

Let's talk about Actual investing some more.

Capital deployment in the real world.

Summary Points

- 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.

As with any investment, your capital is at risk.

Real world capital deployment

Listed equity markets are supposed to be a conduit for long-term savings, facilitating risk-sharing and maturity transformation to capture the power of capitalism.

They allow long-term investment projects to be transformed into tradeable liquid investments, with established governance to mitigate principal-agent conflicts.

In practice, the markets themselves have become the main event. Huge amounts of time and energy are spent analysing their patterns, participants and behaviours, all at the expense of focusing on tangible capital deployment. Things have got so bad that some no longer see allocating capital to listed equities as economically productive. This is a worrying and destructive state of affairs.

The amount of investment on research and development that listed companies make in their own businesses every year is vast. Competition drives innovation, and the result is socially beneficial productivity gains.

Of course not every company behaves in this way. That's why we need an effective system of company-specific oversight that aligns the interests of corporate management and long-term investors. This requires resources that are all too quickly diminishing as a result of intense fee pressure in the investment industry.

Oversight doesn't just mean policing. It also means creating and nurturing an environment that allows management to make the right long-term decisions. In this, it's no different from the engagement clients are used to in private growth equities.

Quality shareholders

Studies have identified what constitutes 'quality shareholders' and why they're valuable. The research shows that companies with a higher proportion of engaged owners can better execute long-term strategies. The value of these investors materialises in better long-term returns for all who hold shares in those companies.

The trend towards passive investing, and intense fee pressure on active managers, are reducing the preponderance of quality shareholders. The 'ownerless corporation' is coming into sight.

When too many investors free-ride on the deep engagement effort of others, it becomes economically unviable for the few quality shareholders to continue, and systematic returns will be reduced. Index-tracking funds will continue to follow the index, but they'll be tracking an ever more dysfunctional system that creates less wealth.

Importantly, there is ample evidence that simply exercising voting rights is not enough to give you the influence of a quality shareholder.

Good active management

The proper role of active managers is fourfold:

- identifying underappreciated real-world investment opportunities
- finding well-managed companies positioned to capitalise on these
- acting as quality shareholders providing constructive oversight
- staying alert to when the market catches up in order to move to the next idea

This has little, if anything, to do with the analysis of share price patterns and the manifestly wrong assumptions about efficient markets on which passive strategies rely. Efficient markets don't exist. To society's cost, such mistaken thinking will only get worse as the number of quality shareholders reduces.

Actual investing is not just an exercise in calculation. It requires curiosity, imagination and asking "what if?" rather than merely "what is?". Building teams with cognitive and social diversity helps. So do funding academic research partnerships, engaging with world-leading entrepreneurs and founder-leaders, and focusing on long-term industry developments rather than quarterly results.

Yes, it works...

Despite recent headwinds, there is plenty of evidence for the efficacy of long-term growth investing, starting with the principle that share prices eventually follow earnings-per-share (EPS) growth. On average, companies with the fastest EPS growth outperform over periods of five years and longer, regardless of starting valuation. Markets struggle to look that far ahead. This is an opportunity for outperformance.

Active management is not homogenous. Independent research shows that strategies that combine high active share (differentiation from the index) with low turnover significantly outperform other approaches over the long term.

...but not everywhere and always

While some Baillie Gifford strategies have underperformed over five years, this should be seen in a historical context. The firm's investment success story over the decades has contained several periods of underperformance.

We know that peak-to-trough valuation shifts can obscure companies' fundamental progress. Continual re-examination of investment cases is needed, but so too is patience – something that becomes more valuable as it becomes more difficult.

Baillie Gifford portfolios now trade at a price/earnings-to-growth ratio of 1.3. That's cheaper, according to that calculation of stocks' value, than the market's 1.6. It's also cheap relative to those portfolios' own history. This is especially unexpected given that our focus on disruptive and idiosyncratic growth equips us to withstand a Trump-inspired re-ordering of world trade. We don't invest in many companies heavily reliant on free trade in goods.

Listed companies remain central to productivity growth and wealth creation. Ensuring alignment of interests and overcoming risk aversion within companies are two vital and underappreciated parts of the role of good active managers. In the long run, this is the path both to outperformance and the rising living standards that a well-functioning capital system should deliver.

Baillie Gifford, May 2025

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