RIP UP THE RULE BOOK

Why most US equity investors have got it wrong

Helen Xiong, Investment Manager. Second Quarter 2019

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	2014	2015	2016	2017	2018
Baillie Gifford US Equities Composite	9.4	8.4	6.4	35.5	9.0
S&P 500	13.7	1.4	12.0	21.8	-4.4

Source: Baillie Gifford & Co and S&P 500. US dollars.

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WHY MOST US EQUITY INVESTORS HAVE GOT IT WRONG

Investment manager Helen Xiong addresses three of the most common misconceptions held by US equity investors.

Most people believe that the US market is the most efficient market in the world. If this is true, then this is bad news for us as equity investors – it means that it is nigh on impossible to outperform the stock market on a consistent basis. Thankfully however, in this instance, most investors are wrong, because the US market is highly inefficient.

A MATTER OF FACT

This is not just hearsay or a matter of opinion. Last year, a comprehensive study of the long-term equity returns of US stocks from 1926 to 2016 was published by Professor Hendrik Bessembinder of Arizona State University. His research identified that over the 90-year period, equities outperformed all other asset classes and created $35 trillion of wealth above and beyond one-month Treasury-bills (T-bills). But before this information prompts you to go on an all-out US equity spending spree, then read on. It was not all equities that performed well, or even a significant proportion of them. Bessembinder's figures reveal that of the almost 26,000 companies included in his study, only four per cent of stocks accounted for the $35 trillion of wealth created by all listed companies in the US over this period. A staggering 25,000 of the 26,000 companies surveyed did not matter for long-term equity returns – their net contribution was no better than T-bills (i.e. cash). Even more extreme, he discovered that 90 companies created half of the wealth. Or, to put it another way, approximately 0.3 per cent of the companies created around 50 per cent of the wealth.

This makes it clear that the Capital Asset Pricing Model (CAPM) and the Efficient Market Hypothesis (EMH) are nonsense. It is not about a risk premium to the 'average' stock. As Bessembinder demonstrated, most stocks do not matter for long-term equity returns. The underlying 'reversion to mean' mantra that most people believe in misses the point. Rather, in our view, the key to successful long-term investing is:

- to identify the exceptional growth companies,
- to hold them in size,
- and to retain ownership of them for sufficient time so that the characteristics of their business model shine through in share prices.

If identified correctly, these are the companies that create long-term wealth. Their return distributions are not normal. They are highly skewed, and for us as long-term equity investors, that is a very good thing.

The underlying 'reversion to mean' mantra that most people believe in misses the point.

PUTTING A VALUE ON IT

And this leads to my second point – that traditional valuation metrics are irrelevant. It's not that valuation doesn't matter, it does. However, we don't believe that short-term Price-Earnings (P/E) ratios or Price-to-Book (P/B) multiples carry any weight in this regard. The value of a company is forward-looking, being based on the discounted value of future cash flows. There is a certain juxtaposition in the fact that all the value lies in the future, yet all the data upon which the financial metrics are based reflects the past. Furthermore, qualitative measures, such as quality of management, how innovative a company is, cannot be captured in a number. Yet, they can be very significant in determining how successful a company might become.

So how then should we think about valuation? Our own research into US company returns over the past 30 years has shown us that over any rolling five-year period, approximately 30 per cent of stocks go down, approximately 50 per cent of stocks go up slightly, and these two groups roughly cancel each other out. The remaining 20 per cent go up by at least 2.5x. These stocks drive the vast majority of market returns and hence are the stocks that we're trying to find.

For us to consider owning a stock, we first ask ourselves two questions: how can we make at least 2.5x returns over the next five years? And why is this more likely than the 20 per cent implied by the base rate? In other words – we think about valuation in terms of probabilities, not certainties. We care about the upside. We don't care about the downside.

This may sound unconventional, but we believe this is the only rational response to our fundamental belief in the asymmetry of equity markets. We accept that if we're wrong, the potential downside on any one of our holdings is 100 per cent. But our upside is uncapped, and as we've seen, long-term equity returns are driven by a small handful of companies that deliver extreme upside. For this reason alone, we're concerned with what might happen if we're right.

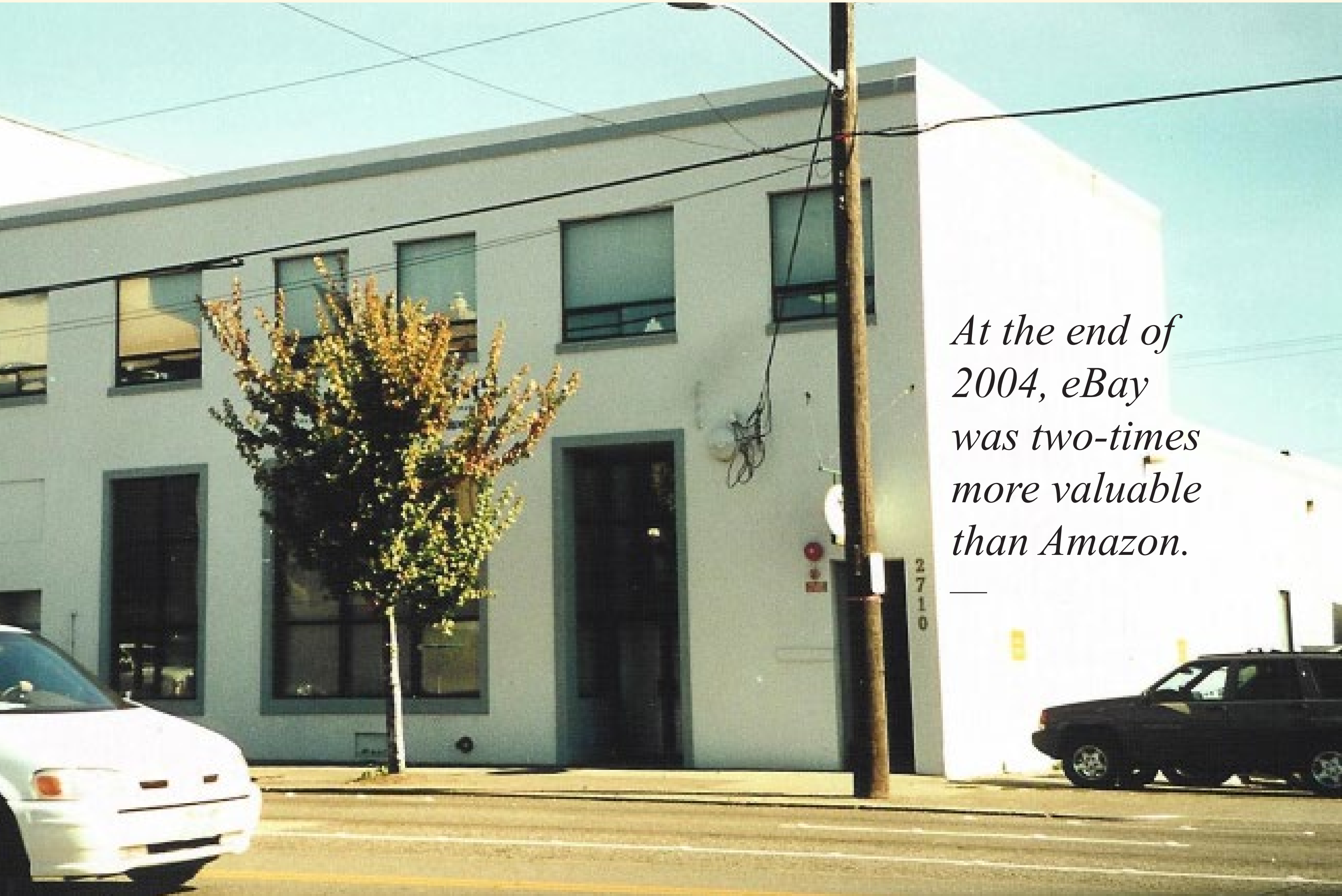
Mathematically, the biggest costs in terms of performance is not our sins of commission, but our sins of omission. And we learnt that lesson the hard way. One of the companies that we got very wrong was Lending Club. We bought it in 2015 and subsequently lost nearly 70 per cent of our initial investment. It was one of our worse holdings ever. Or was it? Compare it to Netflix, which we looked at in 2011. At the time, although we liked the company, we decided against buying it. By the time we bought it in 2016, the shares had already gone up seven-fold. So, which was the bigger mistake? We never talk about Netflix as a mistake: it has risen nearly four-fold since we bought it in 2016. Netflix, in this respect, has been a very successful investment. Yet, not buying Netflix at the end of 2011 was seven times costlier in performance terms than buying Lending Club and getting that wrong.

ANOTHER RABBIT HOLE

My third contention is that it's largely a waste of time to analyse the company's current products and markets when trying to ascertain the company's future value. You could have analysed Amazon's products and markets to death in the early years, and still you would have missed almost everything that makes Amazon valuable today. In fact, when Amazon listed at the height of the dot.com boom in the late 1990s, even the most bullish analysts thought that the total addressable market for Amazon was $26 billion, which equated to the total size of the book market in the US.

Why so? Investors failed to appreciate two things: first, how dynamic a market can be during periods of structural change and second, the importance of culture. Culture trumps everything else in the long term. What do I mean by culture? Simplistically, it's where companies are genuinely run for the long term. These are the exception, rather than the rule. Most companies in America are not run for the long term – they are run to hit short-term earnings targets. We're looking for companies that are doing the opposite. Companies that are willing to invest for the future, that are unafraid of failure, that embrace change, and in doing so are unconcerned with the short-term quarterly circus of Wall Street.

For example, in 2004, we bought both Amazon and eBay. At the time, eBay looked to be the better company on business fundamentals – it had a much higher Gross Merchandise Volume, a more well-known brand, it was capital light, and its margins were already in the mid-30s. Amazon was selling books and DVDs online and wasn't making any money. Yet all the cultural clues were already there. At Amazon, Jeff Bezos was at the helm: someone who had a very clear long-term mission, did not care about short-term profits, preferring instead to invest in the business for the long term.
In contrast, Pierre Omidyar, eBay's founder, had taken a non-executive role and was more interested in spending time at the beach in Hawaii. eBay was being guided by a financial manager, John Donahoe, who was incentivised on financial metrics. It should be no surprise that he failed to invest in the business because doing so would have hurt short-term profits, and consequently his pay. We would argue that that appears to have been a key determinant in the relative performances of the two companies. At the end of 2004, eBay was two-times more valuable than Amazon. Today, Amazon is over 25x more valuable than eBay.



At the end of 2004, eBay was two-times more valuable than Amazon.

Amazon.com's first office in Seattle.
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WE'RE NOT LOOKING FOR AVERAGE

Our investment raison d'être on the US Equities desk is to find exceptional growth companies in America, to hold them in concentration, and for a very long time. It sounds easy, but it's extremely hard to do in an institutional context, where more and more managers are hugging the index because they're concerned about career risk. The average American mutual fund has a portfolio of 100 stocks – our American Fund has 43. The average American mutual fund's turnover today is approximately 60 per cent – we are sitting at around 15 per cent; and if you define 'truly active' as funds with an active share of greater than 80 per cent, then only one-in-five American mutual funds can be considered truly active today, compared to about one-in-two twenty years ago. Our active share is above 90 per cent.

Such a feat is only possible because of culture, which is why the partnership structure of Baillie Gifford gives us a structural advantage. We are not beholden to external shareholders. All the partners work at the firm and make decisions for the long term. More importantly, we are fortunate in that our clients understand what we're trying to do and are equally long term in their outlook. And it's that structural advantage combined with very understanding clients that enables us to focus all our energy on seeking to identify and invest in the exceptional growth companies.

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Helen graduated BSc (Hons) in Economics from Warwick University in 2007 and an MPhil in Economics from the University of Cambridge the following year. She joined Baillie Gifford in 2008 and has spent time working on our Developed Asia, UK, North America, Emerging Markets, and Global equity teams prior to becoming an investment manager in the US Equities team. Before coming to live and work in the UK, Helen has lived in China, South Africa and Norway.

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