

THE DIAMOND AND THE OASIS

INTRODUCING THE RADAR

Brian Lum, International Smaller Companies. Third Quarter 2018



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THE DIAMOND AND THE OASIS

INTERNATIONAL SMALLER COMPANIES

No two diamonds are the same. The unique qualities of each are reflections of individual billion-year journeys through the Earth's mantle, as well as the effort and skills of the craftsmen responsible for unlocking the gemstones' inner beauty.

In the industry, diamonds are assessed by the '4C's – Cut, Carat, Clarity and Colour. While the grading system has its detractors, the framework clearly identifies the key attributes that define 'quality', and it also serves as an effective way to communicate these properties to others.

As investors looking to uncover hidden gems (sorry...) in the vast and diverse smaller companies universe, we find a framework in a similar vein helpful for 1. articulating our own investment philosophy and distilling this down to a number of critical factors and 2. using the system to assess ideas in a systematic and rigorous manner, while recognising the idiosyncrasies of each opportunity that comes our way.

UNDER THE RADAR

INTERNATIONAL SMALLER COMPANIES

In this short series Baillie Gifford's International Smaller Companies team explores how their radar framework helps them to uncover the most exciting small businesses from around the world.

OPPORTUNITY

What is the nature and size of the company's addressable market?

SUSTAINABILITY

How do the company's activities impact the broader society?

ALIGNMENT

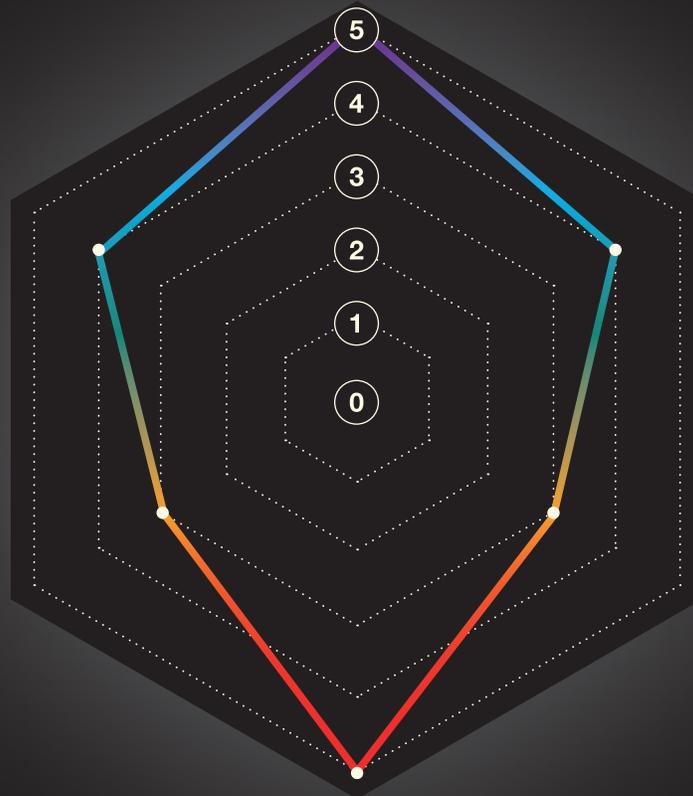
Are management and other stakeholders aligned with long-term success?

INSIGHT

What might the market be missing? Why might the company be undervalued?

EDGE

Can the company build a strong and sustainable competitive advantage?



SCALABILITY

What are the company's financial characteristics as it scales, and what are the key growth bottlenecks?

We believe these are six of the key areas for us to consider as investors. We look forward to sharing how we approach each of these radar points in future pieces, as well as exploring the interplay between these factors at a conceptual level. We will start by looking at ‘Opportunity’, using Fjällräven, DaikyoNishikawa, Zooplus and First Derivatives as case studies.

We may also further develop this as a tool to help us understand the broader profile of the portfolio, as well as to use this as a graphical aid to help us track the evolution of individual cases. This is where the comparison to diamonds breaks down definitively – we do take long-term views but investment cases are certainly not forever.

It is perhaps worthwhile to highlight what else this is NOT. Numbers and charts often give a misleading impression of certainty, precision and objectivity – this is one of the tricks of the trade that we come across on a daily basis in company presentations. With this in mind, we should emphasise that despite the scoring, our investment process is fundamentally biased towards qualitative analysis; and that we are by no means suggesting equivalence of importance among these six factors (that depends), or indeed direct comparability between ratings from different members of the team.

Like diamonds, great investment opportunities come in different shapes and sizes.



We are also not insisting that our ideas ‘tick all the boxes’. That is neither a practical nor desirable approach – much of what we do is about making judgements on what really matters in an investment case, embracing the inherent uncertainty in what we do, and in aggregate harnessing the benefits of the asymmetry return potential inherent in equities ownership (particularly in smaller companies). If anything, at least my own observation is that investments with one or two outstanding attributes are often more rewarding to own than those that are merely ‘quite good’ at everything. After all, even some of the most valuable diamonds in the world are indeed far from perfect; they are special by being exceptional in some aspects and in spite of their flaws.

Like diamonds, great investment opportunities come in different shapes and sizes. We think that keeping an open mind to appreciate the individuality of each case is rather important, and we hope that the radar is a useful, albeit imperfect, tool to help us capture the essence of each company that we invest in.

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Brian chairs the Portfolio Construction Group for the International Smaller Companies Strategy, a strategy dedicated to investing in the most exceptional smaller companies internationally. Brian graduated MSci and BA (Hons) in Physics from the University of Cambridge in 2006 and joined Baillie Gifford in the same year. He is a CFA charterholder.

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