Baillie Gifford™

Why ants, scaffolding and long jumps matter to growth investors

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Investment manager Kirsty Gibson explores the role of culture in successful organisations, and the common characteristics underpinning them.

Your capital is at risk.

Kirsty Gibson: So I'm going to begin today by potentially getting myself in rather a lot of trouble with my historian colleagues and asking the question, what drove the Renaissance? Now, some say it was the rediscovery of classic texts. Power to the people. The failures of the Holy war, the Black Death. But what intrigues me most, and what matters most in an investment context is what underpins any successful investment, culture?

Now, the human capabilities that are most critical to success, the ones that enable an organization to be more innovative, more creative, more resilient, are precisely those that cannot be managed in a conventional sense. You cannot command initiative or passion or creativity. Employees choose whether to bring these to work each and every single day, or whether to leave them at home.

And the right culture will encourage employees to bring them more often. Because culture, the way we act and think, those unwritten rules that impact our decision making, enables creativity. It fosters adaptability and, if harnessed, effectively enables the human race to not just survive, but thrive. But culture is notoriously difficult to analyse.

It doesn't fit neatly into a discounted cash flow or a spreadsheet. It does not matter to short term investors. But to long term investors, like ourselves, it can be a source of insight, an alternative view and analytical advantage. Now, I've been developing my thinking on the topic of organizational culture for the best part of a decade, and I'm going to share some of that thinking with you today. Now, I could talk about culture for the best part of a day.

So giving me this final presentation slot was clever, because I do appreciate that you all want to get home. I am on the other hand, going to talk about it for the next 30 minutes or so, and hopefully by the end of it you have a better understanding as to my approach to cultural analysis, but also some tools for your own toolkit for the cultural analyses you may need to make in your own roles.

For me, every investment case boils down to culture. Now, that's not to say it's the only thing that matters. Far from it, but it is foundational. What problem a company looks to solve. How they go about solving it. How they develop their competitive advantage. How they allocate capital. How they incentivize their employees. It all comes down to culture.

Now, my colleagues on the US team will attest that there is not much that I love more than culture, analogies and evolutionary biology. So when the opportunity presented itself, when I was writing this presentation to combine all three, well, I could not resist.

So ants. When ants search for food, they deploy a variety of strategies. Ants leaving the nest tend to follow the pheromone trails of those that have gone before them. And over time, these pheromone trails become more and more reinforced. And because ants leaving the nest tend to follow the trails that they know will lead to food. So some ants follow the well-trodden paths. Some ants take the less established paths. And then a few ants, well, they break out on their own in search of ant glory. And we can call these ants the stewards, the followers and the explorers. And they're analogous to companies.

The stewards are about protecting, maintaining. The followers are about trying new things, but not necessarily being the first to do so. And the explorers, they're the wanderers, the dreamers, the ‘oh, what if we did that’ kind of companies.

And all three can be good investments, but they need to be managed in different ways. Nobody wants an explorer CEO like Elon Musk running a Steward style company like Hermes.

Ultimately, however, these companies and ants are deploying different tactics. But they all have the same strategy. And that is to survive and thrive. And surviving and thriving is key to any successful investment.

In 1932, geneticist Civil Right introduced the concept of a fitness landscape. Each peak represents a specific gene combination for a particular species, and the height of the peak represents that combinations evolutionary fitness. That is to say, the likely hood that that variant will survive and go on to reproduce. And this is an interesting lens through which to view companies.

Let's have a look at this company. It looks pretty fit doesn't it? Let's zoom out a bit. Not so fit now. And that's because company fitness is relative to the industry in which it operates. Fitness is a relative concept. It's not enough for a company to be absolutely fit, because the industry in which it operates is not static.

Incumbents and new entrants are constantly changing the environment. Thus, Biophysicist Stuart Kaufman and biologist Sophie Johnson speak of a dancing fitness landscape. With a landscape and the organisms within it, the fitness of those organisms is dependent upon themselves, but also those around them. And that leads us to the core foundation of any great company culture, and thus company itself, whether they be a steward, a follower, or an explorer.

And that is adaptability. Now, as companies mature, their growth rates can slow as inertia can give way to a slowing of that growth. In order for a company to deliver a more consistent level of growth throughout its life cycle, they must attend to their existing business, but also consider the ways that they can adapt in order to be able to grow in future.

Now, in 1999, management consultancy McKinsey wrote a paper which showed that the 30 most successful growth businesses had strategies which spanned both the present but also looked to the future. Now the first idea was what they called short jumps. Now these short jumps are about moves that you make where you know precisely where you're going to land and these are balanced by the what could be jumps, the long jumps. The jumps you make where you know the general sense of the direction in which you are heading, but you don't know precisely where you're going to land. And McKinsey called this framework the three horizons of growth. And we're going to see it here in visual form.

So horizon one is about the existing core business. This is the part of the business which presently and the emphasis is on the word presently delivers the greatest levels of profitability of free cash flow. Growth here is about attending to that existing business and thinking of the ways that you can improve it in order to maximize its remaining value.

Let's take an example. Language learning app Duolingo. Horizon one for Duolingo would be the addition of new languages into its core language learning app, which is enabling the company to address a greater number of potential language learners in future.

Horizon two is about new business opportunities which leverage the existing business. Now these are the medium jumps. They are more intensive than horizon one, and they usually come in the form of more time or a greater level of investment. Bringing back our old friend Duolingo. This would be the inclusion of artificial intelligence into its core language learning app, which is enabling the company to develop a new subscription tier, which is both higher priced and contains additional features.

And finally, we have horizon three. These are the ideas for businesses that might exist down the road. These are the long jumps planting the seeds for businesses that don't actually exist yet. For Duolingo this is the inclusion of maths and music into its core language learning app, neither of which contribute significantly to revenue today, but have the potential to do so in future.

Now, what is most intriguing about the McKinsey study is that the great growth businesses have investments and strategies which span all three of these horizons. Whereas the average

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performing growth business tends to focus its investments on horizon one. And this makes sense. Short jumps are just more comfortable, they are less risky, and they pay off in a shorter period of time.

But if you only ever make the same size jump, you lose the ability to flex the size of your job. In a nutshell, you lose the foundation of any great company, an adaptable culture. A culture nimble enough to make any sized leap out of it. So what, I hear you ask? Assuming that you are still with me, enables an organization to foster adaptability within its culture. I mean, I did say at the beginning of this presentation, there are certain aspects of company culture that management teams just cannot command. In order to explore this a little more. We're going to take a foray back into my favourite topic of evolutionary biology.

So the theory of facilitated variation states that an organism is made up of sets of core processes. These processes enable adaptation and flexibility, but ensure that the organism doesn't lose its core strength. This means that the organism can adapt quickly when an environment changes but can also renege on any path that fails should the circumstances change. Now, I like to think of these core processes as like scaffolding. They provide support for the organism to try new things, but they ensure that it never loses sight of its core purpose.

So what enables a company to foster adaptability within its culture is the right scaffolding. And scaffolding, the choice of that scaffolding alongside its maintenance is the responsibility of a management team. It is a management teams decision which parts of the organization they want to endure, and are therefore happy to provide scaffolding to protect, and which parts they are happy to leave behind.

And this is a huge responsibility because the lesson we must take from facilitated variation is that great care must be taken in the choice of this scaffolding. Because it is foundational, it is slow to change, but it also defines how much de constraint surrounds an organization. That is to say, your scaffolding defines what you can do, but also what you cannot.

Now I read a book, more than three years ago now, which really cemented my thinking on the topic of scaffolding. Was it by some great cultural writer on a famous CEO like Elon Musk or Steve Jobs or Jeff Bezos? No. It was a book called Fear and Trembling by a Danish philosopher called Soren Kierkegaard. Now, Kierkegaard interprets the self as having to opposing aspects the finite and the infinite, and the relationship between them is dialectical. One cannot exist without the other, and they must be balanced in a constant state of tension.

Now the infinite is about abstraction, possibility, imagination. The realm of the infinite is what could be, as opposed to what is. The finite, on the other hand, is about necessity as opposed to possibility. It's the steps, the structures, the incentives necessary to unlock the infinite and success, success requires both.

Now I call the infinite foundational culture. Foundational culture is about vision. It's about deeply held beliefs, which have developed over time and through life experience, and which are unique to the CEO or founder of a business. Foundational culture defines what problem you look to solve. How you go about solving that problem, and how really big decisions are made within an organization.

Foundational culture is a company's scaffolding. And understanding it is important to me because it gives me an insight into the cultural DNA of a business. It gives me a better understanding as to how I believe situations may be dealt with, or decisions may be made in the future.

Now, created culture is what I call the finite. Created culture is the manifestation of foundational culture. It's influenced by foundational culture, for sure, but it's more specific to the task at hand or the point in time. Created culture is how you come together as a team, how you incentivize your employees, and most importantly, how employees act when a management team is not directly supervising.

The challenge for these companies, is to balance both of these aspects. Because whilst foundational culture is slow to change, created culture is much more nimble and it adapts and evolves in order to help a company to unlock its long run ambitions. Now, what is also most important to remember, though, is that a management team cannot directly control how their culture manifests. As much as they might like to. What they must do instead is put in place the necessary scaffolding and cultural guide rails to ensure that the core tenants of what they believe to be important is allowed to permeate throughout an organization.

Now, I've thrown a lot of theory at you since the beginning of this presentation. So let's bring in a few company examples to bring this idea of foundational culture and scaffolding alongside created culture to life.

Now, the first company I'm going to mention today is famed for its high performance scaffolding. And that company is Netflix. So within Netflix, high performance permeates throughout the organization. Netflix describes itself as a sports team, not a family. Families are about unconditional love. Sports teams are about having the right person in the right role at the right time, for the good of the team. Managers at Netflix are encouraged to use what's known as a key protest, asking themselves on a regular basis if anyone on my team was to say they were leaving tomorrow, how hard would I fight to keep them? Netflix is also famed for the fact that adequate performance receives a generous severance package.

Now, we can also see how this high performance culture distills into the company's created culture. Staff at Netflix give each other regular and extremely frank feedback, and that is allowed the company to develop a culture of trust and adopt a context over controls approach. Where those cultural guardrails are well understood, but the creativity within them is to be celebrated.

Now for my second company, I'm going to play you a sound, and I'm willing to bet that 80% plus people in this room will have heard this noise before. Even if you don't recognize it. So here we go.

Would anyone like to hazard a guess as to what that is?

No. Go on. Somebody have a go.

At the two where they suck up things in your businesses.

Right? Oh, yeah. No.

That is the sound of an iPhone box opening. And that is because Apple foundational culture is all about design. From the phone in your hand to the experience you gain in opening the product, Apple has designed every single part. Why? Because people really do judge a book by its cover. People form an opinion or a product or a company based on the signal it imputes.

Now, Apple is famed for the sleek design of its iPhone, its iPad, its iPod, and even those sort of flashes of colour that you used to see on the old Macintosh computers. But Apple's design philosophy runs so much deeper than that. And that is why the company has spent thousands of hours developing the packaging for its iPhone. That sleek, luxe feeling box. The fact that the two pieces of the box fit together so snugly, which is deliberate to ensure that you cannot possibly open the product quickly. And that woosh noise that I played you earlier, all of which is designed to create anticipation.

Now, you may not be an Apple product fan, but it's easy to understand the heuristic. If a company puts that much effort into its packaging, its products got to be pretty good too.

Now for my final company. Today, I'm going to touch on a company a little bit closer to home, and that is Baillie Gifford. So Baillie Gifford, foundational culture is all about long termism, from our partnership structure to the time period over which we invest, to the tenure of you, our clients, to the tenure of our employees, to the investments that we make in those employees, to the annual office outing, to the most protracted office move in company history.

Jokes aside, investing over the long run is hard. And to stand any chance of doing it well, the right long term scaffolding has to be in place. Now, when I start my analysis of company culture, I begin with that foundational that created culture. But that's just the first step. What comes next is to consider that culture's effectiveness.

What is it about this company's culture that increases the likelihood that it will be able to deliver on its long run mission? And for that, I use a relatively simple formula, a formula that belies the philosophy, evolutionary biology, and copious reading of company history that has gone into its development. And that formula is aligned motivation, times, scale of ambition, times, ability to execute.

So let's take each of these in turn. Now a management team can be intrinsically or extrinsic motivated. What matters is whether that motivation is aligned with our client's time horizon. Now intrinsic motivation is easier to understand if you have a management team that is motivated to solve a long term problem that creates alignment with our clients. Extrinsic motivation, on the other hand, is a little bit more complicated.

So let's take an example. CEO of Pinterest, the online pinboard company, is not a founder. Bill Reddy took over the role in June 2022. Now Bill Reddy wants to be remembered as a great CEO. He wants people to remember his name. Now, if this was a Stewart style company like Colgate-Palmolive or Hershey, I think that a CEO that wants to go down in history as a great is probably going to be putting up some red flags. The potential for ruinous mergers or acquisitions is likely on the cards. But for Pinterest, a company which until Reddy took over, has really struggled to find its fit in that social media social commerce landscape. A CEO that basically wants to be remembered for making Pinterest the most successful company it can be. Well, that is alignment.

Next, we have scale of ambition. Do I believe that this is a management team who want to build a really big business? And the emphasis here is on the word big, but also on the word business. There are a lot of people in this world who have great ideas and who want to save the world. But in order to deliver a return for you, our clients, we need them to build a business out of their long term opportunity.

And finally, we have ability to execute. What is it about this company's created and foundational culture that makes me believe that they are going to be able to execute on their opportunity set? What is it about the skill set of the CEO or founder of that business? What other skill sets do they need to succeed? And even if that CEO or founder doesn't have all of those skills themselves, who are they surrounding themselves by in order to access that skill set? Who is in their management team and who is on their board?

So that's my formula for considering the effectiveness of a company's culture. And that might be a formula which is useful for the cultural analyses you need to make in your own roles. Do you see alignment? Do you see a scale of ambition? And do you see an ability to execute? And you need all three.

I'm going to leave you today by circling back on the Renaissance. And just to check that you are still all awake. I am going to bring up a piece of very famous Renaissance art, and hopefully you'll be more enthusiastic this time to shout out the name of this piece of art and also who it is by.

So here we go. Leonardo da Vinci. Anyone know the name of it? Vitruvian man. Correct. So this is based on, Leonardo da Vinci based this piece of art on the work of a Roman architect called Vitruvius. Now, Vitruvius, in his book Da Architecture, states that a well-designed structure will exhibit three distinct qualities and they are for ‘firmitasis’, ‘utilitasis’, and ‘venustasis’. That is stability, utility, and beauty.

Now these collectively are known as the Vitruvian triad, and the Vitruvian triad applies to company culture too. Companies need stability within their cultures. That is not to say that they cannot adopt adapt or they cannot evolve, but they need strong scaffolding. Company culture also has to have utility. Why is this the right culture for this company, for this mission, for this industry?

It's not about whether a company's culture is good or bad or whether I would like to work there. It's about effectiveness. And finally, company culture needs beauty. Culture is not something you can just port from one company to another. It's not cookie cutter. A company's quirks and differences are its beauty, warts and all. So culture is everywhere, and it affects everything. And the way that a company goes about getting work done can be a significant source of competitive advantage. Culture really matters. Thank you for listening.

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