DOES ANYONE REMEMBER WHAT 'INVESTING' ACTUALLY MEANS?

OUR OVER-EVOLVED INDUSTRY

First Quarter 2017

BAILLIE GIFFORD

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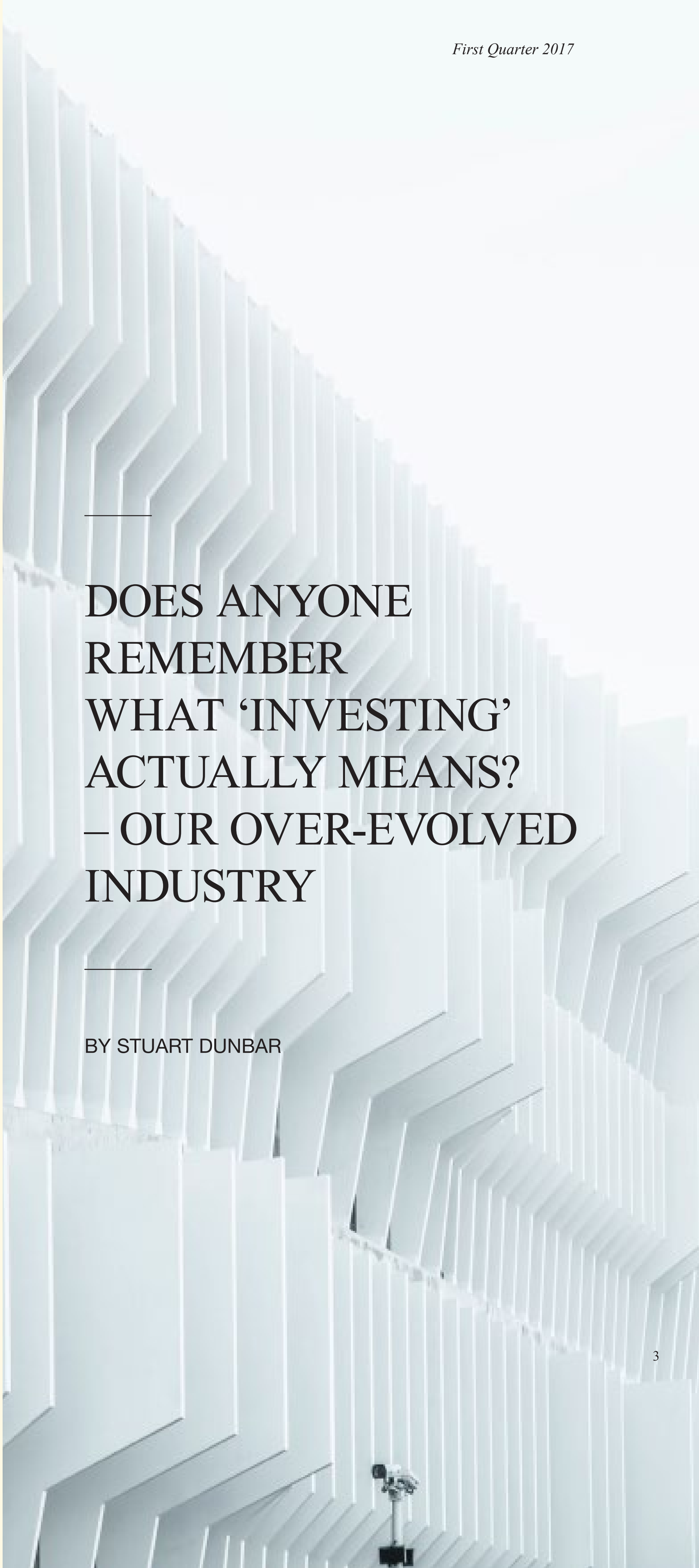
Stuart graduated BA in Finance and Business Law from the University of Strathclyde in 1993. He joined Baillie Gifford in 2003 having previously worked with Dresdner RCM in Hong Kong and Aberdeen Asset Management in the UK. Stuart is a Director within the Clients Department, where he focuses on client relationships with external financial institutions. Stuart became a Partner in 2014.



DOES ANYONE REMEMBER WHAT ‘INVESTING’ ACTUALLY MEANS? – OUR OVER-EVOLVED INDUSTRY

BY STUART DUNBAR

At the end of last year I attended a two-day institutional investor conference in Singapore. It was well organised and had the added amusement of using 'Slido', an app allowing participants to pose live, anonymous questions to the speakers. There was talk about what the election of Donald Trump might mean for asset allocation and whether we should be over or underweight equities, bonds and alternatives. We heard that 'bond proxies' might be expensive and cyclical equities cheap, or vice versa. We listened to how demographics might impact on future investment returns, and what the likely path of interest rates might (or might not) be. We learned about smart beta strategies in which mathematicians, armed with mountains of data, construct portfolios with specific characteristics that have historically outperformed, and we saw how passive funds and ETFs are a cost effective means of accessing specific slices of the market and moving assets around easily and efficiently. A fund-of-hedge-funds provider explained how through dynamic allocation we can aspire to double-digit returns at low volatility (and at 2%+ p.a. fees – really?).

Here's the thing: for two days, *no-one actually said a word about investing.* Everything, and I mean <u>everything</u>, was about how to outsmart other investors by reacting when the average valuation for one asset class or another diverged from its historic norm, or through bigger, better and faster processing of market information. As the event wore on I found myself torn between sadness at what our industry has become, and a sort of anxious optimism that here is a great opportunity for those of us who still believe that investment means something altogether different.

Let's remind ourselves what we, as investment managers, are for: the investment industry exists to help providers of capital allocate it to those who wish to put it to good use. This generally means businesses and entrepreneurs who have good investment ideas but lack the funds to put them into action, or governments who, at least in part, invest it to facilitate the progression of the economy for which they are responsible. New technologies and business models are created which improve upon and displace the old; bridges, roads, railways and other social infrastructure is created to improve economic efficiency. Risks

are involved – some ideas and projects are successful and some aren't. Through the wonders of creative destruction and innovation, economic progress is made, living standards rise and 'returns' are generated for investors.

Generally, investors want to be able to exit these projects at some stage and enjoy the wealth created by their risk-taking, or redeploy the funds into new ideas. Thus a secondary market for investments is born which makes it possible for capital to be 'invested' without any real thought as to what it's being used for. The fundamental problem is that with this possibility has come widespread amnesia as to what the investment industry is actually supposed to be doing: it is still our basic purpose to allocate capital to actual (sensible) investment ideas. If we don't, there will be fewer and fewer investment returns available for my conference-attending colleagues to squabble over. I fear that we are far down this path of foregone returns already. The great debate about passive versus active investment completely misses the point: real investors are now few and far between. To repeat the core point: in a two-day investment conference in which we heard from over 30 speakers, no-one said a *single word* about actual, returns-generating investment opportunities.

FOR TWO DAYS, NO-ONE ACTUALLY SAID A WORD ABOUT INVESTING.

On the long flight home, I found myself wondering what the owners of capital – our industry's clients – actually think we do for them. Given how much our industry gets paid collectively, this seems a pretty basic question. Are we paid to outsmart other market participants, or are we paid to find positive, returns-generating investment ideas and put clients' money to work in them? I sincerely hope it's the latter, because if it's the former then the industry has no real social purpose and we're really just working in our own interests. Of course, it's not in reality an either / or question, but given the fixation that both we and our clients have for benchmarks, peer groups and all manner of market data mining and number crunching, it seems clear that the 'outsmart' goal gets by far the more attention.

This has profound emperor's-new-clothes implications and it should come as no surprise to anyone that the current result is an avalanche of regulatory pressure and industry criticism. We have created our own monster by forgetting what we are for. We and our clients focus on the wrong things – we measure ourselves on benchmark-relative performance and relative to each other instead of by reference to actual investment returns and meeting client needs; we have a huge surfeit of phony analysis which is nothing but a complicated version of history (but with the useful quality for our industry of making the straightforward inaccessible); and we have allowed far too many links to be created between the ultimate owners of capital and those who 'invest' their money, so that there is virtually no hope of proper alignment of interests.

Try this: find someone you know well, who knows enough to understand that their pension is invested somewhere, but who works somewhere far outside the investment industry. Ask them what they think we do with their money, and actually listen to their answer. Then think about what really drives the industry's day-to-day decisions and come to your own conclusion about whether we're doing what's asked of us.

There is another fly in our industry's ointment: these days, who needs capital anyway? With share buybacks prevalent, pressure on mature companies to pay steady dividends, and technology-enabled businesses able to grow to huge size with little or no outside capital, is there really much of an investment element to stock markets at all? The answer to this is yes, but not in the way that most of us seem to understand it. The weight of assets in the savings system is such that the vast majority of it has to be invested in secondary markets where companies have already grown big enough to be accessible for the bulk of investors. So, the idea of investing client assets in specific projects is unrealistic (though not impossible – look at Tesla, for example). However, our task remains: returns are generated by backing sensible investment projects. If we can't do that individually, we should be engaging pro-actively and in a spirit of co-operation with those who are making individual decisions on our behalf, i.e. the management of the companies we invest in.

We do clients an injustice by frequently buying and selling shares to each other – playing the 'outsmart' game. We would do our clients a great service by helping companies deploy their capital in returns-generating projects, encouraging management to implement well, exercise patience, and act in the long term. Surely this is what 2016's 'engagement' zeitgeist should really be about, rather than (or as well as) the industry's tick-box obsession with executive pay and share structures?

Please, let's get back to thinking what 'investing' actually means. Maybe then active management will be seen for the value adding activity it so surely should be.

CURIOUS ABOUT THE WORLD

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