TILTING THE ODDS IN YOUR FAVOUR

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BAILLIE GIFFORD

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Annual Past Performance to 30 December each year

	2016	2017	2018	2019	2020
International Alpha	5.2	34.9	-16.9	32.8	26.7
MSCI ACWI ex US	5.0	27.8	-13.8	22.1	11.1
MSCI EAFE	1.5	25.6	-13.4	22.7	8.3
S&P 500	12.0	21.8	-4.4	31.5	18.4

Source: Baillie Gifford & Co and relevant underlying index providers. US Dollars.

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APRIL 2021

TILTING THE ODDS IN YOUR FAVOUR

BY STEPHEN CORR

Tesla has become the poster child for phenomenal innovation, genius leadership, and exceptional returns. Few remember that Elon Musk struggled to get funding for his project from the capital markets, a fact the writer Michael Lewis reminds us about in The Fifth Risk. *It was the US Department of Energy which lent money to Tesla to build its factory in Fremont, California, when the private sector would not. Would Mr Musk have built his factory in South Africa had that government been able to lend money, or China had they been willing to do so? America has long been the leader in putting risk capital to productive work, and having policies and rewards in place to encourage entrepreneurship.*

If it seems unusual to start an 'International' paper referencing a US company, it is worth remember that in financial markets, it is the rate of change and its direction that dominates, and in this regard, it may be the International market place that has the US in its rear view mirror in the coming decade.

PICK THE RIGHT MARKETS

The international asset class finds itself under pressure and has been eclipsed in performance terms by US stocks in more recent times. We think it is time to question if this can continue. Our experience in managing international portfolios dates back to the 1980s, but investing overseas is more deeply embedded in our firm's DNA. Indeed, Scottish Mortgage Investment Trust was founded in 1909 and has been managed by Baillie Gifford for 112 years. We first wrote about the international opportunity set in 2019, and this paper looks to build on that original piece, expanding on some of the arguments highlighted back then, specifically, how the international horizon looks for an active investor over the coming years and why its attraction is growing.

For the purposes of this report, we define our investible universe as stocks with a market capitalisation above $2bn. The universe is summarised below.

Our Investible Universe

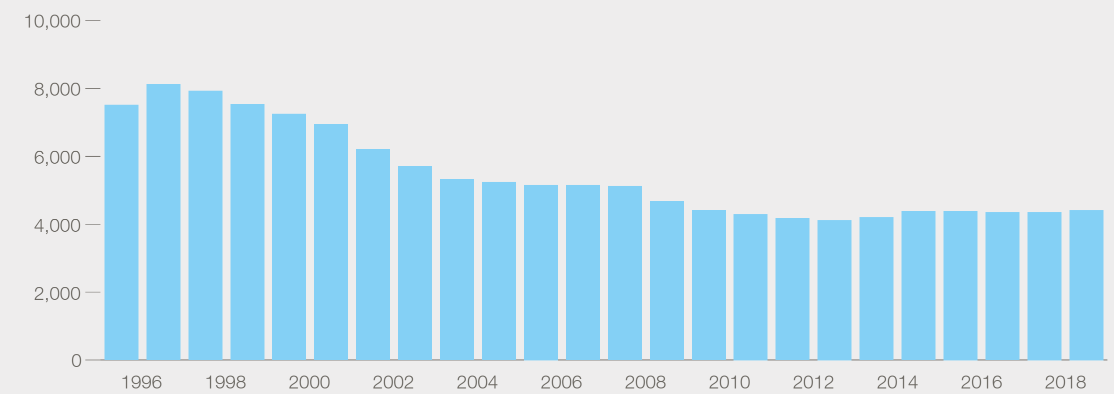
	$ Value	% $ Value	No. Stocks	% Stocks	No. Countries
US Market	46,049,264,308,224	45	1909	30	1
International Market	57,384,898,097,152	55	4527	70	82
Total Universe (>$2bn)	103,434,162,405,376	100	6436	100	

Source: Bloomberg. As at 31 December 2020.

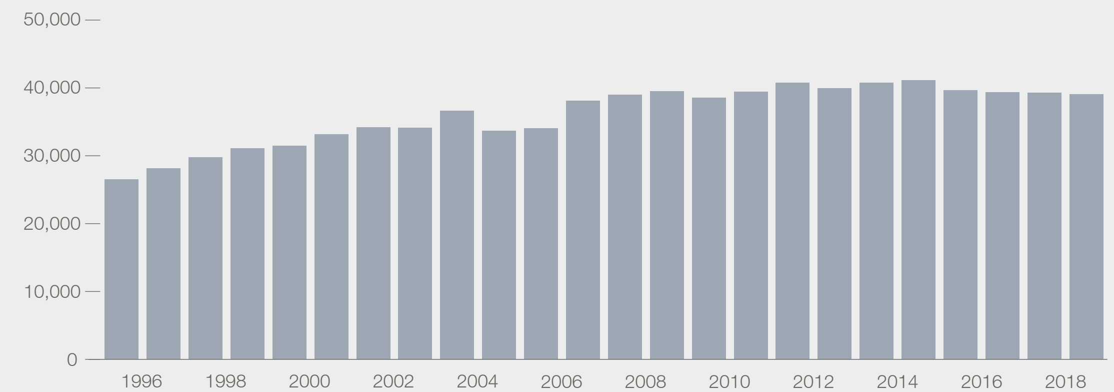
When we wrote the first iteration of this paper, the dollar value of the US market was higher than the combined international markets. In three short years that situation has now inverted.

Since 1996, the broader universe of US-listed securities has declined from a peak of 8,090, to a 2018 count of 4,397, a 46 per cent drop. Today, there are fewer US-listed companies than in the early 1980s, when the US economy was less than half its current size.

US Listed Companies



Global Listed Companies



Source: World Bank.

There is no such shrinkage in international equity markets. Quite the opposite in fact, with internationally listed businesses growing from 26,432 to 38,945, a 47 per cent increase. For several years, Ernst and Young has tracked global IPO trends. In 2014, its research showed that the Americas accounted for 25 per cent of all new listings and 38 per cent of the proceeds of those. By 2020, the US share had fallen to 21 per cent and the proceeds to 36 per cent, with much more fallow periods in the intervening years.

RECENT IPO ACTIVITY

Selected IPOs by Proceeds

2020	$bn
SMIC	7.5
Beijing-Shanghai High Speed Railway	4.4
JD Health	4.0
Pershing Square Tontine Holdings	4.0
Snowflake	3.9
JD.com	3.9
AirBNB	3.8
NetEase	3.1
JDE Peet's BV	2.9
Central Retail Corp	2.3
BlackRock Health Sciences Trust	2.3
Rede D'Or Sao	2.2

2019	$bn
Saudi Aramco	25.6
Alibaba Group Holding	12.9
Uber	8.1
Budweiser Brewing APAC	5.3
Postal Savings Bank of China	4.7
Avantor	3.3
Nexi	2.3
CGN Power	1.8
TeamViewer	1.6
Alight Inc	0.8
Embassy Office Park REIT	0.7
Levis Strauss & Co	0.6

2018	$bn
Softbank	21.1
China Tower	6.9
Xiaomi	5.4
Siemens Healthineers	5.2
Knorr-Bremse	4.4
Foxconn Industrial Internet	4.2
Meituan Dianping	4.0
AXA Equitable Holdings	3.2
PagSeguro	2.3
DWS Group	1.8
Tencent Music Entertainment	1.4
Vinhomes	1.3

2017	$bn
Snap	3.9
Landis & Gyr Holdings	2.4
Netmarble Games	2.3
Goutai Junan Securities	2.2
BAWAG Group	2.0
Galencia	1.9
Invitation Homes	1.8
General Insurance Corp of India	1.7
NetLink NBN Trust	1.7
Petrobras Distribuidora	1.6
ZhongAn	1.5
Becle SAB de CV	0.9

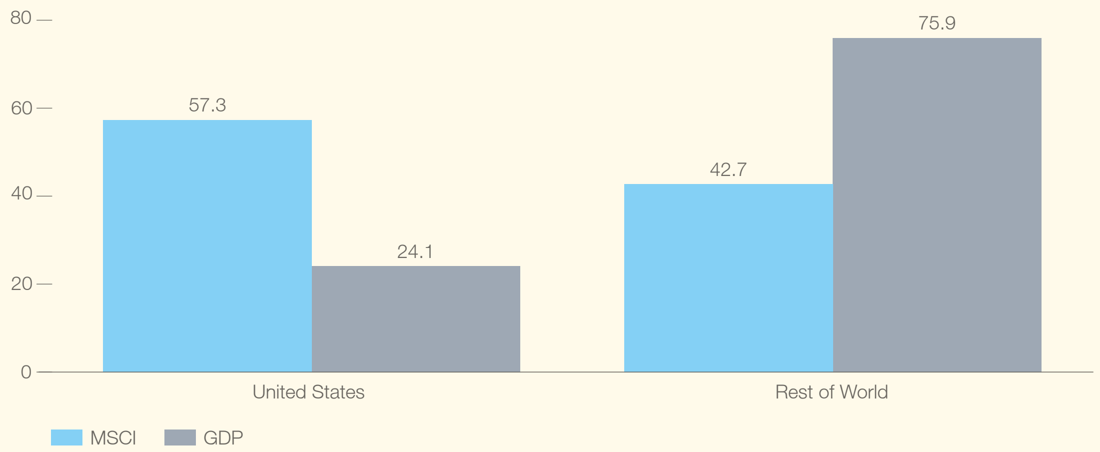
2016	$bn
Postal Savings Bank of China Co	7.8
Innogy	5.2
JR Kyushu Railway Company	4.0
Dong Energy	2.6
Samsung Biologics	2.0
Nets	2.0
China Zheshang Bank	2.0
LINE Corp	1.3
MGM Growth Properties	1.2
US Food Holdings	1.2
LaSalle Logiport	0.9
Metro Bank	0.6

NYSE Listed

Source: PwC, Ernst & Young, Global IPO Trends, 2016, 2017, 2018, 2019, 2020. The IPOs selected represent the top three listings by proceed in each quarter between 2016 and 2020. Note: Baillie Gifford does not necessarily hold these companies.

For several years, Hong Kong and China have topped the IPO league table. As the chart below illustrates, we can expect this trend to continue as emerging market companies redressing the imbalance imposed by legacy benchmarks. The link between GDP and market cap is far from linear, but the direction of travel seems clear to us.

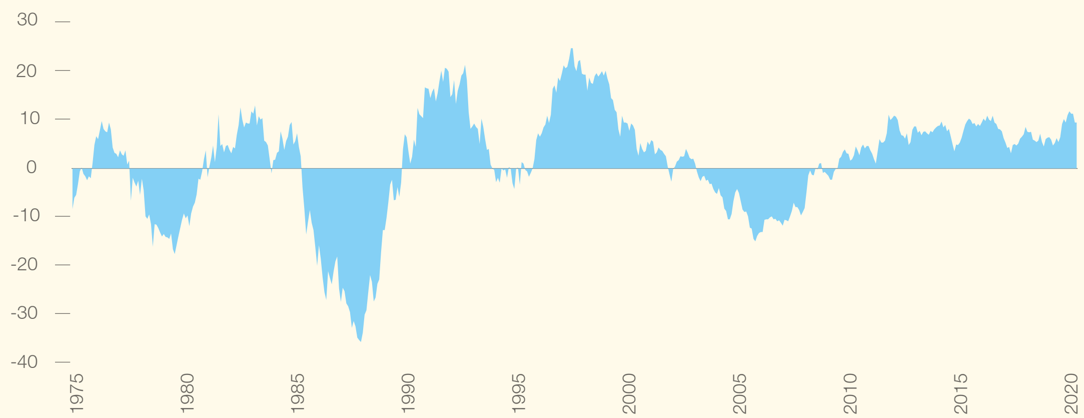
US companies are over-represented in global benchmarks



Source: Refinitiv Datastream.

Over the years, the level of interest in US domestic equities versus international equities has waxed and waned, most commonly when one asset class has enjoyed a prolonged period of outperformance. We are at one such juncture today. Taking three-year rolling returns for the S&P 500 and the MSCI EAFE index as our comparative benchmarks, domestic US equities have enjoyed 11 consecutive years of outperformance against international equities. As this is one of the longest periods of relative strength in the past 45 years, it is not surprising that more people are calling for more assets to be allocated domestically. However, after such a lengthy period of outperformance, history tells us this may not be the best time to make that switch.

Three-year rolling returns – S&P 500 vs International Index



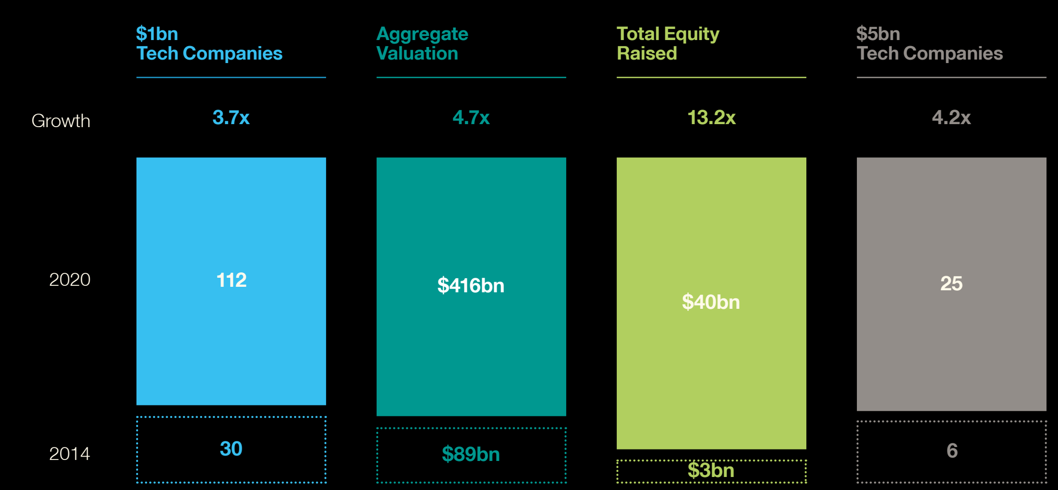
Source: Refinitiv Datastream.

PICK THE RIGHT ENVIRONMENT

Favourable policies, capital markets and regulations have given the US a huge advantage over many other parts of the world in recent decades. In the financial environment it is, as always, the pace of change that matters most. As my colleague Chris Davis recently explained, summarised in the following paragraphs, investment beyond US shores is quickly closing the gap.

"The foundations have been laid for European tech to flourish long term as never before. Capital is available in large quantities, increasingly coming from patient, supportive investors who understand the challenges of building tech winners. This powerful combination is fostering a wave of European entrepreneurs ready to take on the world. The past six years alone have witnessed more than a thirteen-fold increase in the amount of equity raised by Europe's tech ecosystem, a colossal $40bn that dwarves the $3bn raised in 2014. There's also been a near fourfold increase in the number of European tech unicorns (companies worth more than $1bn) and more than a fourfold increase in the number of companies valued $5bn and above. Even the European Commission has realised the need for money, setting up the European Innovation Council in 2017 with the explicit goal of making approximately €3bn of funding available to 'the most talented innovators to help their companies scale up and expand beyond European borders".

Europe's Transforming Tech Ecosystem



Source: GP Bullhound, Capital IQ, Mergemarket. Pitchbook and Crunchbase. Equity funds raised refer to capital raised through primary equity offering. Cut-off date for inclusion in report 31 March 2020; valuations correct as at 14 May 2020.

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What matters most is the transformation in ambitions.

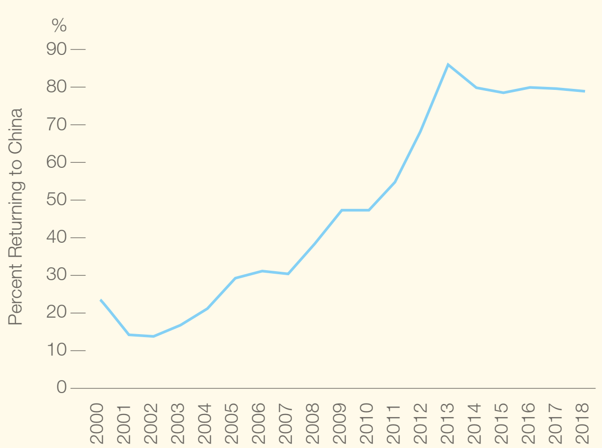
What matters most is the transformation in ambitions. The thriving tech ecosystems in various European cities – from Paris to Berlin to Stockholm – have provided nurturing environments that allow entrepreneurs to aim high.

And aiming high they are. Spotify's Daniel Ek is taking on American giants Apple and Amazon in music streaming. He is winning the battle for subscribers with over 130 million paying subscribers, more than Apple and Amazon combined. Classifieds marketplace operator Adevinta – which runs several real estate, car and job marketplaces around Europe – is about to become the largest in the world as it digests eBay's classifieds division. Then there's Jitse Groen, the ambitious founder of Dutch online food delivery business Takeaway.com, which recently merged with the UK's Just Eat. He is currently in the process of trying to acquire American peer Grubhub, a deal that would crown Just Eat Takeaway as one of the biggest online food delivery businesses in the world.

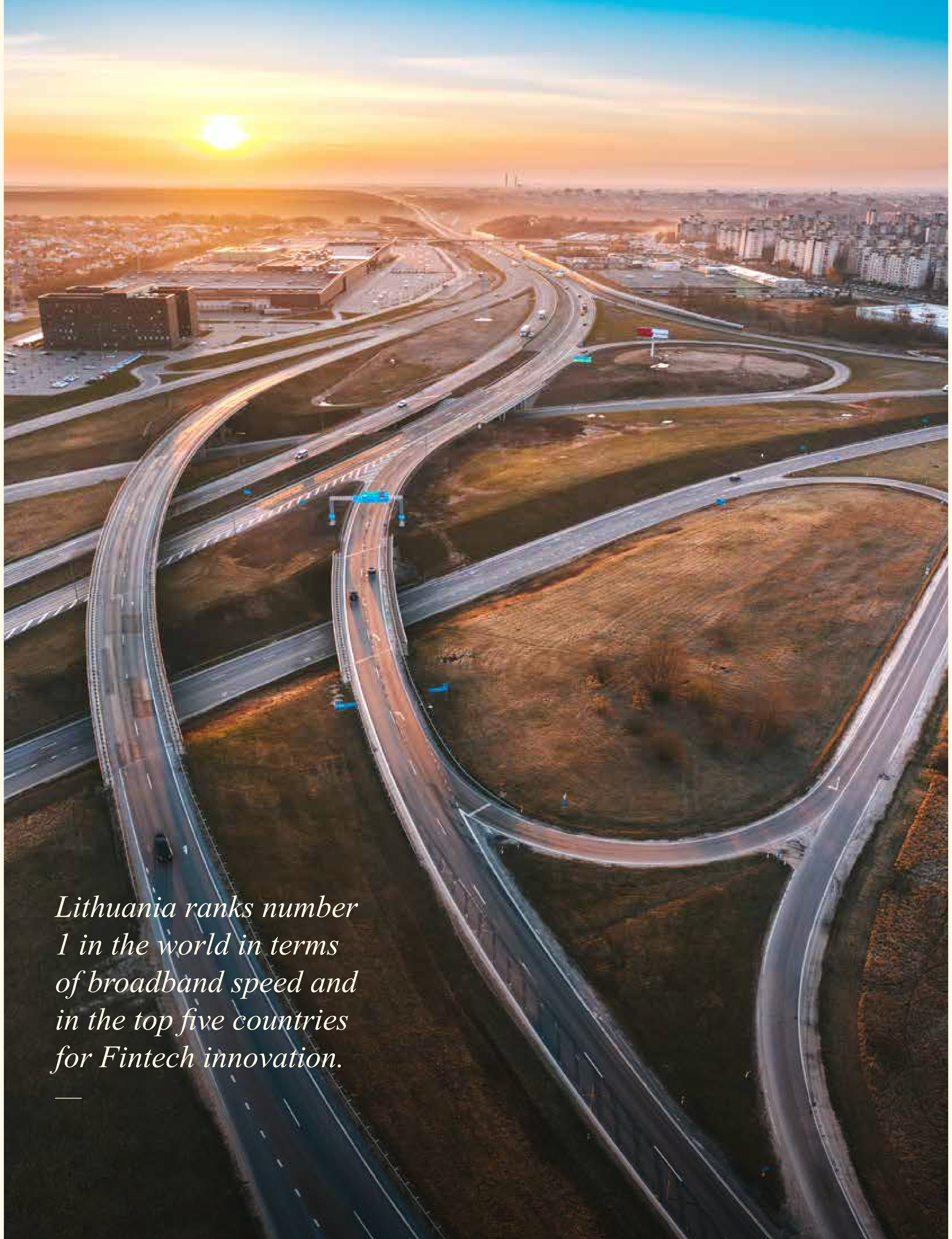
It may come as a surprise to learn that Tel Aviv (Israel), Vilnius (Lithuania), and Tallinn (Estonia) all rank in the top 50 cities in the world in Fintech. You may not yet have heard of many of their leading companies, but I'll wager you will in the coming decade. Lithuania ranks number one in the world in terms of broadband speed and in the top five countries for Fintech innovation. Investment in the right infrastructure has given that country a head start it is not wasting.

Access to capital and need for less of it in today's capital-lite, 'free money' world means more and more entrepreneurs, the geniuses who will lead the exceptional companies of tomorrow, no longer feel anchored to the US. 20 years ago, fewer than 15 per cent of Chinese students studying abroad felt compelled to return home, filled with ideas but lacking the capital to fund their ambitions. Today closer to 80 per cent see a much more favourable environment in which to put their western education to profitable use domestically.

Percentage of Chinese Students Studying Abroad and Returning to China



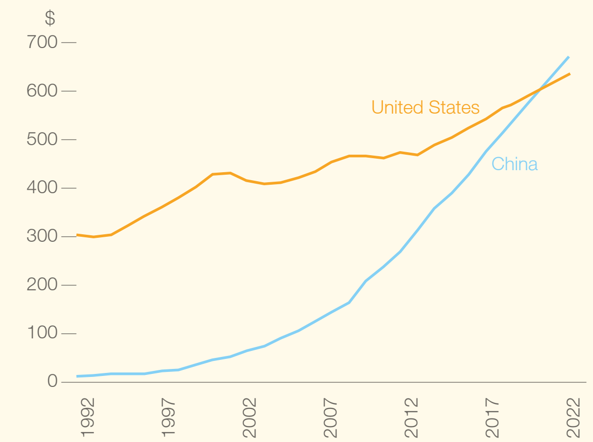
Source: National Bureau of Statistics of China, China Statistic Yearbook 2019. The figure is reproduced from American Academy of Arts and Sciences, *The Perils of Complacency: America at a Tipping Point in Science & Engineering* (Cambridge, Mass.: American Academy of Arts and Sciences, 2020).



Adding to the earlier comments on the popularity of the Hong Kong stock market, companies are increasingly eschewing an ADR listing entirely, preferring a Hong Kong local listing, with exchange regulators encouragingly supportive. For the Chinese company of the future, a dual listing may well mean H-shares (HK) and A-shares (mainland China).

In a world obsessed with buybacks (at the wrong time) and cost-cutting (at the wrong time), we look for investment and expansion. Here, the US is no longer the world leader it once was.

Gross Expenditure in R&D



Source: OECD, 2019.

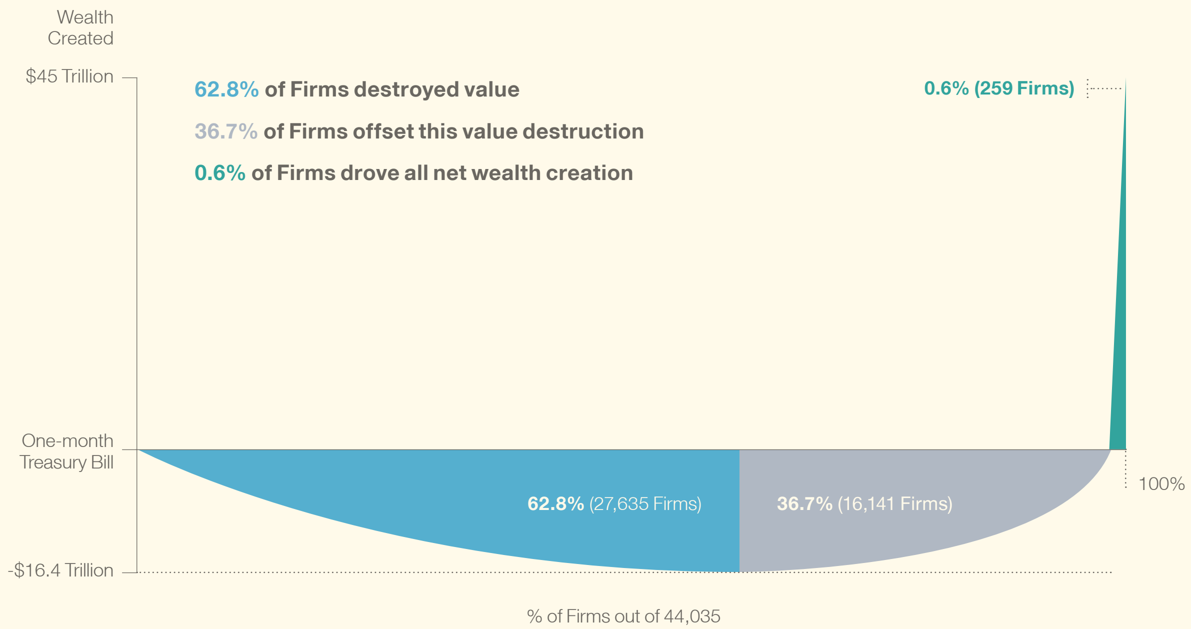
Despite the protestations of politicians garnering votes in the almost unending US election cycle, the American chant 'we're number one' is under pressure on multiple fronts, not just the perceived threat from the rise of China.

Europe's regulatory regime shift, China's R&D investment and Lithuanian's infrastructure investment are but three small examples that show there are confluences of disruption, development, and innovation going on in corners of the world where such activity was previously unimagined. Our job as investors is to find those exceptional companies, purchase them on our clients' behalf, and hold them in meaningful size above an index weight to generate better than average performance.

PICK THE RIGHT MANAGER

Finding those expectational growth companies is difficult, and it is very hard to outperform over the long term. Indeed, the work of Professor Hendrick Bessembinder at Arizona State University tells us that a tiny fraction of all internationally listed companies – 0.6 per cent, or 259 companies – have generated all the wealth in international markets since 1990. The value created by 27,635 firms was offset by the value destroyed by 16,141 others.

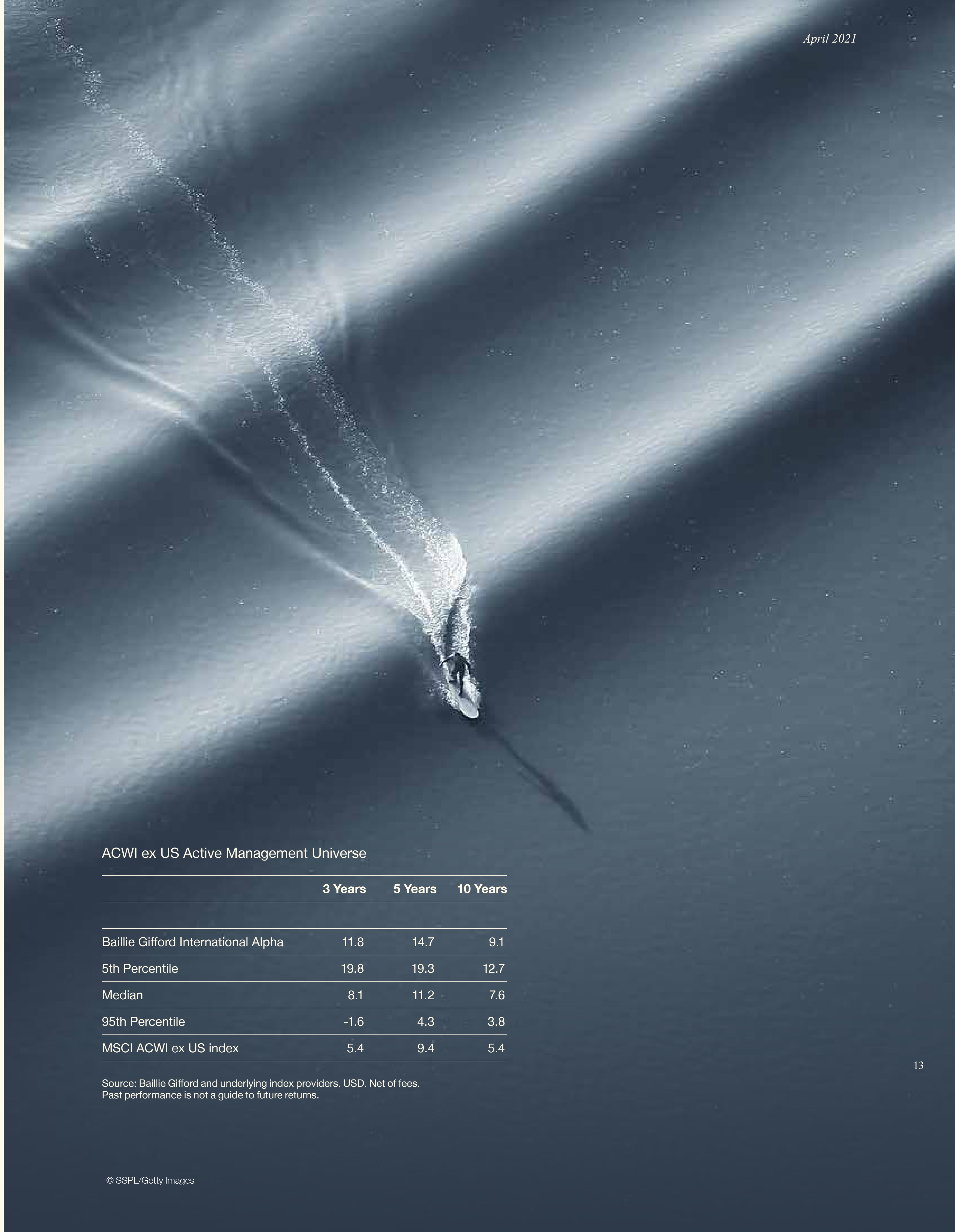
Total wealth created by all listed global stocks between 1990–2018



Source: Bessembinder, H., Cheng, TF., Choi G. and 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.

The right manager won't find the exceptional growth companies of the coming decade by staring at a Bloomberg screen or tuning in to CNBC, and they won't find it in the consensus. They won't find it over a week, month or quarter either. The right manager supports the companies they invest client money with, encourages improvement where needed and challenges behaviours they disagree with.

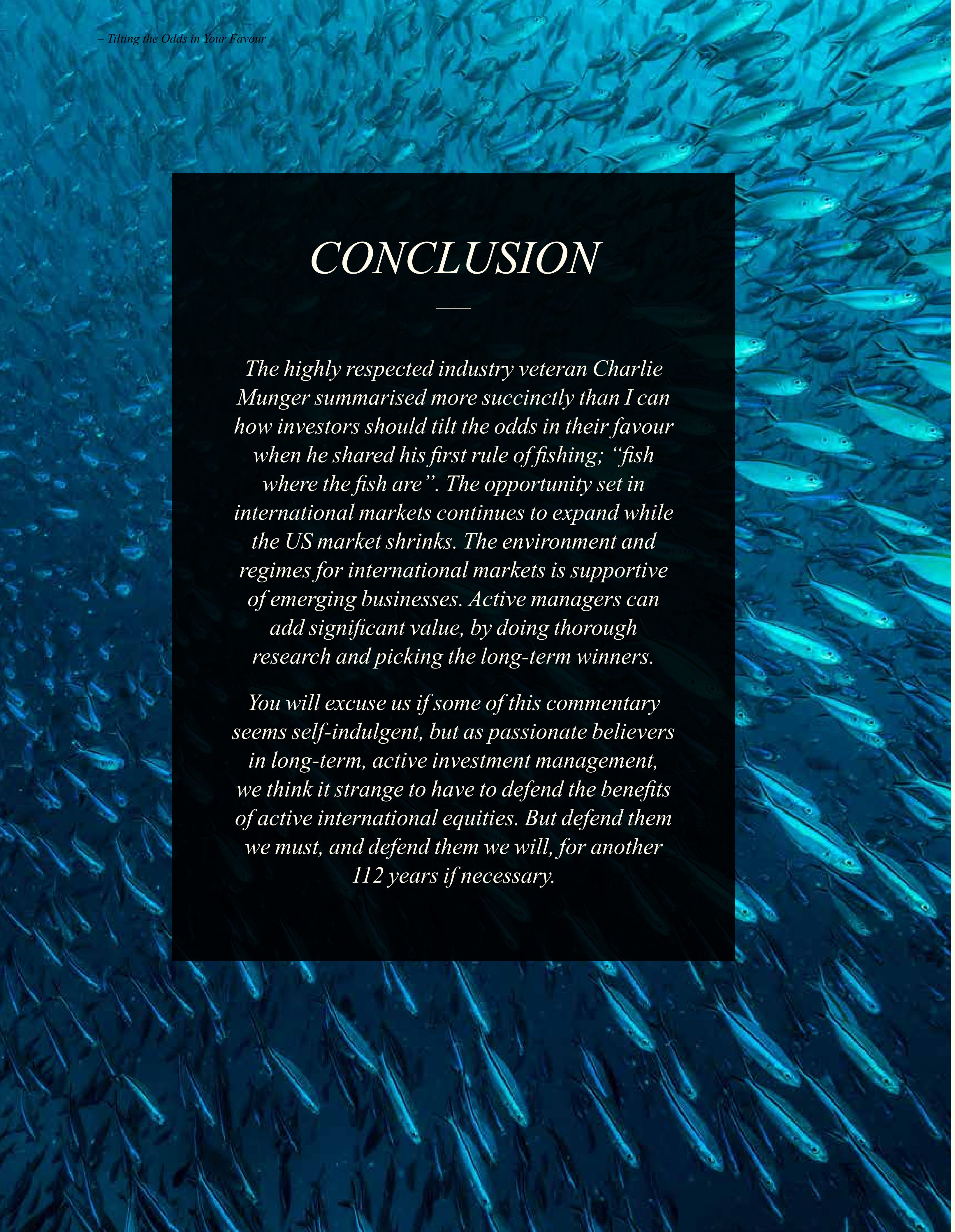
For now, the tsunami of money flowing into (mainly passive) US funds continues unabated. An acceleration of that pattern cannot be ruled out, but the following table is illustrative for those who do believe in active international management. Taking the 10-year column as our example (very few do these days!), the benchmark has returned an annualised 5.4 per cent. A first quartile manager has returned an annualised 9.3 per cent, and the top 5 per cent of managers have returned an annualised 12.7 per cent. Done correctly, truly active management can – and does – outperform. Glib statements that active international managers cannot add value are simply misleading.



ACWI ex US Active Management Universe

	3 Years	5 Years	10 Years
Baillie Gifford International Alpha	11.8	14.7	9.1
5th Percentile	19.8	19.3	12.7
Median	8.1	11.2	7.6
95th Percentile	-1.6	4.3	3.8
MSCI ACWI ex US index	5.4	9.4	5.4

Source: Baillie Gifford and underlying index providers. USD. Net of fees.
Past performance is not a guide to future returns.



CONCLUSION

The highly respected industry veteran Charlie Munger summarised more succinctly than I can how investors should tilt the odds in their favour when he shared his first rule of fishing; "fish where the fish are". The opportunity set in international markets continues to expand while the US market shrinks. The environment and regimes for international markets is supportive of emerging businesses. Active managers can add significant value, by doing thorough research and picking the long-term winners.

You will excuse us if some of this commentary seems self-indulgent, but as passionate believers in long-term, active investment management, we think it strange to have to defend the benefits of active international equities. But defend them we must, and defend them we will, for another 112 years if necessary.

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Stephen graduated from Dublin City University with a Bachelor of Business Studies (BBS) in 1998 and became a CFA charterholder in 2003. He spent 16 years as a Global, ACWI and EAFE portfolio manager with Blackrock, Scottish Widows Investment Partnership and most recently Nikko Asset Management. Stephen joined the Clients Department at Baillie Gifford in 2016, where he is Client Service Director within the ACWI Alpha Team.

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