JUNE 2021

WHAT PICASSO CAN TEACH US ABOUT INVESTING

Cubism changed art by depicting objects from multiple perspectives. Investors can learn from this approach by looking beyond the narrow confines of the financial industry and seeking a wide range of viewpoints rooted in the real world, argues Tom Coutts, partner at Baillie Gifford.

© Popperfoto/Getty Images

One of the few benefits of lockdown has been the opportunity it gave to pick off the shelf books that had been sitting there for years staring in silent accusation at not having yet been read. One such book for me was the autobiography of Herb Simon, who made seminal contributions to the study of organisational behaviour and artificial intelligence. In it he describes his Travel Theorem: “Anything that can be learned by a normal American adult on a trip to a foreign country (of less than one year’s duration) can be learned more quickly, cheaply, and easily by visiting the San Diego Public Library”.

He writes with evident glee, that “people react almost violently” to his theorem – and helpfully clarifies that public libraries outside San Diego will also serve his purpose.

The last year has presented an opportunity to test this theorem, of which – to judge from Simon's comments – I was initially as sceptical as most people. I remain sceptical. It is certainly true that the enormous leaps in communications technology have made this year easier than it would have been. And it has been strikingly easy to have access to the management teams of companies in which we invest and, though the sample size is smaller, to start to build relationships with the leaders of companies we know less well but find interesting.

But there's still something missing. Perhaps for those of our competitors who want little more than to glean some small insight into current trading or to parse recent results announcements, the functionality of Teams or Zoom is sufficient contact with a management team. But when you're trying, as we do, to understand the history and culture underpinning a company and to have an open-ended discussion exploring possible scenarios ten years from now, it's more limiting.

It's often the five minute chat while walking out of a company meeting or waiting for the lift that sheds a light on a company's culture or a person's values. Our long investment horizon means that we have had versions of these conversations many times over the years with most of our holdings, a benefit of our low portfolio turnover and our focus on exceptional companies, so we haven't missed out too much. But we can't just stay in the library forever, and I, like many of my colleagues, am keen to get out again.

Reading books like Herb Simon's autobiography is an example of what Charlie Munger calls "making friends among the eminent dead". It's important to us as long-term investors to seek insight and wisdom from beyond the conventional sources on which our industry relies, and to develop mental models and perspectives that are far removed from the reductive limitations of the Capital Asset Pricing Model or the CFA Institute.

But we also try to make friends with the eminent living. We had been due to host our North American client conference last autumn, at which I was to moderate a discussion between two of the academics whose work we follow closely, Mariana Mazzucato and Branko Milanovic.

EXPANDING HORIZONS, QUESTIONING ASSUMPTIONS

Branko's latest book, Capitalism, Alone describes the victory of the capitalist model and explores the various ways in which it has evolved and been adopted across the world, notably contrasting the American and Chinese versions. Mariana's work has explored the interplay between the public and private spheres and emphasised the role the state has played in fostering innovation. More recently, her book The Value of Everything, argues for a far clearer distinction between activities that genuinely create value and those whose purpose is little more than the extraction of economic rent.

We had planned to use the occasion of the 50th anniversary of Milton Friedman's famous New York Times article about the purpose of business to explore the conceptual and practical underpinnings of the capitalist model as expressed in the corporate and financial world. We all spend our professional lives trying our best to do the task in front of us – adding value for clients, or beneficiaries – and rarely have time to raise our heads and examine the assumptions under which we operate. What do we mean by 'adding value', for example? When we speak of the capitalist model, exactly which model are we referring to? At a time when attention spans have compressed and political discourse has been diminished to a series of soundbites, digging deeper into the foundations of our beliefs through discussions with thinkers like Branko and Mariana feels more important than ever.

Milton Friedman, Nobel Prize-winning economist.
© Chuck Nacke / Alamy Stock Photo

FRIEDMAN, FIFTY YEARS ON

It is the curse of every successful public thinker to have their context-dependent, nuanced, finely argued insight reduced by their disciples to something that could fit onto a bumper sticker. Think of Adam Smith writing of the 'invisible hand' or the 'self-interest' of the butcher, the brewer or the baker. This is a partial view of the Smith of The Wealth of Nations, with little attempt to reconcile such expressions with his writings in The Theory of Moral Sentiments. The view is partial in both senses of the word, in that it is neither complete nor is it unbiased. It only provides a very limited perspective on Smith and his work, and it serves the interest of those who use Smith's observations to add intellectual ballast to their existing beliefs.

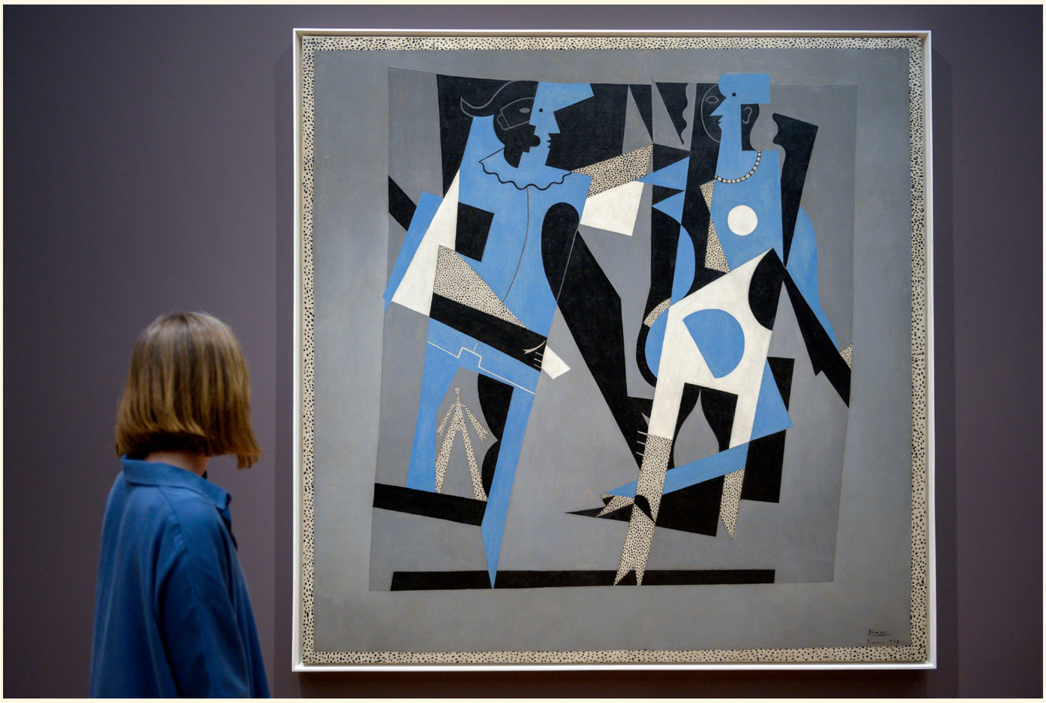
In similar vein, Friedman's 1970 article was a product of its times and can't be understood without an appreciation of the context in which it was written, notably the collectivist doctrine espoused by the Soviet Union and China and of which he saw worrying signs domestically. Even leaving aside the geopolitical shifts since then and the dismantling of such collectivist ideologies, today's context is very different in three ways that are directly relevant to how we might interpret Friedman's conclusion, and to our task as investors.

The first change is that the power of the corporation relative to the rest of society has greatly increased, not least through the Citizens United ruling a decade ago which gave companies the potential to influence policy to a vastly greater degree than the ordinary citizen.

The second change is that financial markets are more influential, more global, and critically, more short term. As has been pointed out, Friedman's article reads very differently if you mentally add the words 'long term' at various points. He uses that expression only once. A long-term emphasis may have been implicit in his work, but the fact that he doesn't make it explicit allows for a very different interpretation, prioritising the self-interested pursuit of near-term profits.

The third is that the problems we are facing are more complex. Climate change is the largest and most pressing: a systemic, globally-linked problem that cannot be addressed without consideration of matters such as intergenerational fairness that cut across the narrow categorisations we have put around certain human activity – finance and business among them.

Companies are more powerful, finance is more influential and short term, our challenges are more complex. We need to think at a systemic, global level as we ask ourselves what the societal role of business should be.



'Harlequin and Woman with a Necklace' (1917) by Pablo Picasso, on display at the Kunstmuseum Basel, Switzerland.
© GEORGIOS KEFALAS/EPA-EFE/Shutterstock

PERSPECTIVE, PICASSO AND MODERN PORTFOLIO THEORY

The best investment book I've read recently is The Shock of the New, by Robert Hughes. It's not an investment book at all, of course, it's a book about modern art, written by Hughes to accompany a TV series he presented in 1980. But it's directly relevant to investment because it is about change – how radical change happens, the conditions that foster it, and how humans respond.

What Hughes does brilliantly is capture the moment in which new possibilities emerged and centuries of convention were broken down never to be remade. He takes us back to a time in the early years of the 20th century when new technologies and ideas were emerging at an astonishing pace, building one on top of the other and creating a ferment of change.

As Hughes writes, what "emerge[d] from the growth of scientific and technical discovery as the age of steam passed into the age of electricity, was the sense of an accelerated rate of change in all areas of human discourse, including art. From now on the rules would quaver, the fixed canons of knowledge fail, under the pressure of new experience and the demand for new forms to contain it."

Before Picasso, Braque, Delaunay and the other Cubists, artists used a one-point perspective. The discovery of perspective as a tool of artistic creation in the 15th century was regarded at the time as near-magical, a way of representing the real world in two dimensions. But as Hughes reminds us, artistic perspective is simply a device for abstracting reality, it allows us "to conjure up a measurable, precise illusion of the world". Just as assumptions about homo economicus as a rational, utility-maximising agent simplify the messy reality of human behaviour, and just as treating a company as a share price reduces it to something that is measurable and precise, but irredeemably shallow. In contrast to the single-point perspective, Cubism, by depicting objects from multiple perspectives at the same time, attempts to engage with the messy complexity of the real world.

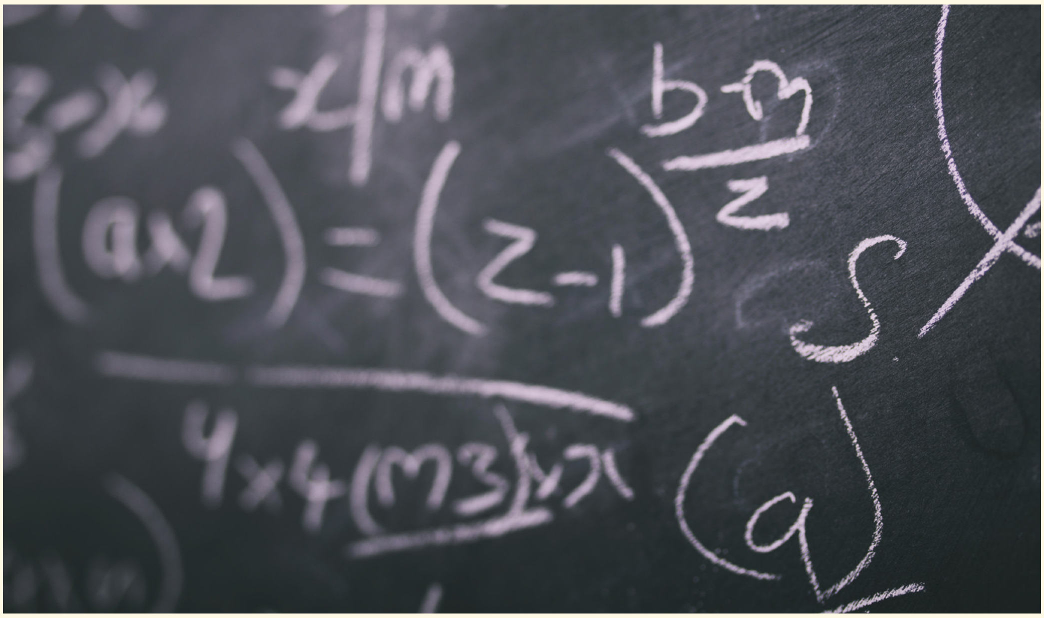
SO WHAT?

As usual when indulging myself with these sorts of musings, I can hear my friend and colleague Stuart Dunbar muttering, “Yes, Tom, very interesting but so what?” The so what is this: First, that change is hard, intellectually and emotionally. It is unsettling and uncomfortable, it tilts the foundations on which our world rests. To return to Hughes’s title, the New is always a Shock.

The second is that in order to deal with a changing world we abstract and simplify. This is a psychological defence mechanism to help us deal with the complexity and uncertainty of change, but it prevents us seeing reality as it truly is. Portraying things in two dimensions from a single perspective makes them more comprehensible on the canvas, but what we are seeing is no longer real. The same is true of the simplifying assumptions of the Capital Asset Pricing Model, Modern Portfolio Theory, GDP, inflation targeting and so on. These fixed canons of knowledge are failing.

The third is that we are in a period of profound global and personal change where many of our beliefs and assumptions will be challenged. To pick just a few: China is highly likely to become the world’s largest economy in the next few years. Those of us who live in Europe and North America will become ever less relevant in a global context. Populations will grow older, and retirement ages rise. The digitisation of physical goods and services will continue. Genetic modification and the rise of artificial intelligence will raise profound questions about what it means to be human, and about what behaviours should be permitted (and by whom). Our exploitation of the planet’s resources at historic rates will fall. Questions of how wealth is distributed through the economy and of the value of different roles – carer, nurse, teacher, fund manager – will need to be addressed. All of these changes have been building for a while, but they have reached, or soon will, a tipping-point where they suddenly matter a whole lot more.

Robert Hughes’ book tells us nothing directly about investment, of course. But it drives home to us how violently disruptive change can be, and yet how change is inevitable, driven by technological innovation but also by disjunction and frustration in society. The fact that his book is so infused by a white, male, Anglo-European perspective – and is in some ways very dated as a result – illustrates how our own society has changed for the better over the last 40 years, a process that needs to continue. We should prepare to be shocked by the new, since the new is coming whether we like it or not.



WHICH PROBLEMS ARE WE TRYING TO SOLVE?

In The Structure of Scientific Revolutions, Thomas Kuhn distinguishes the hard sciences from "fields like medicine, technology, and law, of which the principle raison d'être is an external social need". Economics is one such field: its role is not to seek absolute truths but to help our societies make informed decisions about trade-offs and the allocation of resources. And investment, as a branch of economics, should be judged by the same criteria: how do we meet the social need placed on us?

Sixty years after it was written, Kuhn's book is still the best conceptualisation I know of how shifts in scientific theories occur, whether in the hard or soft sciences. Kuhn describes how new theories – paradigms – emerge when the old ones are seen to have failed, in particular when they fail to address what he calls anomalies. "Paradigm debates always involve the question: which problems is it more significant to have solved?"

Following Friedman and his disciples the dominant economic approach of the last 40 years in Europe and North America has thrown up several anomalies, even as it has delivered headline economic growth, low inflation and all the amazing developments that the profit motive has inspired. Chief among these anomalies are climate change, inequality and the economic collapse of 2008-09 whose impact still ripples through our lives today. Politicians and regulators are now finally asking themselves, 'Which problems is it more significant to have solved?' and investors – ourselves trying to meet an external social need – are not immune from that questioning. Every company requires a social licence to operate, and the terms of that licence are being questioned as rarely before. The best companies in which we invest, today and in the future, will be those that are driving change and addressing these anomalies with their innovative products and services.

There have been few more striking examples of the shift in priorities than a recent speech by Christine Lagarde, President of the ECB, the central bank which above all others emphasises price stability as its own principal raison d'être. In that speech she said: "Climate change affects all of our policy areas". And if that wasn't sufficiently blunt to persuade listeners that attitudes in Frankfurt have undergone their own revolution: "Climate change also impacts our primary mandate of price stability through several channels. This is why climate change considerations form an integral part of our ongoing review of our monetary policy strategy." Times are changing.

THE RADICAL ROAD

The world that emerges from this multidimensional process of change will, I believe, be better. And we are privileged as growth investors to talk to, and invest in, many of the companies that are driving change and shaping the new world as their innovations create new profit pools and destroy old ones. That requires of us analytical skill, of course, but even more important are imagination and a willingness not only to think about outliers, but to ask 'what if it really works?', and to commit our clients' money to investing in such possible outliers in the certain knowledge that some of them will fail. There was an inspirational description of the required mentality in a recent interview given by Noubar Afeyan, Chairman of Moderna: "We have to be willing to embrace unreasonable propositions and unreasonable people in order to make extraordinary findings because the notion that utterly reasonable people doing utterly reasonable things will produce massive breakthroughs doesn't compute to me."

Returning to home, there's a volcanic hill in the middle of Edinburgh called Arthur's Seat, which anyone who's visited the city will know. The hill itself helped inspire James Hutton, the founder of the science of geology, to develop his theory of how the world was made[1]. One of the paths around Arthur's Seat is called the Radical Road, so named because it was built by unemployed weavers who were part of the Radical uprisings in 1820. Leaving the political and social aspects of its history to one side, however, it has long struck me as an appropriate name for the path we need to take as investors. Hutton was a radical, the weavers were radical, and we need to be radical too, in the companies we invest in, the thinkers from whom we learn, and the possible futures we imagine.

1. In passing, one of our academic relationships today is with the James Hutton Institute in Dundee, whose Climate-Positive Farming Initiative we support.

EMBRACING MESSY REALITY

The last client conference we held, back in 2018, was called 'Getting Out More', which has seemed a grimly ironic title over the last year or so. It resonated at the time because we find huge value in getting out on the road to meet companies and inspiring thinkers, but also because it encapsulates our belief that, while we operate within the financial world, we seek wisdom and insight from outside it: there is an attitudinal sense in which we try to get out more as well as a physical one. And it's only fair to recognise that the San Diego Library approach certainly helps with that attitudinal aspect: there are always more brilliant books to read.

But as I write this in the spring of 2021, over a year since we left our office in Edinburgh, it feels appropriate to end with one small way that I have been trying to get out. The picture above is of Inverleith Park, a five minute walk from our house. It was at the turn of the year and shows Edinburgh Castle visible in the middle, our current offices somewhere on the left of the photo and our new offices – from 2023 – to the right. I have done dozens of laps of this park, with dozens of colleagues, over the last year. (Our dog, at least, is happy.)

It's been a different sort of getting out. A small break from the current reality of staying in more. But that forced reality has provided valuable new perspectives – on colleagues, on companies, on the nature of our task. As humans we need to adapt to a constantly changing world and be willing to embrace different viewpoints. Any organisation that wants to thrive over long periods must do the same. Our long-term perspective as a private partnership should give us a head-start in doing so, and in meeting the shifting societal expectations of our role. But success isn't guaranteed, we still have lots of hard work ahead.

It seems highly likely that delivering financial returns alone will no longer be enough: it will be necessary, but not sufficient. Jean-Paul Agon, the retiring CEO of L'Oréal, described this brilliantly on a recent call with us when talking about the similarly changing demands on his own business: "Products will be judged on their skin performance and on their societal performance. It's a virtuous cycle."

This will be true of investment strategies too: those that try too hard to defend their existing business will be innovated around, just as Clay Christensen described in The Innovator's Dilemma. Those that embrace the challenge and opportunity of helping societies achieve non-financial goals have a chance of developing their own virtuous cycle.

The simple old one-point perspective of investment returns will, I believe, disappear. Like people gazing at a Cubist painting for the first time, we will have to engage with the messy reality of multiple perspectives as we try to make sense of the world before us. There is much to work through as companies improve their reporting, we work out which non-financial metrics really matter, and we try to cut through the fine words, distant promises and simplistic measures that pass for an environmental and social strategy at many businesses today. For a while, it will be messy. Change always is.

Ultimately, though, this is good news: it means that the financial world will no longer exist in parallel to Main Street but will have to recognise that investment decisions have real-world consequences in the allocation of resources, in jobs, in taxes, and in planetary impact. The singular viewpoint of Friedman's disciples is no more. The current lack of simple tools to assess these consequences gives an opportunity for those of us who take a long perspective and are comfortable dealing with ambiguity to work with clients, companies, regulators and outside experts in developing our mutual understanding of the challenges and seeking answers.

And we need to engage in this multi-faceted endeavour while continuing to get better at our core task of finding exceptional growth businesses that can deliver good investment returns to our clients. We will make mistakes along the way, but if we do this well and successfully marry financial outcomes with societal ones through investing in and supporting transformative growth companies, we will be engaged in an even more valuable task of which we and our clients can be proud.

RISK FACTORS

The views expressed in this article are those of Tom Coutts and should not be considered as advice or a recommendation to buy, sell or hold a particular investment. They reflect personal opinion and should not be taken as statements of fact nor should any reliance be placed on them when making investment decisions.

This communication was produced and approved in May 2021 and has not been updated subsequently. It represents views held at the time of writing and may not reflect current thinking.

Potential for Profit and Loss

All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk. Past performance is not a guide to future returns.

Stock Examples

Any stock examples and images used in this article 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.

This article contains information on investments which does not constitute independent research. Accordingly, it is not subject to the protections afforded to independent research, but is classified as advertising under Art 68 of the Financial Services Act ('FinSA') and Baillie Gifford and its staff may have dealt in the investments concerned.

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

The images used in this article are for illustrative purposes only.

IMPORTANT INFORMATION

Baillie Gifford & Co and Baillie Gifford & Co Limited are authorised and regulated by the Financial Conduct Authority (FCA). Baillie Gifford & Co Limited is an Authorised Corporate Director of OEICs.

Baillie Gifford Overseas Limited provides investment management and advisory services to non-UK Professional/Institutional clients only. Baillie Gifford Overseas Limited is wholly owned by Baillie Gifford & Co. Baillie Gifford & Co and Baillie Gifford Overseas Limited are authorised and regulated by the FCA in the UK.

Persons resident or domiciled outside the UK should consult with their professional advisers as to whether they require any governmental or other consents in order to enable them to invest, and with their tax advisers for advice relevant to their own particular circumstances.

Europe

Baillie Gifford Investment Management (Europe) Limited provides investment management and advisory services to European (excluding UK) clients. It was incorporated in Ireland in May 2018 and is authorised by the Central Bank of Ireland. Through its MiFID passport, it has established Baillie Gifford Investment Management (Europe) Limited (Frankfurt Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in Germany. Baillie Gifford Investment Management (Europe) Limited also has a representative office in Zurich, Switzerland pursuant to Art. 58 of the Federal Act on Financial Institutions (‘FinIA’). It does not constitute a branch and therefore does not have authority to commit Baillie Gifford Investment Management (Europe) Limited. It is the intention to ask for the authorisation by the Swiss Financial Market Supervisory Authority (FINMA) to maintain this representative office of a foreign asset manager of collective assets in Switzerland pursuant to the applicable transitional provisions of FinIA. Baillie Gifford Investment Management (Europe) Limited is a wholly owned subsidiary of Baillie Gifford Overseas Limited, which is wholly owned by Baillie Gifford & Co.

China

Baillie Gifford Investment Management (Shanghai) Limited 柏基投资管理(上海)有限公司 (‘BGIMS’) is wholly owned by Baillie Gifford Overseas Limited and may provide investment research to the Baillie Gifford Group pursuant to applicable laws. BGIMS is incorporated in Shanghai in the People’s Republic of China (‘PRC’) as a wholly foreign-owned limited liability company with a unified social credit code of 91310000MA1FL6KQ30. BGIMS is a registered Private Fund Manager with the Asset Management Association of China (‘AMAC’) and manages private security investment fund in the PRC, with a registration code of P1071226.

Baillie Gifford Overseas Investment Fund Management (Shanghai) Limited 柏基海外投资基金管理(上海)有限公司 (‘BGQS’) is a wholly owned subsidiary of BGIMS incorporated in Shanghai as a limited liability company with its unified social credit code of 91310000MA1FL7JFXQ. BGQS is a registered Private Fund Manager with AMAC with a registration code of P1071708. BGQS has been approved by Shanghai Municipal Financial Regulatory Bureau for the Qualified Domestic Limited Partners (QDLP) Pilot Program, under which it may raise funds from PRC investors for making overseas investments.

Hong Kong

Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 is wholly owned by Baillie Gifford Overseas Limited and holds a Type 1 and a Type 2 license from the Securities & Futures Commission of Hong Kong to market and distribute Baillie Gifford’s range of collective investment schemes to professional investors in Hong Kong. Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 can be contacted at Suites 2713-2715, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. Telephone +852 3756 5700.

South Korea

Baillie Gifford Overseas Limited is licensed with the Financial Services Commission in South Korea as a cross border Discretionary Investment Manager and Non-discretionary Investment Adviser.

IMPORTANT INFORMATION

Japan

Mitsubishi UFJ Baillie Gifford Asset Management Limited ('MUBGAM') is a joint venture company between Mitsubishi UFJ Trust & Banking Corporation and Baillie Gifford Overseas Limited. MUBGAM is authorised and regulated by the Financial Conduct Authority.

Australia

This material is provided on the basis that you are a wholesale client as defined within s761G of the Corporations Act 2001 (Cth). Baillie Gifford Overseas Limited (ARBN 118 567 178) is registered as a foreign company under the Corporations Act 2001 (Cth). It is exempt from the requirement to hold an Australian Financial Services License under the Corporations Act 2001 (Cth) in respect of these financial services provided to Australian wholesale clients. Baillie Gifford Overseas Limited is authorised and regulated by the Financial Conduct Authority under UK laws which differ from those applicable in Australia.

South Africa

Baillie Gifford Overseas Limited is registered as a Foreign Financial Services Provider with the Financial Sector Conduct Authority in South Africa.

North America

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 North America. Baillie Gifford Overseas Limited is registered with the SEC in the United States of America.

The Manager is not resident in Canada, its head office and principal place of business is in Edinburgh, Scotland. Baillie Gifford Overseas Limited is regulated in Canada as a portfolio manager and exempt market dealer with the Ontario Securities Commission ('OSC'). Its portfolio manager licence is currently passported into Alberta, Quebec, Saskatchewan, Manitoba and Newfoundland & Labrador whereas the exempt market dealer licence is passported across all Canadian provinces and territories. Baillie Gifford International LLC is regulated by the OSC as an exempt market and its licence is passported across all Canadian provinces and territories. Baillie Gifford Investment Management (Europe) Limited ('BGE') relies on the International Investment Fund Manager Exemption in the provinces of Ontario and Quebec.

Oman

Baillie Gifford Overseas Limited ('BGO') neither has a registered business presence nor a representative office in Oman and does not undertake banking business or provide financial services in Oman. Consequently, BGO is not regulated by either the Central Bank of Oman or Oman's Capital Market Authority. No authorization, licence or approval has been received from the Capital Market Authority of Oman or any other regulatory authority in Oman, to provide such advice or service within Oman. BGO does not solicit business in Oman and does not market, offer, sell or distribute any financial or investment products or services in Oman and no subscription to any securities, products or financial services may or will be consummated within Oman. The recipient of this document represents that it is a financial institution or a sophisticated investor (as described in Article 139 of the Executive Regulations of the Capital Market Law) and that its officers/employees have such experience in business and financial matters that they are capable of evaluating the merits and risks of investments.

IMPORTANT INFORMATION

Qatar

This strategy is only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved. This does not constitute an offer to the public and is for the use only of the named addressee and should not be given or shown to any other person (other than employees, agents, or consultants in connection with the addressee's consideration thereof). Baillie Gifford Overseas Limited has not been and will not be registered with Qatar Central Bank or under any laws of the State of Qatar. No transactions will be concluded in your jurisdiction and any inquiries regarding the strategy should be made to Baillie Gifford.

Israel

Baillie Gifford Overseas is not licensed under Israel's Regulation of Investment Advising, Investment Marketing and Portfolio Management Law, 5755-1995 (the Advice Law) and does not carry insurance pursuant to the Advice Law. This document is only intended for those categories of Israeli residents who are qualified clients listed on the First Addendum to the Advice Law.

BAILLIE GIFFORD

CM15657 Picasso on investing WP Opt2 0521.indd
Ref: 52729 ALL WE 0482