GIC Conference
Rates and Currencies; The Long View

April 2012

Ken Barker CFA
Partner, Baillie Gifford Overseas

The Grip of Short-termism

The average holding period for a US Treasury is 12 days
The futures-adjusted holding period is 2½ hours
Bond market volatility has risen

Results
— Economic planning is harder
— Increased economic vulnerability
— Dead weight of socially useless activity
Impact on Asset Management

Investment banks dominate market research

Short horizon for trade recommendations and economic forecasts

But we have poor predictive ability over short periods

Professional Economists’ Three Month Forecast Accuracy – Short-term Rates

<table>
<thead>
<tr>
<th></th>
<th>Average Error</th>
<th>Average Volatility</th>
<th>Error/ Volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>0.4</td>
<td>0.2</td>
<td>200%</td>
</tr>
<tr>
<td>Canada</td>
<td>0.5</td>
<td>0.2</td>
<td>250%</td>
</tr>
<tr>
<td>Japan</td>
<td>0.1</td>
<td>0.1</td>
<td>100%</td>
</tr>
<tr>
<td>Germany</td>
<td>0.3</td>
<td>0.1</td>
<td>300%</td>
</tr>
<tr>
<td>UK</td>
<td>0.5</td>
<td>0.1</td>
<td>500%</td>
</tr>
</tbody>
</table>


An Alternative Approach – Country-picking

Look for sustainable trends

Take into account

— Economics
— Politics
— Other social factors

Test the thesis consistently and rigorously

Cast the investment net wide

Be patient
An Example – Productivity and Real Effective Exchange Rates

Balassa-Samuelson Effect
— A country’s productivity determines its spending power
— This drives its real exchange rate
— There is a reasonable correlation between the two

Balassa-Samuelson’s Predictive Power

To be sustainable we test for the following
— Potential – productivity gains from industrializing
— Political risks – stability and corruption
— Inflation risks – nominal rates vs. effective rates
Emerging Markets’ Past, Europe’s Present?

Fatal flaw – debt issued in ‘hard’ currency

Feedback loop between markets and economy

Coloured political attitudes – made default ‘cheap’

Result – serial defaults and crises

Post-Asian Crisis

Local currency bond issuance key

Positive feedback loop

Reduced volatility

Reduced default risk

Greater prosperity
Political Factors

The state is the largest economic agent in most countries

Predicting party politics is a fool’s game

The political settlement is what matters
  — Size and role of the state
  — Approach to budgeting
  — Market liberalism
  — Property rights
  — Commitment to transnational bodies

Political Settlements and Financial Outcomes

<table>
<thead>
<tr>
<th></th>
<th>USA</th>
<th>Chile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal conservatism</td>
<td>Persistent deficits</td>
<td>Surplus over the cycle</td>
</tr>
<tr>
<td>Long-term budgeting</td>
<td>Social security time bomb</td>
<td>Copper “rainy day fund”</td>
</tr>
<tr>
<td>Budgeting process</td>
<td>Better funded, more transparent</td>
<td>Technocratic, less personal</td>
</tr>
<tr>
<td>External settlements</td>
<td>Politically linked</td>
<td>Limited</td>
</tr>
</tbody>
</table>

Debt/GDP

Source: Ministerio de Hacienda, Federal Reserve Board/Haver Analytics.
Triggers for Change

Political settlements
— Post-revolutionary United States

Charismatic politicians
— Deng Xiaoping

A crisis
— Asia 1998
— Canada mid 90’s
— Europe today?

Fiscal Transformation in Canada

Source: IMF.

Practical Investment Precepts

Avoid being busy fools
— Fewer meetings and less headline chasing
— Rigor in process

Be sceptical of the consensus
— Question credit ratings and other labels
— Rotate investment coverage periodically

Manage portfolio for a patient approach
— Genuine diversity
— Favour relative-value investments
Case Study – Global Imbalances

Longer-term Global Context
- Developed markets must regain competitiveness
- Demand should rebalance towards EM countries

How will this occur?
- Nominal exchange rate appreciation for EM?
- Higher inflation in EM than developed markets?

Translating this to investment positioning
- Sporadic FX appreciation likely – diversified ‘basket’ of EM currencies
- Higher EM inflation likely – favour inflation-linked bonds
- EM risk premiums to decline – further boosting relative returns

Summary

Rates and currencies investment horizons are too short
A patient country-picking approach will yield better results
Exploit sustained trends backed by economic and political fundamentals
Set up portfolios to allow a patient approach
Important Information and Risk Factors

Baillie Gifford Overseas Limited is wholly owned by Baillie Gifford & Co, Investment Managers, and is the company through which Baillie Gifford & Co provides investment management services for clients outside the United Kingdom. Both are authorised and regulated by the Financial Services Authority. Baillie Gifford Overseas Limited is registered with the SEC in the United States of America (for the purposes of US clients).

Baillie Gifford International LLC is wholly owned by Baillie Gifford Overseas Limited; it was formed in Delaware in 2005 and is registered with the SEC. It is the legal entity through which Baillie Gifford Overseas Limited provides client service and marketing functions in America as well as some marketing functions in Canada.

Baillie Gifford & Co claims compliance with the Global Investment Performance Standards (GIPS). All performance data presented is supplementary to an appropriate compliant composite presentation. A complete list of the Firm’s composites and performance results is available on request.

This presentation contains information on investments which does not constitute independent research. Accordingly, it is not subject to the protections afforded to independent research and Baillie Gifford and its staff may have dealt in the investments concerned.

All information is sourced from Baillie Gifford & Co and current unless otherwise stated.

Stock Examples

Any stock examples used in this presentation are not intended to represent recommendations to buy or sell, neither is it implied that they will prove profitable in the future. It is not known whether they will feature in any future portfolio produced by us.

Any individual examples will represent only a small part of the overall portfolio and are inserted purely to help illustrate our investment style.