Investing for the Long Term

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This article looks at the background to Baillie Gifford's style of investing. In particular, it looks at our long term, low turnover approach. It considers four factors that underpin our thinking: investing in high quality growth companies, keeping our trading activity low, not selling shares "short", and maintaining a long term approach.

Invest in attractive businesses

At Baillie Gifford we think that the best investments are companies with above average growth rates. We believe that, over time, these companies are rewarded with share prices that outperform.

To identify attractive investment opportunities, we look for businesses earning high returns on capital and with above average growth prospects.

We do not focus on the short term fluctuations of share prices, but we do think we can apply our investment process and a bit of common sense to identify above average businesses. If we can buy these businesses at attractive prices then we feel we will be well placed to deliver performance to clients over the medium term, which we consider to be three years.

Nor do we let macroeconomic issues cloud our decisions about investing in attractive companies. Despite all the major macroeconomic events of recent decades — oil price shocks, devaluations, stock market crashes, emerging market contagions — long term investments in strong businesses with attractive prospects have generally proved to be very good for clients.

As we have no control over external events, we would not wish to postpone the purchase of shares in an attractive business with excellent long term prospects because of short term macroeconomic worries. We believe it is more important to get the pricing of an investment decision correct, than the timing.

Keep trading to a minimum

We expect to add value for clients by identifying and backing attractive businesses at attractive prices. We do not believe that our competitive advantage lies in regularly trading in and out of shares.

In fact, we think that excessive trading quickly takes a toll on portfolio returns. Consider a pension scheme that pays 0.40% p.a. in management expenses (to fund managers and consultants). If we then assume that this scheme has annual trading turnover of 60% (which is around the industry average) and is subject to broker commission of 0.15% on each transaction plus 0.5% stamp duty on all purchases, then the scheme has another 0.40% or so of expenses.

However, these costs are small relative to the impact that dealing can have. Trading institutional money of any size has an effect because fund managers' purchase and sale orders affect the market price of assets: independent measurement firms call this effect "market impact" — it comprises bid/offer spreads and the typical price movements of assets as they are bought and sold. This is typically 100bp for both purchases and sales — so continuing with our assumption of 60% turnover, we can add another 1.2% p.a. to a fund's running costs.

So it is not difficult to see how the annual costs of a UK equity portfolio can quickly add up to 2%: 0.4% of management fees, 0.4% to stockbrokers and the chancellor, and 1.2% in market impact costs. Roughly 80% of these costs are directly related to the level of trading in the portfolio!

These costs make a huge impact on the long term returns of pension schemes. A 6.0% real return from equities over 30 years will lead to the scheme growing in value by 5.7 times — as Keynes said, "Compound interest is the 8th wonder of the world."

However, take out 2% p.a. running costs and that multiple drops to 3.2 times — over 40% of the value of the scheme is eroded by running costs. For schemes with higher than average levels of turnover this effect obviously becomes more dramatic.

In summary, we think it makes sound economic sense to keep portfolio turnover to a minimum. We also think it makes good investment sense. Frequent trading simply increases the chances of our making a mistake. The longer we hold on to our favoured

holdings, the more the underlying performances of the businesses will drive the performance of their share prices and therefore our clients' returns—and the less it will matter whether or not we have managed to finesse the purchase of the stock in the first place.

Our job is to try and buy attractive businesses at sensible prices. We then need to monitor the holdings to ensure that the properties we like are being preserved. We think there is something in Warren Buffett's description of his approach to investing in a recent annual report for Berkshire Hathaway: "Inactivity strikes us as sensible behaviour."

Take a long term perspective

We have also considered whether it makes sense to try and identify companies with below average prospects and to try and capitalise any weakness in their shares prices. This can be done by "selling short", which is done by borrowing shares in order to sell them, in the expectation of being able to buy them back at a lower price (thereby making a profit). Short selling is often employed by hedge funds and forms of alternate investments, and is usually linked to strategies that attempt to deliver attractive absolute returns (rather than trying to outperform an index).

We think that "shorting" shares is very different to investing in companies on a long term basis, and that our investment process does not work "in reverse". There are a number of reasons for this, including the following:

- We would need to have specific views on which shares we expect to fall. Aside from the speculative nature of predicting short term share price movements, businesses that we don't think are particularly attractive will not always have falling share prices—especially if the market as a whole is rising.

- In order to successfully "short" shares, we would need to apply extra resources to analysing these unattractive businesses. We would rather use our resources to focus on long term winners.

- There are also potential internal conflicts: would it be appropriate to take a short position in a share which might also be held for other clients. How would we reconcile these issues equitably for all clients?

At Baillie Gifford we have recognised that there is demand from clients for an investment approach that can deliver absolute returns, without the added complications and costs of selling stock "short". To meet this demand we have introduced a "Global" team to complement our other regional equity teams. The Global team's portfolios share many of the characteristics of other Baillie Gifford portfolios: concentrated holdings (fewer than 60 stocks) and turnover is expected to be low. The key difference is that the portfolio is run without any regard to an index. So each holding will reflect the team's conviction about that stock in an absolute sense.

Long term investing suits our style

In addition to believing that a long term approach is the best way to generate above average returns for clients, we think that our internal structure also helps to promote this style.

The continuity of people in our investment teams enables us to maintain a consistency of analysis over time. It also means that we can build up a rapport with company managements. Staff continuity also results in very careful decision making processes: investors to have to account in the future for their investment decisions made in the past.

As a firm, our only source of revenue is the fees we derive from our clients. So we are well motivated to make the best possible investment decisions: we only do well as a business if our clients are happy with our performance and service. Our partnership structure enables us to take decisions which should benefit clients in the long term, rather than leading to short term decision making.

Our investors' remuneration is linked to their performance with an emphasis on returns over rolling three-year periods, in line with the objectives of most of our clients.

It is also worth considering the many surveys that show that even the best fund managers tend to underperform an index on average one year in three. Indeed, it strikes us as odd that so much emphasis is put on short term annual returns when it has been so apparent in recent years that stock market volatility can lead to such wild divergences in value for periods of over a year. We recognise that investment returns can be lumpy and are prepared to ride out underpeformance in the short term in order to achieve better long term performance for our clients.

Conclusions

We believe that it is in the interest of clients to make investments in sound, long term businesses. Frequently trading portfolios merely adds extra layers of cost to a client, and detracts from the long term perspective. Baillie Gifford's structure is well suited to long term investing and our interests are aligned with those of our clients. Lastly, it is really important to keep it simple: invest in profitable growth businesses and allow the laws of compounding to do the rest.

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