

BRESLER FAMILY GALLERY

# CULTURAL ADVANTAGE

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*BAILLIE GIFFORD US EQUITIES*

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Gary Robinson, Investment Manager. First Quarter 2018



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## GARY ROBINSON

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Gary is a Partner and Investment Manager in the US Equities Team. He graduated MBiochem in Biochemistry from the University of Oxford in 2003 and joined Baillie Gifford the same year. He spent time working on our Japanese, UK and European Equity Teams before moving to the US Equities Team in 2008. Gary is a generalist investor but retains a special interest in the healthcare sector dating back to his undergraduate degree. Gary is also a member of the Global Stewardship Portfolio Construction Group.



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# CULTURAL ADVANTAGE

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BY GARY ROBINSON

*Corporate culture is one of the things which separates exceptional growth companies from the merely good or average ones. Our aim in Baillie Gifford's US Equity Growth strategy is to find these outstanding companies and it is rational that we should focus a significant proportion of our research efforts on analysing culture. One of the key questions in our US equity research framework is – "How does the company's culture align with its long-term ambitions and is this a source of competitive advantage?"*

We believe that finding companies with a distinctive culture provides us with a source of edge over other US investors. Indeed, in spite of evidence to support the contention that culture is a critical driver of long-term stock returns, it is routinely ignored by most investors.

Companies with distinctive cultures behave differently from the norm. They are thoughtful in their approach. They are run with a clear sense of purpose and vision for the future by founders or management teams with significant skin in the game. However, there is no cookie-cutter model for culture – what works for one company may not be appropriate for another. For example, Google's 20% time<sup>1</sup> would feel quite out of place at an industrial company such as Fortive whose distinctions are in capital allocation and lean management practices. What is key, is that the culture of the company provides a source of advantage in the path to achieving its aims.

In general, however, companies with distinctive cultures understand the need to provide products and services which add value for customers and for society. They understand that to endure and thrive over the long term, they have to be willing to invest in the future and embrace change. Moreover, the people who run these companies tend to be driven by factors other than short-term monetary gain. These managers have vision, ambition and determination coupled with a bias to action and a willingness to experiment.

Our experience is that companies with distinctive cultures tend to be more adaptable and durable than average. They also grow faster and are more adept at unlocking new growth opportunities that weren't apparent at the time of our original investment. Indeed, we would contend that culture is one of the most important drivers of long-term stock returns.

1. Google's engineers are encouraged to spend up to 20% of their time working on their own projects, so long as they benefit Google.

A photograph of Mark Zuckerberg speaking on a stage. He is wearing a grey t-shirt and has his hands raised in a gesturing motion. The background is a dark blue wall with a large, faint Facebook logo.

*“The biggest risk is not taking any risk...in a world that’s changing really quickly, the only strategy that is guaranteed to fail is not taking risks.”*

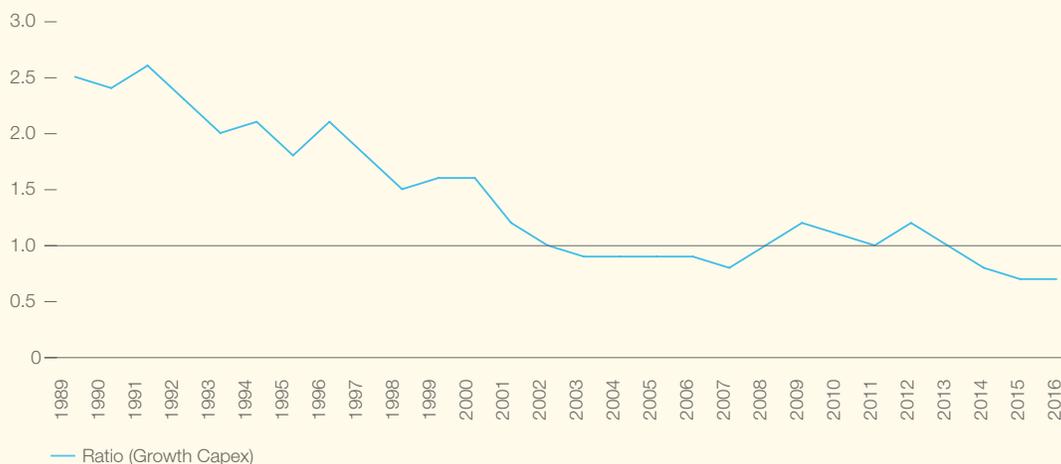
MARK ZUCKERBERG

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This might all seem like common sense. The attributes of companies with distinctive cultures are not proprietary or even particularly radical. However, most companies are not run this way. Instead, they march to the beat of the quarterly earnings cycle, and prioritise share repurchases and near-term growth over investments in long-

term value creation. Indeed, a survey of 400 executives found that almost four out of five of them would sacrifice long-term value in order to smooth earnings. Another study found that in the decade to 2012, companies in the S&P 500 paid out over 90% of their net income in dividends and share buybacks.

### The Ratio of Growth Capex to Dividends and Buybacks is in Decline



The data has been produced by Baillie Gifford, using Factset and the Worldscope database. Furthermore, a combination of FTSE and MSCI indices have been used in order to establish a global universe for the analysis. All of the underlying data is in USD.

This shortage of long-term investment may stem, at least in part, from poor alignment and badly designed incentives. Many corporate CEOs have very low levels of genuine ownership in the firms they manage and are incentivised primarily on short-term earnings-per-share targets or share price movements. These sorts of incentive schemes do not engender long-term thinking. It should be no surprise that many corporate CEOs choose to buy back shares and boost their earning per share rather than invest in projects with long-term and uncertain payoffs.

Investors must share some of the responsibility for these short-term corporate attitudes too. Arguably the time horizon of companies has simply been shrinking to match that of their shareholders. In stock market terms, this manifests itself in maniacal swings in share prices around quarterly earnings reports, and hostile reactions to the companies which choose to ignore these demands and instead invest in their competitive advantages at the expense of short-term profits. We've seen this pattern time and time again in the portfolios that we manage.

Take Grubhub as an example: in 2015 the online food ordering company took the decision to improve its service through investments in its own delivery capabilities, which was celebrated by the markets with an almost halving of the share price. It's no surprise to us that many companies are choosing to shield themselves from the mania of markets and stay private longer.

Fortunately, not all companies have felt the need to succumb to such short-term pressures. As mentioned earlier, there is a select group of exceptional US growth companies that have had the fortitude to ignore Wall Street's calls for smooth quarterly earnings progression and invest for the long term. These companies understand that the traditional definitions of shareholder value popularised by Welch and GE are deeply flawed and, to borrow from Professor John Kay, that goals are often best achieved when they are pursued indirectly. Amazon understood long before a majority of investors that, if it focused on delighting customers, over the long term the economics would follow.

We believe these are the sort of companies that long-term investors should try to identify, own and support. Our ultimate aim is to find businesses that can grow faster for longer, but the forces of capitalism are constantly fighting back against this outcome. To succeed in the face of these forces requires a bold approach. As Mark Zuckerberg, the founder-CEO of Facebook says, “The biggest risk is not taking any risk...in a world that’s changing really quickly, the only strategy that is guaranteed to fail is not taking risks.” The types of companies that have the best chance of succeeding are the ones that focus on the long term and which possess distinctive cultures.

We are amazed by how little attention culture gets from the rest of the investment community. We recently participated in the Stitch Fix IPO and were told by its founder that we were the only investor to ask the company about its culture during the due diligence process. We think the question of whether Stitch Fix’s culture is a source of edge is the most critical question in understanding whether the company can maintain and build upon its early leadership in the personalised online clothing subscription market.

So why don’t investors dedicate more time to this important issue? We think it stems from a couple of factors. The first is that the benefits of a special culture only really manifest themselves over periods of years. To investors with a short-term time horizon, culture is not worth bothering with. It’s only when you stretch out the time horizon that the benefits of a special culture really shine through. The second reason is that culture is, by its very nature, intangible. The benefits of a strong culture – for example, durability and adaptability – are difficult to measure precisely and are therefore not easily incorporated into Wall Street’s cash-flow models. But just because something is hard to measure doesn’t mean to say one shouldn’t try. We reject any notion that it’s impossible to identify a special culture in advance. Indeed, we would



*CeBIT 2016 Digital Technology Trade Fair.  
© Getty Images Europe.*

argue that the challenging nature of quantifying the impact of a strong culture makes serious analysis all the more worthwhile.

We believe that some of the best examples of companies with distinctive cultures are those which are run by their founders. It is no surprise to us that almost all the examples of extreme wealth generation over the last couple of decades have come from founder-run companies. Founder managers possess many of the attributes described in previous paragraphs. Naturally they take the long-term view because their companies reflect the culmination of their life’s work. They have an attachment to the business, rather than the stock price, and their aim from



the outset is to build something meaningful and significant. They also typically have significant skin in the game, and as founders of the business they have the moral authority to make tough decisions, challenge assumptions and position their businesses for the future, even if it involves some pain in the short term. The vision is theirs.

Take Amazon, the largest holding in our US equity portfolio, as an example. The business was founded just over 20 years ago as an online bookseller in the US. Today the company is a global behemoth and one of the dominant forces in global retail, IT infrastructure and media. Founder Jeff Bezos has achieved this success through consistent reinvestment in

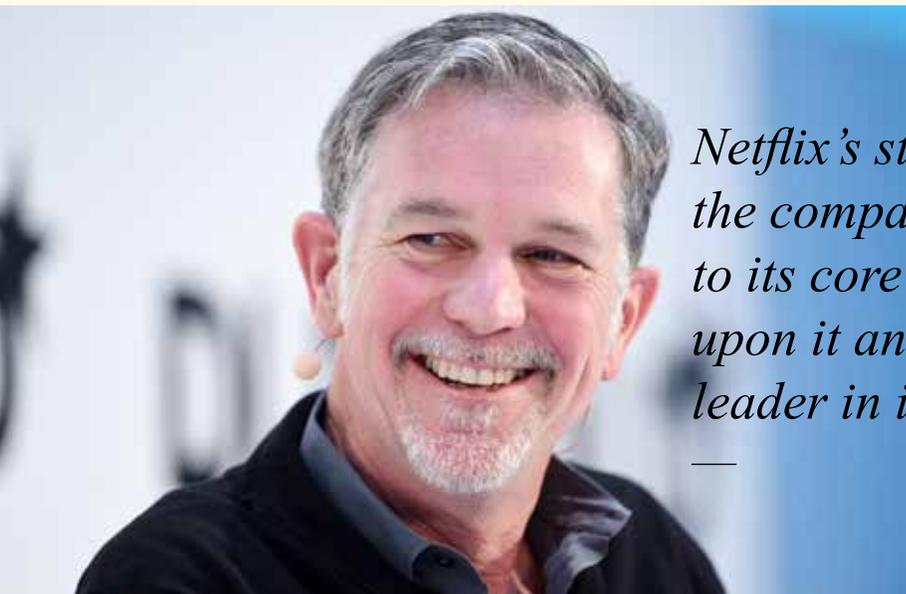
the business. Despite sales totalling over \$100 billion, the company has barely turned a profit. This is because Amazon chooses to invest in its own future rather than maximise near-term profits. Such investments have seeded valuable businesses such as Amazon Web Services, Amazon Prime, Amazon Prime Video, and Kindle. However, throughout this period of investment, Amazon has had to withstand constant criticism from the media and certain factions of Wall Street. It would have been difficult for anyone other than a founder as talented and resolute as Jeff Bezos to have succeeded with this radically long-term strategy.

Netflix is another great example of where a founder's mind-set has proven invaluable. It's easy to forget, given its current dominance of online video streaming, that Netflix actually started life as a DVD-by-mail subscription business. What's most remarkable about the Netflix story is that not only did the company respond to a challenge to its core business, it capitalised upon it and emerged as the clear leader in internet streaming. Major strategic changes like this are incredibly rare because of barriers to change, such as vested interests within existing business lines and corporate inertia. To overcome these barriers requires vision, ambition and leadership. In Netflix's case it was founder Reed Hastings who, from the outset, understood the inevitability of online streaming and used his moral authority to lead a timely change in direction at the company once it was clear to him that the time was right.

The above are just two examples in a long list of situations where the long-termism and leadership

qualities of a founder were beneficial. However, evidence for the benefits of founder leadership are more than anecdotal. Recent academic work indicates that founder-led businesses tend to be more innovative, create more valuable patents, and are more likely to change technological direction. Other work suggests these traits of founder-led businesses can translate into strong outperformance.

There is a very strong expression of these viewpoints in our US portfolios. Founder-run companies currently comprise 70% of the portfolio, a lot higher than the US market as a whole, which our research suggests is around 25%. History teaches us that only a small number of companies will really matter over the next decade. We would wager that most, if not all, of these companies will be founder-run or, at the very least, that they will possess distinctive cultures. We hope and indeed have the aim that some of these future winners are already held in our portfolios.



*Netflix's story is that not only did the company respond to a challenge to its core business, it capitalised upon it and emerged as the clear leader in internet streaming.*

Reed Hastings, the head of the online video store Netflix.  
© TOBIAS HASE/AFP/Getty Images.



Netflix, Amazon Fuel L.A. Office Demand as Streaming Flourishes.  
© Bloomberg/Getty Images.

As significant and long-term investors in these businesses we aspire to play a role in their success by supporting them in their long-term aims. It helps that we run our own business for the long term. Baillie Gifford is a private partnership, so we don't have to answer to outside shareholders. This means we can focus our efforts on what is in the best interests of our clients and supporting the companies that we invest in on their behalf. To be clear, we have no ambitions to interfere with or impose our views on these companies. It would be ludicrous for us to suggest that we know better than Bezos or Hastings. However, we do believe we can play a useful role in providing counterbalance to the prevailing short-termism of markets and in providing management with the space to get on and do what they're best at doing – building great businesses.

The US is home to a large proportion of the world's truly exceptional growth businesses. These companies are novel not only in terms of the size of the markets that they address but also in their ability to drive increasing returns and compound their power as they scale into these opportunities. They also stand out on account of the vision and mind-set of the people who run them. Their managers, who are often founders, are bold and long term in their attitudes and in their actions. We feel fortunate to invest in these outstanding businesses on behalf of our clients. We believe that investors ought to have significant exposure to them.

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