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LESSONS FROM THE SONORAN DESERT

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All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk.

What an Arizona-based academic taught us about where growth springs from.

THE INITIAL EVIDENCE

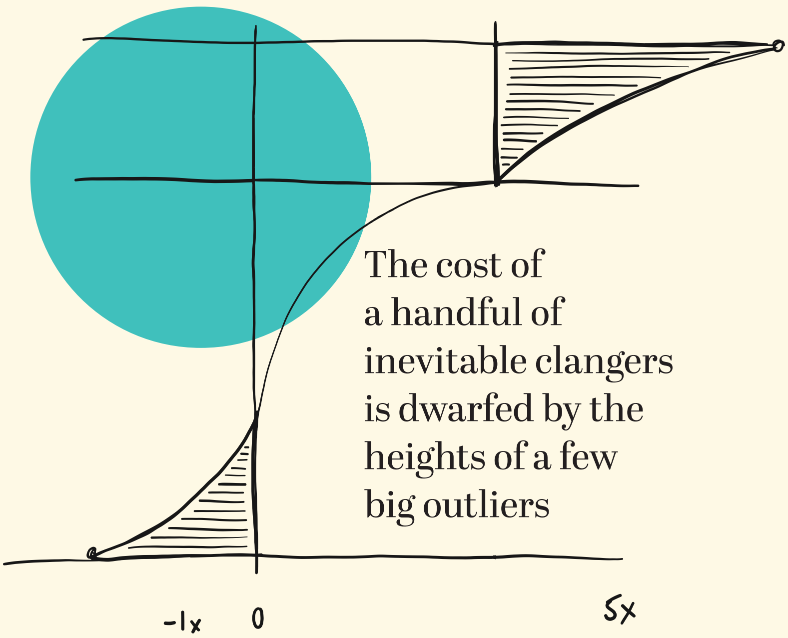
Back in 2014, we conducted some detailed empirical work on the pattern of returns in equities, using the US market as our dataset. One key observation was that the top five per cent of stocks in the US equity markets tend to be 'five baggers', investments that earn five times their purchase price, over rolling five-year periods.

For many years, our focus had been on finding the stocks that could grow many times over, but this elegant empirical finding was a helpful step towards establishing the five-bagger baseline for our growth hurdle. It also showed the importance of the large outliers. We didn't need to find many to drive strong client returns.

But a couple of niggling questions remained.

How could we be sure that this performance wasn't a temporary phenomenon?

Was there any independent evidence to back up our observations?



THE INDEPENDENT PROOF

In 2017, these nagging questions were addressed in a paper that was published without fanfare by a modest Swedish academic called Hendrik Bessembinder. Based at Arizona State University, he had analysed over 25,000 stocks between the years 1926 and 2016.

Collectively those stocks had generated net returns of around $35 trillion over and above US Treasury bills, but when Prof Bessembinder ranked them by return he found that:

58% of them had destroyed value, collectively posting a return around minus $6 trillion

Another 38% of them had made up for that value destruction, collectively posting a return of around $6 trillion

A mere 4% of them had collectively driven the entire net return, collectively delivering around $35 trillion between them

We viewed these observations as probably the most important findings we had ever encountered in equity investing. They were the first independent proof of the persistently extreme skew in US equity market returns over long periods of time. Just four per cent of stocks drove all returns, a fact completely overlooked by most of the investment community.

The paper was important and exciting, but there was another question: How could we be sure that this wasn't a US-centric phenomenon? We asked Hendrik to explore this important question further on behalf of Baillie Gifford.

FURTHER ROCKET FUEL

With our support, Prof Bessembinder embarked on a heroic feat of data collation. He built an enormous dataset containing the returns of over 62,000 companies, delivered between 1990 and 2018. He then spent months diligently crunching the numbers and in mid-2019 was ready to share these conclusions:

Collectively the 62,000 companies had generated net returns of around $45 trillion over and above T-bills, but when ranked by return, it was found that:

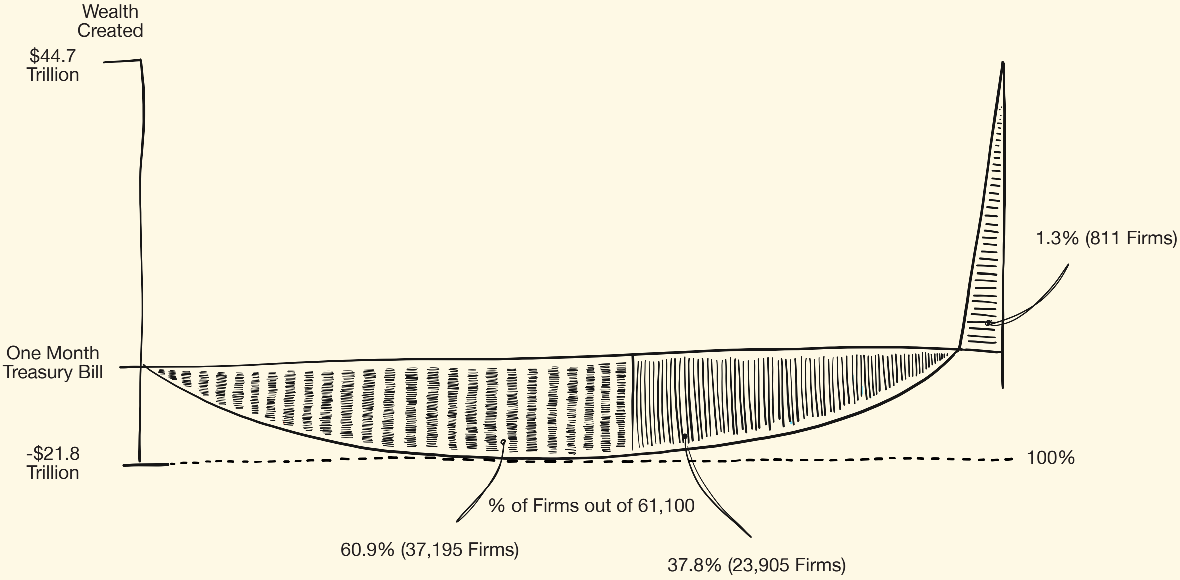
61% of them had destroyed value, collectively posting a return of around-$22 trillion

Just 1% of them had driven the entire net return, collectively delivering around $45 trillion between them

Another 38% of them had made up for that value destruction, collectively posting a return of around $22 trillion

So the overriding observation was that the extreme skew of returns applies globally, not just at US level. Indeed, at a global level, the extremes are even more pronounced.

At this stage, it seemed sensible to explore whether that special one percent of companies had anything in common. We had demonstrated an ability to identify these outliers historically, but how could we maximise our chances of doing so in the future? We thought that understanding shared characteristics would help.

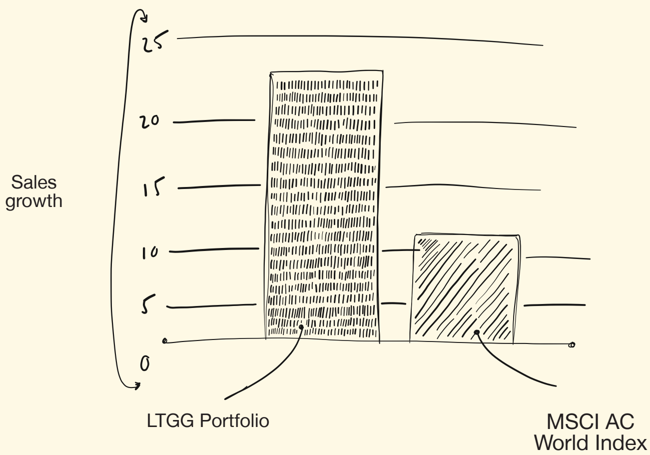


THE ANATOMY OF OUTLIERS

This piece of work is ongoing, and a supporting white paper is in the offing. But some of Hendrik Bessembinder's initial conclusions are illuminating:

1. Sales growth appears to be a good forecasting variable for identifying outliers.
2. Organic growth is a more important explainer of success than asset growth achieved through other means (for example, net new issues of equity and/or acquisitions of assets via mergers).
3. High levels of spending on research and development in the prior decade are a significant forecaster of success.
4. A big drawdown in the prior decade is associated with a higher chance of being a big winner in the current decade.

Based on these observations, it seems appropriate to map the LTGG portfolio against them.



HOW THE LTGG PORTFOLIO STACKS UP

On each of the first three metrics, the picture is encouraging.

1. Sales growth remains substantially in excess of the broad index; around 4.5 times higher in fact.
2. Asset growth is driven by organic progress far more than acquisitive activity.
3. Our clients' holdings are spending substantially more than their peers on capital expenditure and research and development.
4. The largest outliers for LTGG have often proved very volatile. Indeed, the top 15 absolute returners (all greater than three-baggers in US dollars) have an average maximum drawdown of almost 50 per cent. In other words, patience on the part of our clients is crucial to unlocking returns and any panicked rebalancing is likely to destroy value.

THE IMPORTANCE OF STAYING THE COURSE

Wealth generation by outliers is driven by the weight of capital deployed in them as much as by their individual returns. In the light of these twin growth turbos, our role is not merely to identify the outliers but to also hold them in size by running the winners. Is it possible to quantify the importance of holding as a driver of client returns? We recently had a go by conducting a small experiment.

We assembled a couple of 'controlled conditions' portfolios. The first was a 'stock-ranked' LTGG portfolio where stock positions were left to play out organically and without interference. The second

*Various anomalies and a degree of portfolio proliferation in the early days made it difficult to trace the data right back to the start, but you get the gist…

was an ‘equally weighted’ portfolio of LTGG stocks, hypothetically rebalanced (at zero cost) once a month. This experiment spanned a 15-year period from September 2004 (just after the inception of LTGG*) to September 2019 with associated buys and sells being incorporated along the way. The difference was stark, with the stock ranked portfolio outperforming the equally weighted one by 1.4 per cent per annum.

To our minds, this exercise amply illustrates why we, and our clients, need to resist the temptation to tinker. Rebalancing away from the outliers risks destroying a lot of value.

SUMMING UP

The lessons above leave us excited about the years ahead. There are few signs that the broader stock market attaches anything like enough significance to the smoke signals that identify outliers. There is still less evidence that many see volatility as a potentially positive lead indicator and can therefore resist the temptation to keep top-slicing their winners.

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