# THE NEXT BIG THINGS

*Tom Slater on tomorrow's opportunities*

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BAILLIE GIFFORD

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# THE NEXT BIG THINGS

BY TOM SLATER

*Why are the visionary leaders of the world's biggest companies unfazed by market setbacks? Because they're already at work on tomorrow's opportunities. Tom Slater, head of Baillie Gifford's US Equities team reports from the frontline of innovation.*

I spent most of last autumn working on the West Coast of America. Another member of the US Equities team spent six weeks in Eastern China.

We both came back with good news. The misery now pervading markets is, for now, a financial services industry phenomenon, a million miles from the concerns of the world's most dynamic growth companies. It barely registers in the calculation of their entrepreneurial bosses.

Listening to Jeff Bezos, Amazon's founder and chief executive officer at the company's HQ in Seattle, I noted that he didn't speculate about the impact of rising interest rates on US consumers or what Brexit might do to Amazon's UK sales. He started by declaring that he spends most of this time living in the future: "a wonderful place!"

Bezos was making the point that he only concerns himself with Amazon's immediate operational reality if something goes drastically wrong. Otherwise his focus is on the next big opportunities.

I share the following thoughts of Mr Bezos to convey something of the flavour of our US equities research process. We describe it as trying to learn from genius.

We know that if we start by looking at the same market data as everybody else we are doomed to produce – at best – the same investment results. A different outcome requires a different approach.

We also know that there are people out there who are much smarter than we are. Understanding what they are talking about and what they are doing to create the growth companies of tomorrow is an important stimulus to our own thinking.

Here we have the opportunity to gain competitive advantage. Because access to smart people is not dependent on funds under management or the ability to write a large cheque. It is about your record of behaviour and credibility as a long-term investor and business owner.

During our discussion Bezos chose to focus on four areas: Amazon's virtual assistant Alexa and its media, grocery and cloud computing businesses. Here follows some reflections on what he had to say.

# *ALEXA*

The Amazon Echo speaker and Alexa, its integrated voice assistant, are already ubiquitous. Market attitudes to Alexa in Silicon Valley and on Wall Street illustrate the divergence between West Coast and East Coast thinking. Cursory analysis might suggest that the smart speaker market is maturing and the fastest revenue growth phase is behind us. It will be another contributor to a slowing top line at Amazon over the coming years.

It is precisely this narrow type of thinking which has led Wall Street to underestimate Amazon for the past two decades. I would not disagree that the smart speaker market is no longer of much interest. But Amazon has laid the foundations of a new era of computing. It has created an expectation that we ought to be able to speak to our devices. The monitor, the keyboard and the mouse are too expensive and cumbersome to fit our lifestyles and consumers are warming to their alternative. Alexa, is coming to your microwave, to your television, to your car, and even your bicycle. Ambient computing is becoming a reality.

As for the competitive position, very few rival companies have the infrastructure to create a product like this. More importantly, Amazon now has over 100 million Alexa-enabled devices in circulation which means it is collecting data faster than rivals. Its competitive edge is increasing.

Data matters because of how inadequate Alexa now is relative to our expectations. We want to interact with 'her' like a person, whereas in reality 'she' is a four-year-old algorithm. Those managing the business within Amazon see themselves as a four-year-old start-up. The things they need to improve are predominantly engineering problems within their control. They need to improve their natural language processing, they need to connect Alexa to more devices, and they need to strike more partnership deals. They are not dependent on the vagaries of markets.

Think of the potential: if this technology becomes our default household assistant and the means by which we organise our households, then Amazon has just taken an important step closer to influencing the way we decide to spend our money. And crucially, it can monetise this role by selling shoes, not just advertising shoes. This is a business model edge that no others can match. No wonder Jeff is excited.

# *MEDIA*

In the past we have focused on the distinction between offline and online media but the issues have moved on and so have our investments. Today, Amazon and Netflix and new purchase Roku dominate our US equities media exposure.

We are seeing the accelerating decline of the traditional media industry. ESPN, the powerhouse of the cable industry, peaked at 100 million subscribers in 2011. Since then it has fallen 14 per cent. In 2018, Disney's purchase of 21st Century Fox and Comcast's purchase of Sky illustrated the kinds of pressure this is creating. Since peak ESPN, Netflix has grown from around 25 million subscribers to almost 140 million today. It is spending close to double what some of the biggest traditional media companies spend on content and customers are voting with their eyeballs. As many as 45 million households watched Netflix's horror thriller Bird Box in its first week of release, more than twice the total number of cinema tickets sold that week in North America for all films.

With the industry in flux, it is understandable why this area is such a priority for Bezos. Amazon spent just under $5 billion on content last year, signing Jen Salke from NBC as the new head of its studios business. As Amazon is data-driven, this spending is motivated by the information derived from customer spending patterns. When a Prime member watches their first piece of content on Prime Video they become a much more committed Prime member. Renewal rates improve.

This brings us back to Amazon's business model advantage of not being compelled to monetise directly. Investment in content sells more 'shoes'. So in a way we have become familiar with elsewhere, in the age of on-demand viewing there is no longer competition for audience share at a particular time. All the competition is for the talent that creates unmissable content.

Elsewhere within our media holdings, Facebook is working hard to rebuild trust after the damage inflicted by the Cambridge Analytica data privacy scandal. It has its work cut out in the face of a hostile traditional media industry but we hope to see a return to profit growth over the coming months. Gaming continues to grow and in the UK is now bigger than the music industry and video industry combined.


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Big internet platforms like Facebook and Alphabet are still extremely powerful businesses, addressing vast opportunities, many of which lay far in the future. While these major companies work through the challenges of regulation and governance, we have been trying to identify companies that could become the platforms of the future.

That is the backdrop to our holdings in companies such as Shopify. Could it become the key infrastructure for entrepreneurs to operate online globally?

# GROCERY

Bezos' third topic was grocery. I would like to broaden consideration of this to include the entire food industry.

As recently as five years ago it might have seemed that the food industry would be one of the last to be affected by digitalisation. Instead it has become one of the most interesting parts of the online market.

As Amazon seeks to offer a broadening array of services to its customer base, grocery is clearly a top priority. It is a huge market and also one in which there has been very little radical thinking for a long time.

If one looks at one of the most ecommerce-penetrated grocery markets in the world, the UK, you can begin to realise the potential opportunity: online sales still account for only seven per cent of the total spend on groceries. There is still a lot to play for here, and elsewhere in the world penetration is lower still. The frequency of purchase and the scale of the market make the sector very attractive for technology-led entrants.

Today's customers are looking for a combination of physical stores, click-and-collect and home delivery. This is a battle that is likely to consume capital and take time to develop.

It is also, of course, exactly the type of competition Amazon loves. The company is tying together its online pantry service with click-and-collect and its estate of Whole Foods stores. It enthusiastically acknowledges that it needs to get to a different level of inventory control and picking capability for this to be a big growth driver for the next decade.

Technology is enabling some amazing experiences. At one of the five Amazon Go stores in Seattle and San Francisco, you can scan your mobile on the way into the store, pick items from the shelves and walk out. No item-scanning, no tills, no queues: just cameras and machine intelligence. This is a meaningful improvement on the customer experience in a traditional store.

The key to achieving success in this retail format is rich data on the customers, an area in which a traditional food retailer has comparably little experience.

Meanwhile the progress being made by food ordering companies such as Grubhub and others may lead to other structural changes in the market. As ordering prepared food gets easier, the range and options available improves, delivery costs decline and speed increases, which will help the market grow.

We are also seeing the emergence of 'dark kitchens', operations run from industrial parks with no counter or covers whose business is built on marketing and distributing through these online networks.

The combination of changing habits and local monopolies is creating some great opportunities in the food industry.


*Customers scan their mobile phones as they enter Amazon Go, Amazon's high-tech, cashless convenience store.*

# CLOUD

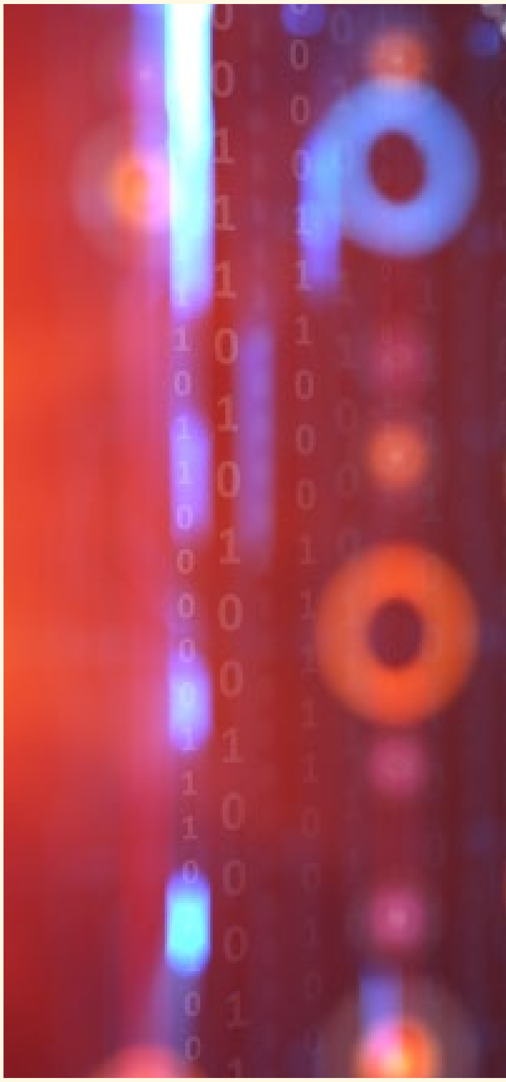
The final area Bezos mentioned was cloud computing. At a superficial level you could describe this as the move from on-premise systems to third party infrastructure. We think the change is more profound and should really be thought of as the digital transformation of enterprise.

It is being driven by information technology becoming a central and strategic activity for many businesses. This isn't a technology cycle, it is a fundamental change that will play out over decades.

Three observations: Firstly, it is clear that enterprises are moving workloads to the cloud at an accelerating rate. Secondly, it appears to be a winner-takes-most industry with customers typically having a main supplier and then a backup. Thirdly on-premise giants such as Oracle and SAP have failed to find ways to adapt their business model to embrace Cloud, which broadens the opportunity set for new players.

Bezos is most enthusiastic about databases. He thinks that the advantages of a Cloud-based system are sufficient for corporates to consider switching. At the very least it would be unlikely that a startup would tie themselves to the Oracle ecosystem. Amazon's cloud database, Aurora, has been a long time in the making but in Bezos' view, the long learning time shows that the opportunity is gigantic.

Microsoft's Azure is currently the only credible competitor and the outstanding question is whether Alphabet's Cloud efforts, under new leadership, can leverage its computing scale and artificial intelligence expertise to win a place at the table.

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# HEALTHCARE

Having covered Bezos' four major topic areas, here is one he didn't mention but about which his actions denote strong interest. That is the topic of healthcare-meets-data.

There has been a massive change over the past 10 years to a data-driven world and our expectations as consumers have changed. But our healthcare institutions suffer from chronic inertia and it is difficult to get prompt answers in a way we've come to expect in other industries.

Against this backdrop, we have been looking for the healthcare companies that can drive the shift to data-driven based treatments. By far the most important are our holdings in gene sequencing company Illumina which marked its twentieth anniversary this year. Illumina's mission remains the same but a new phase has begun.

The first part of this new healthcare journey was about refining the technology, serving the research markets and putting in place the building blocks necessary to address the real world of patients and therapies. The next phase is about unlocking this clinical sphere which is happening already. One million individuals have now had their genome sequenced but it is still very early days.

Only a tiny proportion of those diagnosed with cancer have their disease sequenced but that number is growing fast. For example, the UK Government recently announced that all children in England diagnosed with cancer will qualify for whole genome sequencing.

Meanwhile, the clinical data that Illumina's unlisted offshoot Grail has published suggests that its quest for an early stage pan-cancer blood test is showing promise and is happening much faster than anticipated.

# *CONCLUSION*

*I hope I have managed to convey some of our thinking as we navigate 2019, although a whistle-stop tour of the portfolio must inevitably leave out more than it includes. Our US Equities portfolio will continue to search for the companies that have the best opportunity to be outliers when it comes to delivering returns to our clients. We aim to own these companies for long periods, and without unnecessary transactions, so that the maximum possible returns accrue to our clients.*

*We believe that having the confidence in these companies to remain steadfast is the best way to convert current opportunities into outsized future returns.*

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Tom graduated BSc in Computer Science with Mathematics from the University of Edinburgh in 2000. He joined Baillie Gifford the same year and worked in the Developed Asia and UK Equities teams before joining the Long Term Global Growth Team at the start of 2009. Tom became a Partner in the firm in 2012. Tom was appointed Joint Manager of Scottish Mortgage Investment Trust in January 2015 having served as Deputy Manager for the previous five years. In 2015 Tom was appointed Head of the US Equities team and is a decision maker on Long Term Global Growth portfolios. Tom's investment interest is focused on high growth companies both in listed equity markets and as an investor in private companies.

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