NEITHER HEROES NOR VILLAINS

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Long-term investing isn't easy, and often involves holding your nerve through short-term setbacks. James Budden talks about why it's important to stay committed to finding and supporting exceptional growth companies.

Tom Slater, joint manager of Scottish Mortgage Investment Trust and Head of US Equities at Baillie Gifford wrote the following paragraph in the Scottish Mortgage Report & Accounts year to 31 March 2021.

"We are focused on the long term. We do not believe that our returns in any given year convey much information about the strength or otherwise of our investment approach. Far longer periods are required to make such an assessment. We would caution against elation after the past 12 months just as we would counsel against misery following unprofitable years. To create long-term value, we seek companies pursuing big opportunities and investing in projects with uncertain payoffs. Their shareholders will need to hold their nerve, take the long view and offer thoughtful ongoing support."

His comments were coming off the back of a year when the trust's net asset value rose by 112 per cent and its share price by 99 per cent. His point is well made – one or two years offer no practical timeframe from which to judge investment returns. We have always asked investors to measure us on 5 to 10-year horizons. However, the last two years have been extraordinary and extreme. This has been reflected in volatility around markets and stocks, driven by short-term perceptions and constantly changing sentiment. Against this background many of Baillie Gifford's funds and trusts enjoyed a stellar 2020 and a sobering 2021. The truth is that we were neither heroes in 2020 nor villains in 2021. Those investors who know us well will be well versed in our approach, but those new to investing with Baillie Gifford may find this note a more helpful explanation of the ups and downs of 2020-2021 as they will have experienced more misery than elation of late.

We are looking for companies that can benefit from long-term, profound change. Our investment team is diverse, by nationality, culturally and cognitively, leading to lively debate within the tramlines of a strong common purpose. We much prefer the company of entrepreneurs and academics to that of brokers and financial commentators. True long-term investing is not easy. Resisting external pressures can be tough, so it's no coincidence that our firm operates as a multi-generational private partnership. Significant wealth creation is, and always has been, the preserve of a tiny fraction of companies with blue-sky opportunities and inspired leadership. Not, for us, seeking 'market coverage' or fixating on share prices. We look for real-world opportunities as technology and business models evolve. This means we're not simply active investors. We're Actual Investors valuing constant learning, patience and fortitude. At the heart of this philosophy is a belief that share prices follow cashflows and earnings over the long term. So, we are focused on what might go right in the long term rather than what might go wrong in the short term. We will be at odds with the index and our performance volatile against it. But over 5 and 10 years we aim to outperform.

And outperform we did in 2020 by some considerable margin across a wide range of funds and trusts, some of which went up by over 100 per cent. Many of the long-term themes we were enthusing about became central to behaviours during the pandemic. We saw more use of ecommerce, food delivery, online entertainment, online communication for work, school and play. All this required more cloud computing power to make it work. Many of the companies we had owned for some time such as Netflix, Amazon, Spotify, Zoom and Hello Fresh saw significant operational progress and share price growth. Allied to this were breakthroughs such as the strides forward taken by Tesla in the manufacturing of electric vehicles and the Covid-19 vaccine success at Moderna. It was a year in which many of the businesses we owned saw increased demand brought forward by necessity speeding up, in our thinking, eventual adoption.

It should not come as a surprise that 2021 was different. Several factors combined to change investor sentiment away from growth companies, especially those that had done so well the year before. Markets had to contend with multiple unknowns and areas of risk, such as the impact of economies reopening, prolonged supply chain disruption, price inflation, tightness in the labour market and wage inflation, emerging variants of Covid-19, and a regulatory crackdown in China. While macro-economic analysis is not our area of expertise, we would highlight some of these factors which have had a pronounced impact on performance.

Style rotation – Towards the end of the first quarter of 2021 we saw investors' attention shift from the technology-led stocks, which performed well during 2020, towards more economically sensitive assets which would benefit from economies reopening. Crudely put – a rotation from growth to value stocks.

Inflation concerns – 2021 saw some inflation measures reach heights not seen for decades. These concerns, and the subsequent shift in tone from central banks, shook markets and had a detrimental impact upon company valuations. The companies we invest in are high on promise, but due to their relative immaturity the majority of their cash flows can be years into the future. This makes their valuations more susceptible to changes in interest rates.

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Crackdown in China – The scale and scope of regulatory change in China took markets by surprise and badly affected sentiment towards technology giants and large ecommerce platforms.

As a result, many of Baillie Gifford's portfolios fared poorly over 2021 against the index, but a few exceptions still provided positive absolute returns. Plenty of our winners in 2020 saw their share prices reverse in 2021. But in many cases their operational success continued. Zoom's share price fell by over 40 per cent over the year while revenues grew at more than 30 per cent year-on-year. Other examples of strong sales growth being rewarded by share price falls included Spotify, Delivery Hero and Zalando. Investor sentiment can be fickle, savage, and short term. It matters more that our managers remain convinced of the long-term prospects of these businesses. Indeed, owning growth companies can be behaviourally testing. In a decade of ownership Tesla's share price fell by 30 per cent on more than 10 separate occasions while Amazon's fell by a third when it launched Amazon Prime and halved during the global financial crisis. We must ignore the noise and focus on long-term fundamentals.

With reference to inflation, we are comfortable, but not complacent, about current positioning. We perform analysis to better understand the potential impact of inflation on our portfolios. Much of the conversation focuses on the operational impacts of inflation. This work helps solidify two key points in our thinking – the importance of the financial resiliency of portfolios and the holdings' pricing power. Firstly, our portfolios tend to be in aggregate well-funded, sitting on net cash versus the benchmark's net debt. Consequently, many stocks we own are entering this period in a position of balance-sheet strength, with less debt to service if interest rates increase. Secondly, we believe that generally our holdings will have a high degree of pricing power as they provide valuable products and services to their customers. This means they should have the ability to pass cost increases through to users and maintain their own margins. Over the longer term, we continue to believe that inflation will be transitory and it's likely that the long-running trends of technological deflation and ageing populations will return us to a low-inflation environment.

As for China, we would caution against the more melodramatic reactions to Chinese regulations. China remains exciting to us; there is an abundance of growth opportunities to pick from. Remember private sector companies in China provide more than 50 per cent of the tax, 60 per cent of the GDP, 70 per cent of technology innovation and 80 per cent of the jobs, so it seems unlikely to us that the government would persistently jeopardise their growth. In hindsight, last year's Central Economic Work Conference in China signalled the crackdown on internet platforms with the slogan: "prevent the disorderly expansion of capital". This year's strapline has been modified to: "allow capital to play a positive role while effectively controlling its negative impact". At some stage, the west will have to grasp this nettle too. There is also significant emphasis on the need for 'economic stability'. Monetary easing has started, and the government very clearly wishes to remain open to foreign capital. The rules of the game have changed slightly, but there's still a profitable game to be played.

Volatility in markets may persist as the world struggles out of a pandemic and geopolitical gyrations encourage uncertainty. However, what is certain is that as long-term growth investors we will not divert from our tried and tested approach. Style drift can be lethal in investing as it betrays investor expectation and incurs needless cost. We fully acknowledge that there will be times when our style is out of fashion – 2021 being an example. Yet we remain committed to finding exceptional companies and supporting them in finding solutions to some of the world's great problems. With this in mind, we see great opportunities ahead emanating from areas such as the decarbonisation and digitisation of our economies to the intersection of information technology with biology. Success requires patience, we promise to be patient as managers and hope to earn your patience as investors in our funds.

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Annual Past Performance to 31 December Each Year (Net %)

	2017	2018	2019	2020	2021
Scottish Mortgage	41.1	4.6	24.8	110.5	10.5
FTSE All World	13.8	-3.4	22.3	13.0	20.0

Source: Morningstar, FTSE. Share price, return in sterling.
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