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The retirement date lottery – can it be avoided?

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First part: Investment specialist Tom Danaher chats with manager of the Sustainable Income Fund Steven Hay about three big questions for those weighing up their pension options amid the challenges of the past five years.

Your capital is at risk. Past performance is not a guide to future returns.

Tom Danaher (TD): Good afternoon, and thank you, all, for joining us today for the latest Actual Income Webinar. My name's Tom Danaher, I'm an Investment Specialist covering Baillie Gifford's income strategies, and I'm joined today on screen by Steven Hay, who manages our Sustainable Income Fund, and is also the Head of Income Research here at Baillie Gifford.

So, our Sustainable Income Fund was launched five years ago now. It's designed to be a multi-asset, one-stop solution for those in need of a reliable monthly income. It aims to keep pace with UK inflation over the long term, making it well suited to the growing UK retirement market.

Please do use the Q&A function today, at the bottom of your screen, and we'll answer as many questions as we can in the next 45 minutes. So, Steven, welcome. Let's cut straight to the chase. What do we mean by the term, retirement date lottery?

Steven Hay (SH): Thanks, Tom. Yes, we know there are fewer lucky people these days with defined benefit pension plans, and a growing number of people have defined contribution pension pots that they've accumulated throughout their working life. Now, as they hit their retirement, if they're drawing down from their pot to fund their income needs, two people with the same pot may suffer very different outcomes, simply because of the variability of market returns.

In fact, it's the sequencing of returns in the market that causes this difference, and that's why it's called sequencing risk, as the jargon. So, people have to sell assets to generate income after a big market fall, lose out when markets rise again, and this can make a big difference to their actual income.

And it's not something we've really talked about a lot over the last decade or two, because markets have always tended to go up, and in a relatively smooth fashion. But in the more volatile markets we're seeing today, it's perhaps more relevant than it's been for a while.

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TD: And you mentioned, Steven, there, those starkly different outcomes for people with similarly sized pension pots, who also retire around the same time. Is there a good example in history of that happening, that you could share with us?

SH: Absolutely, Tom. So, as I mentioned, the timing of returns really matters in retirement, mainly because people are drawing down on their pensions each year. So, we've got an example here where let's assume that we've got two retirees that have identical portfolios of 60 per cent equities, 40 per cent bonds, so very typical, and they each draw down from that portfolio at a rate of 5 per cent each year, and then we increase that [drawdown amount] with inflation.

Now, the pension values are the same. The only difference here is that one person retires in 1974 and the other retires in 1975. And what this chart shows is how their pension pot values change over a 30-year retirement.

So, clearly, the 1974 retiree was dealt a really bad hand, or bought a bad ticket in the retirement date lottery, because high inflation resulted in multiple interest rate rises, and we saw a significant bear market in equities and bonds. And that permanently impacts our 1974 retiree, who actually runs out of money altogether after 25 years.

Meanwhile, our 1975 retiree has a very different pathway, and their pension pot comfortably remains above the starting value throughout their retirement. Now, people might say, you've picked a very extreme example, and it probably is one of the more extreme examples. But in terms of what we can take from this, I think it is that finding yourself in a position where you need to sell down capital at the wrong time, to generate income, has a lasting and potentially unrecoverable impact on your pension over the long term.

TD: So, later on, Steven, we might touch on the comparisons between today's environment and that of the 1970s, but for those watching today, who maybe themselves are approaching retirement, or they've got clients in that position, how can they guard against this risk that we see on screen here?

SH: Yes, we believe that the best way to safeguard against this lottery, if you like, is to have a portfolio which pays you an attractive level of natural income. So, what we mean by natural income is the dividends paid by equities and the coupons paid by the bonds, and these are the elements of income which are automatically harvested, month after month, by our portfolio, the Sustainable Income Portfolio, for example.

And if this is enough to fund your income needs, then you never have to sell capital to generate income. And therefore, by design, you're never going to fall into the trap of having to sell capital when markets are down. So, in summary, you can't mitigate the risks of markets being weak, but focusing on natural income can really help to guard against bad long-term outcomes in retirement.

TD: Yes, I think the message on natural income is definitely loud and clear. Let's explore income investing more generally, a concept that's been around for decades, been out of fashion, but perhaps coming back into fashion now. It's not the only approach to investing that you can take in

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retirement, so how does it differ from other approaches?

SH: Absolutely. There's total return investing, where all you care about is the total return of your investments, and you're indifferent to whether it comes from income or capital, which really has very little impact when markets are well behaved and generally rising. But if the income generated, if it was too low, then investors could supplement by selling down capital.

But the world's changed. There's volatile inflation, growth is all over the place, with no certainty of what's happening, and interest rates are a lot higher, a lot more volatile than they've been before, so pursuing a total return strategy can lead to really quite different outcomes.

Another approach would be that of retirement target date funds, and so you're de-risking the closer you get to retirement. And so, this approach really helps to avoid the sequencing risk that I mentioned earlier, but the risk that this approach generates is that it's the safe assets that you have, the gilts or the high-grade corporate bonds, they just won't generate a growing income.

And so, the real risk here is that your pension pot is just not big enough. So, for me, income investing is an approach, it keeps the portfolio invested for as long as possible, in assets that will both grow and pay a high level of natural income.

So, in this way, it gets round the sequencing risk problem of a total return approach, and it gives a higher growth outcome than the target date approach.

TD: Okay, so if we're sold on income investing, then, Steven, could you touch on how the Sustainable Income Fund here at Baillie Gifford is approaching that task differently from perhaps other options?

SH: Sure. Our Sustainable Income Fund is designed to be a one-stop solution for those needing income to last a lifetime. Our entire process, [including] the way the team's been set up, is designed solely around income. So, the asset allocation, the stock selection, the risk management, all squarely focused on growing the monthly income we pay to clients in a sustainable way.

So, these portfolios aren't total return portfolios cobbled together. We have bespoke portfolios in each asset class, managed by specialists, [and] focused on income generation. But what we're doing here, what our real focus is, on growing income over the long run. That's what we believe people really need. And going right alongside that, is the focus on growing the capital in the fund, at least in line with inflation as well, because the capital pays tomorrow's income, so it's important to look after that.

Now, another important thing about what we're doing here is, we're really prioritising income resilience. Some traditional income approaches often try and maximise yield, and that can come at the expense of capital, but we know that many of our investors are really relying on this income, and so we need to make sure it is resilient.

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Now, we've talked earlier about a natural income, and that's exactly what you're getting from our Sustainable Income Fund. So, we don't use derivatives or any other complex instruments to artificially boost the fund's income, as again these can often lead to capital destruction.

And lastly, as long-term investors, we believe the best income payers of tomorrow are those that are really fit for the future, so each investment we hold is compatible with a sustainable economy. We avoid many of the traditional areas of income investing. As a result, things like fossil fuel and tobacco producers, for example, don't have a place in this fund because we don't believe they are fit for the future.

TD: I think that definitely comes through. When you look at the fund today and its largest holdings, they tend to vary quite significantly from what you might typically see, what we're used to seeing in an income fund. So, it's clear that you're taking a very different approach.

A quick reminder to keep your questions coming through, using the Q&A function at the bottom of your screen. So, that's how you're tackling the task.

Moving on, the economic backdrop is clearly very important to you, as a multi-asset investor. And before moving into fund management, you trained and worked at the Bank of England, advising the Monetary Policy Committee. It faces a big and perhaps unenviable challenge today on inflation, which is headed in the right direction, but remains stubbornly high. If you were advising the MPC today, Steven, what would be your assessment of long-term inflation?

SH: I'm quite glad I'm not. I'm quite glad that I've moved on, Tom, to be honest, because the task facing them is quite a big one.

You'll know because we've talked many times in the past, about my view on inflation. It has been that we're seeing a bit more structural inflation coming through now, so many of the things that held inflation low for many decades, things like globalisation and demographics, are actually going into reverse in terms of their impact on inflation.

So, I think we're de-globalising to some degree, and that's going to stop the amount of outsourcing, etc., that we've seen, which has helped keep the lid on inflation. I think the demographics is going to reverse, we're seeing that in labour markets right across the world. There's a shortage of workers, and increased pressure on wages, which really is one of the key elements keeping inflation high.

And for me, the policy backdrop is just not as supportive as it was, back when I joined the bank, when it was all about inflation targeting and everyone was very agreed, that was the way to do it.

Now we've got much higher government debt levels. It's much more painful for the government to have the Central Bank raise rates high for a long period of time, because it costs so much more in interest expense. And I think that means the trade-off there is a difficult one, which means the commitment to fighting inflation is a bit lower in the past.

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So, although [it's] coming down, clearly, cyclical inflation, I think there's quite a chance that structurally [inflation is] a bit higher than we've been used to over the last couple of decades.

TD: Okay, so it's unlikely the UK will return to that low, benign inflation that we saw and got used to for much of the past 15 years. So, what does that mean for interest rates here in the UK going forward? And do you think the market's being perhaps a bit too optimistic about the possibility of rate cuts next year?

SH: I don't think it's hugely optimistic now. And the Bank of England has belatedly done a fair amount of work in raising rates, and we know the economy has slowed quite significantly, and inflation is coming down cyclically.

So, it's not clear they need to do a lot more on policy rates right now. So, the market's looking at 50 basis points of cuts coming through in the next 12-18 months, which is not hugely unreasonable. I wouldn't say that's completely wrong.

However, we're finding it pretty difficult to get very excited about long-dated bonds, particularly in the UK, but also in other markets, because what you're seeing now, and it's really interesting, Tom, it's not just what's happening in monetary policy and short-term rates that's driving longer-dated bonds. It is back to things that we haven't seen since the 70s and 80s, and maybe a little bit of the 90s, which is a concern about the amount of government bonds being issued to the market, and who's going to buy them.

And what that means is that yields are having to rise to induce people to buy them, and you get a little bit of a positive premium at the long end of yield [curves]. So, that's a different environment. We haven't had that for a couple of decades.

And maybe younger, newer investors like the ones [approaching retirement], that we've talked about, they don't recognise this, but it's a feature of when government debt is really high, it could have an impact on yields. So, we're not particularly bullish on longer-dated yields dropping significantly from here.

TD: So, it's a tough and in some ways scary environment for the heavily indebted, including [many] governments, but these higher interest rates mean there are more options today for income investors like the ones on the call.

And we've had a question through on the subject of cash, which is now producing attractive and, ultimately, risk-free returns. So, our questioner asks, what do higher cash rates mean for those approaching decumulation?

SH: Yes, this is a change. So, cash is now a viable option for generating attractive nominal income, at least in the short run, and for those approaching decumulation, it means they don't need to venture beyond their comfort zone to generate a decent nominal income. So, that is a real big

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change from much of the last decade, where it couldn't really be considered an option.

For us, we're holding more dry powder in terms of cash in the fund. UK T-Bills make up about 5 per cent of the fund, because we recognise it's the relative attractiveness of cash, relative to other assets, has improved over the last year or two. So, it maybe does have a place in the portfolio, at least in the shorter run.

TD: So, yes, as you say, higher interest rates mean cash is now contributing to the fund's monthly income payments, which is the first time since the fund was launched, really, as well as giving you a bit of dry powder when we find opportunities to deploy that cash.

But for those thinking about keeping a large proportion of their pension fund in cash today, which might be quite tempting, what are the risks of doing that [over the] longer term?

SH: Yes, the safety aspect of cash does have an appeal to those approaching retirement. They know their £100 invested in the bank is subject to protections, and its nominal value won't fall below that. So, no, there is some attraction, but we also know it brings a different risk, because the real risk, or sorry, the real value or the purchasing power of cash, will be eroded over time by inflation.

So, to put some numbers on that, in a 3 per cent inflation world, the value of your cash will more than halve over a 25-year period. That is really significant. And given that we are all living longer, it's a long time horizon for those approaching retirement, so many people will feel the need that their pensions need to last well over 20 years, and cash isn't going to be the answer over the longer term.

So, yes, it can have a place, particularly in the short run, and perhaps as a part of a balanced portfolio, there's room for a bit of cash. But in terms of putting all of your assets into cash, it's just not going to do the job for you, especially if you're worried, as I am, that inflation is going to be structurally a bit higher than it's been in the past.

TD: Yes, so that erosion of purchasing power over what we all hope will be a long retirement, is the main challenge with cash. There's been lots of talk linked to that, about annuities being back in vogue. We've seen interest rates rising, and annuities of course benefit from that.

Now, Baillie Gifford doesn't provide any financial advice, I should caveat. [We are] purely investment managers. However, how do you think these annuities compare with staying invested, purely from an income perspective, over the long term?

SH: A bit like the cash argument, annuities look a lot more compelling today than they have done for many years. So, just to look at what the numbers are at the moment, a 65-year-old today might be able to achieve a fixed annuity rate of 7.5 per cent, whereas a few years ago, we were nearer 4 per cent, and that [7.5 per cent] is higher than what most drawdown funds would yield today.

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So, for comparison, our Sustainable Income Fund yields around 4.3 per cent today. However, there are two big differences between annuities and drawdown, which are really worth just making sure we're clear about.

Firstly, the drawdown funds can grow their income over time, whereas the real value of the annuity payments will be eroded by inflation over the course of a long retirement, so that's a key difference. I know you can get inflation-linked annuities, but of course those have a significantly lower yield to compensate you for that [protection]. So, keeping pace with inflation is a key challenge with an annuity.

And secondly, by staying invested in the market, you are keeping your capital intact, too. So, of course, capital is subject to volatility but at least it's got a chance of growing over long periods of time, whereas with an annuity, your capital is lost over that period. So, there are really quite stark differences between the options.

And clearly, annuities have a place, and depending on your age and your risk profile and tolerance, etc., but staying invested for longer, and at least with some of your pension pot, we think is a path really worth considering for many of those that're approaching retirement today.

TD: So, you've been managing the Sustainable Income Fund for five years now. We've touched on how the cash and interest rate environment has changed during that time, but if you think about it, this fund is, broadly speaking, from a strategic perspective, a third invested in equities, a third in fixed income, and a third in real assets. How has the broader income opportunity set changed during those five years?

SH: The short answer is, a lot. So, quite a lot has changed. We've seen a lot of capital volatility in supposedly lower-risk or risk-free assets.

As you'll know, Tom, cash and government bonds played a tiny role in the fund for the first four and a half, five years. They've been very small weightings in the fund. But as we've just talked about, we're now seeing these as having more relative attractiveness than they did before, so they are now a proper part of the opportunity set.

What's been really important, for us, is making sure the fund's resilient, so we've got an Investment Guideline, that the fund's income per share shouldn't fall by more than 10 per cent during any given year. And the reason we've got that, is that we know our investors need that reliability of the income to fund their retirement. It's not an annuity, so it won't be completely stable, but it's got to be resilient.

And despite the challenges thrown at us since launching the fund, and honestly, it's been a fairly torrid few years for all investors, but income investors in particular, with the global dividend cuts during the pandemic [in 2020], dividends from FTSE UK companies down almost 50 per cent during that year, despite all that, we've stayed within the guideline since the fund was launched.

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And I think that's a real testament to the resilience of the portfolio. It's the diversification across nine different asset classes, and it's the particular types of resilient investments that we choose within each asset class, that has been the key to that.

TD: Yes, I think for broader income investors, if this has been their first five years of retirement, it sure has been a rollercoaster.

So, not everything in the fund is an income growth asset. You mentioned we've got fixed income assets. Those have faced significant headwinds from higher inflation and higher interest rates. For those approaching retirement, how do you see the role of fixed income today?

SH: I think I'll point to two big reasons why retirees should think about an allocation to fixed income. The first is income, income, income. It's super-important. Real yields on many bonds are now positive for the first time in many years.

So, our fixed-income exposure includes very different underlying holdings to most vanilla drawdown products, and for example, we're using Baillie Gifford's depth of resource with credit and emerging market debt, to find resilient bottom-up ideas.

And just to give you an example, so in the high yield [credit] space, [we own bonds issued by] a company called Veritext. This is a US, single B-rated company. But it's all about automating tasks of reporting, collection and reporting duties within the US legal system, something that's been a highly fragmented business, and they're able to do a lot of automation through AI. So, a very good business model, lots of growth, but something that's still yielding 9 per cent in the portfolio, but something we've had to look very carefully for, to find.

And just another quick example. In the emerging market world, again, we're not typically investing in the riskier types of emerging markets. It's much more about finding the resilient ones.

And Tom, you're a football referee. I know you like your football. Uruguay is a country that has just over-exceeded what it should do in terms of football. I've seen them in the Rugby World Cup as well. And on the economic and development sphere, it does that as well. So, in Uruguay, we hold a hard currency bond which yields about 6 per cent and we've also held an inflation-linked bond, issued by Uruguay.

So, Uruguay is one of the safer and more resilient emerging markets, and to be able to buy inflation-linked debt from a country like that, provides us with a much higher yield than a UK inflation-linked government bond. And so, there's an attraction there, but you have to go looking for these things.

TD: Very good, Steven.

SH: Tom, I'll just give you the other big reason. I know I said there were two. The other big reason is just for diversification. We know that dividends from equities tend to be more volatile than the

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coupon flows you get from bonds, so that's really important in building the portfolio that has got resilient income.

So, we've got the cycles, if you like, of the income, are just different between the different asset classes, and the fixed-income asset classes tend to be an awful lot more stable in terms of the profile, so that really helps the overall portfolio with its resilience.

TD: So, looking for pockets of mispriced resilience in, perhaps, lesser-researched areas of the fixed income market, it's certainly something different.

Let's turn to income growth now. We've discussed the importance of investing to produce income which rises over time, hopefully keeping pace with inflation, perhaps easier said than done at the moment. That is included in the Sustainable Income Fund's objective. So, what types of assets do you look to, for that, to drive the fund's income growth over time?

SH: I think the first thing to acknowledge is that it's been very difficult to keep pace with inflation during a spike, such as the one we've seen in the last two years, and that's not where the objective of the fund is.

Our objective is to keep pace with inflation over longer periods (5 years), so we would never expect or hope to match a spike in inflation like we have seen in the last year or two.

That having been said, it's really important to us to have assets in the portfolio that can match or beat inflation. In the long run, equities are for us the drivers of real growth over time, and we look for established companies whose underlying profit growth enables them to grow dividends over time.

Companies that have real pricing power, that have a real differentiated product or service, those are the ones that are able to raise their prices to keep up with inflation, and that's the best inflation protection you can get.

We also like infrastructure companies. Many of them have explicit inflation-linked revenues, or at least implicit, and they typically have a lot lower sensitivity to the business cycle than many broader equities.

Just to give you an example, people often talk about water companies. We haven't found anything interesting to invest in, in the UK, in terms of water companies. Instead, we've looked overseas, again, to try and pick out investments that offer a really good income. And one example of that is Aguas Andinas, which is a water company based in Chile. It's the largest private water company in Chile, serving the Santiago area.

And there's a great tailwind of a very supportive regulator and lots of investment going into water in that area - something that offers [compelling] returns and really good diversification from the fund.

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And just to give you another example, Terna is effectively the national grid of Italy, and there's substantial investment in Italy's transmission network to enable the clean energy transition. And that's what supports the growth of Terna's regulated asset base, and therefore, its ability to generate income growth over time, and its dividend is growing at [around] 8 per centper year.

So, it's assets like that, which are able to grow their income, and it'll benefit from rising inflation. So, that's exactly the kind of asset you need in this portfolio.

TD: Another asset class the Sustainable Income Fund has exposure to is property, which is topical, after you and I were discussing it earlier today with our property guru, Jon Stewart.

Property's not exactly been renowned for producing resilient income in recent years, but what sorts of property companies, does the fund have exposure to?

SH: Yes, property [accounts for] about 6 per cent of the fund today, and it's mainly in digital assets, healthcare, and logistics companies. That's what we find attractive. So, the companies we invest in are generally specialists in what they do, providing assets where there's clear structural growth in demand.

One example Jon mentioned during our conversation earlier was Unite, which builds purpose-built student housing. And as most people will be aware, there's an acute shortage of UK university accommodation, so it's addressing that need exactly.

The companies we hold in our Property Allocation dance to a different tune than the UK REIT sector They're mostly listed outside the UK, and we certainly avoid the more distressed areas like retail and office space, where we don't have any holdings and don't see the attractiveness at this point.

TD: I think Jon referred to these earlier today as mission-critical property assets that he's looking for, exclusively.

More broadly, are there any companies in the portfolio which have produced either inflation-matching or inflation-beating dividend growth, even during the recent inflation spike that we've seen?

SH: Yes, so I'll be honest, Tom - it's been challenging for the income from the fund to keep pace with inflation during this sharp inflationary spike, and what we're seeing now is that inflation is coming down, and our income is growing and catching up with the lag. I think that's inevitable.

However, there are companies in the portfolio which have produced strong dividend growth, and it's been great to see. If we look at our equity portfolio, one example would be Experian.

It's a UK-listed information company, which makes most of its revenue and profits in North America. It simplifies and automates expensive decision-making processes for its clients, that's what it's

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about, as well as the credit rating stuff that we all know about.

This year, it grew its dividend by 8 per cent, and it's been buying back shares, too. So, Experian is a market leader with credit history data on over a billion people worldwide. It's exactly the type of business which ought to be able to grow its earnings at a high rate for a long time, so that's one example.

And then, [one more] from our Property portfolio, which we've just been talking about. Equinix is a Californian property company specialising in datacentres. As Jon will say, they're the 'junction boxes of the internet' if you like. And it's grown its revenue for more than 20 consecutive years, through lots of different market cycles, so a very strong, secular tailwind to the growth.

It's been a big beneficiary of the move to cloud-based services in recent years, and we expect it will now benefit from the adoption of AI technology, which will create further demand for its physical infrastructure.

Equinix recently grew its dividend by 25 per cent, so that's not something we would expect from many property companies in this environment, and it shows that you really have to go looking for the ones that are able to do that.

TD: If everything could grow by 25 per cent a year, the task would be easy, wouldn't it? So, those dividend growth stories are encouraging, obviously. In those cases, have the companies' share prices been rewarded by the market in what has been quite an unforgiving market, hasn't it?

SH: Yes. Not always, is the answer. If we take that Experian example, it's been an excellent performer over the long term, but their shares have fallen this year, despite that dividend growth. That's okay.

Sometimes, these good companies get caught up in short-term market sentiment. And for us, we're long-term shareholders, and provided the investment case and the dividend growth story persists, we're supportive long-term shareholders. And often, it can be a chance to add to positions when [a company's progress has] not been fully recognised by the market.

Other companies have been able to post stellar dividend growth and enjoy a rising share price, even in this difficult market, so the likes of the Danish pharmaceutical company Novo Nordisk. It's the world leader in tackling diabetes and obesity, and it's really enjoying blockbuster growth at the moment and recently became Europe's most valuable listed company, and has been able to grow its dividend significantly. So, there are examples on both sides.

TD: I guess what brings those examples together is, these are companies that are generally fairly well-established, sector leading, and masters of their own destiny in the long term, self-financing and so on.

So, Steven, we've covered quite a lot of ground in just over half an hour. We've had several

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questions come through. An invitation to add some more through the Q&A function, as you please.

So, we discussed the retirement date lottery and how you can mitigate, at least, the risk of retiring at a bad time. We've also discussed the role of cash in a retiree's pension fund, and the asset classes that can deliver that real income growth over time. Looking ahead to the next five years for this fund, what are you most excited about as an income investor?

SH: Yes, there's plenty of stuff to choose from. I think for me, as we were talking about earlier, it's been a pretty difficult period over the last number of years, with these big shocks with COVID and then the war in Ukraine, and oil prices, etc.

So, it's been a really difficult environment, and at the same time, you haven't always had lots of opportunities across lots of different asset classes. And I do feel, from this point, that it's the breadth of opportunities that we have across the different asset classes, and the debates we're having that are raging all the time [about] how much should we have in fixed income, now that yields have risen significantly?

We can see the attractiveness of it, but at the same time, James Dow, who manages our equity component of the portfolio, is really excited about the equities that he holds. And this wasn't really as much of a debate before, because fixed income just wasn't attractive enough to really warrant that debate.

So, for me, it's the fact that through all our asset classes, we've got everyone enthusiastic about the opportunities, which gives you a much more positive outlook and breadth of opportunity. And hopefully we [avoid] some of the shocks that we've had in the last few years. I think they were definitely unusual. So, while it's never plain sailing with investment, I think hopefully we can consign some of those big shocks to history, and we'll get maybe a smoother environment going forward.

The peak in rates is probably close and inflation's coming down. I think there are a lot of positive things, so that's great from an income growth perspective and from a capital return perspective. So, I can see lots of opportunities in lots of different areas, and it's the breadth of those which is probably the most striking thing for me.

TD: Yes, I think one of our colleagues described it as income from everything, everywhere, all at once, which is pretty neat.

One of our questioners has asked about how this fund's asset allocation compares with that of the Managed Fund or the Balanced Fund. You're a named manager on that strategy, too. Do you want to touch on the key differences between Sustainable Income and the Managed Fund?

SH: Yes, the Managed Fund, its objective is capital growth over a rolling five-year period, with no income objective or anything, and to achieve that, the fund is very heavily biased towards equities. So, we have typically in the fund, 75 per cent in equities and 25 per cent in fixed income and cash, to provide some balance to those equities. And then, so that's one big difference.

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Whereas in Sustainable Income, we have about a third in traditional equities, a third in those real assets that Tom mentioned, and a third in fixed income. So, there's a broad difference in asset allocation. That's one big difference.

And then, the types of equities that the Managed Fund holds are quite different. So, as people will know, we are looking for growth companies, the companies that can grow their earnings faster than the average company in the index.

So, the equities that are in the Managed Fund will be growth equities, and we're looking for that because the capital growth is the objective, whereas the equities we hold within our Sustainable Income Fund are a different set of equities, the more established companies that you mentioned, Tom, or ones that can still grow, and that's where we are a bit different from your average income manager.

So, the equity investments that we have in the Sustainable Income Fund will be ones that can grow their income, but they'll also be ones that can pay a dividend right now as well. So, we need to have that dividend. So, they tend to be more stable, slower growth than you might expect from the types of companies you're going to get in the Managed Fund, but they clearly play an important role for growth in our portfolio.

TD: Yes, so there are some differences there, both in terms of the asset allocation, but also the underlying investments that are held within the fund.

We've had another question through, on the UK economy. So, do you think there is a recession on the cards in the UK, and how is the fund exposed to this risk?

SH: So, most of our clients are UK based, but the fund by no means dances to the tune of the UK domestic economy. Only 9 per cent of the fund is invested in UK equities, and that's including the equities, property, and infrastructure.

Most of our clients have a sterling income need, of course, so we do use currency hedging to make sure our primary exposure is to sterling and take out the currency risk when appropriate.

In other words, what I'm saying is that the UK growth cycle isn't really the important determinant for what happens in the Sustainable Income Fund, but of course it's interesting to all of us, because we live in the UK and we have exposure to UK assets in lots of different ways.

We're clearly slowing down significantly, and we might even be in a recession now in the UK, and that's been required, I think, to alleviate some of the pressure of inflation that you were seeing. The labour market was too hot. That's clearly cooled down, significantly. Inflation is now beginning to come down. You're seeing [the rate of] grocery price [inflation], if you've seen the latest data, falling quite significantly.

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So, we're getting to that point where the tightening's having an effect, which was necessary. I don't think it'll be a particularly deep recession. I think we'll be able to get through it reasonably well, but a slowdown was needed, and hopefully we can get the inflation back down to a more reasonable level.

As I said before, I'm slightly sceptical it will get back down to worrying about inflation being too low, for quite some time. But if we're much closer to target, and under three [per cent] at least in the CPI measure, then I think we can get back to more business as normal, and rates can start to come down. But I don't think that's going to happen anytime soon.

TD: So, that tougher economic data probably making life for your former colleagues at the Bank of England a bit easier.

Steven, related to that, on currency hedging in the fund. Without going into too much detail, most of the [Fund's] clients are sterling spenders, so how do you approach currency hedging?

SH: So, for us, the basic point is to hedge any overseas currency exposure back to sterling, because we don't want to take any unwanted currency risk in the fund. In terms of how you actually do that, we don't always know the exact currency exposure of each of the equities, so we have a rule of thumb, [which is to hedge] 50 per cent of the [foreign] currency risk (by listing currency) back to sterling.

And we think that's the best approximation to hedge the currency risk back to sterling, because of course some of these companies may have sterling exposure, even if they're listed in the US.

The only place that we actually take any [unhedged] currency risk in the fund is in our Emerging Market Local Currency Bond Allocation, which is currently about 8 per cent of the portfolio. I mentioned Uruguay earlier. That's a bond issued in the local currency in Uruguay, and therefore, part of the investment case is that we want to have exposure to that local currency. And therefore, we don't hedge that back.

So, there is a limited amount of currency risk [through] what we described earlier as being the more stable emerging markets, but actually versus sterling, the currency volatility is very low, and it's not really a big part of [what drives] the portfolio.

TD: It was one of the best-performing currencies last year, yes, incidentally, in Uruguay. We've got another question, totally unrelated, come through. Does the Sustainable Income Fund have any exposure to private assets such as private equity, infrastructure or credit?

SH: No. All underlying investments in the Sustainable Income Fund are listed equities or bonds. Firstly, there's a lot of competition for space in the portfolio, because, as I said, nine different asset classes and everyone arguing about what should get in there.

And none of our investors feel there's a shortage of income opportunities in public markets, and it's

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maybe the fact that, unlike [many] other Baillie Gifford strategies, Sustainable Income has got that focus on companies that are more established. And those companies are often found in public markets, rather than maybe the higher-growth end of the spectrum, where they are [often] private, and that's been a fruitful picking ground for some of our other equity strategies.

One benefit of sticking to listed investments in Sustainable Income is that we can change the asset allocation very quickly. Lots of flexibility to change the asset allocation as we [deem] appropriate, when return opportunities are changing between different asset classes. And that's an important part of our approach, so lots of liquidity in the fund [for that reason].

TD: As you have been doing recently, of course.

SH: Yes, absolutely. So, adding to fixed income recently, as we're seeing it be more attractive, yes.

TD: Great. Thank you, Steven, and thank you, all, for joining. If you'd like to learn more about our Sustainable Income Fund, please either visit our website or get in touch with your usual contact here at Baillie Gifford. And we hope to see you next time.

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Annual past performance to 30 September each year (%)

	2019	2020	2021	2022	2023
Baillie Gifford Sustainable Income Fund Class B-Inc	11.9	2.1	11.1	-9.4	5.9
IA Mixed Investment 40-85% Shares Sector	4.2	-0.2	16.6	-10.2	5.1

Source: Baillie Gifford & Co Limited, FE, Revolution. Total return in sterling.
The Fund has no target. However, you may wish to assess performance of both income and capital against inflation (UK CPI) over five-year periods. In addition, the manager believes an appropriate performance comparison for this Fund is the Investment Association Mixed Investment 40-85% Shares Sector.
Past performance is not a guide to future returns.

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All data is sourced from Baillie Gifford & Co unless otherwise stated.

The specific risks associated with the **Baillie Gifford Sustainable Income Fund** include:

- Market values for illiquid securities which are difficult to trade, or value less frequently than the Fund, such as holdings in weekly or monthly dealt funds, may not be readily available. There can be no assurance that any value assigned to them will reflect the price the Fund might receive upon their sale. In certain circumstances it can be difficult to buy or sell the Fund's holdings and even small purchases or sales can cause their prices to move significantly, affecting the value of the Fund and the price of shares in the Fund.

- Custody of assets, particularly in emerging markets, involves a risk of loss if a custodian becomes insolvent or breaches duties of care.

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- The Fund invests in emerging markets where difficulties in trading could arise, resulting in a negative impact on the value of your investment.

- Bonds issued by companies and governments may be adversely affected by changes in interest rates, expectations of inflation and a decline in the creditworthiness of the bond issuer. The issuers of bonds in which the Fund invests, particularly in emerging markets, may not be able to pay the bond income as promised or could fail to repay the capital amount.

- Investments may be made directly in hedge funds or, through specific investment vehicles into property, infrastructure and commodities. Returns from these investments are sensitive to various factors which may include interest and exchange rates, economic growth prospects and inflation, the occurrence of natural disasters, and the cost and availability of gearing (debt finance).

- The Fund has exposure to foreign currencies and changes in the rates of exchange will cause the value of any investment, and income from it, to fall as well as rise and you may not get back the amount invested.

- Derivatives may be used to obtain, increase or reduce exposure to assets and may result in the Fund being leveraged. This may result in greater movements (down or up) in the price of shares in the Fund. It is not our intention that the use of derivatives will significantly alter the overall risk profile of the Fund.

- The Fund's share price can be volatile due to movements in the prices of the underlying holdings and the basis on which the Fund is priced.

- For distribution purposes the ACD has the facility to allocate some or all expenses to capital. For the year to 30 June 2022 100% of expenses were allocated to capital (year to 30 June 2021: 100%). This will reduce the capital value of the Fund. This number will vary from year to year.

- The Fund invests according to sustainable and responsible investment criteria which means it cannot invest in certain sectors and companies. The universe of available investments will be more limited than other funds that do not apply such criteria/exclusions, therefore the Fund may have different returns than a fund which has no such restrictions.

Further details of the risks associated with investing in the Fund can be found in the Key Investor Information Document or the Prospectus, copies of which are available at **bailliegifford.com**.

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