Long Term Global Growth

Reflections

First Quarter 2023

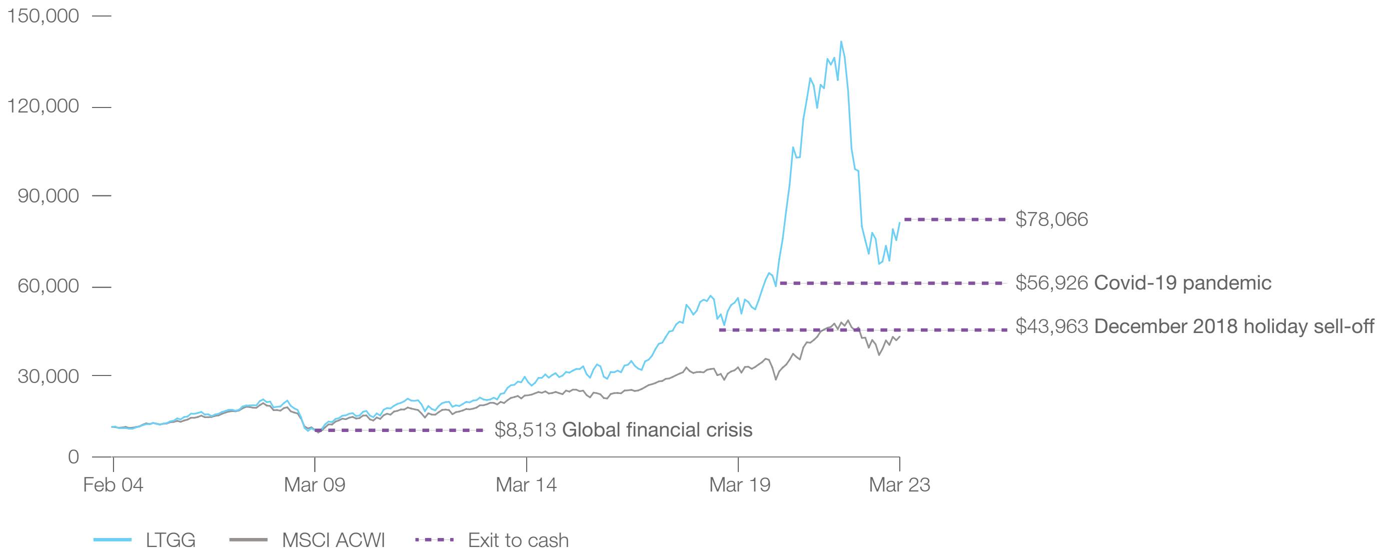
The Oscars season

Everything Everywhere All At Once. The Oscars season has come and gone. The sci-fi multiverse adventure starring Michelle Yeoh and Goonies star Ke Huy Quan dominated, winning seven statues. You could be excused for thinking that the title better describes what investment markets have attempted to digest in recent years – a global pandemic, war, rising rates, and elevated inflation, to name a few. We know markets dislike uncertainty, and fleeing to perceived safety may provide some understandable comfort. However, you only benefit from the upward trajectory of equities over the long term by staying invested. As the last instalment of this letter reminded us, form is temporary; at some point, the market will begin to entertain future possibilities rather than seek solace in short-term probabilities. It is early days, but the portfolio is back on the front foot, posting double-digit relative returns after a buoyant start to the year.

The Chimp Paradox

Professor Steve Peters eloquently explained our behavioural tendencies in his book *The Chimp Paradox*, exploring the tensions between our brain's rational and irrational parts – the 'computer' and the 'chimp'. The chimp brain is highly emotional, you can manage it, but it can sometimes take over. When share prices drop precipitously, the chimp demands your time, but the computer needs to remain centre stage. We get excited by flash sales when shopping on the high street but not in the stock market – a sign our chimp is taking over. As the value of a $10,000 investment in Long Term Global Growth (LTGG) shows in the chart below, exiting can prove costly. Our chimps were on red alert during the financial crisis in 2008, but most of our clients stayed the course – and just as well because that period now looks like an inconsequential blip following over a decade of progress.

Patience is rewarded



$10,000 investment from the inception of LTGG.

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The growth investing movie

The tone of the growth-investing movie purveyed by the market remains sombre. The script goes that:

Inflation is high and could be prolonged, so companies will struggle to handle spiralling costs. Interest rates are rising, which doesn't help growing businesses. Future earnings are worth less, so I wouldn't say I like their prospects. Growth businesses need a healthy economy and new markets to explore, but we are in a recession. Worse still, rising rates mean the cost of capital is increasing. These financially frail and unprofitable companies will not survive, or growth will underwhelm if they do. This doesn't look good; get me out of growth!

This is a caricature, but some concerns are valid from a market perspective. High inflation hampers company progress if costs spiral and spending is truncated. But what if the business can easily pass costs on? A rising cost of capital hurts firms that rely on debt to fuel growth, but what if the company is self-financing? Demand will weaken during a recession. But what if alternative ways exist to grow without a healthy economy or global expansion? Some companies will struggle or perish altogether as free-and-easy capital is withdrawn. But what if their financial position is more stable than first thought? As we wrote in a recent monthly reflection, the market doesn't differentiate in the short term. Instead, "At night, all cats are grey". So runs the aphorism variously attributed to John Heywood's 1547 book of Proverbs and Benjamin Franklin, and the current growth-investing movie is on a night shoot.

Fact or fiction?

Luckily, we don't have to invest across a broad asset class or style. We are highly selective, so the growth movie above is more fantastical fiction. Exceptional businesses hold their destiny in their own hands. Luxury goods company Hermès typically raises its prices by 2 per cent yearly. But it passed on c.8 per cent price increases this year to reflect the cost environment. Demand for its sought-after Kelly and Birkin bags remains constant.

Shopify has increased platform prices for the first time since 2006. Given that the customer proposition has broadened and deepened extensively since then, most merchants see this as a fair exchange. Tesla is going the other way by reducing prices. Musk said on a recent call that he was keen to test the elasticity of demand for Tesla's vehicles, and the results have been positive. Accelerating the advent of EVs won't happen if its cars remain unaffordable and its superior margin structure can more than handle it.

Similarly, if companies can become the new infrastructure of the global economy, macroeconomic pressures will have less impact on their prospects and could enhance them. Instead of physical roads and railways, it is the infrastructure and plumbing of the digital world we are excited about. ASML, NVIDIA and Amazon have already become infrastructure, making their competitive positions harder to displace. Several other companies in the portfolio, like Cloudflare, Adyen, The Trade Desk, Shopify and Moderna, are vying to join them. Many companies drive or benefit from continued deflation through the relentless fall of computing, gene sequencing, and renewables costs. Deflation is not something market commentators are considering, but it will surely cause more creative destruction in the coming decades.

So, what is our advantage during volatile periods like this? Our long-term view. So be it if we are out of step with the market for periods. We have outperformed only 70 per cent of rolling one-year periods since 2004 but 98 per cent of all rolling five-year periods. Mispricing is an opportunity, but our loss-aversion tendencies can swamp our rational minds. In 1979, the front cover of *Business Week* proclaimed, "The Death of Equities: How Inflation Is Destroying the Stock Market". What happened next? A sustained bull run for 20 years. We must be wary of how often we listen to our chimp.

Financially frail?

A criticism often aimed at growth businesses is that they are financially frail. In the search for rapid growth, debt is accumulated, and cash is burned at an extraordinary rate, leaving companies in peril if interest rates rise. Is this a fair characterisation of LTGG? No. Over 80 per cent of the portfolio has positive earnings or cash flows, and two-thirds of the portfolio sits on net cash. By contrast, three-quarters of the index sits on net debt. For the portfolio holdings that are yet to turn profitable, our analysis suggests they have a healthy cash runway cushion which provides ample firepower for continued investment.

Strong cash generation and self-financing growth are precious in a rising-rate environment. Undisciplined companies are forced to withdraw from debt-laden spending given the rising cost of capital, leaving capital-efficient growers to take share. **As we wrote recently**, online gaming platform Roblox generated cash and was self-financing at a mere $100m in revenue, thanks to network effects powering organic customer acquisition. Jeff Green, the CEO of the programmatic advertising business, The Trade Desk, insisted on reaching profitability of just $7m in outside capital and has remained consistently profitable for eight years, growing revenue more than 35-fold while gaining market share.

However, we should acknowledge that the proportion of unprofitable companies in the portfolio has increased over the last decade. Should this be a concern? A complexity theory proponent, Professor Brian Arthur, has helped our thinking here. His work posited two economic regimes: a bulk-production world and a knowledge-based part of the economy. The first predominantly invests in tangible assets like machinery or property, and the other intangibles like customer acquisition costs, research and development (R&D), and software development. Over the last decade, our attraction to software and other technology-driven business models has tilted the portfolio towards companies with higher intangible investments.

Why does this matter? Tangible investments go through the balance sheet and are depreciated over their useful life, which helps to stabilise earnings over time. On the other hand, intangible investments often hide among R&D and selling, general and administrative expenses are expensed through the profit and loss statement in the year incurred, impacting earnings at once. Currently, LTGG companies spend three times more on R&D than the average index company, which leaves us with a distorted picture of reality. The profits of companies with significant intangible investments look worse than those with tangible investments, all due to accounting rather than operations.

Unsurprisingly, our currently unprofitable holdings tend to operate in the knowledge-based part of the economy. To illustrate, Shopify's investments in its software platform will reduce operating profit immediately, but if you were to treat these investments the same way you would machinery (so capitalise it on the balance sheet and depreciate over time), Shopify's earnings before interest and taxes over the last three years would be 17 per cent per annum better on average, in absolute terms, which would flip it into a healthy profit. Loss-makers are punished more severely when markets demand short-term certainty, but they are in much better shape than they seem.

Engines of change

Another mischaracterisation of the LTGG portfolio is that it relies on economic growth to prosper. The correlation between equity returns and economic growth is weak at best. Intel's share price rose 11-fold by the decade after its early 1970s as Moore's Law – coined in 1965 by Gordon Moore – helped herald the computing era. Although progress seemed steady, the share price still more than halved several times throughout that period, falling by 80 per cent at one point. There will always be periods when our chimp wants us to run for the exit.

A recent paper by one of our investors posited that there are more ways to grow than just expansionary growth driven by a healthy economy. Businesses benefit if they maintain share in a market where the overall pie expands. However, growth can be stoked by new types of supply within an inert opportunity set. Think about what is changing rather than growing, such as the shift to ecommerce, content streaming, or the ascent of electric cars. These markets didn't suddenly double in size, but alternative supply forms spurred a new form of disruptive growth. Recent new purchase Samsara targets businesses with physical operations, which already comprise 40 per cent of global GDP but remain less than 1 per cent penetrated across all its markets today. The case for another new holding, the American semiconductor company, AMD, is not predicated on rampant market growth but more share gains from a floundering competitor.

Similarly, our demand preferences can evolve. Think of our collective focus on environmental challenges around climate change, supported by regulatory changes. The 2022 Inflation Reduction Act in the US provides billions of dollars of tax credits to help electrify homes and encourage the purchase of electric vehicles. The Bipartisan Infrastructure Law will also help develop much-needed charging infrastructure. Tesla opening 7,500 superchargers across the US to non-Tesla EVs by the end of 2024 will create a groundswell of shifting demand. In China, peak emissions by 2030 and net zero by 2060 goals, twinned with EV sales targets and a home bias, provide a tailwind of demand for the industry. Entrepreneurs invent new forms of supply to address a new set of problems.

Deglobalisation

LTGG invests globally, but it is not a globalisation portfolio. Few investment cases are predicated on global expansion, and the Chinese-American exposures are primarily independent. We are aware of the evolving tensions between these two superpowers; developing technologies in competition with each other. This creates a dynamic, competitive landscape for western companies such as NVIDIA and ASML in advanced computing, Intuitive Surgical in robotics and Tesla in EVs. It also presents exciting opportunities for Chinese domestic players such as CATL in batteries, NIO in EVs and BeiGene in healthcare.

Meanwhile – for the time being at least – new premier Li Qiang seems keen to convey a pro-business stance, providing a near-term shot in the arm to the portfolio's Chinese holdings. We continue to monitor this dynamic closely within the portfolio. The downside risks have increased, so we need the degree of potential upside to compensate. In this vein, it feels right to have less Chinese exposure than in previous years, now sitting around 17 per cent.

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Embrace volatility

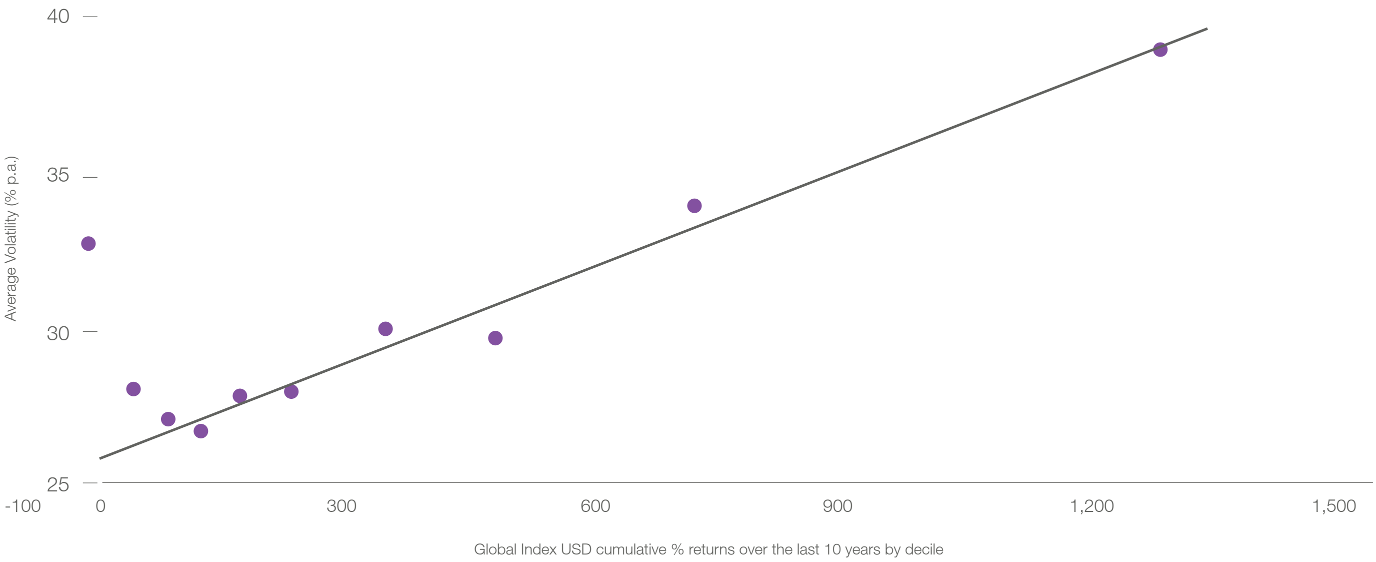
Running a concentrated global strategy for nearly 20 years has taught us not to expect linear progress. Would you want it to be? In a perfect world, yes, but our risk team recently found that the highest-returning stocks of the last decade have been the most volatile (see chart below). Although uncomfortable, volatility should be embraced. This makes intuitive sense. Investment cases driven by the change are inherently hard to value in the short term; they wouldn't be disruptive if they were easy.

In search of continuous improvement, we have been in a reflective mood, probing at what lessons we can learn from managing the portfolio over the past couple of years and longer.

Constructive conversations with our risk team on analysis around trading, correlation networks and drawdowns have been equally helpful. We will make sure to share views on these in due course. Competition for capital remains intense, and we look to move on from holdings that no longer make the cut, such as Salesforce. The two new additions of Samsara and AMD to the portfolio this quarter reflects the seeds of growth planted for the future. New ideas like Cognex, Joby Aviation, and On Holdings pique our interest.

Volatility risk

Highest returning stocks in the index are most volatile



Source: StatPro. In US dollars. As at August 31, 2022.

Conclusion

Given the state of investment markets in recent years, 'Everything Everywhere All at Once' is a fair summary of the deluge. Soon enough, though, 'nothing nowhere often' will be more appropriate as the noise fades away and fundamental progress is rewarded. Rate changes have already impacted share prices, and valuations on traditional measures languish below pre-pandemic levels – we are already seeing signs of performance progress since the start of the year. The truly long-term investor can take advantage of flash sales, but not many others do. Participating in the upward trajectory of equity returns over the long run is essential. Expect your chimp to rear its head now and again (recent banking issues are a case in point) but buying and holding great growth companies is a suitable remedy.

Important information and risk factors

Annual past performance to 31 March each year (net %)

	2018	2019	2020	2021	2022
LTGG Composite	8.4	10.7	104.4	-18.1	-18.1
MSCI ACWI Index	3.2	-10.8	55.3	7.7	-7.0

Annualised returns to 31 March 2023 (net %)

	1 Year	5 Years	10 Years
LTGG Composite	-18.1	10.5	15.2
MSCI ACWI Index	-7.0	7.5	8.6

Source: Baillie Gifford & Co and MSCI. Net of fees, USD. Changes in the investment strategies, contributions or withdrawals may materially alter the performance and results of the portfolio. All investment strategies have the potential for profit and loss.

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