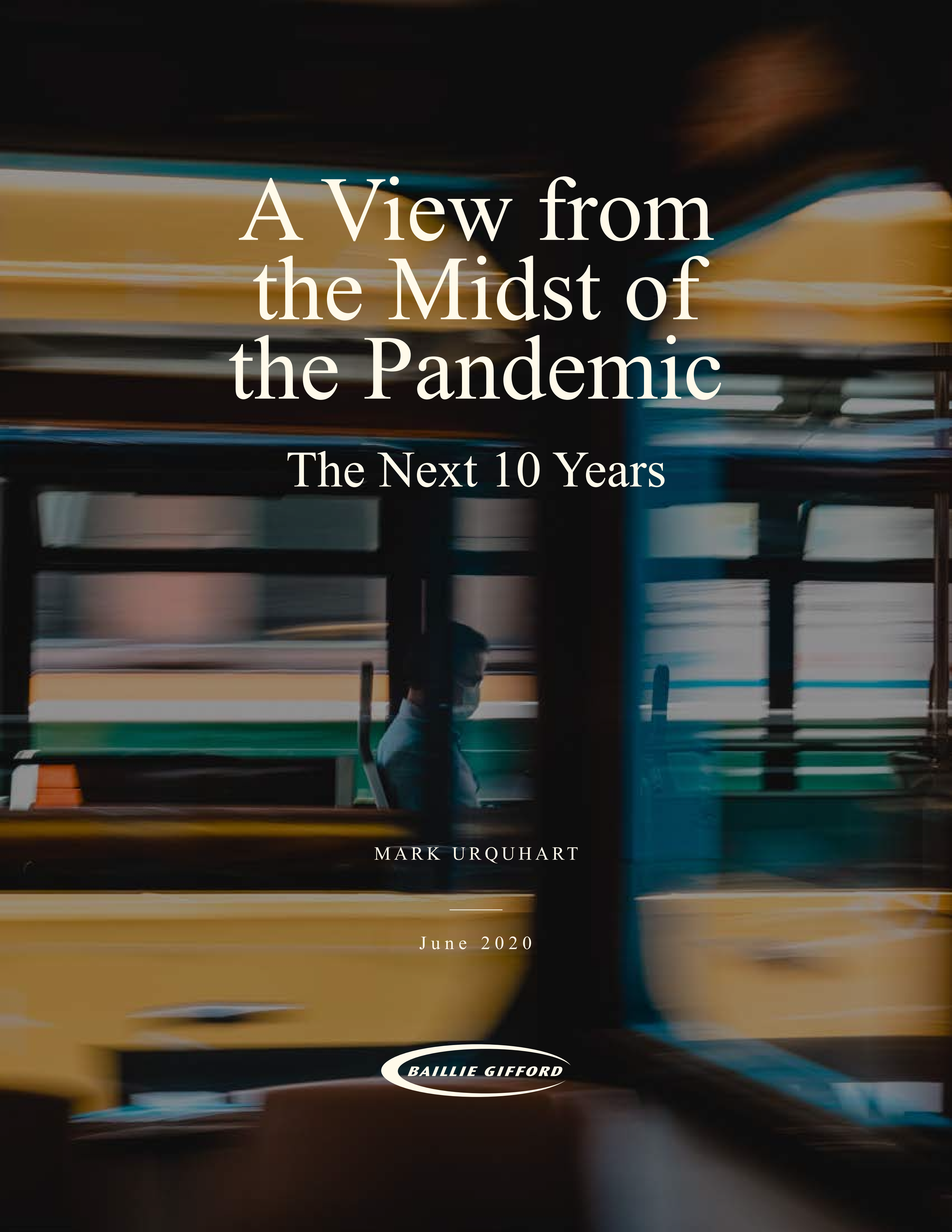

A View from the Midst of the Pandemic

The Next 10 Years

MARK URQUHART

June 2020

BAILLIE GIFFORD

RISK FACTORS

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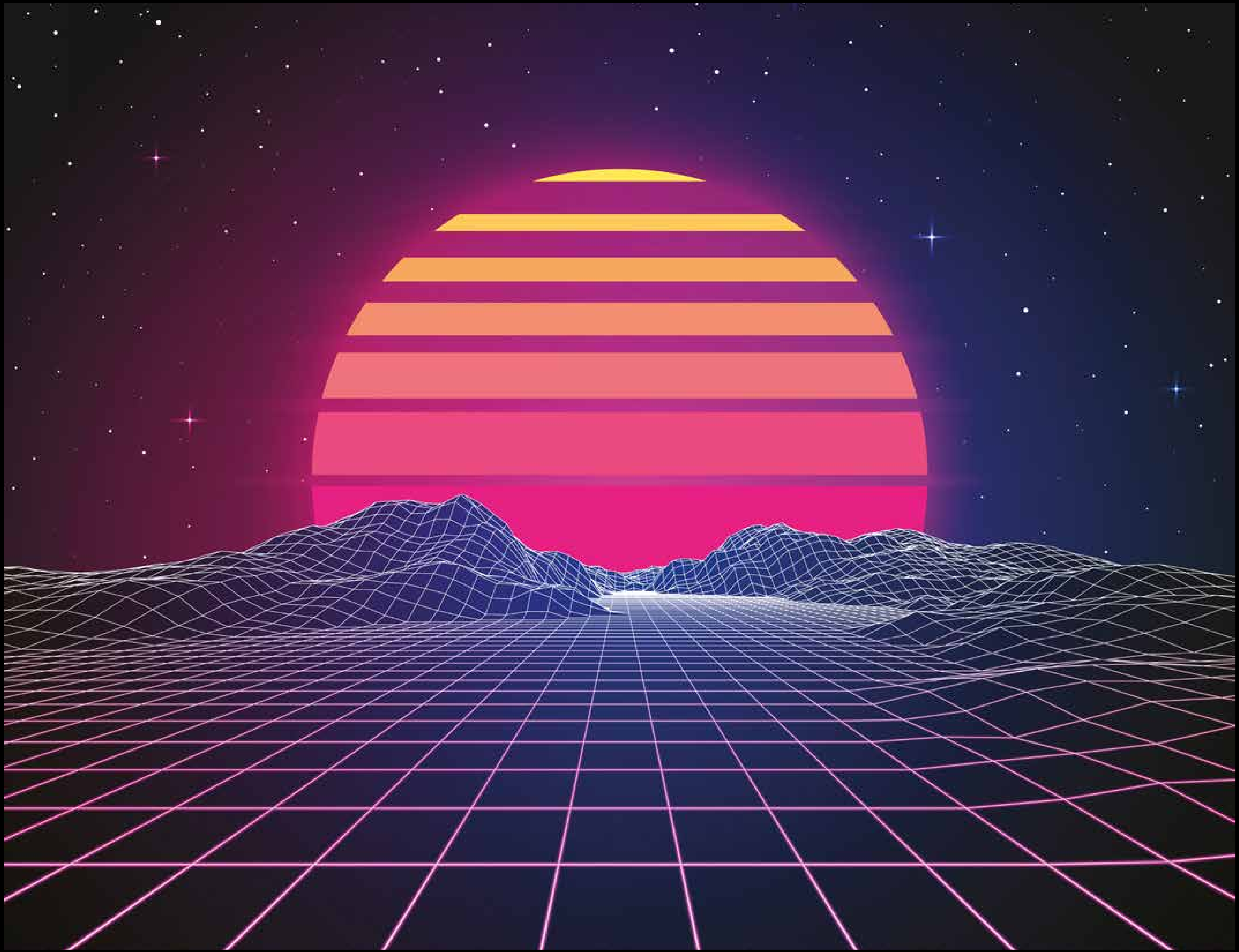

2020: ALWAYS EMBLEMATIC FOR ME

Growing up as a child in the 1970s and a teen in the 1980s, there was always something alluring to me about the year 2020. It seemed so far off – a full two decades beyond the change of millennium; there was a science fiction element to what might be possible by that date and I am sure that, subconsciously, it appealed to me because of the regularity of the numerals and the fact that my 50th birthday would fall in the subsequent year.

Now as I survey the next 10 years and beyond from the vantage point of 2020, it feels worth pausing and reviewing what has happened in the intervening decades and which parts weren't foreseen. I have tried to make some sense of all that has happened during my investment career (which will reach its 25th anniversary next year) and to consider some ideas of what we might expect in the next decade.

I think it is not hyperbolic to say that much of the science fiction of my youth has proven itself to be way too conservative in terms of the power of the silicon chip to affect every facet of human life. The global economy of 2020 was unimaginable to the analogue, Cold War scribblers of my childhood. The ubiquity of communication is a world away from the fax machines and expensive international calls of the late 20th century (innovative as they were at the time). Likewise, for medical research to be looking at replacing and repairing genes really was the stuff of fantasy for a schoolboy in the 1980s, when biology lessons focused on the holy grail of one day being able to sequence the human genome.

We now readily take for granted advances that seemed truly fantastical just a few short decades ago. This is not a new human trait and – from the printing press to the Wright Brothers' bloody-mindedness to facilitate the flight of man – I would contend that proximity bias often occludes the profound changes which true innovation brings. I think the biggest shift I have seen in the investment universe in the last quarter of a century is the ability of companies to disrupt the established norms and shibboleths of virtually every industry. Many of the previous rules of economics have been overturned and it is my strong contention that this period will come to be seen historically on a par with the Industrial Revolution in terms of its economic and sociological effects. From the vantage point of the emblematic 2020, I find the view out over the next decade as exciting as at any time in the preceding quarter century.

PANDEMIC REFLECTIONS

I started writing this piece in the early part of 2020, actually on return from my most recent trip in January to China where, as usual, I was blown away by the combination of the innovation and growth opportunities presented to us as investment opportunities. At the time, the picture of a bad flu outbreak in Wuhan (a region I previously only associated with China's fresh fruit and vegetable industry) was starting to emerge but I don't think anyone would have thought that by March over a billion people around the world would be effectively contained in their own abodes as every polity attempted to contain the spread of the already notorious Covid-19 virus. It is clearly far too early to draw long-term conclusions from a disease which we are still starting to understand, let alone conquer. However, I have found it consuming much of my thought in terms of trying to look out over the next decade, and want to offer some ruminations on areas which the pandemic has stimulated me to think about.

It is clearly far too early to draw long-term conclusions from a disease which we are still starting to understand.

A RENAISSANCE IN MATHS!

We have talked for years about exponential change, fat tails, black swans and the like. This has been based on both their import to long-term investing and the contention that they are far more common than the reversion to the mean mantra (which I have critiqued in previous pieces) would have us acknowledge. I wonder if the daily exposure to the maths of exponential change through the need for social distancing to reduce transmission factors will have a long-lasting effect. The term 'going viral' has been commonly used in the 21st century vernacular to refer to social media posts, YouTube videos and the like, but I think this was often just a figure of speech without a true understanding of how a virus can operate and spread at almost incomprehensible rates when left unchecked. Clearly, lots of people haven't yet grasped the true meaning of viral load when it impinges on their perceived freedoms, from the stubborn Australian beach surfers to UK day trippers to Americans protesting their fundamental liberties in large groups, but I do think that the general appreciation of the power (good and bad) of exponential change will emerge from the pandemic at a heightened level.

THE RISK IN THE INDEX…

One other nascent feature of the pandemic in stock market terms has been a further illustration of our much repeated mantra that the index contains fundamental risk. The notion that equity indices are somehow risk-free states has to my mind always been a dangerous fallacy which has been amplified by the rise of passive investing. Actually, all three of the significant market crises which my career has contained – technology, media and telecoms (TMT), the financial crisis and now the coronavirus – have been linked by so much damage being done to particular parts of the index that it demolishes the thesis that index investing can diversify away such risk.

In the current iteration, the demand shock to many parts of economies has exposed risk in supposedly 'robust' areas and large index constituents. This is most obvious in the collapse of traditional extractive energy which simply cannot store the resources being produced and therefore only has the safety valve of falling prices. But it is also present in second order ways – those companies which prided themselves on resisting the move to sell goods online – such as Primark in the UK's fast fashion sector – suddenly look very risky at a time when their customers cannot travel to their deserted retail temples. Of course, some of this is short term in nature but it would appear to me likely to accelerate many of the trends already in place in terms of different ways of consuming, and enhance the economics of the disruptors.

There is a second huge challenge presented to market orthodoxy in the form of the disappearance of apparently safe dividends. It is hard to escape the symbolism of Royal Dutch Shell cutting its dividend for the first time in 80 years and the reaction of how devastating this is to those who 'relied' on such dividends as providing superior returns to cash. There are several elements to this. The first is that there is an immediate shock to valuations which relied on dividend growth models and a challenge to the future reliance on dividends, especially as many of those which have been cancelled had already been agreed to be paid. There would seem to me to be a further impediment to the difficult task that value managers have of assessing intrinsic value with one of the tools in their toolbox being severely impaired. At the time of writing, estimates are that 2020 dividend income globally will decline by 25–40 per cent and even these figures could prove conservative. Many of the fabled dividend payers with consistent and growing dividend streams have lost their halos. It is worth saying that this is the right decision for companies whose revenues and cash flows have evaporated but that doesn't lessen the potential impact. Of course, there will be some recovery in pay-out ratios and growth in future dividends, but it seems to me that 2020 will be seen as an epochal moment when the relative import to shareholders of long-term revenue and earnings growth became amplified against the diminished security of dividends.

companies which prided themselves on resisting the move to sell goods online – such as Primark – suddenly look very risky.

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LONG-TERM WINNERS

Many of our initial efforts have been focused on thinking about more granular effects of the pandemic. There are some very obvious beneficiaries, such as Amazon, which has hired a staggering 170,000 people in the first four months of 2020 to fulfil the global spikes in demand, Zoom, where active users are running at 10 times the level of just one year ago, or Peloton, where suddenly the idea of having connected, high quality fitness kit at home seems extremely compelling. Again, we do not expect current heightened levels of trading to be maintained as some normality returns to economies, but it seems highly probable that many of the trends which we were already excited by will be accelerated. For example, Netflix has seen a surge in new subscribers and, while not all of these may stay, it seems improbable that many won't realise the value and utility of the Netflix service, especially with its new content schedule already largely in place for the next two years at a time when TV and film studios have been shuttered, live sport has been halted, and theatres and cinemas will struggle to social distance in an economic way.

Trying to disentangle some of the longer-term changes from short-term stimuli is challenging but valuable. It would seem plausible to me that one lasting effect of the pandemic may be fundamental changes in the ways we work and travel. However long lockdown lasts, it has proven to millions of enterprises that it is not only possible to work from home but may also have considerable positive upsides to it. This has a potentially profound impact on the idea of large office buildings where employees expend carbon and waste time to gather together on a daily basis. It would seem to me entirely likely that the attitudes both of employees and employers will be radically different in terms of flexible and remote working as we progress through the next decade. This, in turn, could have equally significant consequences for the use of cloud platforms as, in a dispersed-employee world, the need for centralised services dissipates faster than even before – a potentially powerful example of the acceleration of an existing trend alluded to above.

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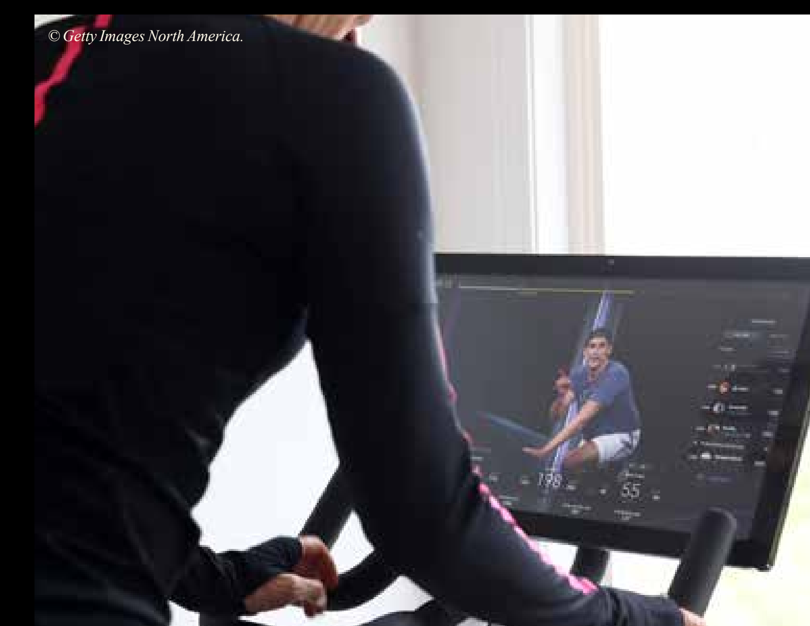
I think this logic also extends to how travel will look moving into the next decade and beyond. Both in a professional and personal guise, we have all blithely taken for granted the ability to travel, but this freedom has been challenged through being seen as the conduit of disease, and by the closing of borders. It seems highly unlikely that travel returns in the same way, not least because the ability to enter foreign lands is likely to be curtailed or could be changed at short notice as virus outbreaks return. I also think that our confidence in communicating through different media will increase and the desire of our clients to see us face to face will be reduced. The idea of business travel could well be a relic by 2030 in the sense of expending a huge amount of carbon for a relatively short meeting which can be better done by a non-jet-lagged person over a video call. This is not to say that the human desire to travel and explore is diminished, but the potential behavioural aspects definitely seem changed and the environmental aspects, explored later, would appear to me to loom much larger. I wonder if by 2050 the gilded status of frequent flyers will be inverted and they will appear as an early 21st century relic in the same way as the glamourous cigarette smokers of the mid-20th century ads.



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HOW WILL HEALTHCARE BE VIEWED?

A street art graffiti mural, showing the logo of the NHS (National Health Service), and an image of 100-year-old veteran Captain Tom Moore who raised over GBP 30 million for NHS charities, is pictured in east Belfast on 5 May 2020. © PAUL FAITH/AFP/Getty Images.

There will be many other industries and areas of activity where fundamental changes are likely to occur over the next decade and beyond, but none seems more likely than the sphere of healthcare. Perhaps the most widespread commonality between all nations during the last couple of months has been the global wave of gratitude toward all those involved at the front line of hospitals in dealing with the virus. From our local UK fundraising hero, Captain Tom, to the global hand-clapping of healthcare workers which started in Spain; from the impromptu operas of Italian town houses to the micro efforts to manufacture PPE – seldom can a global community have had such a united attitude toward a sector of their economies.

no-one could have foreseen 30 million new jobless claims in little more than a month.

Of course, healthcare has always possessed the qualities of a public good and, in my experience, this has led it to behave differently when it comes to the quoted stock market. Indeed, much of the debate surrounding its outsize proportion of the US economy stems from that society's evolution of a public good as a primarily private enterprise. The challenges of dealing with the ageing populations of many societies and the trade-offs inevitably involved in deciding how much of the public purse should be directed toward healthcare will not diminish, but my sense is that both politicians and the public may well have a different answer to some of these conundrums going forward, whether it be toward public sector wages or investment in facilities. The US will remain a law unto itself, but no-one could have foreseen 30 million new jobless claims in little more than a month and the

As unemployment claims continue to increase in New York City, the lines for free food continue to grow.
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concomitant chaos of almost one-tenth of the population dropping out of the insurance system. This seems likely to have consequences for any future debates on Medicare and to my mind again raises the spectre of some form of price controls or, at least, increased government intervention. These are huge political questions which are likely to continue to exert a large influence over companies involved in this area.

Some of the consequences of the crisis are easier to predict – research budgets into virology are surely destined to be sustained at much higher levels, but there are already worries emerging on the decline of prevention in second order health services, such as dentistry or ophthalmology. The most success in the healthcare area over the last decade or so has been in companies which innovate and take costs out of the system, whether that be Intuitive's robots or Illumina's sequencers. While we are interested in the science of a vaccine, it may well be that more rewarding paths of research revolve around telemedicine or remote diagnosis and dispensing of drugs.

THE PARADOX OF 'THE OTHER' – GLOBAL DEPENDENCY VS NATIONALISM

If one can be cheered by the commonality of the appreciation of health professionals, it is hard to be anything other than depressed by the retreat behind national boundaries of societies in dealing with the spread of the virus. My doctorate before joining Baillie Gifford focused on the topic of nationalism, and the definition of that phenomenon which I always found most salient was that proposed by the Czech philosopher, Ernest Gellner. This was that nations were defined most often in relation to 'The Other' – Scots are not English; the Brazilians are not Argentinians; the Poles are neither Germans nor Russians, etc. There is a paradox currently in that nations have reverted to their national units to fight a common 'Other' – the virus respects no border, race, religion or any of the defining units of identity which humans commonly use; yet we have reverted as societies to our nation states. This paradox lies in Covid-19 reminding us that we all belong to one human species and it is our interactions which have made the spread so rapid and deadly, but our default position to dealing with its consequences is to seek national solutions.

Part of this reversion is the necessary consequence of legislative restriction, although it appears strongly to me that this has been far easier in unitary countries than in federal models. The conflict between New York's Cuomo and other governors and the current White House incumbent has been mirrored by very different policies in Australian states, and stands in stark contrast to the adherence to the central government's edicts which facilitated China emerging so relatively unscathed from the virus.

The possible long-term consequences of such nationalism will become clearer over the next few years and will vary considerably depending on the duration and return of the disease and any subsequent mutations. I personally think that the causal racism being employed by many in the west in calling this 'the Chinese virus' will come back to haunt the politicians who are employing it for domestic political gain. It seems to me that our thesis that the 21st century belongs to the continent of Asia will be further accentuated by current events, and we will look back on the year 2020 as one when the world's economic centre pivoted further and faster toward that continent.

The virus respects no border, race, religion or any of the defining units of identity

A REHABILITATION OF SORTS FOR TECHNOLOGY…

In the last few years, one of the most common questions we have received and concomitantly debated internally has been about the power and potential regulation of large technology companies. Companies such as Facebook, Google, Amazon, Tencent and Alibaba have grown to be substantial and powerful parts of the economic ecosystem, and with this has come increased scrutiny and differing levels of critique. For some, their motives are nefarious and they seek to abuse their market power in very similar ways to Big Oil, Big Pharma, Big Banks et al. before them. For others (myself included), these companies are consumer-centric and focused not on gouging but on providing more utility at lower prices; however, with size comes unintended consequences and responsibilities that many of us are still grappling with, such has been the alacrity of their ascent.

Wherever one lies on this spectrum, it would seem to me that the pandemic perhaps offers an alternative narrative to this prevailing critique of 'big tech'. In the absence of a vaccine, the widespread use of contact tracing and testing appears to offer the most plausible way out of the crisis. In China, the WeChat QR code quickly became the badge of health, helped by its ubiquity and the acceptance of the population that the sharing of private data contributed to a larger public good.

This debate on the trade-offs between data and privacy is now starting to occur in polities of every philosophical persuasion, and different societies and individuals will reach different conclusions. But these trade-offs do look very different when it is a question of life and death. I am struck by the degree of collaboration between companies which are commonly fierce rivals, such as Apple and Google, and also by the fact that size and reach matters hugely to the potential impact of such tracing technology. It seems to me that the very thing which was at the nub of many concerns surrounding these companies – namely their size – is now the potential route out of very strict long-term social distancing. The trade-off between privacy and utility will rage on, but it appears to me that, with this utility now encompassing life itself, many people's previously strident views may well soften and the power of the large platforms will stand enhanced.

A passenger wearing a face mask as he shows a green QR code on his phone to show his health status to security upon arrival at Wenzhou railway station. © NOEL CELIS/AFP/Getty Images.

After three months of lockdown, services restart at the Saint Tomà station for the gondolieri on May 18, 2020 in Venice, Italy. © Getty Images Europe.

REIMAGINING THE JOINT-STOCK COMPANY

I don't like the term ESG. In the same way I dislike TMT, BRICS or my current *bête noire*, TAM, I think it is an epithet which tries to capture a very complicated area in a narrow heuristic and therefore removes much of the granularity which is where the import often lies. However, if I was to pick one topic which I think could define the next decade, it would centre on the role of the corporation in a world in which the broader responsibilities of businesses including, but not confined to environmental and social issues, become far more important.

It is a little known and delightfully ironic fact that the first joint-stock companies emerged in China in the AD 700/800s and over the subsequent centuries they have transformed into the central unit of economic organisation in almost every global society. Most often but not exclusively it has the profit motive at its fulcrum (the stakeholder nature of Japanese capitalism is an honourable example of this) although often chasing short-term profits or rewards to the executive layer sows the seeds of downfall or, at the very least, atrophy.

We have, for many years, tried to find companies which think in a long-term fashion about their own enterprise, as we think such alignment of timeframe creates the best conditions for prosperity over multiple decades. Increasingly in the last decade, this has involved explicit thinking about the company's contribution to society and I think it is no exaggeration to say how companies are perceived and their actions and motives are examined could change more in the next 10 years than it has in many previous decades. It is not enough now to provide a good product or competitively priced service – where the raw materials are sourced and how workers are treated has become increasingly and rightfully a consideration for many making their consumption or procurement decisions.

This is not ubiquitous by any means – many still turn a blind eye to the environmental and social impact of fast fashion or to the environmental footprint of moving goods around the globe – but it seems to me to be an inexorable path toward this being of greater import. The images of nature re-emerging from mankind's rampage of the planet will surely be among the most enduring of the pandemic – from wildlife returning to the blue canals of Venice, to the Himalayas being clearly visible to parts of India for the first time in decades, to bears wandering freely in Yosemite. Such powerful symbols of nature using a virus to reassert a visible presence on our shared planet seem to me likely to only further fuel the overriding environmental questions of the next decade and beyond.
What I find most exciting is that companies which do the right thing and act responsibly are now putting themselves at a potential large competitive advantage, and consideration of a company's societal impact will become ever more central to our investment process.

SOME HEURISTICS TO STICK TO

Trying to pull all of the above together into our investment task is the challenge we face over the next decade and beyond. In terms of what we should do, I set out below some heuristics which I will try to stick to in the coming years. These are a distillation of many of the things I have learned over 15 plus years of investing in this way and a desire to carry on improving what we do.

BE CURIOUS

BE BOLD

BE COMMITTED

BE WRONG

BE HOLISTIC

BE LONG TERM

BE CURIOUS – Curiosity is fundamental to everything we do. I personally think the biggest skill any investor can possess is to be open-minded. We deal every day in the imprecise and uncertain, yet many market participants have huge amounts of certainty over what will happen. If we can navigate with an open mind to the companies and industries which haven't yet been invented and embrace the blue-sky outcomes, then we change the probabilities of successful outcomes in favour of our clients.

BE BOLD – Many of our greatest investment successes have come from backing mavericks – the people who see the world differently and devise different ways of doing things. I have had many clients quietly thinking we are mad over the years and welcome this as it shows we are hunting for ideas away from the conventional crowd. We should continue to seek out the crazy entrepreneurs.

BE COMMITTED – We spend a lot of time trying to assess the motivations of management teams and the culture of businesses. This stems from a strong belief that those companies which deserve our committed support should share our timeframe and vision for the business. They should take decisions not based on next quarter's earnings but on what their best guess is at their business in five or ten years. In my experience, there are not many companies who can truly think in such terms, but that makes those that do all the more special and worthier of our support.

BE WRONG – We cannot possibly do our job properly without making mistakes. We have previously made forays into alternative energy, 3D printing, biotech platforms and other areas which were rich in potential but didn't deliver strong returns. But it is intrinsic to our process that we seek out businesses which have the potential to change the world and embrace the fact that not all of them will succeed. The most neglected facet of equity investing in my experience is the asymmetry of returns on offer. This is mired in the risk aversion so prevalent across our industry. Embracing being wrong affords us the ability to be very valuably right.

BE HOLISTIC – As we think about companies over the next decades, I am utterly convinced that the idea of the place of a company in society will become much more holistic in the sense that the most prosperous businesses will be those which think about all their stakeholders and not just their shareholders. We need to be broad in our thinking about how any company we invest in thinks about its suppliers, its customers, its employees and their health, the environment and the company's place in society. I don't think it is hyperbole to propose that the most successful businesses over the coming decades will be those which think most broadly about the type of enterprise they wish to be in the 21st century.

BE LONG TERM – This facet of my thinking is so engrained in me that it almost goes without saying that we should strive to be long term in everything. Yet I think it underpins everything that we do and links all of the exhortations above. Put simply, I don't think we can try to do the task with which we are entrusted by our clients without having a long-term view. It allows compound growth to prosper and real enduring change to occur, and by escaping the myopia of markets and their apparatus, we can use the different timeframe to differentiate ourselves and invest rather than speculate.

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CONCLUSION

Returning to the original intent of this piece and asking what the next 10 years might look like, I find myself critical of my own lack of ambition in imposing such a narrow timeframe. If I transport myself back to 1980, life in 2020 is unimaginable – every aspect of daily life from commuting to shopping; education to entertainment; banking to healthcare is so fundamentally different to how it was as to be unrecognisable. This is despite the 80s being defined by its own embrace of new technologies in the form of the PC, the mobile phone, the CD player et al. and it reminds me of the importance of remembering how much things can change over the long term.

The really valuable question to ask is how the world will look in 2050 and beyond as it is transformational change over this timeframe which will be truly valuable for our clients. What I can say with certainty is that the staging post on that journey that 2030 represents will hold many surprises. I fully expect there to be new ways of doing things which have yet to be invented. It is our job to continue to be as curious and open-minded as we can and to navigate our portfolios toward such change, with the promise that the rewards from such growth will be more valuable than ever over the next decade and beyond.

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CURIOUS ABOUT THE WORLD

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