THE PURSUIT OF EXTREME RETURNS

Lawrence Burns, Investment Manager. First Quarter 2018.

BAILLIE GIFFORD

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International Concentrated Growth Composite Annual Discrete Performance to 31 December Each Year (%)

2013	2014	2015	2016	2017
34.7	1.0	8.0	3.5	49.3

Source: Baillie Gifford & Co. Returns net of fees in US$.

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Lawrence graduated BA in Geography from the University of Cambridge in 2009. He joined Baillie Gifford the same year and has spent time working in both the Emerging Markets and UK Equity departments. Lawrence is a co-manager of the International Concentrated Growth strategy as well as a member of the EAFE Alpha Portfolio Construction Group. He is involved in both listed and unlisted investing and travels extensively researching his particular interest in how pervasive technology and China are changing our world.

THE PURSUIT OF EXTREME RETURNS

BY LAWRENCE BURNS

The sad truth is most companies don’t really matter. It is only a very small selection of companies that genuinely change the world.

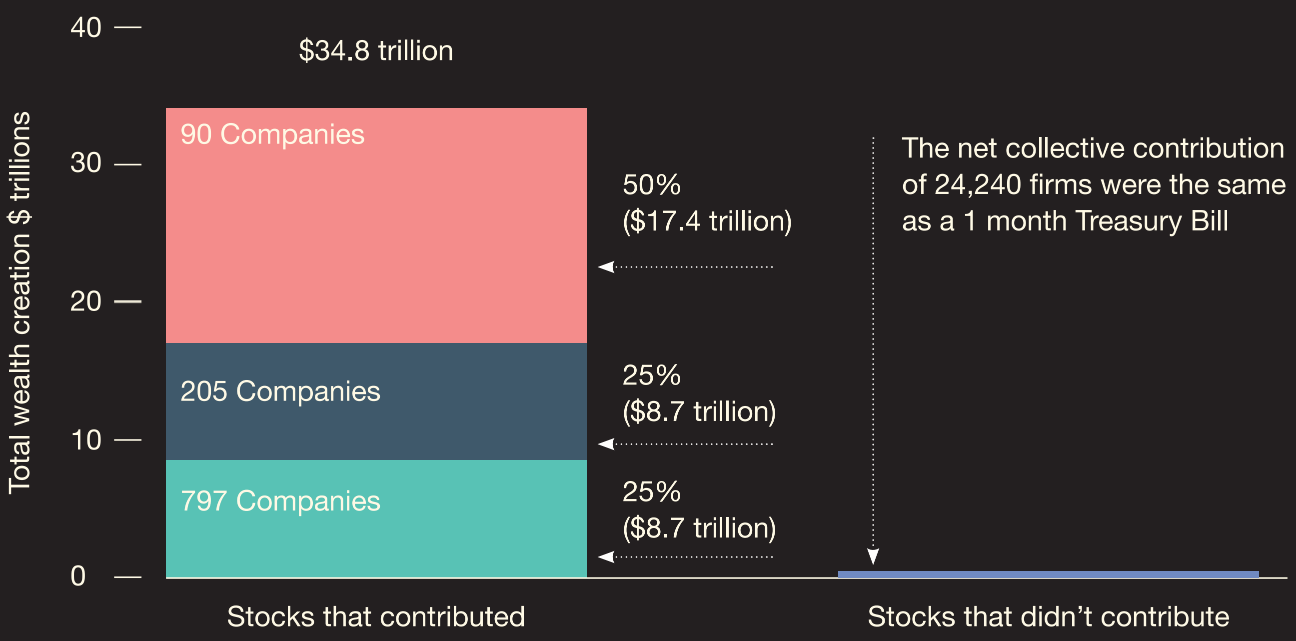
Companies like Ford introducing mass automobiles, Bayer with antibiotics, DuPont with new materials and Apple with the iPhone.

The same is true in investment. Research has shown that, as one would expect, equities have collectively outperformed US Treasury Bills over a 90 year period. However, it has also shown that most stocks actually underperform US Treasury Bills. The reason is that long-term wealth creation is driven by positive outliers: exceptional companies that reshape our world and in the process reap the rewards for doing so. It is these companies that make equity investing worthwhile.

Consider that academic research has shown that from 1926 to 2016, a mere 90 companies were responsible for half of the $35 trillion of wealth created by US equities. It is then you realise that the story of investing is really the story of big winners, it’s the story of a small number of exceptional companies.

Given this, we believe that active fund management should be almost exclusively dedicated to the pursuit of identifying, owning and supporting these exceptional businesses that ultimately drive long-term equity returns. However, we also believe this requires a very different approach to investment, portfolio construction and research.

Total net wealth created by all listed US common stocks 1926–2016



Stock market wealth creation is defined as an accumulation of value (inclusive of reinvested dividends) in excess of the value that would have been obtained had the invested capital earned one-month treasury bill interest rates.

Reading the data: The data includes all 25,967 CRSP common stocks (25,332 companies) from 1926 to 2016. Beyond the best-performing 1,092 companies, an additional 9,579 (37.8%) created positive wealth over their lifetimes, just offset by the wealth destruction of the remaining 14,661 (57.9% of total) firms. The implication is that just 4.3% of firms collectively account for all of the net wealth creation in the US stock market since 1926.

Source: Hendrik Bessembinder, Do Stocks Outperform Treasury Bills? (August 2017).

A 10-YEAR TIME HORIZON

First and foremost, at Baillie Gifford we believe the pursuit of extreme returns requires a long-term and patient approach to investment. Truly great companies are not built in a single quarter nor over the course of a few years. It takes time for companies to seize large market opportunities, for formidable competitive advantages to be recognised and for management's vision to come to fruition. Amazon did not become worth half a trillion dollars in a single year. To benefit from its astronomical rise you had to hold the shares for many years and hold on through the inevitably tumultuous periods.

Claiming to be long term and being long term are, of course, two very different things. With financial markets becoming ever more short term, we are fortunate to be able to invest within a century-old independent partnership structure that provides shelter from external pressures. Moreover, this structure has helped to create a patient and long-term culture. The result is the ability to take a genuinely long-term approach as demonstrated by our average holding period of over seven years.

FOCUS ON THE UPSIDE

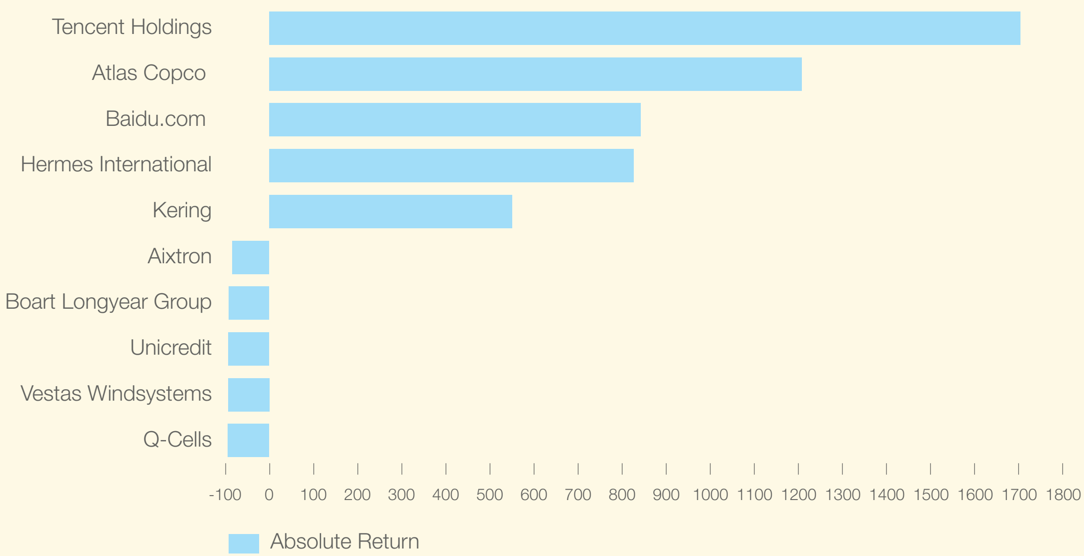
Second, we are adamant that what matters most in investment is what could go right for companies, not what could go wrong. We focus our analysis and decision-making accordingly and very much take to heart Jeff Bezos' remark that:

> *"Given a ten percent chance of a 100 times payoff, you should take that bet every time. But you're still going to be wrong nine times out of ten."*
>
> JEFF BEZOS

We try, of course, to tilt the odds further in our favour but the central point is clear. Our biggest mistakes are therefore not the investments we made that lost money, but those exceptional companies we failed to recognise and invest in. This is because the pay-offs in equities are asymmetric. The maximum possible downside is capped at the funds invested, while the maximum possible upside is near unlimited. For example, just one of our most successful investments more than offsets our five worst investments over the course of the last 14 years:

Inside the WeChat Open Class Conference
© Bloomberg/Getty Images.

Asymmetric Returns –
Top and Bottom Five Stock Returns



Source: StatPro. Representative International Concentrated Growth portfolio. US Dollars.
Since 31 March 2004 to 31 December 2017.

CONCENTRATION

Third, Baillie Gifford's International Concentrated Growth Strategy believes in concentration, operating with 20–35 holdings. We view this as a rational response to the reality that companies able to deliver extreme returns are rare. Moreover, we do not wish to dilute the transformative return potential of such companies under the pretence of diversification.

Rather than view ourselves as highly concentrated, we view others as over diversified. We want every holding to matter to our clients. Moreover, we believe it is a luxury to be able to avoid the large swathes of the index from retail to energy that are under structural threat. We fear similarity to the index, not difference.

AN ANALYTICAL AND RESEARCH CHALLENGE

This approach does, however, pose challenges both practically and psychologically for analysing companies. It means dealing with the future a decade from now and the inherent uncertainty that comes with it. In this context, current earnings mean little as do spot multiples. Information may be plentiful today, but it still predominately concerns the past and present alone, and if it comes from Wall Street and the City is already well known.

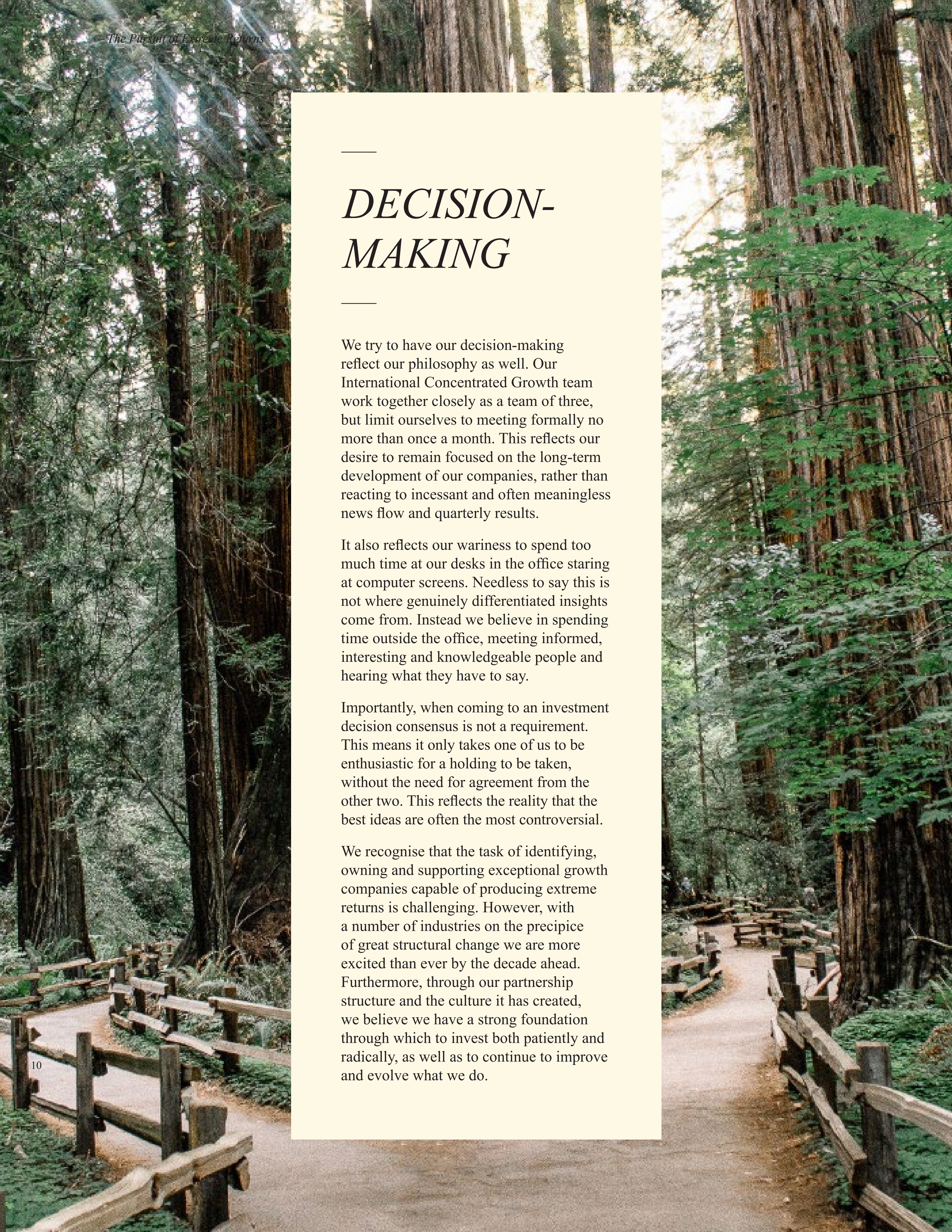
Our response is two-fold. We opt more for creative imagination than cold data analysis and we seek information sources that are both geographically diverse and distant from the financial markets.

To understand how companies could transform themselves and the world in the decade ahead you cannot create comforting yet meaningless discounted cashflows (DCFs) that merely extrapolate the present. It requires multiple mental models and the acknowledgment of different possibilities. This is reflected in our analysis through the creation of multiple scenarios with differing levels of probability and through placing serious focus on positive tail scenarios. As with Bezos, even a 10% chance of a transformational outcome still matters to us. We focus on the possibility of great change, not extrapolation nor reversion to mean.

We also believe that the quantitative approach, so persuasive in finance, downplays those qualities that cannot be measured such as a founder's drive, ambition and vision.

For information sources we recognise and are grateful that there is more genius outside of the world of finance then there is inside it. We seek to build links with academia, such as with the Santa Fe Institute concerning power laws, exponential progressions and scalability. We have also formed a link with Sussex University to fund new work in Deep Transitions, and with the understated Delft University of Technology, who are helping us better understand everything from robotics and quantum computing to the ethical implications of social media.

Our long-term approach to investing also allows us to build relationships with our holdings. This enables us to talk with visionaries from Elon Musk to Jack Ma gaining invaluable perspective from those creating the future. We also believe that whirlwind investment trips, where fund managers spend a few days meeting companies and seeing different hotels and conference rooms, are likely to provide superficial insight at best. Instead, we are increasingly opting for longer stays of several weeks and preferably months in places such as Berlin, Amsterdam and India. This is allowing us to hear a wider range of views from public companies, private companies, bloggers, students and entrepreneurs.



DECISION-MAKING

We try to have our decision-making reflect our philosophy as well. Our International Concentrated Growth team work together closely as a team of three, but limit ourselves to meeting formally no more than once a month. This reflects our desire to remain focused on the long-term development of our companies, rather than reacting to incessant and often meaningless news flow and quarterly results.

It also reflects our wariness to spend too much time at our desks in the office staring at computer screens. Needless to say this is not where genuinely differentiated insights come from. Instead we believe in spending time outside the office, meeting informed, interesting and knowledgeable people and hearing what they have to say.

Importantly, when coming to an investment decision consensus is not a requirement. This means it only takes one of us to be enthusiastic for a holding to be taken, without the need for agreement from the other two. This reflects the reality that the best ideas are often the most controversial.

We recognise that the task of identifying, owning and supporting exceptional growth companies capable of producing extreme returns is challenging. However, with a number of industries on the precipice of great structural change we are more excited than ever by the decade ahead. Furthermore, through our partnership structure and the culture it has created, we believe we have a strong foundation through which to invest both patiently and radically, as well as to continue to improve and evolve what we do.

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