# EXTREME RETURNS

At Baillie Gifford we generally prefer our research to appear irrelevant. The further it is from being a direct debate about the merits of a company as an investment the happier we tend to be. Much of the most valuable research is deeply indirect in its investment implications and surprising in its eventual impact.

***The value of an investment and any income from it is not guaranteed and may go down as well as up and as a result your capital may be at risk.***

But occasionally direct assault has its virtues. This particularly applies to academic input. It can have the ability to stand outside the moment. It certainly has the ability to free itself from the preconceptions, self-interest and necessary operating dogma of practitioners and industry insiders. The very absence of skin in the game can be a virtue. Radical reappraisal is possible. Sometimes external authority gives the necessary evidence and context to build on uncomfortable and unexpected rumblings of our own.

Such has been our experience of working with Hendrik Bessembinder of Arizona State University. In early 2017 Professor Bessembinder released his initial drafts of a paper entitled *Do Stocks Outperform Treasury Bills?* The title itself is heretical. It is a central assumption of Modern Portfolio Theory that because equities are riskier they must have higher rewards. But Bessembinder showed that "slightly more than four out of every seven common stocks have lifetime buy-and-hold returns, inclusive of reinvested dividends, of less than those on one-month treasuries.

"When stated in terms of lifetime dollar wealth creation, the entire gain in the US stock market since 1926 is attributable to the best-performing 4 per cent of listed companies."

If this is right then our task is transformed. Our job is solely and simply to find and invest in the stocks that are capable of producing the extraordinary returns of the 4 per cent. So what characteristics might the companies need to produce these returns? What attributes in turn do we need to hope to identify them? As Bessembinder writes, "The returns to active stock selection can be very large. If the investor is either fortunate or skilled enough…". So the natural course of affairs was for us to build a relationship with the Professor so that we could learn how to become skilled (or lucky). In March of 2018, James Anderson and Tom Slater, joint managers of Scottish Mortgage Investment Trust, travelled to Tempe, Arizona to discuss these matters with Professor Bessembinder.

The two main areas of research that they agreed to work with the Professor on at this early stage are focussed on expanding data to the rest of the world, and trying to find common factors

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behind both the 4 per cent of the companies that have created all the return and the even more remarkable 90 companies (out of over 24,000) that have contributed half the wealth created in US equities since 1926. It’s this question of how to identify the qualities that have made these companies so successful, that has begun to unearth potentially crucial insight. It looks as if there could indeed be common factors behind the brilliance. Although many stocks with the most stellar returns now appear ex-growth (Exxon Mobil) or once mortally wounded but now surgically reassembled (General Motors), at the start of their lives they were all participants in markets that would become very large and they entered, if not first, then at early stages (this has been the case from Exxon Mobil to Google). As these names indicate, titanic founder-owners or at least missionary leaders are the enduring pattern.

An assemblage of FTSE 100 style companies boasting chief executives with three-year tenure does not feature. Moreover, these companies have not been run with slide rules or their ancient and modern equivalents. They are companies that acknowledge doubt and embrace emerging opportunities.

Now in a sense much of this is predictable, even if it’s more acute and structural than James Anderson and Tom Slater surmised. What is more striking and even more exciting is the attributes that the Professor believes investors in their turn need to possess to identify the truly great potential companies. Just like the company founders themselves, he thinks the skills we need are centred on dreaming of a grand future, backing great people and coping with ups and downs.

His explication seems to run very counter to the perceived market wisdom. It certainly casts doubt over the strong preferences of most investors for predictability and certainty. But still more, his perceptions indicate that our job is much more about the imagination of the future and the qualitative assessment of leadership skills than about the hard analytic numbers and confident financial mastery. So the hope – or inspiration – that Professor Bessembinder provides to us is that as our financial industry marches firmly and unanimously up one hill, we should be running determinedly in the opposite direction. If we are right, that is a compelling competitive advantage.

But there’s one last essential to the Professor’s current thinking. Identifying the great investments isn’t enough. As Hendrik Bessembinder makes plain it is the long-term compounding of their share prices that matters. This seems to us to require an additional set of skills such as the creativity to imagine greatness discussed above. The compelling urge amongst ordinary humans for sure, but far more damagingly amongst that odd sub-breed that are fund managers, is to take profits and lock in performance. As the old saying goes: ‘it’s never wrong to take a profit’. We believe it is often not just wrong, but the worst mistake that can be made. ■

### S&P 500 Annual Past Performance to 31 December each year (%)

| 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|
| 13.7 | 1.4 | 12.0 | 21.8 | -4.4 |

Source: S&P. Share price, total return in US dollars.

Past performance is not a guide to future returns.

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