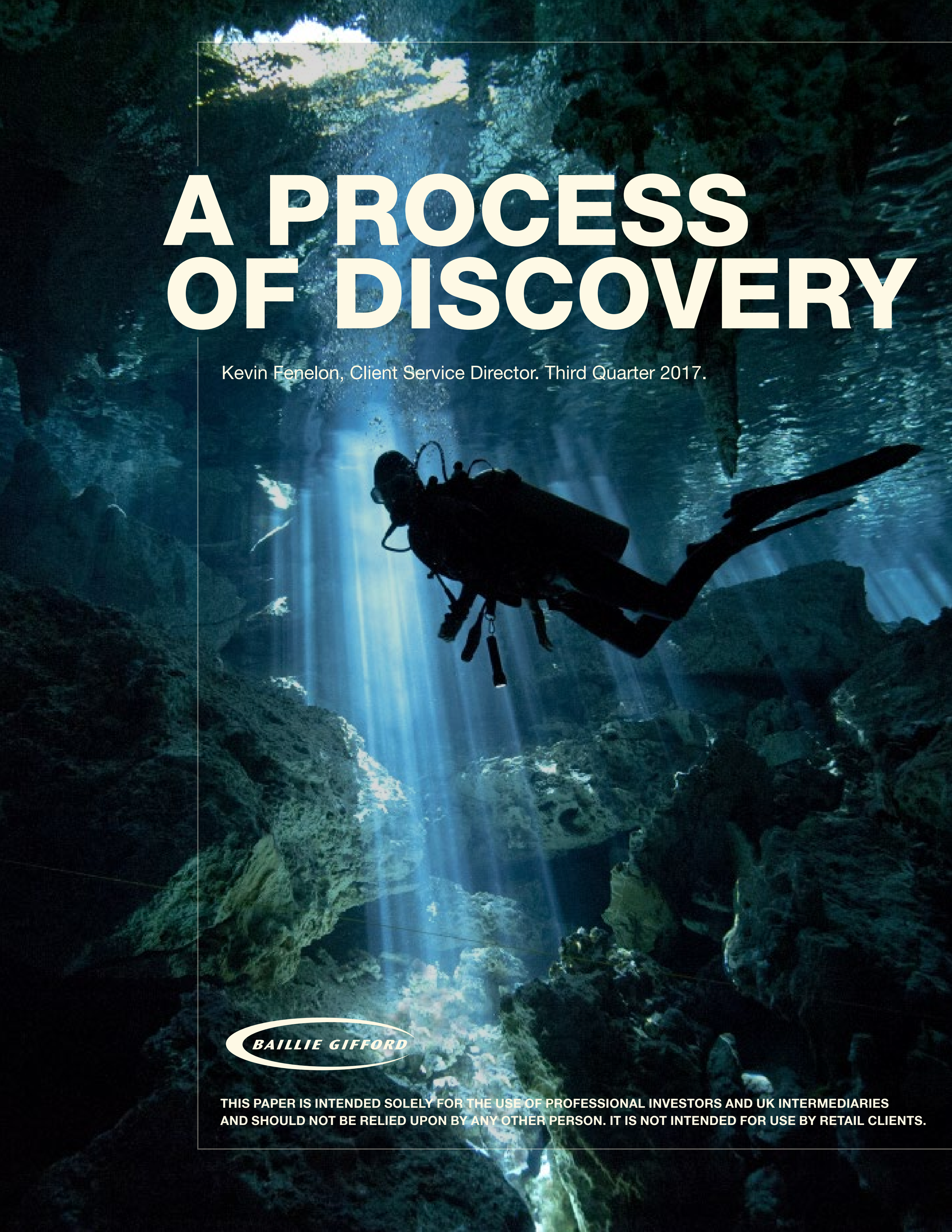

A PROCESS OF DISCOVERY

Kevin Fenelon, Client Service Director. Third Quarter 2017.

BAILLIE GIFFORD

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KEVIN FENELON
Client Service Director

Kevin graduated MA in German from the University of Edinburgh in 1981. He subsequently worked as an investment manager before joining Baillie Gifford in 2007 as a Client Service Director. Kevin is responsible for clients in a variety of strategies, mainly in Europe and the United States.

INTRODUCTION

Salvator Rosa – self-portrait.
© Hulton Archive/Getty Images.

If you visit the National Gallery in London you may well come across a self portrait by 17th century Italian artist and poet Salvator Rosa. You will see a slightly brooding figure, seated against the backdrop of a darkening sky and holding a stone tablet. Inscribed in Latin on the tablet are words that can be translated as "keep silent unless your speech is better than silence".

The investment world is full of people who don't keep silent, but rather produce a running commentary of events. However, we are fortunate at Baillie Gifford that we don't have to play this game. We are long-term investors, so we try very hard to place the typically random nature of short-term news flow and market gyrations in their proper context. Our investment managers focus their energies instead on the strategic issues that matter most to a company's long-term growth prospects.

But what does that actually mean in practice? Last year we explained why we think growth investing is the best way to generate good long-term returns for clients. We ended that article by suggesting that 'all' we have to do is find the right stocks, and that we would return to the topic and attempt to articulate how we go about that. How then do our investors discover the companies that stand a decent chance of being tomorrow's winners for our clients' portfolios?

A PROCESS OF DISCOVERY

BY KEVIN FENELON

Investment managers tend to talk about their investment process in the context of factors such as competitive advantage and financial strength. Whilst an analytical framework is necessary, it is less important than the mindset behind it. What matters more is a willingness to embrace risk, to think creatively and to have an open mind in relation to the future.

Most of us drive a car, and although when we get behind the wheel we might think that any one of a number of features such as speed or environmental impact or technology matter most, what we actually rely on is predictability. We need our vehicle to behave in the same way as the next one off the production line. Traditional automobile manufacturers have spent billions of dollars with this aim in mind, and over the decades they have developed, with varying degrees of success, highly automated processes to meet this objective. Car production is basically a linear process in that it has a defined beginning, middle and end. And volume is typically the name of the game, so the production line marches to the same beat, day in day out. To keep their customers happy, auto manufacturers require an orderly environment, deviation from the norm is bad, conformity is everything and mistakes cannot be tolerated.

Investment managers are sometimes described as 'manufacturing' performance, but what we do bears very little comparison to the type of process described above. Yes, Baillie Gifford's research process has also evolved over time and, like an auto manufacturer, possesses elements of routine. But that's as far as the very limited parallel stretches. The manufacturer of your car has a neatly defined source of raw materials, whereas our raw materials – our ideas – come from different and sometimes surprising locations. We have no automation to assemble our thoughts, as each company has to be analysed on its own merits given its specific circumstances and prospects. We have no desire to produce a batch of identical finished goods, as even the most concentrated portfolios have some measure of diversification. And quality rather than quantity is our objective, as a long-term investment horizon leads to low turnover and means that a relatively limited number of new ideas are required.

Furthermore, predictability is simply unachievable, because you can't possibly know everything about a stock before purchase and there are certainly no guarantees as to its performance. Deviation from the norm is good not bad: we must actively seek out alternative sources of information and ideas. Conformity is disadvantageous, because if we are not doing anything different then how can we hope to beat the crowd. Finally, we know we are going to make mistakes, so we must embrace that inevitability and continue to manage portfolios with conviction in the knowledge that the asymmetry of returns will help us.

Nor are we operating in an orderly environment. In contrast, the ground under our feet is constantly shifting. Companies develop in unpredictable ways, competitors respond, new opportunities and threats emerge, and growth patterns shift over time across industries and territories. Meanwhile, there are thousands and thousands of listed stocks across the world, yet we arrive at portfolios containing a tiny fraction of that total – our most concentrated global strategy contains only around 30 holdings.

To help us pick stocks against the backdrop of such a fluid and complex environment, our starting point is to analyse each potential investment in the context of a research framework that aims to find stocks capable of generating bumper pay-offs for clients.

We look for companies that can grow significantly faster than the market over the long term, we conduct the thorough financial and operational analysis that you would expect from us, and we spend an increasing amount of time thinking about management and company culture. Importantly, we must accept that any attempt at overly precise forecasting is likely to be fruitless, so we think more in terms of probabilities.

But, while we have a clear framework, our research process is at heart not one of routine or repetition, but one of discovery. It's not what we do that matters most, it's the thinking behind it. In order for you to truly benefit from the asymmetric nature of equity returns, we must be prepared to consider unlikely and even extreme outcomes. So our process is founded on a willingness, in fact a necessity, to take risks and hence it brings with it all the elements of uncertainty that that entails – right and wrong turnings, good and bad luck, pleasant and not so pleasant surprises, but ultimately the gratification of finding new and exciting investment ideas. Peter Diamandis, co-founder of the Singularity University, captured this when he said "have an open mind – allow different ideas into your way of thinking."

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BEING DIFFERENT

Being different isn't easy but there is simply no point in following the same path as the industry at large, because if you do the same thing as everybody else all you do is increase the chances of producing the same returns as everybody else. One obvious example is that in the asset management world there is still an over-reliance on investment banking research, which may fulfil a certain function for, say, less well resourced investors, but which is typically pretty undifferentiated and short-term focused. But we have some 100 investors with a combined investment experience of over 1,000 years, so we have the resource, the accumulated knowledge and, crucially, the desire to take a different approach.

So being different means being ambitious and taking risks. Fundamentally it speaks to a state of mind, and in practical portfolio terms this means taking long-term high-conviction views in stocks, trying to find the 'multi baggers' that really drive alpha for clients, and having the stomach to ride out the inevitable rough patches.

In terms of the day-to-day job, let's have a look at just three concrete examples of how we try and create an edge in a highly competitive industry through being different.

1

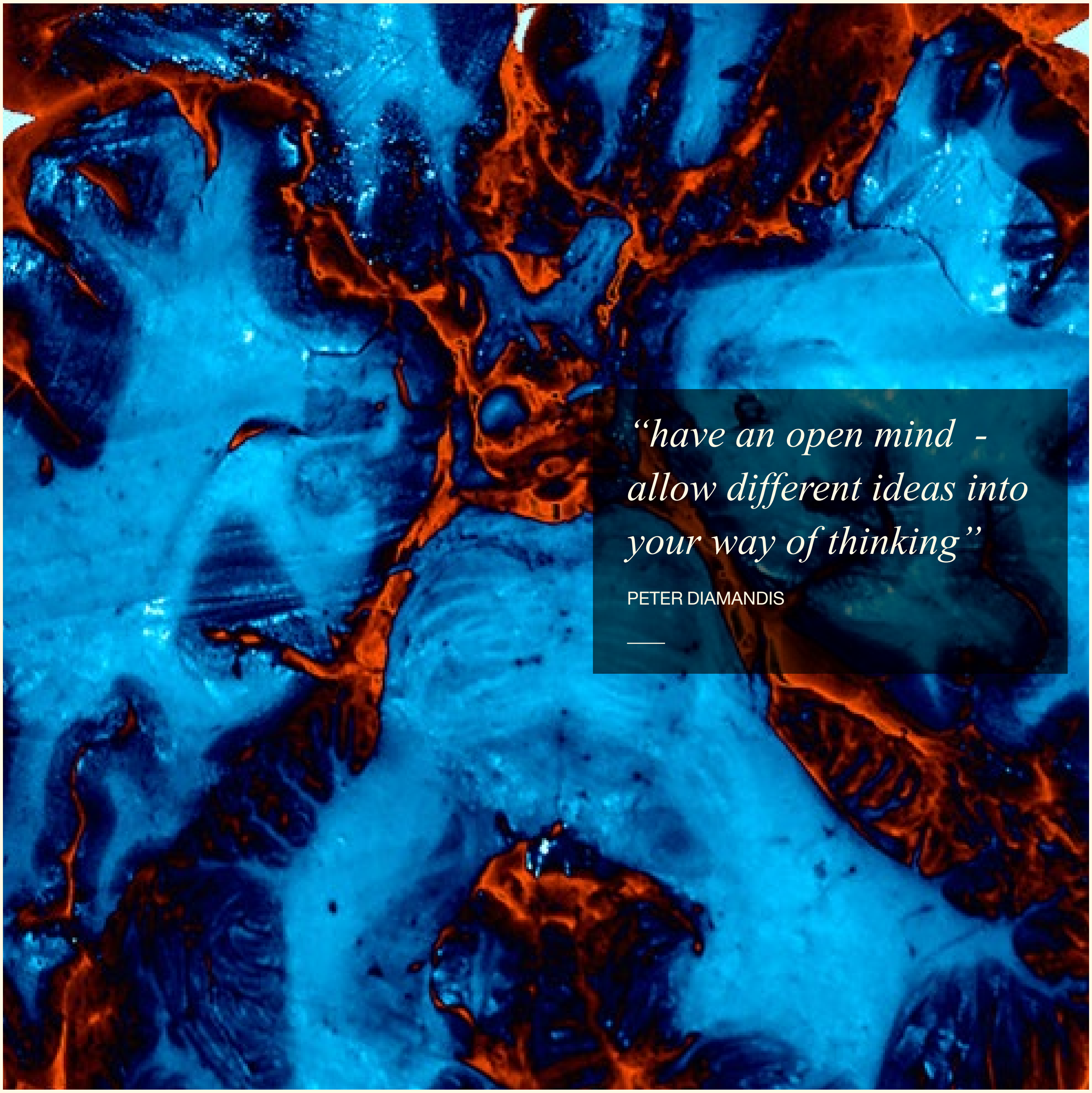
It starts at the beginning with recruitment. We actively seek out individuals from varied backgrounds, both geographically and academically. At 30 June 2017 we had 37 nationalities represented across the firm, people who have studied a diverse range of disciplines, from astrophysics to the classics. The academic background doesn't matter; the key attributes we look for are an enquiring mind, a positive interest in the investment world, and an enthusiasm to learn.

2

We try to learn from, and develop, relationships with, the best brains out there. This includes not just the corporate world, where our stance as a long-term and supportive shareholder allows for the development of meaningful dialogue with the management of some of the world's most successful growth companies. We also engage on a regular basis with academic experts, such as those working at the leading edge of healthcare and technology, and, perhaps more surprisingly, the arts world, where our sponsorship of various literary events such as the Edinburgh International Book Festival allows us to meet with authors who can provide fascinating and alternative perspectives on a whole range of topics. We also make use of our retained 'inquisitive researchers', who are assigned specific projects by investment teams to deep dive into various subjects.

3

We get out of the office on extended research visits. As an example, several investors have in recent years spent lengthy periods on the US West Coast, immersing themselves in the world's leading tech environment. We meet with the management of existing portfolio investments, establish contact with other interesting companies, both listed and unlisted, and network with key players in industry and academia. We have done the same thing on the US East Coast, deepening our understanding of the rapidly developing biotech industry, and similar exercises have taken place in Berlin, China and India.



Enhanced Brain Section.

Supporting all of this is Baillie Gifford's own wealth of knowledge and its strong growth investment philosophy. Almost 90% of the previously mentioned 1,000 plus years of aggregate investment experience has been spent at Baillie Gifford. That's an amazing figure when you think about it. Not only does it provide a gigantic store of experience, but more importantly it has been lived by the individuals who are researching ideas for your portfolio.

Furthermore, new investment ideas face a high bar. High conviction portfolios and a long-term perspective mean that a stock has to be very attractive to displace or add to what we already own. It's not that easy for a new idea to make it into a portfolio, nor should it be. We prefer to give companies a chance to develop and our instinct, when portfolio investments hit those inevitable rough patches, is to support rather than sell. We don't churn. Focused portfolios with a low turnover rate don't have to find that many new stocks each year. We only need to buy a very small percentage of the number of ideas we consider, or of the number of investable stocks we could buy, so we are choosy.


RESEARCH IS THE
PROCESS OF GOING UP
ALLEYS TO SEE IF THEY
ARE BLIND.
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SUMMARY

We are frequently asked to describe our investment process. It's a straightforward question that can be subject to long and complicated answers. Investment managers do not operate in a static environment, but rather one of constant change – the companies in which we invest develop in ways that can be unpredictable, new competition emerges, managements inevitably make mistakes, and economic activity ebbs and flows. We must recognise and embrace the fluidity and complexity of this landscape, so whilst it is, I hope, reassuring that we have a robust research framework in place to ensure that we properly analyse investment opportunities, it is equally critical that we encourage our investors to seek out different sources of information and ideas, to be prepared to accept risk, and to think as creatively as possible. Perhaps we should leave the last word to one Barstow Bates, erstwhile president of New Product Services Inc., who summed it up neatly by saying, "Research is the process of going up alleys to see if they are blind".

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