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# WHAT'S THE PURPOSE OF INVESTING?

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INTERVIEW WITH STUART DUNBAR

MB – Malcolm Borthwick

SD – Stuart Dunbar

MB Hello and welcome. Thanks for joining us. I'm Malcolm Borthwick, managing editor of Intellectual Capital at Baillie Gifford.

'High frequency trading', 'short selling', 'smart beta'. Over the last decade the investment industry has become increasingly short term and increasingly complex. There are now more stock indices in the world than companies listed on stock markets. Some fear the industry has lost its way. I'm joined in our Edinburgh studio by one of them, Stuart Dunbar, who's a partner at Baillie Gifford.

But before we start, some important information. Please remember that as with all investments, your capital is at risk.

Stuart let's go back to basics. What's the purpose of investing?

SD The purpose of investing is to deploy capital wisely into investment projects, in the hope and expectation of generating long-term positive returns, which can then be paid back to those who invest in the first place. Now, that is very different than what most people would say these days, which would be that the purpose of investing is to outsmart other investors by investing in the stock market.

A rather peculiar place to start, perhaps, is that, although we are clearly an investment company, we're not that interested in the stock market. Now isn't that a peculiar thing to say? This business of secondary market trading and daily prices and share price volatility is not the business of investing. That's the business of one set of people who want to trade with another set of people on a daily basis, on the assumption that 'we are smarter than they are'.

That is what I would describe as a zero-sum game. One that everybody, slightly unthinkingly, references in terms of active management. I think it's all a colossal distraction from the job of capital deployment and wealth creation. I'll pick up on something you mentioned in the intro about there being more indices than stocks in the world. It's not just more, it's about 70 times more.



There are well over 3 million different stock indices. Now, in fairness to the providers of such indices, there will be all kinds of strange little quirks about not holding this stock, or that stock. But the fundamental point is you don't need to have some sort of PhD in finance, in fact, it's probably quite unhelpful to have a PhD in finance, to work out that you don't need 70 times more ways to combine stocks than there are stocks to invest in. And there's just a reflection of the priorities of the industry having got all out of kilter.

MB Where do you think, as an industry, we started to go wrong?

SD Well, here's a bit of history. As you may tell from my accent, I grew up in Glasgow. I also studied in Glasgow. I did a degree in finance, actually. So, I am very well-versed in efficient market theory and Fama and French and all this stuff.

What's remarkable to me is that this was the mid-to-late 1970s, when a lot of this academic work was being done. I learned it at university and thought, 'this is going to be very helpful in my career'. Yet here we are, a large number of years later, and what I've really learned from working in this industry is how much of that academic work is just completely not reflective of the real world.

There's a wonderful survey, done by a professor of finance in Madrid a couple of years ago. He surveyed other professors of finance from around the world at very reputable business and finance schools. The most interesting thing to come out of it was a fairly strong consensus among those who teach capital markets theory that it doesn't apply at all in the real world. It's the starting point for a way of thinking about the world, but by the time you acknowledge all the assumptions that don't hold true in reality, the financial theory is just not a basis on which to invest.

So, to answer your question, 'where did it all start', it started when the business of investing became the analysis of stock markets, rather than the thoughtful consideration of how to put real money into real projects.

MB You've talked about the purpose of investing, Stuart. How does that fit into the active-versus-passive debate?

SD I think there's a very unhelpful simplification in that debate. Rather strangely, I'm not anti-passive. In fact, I have admiration for some of the big passive providers. I wouldn't necessarily describe what they do as investing, not in the pure sense, but they provide broad market access at low cost.

Our industry has a problem with charging clients. Not so much charging too much, but, taking too high a share of whatever value has been added. Many active managers outperform a little bit, but then essentially take it all back in fees. You'd be better off with a passive manager in those instances.

The real question on passive versus active is what types of active management work. And it's very difficult to drill down into that. The vast majority of studies, faithfully reproduced by various financial press, will tell you the average active manager underperforms after fees. Therefore, why bother?



There have been some more interesting studies in recent times about the characteristics of active managers that make the probability of adding value for clients much higher. The two strong signifiers of active management done well are low turnover and high active share. Active share being the level to which we differ from an index.

Active share – or divergence from an index – suggests to me, again, that these are managers who are not starting by looking at the whole opportunity set. These are managers who are trying to find great ideas.

They won't find all of them, but they're focused on finding those great ideas, rather than trying to cut down the universe and be, say, underweight on banks because they don't really like them. That's not the thought process that we follow. If we don't like banks, we don't invest in banks.

The real point is that there are signposts of active management done well. You can quite quickly narrow down on investment companies that are looking at capital deployment rather than playing the markets.

So, to answer your question, it's not about active versus passive, it's about what I would describe as 'Actual Investing', as opposed to trading the stock markets.

MB Actual Investing is the first really sizeable, high profile, advertising campaign that Baillie Gifford has rolled out since 1908. But what does 'actual' mean?

SD It's quite interesting to me. We've started to describe what we do. As opposed to the other way around, where you latch onto a phrase and alter your behaviour. It's just a summation of everything we've been talking about. It's a focus on wealth creation, capital deployment, working with management, leaving the value for the clients rather than taking it for ourselves, thinking long term and being pretty much indifferent to share prices.

So, it's all of those things. But how do you encapsulate that in a short phrase? This is where we came up with 'Actual Investing'. And of course, it's a nice play on 'active versus passive'. It's not active versus passive, it's actual versus not-actual. I've got no real interest in defending the active management industry. I do have an interest in defending the concept of capital deployment in the interests of society.

We're affected by the poor quality of the whole active versus passive discussion. It's appropriate for a company like ours to stand up and say that we think this whole debate is wrong and start to think about what we *do* think people should focus on. Remember, the existence of the investment industry is not some sort of self-enriching game. The investment industry has a phenomenally important job to do.

Economic progress and productivity gains rely on capital deployment, into new and better ways of doing things. It's really important that our industry, I think, gets back to focusing on that. It's very hard to prove this, but I suspect that the relatively poor productivity enhancements of the last 20 years, or so, in developed market economies, is because hardly any new capital's been deployed. Research and development (R&D) spending is so low.



Leaving aside any competitive positioning of our firm or anything like that, it's just important that the asset management industry gets back to focusing on wealth creation, rather than squabbling over returns. Because if nobody's creating wealth, there aren't any returns for us to share out.

**MB** And how does that affect the way we research into companies at Baillie Gifford?

**SD** It means you start in a different place. I guess, we try to have big ideas in the sense that we're interested in disruption and what's changing in the world. And that, in the main these days, is driven by what's technologically becoming possible. Some people call us a tech investor. We're not. Saying we're a tech investor is like saying everyone was an electricity investor in 1915.

Every company that is growing and aiming to be successful is using technology in some way. It's all about what is technology making possible. What we try and do is understand what's changing, whether it's in the fields of genomics, or artificial intelligence, or robotics and all sorts of technologies that converge to create new possibilities.

To leave the abstract behind, think about robots. Robots at the moment tend to be nailed to a factory floor, moving around in a very limited fashion, in order to put a car together. But what can you do with robots when they can artificially see? Suddenly you move from a robot doing one repetitive thing over and over - which is cheaper than having a person do it and probably socially better as well - to a robot that can undertake variable tasks in a way that a human would do.

To give you an idiotically simple example, there is now a robot that you can put a bunch of cardboard boxes in a heap in front of, and it'll move itself around and pick up the cardboard boxes. Think about that. Not squash them. Pick them up gently and stack them up into some sort of sensible structure. Isn't that the simplest thing in the world? Any human being, pretty much, could do that. But that's a leap forward in terms of what robotics is starting to make possible.

**MB** Yes, that sensitivity is really interesting, isn't it? In terms of the massive difference between picking up that cup you're holding, or a credit card, for example.

**SD** Exactly. And we're still in the very early stages of that. I'll give you another slightly mad example. This is not really investible, but the point here is imagination. We work with a lot of different academic institutions. One of them made a robot that can roll around in a field of lettuces, zapping the weeds. Literally down to a couple of square centimetres. Thereby using a vastly smaller amount of pesticide, which is plainly good for the environment. It can do it automatically so you don't need to employ people to do this job.

Think about the complexity of that. It's navigating itself around, it's telling the difference between what's a lettuce and what's a weed, and it's accurately spraying tiny amounts of pesticide onto these little weeds before they even start growing.

**MB** So, we can learn more from academic institutions than investment bank research?



SD It's now a traditional view in the asset management industry, despite the fact that, as an industry, we have largely used the research of investment banks for years - not us I hasten to say - as if it's beacons of light. It's now become fashionable to say that it's all nonsense. I actually think that there are some smart analysts in investment banks, it's just that there used to be a lot of *other* analysts as well.

There's a danger here that we're overly dismissive of others. We've spoken about what we at Baillie Gifford mean by investment, and it's not share prices. We're not some sort of geniuses, the only ones to have worked this out. There are some good researchers at investment banks. You just need to know who they are.

We tend to be interested in those that write longer-term perspectives. We're really not interested in somebody's spreadsheet about a company's earnings next quarter. But there are smart people out there.

It's important to be humble, actually. You always have to remember, you might have been lucky rather than smart. Probably we're not, but let's not get carried away with ourselves. One of the big reasons, I think, we've been successful, is our willingness to learn from people who are smarter than we are.

I like coming to work every day, because it's nice to be in an office full of smart people who – as they'll probably tell you - are a lot smarter than I am. Listening to smart people is a really smart thing to do, isn't it? We're fortunate to have access to some of the great entrepreneurs of our time, and academic thinkers of our time. We can scarcely spend our time better than listening to how they perceive the world, because that allows us to conceive of what the next big investment opportunities might be. It also guides us in some cases to individual companies that might be interesting.

MB Stuart, that's a good place to end. Thanks very much for joining us on the podcast.

SD Thanks very much.

MB If you'd like to hear more about what we mean by 'Actual Investors', and read more straight talking and original views, subscribe to our blog, Actually, at [actually.bailliegifford.com](http://actually.bailliegifford.com).

And many thanks to Lord of the Isles for the music. The track we've used is called *Horizon Effect*, which was released on Permanent Vacation. Until next time.

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