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# SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 29

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What's next for growth stocks?

MB Hello and welcome to *Short Briefings on Long Term Thinking*. Thanks for joining us. I'm Malcolm Borthwick managing editor at Baillie Gifford.

The years after the financial crisis of 2007 and 2008, were a golden period for growth investors. Innovation by tech giants such as Apple, Amazon, Microsoft and Netflix propelled their progress. While the rise of cloud computing helped smaller companies scale faster and more cheaply than before. Historically low interest rates also played a part in encouraging firms to invest in themselves and in turn institutions and individuals to invest in them. But the outperformance of many growth stocks ended abruptly near the end of 2021, the knock-on effects of the pandemic and the war in Ukraine, of course, rampant inflation and supply chain disruption among other problems, left many of us wondering what's next for growth stocks.

So, to discuss this, I'm joined by Dave Bujnowski, co-manager of the American Fund. Dave is based in New York, but he joins us in our Edinburgh studio.

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

Dave, great to have you with us in the studio, welcome to *Short Briefings on Long Term Thinking*. And you've probably joined us from one of the few places in the world that is actually colder than Edinburgh.

DB It's nice to be here, Malcolm, thanks for having me.

MB So, let's start. Great growth ideas. Do they still exist?

DB Yes, absolutely. I think there's a temptation to link the idea of growth, and growth companies, with the notion of expansion. And I prefer to link growth opportunities with change, not necessarily expansion. And I think that for identifying great growth opportunities of the future, I think it's important not just to ask what's expanding, but what's changing. And the good news is, there's an awful lot of change still happening in the world.



MB And you've just published a paper recently about the new engines of growth. Why have you chosen now to write that paper?

DB Yeah, there are two coinciding events that took place in April or May of this year.

One was in a team meeting. And one of the questions that we come back to, in many of our team meetings, oftentimes relates to a specific company. But in this case, it related to something much broader. And that question is, what matters, what really matters? There's a lot of noise out there, always, but particularly right now, a lot of volatility.

So, we asked what matters these days. And at the time, the world, the media, Wall Street was hyper-focused on the cycle, inflation, the Fed - all for very, very good reasons. But as long-term investors, we were inquiring, is that what we should be focusing on? If our investment time horizon is five to 10 years, should we be looking through a cycle? Are the forces behind the cycle what matters? Or are the structural shifts that drive long-term growth opportunities what matters? So that was one thing that compelled me to start thinking about the engines of growth, that would go potentially beyond the cycle. That was the first event.

The second event happened around the same time. And it did involve a book club that our team has done this year. So, each month, we pick a book to read. And in May, it was *The Rise and Fall of the Neoliberal Order* by Gary Gerstle. Essentially, the author highlights the contributing factors behind the politics of the day, really, for the past 100 years; the politics of the day, social norms, the economy, culture, and really dissects it deeply at a deep level.

And his contention was those contributing factors that drove the past 40 years from maybe the late 1970s, 1980s to the global financial crisis have ended. And during that period, those forces were driving just unfettered capitalism. Globalisation very lacks regulation, things that he believes are coming to an end. Now I don't have particular insight into whether they're coming to an end or not. But the book was fascinating, but it made me think about, okay, if we want to focus, if we think what matters, the structural shifts behind long-term growth opportunities, this book really spoke that language. And it had me wanting to dig deeper into what some of those engines that drove growth from the financial crisis to the present and the state of them.

MB So how can we predict where growth comes from?

DB I think that growth, if you really, really boiled down the core essence of where growth comes from in the first place, I believe it's when supply meets demand in new ways. And that creates a transaction. And the more that that happens, something grows. So, I think I really like stripping the whole concept down to its roots around supply and demand and looking for situations where there's a dislocation between demand and supply.

So that dislocation, I think, invites innovators to come in and fill that void, to come in and fill that dislocation. And when they do, it creates a growth opportunity. So that's my starting point.



MB So that's interesting. That's where the opportunity is, for us as investors, and what are these engines that power growth?

DB So, I identified three. So, one we called expansionary, the other is disruptive. The third was replacement growth engines and I'm happy to go into details about each.

MB Let's start with the first expansionary growth.

DB Sure. So expansionary growth, as we defined it, is when demand actually grows, and supply needs to chase it and meet it. And when, again, they meet, there's growth. And this I think is probably the most conventional way to think about growth. It's when demand grows. And it can come in many different ways.

One would be if more participants enter the system, that creates more demand potentially. Another is if just the economic means of the same people in the system grow, then that also drives demand growth. So, I think just understanding some of those forces will help then determine what's the state of this engine. How much of a role did this engine play in that magical 13-year period between the global financial crisis and the end of 2021? And what is the state of it today?

MB And give me an example of a company that would fit into the expansionary growth criteria.

DB All of the companies you mentioned in your introduction had an expansionary growth element to it. But let's pick on Amazon. One of the magical expansionary elements of the internet is that it allowed consumers to purchase goods from merchants well beyond Main Street. So that brought more merchants into the system. And the merchants on Main Street were able to now sell to far more consumers beyond their locale. And that brought more participants into the system. So, the whole system kind of ballooned outward as the internet grew and reached more participants. So, it's really a magical force that happened throughout the course of that time period.

MB And you mentioned that the macroeconomic environment is important with expansionary growth at the moment. It looks like we have certainly a downturn, if not a global recession on the horizon. Does that make it harder to find expansionary growth opportunities?

DB I think it does play a part. A lot of the great growth companies from the past decade were starting to have some fundamental slowdowns. The question that I started this exercise with was, oh, are these engines sputtering out? As a growth investor, I need to acknowledge that if it's the case, and you know, consider what the investment opportunities are beyond that.

So, I think in looking at this one engine, and understanding the dynamics, around whether innovation can drive expansion, as I just mentioned, with the internet, or whether it was macroeconomic conditions that drove the expansionary engine is really important. And to the extent that the macroeconomic forces drove the engine, then yes, I think we have to look at ourselves in the mirror and say that fuel behind the engine in that particular case, is depleted, probably for a good bit now.



MB And we all see anomalies, don't we, looking back? There have been some great growth companies that have emerged during times of recession, Microsoft after the oil shock in the 70s.

DB During a downturn, there can still be magical innovations taking place. Because macroeconomic conditions might be challenging, it doesn't necessarily mean that there aren't still amazing visionaries out there looking for problems to solve in that system that I'm talking about, and develop a business behind it and grow it.

MB Let's, let's move on to the second engine of growth, disruptive growth.

DB Sure, when a disruptive growth engine is at play, the demand in the system doesn't necessarily grow. So, the system itself doesn't necessarily grow. But new supply is created within the system that meets that demand in the system in a new and better way. And again, all we need for a growth business not to grow the system, but to grow a business inside the system is for that dislocation between supply and demand to exist. So, a new type of supply to address that void is a great growth opportunity.

MB And something close to home may be your pet.

DB Right. In the white paper, I wrote about a couple of examples. And this is my favourite, it's thinking about disruptive growth engines. And referring to my dog and her demand for food has not grown in the past three or four years. But how I supply that demand has changed with companies with ecommerce and companies like Chewy, to order it conveniently online instead of having to go to a pet store a few miles away. So that's one example.

Another example I think we can all relate to whether you have a dog or not, is video streaming services. My demand for video entertainment has not increased in the last five or 10 years, nor has the number of hours in the day. But how I supply that demand has changed with different types of streaming services and whatnot. So, a great opportunity for a company to come in and again, fill that void with an innovation despite the fact that the demand has not actually increased.

MB So, I guess the internet and the cloud and other things have been great enablers of these changes.

DB Absolutely. Yeah, I'd like to think it's one of the things that leaves me most enthusiastic about the next decade is that the infrastructure that has been laid down, an infrastructure that reaches virtually every corner of the economy and every corner of society is hyper-connected. It's a data-driven. It's software-oriented, and from those, amazing innovations can take place. It's fascinating to think about what an army of developers out there in the world who are kind of seeking, looking at the world, and looking for the new problems to solve, having this infrastructure that they can write to and write code for and develop applications for to go out and solve the problems of tomorrow. It leaves us really excited.

MB So, we've looked at expansionary growth. Thinking of Amazon there, we've looked at disruptive growth like Netflix. Let's look at the third area replacement growth.



DB Yeah, this is one that kind of surprised me as I was going through the exercise. And I didn't envision it before I started the exercise. But looking again, at the dynamic between supply and demand, and just looking for situations where there might be a dislocation, I thought, well, if disruptive growth engines involve demand not changing, but a new type of supply changing, then what would happen if demand itself changes, and doesn't necessarily grow.

So, it's not existing demand grows, like in an expansionary engine, it's that a new type of demand surfaces, and as a new type of demand surfaces, then again, supply would need to chase it. It's an invitation for innovators to go and meet that demand.

So, it's an entirely different dynamic. And I think it needed to be acknowledged as a third type of engine.

MB And what examples would you give here?

DB One involves sustainability. And you know, there have been, thankfully, pockets of society who have been awake and evangelising the need for sustainable energy and sustainable innovations and more sustainable products. But 20 years ago, it certainly wasn't mainstream. And it's crept closer and closer to mainstream. And I would say, today, there are companies that are growing, largely because there is this zeitgeist that has taken hold, that drives that demand for sustainability that has emerged.

And it's a new type of demand that just did not exist 20 years ago, it may have been a social issue, perhaps. But as far as a business demand, it didn't exist. And today it does. So that has opened the door and invited companies like Sweetgreen, the salad company, in the US, the fresh salad company, or even the electric vehicle movement.

I think there is a disruptive element to electric vehicles, they're amazing machines, and they've come in and they are replacing internal combustion engine vehicles. But there's also an element of a replacement engine behind them too, because some people might not have purchased a Tesla or Rivian because of the delight in driving them or maybe the status you might have in being the first on your block with a Tesla. But rather, they're purchasing it strictly because of sustainability.

MB Tell me more about Sweetgreen, that's a company I haven't heard much about.

DB They make fresh and delicious salads. There's roughly 140 storefronts in the US. And the founders work really closely with the supply side of the industry, the farmers, who are all organic, typically local, but they work with the farmers to help them get the most out of their crop. To do so sustainably, to do so organically, helping them plan years in the future, depending on what their yields might look like, or what they've planted in the past, or even what their customers are demanding. And so, these farmers have some visibility and now a partner to sell to in a chain of growing restaurants that is really popular.

MB And how does having this framework of growth help you as an investor? Does it help you in a forward-looking capacity? Does it mean that you reassess some of



your current holdings? Tell me more about that.

DB Sure. So, in both cases, yes, it helps. And relative to our current holdings, because there's so much volatility these days and questions about what lies ahead, fundamentally, for these businesses. One of the exercises I've done on the back of this framework is to look at every single one of our holdings in our current strategy and plot which of the engines are driving this opportunity. Again with the premise that some of these engines might not be as strong in the next 10 years as they were in the last 10 years.

So, if I look at a company and think, okay, well, the reason it has been growing is because of this expansionary engine that we've defined, and then take it a layer deeper. Well, the expansionary engine, was it being driven by the economic forces that we talked about earlier? Or is it being driven by innovation that is still just beginning? And that will help me build conviction in the investment case, looking at a five-to-10-year horizon.

One specific example is, as we go looking for new fresh ideas looking forward, is looking for situations where there is room for future expansion, particularly around data as it relates to life sciences.

MB So that's really interesting. It can also tell you, as an investor, when you think one of these growth companies is possibly running out of steam. Can you give me an example of a stock like that, that you've thought about that recently?

DB Sure. I sometimes joke that the words you said, 'running out of steam', I think, it makes me think of saturation, and I call that word one of the dirtiest words for a growth investor.

I think there's different ways a business can run out of steam, it could be because of an economic cycle hitting, which can tend to be transient, it doesn't mean the game is over. It could be because of competitive forces entering the market. I think a great growth company with great management can identify that and maybe navigate around it. But when saturation hits, it's the end.

I've had this question of, where might saturation be creeping in, because we've also been through this period during the pandemic, where, almost famously so, the future has been pulled forward, demand has been pulled forward for a lot of growth businesses.

So, it's a question that we have to address, whether saturation is taking hold. So, some companies that I think it has come to mind, that this question is at least relevant. One would be Netflix, it's a holding of ours. Growth has slowed this year, as so many people joined as subscribers during the pandemic. And when it comes to businesses where the current demand opportunity might be saturated, I think it's important then to ask, is there an act two? If act one has potentially played itself out. And I think, again, for the great companies, they will have the foresight to realise that act one, the wall might be creeping closer, and there is an act two and now's the time to press the button on that. So, with Netflix, they're aiming to do so with their advertising service.





MB So, there is an act two with Netflix?

DB Right.

MB Dave, this might sound a little bit leftfield, but I wonder what Josiah Wedgwood would make of your theory. I recently wrote an article about the 18<sup>th</sup> century entrepreneur and craftsman for Baillie Gifford, and what's really interesting about Wedgwood is he created a market for vases and other luxury goods that hadn't previously existed. So, there was no demand for his products until he made them. How does your model account for this?

DB I love the example. And I would push back a little bit and say, maybe the demand did exist. It was just latent. And he was creative enough imaginative enough and had enough vision to understand that there was latent demand that wasn't being met. Inside of the framework that we're talking about today, I view that as a potential source of an expansionary engine.

I get really excited when I see a situation where there is latent demand in the systems that I'm talking about. The demand is not being served. It may not even be realised yet. It might not be understood that demand is there inside the system. But if an innovation can come along to unlock the awareness or remove the latent part of that demand and make it realised and known and aware, then it's an amazing opportunity. So, I think your example is an example of that.

I think another classic and famous example is Steve Jobs. He told us what we wanted, what we demanded. At the time, we didn't demand it. We didn't know that we wanted these amazing devices in our pockets. He saw that we did and put it in front of us. And wouldn't you know it, there was a lot of latent demand there that has driven one of the most remarkable growth companies of all time.

MB And I, you know, just listening to you, I can feel throughout our conversation, there's an element of expansive thinking, philosophy, you majored in philosophy, does that feed into your thinking as well, your philosophical background, Dave?

DB Not directly, but as I've gone through my career, I've realised that it does indirectly. So I majored in finance and philosophy in college. A left brain right brain combo that, I didn't realise at the time, I think would be a wonderful asset to be an investor.

And how, practically speaking, how it relates to how I invest is, I've talked a lot today about demand. And I start from the premise of any business out there needs to address a demand or it's not going to be a business for long. So, I start by looking at demand. And I think studying philosophy helps you think with your right brain, but it helps you think about people and humanity, what they're going through, what their aspirations are, what their demands might be.

So that's the bridge between, I think, studying philosophy and investing, is that well, what might demand be? And might there be demand that exists out there that we don't realise yet, but there is a founder out there, there is a visionary out there who says, there's latent demand in this system, I'm going to create something that's going to unlock it.



MB So, it's good to start *Short Briefings on Long Term Thinking* with growth and end with philosophy. Dave, thanks for joining us on the podcast.

DB It's a pleasure. Thanks, Malcolm.

MB And thanks for investing your time in *Short Briefings on Long Term Thinking*. You can find our podcast at [bailliegifford.com/podcasts](http://bailliegifford.com/podcasts), or subscribe at Apple podcasts, Spotify, or on TuneIn.

And if you'd like to read more about Dave's thoughts on growth investing, you can find his paper *The New Engines of Growth* on the insights sections of our website at [bailliegifford.com/engines](http://bailliegifford.com/engines).

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