in the latter. We have now sold First Solar but not before it was one of our worst investment decisions. Whilst the cost of solar energy has fallen even more sharply than we believed likely, the competitive advantage once enjoyed by First Solar has been eaten away by the power of Chinese competition and by the advent of shale gas.



Healthcare requires reform. It is costly, inefficient and frequently fails to provide the best available medical outcomes. Whilst improving this situation will be the task of decades it is possible the pace of technological innovation is starting to chip away at a previously impervious system. Just before his death Steve Jobs remarked that 'I think the biggest innovation of the 21st century will be the intersection of biology and technology. A new era is beginning.' Genome sequencing appears to be the critical scientific advance enabling such a new era. Its costs are also falling at around twice the pace of the famed Moore's Law that has transformed semiconductor performance over the last four decades. We have a large shareholding in Illumina which is the established leader in this technology. We have recently supported the company in its (thus far) successful battle against hostile takeover by Roche. We also have what has become a large holding in Intuitive Surgical, which is not just the dominant leader in robotic surgery but is also the first pure robotics company in any field of activity to become highly profitable and of substantial size.

China

It is fashionable to be gloomy about Chinese prospects. We are not. We think that the transition from a low cost, low valued added export behemoth to a domestic empire driven first by infrastructure and increasingly by consumption is further and more smoothly advanced than was believed possible. Productivity has risen impressively. The trade surplus is largely a memory. Naturally there will be pauses and blockages. Whilst we think the authorities have been right to clamp down on an overly-exuberant housing market before it assumed bubble proportions this could not prevent local excesses nor does it prop up growth. As productivity rises and innovation accelerates the Communist Party is likely to find the process of evolution still more complex.

But such concerns are minor compared with the scale of the achievement and of the remaining potential. We think China has the human capital, the patience and the competing multiplicity of cities and regions to continue its rise. Growth may, indeed should, slow but we doubt it will collapse. We see no eventual reason why China should be poorer than Britain. We are encouraged that we can find enough individual companies of imagination and innovation and with strong competitive moats that this admiration is a matter of practical importance. We have already discussed Baidu but arguably Tencent has been even more prescient in developing the Chinese internet with its focus on social aspects and on mobile. Certainly Facebook respects its prowess.

China's return to prominence has been distinguished more by the absence of dramatic disruptions than by their presence. Whilst American ascent was marked by internal and external wars, booms and busts, the last thirty years of Chinese progress has been remarkable in its consistency. The current comparative serenity in the face of a troubled Western economy equally appears remarkable. In contrast India, Brazil and Russia all appear to be struggling with these changed conditions. Inflation, deficits, uncompetitive industries and political failings have combined in varied guises to trigger significant productivity and growth disappointments. China is very special.

Western Financial Weakness

We do not have much to add to the daily media preoccupation with the systemic fall-out from the catastrophic implosion of the bloated world of finance in 2008–9. But some comment is probably required. At one level we are moderately encouraged. Both the American and German economies show signs of gradually overcoming the damage inflicted by finance. Given that it is now 7 years since the U.S. property bubble initially burst and that American animal spirits are hard to repress entirely in perpetuity this is pleasing but perhaps not surprising. In Germany finance and housing were never so proud but that employment and business confidence remain so buoyant despite banking frailties and Eurozone anxieties is tribute to the remarkable strength of German

industry. Further south we are more concerned that Spain still has several years of working through a fearsome housing bust than we are that the age-old infelicities of the Italian state will entirely undermine a population of cautious savers and serious industrialists. Indeed we have recently bought shares in Fiat Auto as an improved generation of managers can combine with the allure of Ferrari to revive the company. Less controversially we would simply observe that replacing Silvio Berlusconi with Mario Monti is also a managerial improvement.

Such notes of comparative optimism may be unusual amongst the unremitting media gloom but they are not raised to obscure our concern at the continuing inability of the financial sector to reform itself. Whilst modest and piece-meal measures have lessened the returns and attraction of investment banking there is no evidence that a culture of stability, restraint and modesty has yet been embraced by the industry or been enforced by regulators. Whilst the shock of the crisis and the generosity of tax-payers may defer disaster, the temptations and immediate rewards of finance capital will remain serious threats to the health of the Western world.

Conclusion

Although it has been a frustrating year we find more to be excited about than to fear. Innovation combined with globalization has enabled the rise of a series of companies with historically unparalleled returns and growth opportunities. We think that this process is far from complete. We think that it is underestimated and misunderstood by markets. Whilst we hope we are aware of the dangers of overconfidence, we are also convinced that impatience and fear have all too often exerted too great an influence on markets. At times over the last year, most notably in late 2011, it has seemed to us that the flight to presumed safety has been as exaggerated as the rush towards technology stocks in 1999–2000. Market distortions can just as easily result in undue depression as in overvaluation. Indeed given the difficult recent experience of market participants, this currently seems more probable than an outburst of excessive optimism. Pessimism is very popular. We do not share it.

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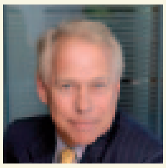

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