

IDEA GENERATION

ACWI Alpha Team. Second Quarter 2018



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IDEA
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ACWI ALPHA TEAM

Neil Gaiman, the British fantasy author whose work inspired the Starz series *American Gods*, has written about the frustrations of being a writer:

Every profession has its pitfalls. Doctors, for example, are always being asked for free medical advice, lawyers are asked for legal information, morticians are told how interesting a profession that must be and then people change the subject fast. And writers are asked where we get our ideas from.



In Conversation With Neil Gaiman at SXSW Festival.
© Getty Images North America

He became so fed up with being asked that for a long time he would answer “*From the Idea of the Month Club*” or “*From a little ideas shop in Bognor Regis*”.

It’s a tricky question for fund managers too. It’s quite striking how many investor-written books spend a lot of time on ‘what I look for’ but very little on ‘how I look for it’; how many pitch books feature funnel diagrams that seemingly effortlessly convert the investable universe into a portfolio; and how many process documents simply tally company meetings. I admit we have done all of these in our time, but we owe you a better answer, especially as our qualitative approach doesn’t lend itself very well to simple screening.

Gaiman’s better answer, which proved unpopular with his readers, was “*I make them up. Out of my head.*” I have to confess that many years ago I was part of a pub-fuelled effort to invent a stock to present at an outgoing CIO’s last investment meeting, one that would incorporate all his least favourite elements, push all his buttons. But investors can’t just make stocks up, which means that writers who deal with the world as it is rather than conjuring new worlds may be more helpful for our purposes. Michael Lewis, author of *Liar’s Poker* and *The Big Short*, has answered the ideas question by saying, “*I bump into a lot of stories one way or the other, reading the newspaper, meeting people, and wandering around. I usually start with some small curiosity.*”

And there you have it. If you want the short version of what follows, reading, people, wandering and curiosity will do pretty well.

It is striking how much emphasis some of the very best investors put on reading, most obviously at Berkshire Hathaway. Warren Buffett is said to read 500 pages a day; Charlie Munger has joked that, growing up, his children thought he was “*a book with a couple of legs sticking out*”; and their younger protégés Ted Weschler and Todd Combs have said that they spend the majority of their time reading. Sometimes reading produces investment ideas directly: I came across Constellation Software after reading a profile of its CEO, Mark Leonard, in the Canadian newspaper, *The Globe and Mail*. But more often it provides background awareness – the histories of A&P, Walmart and the other leading retailers of their day help shape our understanding of, and questions about, retail today, for example, while reading about scientific developments, both current and historic, helps us to assess disruptive technologies as potential investments.

Another potent source of ideas is other people. Phil Fisher was an investor and writer who is widely credited with convincing Buffett of the value of growth. He was also notable for his ‘scuttlebutt’ style, cultivating a network of experts, both academics and executives, who could inform his investment choices, and interviewing suppliers and competitors to deepen his research on individual ideas. But when he came to analyse the origins of these ideas he was ‘astonished’. Only one-fifth of those worth pursuing and only a sixth of his eventual investments came from his carefully assembled expert network. The rest, and therefore the great majority, came from other growth investors he had come to know and respect over the years.

We also collect like-minded rivals. Researching the holdings of investors who had been quicker than I was to appreciate the virtues of Constellation led me to a handful of interesting, entrepreneurial Canadian mid caps that may feature in the portfolio one day. Other teams at Baillie Gifford, with higher growth approaches than ours, have found networks of experts a more fruitful source of ideas than Phil Fisher did. But whether your networks are investment-focused or not, and whether they are composed of people you’ve only met through their writings or those you know in person, the key thing is that they should be as broad as possible.



A likeness of Warren Buffett, made entirely of Duracell batteries at the Berkshire Hathaway Inc. Annual General Meeting.

© Bloomberg/Getty Images.

Wandering is hardly the sort of activity that will feature in the process description of any manager who wants to be seen as serious, rigorous and respectable and it can often look like wasted time in retrospect. But it's very important. Amos Tversky, the great psychologist and behavioural economist, believed that *“the secret to doing good research is always to be a little underemployed. You waste years by not being able to waste hours.”*

We need to wander in our reading – Berkshire's Weschler says that he tries to make half of his reading 'random', by which I think he means material not obviously directly related to investing and that may later seem like wasted hours. We also need to wander in our personal networks – there is a good deal of evidence that it's our most peripheral contacts, our most distant friends and colleagues who help us to our most interesting ideas because they're most likely to tell us something we don't already know. Mark Granovetter, the sociologist, has called it *“the strength of weak ties”*.

But a more literal wandering can also generate ideas. Peter Lynch, the renowned former manager of Fidelity's Magellan Fund, wrote that:

I talk to hundreds of companies a year and spend hour after hour in heady pow-wows with CEOs, financial analysts, and my colleagues in the mutual-fund business, but I stumble upon the big winners in extracurricular situations, the same way you could...



Indeed he believed that the average person would come across two or three good prospects a year this way. He himself wandered around mostly in his Volvo (naturally he bought the stock) visiting restaurants and retailers along the way – he bought Dunkin Donuts after developing a taste for the coffee and Taco Bell after a good burrito. And famously his wife also brought him ideas: he made six times his money in Hanes after Mrs Lynch told him about their L’eggs brand of tights.

ASOS

This sort of direct personal experience still works and has helped put stocks into the portfolio – one of our investors began to be interested in Discovery after signing up for their innovative Vitality health insurance product; while another started seriously researching Hargreaves Lansdown, the online investment platform, after finding it was the only effective solution to his personal investing needs. Sometimes the inspiration is a little less direct: one first became interested in ASOS, the online fashion retailer, when he noticed the increasing number of their parcels arriving in the office.



Such origin stories are vivid and fun, but focusing too much on the lightbulb or eureka moments can lead us to miss the crucial importance of the underlying attitudes and structures that allow them to happen in the first place and the disciplined effort that brings them to fruition. For, as Steven Johnson has written in *Where Good Ideas Come From: The Natural History of Innovation*, while we all love ‘the narrative thrill’ of epiphanies, true moments of inspiration are the exception and new ideas are more often the product of what he calls “*the slow hunch*” which is “*much harder to convey*”. This is probably even more true of an experienced Portfolio Construction Group working within a large and long-tenured investment department: ‘new buys’ are rarely genuinely new to us, more often old friends that we now see in a slightly different light because their opportunities, management or valuations have changed.

At the heart of all of this is what Michael Lewis called “*a small curiosity*” by which he means an unresolved question that begs to be answered. But even before that comes the key attitude, a big curiosity, one of the most important attributes we look for in our entry level investors and the source of one of our key taglines, ‘Curious about the world’.

Curiosity and wandering around, however, are of limited use without some focus, without some sense of purpose and this is provided by our investment philosophy which looks for above average growth founded on and backed by competitive advantages, strong finances and aligned and capable management. One of the things that caught our attention in the Mark Leonard profile was Constellation’s unusual, highly aligned compensation system: no options but mandatory minimum shareholdings bought with executives’ own money.

Many ideas simply don't lead anywhere useful. Daniel Kahneman, the Nobel laureate behavioural economist, has written that:

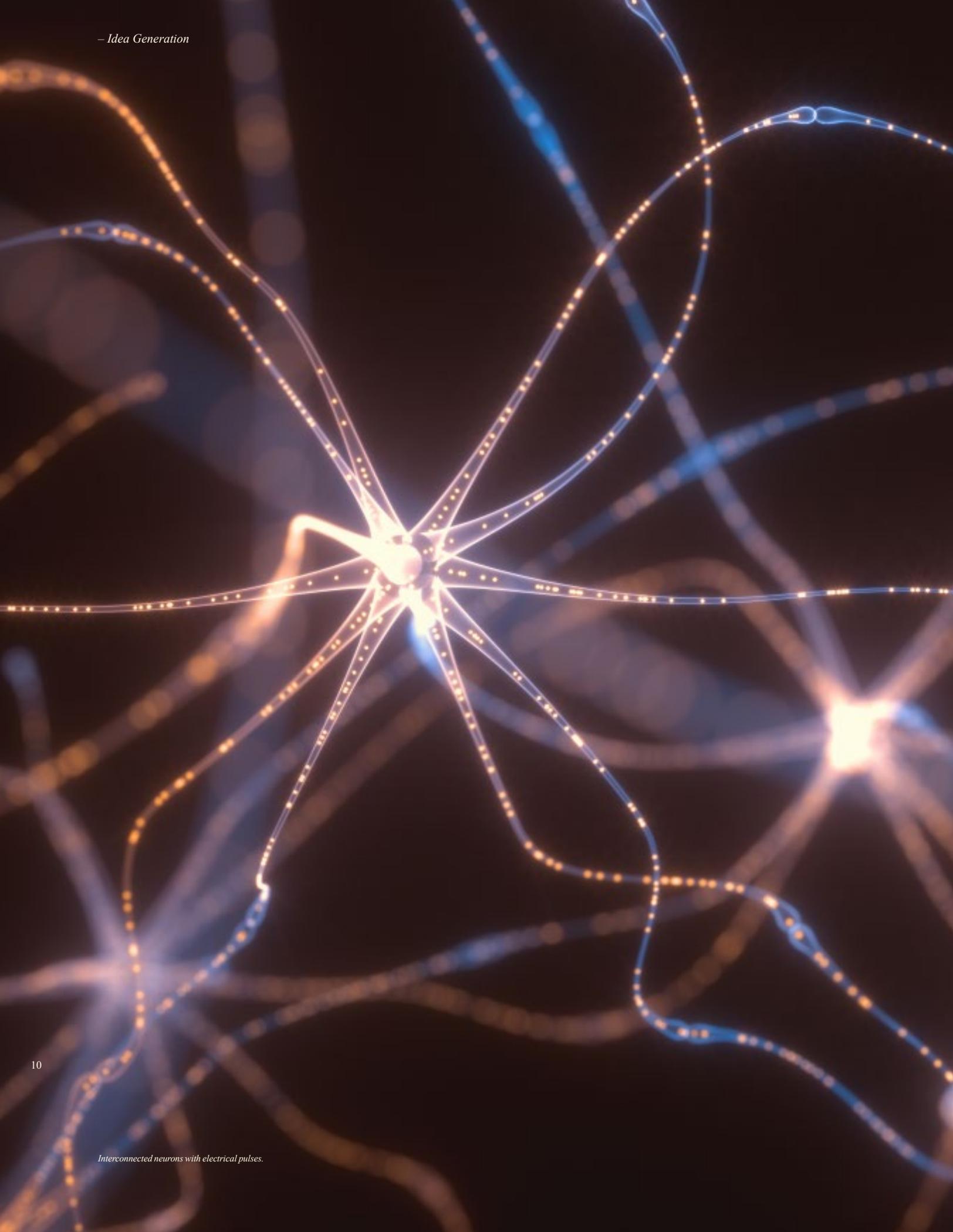
I've always felt that ideas were a dime a dozen. If you had one that didn't work out, you should not fight too hard to save it, just go find another.

But, equally, the good ideas need a lot of work. Vitality isn't a standalone company, but rather part of the life insurance division of a broader financial conglomerate. Will others be able to copy the product? Will stagnation or contraction in other parts of the business overwhelm Vitality's success? Will further diversification at the quoted company level destroy value? All these questions needed to be examined before Discovery was bought, and we continue to monitor and investigate them.

The Baillie Gifford International Equity Fund
Top Ten Holdings at 31 March 2019

Holdings	Fund%
1 TSMC	3.42
2 MercadoLibre	3.39
3 SAP	2.79
4 AIA	2.75
5 Rio Tinto	2.67
6 Deutsche Boerse	2.23
7 Samsung Electronics	2.18
8 Alibaba	2.16
9 Nestlé	2.12
10 Edenred	2.06

It should not be assumed that recommendations/transactions made in the future will be profitable or will equal performance of the securities mentioned. A full list of holdings is available on request. The composition of the Fund's holdings is subject to change. Percentages are based on securities at market value.



Coming full circle, Neil Gaiman finally gave his best answer to the ideas question when he was invited to give a talk to his seven year old daughter's class:

*“You get ideas from daydreaming.
You get ideas from being bored.
You get ideas all the time...”*

“You get ideas when you ask yourself simple questions. The most important of the questions is just, What if? ...”

“Another important question is, if only... and then there are the others: I wonder... and if this goes on... and wouldn't it be interesting if...”

Often ideas come from two things coming together that haven't come together before.

Curiosity, questions and time to think.
That's where ideas come from.

CURIOUS ABOUT THE WORLD

bailliegifford.com/thinking

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