

An aerial photograph of a winding river flowing through lush green hills. The river is a light brown color, contrasting with the vibrant green of the surrounding landscape. The hills are rolling and have a textured appearance, possibly due to vegetation or soil. In the top left corner, a small beach and turquoise water are visible. The overall scene is serene and natural.

LONGEVITY

Mark Urquhart, Investment Manager. July 2016



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Investment Manager

Mark graduated BA in Philosophy, Politics and Economics from Oxford University in 1992. He spent a year at Harvard as a Kennedy Scholar in 1993 before completing a PhD in Politics at the University of Edinburgh in 1996. Mark joined Baillie Gifford in 1996 and was an Investment Manager in the UK and Japanese Equities Teams, until co-founding our Long Term Global Growth Team when it was established in 2003. Mark became a Partner in 2004.



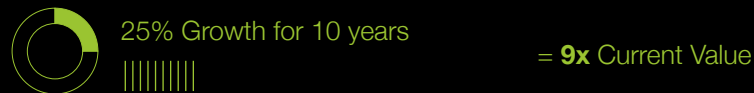
LONGEVITY

If we in Baillie Gifford's Long Term Global Growth team are trying to invest on a ten year or more time horizon, then by definition we must seek to find businesses which not only endure but also prosper. But, as I think about longevity, it runs much deeper than this – for me it encompasses how companies think about themselves and how this manifests in culture, risk-taking and capital allocation.

Firstly, it is worthwhile to start with some simple arithmetic. I hope we all appreciate the power of compound growth but it still startles me to see some of the figures written down. For example:



Or taking a more extreme example:



All of these scenarios represent very good growth outcomes but I think both help to emphasise the power of longevity in terms of being an engine of growth – this is simply the law of large numbers put another way. Intuitively, as revenues get larger, growth becomes harder to achieve but this is what makes it by definition so valuable. Google or Amazon growing at mid-teens to 20 per cent or more off bases of \$75 billion or \$100 billion literally adds billions of dollars which can transform long-term profits and discounted cash flows (DCF). Contrast this with Groupon, where revenue growth has gone from more than 500 per cent in 2011 to almost no growth in the current year. Of course, such observations are easy to make with the luxury – which no investor is afforded – of 20/20 hindsight.

Longevity is about much more than simple revenue growth. At times it is simply about the survival of the company and the endurance of the brand. If one thinks back to Apple's lost decade, where revenues in 1999 were below those of 1991, it was virtually impossible to foresee the explosive growth which would follow Steve Jobs' return in 1997. Through this period the company had some rocky moments which could have led to its demise, however, it endured. Apple has now moved into the echelons of long-lived technology companies which have previously been discussed by the Long Term Global Growth team.



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At times, endurance in itself is an achievement and creates opportunities for future growth. Perhaps we should view these as the corporate equivalent of the teenage years – some companies go off the rails but those which survive may have something pretty special about them. As an aside here, I was struck while recently reading the excellent book about Pixar, *Creativity Inc.* by its co-founder Ed Catmull, how that business only survived through the stubborn belief and deep pockets of Steve Jobs – no venture capitalist would go near it. So, longevity, whilst extremely valuable in my opinion, is extremely hard to spot before it occurs. The odds were stacked against Pixar producing its first movie but now it will probably make a hundred.

This facet of not knowing how long-lived a business might be is amplified by the economic theoreticians. There is no place for a Hermes or Chanel in the free-market theories of perfect competition and Schumpeterian disruption but I think we all know the greater fallacy lies in the underlying concept of rational agency. Concepts such as creativity, beauty, craftsmanship

NOT ALL DESTRUCTION IS CREATIVE AND NOT ALL CREATION IS DESTRUCTIVE.

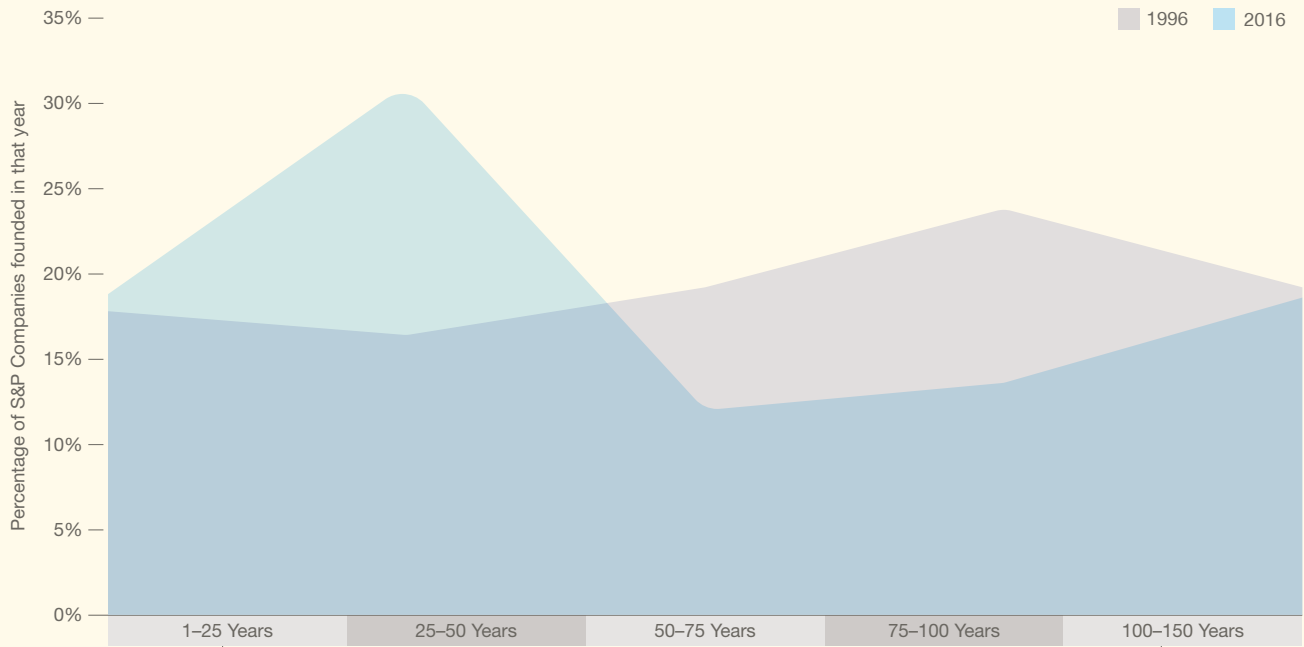
and brand do not fit neatly into efficient consumption frontiers but are absolutely key to understanding the longevity of companies. Not all destruction is creative and not all creation is destructive. More recently, I would contend, the economic profession does a particularly poor job in understanding the concepts of first-mover advantage and network effects. For example, how has Tesla built an order book worth around \$15 billion (the largest ever consumer product launch) without spending a dime on advertising, and why does Google have such commanding shares in the search market everywhere except China?

In my view, the biggest failing of investment managers pouring over companies' figures is forgetting to value the intangible assets which do not appear on the balance sheet. This is understandable because the number is not by definition objective. It involves judgment, subjectivity and embracing uncertainty but I would contend that for truly great and long-lasting companies it is the single most important figure – it is the DNA of the company and the

essence of longevity. Facebook has \$21 billion of intangible assets on its balance sheet, a sum which consists of its goodwill paid in the acquisitions of Instagram, Oculus Rift and WhatsApp. But it has nothing there for its greatest assets, the 1.5 billion or more users of its eponymous site and the probable genius of Mark Zuckerberg. For me this is as, if not more important, for a Netflix or an Under Armour than it is for a Gucci or a L'Oreal. The maturity of a company does not make its future longevity more valuable.

So what endures and what fails? This is not only the hardest question to answer but also one of the most important, with lots of studies and data pointing to a continued contraction in the lifespans of companies. The graph opposite illustrates the shrinking lifespans of companies and as usual, there are numerous academic debates on whether we are currently plateauing and arguments over M&A. But note within the overarching trend to contraction those special few which endure and have done for over a century.

Company founding dates S&P 500 2016 vs 1996



LTGG portfolio holding examples



AMAZON



FACEBOOK



INTUITIVE SURGICAL



HERMES



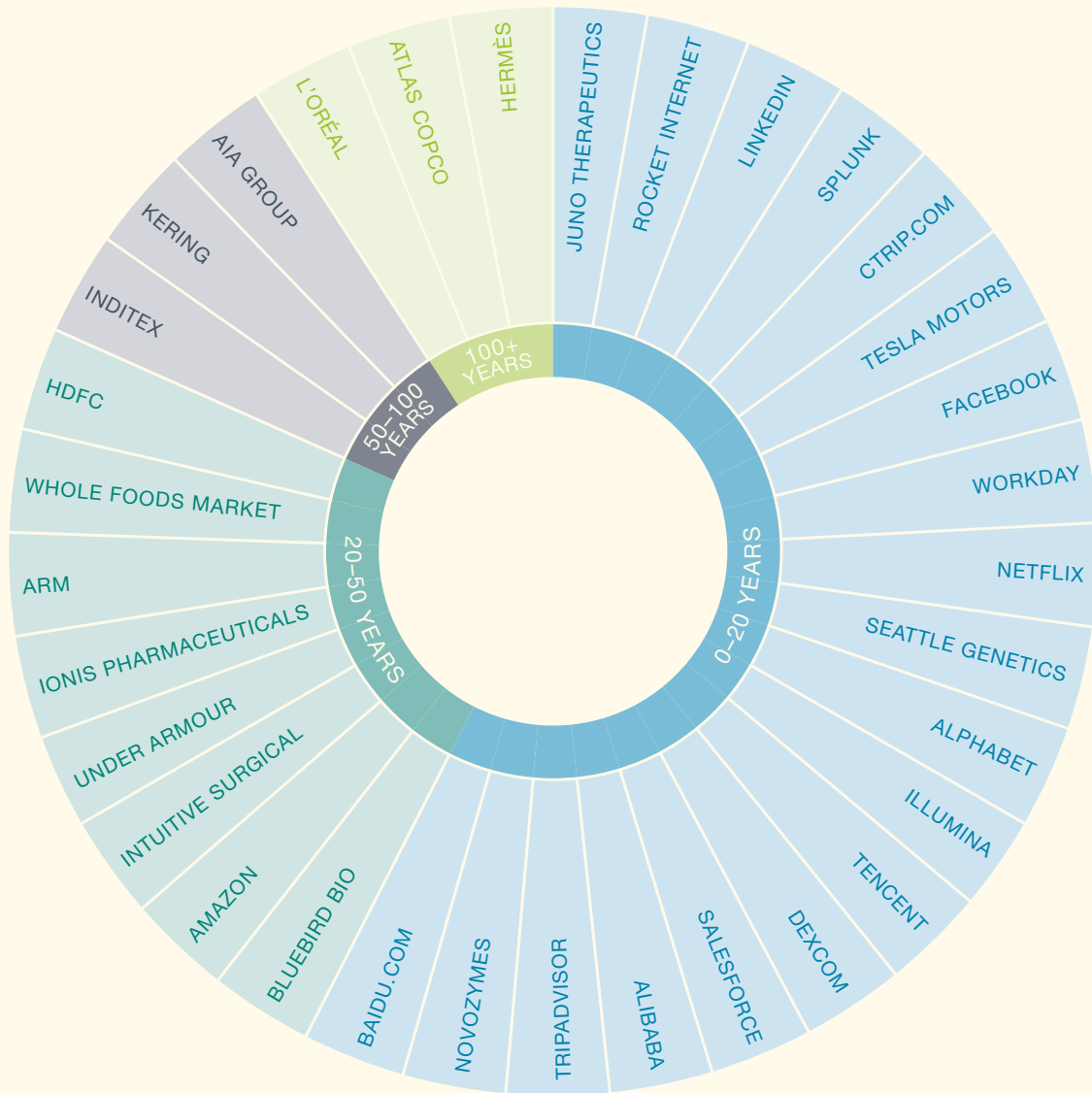
L'OREAL



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LTGG Portfolio Holdings by Company Age



Based on a representative portfolio, new client portfolios may not mirror the representative portfolio exactly.
As at May 2016.

This trend is entirely in keeping with our theories of an acceleration in innovation, but it also concurrently makes longevity all the more rare and therefore intuitively more valuable.

My answer to this question of what endures and what fails would be that the odds of survival and, more positively, being long-lived increase dramatically with special cultures and management teams. We know from experience how some companies cannot lift their horizon away from the next quarterly data point (often because their own remuneration is tied to short-term performance) but the great companies think in, plan for and take risks over decades. Of course, we cannot predict what disruption might occur in the future but we can look to companies which are willing to embrace uncertainty and disrupt themselves as signals of their desire to endure. We should embrace executives who are there to build great businesses and change the world rather than those who professionalise the task and see five years as a lengthy tenure. We should also pay ongoing attention to the make-up of boards and whether they will tolerate time horizons and experimentation which help enhance the odds of longevity.

We can look to companies which are willing to embrace uncertainty and disrupt themselves as signals of their desire to endure.

As a word of caution, we need to guard against valuing longevity for its own sake. There are lots of companies which are long-lived but which sustain rather than prosper. We should not be interested in companies which are cash-rich, perhaps protected from takeover, but are not growing. For us, the enticing prospect of longevity combined with growth provides the heady combination which we should seek. Our portfolios should reflect businesses in which our confidence that they will not only be here but be growing in 2025 and beyond is high. Of course, we will not get these predictions all right – ABB, First Solar, Nintendo et. al. stand as our own reminders of the chimera of future growth which historical numbers can create. We should hold all our beliefs about future growth strongly but lightly in my opinion – embrace the asymmetry of returns which the market so regularly overlooks, but be willing to admit when we have made mistakes in our future prognostications.

OUR 10 QUESTION STOCK RESEARCH FRAMEWORK SITS AT THE HEART OF OUR INVESTMENT PROCESS

10 QUESTION STOCK RESEARCH FRAMEWORK

Industry Background	1	Is there room to double sales in the next 5 years?
	2	What happens then?
Competitive Advantage	3	What is your competitive advantage?
	4	Is your business culture clearly differentiated? How?
	5	Why do your customers like you?
Financial Strength	6	Are your returns worthwhile?
	7	Will they rise or fall?
Management Attitudes	8	How do you deploy capital?
Valuation	9	Is it attractively valued?
	10	Why doesn't the market realise this?

Great companies innovate to create new areas of opportunity and by doing so help to prolong their corporate life.

To close I have a couple of suggestions for changes, which I hope will be improvements, to our process. Firstly, we should ban all talk of TAMs – the total addressable market – these are spot numbers in any other guise and useless in my view. Ten years ago, did anyone imagine the success of Amazon Web Services or YouTube? The supposed experts had no conception of how large cloud computing might become or how many smartphones would be sold. Tesla's potential in the mass market today looks rather different than when the company produced the first Roadsters, etc. The point here is not to constrain ourselves to a point in time – great companies innovate to create new areas of opportunity and by doing so help to prolong their corporate life. Secondly, I think we should think about longevity explicitly in our stock research framework.



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Within our 10 Question Stock Research Framework, Question 4 asks, *Is your business culture clearly differentiated? How?* I suggest we now ask *How long might this culture last?*

Question 9 asks *Is the business attractively valued?* Here I suggest we now ask *What time-frame should we consider valuation over?*

I look forward to debating these suggestions with the team.

I feel more and more strongly that longevity is an asset with which we can differentiate ourselves from the market. This is not in any way an attempt to say we should not own companies which are growing more slowly although it does, I hope, explicate some of my portfolio enthusiasms. Longevity is most exciting and rewarding in companies which are growing fast and should be very highly valued by us as long-term investors.

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