CHINA – ADJUSTING THE LENS

Ben Lloyd, Client Service Director

BAILLIE GIFFORD

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CONTENTS

Two Chinese men playing Go. Image from circa 1870–1890.

You can't win at go with a chess mindset

DR. GRAHAM ALLISON, 2017

SEPTEMBER 2020

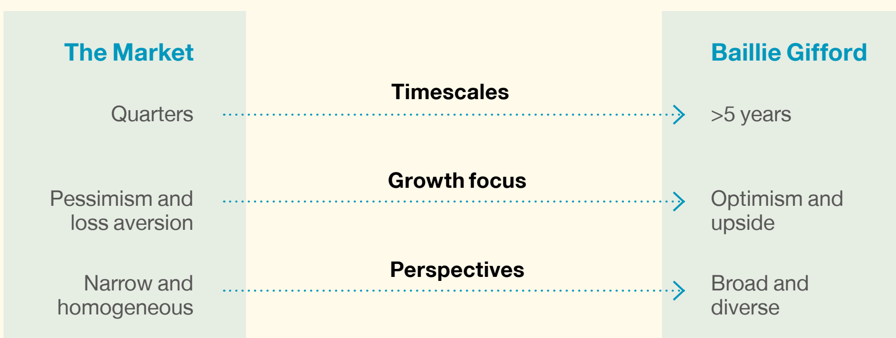
INTRODUCTION

BY BEN LLOYD

The world is witnessing significant structural economic changes. These include some big, decade-long trends that excite us as fund managers with a long-term investment horizon. The future is inherently uncertain, but the acceleration of disruption, developments in innovation and shifts in consumption patterns will create winners and losers. China will play a critical role.

Geo-economics is altering the balance of global power and changing the world's ideas about politics, economics and order. Increasingly, companies and countries will have to understand the thinking process and viewpoints of China's government, its companies and its consumers.

The following note expands on Baillie Gifford's approach to China. An investment philosophy based on long-term investment horizons, focusing on upside and the asymmetry of equity returns, and seeking information sources whose time-horizons and insights are rarely incorporated efficiently into stock markets.



GOING INTO PARTNERSHIP – CULTURE AND STABILITY

Being genuinely long term and patient in approach may sound simple, but it isn't easy.

Baillie Gifford is a multi-generational private partnership founded in 1908. All partners work in the business. We have no business outside investment and have grown organically for over a century. This partnership structure is rare among large investment management companies. We have no short-term commercial imperatives and no outside shareholders to distract us. This creates one key advantage; we can focus solely on what we do best, seeking out long-term investment returns for our clients.

As part of our investment research, we focus on governance and culture. In our own business, the organisational stability created by our ownership structure is a key advantage. Most of our investment professionals begin their career on Baillie Gifford's graduate training programme and few come from a traditional finance education. We value curious thinkers willing to contemplate an uncertain future. By training the majority of our analysts and portfolio managers in-house, we are able to combine a common culture with an atmosphere that encourages vigorous debate. Regardless of seniority, all fund managers are first and foremost analysts. They spend the lion's share of their time researching companies. That's also why we value portfolio construction groups and avoid the tendency to prize individual fund managers.

This is how we offer something different. Our route to delivering long-term returns for clients involves us sticking to a single philosophy – one focused on growth, looking over longer time periods, seeking information from those who share our time horizons, contemplating the upside of an investment and recognising that a key source of alpha is gained from holding on to your winners.

Only a small number of companies matter to stock market returns. This thinking is critical to how we go about finding the exciting companies that get into our China portfolios.

TIME HORIZONS – THINKING IN DECADES NOT QUARTERS

Over the last century, the increasingly short-horizon perspective of market-driven economics, the next-election perspective of democracies, and the rapid speed of technological development have lead investors away from core tenets of patience and long-termism.

Companies grow over time. The true value of a business is rarely determined by what will happen in the next few quarters but instead what will happen in the many years ahead. It is over years that deep changes in industries and behaviour occur and that competitive advantage and management excellence are recognised.

Actual investors imagine 'what if?' Not 'what is'.

Actual investors emphasise what might go right. Not wrong.

Actual investors help shape the new world. Not shore up the old one.

Actual investors build relationships. Not just portfolios.

In the investment world, being able to think and act independently of the structures and short-term incentives in traditional finance is an important advantage. A large market opportunity is created by the inefficiencies of a financial world chasing immediate gains. Over time, agency issues have got in the way. We have little interest in short-term trading or speculation, where money is lost to market makers in commissions on high turnover. To us, investing fundamentally involves the creative deployment of capital into tangible, return-generating opportunities. Helping create, shape and benefit from the ultimate wealth creation. We call this 'actual' investing.

Actual investment is not easy in our world of 24-hour news and quarterly earnings cycles, where complexity and noise is confused with rational judgement. It requires the resolve to focus only on what really matters, to think independently and to maintain a long-term perspective. It requires a willingness to be different, to accept uncertainty and the possibility of being wrong. Most of all, it requires a rejection of the now conventional wisdom that has led our industry astray: investment management is not about processing power, trading and speed. It is about imagination, creativity and working constructively on behalf of our clients with inspiring individuals and companies who have greater ideas than our own.

This approach is even more relevant in China. In 2015, turnover of the A-share market peaked at almost 500 per cent. This has since fallen, but average holding periods remain under six months. If you're holding something for such a short time period, then you're unlikely to be focused on the drivers of long-term business opportunities, sustainability and governance that we see as a core element of our fundamental long-term research. This is exacerbated by fund managers being forced to worry about weekly or monthly performance; the anti-thesis of our approach, which leads to speculating on share prices and not on understanding industry trends, business cultures and strategy.

Fighting that instinct to involve ourselves in conventional market short-termism requires important behavioural and cultural traits. We can think differently and independently, and that provides our opportunity. We care little about next quarter's earnings, sentiment or news-flow-driven momentum. This is reflected in the dialogue we have with management teams, and consequently in the quality of relationships we build.

Clock-driven celestial globe, Chinese, 1830.
© SSPL/Getty Images.

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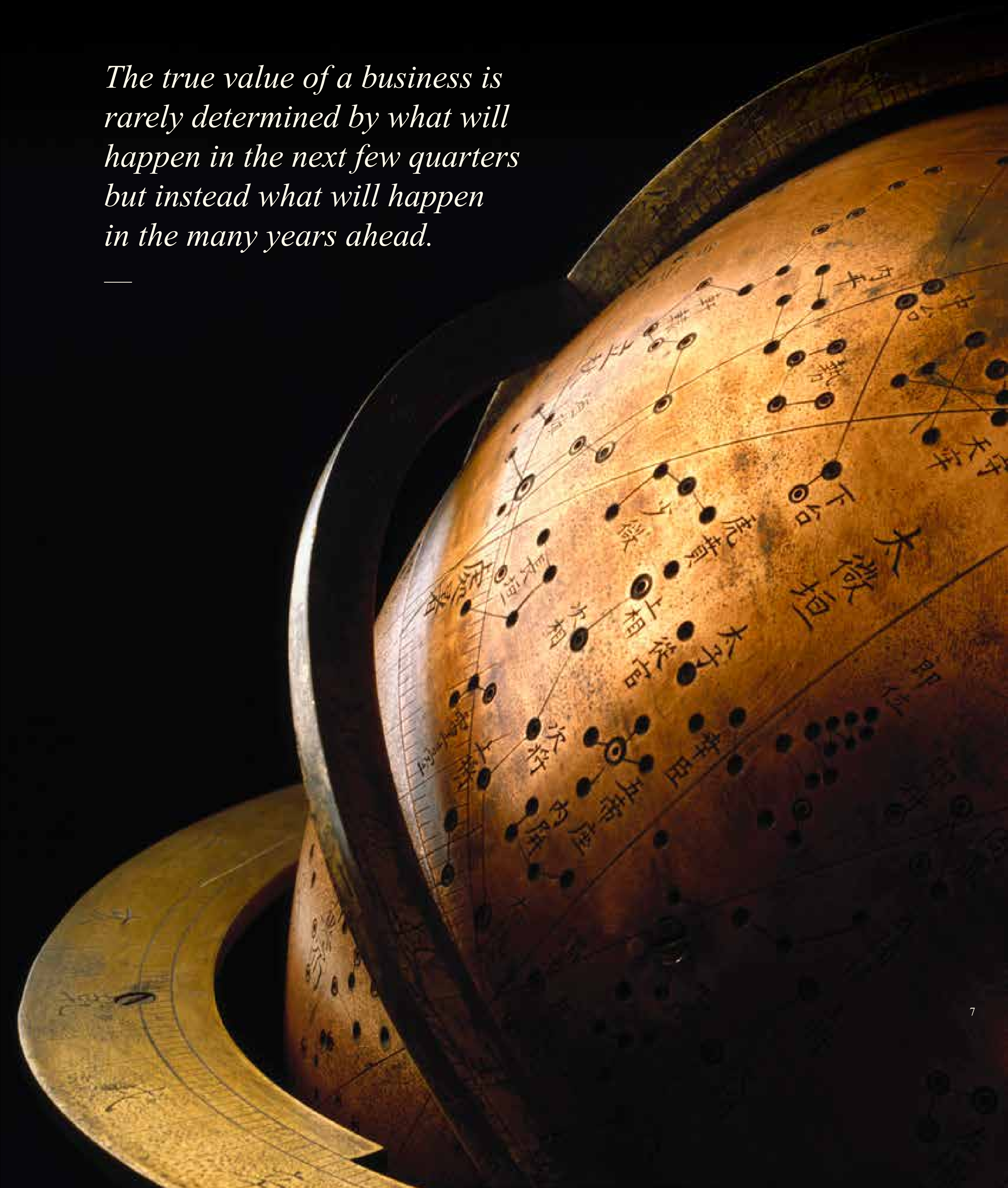

INFORMATION – BE DIFFERENT

In the midst of chaos, there is always opportunity.

ATTRIBUTED TO SUN TZU 'ART OF WAR'

Great ideas don't come from staring at a screen, coverage lists or research targets. We think the best insights come from outside of the financial world. If you want to perform differently to the market, you need to do things that are different to the market.

We strongly believe in the benefit of perspective derived from on-the-ground research in China, balanced with a global perspective gained from sharing analysis and open discussions with our Edinburgh office.

Because we expect our average holding periods to be over five years, our time horizons are not very well aligned with the very short-term nature of the Chinese stock markets and the quarterly focus of traditional finance found in Shanghai and Hong Kong. It is therefore no surprise that we seek information from a wide variety of different sources who share our timeframe of analysis. It was Benjamin Franklin who highlighted that an investment in knowledge is the one that pays the best interest. We would agree. We prioritise meetings with academics, industry specialists and owners of businesses who think about their strategy, not analysers of those businesses who think about next quarter's earnings.

Academia provides us with different perspectives and very long-time horizons. When looking for companies to invest in, we are thinking about what the world might look like in ten years' time. We want to better understand important trends, how these will impact society in the future, and what that means for the companies we are thinking of investing in. A good example here would be our academic relationship with Tsinghua University in Beijing which is helping us to deepen our understanding of how technology is transforming the healthcare sector in China.

Our ability to sustain meaningful interactions with long-term, visionary founders and CEOs is also key to better understanding future challenges and opportunities for the companies we hold. We are always looking out for disruptive companies with the possibility of shaping parts of the future. Reputation is critical here. By providing long-term capital and support to business owners whose vision is not always well understood or valued in the stock market, we have built strong relationships in China which are highly informative and help us to look toward exciting opportunities in the future.

These relationships, often built on trust and reputation over many years, help open doors across a range of interesting private and public companies, ensure management teams are aware of our approach and philosophy, and in doing so, help position us and our thinking in a different light to much of the market. That's why companies often make introductions for us, and how we get to know and understand businesses like Meituan and Bytedance early in their growth stages.

Baijiu Production Inside China's Biggest Distiller Kweichow Moutai Co. © Bloomberg/Getty Images.

Perspective: Global and Local

Does being a large shareholder in Tesla inform our thoughts on the future of EVs and energy, where Nio may be on its development path or help deepen relationships with key supply chain companies like CATL? Absolutely. On top of that, knowing Samsung SDI and LG Chem helps position the opportunity set and competitive landscape for CATL too…

Does having owned Illumina for almost a decade help when it comes to understanding the outlook for Berry Genomics and BGI? Yes. But there are gaps. That's why we've built a relationship with Tsinghua University's genomics department, and how we've attracted two students to join us for an internship.

But then some things are unique. Being on the ground helps understand consumer shifts. There is no sector in the world like the Chinese liquor, Baijiu. Few outside of China have heard of it, let alone tried it, and yet it outsells vodka, whisky, gin, tequila and rum put together, globally!

No other countries of China's scale are so under researched, which provides a genuine opportunity for true stock pickers. We think that balancing the local and the global perspective is an important creator of value when thinking on the five plus years timescales that we do.

LOOKING TO THE FUTURE – IGNORING INDICES

Why is it important to be long term and upside focused? If we think in decades not years, we can often see a different picture. A large part of China's indices are made up of old economy companies in capital-heavy industries dominated by state-owned-enterprises such as financials, energy and transport. As growth investors, we're more focused on the innovative and disruptive trends of the future, not those of the past. Academic evidence suggests that much of the market doesn't matter: it is the small number of big winners that truly drive investor returns. Our approach to navigating change, ignoring indices and focusing on the long term has proved successful and stands us in good stead for the future. This is as true of China as anywhere else.

There are over 5000 listed Chinese companies. At Baillie Gifford, we invest in approximately 100 on our clients' behalf.

With more than three times the number of mobile phone users than the US, with an engaged younger, tech-savvy generation using super-apps like WeChat and Meituan, it is no surprise that China is leading the world in ecommerce penetration, online payments and food delivery. The next disruptive steps look to the 'cloud', be it office automation, Enterprise Resource Planning (ERP) systems, on-demand doctor appointments, education or gaming. Barriers to adoption for many internet businesses have come down and competitive moats for some of the key digital companies, all of which benefit from network effects, look to be widening.

We are also finding innovative and exciting growth companies in other sectors, benefiting from the rise in consumer wealth, a shift in the economy towards the service sector, and a medium-term focus of government on areas like industrial upgrading, environmental sustainability and healthcare reform.

Many industries are not only becoming automated, they are completely re-architecting the way they do business. In places where we see significant scope for disruption, including the likes of transportation, streaming, insurance and retail, there are exciting companies whose growth when looked at in the rear-view mirror, may be insignificant relative to the opportunities they have ahead of them. In this environment, the best can continue to get much better.

Yet despite the excitement and opportunities, old economy sectors such as financials, industrials, real estate and materials still account for a significant part of the index. In this environment of disruption, the traditional focus of portfolio managers to start with the largest index constituents and work down the index is clearly misguided. We want to give ourselves the best chance of owning the outliers.

Resisting the Marshmallow

In 1970, Walter Mischel developed the 'Marshmallow Experiment' for children to demonstrate how patience and the postponement of self-gratification are powerful predictors of success in life. We see parallels in the irrational mindset of many market professionals eager for instant gratification. At Baillie Gifford, resisting eating the marshmallow is one cornerstone of our investment success. We do this by running winners and not taking profits in shares that have gone up, when others simply can't resist doing so. Having succumbed to a quick feast, they then miss out on the continuing growth. One of our holdings issued shares at its IPO in 2004 giving it a market cap of HK$6.2 billion. We first bought shares in the company in 2006 after it had doubled. Tempted to sell at HK$100 billion or HK$200 billion? In annual client meetings since, one of the most frequently asked questions has been, 'Surely, you're going to take profits in the holding now?'. The answer is, "No, as it is still growing strongly with exciting future prospects". In July 2020, the holding's market cap was over HK$4.5 trillion. This is an extreme example, but it does highlight that for returns to grow to be outliers, it is as a result of the length of holding period and the ability to resist taking profits while opportunities still exist.

Credit: Josie Garner / Alamy Stock Photo.

Electronic screen displaying turnover, market indices and index futures at Hong Kong Stock Exchange, March 2020 in Hong Kong, China.

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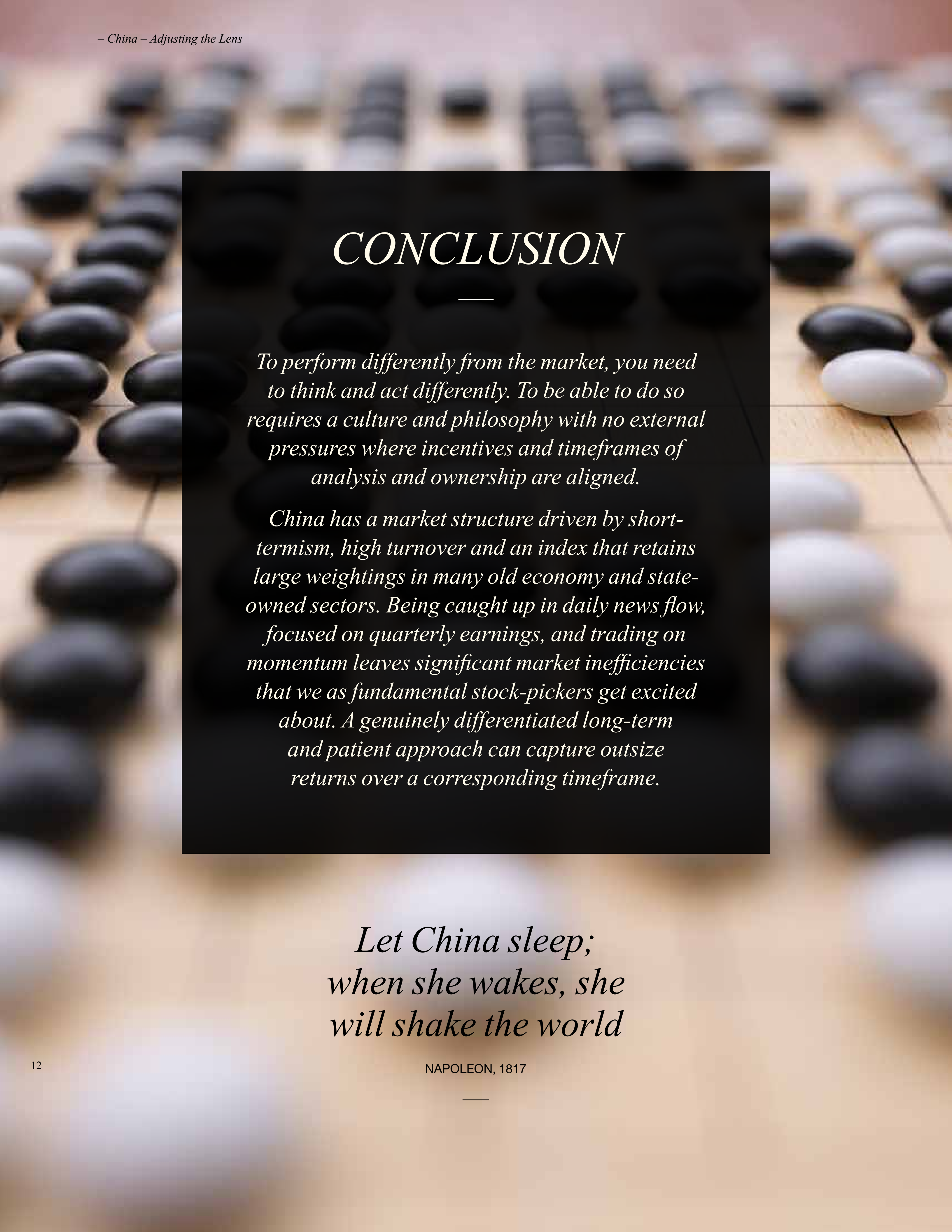

CONCLUSION

To perform differently from the market, you need to think and act differently. To be able to do so requires a culture and philosophy with no external pressures where incentives and timeframes of analysis and ownership are aligned.

China has a market structure driven by short-termism, high turnover and an index that retains large weightings in many old economy and state-owned sectors. Being caught up in daily news flow, focused on quarterly earnings, and trading on momentum leaves significant market inefficiencies that we as fundamental stock-pickers get excited about. A genuinely differentiated long-term and patient approach can capture outsize returns over a corresponding timeframe.

> *Let China sleep; when she wakes, she will shake the world*
>
> NAPOLEON, 1817

For more intellectual capital on the China A-Share market, please see our other pieces *Changing China* and *Governance in China*.

ABOUT THE AUTHOR

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Ben is a Client Service Director in the Clients Department and chairs the China Product Group. He joined Baillie Gifford on the Investment Management Graduate Scheme in 2001 and was an Investment Manager in our Emerging Markets Team until 2008, when he relocated to China. Ben worked in Hong Kong for 6 years as an Executive Director in the Asian Equities business at UBS. He returned to Baillie Gifford in 2018. Ben is a CFA Charterholder and has an MBA from the University of Oxford. He graduated MA in Geography from Mansfield College, Oxford in 2001.

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