
SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 23

Growth or value: it's not a black or white choice

MB – Malcolm Borthwick

MM – Malcolm MacColl

MB Hello and welcome to *Short Briefings on Long Term Thinking*. Thanks for joining us. I'm Malcom Borthwick, editor of Intellectual Capital at Baillie Gifford.

The personal finance pages are dominated by discussions about whether the investment cycle has moved from growth to value investing.

To provide a crude definition, value investors buy stocks that are cheap relative to their earnings and potential, whereas growth investors target stocks expected to grow rapidly with higher valuations. That's in recognition of their long-term potential.

So, these are two neat categories, but are they helpful for investors? To discuss this, I'm joined in our Edinburgh studio by Malcolm MacColl, deputy manager of The Monks Investment Trust and manager of the Global Alpha Growth Fund and the Global Alpha Paris-Aligned Fund. Malcolm is also joint senior partner at Baillie Gifford.

But before we start our conversation, some important information. Please remember that as with all investments, your capital is at risk and your income is not guaranteed.

Malcolm, welcome to the podcast, and I think this is the first time that we've had two Malcolms in the studio, so it's great to have you on *Short Briefings on Long Term Thinking*. Thanks for joining us.

MM No, thanks very much, indeed. I'm sure there are different witty aspects to the double Malcolm, but I can't quite think of them myself.

MB Baillie Gifford is often described as a growth investor. Would you describe Baillie Gifford as a growth investor?



MM Yes, absolutely. So, what we're trying to do at Baillie Gifford is to identify businesses with the ability to grow their underlying profits and cash flows very meaningfully over periods of time. What we're trying to do is identify these businesses, the wealth creators of the future. That's an underpinning to what we're doing, philosophically.

MB And is there an element of the growth versus value debate that is unhelpful?

MM Yes. So, right at the top, when you were explaining this divide between growth and value, it almost gets my heckles up a little bit. For a long time, I've felt that the divide people like to put down between growth and value is a little bit unhelpful. It's a bit artificial and, actually, increasingly, I'm of the mind that it's quite a dangerous thing, or it's quite a limiting thing. So, to explain that a little bit, what we're trying to do is to identify businesses where there is growth, but it's got to be growth in value.

So, there's no point in a business growing without the underlying margin structures or the returns and the capital being there to support higher valuations into the future. And what I think happens an awful lot of time, is that people like to pigeonhole you into one section, of either this growth area or this value area, and that can be very limiting. It can be very limiting in terms of stopping your flexibility as an investor.

So, there are different types of growth companies and some of them will be very high growth in nature, some will be more stalwart, like compounding businesses, and I like to have the ability to go to both of those areas and to look for mispriced growth over long periods.

MB And give me a couple of examples of stocks that fit into that style and tell me why.

MM Well, two examples, as you're asking for there, I'll actually give you from businesses that we've owned for a long period of time for the clients that I'm involved with, over a decade, let's say. The first one would be Amazon.

So, Amazon, going back to your earlier point with regards to the divide between growth and value, it's a business which has always commanded, or very long periods has commanded very high near-term multiples on its earnings, on its sales and such like.

It's never really been categorised as a value stock, let's say, but it's a business which we think has long been misunderstood, or certainly in its formation years, it was extremely misunderstood. What I mean by that is people were very narrow in their thinking around Amazon. They didn't understand the dynamism involved in the business. They didn't understand the way in which it was going to be able to build out into new areas.

So, expanding from the core of its retail offering into lots of different categories, the way in which it was moving international, what it was able to do with regards to its expansion into media and then, obviously in more later years, what it's been



able to achieve with its web services offering. These are all things that people really didn't see coming or people were limiting themselves from seeing.

I also think that Amazon's an example of where people felt that the margin structures were always going to be quite limited and of course they've proven that to be completely wrong.

So, what we were doing when we first invested in that business is we were paying one cent in the dollar for the assets. So, you can look at this and say, 'well, it was a growth investment', yes, absolutely, it was, but in many regards, it was also a value investment. Perhaps the best value investment we've ever made. So, that is again an example of where that divide is perhaps somewhat artificial in nature. It was mispriced growth.

A separate example, let's say, would be a very different business, that being Anthem, which is a healthcare insurance company in the United States. If you're a UK listener, you can think of Bupa but it's at a much, much grander scale, let's say.

And I like to think of Anthem as being almost like a stealth growth stock. It's a business which has never really been seen as go-go growth, let's say, but it has compounded its profits at 10% per annum over the past ten years, so roughly double the market growth rate. So, it's a fantastic growth business.

One of my colleagues who you know well, Spencer, who co-manages a number of the funds that I'm involved with, he likes to describe Anthem as like a small car with a large engine, and what he means by that is that you don't realise that it's there until it accelerates away from you at the lights. Businesses like this, which are underappreciated as growth companies, again, that can make you huge returns over time, if you're patient with them.

MB Rarely has there been so much interest paid to monthly inflation figures. Looking at the December figures for the UK, inflation up 5.4 per cent year-on-year, highest in nearly 30 years. In the US even higher, 7 per cent, close to a 40-year high. These are both year-on-year figures. There is some concern about how inflation will feed through to interest rates and therefore asset prices. What's your reading of this, Malcolm?

MM Well, I think this is colouring an awful lot of people's thinking today and, actually, understandably so, because we haven't had a period of significant inflation for such a long time and, of course, we've been living through a period of interest rates going down, not up. So, I think it's quite understandable that people are a little bit worried about this.

My take is that, while we can choose to fret about the impact on asset values, and we understand, of course, that higher interest rates theoretically lead to lower prices or lower valuations, let's say, on equities; actually, the primary thing we need to be focused on, again, is the operational performance of individual assets.



The value that's been created at businesses like Amazon or Anthem, that we've just been talking about, the dominant factors there have been the growth in those companies. It's not been the way in which people have attached valuation multiples set by different frameworks relating to interest rates. So, we need to continue to focus on the bottom-up aspects of looking at businesses and thinking about which companies can just burst their way through expectations, accepting that, again, the current mood of the market is one whereby people are a little more nervous.

MB And how does inflation affect the companies that you invest in?

MM That's a very interesting one. So, we've actually done a considerable amount of work on this and, going back some time, we actually started doing work on this theme several years ago. What we focus on is, again, the impact on operational performance of the assets, of the individual companies.

And what we're looking at is the extent to which businesses are able to cope with a more inflationary environment, and the good news for ourselves is that the vast bulk of the businesses that we are invested in for clients are ones which are asset-light in nature. They're very scalable. They typically have large margin profiles and they're businesses which typically will have good pricing power.

So, I think that our assets are actually well set up to cope with a more inflationary environment. Now, in the short term, how people will value those businesses is a different matter and, of course, there will be times when macro elements and people's thinking will pressurise sets of companies within the market.

But, again, that's not what we dwell on. We dwell on the operational aspects of the companies and we think very carefully about how those businesses might look several years out from now, and that's something that we must be rigorous with, and we must be true to.

MB And we've talked a lot about growth and value but what I'm interested in is how you approach investing.

MM So, backing up a little bit, there is this core aspect to my personal thinking, which is about the compounding of growth over long periods of time and how that's pivotal for value creation, or wealth creation.

I'd also say, though, that I think very considerably about aspects of change within the investment landscape, and I think that that is something which is important for this broader framing of the discussion relating to growth and value. Again, it's quite important, I think, for the framing of what's going on with regards to the inflationary environment as well.

So, I think that in the past 10 or 15 years, a lot of people think that growth-related assets, let's say, for the sake of shorthand, have performed well because we've been in a declining interest rate environment. I think that's grossly unfair. I think that there is an element of that which will have played through into valuations but



that's completely overwhelmed by the fact that we've seen some enormously successful businesses bursting through because of change.

So, what am I talking about? What's the big picture here? We've seen an enormous digital revolution, which we can really track back to the advent of the internet 20, 25 years ago, and that's led to huge ripple effects. It's led to the emergence of these fantastic platform companies, the consumer-facing aspects like the Googles, the Amazons we've been talking about, the Facebooks in the United States. More recently the likes of Shopify.

And if you take it through to Asia, the likes of Tencent or Alibaba, perhaps. But you've also seen things moving beyond that and the ripple effects, and the impacts coming into areas like the semiconductor market, which are really helping to build out these types of digital infrastructures.

I also think that the change is being driven enormously by what's been going on with the re-emergence of Asia and, in particular, the rebirth as an economic superpower of China. You can think about the ripple effects there coming through in areas as simple as an investment we've got with AIA, one of the big life insurance companies across Asia. The benefits of the wealth creation are coming through there, with regards to that particular company.

So, the change that is being driven is enormously important for new businesses coming through. And I think that what people often forget is that that change is not necessarily over.

I think that we're actually at a point whereby, in certain areas, the change is going to accelerate, and that fills me with a huge amount of optimism with regards to what we can see next. And I'd much rather be involved in businesses that are on the correct side of that change, rather than businesses which are perhaps optically cheap or lowly valued, which are on the wrong side of that change.

MB Give me an example of a company or a sector that's staying ahead of change.

MM If you're looking at it from the high level, some of the areas I'd be most interested in just now, with regards to change, would be energy. I think the energy transition is a huge theme over the forthcoming years. I'd also say education. To my mind it's hugely surprising that education hasn't seen disruption from digitisation. But I'd also centre on, perhaps mostly, within the healthcare sector, let's say.

I think that healthcare is offering huge amounts of opportunity for the next 10 to 20 years, and that's because we're seeing this fascinating collision, let's say, between what's going on with regards to the availability of data coming from gene sequencing, being powered by the likes of Illumina, which we invest in, and the availability of computational power. All of that coming together and the rapid movement of that section of the arena with the slower moving aspects of biology.

So, how this all plays together into the future, I think, is going to be extremely exciting. One of the take-away points I had from a recent meeting with Stéphane Bancel from Moderna, the vaccine business, was the fact that, he was explaining



to us, he felt that, in terms of looking towards new treatments, the treatments of the future, he was viewing this as being as much a software and coding issue, a coding problem, as he was a biology one.

And that's something which really piqued my interest or took me to a point whereby I was thinking, 'wow, this really could be way beyond what people are currently thinking of in terms of the potential impact'. And perhaps Moderna's not going to be the last business that bursts through with this different attitude. I think, in fact, it probably won't be. I think there's probably a lot more value to be created in this area, again, because of this synthesis between computational power, the availability of data and biology.

MB So, that's a sector and a company on the right side of change but we will also see companies and sectors on the wrong side of change. And that brings to mind a phrase from one of your colleagues about the four most dangerous words in investment, 'reversion to the mean', which is the concept that the valuation of the stock often might revert to its average, which is often not a great starting point.

MM Yes. There are lots of dangerous terms in investment, but I think that you're correct that 'reversion to the mean' is right up there. I'm embarrassed to admit the fact that I studied economics at university and there were lots of different concepts which were pedalled to us, which were completely incorrect and now seem quite silly in retrospect.

But one of the most silly, perhaps, was that of the steady state. I think that mean reversion, and the concept of mean reversion, relies upon steady state thinking: that the world is going to be roughly the same and, therefore, if you buy something 20 or 30 per cent cheap, relative to a long-term average, you will do well. Well, of course the world isn't like that. The world is dynamic. The world does change.

If you're buying a business which is on the wrong side of that change, let's say, taking it back three, four, five, even 10 years ago, hard-line retailers, you're not going to do well. Just because the business is looking relatively cheap, you're actually on the wrong side of the discussion: that industry is going to decline and it's going to do very poorly for you.

Taking that to today, what would I be more worried about as an investor? Where would I not wish to be putting lots of assets? Well, I would say, again, big aspects of carbon-intensive industries, particularly within the energy sphere, let's say. I'd also be a little bit nervous about what's going on with regards to the broader banking industry.

Now, I get the fact that today people think that the environment's a little bit easier for them with rates going up, but these businesses are getting eaten alive by fintechs. I think that the longer-term outlook for these companies, and their ability to grow their earnings power over a 10-year, basis is significantly impaired.

MB And we've talked a lot about change on this podcast, Malcolm. A question I often ask guests on the podcast is 'what has the pandemic changed your mind about?'



MM Well, you gave me a heads up that you would ask this question and I struggled with it a little bit and what I might do, rather naughtily, is actually reframe it a little bit and say, ‘what will I be taking differently away from my thinking after this very odd and difficult period that we’ve all been living through?’

And I actually think that it’s reinforced my belief in ingenuity. It’s reinforced my beliefs relating to the power of innovation, and particularly, what I’m referencing there is the fact that, when we look back on this very difficult period with the huge human impacts in 10 years’ time, actually there will have been a triumph of science.

And what we’ve seen with regards to the way in which the medical community and the broader healthcare community have come together to not just provide treatments but look after people. It’s this vaccine aspect which appears to be getting us out of the pandemic, and the ability to produce that vaccine in such a short window of time, that’s an incredible triumph of science.

MB The triumph of science, that’s a great positive note to end on. Always like to end on a positive note and we’ve covered lots of different topics in this podcast. Malcolm, thanks for joining us on *Short Briefings on Long Term Thinking*.

MM Thanks for having me.

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