# Let’s talk about actual investing.

Stuart Dunbar, Partner

BAILLIE GIFFORD | *Investment managers*

# Risk factors.

The views expressed in this article are those of Stuart Dunbar and should not be considered as advice or a recommendation to buy, sell or hold a particular investment. They reflect personal opinion and should not be taken as statements of fact nor should any reliance be placed on them when making investment decisions.

This article contains information on investments which does not constitute independent research. Accordingly, it is not subject to the protections afforded to independent research and Baillie Gifford and its staff may have dealt in the investments concerned.

All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk. Past performance is not a guide to future returns.

All information is sourced from Baillie Gifford & Co and is current unless otherwise stated.

The images used in this article are for illustrative purposes only.

**Calton Square, 1 Greenside Row, Edinburgh EH1 3AN**
**Telephone +44 (0)131 275 2000 www.bailliegifford.com**



Active Investing 43025 1019.indd
Ref: 43025 ALL AR 0044

# Actual investing.

**Equity investing, the process of funnelling capital towards projects in the search for profitable returns, has been a root cause of societal progress and individual wealth creation since the 19th century. For most of this time the investment industry concerned itself with actual companies and actual projects. Nowadays though our industry is obsessed by abstract concepts – such as regional allocations, sector positions and factor weights – which have little to do with our real purpose.**

**This vocabulary makes us sound like speculators. More importantly managers' collective failure to focus on actual investment lets clients down and contributes to the malaise in which the industry finds itself. It might even have something to do with the low levels of productivity growth in many economies.**

**It is high time for the actual investors among us to explain why actual investing is important.**

# Active? Passive? Actual.


This conversation should not be reduced to a simplistic active-versus -passive debate, as if these things were equally valid approaches to the same activity. They are not. Active investing itself is not a single activity, and much of what is called active investing does not fit that description. The fundamental purpose of investing is to use available capital from those who have surplus to fund the ideas and projects of entrepreneurs and company managers who see an opportunity to generate profits. Our job as professional investors is to weigh up the risks associated with those ideas and projects, the range of possible outcomes and their probabilities, and thereby put a price on the equity or debt that is being used as funding. As an industry, we focus too little on that fundamental purpose.

Passive investing is different. It has a place – cheap market access is better value than poor active management – but allocating capital with no reference to the underlying purpose isn't really investing in a pure sense. The main reason that a passive approach has often fared well against its more fundamental rivals is that far too much of what passes for active management is simply second-order trading of existing assets, with the main focus being to try to anticipate the behaviour of other investors. This has little to do with actual investing, and it creates huge amounts of over-trading and volatility. It also serves no useful purpose other than for those who make a very handsome living from transactional activity, or those who confuse their clients into thinking that short-term volatility is skill.

We need a secondary market in securities to provide occasional liquidity between investors but, beyond that role, we should essentially ignore it. Instead we have arrived at a point where analysis of secondary markets now dominates our fundamental purpose. Moreover, the financial industry now describes its value in terms of market-referencing data points. Everyone is trying to outsmart everyone else by buying and selling existing assets: this is the zero-sum game that is so unthinkingly referenced by commentators and practitioners alike. It has little to do with wealth creation, either for our clients or for society.

# Actual investors look to the future.

# Not the past.


GAME
OVER?

# Is it game over for active already?

According to numbers from the European Federation for Retirement Provision, over the eight years to 2017, passive investment strategies have seen nearly $1 trillion of net inflows. Traditional active strategies have seen outflows of over $600 billion. These large numbers might even be understated. Investment managers who provide passive funds are now, by far, the biggest fund management companies in the world.

Investors have already voted with, if not their feet, certainly their investments. The fact that passive management is gaining dominance in some client segments simply reflects how far the active industry has departed from its original purpose. Not only that but some are making it worse year by year as ever faster processing power combines with instant communications and myriad data sources to allow ever greater analysis of the behaviour of market participants and ever greater neglect of the underlying uses of capital. This phoney sophistication offers a race to nowhere as the financial industry fights over returns rather than creating them. Little wonder that costs now dominate the narrative rather than value for money, and that we are on the receiving end of an avalanche of regulation. What happened to our fundamental role of funnelling capital into attractive projects via companies? Where's the focus on the actual creation of wealth that society needs to fund our future obligations? Progress rests on technological breakthroughs, smarter distribution models, building better and more efficient infrastructure, imagination and creativity. Not deciding that markets might be a little bit expensive this week.

A recent *Financial Times* article opened as follows: “US stocks reversed opening losses, with the S&P 500 sharply extending a rally that began after the index fell below its 200-day moving average on Thursday.” We've become accustomed to reading this stuff, but what relevance does it have to actual investment?

‘The market’ is in fact made up of a huge number of essentially idiosyncratic underlying investment projects, so why do we now talk in term of industry and country attributions, overweights and underweights, factor tilts, momentum, style, mean reversion and any number of other artificial measures that tell you everything except what your actual investment risks are? You can measure your tilt towards developed market growth momentum stocks if you like, but it won't tell you much about how plummeting gene sequencing costs are combining with big data to upend the healthcare industry as we know it.

The charitable part of me thinks that somewhere along the way many well-meaning people have just lost sight of what matters, dazzled by our market-analysing processing power. A less charitable view is that the financial industry has gone down this road because it makes what we do seem impossibly complicated and somehow justifies our extraordinarily high incomes. Perhaps it's time we asked some more searching questions about whether the emperor has any clothes.

# How we got lost.

It is hard to tell exactly when our industry lost sight of what investing should be, but it likely dates all the way back to the 1960s creation of the capital asset pricing model (CAPM), and its corrosive effects in a world where complexity has become confused with value.

CAPM artificially divided investment returns into alpha (stock-level or 'idiosyncratic' risk and return) and beta (market-level risk and return), thereby creating the notion that an efficient market return is available to any investor without reference to, or even knowledge of, any actual investment decisions. Hence beta became the default investment portfolio and 'outperformance' of that became the value proposition of the active management industry.

This, in turn, led to active managers focusing less and less on fundamental investment analysis, and more and more on the completely circular activity of trying to marginally outsmart each other. In this marginal world the definition of investment success became a relative one, along with costs and transparency.

'Active' started to mean being different to the market, and became conflated with activity. Investment managers started to employ ever more sophisticated and costly trading strategies with no reference at all to making fundamental investments. Cue market failure, both in the sense of competition in our industry and with respect to the fundamental deployment of capital.

So, here we are. Most investing is no longer about taking long-term risks in definable investment projects. It's more about free-riding on the mythical 'market return' at minimum cost; participating in an expensive zero-sum arms race of better, faster, smarter analysis of markets and their participants (actual companies nowhere in sight); shuffling risks around through financial engineering disguised as value creation; and about confounding and confusing on costs which are often not justified by managers who have lost sight of their core purpose.

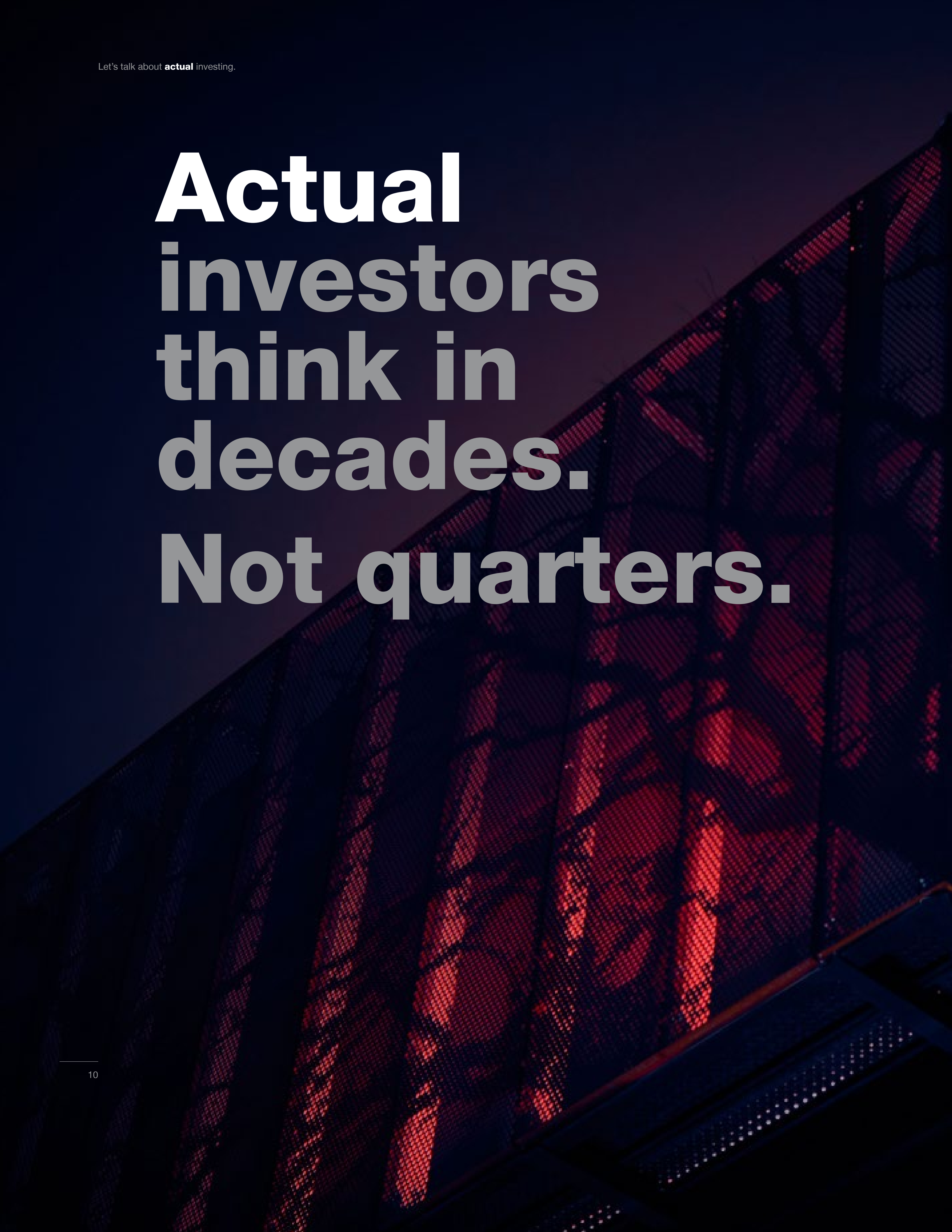
# Investing.
# Not posturing.

Active managers have a real image problem, but it's not just asset managers, it's the whole investment supply chain. We confuse and confound and bundle costs together – advice, trading, servicing, transactions – so much that investors find it near impossible to measure value for money. So instead they just focus on cost and have moved in droves towards passive. Such behaviour is surely not in client interests, and rightly comes in for robust criticism in the press. Unfortunately, all market participants are being tarred with that brush.

Those companies that are trying to do a good job for clients need to stand up and be counted. If this means losing a few friends along the way, so be it. We don't need friends who put short-term profit before client interests and therefore the long-run future of our industry. It means engaging more with clients to help them understand what investment really means. It means charging reasonable fees and voluntarily providing full disclosure of what all of the clients' expenses are spent on. It means unbundling all the parts of the investment food chain in order to allow clients to make sensible decisions about which bits are value for money. It is the failure to do this that has led to such a focus on cost over value and played into the hands of the passive providers.

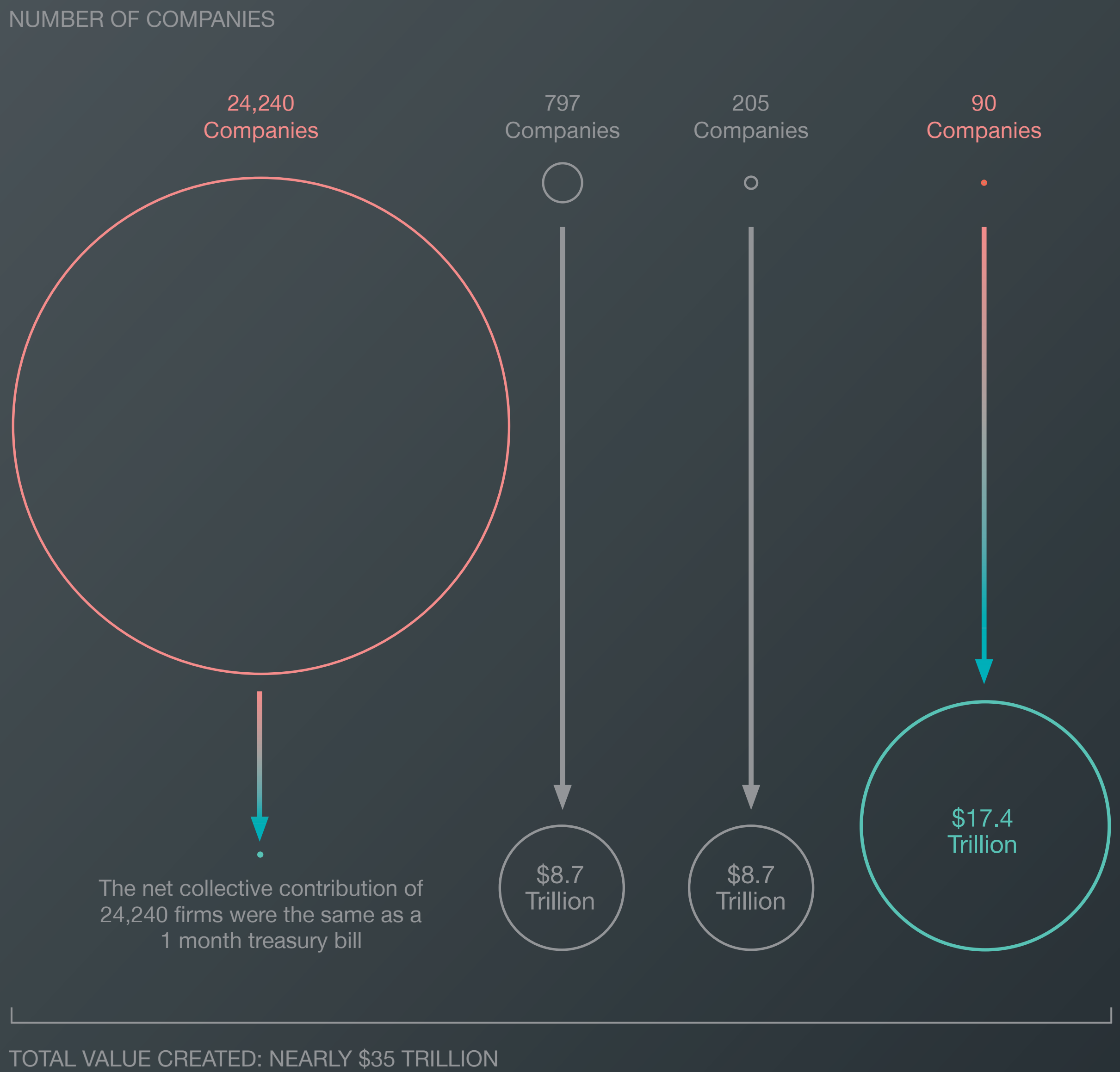
It is often said that clients think short-term and we investors are therefore forced to do likewise. I disagree. If anything, our industry has foisted short-termism on clients in order to manage our own business risks. We create structures in which we measure ourselves and report on quarterly and annual performance against benchmarks; some investment managers are incentivised on short time periods or even assets under management, and we duck the task of educating clients. Many feel driven to hug benchmarks so as not to stand out from the crowd, and to focus more on marketing than on achieving good results. This endemic short-termism means that being predictably average is more attractive than being unpredictably outstanding, even when average is worse than passive after costs.

This is not just some sort of industry connoisseur's point. In the UK, a recent article in the *Sunday Times* – which is widely read by just the sort of people who both use our services and have influence in their companies – suggested that the biggest advantage individual investors have over professionals is that they are not: "subject to the short-term accountability of an investment committee or trustee" and are therefore better-placed to take the long view and focus on investment fundamentals. This is what active has come to: even the casual observer has picked up that the active management industry has such agency problems that it is no longer doing its job.



# **Actual** investors think in decades. Not quarters.

**Total net wealth created by all listed US common stocks 1926–2016**




Stock market wealth creation is defined as an accumulation of value (inclusive of reinvested dividends) in excess of the value that would have been obtained had the invested capital earned one-month treasury bill interest rates.

Reading the data: The data includes all 25,967 CRSP common stocks (25,332 companies) from 1926 to 2016. Beyond the best-performing 1,092 companies, an additional 9,579 (37.8%) created positive wealth over their lifetimes, just offset by the wealth destruction of the remaining 14,661 (57.9% of total) firms. The implication is that just 4.3% of firms collectively account for all of the net wealth creation in the US stock market since 1926.

Source: Hendrik Bessembinder, Do Stocks Outperform Treasury Bills? (August 2017).

# The few not the many.

Research from Professor Hendrik Bessembinder at Arizona State University shows that from 1926 to 2016, *all* of the net wealth created in the US stock market was equal to the best performing 1,092 stocks. Even more incredibly, half of all that net wealth was created by just 90 companies (just 0.3% of companies). That doesn't mean that all the rest were negative, it just means they netted off. The value lies in the outliers. So much for CAPM – the truth could not be further from the normal distribution which underpins it. What does this tell us about how we should invest? Clearly, if you find the right stocks, you will outperform the market and capture a huge amount of the total creation of wealth. On the other hand, missing out on those stocks will result in horrible underperformance. This empirical finding is consistent with our own observations.

What does one do with this information? It depends on the extent to which you think you can identify the big winners. If you can't spot them, it makes sense to buy everything – an index fund. That way you'll hold the winners. Unfortunately, you'll dilute them roughly 25 times with all your other holdings. On the other hand, most bottom-up stock-pickers would claim an ability at identifying such winners, but how many of us actually encourage our clients to accept the full implications of this research? All too often we don't even try.

**"CAPM was never purposed to describe the 'real world' as we know it. CAPM is a model and is a theory. The real problem is not with CAPM itself, but with how people ... have used it. They are like little boys that found a big hammer and started using it where they should not be using it, with accompanying consequences."**

**– Anonymous academic**

# Things to discuss with clients.

**Hendrik Bessembinder's findings highlight a number of points that we should consider carefully:**

**Really big winners compound their gains over long, long periods. Sustainable competitive advantage has incredible power. Stock prices (of the winners) do not revert to the mean and short-term volatility often means nothing. A stock which has already multiplied in value is not an automatic sell. It doesn't even necessarily mean it is 'more expensive'.**

---

**It is highly likely that an active manager who is really trying to capture large outperformance in this way will get more stocks wrong than right, even in the long term. This does not matter because asymmetry prevails. If they are successful, their winners will offset their losers by an order of magnitude. Can you accept that a manager might be wrong more than half of the time, and that this is the nature of uncertainty and a fundamental building block of investing?**

---

**The overall pattern of returns from pursuing the winners will look very different to an index. Short-term deviations will be big but are pure noise. Are you prepared to look through this and focus on the underlying progress of the companies in question? That's what actually matters in the long run.**

There are also implications for the purpose of capital markets. Because of the short-termism (that we don't fight as much as we should) we are now in the invidious position of capital markets not actually being used to raise capital at all. More money now flows out of capital markets than into them. A huge number of companies pander to market short-termism by manipulating their own cash flows to hit short-term targets and pay out dividends or buy back shares, in the process foregoing profitable investment opportunities but handily hitting earnings targets that secure executives' bonuses. We call this alignment of interests: it is anything but.

Far too many companies are not investing in their own future because investors are compelling them to take a short-term view. Over the last 25 years (to 2016) we've seen the ratio of investment (capex and R&D) to pay-outs (dividends and buybacks) fall by almost three-quarters. This is a deeply unsatisfactory state of affairs. If more money comes out of companies than flows into them, on a net basis no new external capital is being employed at all. Little wonder that productivity growth has struggled so much in recent years. What this really means is that actual investors who seek long-term growth need to work in close partnership with those firms that are willing to reinvest capital in new opportunities. It often means encouraging them to ignore the short-termism of other shareholders. The good news is that with so few firms investing meaningfully in their own future, the potential gains available to those who do are correspondingly magnified. How many managers take the time to explain this to their clients?

# How (almost) nobody selects a manager.

Academic research, focusing on the US markets, by Petajisto[1] and by Cremers and Pareek[2] offers some unbiased evidence for how getting back to the fundamentals of investing adds significant value for clients, and could help rebuild trust in what we do. These authors used active share and turnover statistics as proxies for managers that focus on the fundamentals of investing: where high active share suggests a greater disregard for the index, and low turnover suggests indifference for short-term volatility.

Their findings show that managers who have very high active share (i.e. those who ignore benchmarks) are more likely to outperform. This, however, is not sufficient. High active share in the presence of high turnover is still likely to underperform a market cap-weighted index. The key finding was that managers with high active share *and* low turnover on average outperformed market cap weighted indices between 1995 and 2013 by 2.3% p.a. net of costs. This is not exactly rocket science (though it did require the authors to gather a huge amount of difficult-to-find data) so one wonders why manager selection is apparently so difficult to consistently get right. To offer a view:

**There are so many managers that some will have seemingly statistically significant outperformance even if they lack investment skill. This is just the law of big numbers. In the absence of further analysis, historic performance means little. Unfortunately historic and (even worse) short-term performance still figures highly as a search criterion. So by definition the good are mixed with the lucky. Do not use historic performance as a filter.**

**Good fundamental managers stick to their approach through thick and thin. All too often managers who have done a good job through fundamental analysis are blown off course by the investment industry's incessant need to build assets, grow profits, merge together and generally put their own interests ahead of those of clients'. Ownership and motivation – performance, not assets under management – really matter. Pick the right firm.**

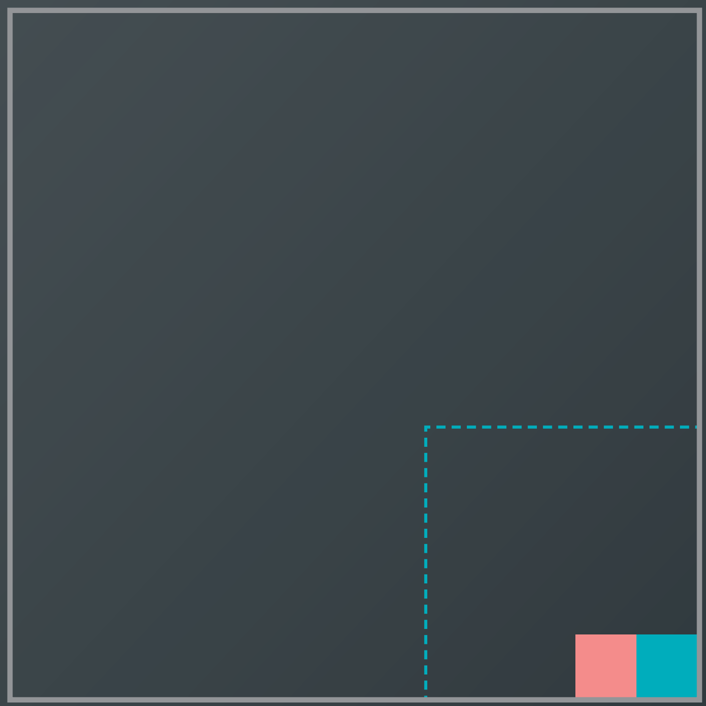
**The good news is if you don't have the internal resource to evaluate managers in this way, your consultant will surely do it for you. Just don't let them over-complicate things.**



1. *Active Share and Mutual Fund Performance*. Antti Petajisto, 2013.

2. *Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently*. M. Cremers, A Pareek, 2014.

**Narrowing the universe: after-fees average excess returns**



Source: All figures are from Cremers and Petajisto 2009 and Cremers and Pareek 2014.

All ‘active’ managers:
Average value added = **-0.4%**

20% most active vs benchmark:
Average value added = **+1.1% p.a.**

20% of most active with highest turnover:
Average value added = **-1.9% p.a.**

20% of most active with lowest turnover:
Average value added = **+2.3% p.a.**

# Back to basics.

**The task in hand is to remind our clients what investing actually means. Actual managers need to demonstrate that we act on behalf of clients to identify and back fundamental investment ideas, not just try to outsmart other investors. We need to talk about the progress and risks involved with those investments, not about short-term share price performance which means nothing in a market dominated by speculators. By doing this we can refocus the discussion on the central and important role we play in the progress of society, and perhaps start to restore the investment industry's social license.**

# About the author.

**Stuart Dunbar, Partner**

Stuart joined Baillie Gifford in 2003 and is a Director in the Clients Department. He became a Partner in the firm in 2014 and is responsible for overseeing relationships with financial institutions, as well as contributing to consultant relationships, marketing and client servicing activities in Europe and Asia. Prior to joining Baillie Gifford, Stuart worked with Dresdner RCM in Hong Kong and Aberdeen Asset Management in the UK. He graduated BA in Finance and Business Law from the University of Strathclyde in 1993.

# Important information.

Baillie Gifford & Co and Baillie Gifford & Co Limited are authorised and regulated by the Financial Conduct Authority (FCA). Baillie Gifford & Co Limited is an Authorised Corporate Director of OEICs.

Baillie Gifford Overseas Limited provides investment management and advisory services to non-UK Professional/Institutional clients only. Baillie Gifford Overseas Limited is wholly owned by Baillie Gifford & Co. Baillie Gifford & Co and Baillie Gifford Overseas Limited are authorised and regulated by the FCA in the UK.

Baillie Gifford Investment Management (Europe) Limited provides investment management and advisory services to European (excluding UK) clients. It was incorporated in Ireland in May 2018 and is authorised by the Central Bank of Ireland. Through its MiFID passport, it has established Baillie Gifford Investment Management (Europe) Limited (Frankfurt Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in Germany. Baillie Gifford Investment Management (Europe) Limited is a wholly owned subsidiary of Baillie Gifford Overseas Limited, which is wholly owned by Baillie Gifford & Co.

Persons resident or domiciled outside the UK should consult with their professional advisers as to whether they require any governmental or other consents in order to enable them to invest, and with their tax advisers for advice relevant to their own particular circumstances.

**Important Information South Korea**

Baillie Gifford Overseas Limited is licensed with the Financial Services Commission in South Korea as a cross border Discretionary Investment Manager and Non-discretionary Investment Adviser.

**Important Information Japan**

Mitsubishi UFJ Baillie Gifford Asset Management Limited (‘MUBGAM’) is a joint venture company between Mitsubishi UFJ Trust & Banking Corporation and Baillie Gifford Overseas Limited. MUBGAM is authorised and regulated by the Financial Conduct Authority.

**Important Information Hong Kong**

Baillie Gifford Asia (Hong Kong) Limited 百利亞洲(香港)有限公司 is wholly owned by Baillie Gifford Overseas Limited and holds a Type 1 licence from the Securities & Futures Commission of Hong Kong to market and distribute Baillie Gifford’s range of collective investment schemes to professional investors in Hong Kong. Baillie Gifford Asia (Hong Kong) Limited 百利亞洲(香港)有限公司 can be contacted at 30/F, One International Finance Centre, 1 Harbour View Street, Central, Hong Kong. Telephone +852 3756 5700.

**Important Information South Africa**

Baillie Gifford Overseas Limited is registered as a Foreign Financial Services Provider with the Financial Sector Conduct Authority in South Africa.

**Important Information Australia**

This material is provided on the basis that you are a wholesale client as defined within s761G of the Corporations Act 2001 (Cth). Baillie Gifford Overseas Limited (ARBN 118 567 178) is registered as a foreign company under the Corporations Act 2001 (Cth). It is exempt from the requirement to hold an Australian Financial Services License under the Corporations Act 2001 (Cth) in respect of these financial services provided to Australian wholesale clients. Baillie Gifford Overseas Limited is authorised and regulated by the Financial Conduct Authority under UK laws which differ from those applicable in Australia.

**Important Information North America**

Baillie Gifford International LLC is wholly owned by Baillie Gifford Overseas Limited; it was formed in Delaware in 2005. It is the legal entity through which Baillie Gifford Overseas Limited provides client service and marketing functions in America as well as some marketing functions in Canada. Baillie Gifford Overseas Limited is registered as an Investment Adviser with the Securities & Exchange Commission in the United States of America.

# BAILLIE GIFFORD. ACTUAL INVESTORS.

**bailliegifford.com/actual-investors**

**Calton Square, 1 Greenside Row, Edinburgh EH1 3AN**
**Telephone +44 (0)131 275 2000 / www.bailliegifford.com**