SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 11

WHY THIS CRISIS FAVOURS GROWTH STOCKS

MB Malcolm Borthwick

TS Tom Slater

MB Hello and welcome to *Short Briefings on Long Term Thinking*, thanks for joining us. I'm Malcolm Borthwick, managing editor of Intellectual Capital at Baillie Gifford.

When something is cheap we often think we've found a bargain. The same goes for stock markets. When markets fall, many investors look for value stocks such as BP or Barclays, which they think are trading below their true value. But during the coronavirus downturn, growth stocks have tended to be more resilient. These are companies such as Amazon or Alibaba, which have more growth potential. And to discuss why, I'm joined by Tom Slater, joint manager of Scottish Mortgage Investment Trust.

But before we start, here's some important information. Please remember that as with all investments, your capital is at risk, and this podcast is being recorded while we're in lockdown, so we're both at home and not in the studio.

Tom, let me start with asking you about growth companies, and why they've tended to be more resilient in this downturn.

TS Well, I think there are several strands to that. The first is that the types of growth companies we're interested in; the ones that are bringing new approaches to existing industries, that are changing the way that we interact socially, that are changing the way we work, are absolutely essential tools in dealing with the current environment.

If you can't go out and meet people face-to-face, then you want to use consumer internet technology companies to socialise. If you can't go into the office to work, then, I think, the tools of remote working become really important to you. I think you also see an acceleration of some of the big trends that have been driving these changes.

To take one example, the online furniture retailer, Wayfair. We've seen furniture purchasing moving increasingly from physical stores to online. Now, in the current recessionary environment, furniture purchasing has collapsed for the market as a whole. But, because online was a relatively small share of that market, and because it's really the only place you can shop now, Wayfair has seen an acceleration in demand for its services. So, the broader economic conditions were not the main driver of that business. The main driver was the move from offline to online, and that has really been accelerated.

Another part of it is that the traditional, in inverted commas, 'cheap industries', where people have often turned to find bargains in these types of environments, have actually proved to be not at all resilient. The oil price has collapsed, so all the energy stocks have been under real pressure. People have learned some of the lessons from the financial crisis in 2008/2009, and so banks and the financial sector have not been a safe haven in these times.

So, it's a combination of the types of growth companies that we invest in helping to be part of the answer to the current crisis, and also the traditionally, in inverted commas, 'cheap' type companies really not delivering for investors at all at the moment.

MB And do you think that the structural changes which are being accelerated will stick?

TS I think that most of the extreme measures we're taking at the moment, to deal with these exceptional conditions, will not persist beyond the end of lockdown. But I think that there are lots of trends, which we were seeing anyway, whose prevalence will have been significantly increased. One example of that has been the explosion of demand for Zoom video calls.

Now, the video conferencing market is one that's been tiny for years, because the equipment was very difficult to use, and the experience was really poor. Zoom has transformed that experience, made it straightforward to use, and has been seeing rapidly growing acceptance in the enterprise market. With what's happening, we've seen an explosion in demand for services. But post-lockdown, as you start to see things moving to a more normal framework in the future, I think people who've become much more familiar with the service will start to say, "do I need to travel in person for this meeting or could I do it via Zoom?".

And so, you accelerate that trend which existed beforehand, but it doesn't become the new normal.

MB And how is this crisis similar or different from other crises you've seen

TS I think the premise of the question is quite an important one. It's not that being a crisis is something that is especially exceptional. Indeed, these sporadic crises in financial markets are what investors should expect. So, the question is, what are the similarities, what are the differences? I think one of the big differences, this time around, is that it's a much deeper and more sudden decline in economic activity.

We haven't, as a society, shut down the economy voluntarily before, but that's what's happening at the moment. I think what's going on currently is much more important than trying to predict what's going to happen, because it's inherently unpredictable. You've had a completely new phenomenon impacting a complex system. Anybody that can tell you definitively what is going to happen is lying. So instead of trying to actually predict the path from here, we focus much more on, "are we investing in companies that are flexible, that are resilient, that can be robust to the circumstances that are being thrown at them?"

And the other thing that's really important is that, in times of stress, the companies that are winning, that are dominant, that are powerful, tend to get more powerful, because their competitors are going to be struggling from a financial perspective. They're going to be focused on how to raise finance, how to cut costs. And what you often see is that the winners actually get stronger, or their advantages accelerate through these times of stress.

So, can you find companies that are robust and resilient no matter what the outcome? Because we don't know what the outcome is going to be. Can you find those companies that, relative to the other companies in their industry, are likely to become more powerful through these times of stress?

MB And do these situations help to clarify, maybe even further support the investment case of why you invest in these companies in the first place, and maybe force you to reassess companies that you also hold in the portfolio?

TS I think it's a really interesting prompt to test your conviction in an investment case. Have events been playing out as you hoped? Is the company doing what you wanted? Because when you go into a period where capital becomes much more scarce, you want to make absolutely sure that your capital is invested in your highest conviction ideas. But you also want to be investing in the companies that you think are able to contribute positively to society through these difficult environments. You want to be investing in the companies that are going to come out of this stronger.

So, take Amazon as an example. People are becoming increasingly reliant on their services to get access to basic goods and services. If you are unable to get out of the house, to go to the shops to buy basic necessities, their service can be a real lifeline. They've gone out and recruited 100,000 new employees in the US, they've pushed up wages for their employees during this period, and that's enabled them to service the increased demand that they're experiencing. They're prioritising away from their full selection of goods and focusing on essential items.

Those are exactly the things that as a society we're wanting them to do through this period, and they are exactly the sorts of things that a company with their balance sheet strength, their position in the market, ought to be able to deliver, to be part of the solution to what we're experiencing.

MB And this is something that you look at as part of your investment process, isn't it, Tom, in terms of how companies are benefiting society?

TS I think that when you're trying to analyse a company, having a clear sense of why it exists is really important. Companies that set out only to make money for shareholders are rarely effective at actually achieving that aim. Really, you're looking for companies that are creating value more broadly. Are they creating value for their customers? Do they help their customers get things done that they want to achieve?

And how you define customers, I think, has to more broadly encompass what's good for society as a whole.

And so, thinking from the point of view of all stakeholders in the company, not just shareholders, is really important. Particularly when time horizons and financial markets are so short. If your shareholders on average own your shares for a very short period of time, you will be optimising for what they want the company to do. Instead you ought to be optimising for the long-run value creation for the stakeholders.

So, thinking about not just shareholders, but the broader set of interests of other parties is really, really important.

MB And you're also investing in a number of healthcare companies that are directly involved in finding a solution to the coronavirus. Tell me more about that.

TS We think that there's some really interesting long-term trends in healthcare. One of those, in particular, is the vast acceleration in our understanding of the genomic and molecular basis of disease. And so, we invest in some companies that are trying to take that greater depth of understanding and apply it in areas that either have not seen as much research historically as they ought to have; or where we think that the chances of being successful have been significantly increased by our greater genomic and molecular understanding of disease.

So, one of those examples, would be Vir Biotechnology. This is a company that Scottish Mortgage bought when it was a private company, and then it subsequently listed on public stock markets. What they're trying to do is develop vaccines and treatments for infectious disease. So, in a sense, it's a company that was set up with the current environment that we're experiencing in mind.

They are one of the companies that are absolutely on a path trying to find vaccines and treatments for the coronavirus. They've been very active in the past few weeks in signing partnerships that will enhance their capability to produce antibodies and treatments, and I hope they will be part of the solution to the crisis that we're currently experiencing.

MB And up to 25 per cent of Scottish Mortgage's portfolio is potentially invested in unlisted companies, or private companies. How are these valuations reflected in the portfolio?

TS The private companies in the portfolio, under normal circumstances, are valued on a three-monthly cycle, looking at the events and the financial results coming from the company, and also comparing that company to the valuation of its listed peers.

But in between those three-month points, a trigger for looking at the valuation can be significant developments. The very dramatic swings in the markets that we've seen absolutely fall into that category of significant developments, because you've seen such a rapid change in the valuation of listed peers. In those circumstances we revisit the valuations of our private companies.

And so, they will be adjusted to reflect current market conditions. We capture, on a real-time basis, the significant moves in markets and the valuation of our invested companies. The accounting basis for the valuation of those companies is our best estimate of the price of what the stock in that company would change hands at today. So, they're current valuations, they're not historical values, they're not stale valuations. The net asset value that we publish on a daily basis reflects our best estimate of what the price of those companies would be today.

MB And who decides what that estimate is?

TS There is an unlisted valuation committee within Baillie Gifford, none of the investors sit on that committee, it's independent of our investment function. They employ third party valuers to value the stocks, and they review those valuations and decide whether or not to accept them. That committee reports into our valuation committee. And that valuation committee, ultimately, for our investment trust clients, reports to the audit committee of the board.

MB How has the environment of working at home affected how you approach things, in terms of how you analyse companies and everything else? Has it made much difference?

TS It's made no difference. The way we work is to think about the long-term prospects of companies. And there's really no particular place that it makes sense to do that from. What's important is to get a diverse set of sources of information. To learn from experts, either at companies or academia or in the fields that you're interested in. To take your time making decisions, away from the noise and hysteria of markets. And none of those things are really affected by whether you're working from an office environment or a home environment.

MB That's a good place to end it, Tom. Thanks very much for joining me in the podcast, and I hope you'll join us again soon.

TS Thank you.

MB And you can find our podcast *Short Briefings on Long Term Thinking* at bailliegifford.com/podcasts. And you can subscribe at Apple Podcasts, Spotify and TuneIn. And if you enjoyed the podcast please spread the word. If you'd like to find out more about Scottish Mortgage Investment Trust and read the managers' thoughts about the next generation of companies shaping the future of food, health care, advertising and manufacturing, check out scottishmortgageit.com. That's 'IT' as in investment trust.

And many thanks to Lord of the Isles for the music. The track we've used is called *Horizon Effect*, which was released on Permanent Vacation. Until next time.

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