Lessons from Bessembinder

BAILLIE GIFFORD

Contents

Introduction

1

Lesson one
Focus on growth

2

Lesson two
Expect drawdowns

6

Lesson three
Beware biases, don’t assume

10

Thanks to Hank

14

Introduction

What can a US academic's research teach Baillie Gifford about the handful of companies behind nearly all net gains on global stock markets?

Tim Alcorn, Head of Investment Risk, looks at what we've learned

Studies of 'asymmetry' by Professor Hendrik Bessembinder – which looked at global stock market returns between 1990 and 2018 – established that just 1.3 per cent of stocks contributed all of the net gain when compared to the performance of US Treasury bills.

Following this discovery, the next step for the Arizona State University scholar was to sift through vast volumes of company data over a much longer time frame to discover the common characteristics of those big winners. Bessembinder looked at the wealth creation of companies over 10 year periods. As the data covers many decades, some companies were measured multiple times.

26,285

1950 — **2019**

number of firms analysed

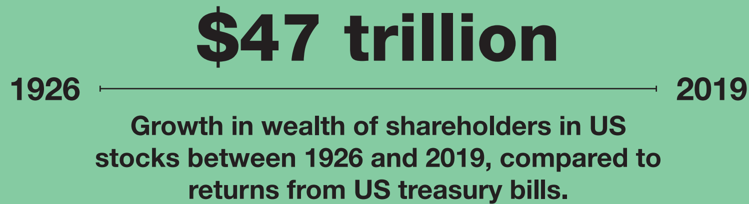
This research, sponsored by Baillie Gifford, revealed surprising things about successful companies – insights that might make these companies easier to spot earlier and to hold over time. The papers are available (links at the end of this document), but what follows is a summary of three big lessons from Bessembinder on extreme stock market performers.

Lesson one

Focus on growth

Investing in research and development while still achieving superior growth in returns, scale and profitability is a key characteristic of winning companies. Firms succeed or fail for myriad reasons, but this appears to be a must-have.

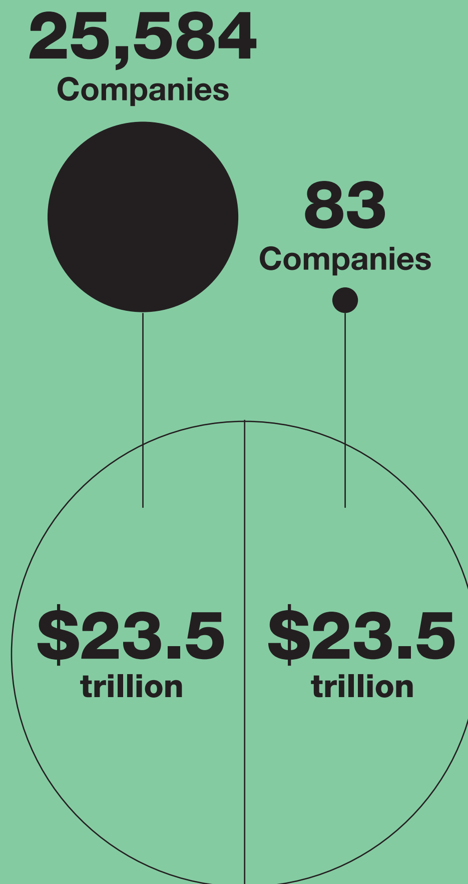
Bessembinder's new research into successful firms stemmed from his discovery of how, over a longer time frame, very few companies have made a big difference.



Growth in wealth of shareholders in US stocks between 1926 and 2019, compared to returns from US treasury bills.

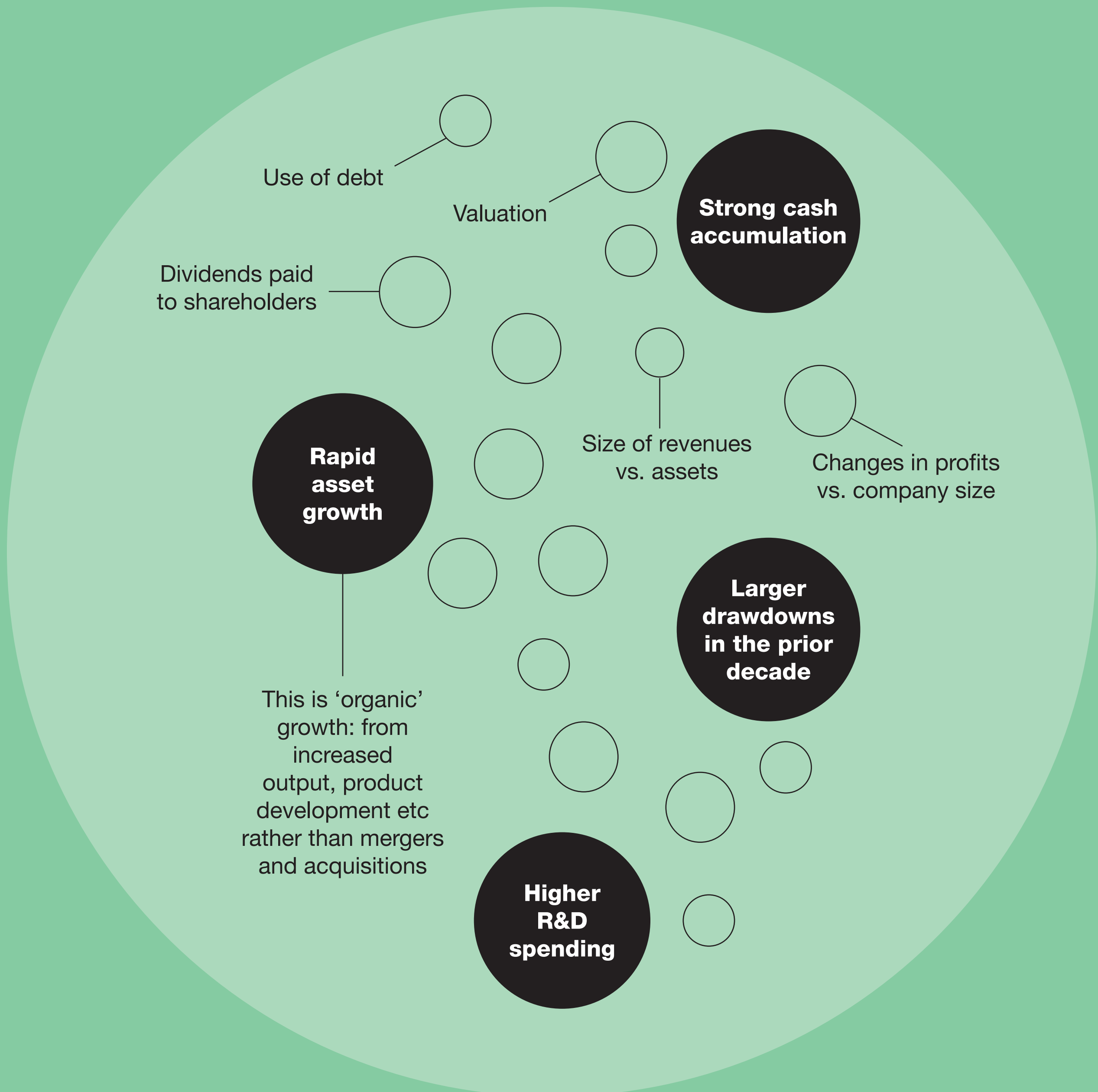
An uneven split

This $47 trillion has been disproportionately generated by a small number of companies – fewer than 100 of them have created half of this wealth.



The data only tells us so much

Bessembinder looked at 22 key fundamental metrics in his analysis of 26,285 firm/decades – the wealth created by a company over 10 years – going back to 1950. He found only four stand-out factors to have statistical significance.



Improve the odds

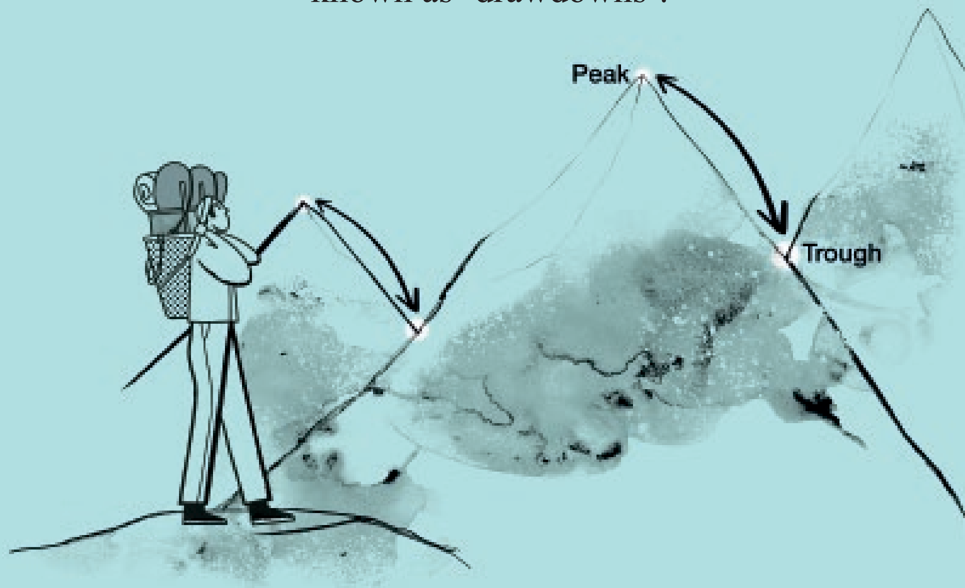
Such analysis of past performance can't help predict which firms will succeed in future. Nevertheless Bessembinder's work points out a clear correlation between possession of these measurable characteristics and long-term performance.

What Bessembinder teaches

By looking at firms' outcomes decade by decade, Bessembinder provides patterns of evidence suggesting that, over long-term horizons, returns follow fundamentals. This means that the firms that perform best are those that quickly grow their assets and accumulate cash. Whether it's a high-returning young company or a wealth-creating mature company, spending more on research and development is key to profitability. Investors should deploy capital into the growth companies likeliest to generate capital returns. Bessembinder's analysis makes these companies easier to spot.

Expect drawdowns

Long-term investors in top-performing companies must have the stomach for large peak-to-trough share price declines, known as 'drawdowns'.



Bessembinder highlighted two examples, Apple and Amazon:

Apple

$1.64 trillion

1981 January — **2019** December

shareholder wealth generated

74% **drawdown**

May–Aug 1983 during infighting leading to ousting of Steve Jobs

80% **drawdown**

Feb 1992–Dec 1997 being outcompeted by PCs and rise of Microsoft Windows

79% **drawdown**

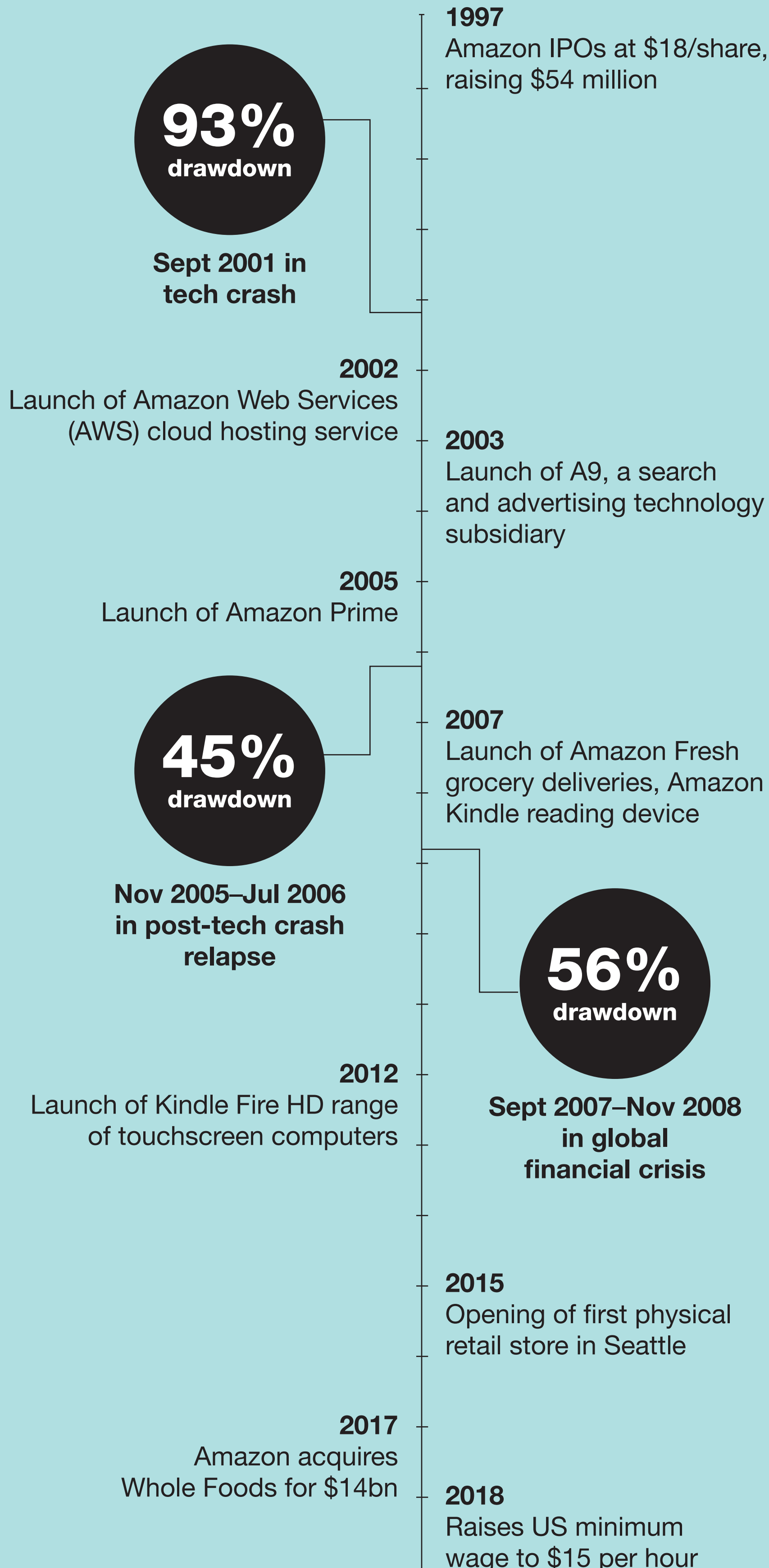
Mar 2000–Mar 2003 (including 76% Aug–Sept 2000) in tech crash

Amazon

$865 billion

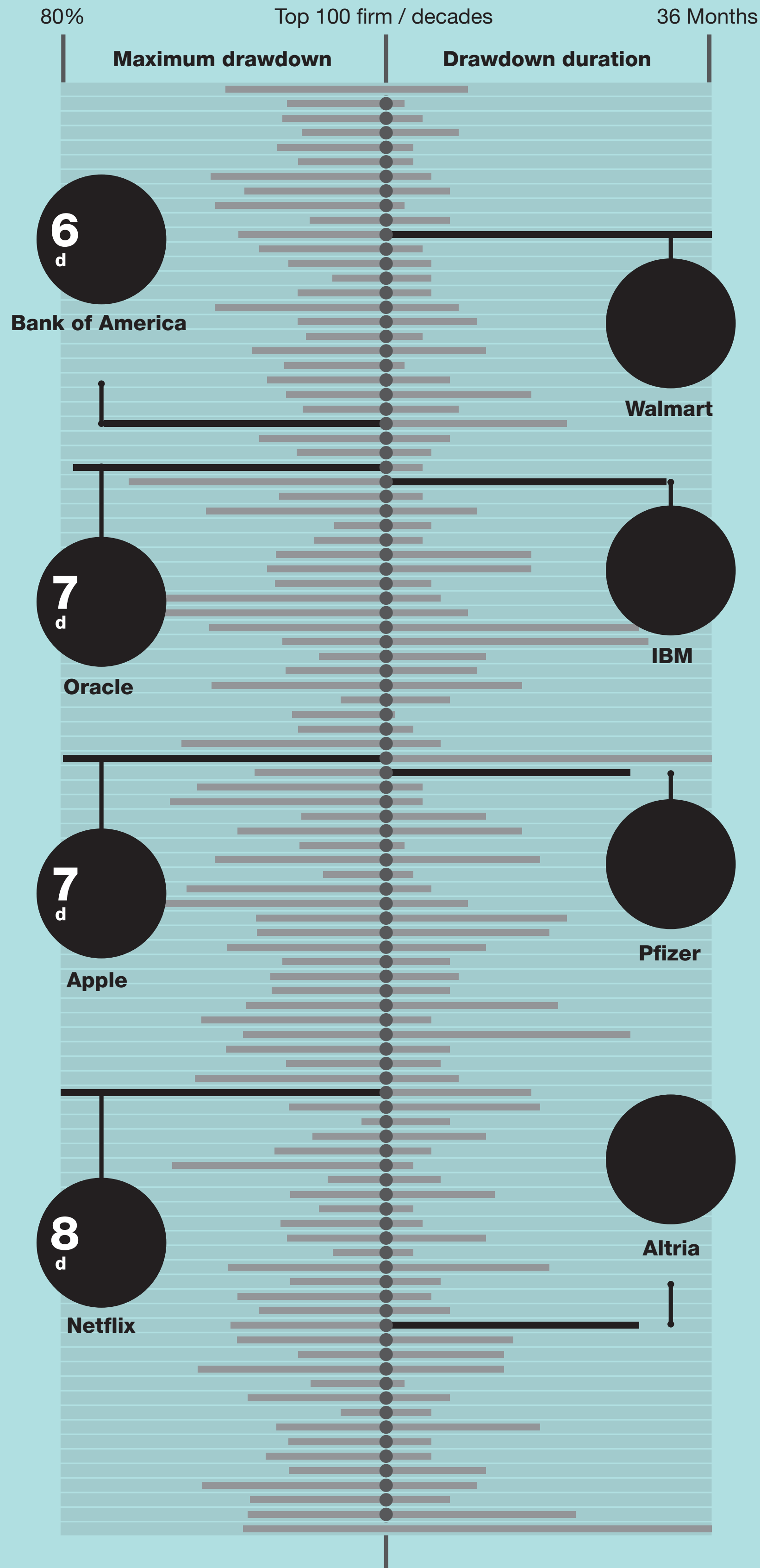
1997 June — 2019 December

shareholder wealth generated



The pattern is replicated across multiple companies and sectors

Painful drawdowns are widespread across the 100 firms that created the most shareholder wealth over the decades.



32.5%

Average loss of value in a drawdown in the same decade as spectacular success

10 months

Average duration of those drawdowns

What Bessembinder teaches

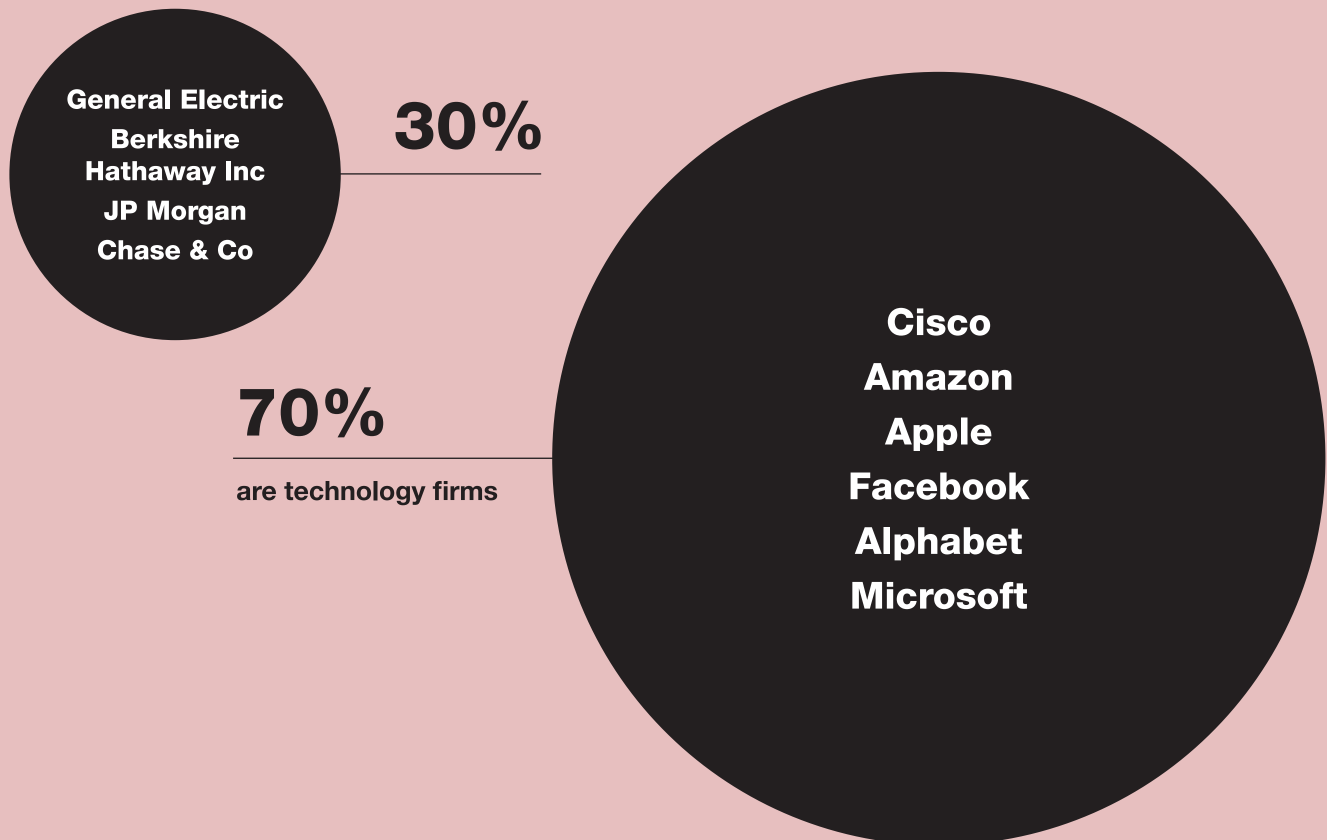
It's not news that even top-returning companies are prone to severe drawdowns. However Bessembinder's research reveals the severity and length of some of these periods of falling value. Investment managers must therefore tolerate occasional volatility in pursuit of big long-term gains. As share prices often reflect investors anticipating each others' next move, the share price of a listed company sometimes has a remote relationship with the business it represents. This suggests that investors shouldn't seek to be different from the index, but to ignore it. The focus should instead be on the fundamental progress of a business.

Lesson three

Beware biases, don’t assume

Just because tech stocks have been some of the strongest performers, it doesn’t follow that companies in that category have an outsized chance of extreme performance. Bessembinder’s research reveals the opposite to be true.

Top 10 examples of wealth creation in US companies over 10-year periods (between 1950–2019)



So are technology firms more likely to succeed?

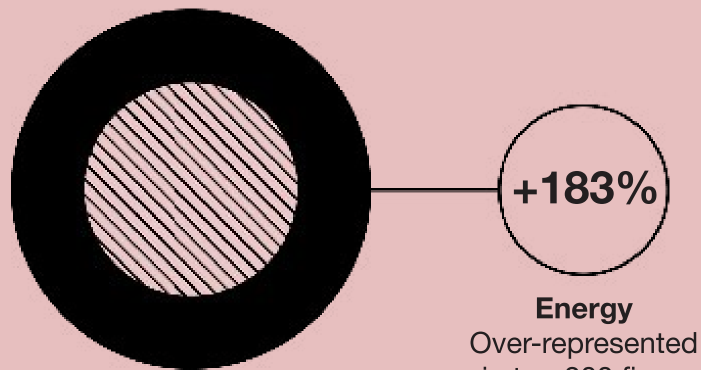
Just because Amazon, Apple and Microsoft are prominent among the wealth creators of recent decades, it doesn't follow that tech companies have a better chance of outperforming. In fact, among outperformers, there is a smaller proportion of tech stocks than those in less glamorous sectors.

Unsung heroes

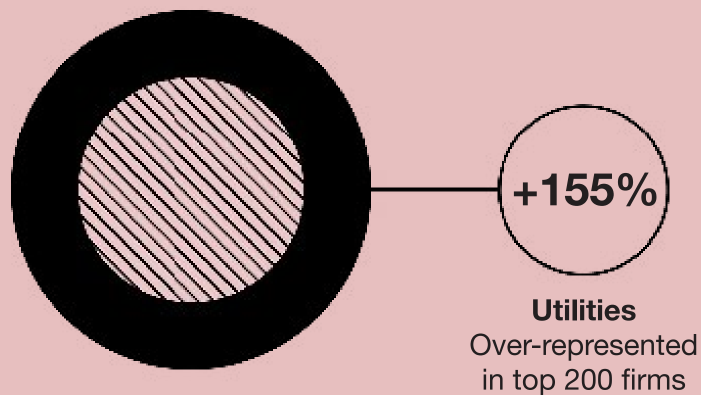
A number of technology firms feature prominently in the top wealth creators in Bessembinder's 26,000-company dataset.

But the proportion of outperformers versus more average performers is higher in other sectors such as energy, telecoms and utilities.

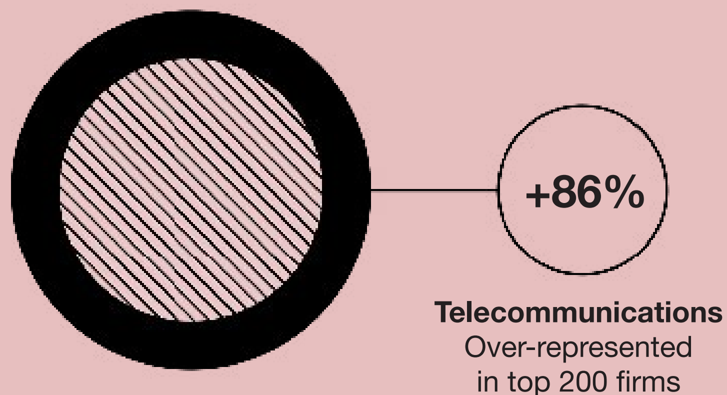
● Number of firms from each sector in the data set's top 200 wealth creators, as a percentage of ◍ the number of companies from those sectors in the entire dataset (minus the top 200 firms)



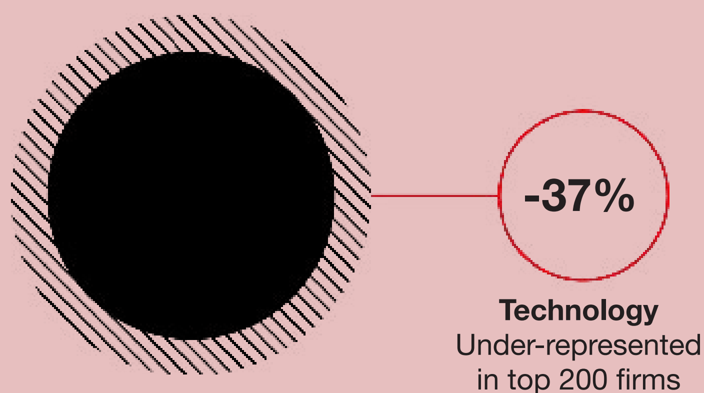
Energy
Over-represented
in top 200 firms



Utilities
Over-represented
in top 200 firms



Telecommunications
Over-represented
in top 200 firms



Technology
Under-represented
in top 200 firms

What Bessembinder teaches

Perceptions of industries can be misleading. Investors should beware the assumptions and mental short-cuts they use in describing top winners and what drives them. Industry definitions don't help and sometimes over-simplify. Amazon for example is not a 'tech company' but a tech-enabled retail company. What's needed is a careful study of individual firms and their competitors. The best approach is to build relations with founders and managers to help assess their chances of success.

Thanks to Hank

Hendrik 'Hank' Bessembinder is a professor of competitive business at Arizona State University. His 2017 paper 'Do Stocks Outperform Treasury Bills?' revealed that the entire gain in the US stock market since 1926 was attributable to the best-performing 3 per cent of listed companies. The paper was the first to provide an academic basis for the long-established investor practice of 'running your winners'. The practice is based on the power of 'asymmetry' in investing: the belief that gains from successful investments can, over time, far outweigh losses from failures. The paper has been downloaded more than 32,000 times and cited in 41 further studies.

In 2019, in research sponsored by Baillie Gifford entitled 'Do Global Stocks Outperform US Treasury Bills?', Bessembinder showed that the skewed nature of stock market returns was even more extreme internationally. About 61 per cent of non-US stocks underperformed Treasury bills in the 1990–2018 period, and 1.3 per cent of stocks contributed all of the net gain when compared to the performance of US Treasury bills.

The above research is taken from Prof Bessembinder's papers, also supported by Baillie Gifford. Published in July 2020, the research examines the characteristics of 'Extreme Stock Market Performers'.

Extreme Stock Market Performers, Part I
Expect Some Drawdowns

bailliegifford.com/drawdowns

Extreme Stock Market Performers, Part II
Do Technology Stocks Dominate?

bailliegifford.com/technologystocks

Extreme Stock Market Performers, Part III
What are their Observable Characteristics?

bailliegifford.com/characteristics

Extreme Stock Market Performers, Part IV
Can Observable Characteristics Forecast Outcomes?

bailliegifford.com/outcomes

IMPORTANT INFORMATION

Baillie Gifford & Co and Baillie Gifford & Co Limited are authorised and regulated by the Financial Conduct Authority (FCA). Baillie Gifford & Co Limited is an Authorised Corporate Director of OEICs.

Baillie Gifford Overseas Limited provides investment management and advisory services to non-UK Professional/ Institutional clients only. Baillie Gifford Overseas Limited is wholly owned by Baillie Gifford & Co. Baillie Gifford & Co and Baillie Gifford Overseas Limited are authorised and regulated by the FCA in the UK.

Persons resident or domiciled outside the UK should consult with their professional advisers as to whether they require any governmental or other consents in order to enable them to invest, and with their tax advisers for advice relevant to their own particular circumstances.

All information is sourced from Baillie Gifford & Co and is current unless otherwise stated.

The images used in this article are for illustrative purposes only.

Europe

BGE provides investment management and advisory services to European (excluding UK) clients. It was incorporated in Ireland in May 2018 and is authorised by the Central Bank of Ireland. Through its MiFID passport, it has established Baillie Gifford Investment Management (Europe) Limited (Frankfurt Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in Germany. Similarly, it has established Baillie Gifford Investment Management (Europe) Limited (Amsterdam Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in The Netherlands. Baillie Gifford Investment Management (Europe) Limited also has a representative office in Zurich, Switzerland pursuant to Art. 58 of the Federal Act on Financial Institutions ("FinIA"). It does not constitute a branch and therefore does not have authority to commit Baillie Gifford Investment Management (Europe) Limited. It is the intention to ask for the authorisation by the Swiss Financial Market Supervisory Authority (FINMA) to maintain this representative office of a foreign asset manager of collective assets in Switzerland pursuant to the applicable transitional provisions of FinIA.

China

Baillie Gifford Investment Management (Shanghai) Limited 柏基投资管理(上海)有限公司 is wholly owned by Baillie Gifford Overseas Limited and may provide investment research to the Baillie Gifford Group pursuant to applicable laws. Baillie Gifford Investment Management (Shanghai) Limited 柏基投资管理(上海)有限公司 is incorporated in Shanghai in the People's Republic of China (PRC) as a wholly foreign-owned limited liability company under the Company Law of the PRC, the Foreign Investment Law of the PRC and its implementing rules, and other relevant laws and regulations of the PRC. Baillie Gifford Investment Management (Shanghai) Limited 柏基投资管理(上海)有限公司 is registered with the Shanghai Municipal Administration for Market Regulation, with a unified social credit code of 91310000MA1FL6KQ30, withits registered office at Unit 4203-04, One Museum Place, 669 Xin Zha Road, Jing An District, Shanghai 200041, China. Baillie Gifford Investment Management (Shanghai) Limited 柏基投资管理(上海)有限公司 is a registered Private Fund Manager with the Asset Management Association of China and manages private security investment fund in the PRC, with a registration code of P1071226.

Hong Kong

Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 is wholly owned by Baillie Gifford Overseas Limited and holds a Type 1 and a Type 2 licence from the Securities & Futures Commission of Hong Kong to market and distribute Baillie Gifford's range of collective investment schemes to professional investors in Hong Kong. Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 can be contacted at Suites 2713–2715, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. Telephone +852 3756 5700.

South Korea

Baillie Gifford Overseas Limited is licensed with the Financial Services Commission in South Korea as a cross border Discretionary Investment Manager and Non-discretionary Investment Adviser.

Japan

Mitsubishi UFJ Baillie Gifford Asset Management Limited('MUBGAM') is a joint venture company between Mitsubishi UFJ Trust & Banking Corporation and Baillie Gifford Overseas Limited. MUBGAM is authorised and regulated by the Financial Conduct Authority.

Australia

Baillie Gifford Overseas Limited (ARBN 118 567 178) is registered as a foreign company under the Corporations Act 2001 (Cth) and holds Foreign Australian Financial Services Licence No 528911. This document is provided to you on the basis that you are a "wholesale client" within the meaning of section 761G of the Corporations Act 2001 (Cth) ("Corporations Act"). Please advise Baillie Gifford Overseas Limited immediately if you are not a wholesale client. In no circumstances may this document be made available to a "retail client" within the meaning of section 761G of the Corporations Act. This document contains general information only. It does not take into account any person's objectives, financial situation or needs.

South Africa

Baillie Gifford Overseas Limited is registered as a Foreign Financial Services Provider with the Financial Sector Conduct Authority in South Africa.

North America

Baillie Gifford International LLC is wholly owned by Baillie Gifford Overseas Limited; it was formed in Delaware in 2005 and is registered with the SEC. It is the legal entity through which Baillie Gifford Overseas Limited provides client service and marketing functions in North America. Baillie Gifford Overseas Limited is registered with the SEC in the United States of America.

The Manager is not resident in Canada, its head office and principal place of business is in Edinburgh, Scotland. Baillie Gifford Overseas Limited is regulated in Canada as a portfolio manager and exempt market dealer with the Ontario Securities Commission ('OSC'). Its portfolio manager licence is currently passported into Alberta, Quebec, Saskatchewan, Manitoba and Newfoundland & Labrador whereas the exempt market dealer licence is passported across all Canadian provinces and territories. Baillie Gifford International LLC is regulated by the OSC as an exempt market and its licence is passported across all Canadian provinces and territories. Baillie Gifford Investment Management (Europe) Limited ('BGE') relies on the International Investment Fund Manager Exemption in the provinces of Ontario and Quebec.

Oman

Baillie Gifford Overseas Limited ("BGO") neither has a registered business presence nor a representative office in Oman and does not undertake banking business or provide financial services in Oman. Consequently, BGO is not regulated by either the Central Bank of Oman or Oman's Capital Market Authority. No authorization, licence or approval has been received from the Capital Market Authority of Oman or any other regulatory authority in Oman, to provide such advice or service within Oman. BGO does not solicit business in Oman and does not market, offer, sell or distribute any financial or investment products or services in Oman and no subscription to any securities, products or financial services may or will be consummated within Oman. The recipient of this document represents that it is a financial institution or a sophisticated investor (as described in Article 139 of the Executive Regulations of the Capital Market Law) and that its officers/employees have such experience in business and financial matters that they are capable of evaluating the merits and risks of investments.

Qatar

The materials contained herein are not intended to constitute an offer or provision of investment management, investment and advisory services or other financial services under the laws of Qatar. The services have not been and will not be authorised by the Qatar Financial Markets Authority, the Qatar Financial Centre Regulatory Authority or the Qatar Central Bank in accordance with their regulations or any other regulations in Qatar.

Israel

Baillie Gifford Overseas is not licensed under Israel's Regulation of Investment Advising, Investment Marketing and Portfolio Management Law, 5755-1995 (the Advice Law) and does not carry insurance pursuant to the Advice Law. This document is only intended for those categories of Israeli residents who are qualified clients listed on the First Addendum to the Advice Law.

BAILLIE GIFFORD. ACTUAL INVESTORS.

bailliegifford.com/actual-investors

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

Copyright © Baillie Gifford & Co 2015.