Baillie Gifford

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Paul Dilworth: As 2026 begins, I'm delighted to report that on a gross basis, the strategy has continued its run of outperformance against its index. That's now 11 quarters, almost three years of unbroken quarterly outperformance over its index. In absolute terms, the strategy generated a total gross performance of around 2.6% during the fourth quarter, taking the total for all of 2025 to around 7.4 per cent.

Despite the wobble in market sentiment that we saw in April, linked to US tariff uncertainty, demand for credit remained strong throughout 2025. Keeping investment grade markets relatively stable in spread terms. By spread, I'm referring to that excess yield that we capture through lending to high-quality corporates, rather than investing in UK government bonds. This market stability, coupled with historically tight spread levels, made for a challenging environment for bond pickers.

Why was that the case? Well, tight markets exhibit low spread dispersion, that is to say, bonds are more bunched up with limited relative value between them. This low dispersion, combined with low volatility, reduces the opportunities for active managers to capture value through capitalising on those market inefficiencies. With this backdrop, we're very pleased that the strategy continued to add value for our clients, with bond selection being the key driver of that outperformance.

This bond selection effect was positive across sectors, but it's worth calling out the particular strength of some of our highest-conviction real estate picks, which included Annington, public property and International Workplace Group. Three very different credit stories within the same sector. Turning to positioning and outlook, I want to draw out four important themes that contributed to performance throughout 2025 and remain relevant as we begin 2026.

Firstly, we retain our structural underweight to long-dated credit risk. Tight spreads and high duration do not, in our view, provide an attractive risk reward proposition. However, we maintain a similar duration profile to that of the index by investing in long-dated UK government bonds, which remain attractive both in terms of total yield and relative value versus other government bond markets.

Secondly, the strategy continues to out-yield the index, in part through investing heavily in short dated high-spread bonds from blue chip companies such as Barclays, Center Parcs, Yorkshire Building Society and the like. This position is funded through a structural underweight to low yielding quasi-sovereign bonds, which we believe offer little value. Thirdly, we're using index level credit default swaps to reduce generic credit risk.

The advantage of this approach is that it allows us to lower aggregate credit risk efficiently, enabling us to continue investment in our underlying bond ideas. This investment tool can be viewed much like an insurance policy. We pay the premium for the protection and in the event that spreads do spike wider, it provides the strategy with a degree of capital protection.

And the final theme that I want to touch on is liquidity. We maintain a keen focus on bond liquidity. We believe the headline market stability, seen through 2025, belies a more nervous position under the surface. While historically tight spreads can persist, and attractive all-in yields continue supporting them, at some point they will be tested and we stand ready to capitalise on that opportunity and invest once valuations become more attractive.

Putting all these together along with our broad market thoughts, I'd summarise our outlook as follows. We are constructive, as evidenced by the strategy's higher yield relative to the index, but we are managing the strategy more defensively than usual.

So why are we positioned defensively? As noted, credit valuations remain historically tight. As the AI age takes off the world is changing quickly and in ways that are difficult to imagine, let alone predict. Uncertainty is rife across governments and businesses, competency seems unable to keep pace with technology. Even the future of money is ripe for change. This all points to more volatility ahead.

And so, why are we constructive? All-in yields remain attractive on a long-term view. That yield, plus capital appreciation from further rate cuts as the economy continues slowing, could provide a platform for another year of strong returns for investment grade bonds.

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Investment Grade Bond

Annual past performance to 31 December each year (%)

	2021	2022	2023	2024	2025
Investment Grade Bond Composite (gross)	-2.4	-18.3	8.9	3.4	7.5
Investment Grade Bond Composite (net)	-2.7	-18.6	8.5	3.1	7.1
ICE BofA Sterling Non-Gilt Index	-3.0	-17.8	8.6	1.8	6.8

Annualised returns to 31 December 2025 (%)

	1 year	5 years	10 years
Investment Grade Bond Composite (gross)	7.5	-0.7	2.8
Investment Grade Bond Composite (net)	7.1	-1.0	2.5
ICE BofA Sterling Non-Gilt Index	6.8	-1.2	2.4

Source: Revolution, ICE. sterling. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite. 1 year figures are not annualised.

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