Baillie Gifford™

Let's talk about Actual investing some more.

Capital deployment in the real world.

Stuart Dunbar, Partner

Risk factors.

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Actual investing.

We first wrote about Actual investing back in 2018, concerned that investment markets had become increasingly detached from the real-world task of thoughtful capital deployment. We argued that a growing obsession with daily prices, volatility and abstract market concepts was distracting investment managers from our original purpose.

Seven years later, the backdrop has changed significantly, in the world and in our firm. Many Baillie Gifford investment strategies have taken a hit as long-termism has all but vanished from equity markets and some clients and prospects will be questioning our approach. In this paper we focus on why we are sticking to it, revisiting the characteristics of managers who are most likely to outperform in the long term, and we look at the growing importance of shareholder engagement.

Growth equity valuations have been on a wild ride, fuelled by pandemic-induced zero interest rates and money creation, rapidly followed by inflation, steep rates rises, volatile geopolitics and extreme market concentration by tech giants as the possibilities of AI dawned. Recently, we've been seeing threats to the post-Second World War international trade order. It's been a difficult time for active managers, particularly for those focusing on long-term growth fundamentals.

It is therefore more important than ever to reconfirm our beliefs about how the world works and why we think we must stay the course. In times of stress and difficult relative performance the value of stoicism is at its highest. We believe the stage is set for a significant recovery for fundamental growth investors, just as we have seen historically.

Remembering our purpose

First, we need to revisit the merits of active management. This is not to defend an industry that has often enriched itself while failing to add value for clients. Our task is to go back to first principles: what is investing? Where do returns come from? Can we capture more of those than 'the market'? And are we operating a financial system fit for its purpose of generating returns through improved productivity and living standards?

A survey by the UK Pensions Regulator in March 2025 purported to show the amount of assets allocated to "productive investment" by UK pension schemes. We were taken aback that it ruled out listed equities as a "productive" asset class[1]. Something has gone very wrong indeed when a regulator sees the trillions of dollars invested in public companies worldwide as entirely unproductive. It reflects a narrow understanding of all the ways capital is put to use by both listed and private companies.

Maybe we shouldn't be surprised, such is the overwhelming short-termism and lack of an ownership mentality that now pervades listed markets. It's certainly consistent with growing criticism in some jurisdictions that large pools of institutional savings are not being used effectively to generate economic growth. This has led to a greater focus on how capital is being deployed, which we welcome. But while primary private capital has a role to play in funding critical infrastructure and other projects, suggesting this is the only form of productive investment is shockingly simplistic[2].

1. Pension schemes representing nine in 10 DC savers invest in productive assets, new data shows | The Pensions Regulator.

2. At Baillie Gifford we invest in both public and private companies. We have no vested interest in promoting one over the other.

Investment returns: theory vs reality

The simple term 'investing' has all but lost its core meaning and now encompasses all sorts of speculation. This has got worse since we last wrote on Actual investing. Easy access to market data on the ubiquitous smartphone has driven huge social media meme-driven stock price moves. The gamification of investing has given investors any number of esoteric things to 'bet' on, not just stocks and bonds but such wonders as geared inverse exchange-traded funds[3].

We define investing as the thoughtful direction of capital into real-world projects with the potential to produce returns through providing goods or services people want to buy. Such activity is long-term, and stock markets exist to allow maturity transformation – converting long-term assets into liquid instruments – and risk sharing between investors.

Seeking to anticipate share price moves based on the short-term behaviour of other market participants, or buying every available investment through an index fund, has little to do with real capital deployment. The first puts the mere existence of markets ahead of their actual purpose. The second provides cheap, broad exposure to economic growth. No harm in that, but it has nothing to do with wealth creation.

Index investing relies on a theory of efficient markets that doesn't work in practice. And it's becoming perilously reliant on a rapidly dwindling number of investors who can hold to account the companies they invest in.

Who makes real-world capital deployment decisions? It's not the institutional asset owners or fund buyers who sub-contract management of their assets. It's not the bulk of directly investing individuals or even professional fund managers.

The reality is that on-the-ground decisions on how capital is spent are made by the entrepreneurs and managers who direct the daily activities of companies. This can range from providing the research and development (R&D) and capital expenditure necessary to create future products and revenues, to funding routine maintenance, training, advertising, deploying human capital and any number of other things.

Some capital decisions are good, well-motivated and thoughtful. Others aren't. There's plenty of evidence that, left unimpeded, management all too often spends destructively on empire-building, or underinvests in order to maximise short term profitability at the expense of the future.

It's essential to the success of the system that shareholders should exercise oversight of how management is making these decisions. The significance of real capital deployment is obvious in the context of private companies intent on fundamental progress, but it clearly applies within listed companies too. It doesn't follow that, if a company lists, its share price should become the focus of attention at the expense of its real-world activities.

3. Complex products that allow investors to borrow money to take positions against the market or a company's stock.

The value of quality shareholders

Social utility is one thing, but there seems little point in arguing for active management focused on resource-intensive engagement and long-termism if it doesn't produce better returns than investors can get elsewhere.

Various studies have shown that companies that attract long-term engaged shareholders achieve better outcomes over long time horizons. One found that listed companies with the highest concentrations of engaged long-term shareholders outperformed those with the lowest by about 3.5 per cent per annum in the 30 years from 1985[4]. It showed that:

> Monitoring by long-term investors generates decision making that maximises shareholder value. Long-term investors strengthen governance and restrain managerial misbehaviours such as earnings management, accounting misconduct, financial fraud and options backdating[5].

The same study also suggested efficiency of innovation – how well a company converts ideas into products and services – is worse in poorly monitored companies.

The George Washington University Law School's Initiative on Quality Shareholders is a rich seam of research in this area. It found that companies that attract high-quality shareholders by foregoing quarterly earnings calls, or otherwise establishing meaningful relationships with long-term investors, tend to outperform the market[6]. The study suggests that quality shareholders on the register may confer advantages on listed companies by:

- giving management more time to execute strategy than in firms dominated by transient shareholders
- allowing more informed votes than is the case with index-trackers
- offering more productive and patient engagement with management than typical activist shareholders.

Another useful contribution to this discussion was produced by a different UK regulator, the Financial Conduct Authority (FCA), which carried out a literature review on whether the growth of passive investing affects equity market performance[7]. It reached no firm quantitative conclusions but referenced evidence that deep engagement by shareholders is valuable – innovative activity increases in companies as the share of non-index ownership increases[8]. The same FCA study also cited evidence that deep engagement is not a direct function of size and resource, but also requires commonality in investment goals within a firm. Large index providers or multi-style investment management firms find it more difficult to lead on deep engagement efforts because of conflicts of interest between their individual funds[9].

But there's a problem: capturing the value of being such a shareholder. We'll return to this.

4. Full disclosure: this includes some long-term index fund holders, though the number excluding such holders was actually slightly higher.

5. Harford, Kecskés and Mansi, 'Do long-term investors improve corporate decision making?', *Journal of Corporate Finance* vol. 50 (2018).

6. See for example 'Initiative in Quality Shareholder Highlights' by Lawrence A Cunningham (2020).

7. Does the growth of passive investing affect equity market performance? Kevin R James et al (2019).

8. 'Innovation and Institutional Ownership', *American Economic Review* 103(1), Aghion et al.

9. 'Too Big to Be Activist', *Yale Law and Economics* research paper, Morley (2018)

Why intracompany cash flow counts

The amount of cash flow productively invested by listed companies into R&D and business expansion dwarfs the primary capital raised by private companies every year. It follows that deciding how to use this cash is central to maximising long-term shareholder value.

However, we live in a world of unequal access to information, misaligned interests and time horizons in markets dominated by short-horizon investors. We can't take for granted that management will always prioritise long-term value. Engaged oversight of business strategy and incentives is therefore of the utmost value, but all too often overlooked.

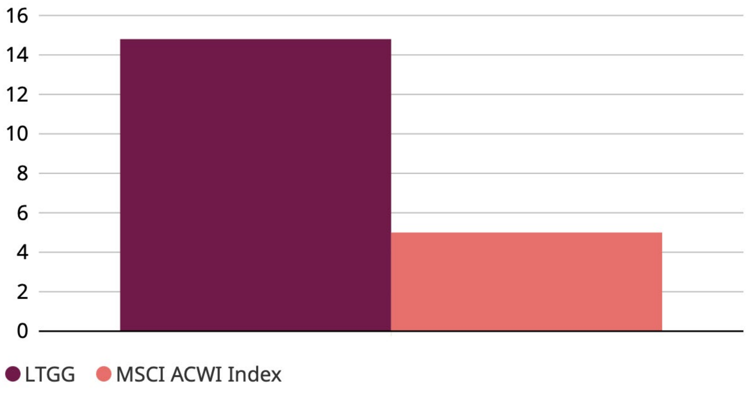
New analysis across all the companies Baillie Gifford invests in shows that, in the 12 months to the end of March 2025, they spent around $164bn US dollars on capital expenditure for growth (growth capex)[10], and a further $420bn US dollars on R&D. This is real capital deployment and it takes place within listed companies, using cash flows belonging to the shareholders we represent.

On a global scale, these amounts run into many trillions of dollars. It's incomprehensible that this spending on growth should be considered definitionally as "unproductive".

This is tangible activity that can be readily analysed and which supports the fundamental purpose of the system. Those deciding how this capital is deployed should be constructively held to account through the lenses of alignment, adaptability and business insights. Constructive oversight of spending should figure much more highly in assessing how active managers add value for clients.

The following chart shows R&D spending as a percentage of sales for one of Baillie Gifford's more concentrated global equity portfolios, compared to the index. The key takeaway is this: given we're investing in companies that are themselves investing an average of 15 per cent of sales on R&D, we need fully to understand how and why that's happening. We need to know how central the spending is to the long-term prospects for each company, when they expect to see a return on those investments, and what margins should ultimately be achievable. If their answers are positive, we're likely to be long-term supportive shareholders. Few such companies exist.

R&D as a % of sales



Source: Baillie Gifford & Co. Factset, MSCI. As at 31 December 2024, in US dollar. Based on a representative Long Term Global Growth (LTGG) portfolio. LTGG is a Baillie Gifford concentrated growth equity strategy.

10. This means spending beyond that required to offset depreciation.

Why are long-termism and engagement underappreciated?

Since 1989 the ratio of growth capex-plus-R&D spending to dividends-plus-share buybacks – shorthand for how heavily the average company reinvests in its future – has reduced from around 2.5-times to 0.7-times. The past 10 years' data is shown in the chart below.

MSCI AC World

Ratio of growth Capex Plus R&D to dividends and buybacks | 10 years to March 2025

Source: Factset. MSCI.

The recent pickup can be largely attributed to heavy investment in AI by a few large companies. Longer term, this reluctance to invest may explain why the focus on real-world capital deployment within listed companies has been dwindling.

Problem or opportunity?

The decline in spending revealed above is both a problem for macro-level wealth creation and productivity gains and an opportunity for active managers to add value with their long horizons and high engagement. Growth expenditure is concentrated in a relatively small number of companies, just like long-term returns. By focusing on companies ambitiously investing cash flows, we can at least narrow down the universe and start to discern how effectively they're doing so. And it's this principle – that a dollar, euro, pound or renminbi spent from cash flow is the same as a dollar of primary capital – that allows us to apply the same analytical framework, regardless of whether a company is listed or private.

Contrast the primary financing needs of a company like Tesla as it built out its manufacturing capacity, with Amazon which famously invested the majority of its internal cashflow for years on end to achieve dominance, amid much market criticism. Both have been phenomenally successful investments. The common thread is their willingness to think way beyond the next few quarters.

Changes in management incentives and behaviour when a company goes public can be striking. One company told us its only goal post-IPO was to generate four quarters of profit, making it eligible for inclusion in equity indices, thus artificially creating demand for its shares. This is not what we would expect in a company truly focused on long-term wealth creation.

That's the problem with public markets. For all too many corporate managers, daily share price movements driven by speculators start to drive their decisions, distorting behaviours and decision-making. The goal of truly long-term investors is to find and invest in companies that can avoid being so influenced. Time and again we hear from company management how much they value our support as long-term shareholders. That doesn't mean agreeing with them on every decision, but it does mean backing them to invest in necessarily uncertain outcomes. The mathematical truth of Jeff Bezos's observation that "Given a 10 per cent chance of a 100 times payoff, you should take that bet every time" is easily recognised. But risk aversion – career risk, the risk of looking foolish – means that most corporate executives will refuse to take that bet, to the detriment of the company, its shareholders, and perhaps broader society. One of our aims as supportive shareholders is to help create an environment where they will accept it.

Governance and oversight

Good governance is about creating enduring companies that build value, help economic advancement and create and maintain competitive advantage. It's not about metrics. Investors must understand the context in which governance is practiced, offering constructive support and guidance and making a case-by-case assessment of its fitness for purpose over time. When done correctly, this adds value for shareholders.

Looking back on a year of engagement with portfolio companies, we see the subjects ranged widely. They included:

- executive remuneration and board composition
- preparedness for the challenges and opportunities of carbon pricing regimes in high-emitting sectors
- weaknesses in financial reporting
- opportunities to achieve stakeholder or regulatory buy-in, even at the expense of short-term profitability

One-size-fits-all voting and engagement policies don't capture fitness for purpose. Effective voting is a time-consuming and resource-intensive exercise. Nevertheless, it should be seen as a bare minimum for responsible ownership.

For active investors, votes against management should not be used as shorthand for exercising governance rights. At Baillie Gifford, by the far the biggest decision we take is whether to invest in a company. If management isn't aligned with our outlook, or if we otherwise lack faith, we don't invest. When we do, it's because we want to be alongside management teams (often founders) we believe in. This means we vote with management 94 per cent of the time. With most companies, we've already exercised the ultimate 'vote against': not to own them in the first place.

In 2024, we held 1,939 meetings with the management of companies we invest in. Of these, almost half had specific engagement goals, with 'governance and strategy' by far the most common topics. These activities are managed using Baillie Gifford's bespoke in-house Engagement Hub which allows us to track progress. This is particularly valuable where more than one of our teams invests in a company.

Free-riding and the hidden perils of low-cost

One issue threatens to undermine the returns even passive investors expect. If even some regulators don't consider listed equity investing 'productive', and if the focus of institutional asset owners is so much on costs that the benefits of governance and engagement – the value-add of quality shareholders – is simply not recognised, our system is no longer fit for purpose. The game becomes one of wealth extraction over wealth creation. This helps neither savers nor society more widely.

A recent survey of large asset owners and managers from the Thinking Ahead Institute – one of the UK industry bodies we support – concluded that the investment industry needs to at least double its stewardship resources[11]. Some suggested the industry requires 10 times more resource dedicated to 'active ownership'. It also recommended facilitating discussions between asset owners and asset managers on how we hold companies to account and encourage entrepreneurship.

The challenge of dedicating resources to active ownership (or being a quality shareholder) is that the benefits accrue to all shareholders even as the cost is borne by only a few. This a classic 'free-rider' problem. Good corporate governance improves the overall quality and returns of the market – better beta – rather than generating alpha for the investors who undertook it. Even where investors understand the necessity of an effective system of oversight and alignment, few are willing to pay for it if they can rely on others to do so.

We see this everywhere, but would highlight the case of defined contribution pension schemes. They overwhelmingly use passive approaches so low-cost and diversified that meaningful company engagement makes no economic sense. As low-cost approaches become dominant, so the stability and efficiency of listed equity markets become more precarious. Index trackers and light-touch managers will faithfully do what they're supposed to, but there will be much less wealth created in public markets to share out.

The incentive to act as an engaged owner varies with portfolio diversification. If a manager owns, say, 5 per cent of a company they invest in, 95 per cent of the added value from engagement activities will go to other investors. Up to a point this doesn't matter. Some of them will also be exercising oversight for the collective good. But the ability to capture the better beta breaks down as managers invest in more and more stocks. It's not long before the benefits of stewardship are defrayed so widely that it's not worth doing. Perhaps this is how regulators have come to see listed equity investing as disconnected from the real world of productive capital deployment.

11. Putting Resources Where Stewardship Ambitions are Structured Measurement to Empower Asset Owner-Asset Manager Conversations

We say **Actual investors** emphasise what might go right.

Because progress is born from positivity.

Pyrrhic victory

We need to differentiate between managers who run concentrated conviction-led portfolios and are therefore incentivised to act as owners and those who simply provide market exposure for their clients. The extent to which the latter rely on the former to oversee the process of wealth generation is not well appreciated and, crucially, not considered when it comes to fees. Those who don't spend on stewardship resources can easily undercut those who do, but this is a pyrrhic victory for overall investment returns.

To be clear, this is not a defence of higher fees. The investment management industry has failed to pass on its enormous economies of scale over many years and has excessively rewarded some who own and work in it. Maybe the industry is simply reaping what it sowed and certainly a sharp reversal in revenues is underway. But we must not overshoot to the point where the very things that bring value to society become babies thrown out with the bathwater.

Two steps forward, one step back

The environmental, social and governance (ESG) movement that took off in 2020 had problems. It measured many of the wrong things and often focused on momentary snapshots instead of enduring progress. But it had the merit of pushing investors to understand how the companies they invest in interact with the real world. For those of us who believe that the financial system does not exist to facilitate a game of speculating on share price patterns and fastest-finger-first trading, this is progress. The closer connection of financial markets with real-world activities can only be a good thing.

But perhaps inevitably, the industry overshot. The pursuit of returns became unhelpfully entangled with pressure on capital to compensate for a lack of consensus on social and environmental issues. Purely from a governance point of view, the resultant backlash has spilled into uncertainty over how shareholders can influence the management of companies they invest in without it affecting their duty to make money for clients.

Combining this challenge with the ongoing move to low-cost listed equity investing brings into sight the advent of the 'ownerless' corporation in public markets. Maybe this doesn't matter. Maybe over time all companies become private and investors end up paying for oversight through the higher fees that private investments still attract. But at this point listed equity markets – intended for risk-sharing and maturity transformation – will have been destroyed from within. Surely this is not what we set out to do. It's not too late to change course.

Understanding the role of the active manager

The first task is far removed from the widespread obsession with daily stock market gyrations. It is to seek out real-world investment opportunities that are not reflected in a company's share price. Those opportunities can be driven by technological breakthroughs, changing market dynamics or smarter business models.

The second task is to find companies not only poised to take advantage of that opportunity, but whose management has the ambition, alignment and skill to make the right decisions to build long-term value.

The third task is to act as a quality shareholder. This means giving management time to execute, holding it constructively to account, encouraging ambition and creating an environment in which the pursuit of long-term goals can flourish.

The fourth task is to be clear-eyed on whether our view is still differentiated from that of other investors. If not, there are likely better and less well-known opportunities where we can see more long-term upside in the share price – what we call 'competition for capital' in our portfolios. This often comes after a company has been visibly and sometimes spectacularly successful. One example is NVIDIA which has returned around 1300 per cent in the past five years. We first bought into this firm for clients in 2016 and have been reducing our position as its potential was more widely reflected in its share price.

These are not easy or low-cost tasks. Seeking out unappreciated real-world opportunities requires sourcing information differentiated from that used by other investors and being open-minded about where enquiries might lead. It means being careful not to stifle creativity in investment teams by salami-slicing them into slivers of sector expertise. It means maintaining significant research capability and being comfortable allowing people to pursue their interests, trusting that – however obliquely – this will lead to insights relevant to the investment task. It means building long-term trusting relationships with company management before and after we invest.

Hiring the right people is crucial. Curiosity and imagination are at least as important as numeracy. At Baillie Gifford, we've found it much easier to train an imaginative lateral thinker to be a good investor than the other way around. This is reflected in the variety of academic and practical backgrounds from which we've built our investment teams.

Our skill lies in asking 'what if?', not 'what is?'. To help us, we fund academic relationships with universities around the world, helping us to direct research to fruitful areas. Partnerships include the Santa Fe Institute and several other universities in the UK, US and China covering topics such as:

- the application and ethics of artificial intelligence
- the development of gene sequencing and editing technologies
- applications of robotics and drone technology
- sustainable agriculture and 'deep transitions'[12]

It's often where these technologies intersect that we get most excited. To gain deeper insights, we sometimes commission external research. One recent example was to better understand the customers of Chinese group-buying platform PDD.

We take time to think, and we listen to those who know more than we do. Because we represent many clients and large sums of capital, we get to spend time with some of the greatest entrepreneurs and business builders of recent years. Although we can identify the areas of greatest potential for progress, the challenges of real-world execution are harder to penetrate. We can learn from those who have this insight. We build relationships and engage with them, not on this quarter's earnings outlook, but on where they think their industry might be in 10 or even 20 years. We align ourselves with those with drive and ambition beyond the merry-go-round of quarterly results and CEO rotations.

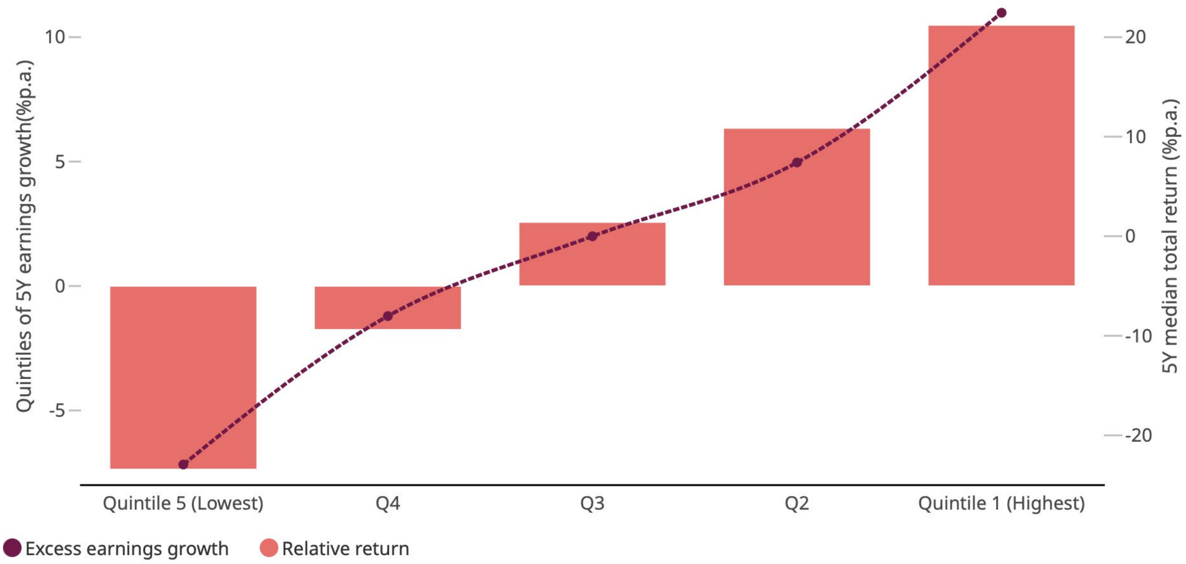
12. This is the effort to understand the full implications of systems change. For example, what would the world look like if we moved to shared autonomous mobility systems. Deep Transitions is led by Professor Johan Schot at Utrecht University in collaboration with others.

Does it work?

There is clear evidence that share prices eventually follow earnings-per-share (EPS). However, prices can diverge far from fair value for long periods, driven by speculators balancing supply and demand based on behavioural expectations, not fundamental valuations.

The following chart breaks out companies by EPS growth quintiles and plots their relative share price movements over rolling five-year periods:

Median total returns on earnings growth quintiles rolling 5-year horizons (1990 – Feb 2025)



Source: FactSet
Universe: The analysis is based on a global universe of companies between December 1990 and February 2020, excluding loss-makers and using an inflation-adjusted minimum market cap of $1bn. Each measurement period is grouped into quintiles of earnings growth, excluding loss-makers, allowing observations of their distributions of concurrent 5-year share price returns. Relative returns for each quintile are calculated by comparing the median return of the quintile to the overall median for the universe.

The chart shows that if investors can find companies with the fastest future EPS growth, they have a much higher chance of outperforming in share price terms over five years, regardless of the initial valuation.

The underlying premise is that markets simply aren't good at looking that far ahead. Or to put it another way, long-term investors should spend their time looking for the future fastest-growing companies, not trying to find patterns in share price performance or anticipating shifts in market sentiment. Finding such companies is far more achievable than predicting others' moods and unthinking extrapolations.

Needles and haystacks

Baillie Gifford believes that growth is misunderstood. Transfers of wealth within economies are far more consequential for growth companies than the changes in interest rates and inflation that fixate commentators. Gross domestic product (GDP) is a simple average that tells us very little about the real underlying drivers of growth. It's an output measure of what companies[13] collectively do, not a precondition for growth investing.

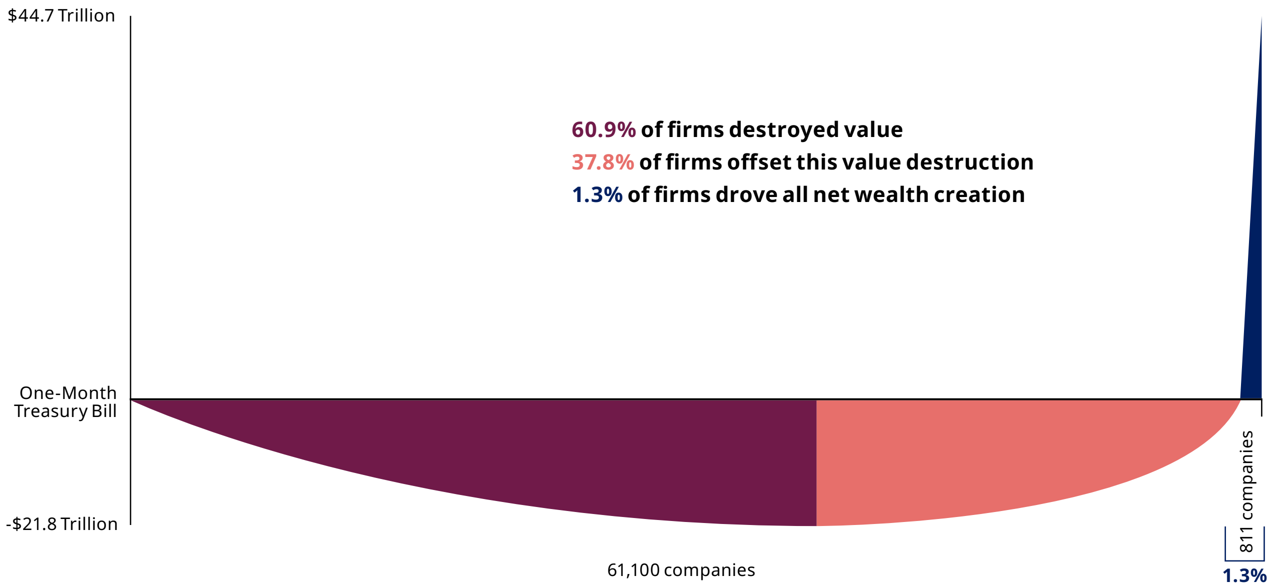
The best companies create growth, they don't just passively benefit from it. This simple reversal of viewpoint leads us to a far more useful question: which companies create that growth? And here we get to the critical insight: wealth creation in the long run is the preserve of a startlingly small number.

Academic research shows that very few companies account for almost all net wealth creation in stock markets over long periods. Prolonged but narrow growth fundamentally underpins market returns. Such extreme skewness is wholly inconsistent with the assumptions of the capital asset pricing model (the theory that markets exist in an information and risk-efficient equilibrium) on which diversified passive models rest. Wealth creation is a vastly asymmetrical process.

Some asset owners think early identification of the very few companies at the upper end of the returns distribution is like looking for needles in a haystack. So the only way to ensure exposure to long-term wealth creation is to buy the whole haystack (ie the index). This is reasonable, though it doesn't address the increasing tendency for growth to happen in private markets.

However, the opposite argument also applies. If you set your investment research function to finding those exceptional listed companies, you can achieve significant long-term added value. Evidence and intuition indicate that focused and original research, and high engagement with companies to understand their ambition and adaptability, are more likely to uncover those long-term success stories.

Total wealth created by all listed global stocks: 1990–2018



Source: Bessembinder, H., Cheng, TF., Choi G., John Wei, K.C. Do Global Stocks Outperform Treasury Bills? (July, 2019). The first author acknowledges financial support from Baillie Gifford & Co. The data includes 61,981 CRSP common stocks from January 1990 to December 2018. In cases where stocks list or delist within a calendar period the return is computed for the portion of the period where data is available. These 61,981 stocks were issued by 61,100 firms owing to dual share classes; dollar wealth is therefore assessed at the company level. Beyond the best-performing 811 firms, an additional 23,094 firms (37.8%) of stocks created positive wealth over their lifetimes. The wealth creation of these stocks was just offset by the wealth destruction of the remaining 37,195 (60.9% of total) firms, so that the top 811 firms created the same wealth as the overall market. US dollar.

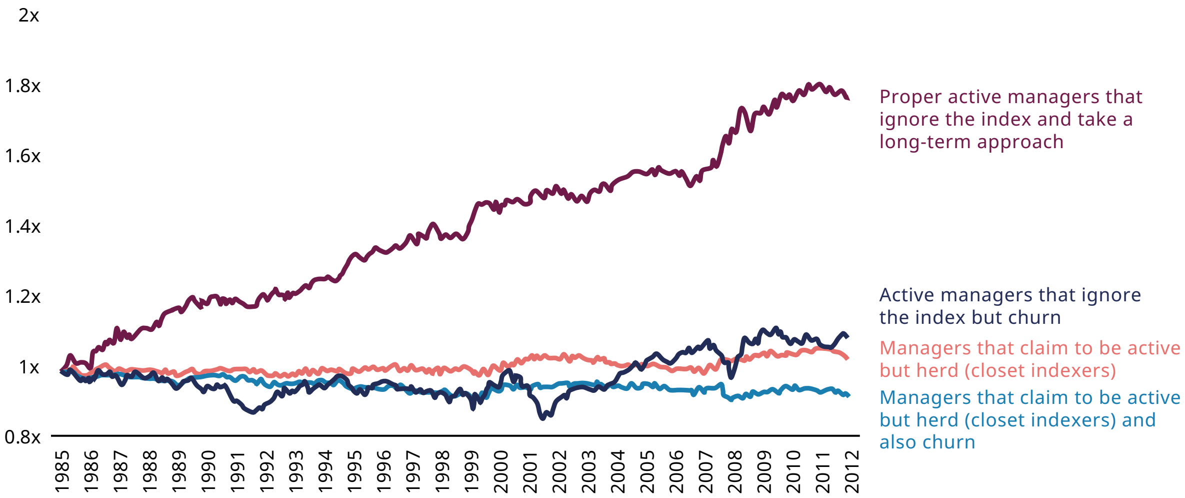
13. In reality not just companies but let's stick with that for this purpose.

So why all the outflows from active management?

Active managers are usually viewed as a homogenous group of interchangeable players. We're anything but. Few studies look beyond the 'active' label to examine the different approaches, but those that do find that managers with high active share and low turnover do much better than all the rest. This fits with what we know about the value of long-horizon investing and the importance of quality shareholders.

The chart below splits performance outcomes for active managers into quintiles of active share and turnover. The key finding is that active strategies in the top quintile for active share *and* lowest quintile for turnover[14] (4 per cent of all strategies) far outperformed the rest.

Outperformance relative to passive net of fees



Source: Cremers and Pareek, 2014 *Patient Capital Outperformance*

More recent but less comprehensive studies have come to similar answers. See for example 'Hallmarks of Successful Active Equity Managers'[15]. The conclusion is clear: not all active management is the same.

14. These variables are measurable proxies for conviction and long-termism.

15. Kevin Ely/Cambridge Associates. This study also found that such managers charge a price premium but that outperformance on average 'far outweighed' the incremental fee.

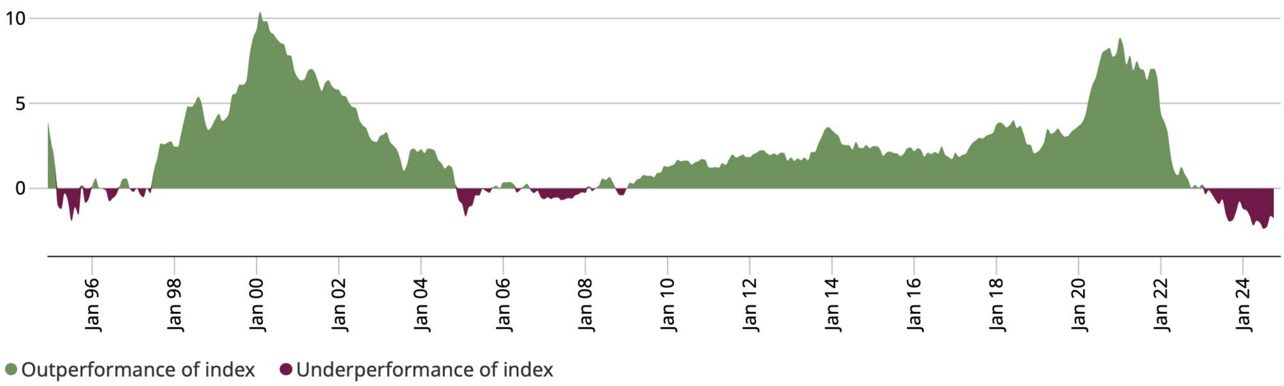
When is ‘long-term’ not long enough?

Usually, five years is long enough for fundamental progress to drown out the noise in valuations. This is what affords high active share/low turnover managers the luxury of not trying to forecast short-term market moves or the sentiment of other market participants. However, in the five years to the end of December 2024, at least for some of Baillie Gifford’s strategies, this relationship between time, share price and fundamental progress has broken down.

The following chart shows average performance against the benchmark for every equity-only strategy that Baillie Gifford manages, using all available data[16]:

Rolling 5-year average annualised geometric relative returns

(Net composite returns versus benchmark in GBP)



Source: StatPro Composites, Revolution and relevant underlying index providers. Rolling 5 year average annualised relative returns are calculated using the overall average of geometric relative, 5 year annualised, gross composite performance of our unconstrained equity only composites. In charting this, we looked at each composite’s outperformance (or underperformance) compared to the composite’s relevant index over five-year periods for each quarter since that composite’s inception. Data excludes composites that include Fixed Interest, Multi Asset and Investment Trust portfolios and any portfolios that invest in Private Companies. The returns presented above are gross of fees. The results do not reflect the deduction of investment management fees; the return will be reduced by the management fees and any other expenses incurred in the management of the account. For example, an account, paying a 0.8% annual fee, with a given rate of 5% annualised over a 10-year period would result in a net-of-fee return of 4.2% p.a. Overall, the chart demonstrates a clear pattern of historic performance against the relevant investment measure for each composite. For more details about performance please visit the Baillie Gifford website. Past performance is not a guide to future returns.

As the chart shows, this isn’t the first time that performance has dipped behind benchmark over five-year periods. Such dips have historically been unusual, and this time, underperformance is proving longer-lived than before.

On each previous occasion, the negative pattern preceded a prolonged period of outperformance. The key point is that peak-to-trough style and valuation shifts can sometimes drown out fundamental progress, even over long periods. We must continually check our assumptions and re-examine our investment cases, but most of all we must be patient.

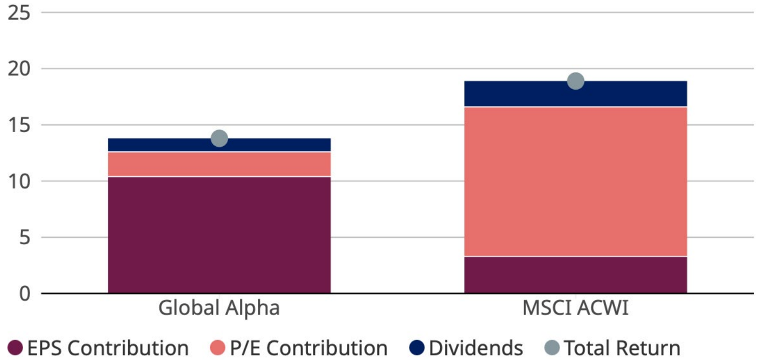
16. Some large strategies have outperformed, so the result would be different in a money-weighted calculation. The chart uses a simple average.

Resolute optimism

There is reason for optimism. If we disaggregate returns for recent years what we see is that most of the return on Baillie Gifford portfolios has come from earnings growth. Elsewhere, most of the return has come from multiple expansion – market willingness to pay more for the same earnings.

Put another way, our portfolios have been getting cheaper relative to the market. The price/earnings-to-growth (PEG) ratio is now at 1.3, the lowest for five years, and well below the market's 1.6. The following chart, showing the underlying sources of share price return for one of our mainstream global equity strategies in 2024, illustrates this:

Global Alpha earnings per share (%)



Source: Baillie Gifford, FactSet, MSCI. USD dollar MSCI ACWI. Return decomposition for Global Alpha and the MSCI ACWI Index from 29th December 2023 to 3rd January 2025.
MSCI ACWI. Return decomposition for Global Alpha and the MSCI ACWI Index from 29th December 2023 to 3rd January 2025. Based on a representative Global Alpha portfolio. Global Alpha is a Baillie Gifford core growth equity strategy.

To us this looks like a situation primed for a sharp reversal simply on valuation grounds. The companies in our portfolios are growing significantly faster than the market but aren't being priced accordingly by investors. These companies will at some point be re-rated, or given time will simply outgrow the market in earnings terms.

But our view is stronger than that. We invest in companies we expect to grow through idiosyncratic opportunity and by disrupting others, not by tapping into general economic progress. We think growth will become harder to find amid the turmoil the current US administration has set in train. We believe we are well positioned in companies that don't depend on the unimpeded cross-border flow of goods. It should only be a matter of time.

Key takeaways

Companies that happen to be listed on stock markets are a central, integrated part of the system that creates productivity growth and raises living standards. They play a major part in growing the wealth that pays pensions and make other forms of saving viable through deploying vast amounts of growth capital.

Overseeing this process is essential to the investment task, and its neglect comes at a cost to all. The gamification of stock markets may be relentless, but to characterise all listed equity investing as “unproductive” is wrong. It is at the very centre of what it means to be an investor.

The separation of ownership and control is well recognised, and systems have long been in place to mitigate it. But those systems are now beginning to break down as the engagement, motivation and policing of companies by a dwindling number of institutional investors goes unappreciated and unrewarded. There is already a lack of stewardship resource in the system and managers who have such resources are being undercut on price by those who don’t. This will not end well. Not everyone can just free-ride on a system they expect others to police.

The past few years have been difficult for active managers. We’ve seen huge valuation swings and very narrow markets. But there is strong evidence that those who adopt a high conviction/low turnover approach and meaningfully engage with the companies they invest in generally outperform in the long run.

In Baillie Gifford’s case, each time we have dipped behind benchmarks over five years it has been a prelude to an extended run of outperformance. Can we guarantee this will happen again? No. But we remain resolutely optimistic.

Stuart Dunbar

May 2025

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