SWIMMING AGAINST THE TIDE

THE CASE FOR ACTIVE MANAGEMENT IN US EQUITIES

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BAILLIE GIFFORD

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The Baillie Gifford U.S. Equity Growth Fund Top Ten Holdings
As at 30 September 2020

Holdings		Fund %
1	Tesla Inc	10.63
2	Amazon.com	9.49
3	Shopify	8.64
4	Wayfair	6.37
5	The Trade Desk	4.23
6	Zoom Video Communications	3.94
7	Netflix	3.92
8	Alphabet	2.61
9	Chegg	2.57
10	Mastercard	2.52

It should not be assumed that recommendations/transactions made in the future will be profitable or will equal performance of the securities mentioned. A full list of holdings is available on request. The composition of the Fund's holdings is subject to change. Percentages are based on securities at market value.

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Tom is Head of the US Equities Team and is a decision maker for the Long Term Global Growth strategy. He joined Baillie Gifford in 2000 and became a Partner of the firm in 2012. After serving as Deputy Manager for five years, Tom was appointed Joint Manager of Scottish Mortgage Investment Trust in 2015. During his time at Baillie Gifford he has also worked in the Developed Asia and UK Equity teams. Tom's investment interest is focused on high growth companies both in listed equity markets and as an investor in private companies. He graduated BSc in Computer Science with Mathematics from the University of Edinburgh in 2000.

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SWIMMING AGAINST THE TIDE – THE CASE FOR ACTIVE MANAGEMENT IN US EQUITIES

BY TOM SLATER

The United States is home to many of the world's great companies. These powerful growth franchises don't have peers in other stock markets and we believe they ought to feature prominently in equity portfolios. As these companies grow they are attacking many established industries. They are making life increasingly difficult for the big companies that comprise the major stock market indices and, in turn, making passive investment more risky. We believe that owning an actively managed portfolio of the strongest companies in America is the best way to deliver attractive long-term returns.

The active management industry has done a poor job of making the case for its own existence. In an era of generally poor relative returns and high fees, it is easy to see why investors have been drawn to passive approaches. However, long-term and highly active investment strategies can work. They are increasingly important as rapid technology-driven change is likely to create a clear divide between stock market winners and losers. Asset owners ought to strive for more than the sub-market return offered by passive funds. There is academic evidence that patient, high-conviction investment strategies can beat the index. However, it is essential to separate some of the truths from the myths in what has become a contentious debate.

ACTIVE MANAGER UNDER-PERFORMANCE HAS NOTHING TO DO WITH MARKET EFFICIENCY

The average active manager will underperform the market. Unfortunately this statement is mathematically inevitable[1]. The market return is made up of the return on passive portfolios (broadly the same as the market by definition) and the return on active portfolios. Therefore the return on the average actively and passively managed dollar will be the same as the market. Passive strategies underperform as they mimic the market but incur trading costs and charge fees. Active managers generally charge higher fees and so their average after-fee performance is worse.

Whilst the headlines often declare that "Active managers underperform in US equities over the past X years", it is actually more interesting that the average active manager in US equities ever outperforms passive peers. Before-fee performance ought to be the same and the higher fees reduce returns. So what is going on? Some have suggested this is a cyclical phenomenon, perhaps reflecting whether it has been 'a stock-picker's market'. However, we think the explanation is much more straightforward.

First, passive fees can be higher than you might expect[2] and in some instances higher than the fees charged for active management. Second, the group of active managers considered by studies is never complete. A study may focus on active mutual fund managers whose performance will differ from pension funds or hedge funds. Third, the collective performance of active often reflects an allocation to assets outside the comparator market. This is particularly true at the moment as mutual funds have a cash balance and this has hindered performance through eight years of rising US equity markets. Similarly, most US funds have an allocation to international equities and this has been an impediment in a period of dollar strength.

Some of the reasons put forward for the travails of active US equity managers are more dubious. We do not believe that the US market exhibits a higher level of efficiency than any other major market. The logic of this argument is that US companies are more intensively analysed than those elsewhere. There is no academic support for such an argument and there is empirical evidence against it. The average large US company has its earnings estimated by 15 Wall Street analysts, which compares to 14 analysts for emerging markets companies and 16 analysts for international developed market companies[3].

1. Sharpe, W.F. (1991) *The Arithmetic of Active Management*.

2. http://www.thisismoney.co.uk/money/diyinvesting/article-3078576/The-best-worst-tracker-funds-following-markets.html

3. Cohen T, DeSantis J, Nielson D, Leite B. (2014) *Active Investing: The Cyclicality of Performance in the U.S. Large-cap Equity Market*.

Quarterly performance is not necessarily the best indicator of long-term value creation.

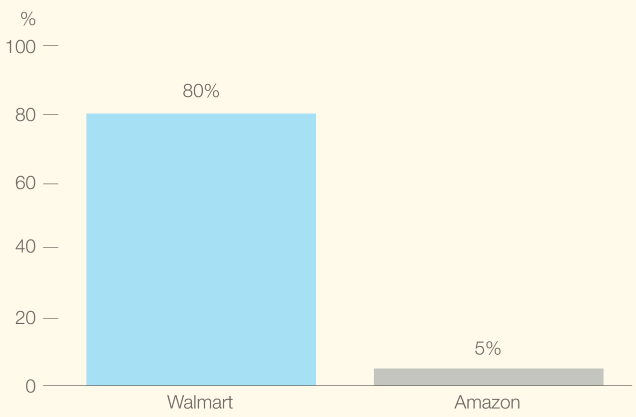
More importantly, the fact that there are lots of analysts looking at a stock doesn't make the market more efficient. The shortcoming that seems clearest to us is that many market participants are trying to do the same thing – predict short-term trends in earnings and share prices and predict how others will react to them. This is evidenced by the continuing decline in average holding periods for stocks listed on the New York Stock Exchange. For those trying to invest for the long-term in the best growth companies in the US, this creates opportunities.

The large and seemingly random perturbations in the stock prices of some of America's most innovative, capital light, technology-driven internet companies when they report earnings suggest that thoughtful evaluation of the opportunities is not the dominant driver of trading in the shares. The idea that estimates of the long-run value creation from these companies could shift by such a magnitude every three months is risible.

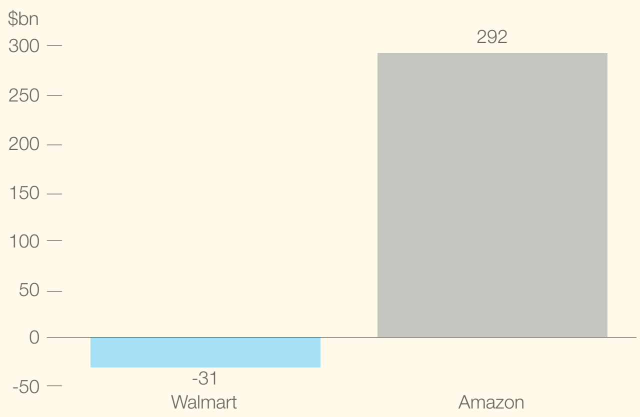
The charts below demonstrate this. On the left we see the frequency with which retailers Walmart and Amazon met analysts quarterly earning expectations over 2005–2015. The chart on the right shows their respective market cap change over the same period. Quarterly performance is not necessarily the best indicator of long-term value creation.

A TALE OF TWO RETAILERS

Frequency with which quarterly earnings expectations have been met over the 2005–2015 decade



Change in market cap over the same decade



Data to end December 2015. Source: Bloomberg, Thomson Reuters.

Past performance is not a guide to future returns.

LOTS OF 'ACTIVE' FUNDS ARE NOT WORTHY OF THE TITLE

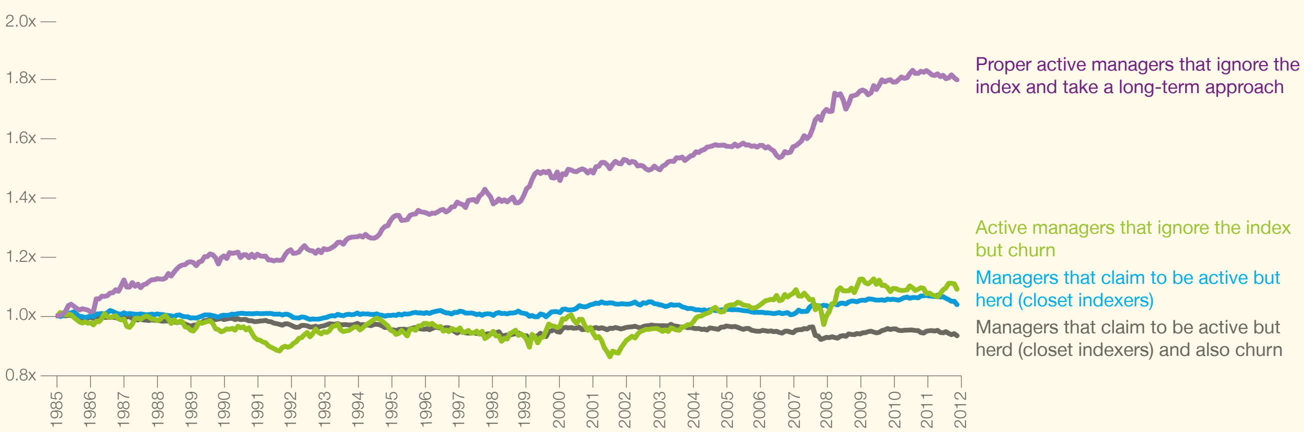
Many funds that describe themselves as 'active' are closet index funds. They overcharge their investors as they do little to earn active management fees. Their holdings overlap so much with the index that their performance is unable to differ materially from it. This leads to a high degree of certainty that they will underperform on an after-fee basis. Such funds have a marked impact on the averages of mutual fund performance.

Active share is a measure of how different a portfolio is from its benchmark. The seminal paper on the topic *'How Active is Your Fund Manager?*[4]' highlighted a remarkable result: true active management as measured by high active share predicts relative fund performance in US equity mutual funds. On average, funds with the highest active share outperform after fees, while funds with the lowest active share underperform. At first pass it seems astonishing that such a blunt tool could be a predictor of performance. Is it really true that you only need to know that your fund manager is taking bets, not whether those bets are good or bad?

The explanation may lie in the reason that closet index funds with low active share exist in the first place. As outlined eloquently by former Vanguard CEO, Jack Bogle, it is the constant pressure to post good short-term relative results that can push managers to move close to an index. More cynically, tracking a benchmark closely ensures that a manager never underperforms by a wide margin in any one period which can be a trigger event for the termination of a relationship by fund investors. This is known as 'herding'.

When a fund manager trades frequently, the one guaranteed outcome is that there will be trading costs. As market short-termism has increased, studies have looked at the impact of the holding period on delivered returns. This work[5] shows a clear positive relationship between time horizon and performance. i.e. the longer the average holding period for stocks in a portfolio, the better the relative performance of the portfolio. When this information was combined with the data on active share, an important result emerged: the best results were obtained by those US equity funds that combined both high active share and patience. Funds with a low turnover but low active share did not outperform nor did the funds that combined high active share with high turnover.

Outperformance relative to passive net of fees



Source: Cremers and Pareek, 2015, *Patient Capital Outperformance.*

Past performance is not a guide to future returns.

4. Cremers M, Petajisto A. (2009) *How Active Is Your Fund Manager? A New Measure That Predicts Performance.*

5. Cremers M, Pareek A. (2015) *Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently.*

THE VALUE OF HIGH ACTIVE SHARE AND PATIENCE

Another study[6] has looked more closely at what is meant by 'active' management. Funds can be active through stock selection or through tactical asset allocation and taking factor bets. It is always interesting to prognosticate on politics or the economy, but transposing such opinions into sector allocations has not been a reliable way to make money.

One might naively assume that if the academic evidence suggests that high active share, a focus on stock selection and a long holding period are useful predictors of long-term relative performance, the fund management industry would be keen to adopt this approach. However, the data[7] show that only 15% of the assets invested in over 1,000 US equity mutual funds are invested in this way. In a sample of institutional portfolios, the proportion is even lower. This may well reflect the pressure on fund managers to produce consistent quarterly results. The performance of a highly active long-term US equity fund is likely to be very volatile when compared to the benchmark over short periods of time. Many fund investors are uncomfortable with such volatility and it can be a bad business strategy to make your clients uncomfortable. This, in turn, suggests that investing in a patient, active way requires fund investors to have a long-term horizon themselves and a belief that the benefits of high conviction investing in US equities outweigh the short-term volatility.

6. Petajisto, A. (2013) *Active Share and Mutual Fund Performance.*

7. Table 2. Online Appendix to *Patient Capital Outperformance.*

WE BELIEVE WE CAN DELIVER FOR YOU

The objective of our philosophy and process is to identify the exceptional growth businesses in the US and own them for long periods of time. The academic evidence suggests that we are maximising our chances of success by managing our US equity growth portfolios with low turnover and high active share but we know this is not sufficient to achieve outstanding performance. Having a clearly defined philosophy executed by an experienced team within a stable investment organisation is crucial.

We define an exceptional growth business as a company with a special culture that is addressing a large market opportunity and possesses an edge that will allow it to deliver high future returns. One of equity investment's greatest attractions is the potential for uncapped upside but limited downside. Having a long-term time horizon allows us to take advantage of this return structure with the potential to capture the disproportionate impact of exceptional businesses in our portfolios. We run concentrated portfolios, as we believe the potential returns on offer are compelling, and we do not want to dilute them through unnecessary diversification.

The ability to grow rapidly, from already large sizes with modest capital requirements, sets the current generation of great US growth companies apart. Their core businesses generate prodigious cash flows. Their founder CEOs have the long-term vision and commitment to invest for the future in a world increasingly dominated by the quarterly results cycle. We believe it is a great time to be an active long-term US growth investor.

CURIOUS
ABOUT
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WORLD

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