SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 32

From steam trains to AI vision: 150 years of investing

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

When the Scots lawyer, William Menzies, first travelled to the United States of America in 1864, the Civil War was still raging. His two return trips in the decade that followed opened his eyes to the scale of the investment opportunity. Like the internet today, the transcontinental railroad created new markets and industries and led to the US's gilded age of expansion and wealth.

Railway hubs such as Chicago and Kansas City became thriving centres for trade in grain and cattle. While Pittsburgh's steel mills prospered, thanks to better access to iron ore and coal. Soon after his third trip, Menzies launched the Scottish American Investment Company. Initially, it invested largely in railroad bonds before broadening out its remit first to other types of debt and then equities.

As the decades rolled on, the company broadened its horizons further beyond the US to numerous other countries around the world, becoming the global investment trust that it remains today. The investment trust celebrates its 150th anniversary this year. And I'm joined by James Dow, who's the joint manager of the Scottish American Investment Company, often referred to as SAINTS. James is also co-manager of the Global Income Growth and Responsible Global Equity Income funds.

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.

James, it's great to have you back on the podcast. This is your third time.

JD: Yes, well, delighted to be back. Thanks for having me.

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MB: And we're here to commemorate the 150th anniversary of SAINTS. But I want to hear more about William Menzies, a really interesting character, both conventional and unconventional. Conventional maybe in the sense of his education going to Edinburgh Academy and then the University of Edinburgh, but very adventurous as well.

JD: Yes, that's right. I think one of my favourite pieces of knowledge we have about William Menzies is, one of the board directors he worked with for many years on the trust, in his advancing years put down on paper reflections of some of the folks he'd worked with, including William. And he says in his a few sentences on William Menzies, “I lay this garland on his grave, he had a heart of gold.”

And this comes through a few times, that he was very much an open-minded character, someone with empathy, someone who was just interested in the world, who was prepared to go out, you know, a bit unusual in those days, to travel out to the states during the Civil War and think about investing and what he could do for shareholders money.

So, we know he travelled a lot. We know that he was, if you like, a man of the world. I may be reading too much into this, I may be biased, because I think these are quite good qualities in fund managers generally. And so maybe I'm projecting this onto him. But yes, and we know that and, of course, he had the rigor of being a lawyer by training.

So, we can assume that he brought some kind of good financial discipline and structured thought to his investments as well. So all round, a very interesting character and a great founder in many ways.

MB: The early years of SAINTS are fascinating, and we've got pretty much a final draft of the 150 years of SAINTS [book] in front of us here, written by the historian John Newlands. One of the interesting things that John uncovers is the early shareholders in SAINTS.

JD: Yes. And they were a very wide range of people from all kinds of backgrounds, plasterers, opticians, some of the financial great and good of the day, as you might expect. For me, I think one of the most interesting is SAINTS single biggest shareholder initially was a lady called Janet Wahab.

She married a Charles Wahab who was in the British army. But she came from a very well-known and famous family of paper makers who were based in the Edinburgh region, the Cowans – she was born Janet Cowan. If you look back at the history of that company, they were known around the world for their finest quality Cowan's papers that was exported all round different countries. And I wonder if that sort of knowledge of the world and that open mindedness – she travelled a lot – again explains why she had this willingness to put a lot of her savings into an investment trust company, which was set up to invest overseas.

It was saying, look, you've got limited options as a saver here in the UK. You might have to buy more UK government bonds and just take your rate of interest. Why don't we go abroad, invest overseas, find some of the exciting growth

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opportunities of the day? That was true of William Menzies and his attitude. It was true of Janet as the single biggest shareholder originally. That kind of open mindedness to global investing.

MB: Yes, the plethora of different types of shareholders, as you mentioned, was also fascinating. I think the other interesting thing, SAINTS was not necessarily the first investment trust *per se*, but the first of its type.

JD: Yes, that's right. Because we go back to, we're talking about 1873 here. You have to remember that for savers of the day, there were very limited choices. You were effectively talking about being handed low rates of interest on British gilts. The opportunities to invest overseas were very, very limited. And the real revolution of the investment trust company, and the form, was this kind of democratization of investing, so that many different investors or savers had a way to put their savings to work, whether that be in the UK or overseas.

But they didn't have to have huge sums of money to invest. You didn't have to go out and be able to buy a US railroad company. You didn't have to have incredible connections of, you know, knowing the right people who could put your money somewhere. By setting up the investment trust company form, the early investment trust SAINTS being one of them, were able to allow smaller shareholders to find ways to invest in a diversified portfolio without some of those other privileges or accesses that other investors might have had at the time.

And what was unique about SAINTS, what was especially interesting, it wasn't the first investment trust set up, but it was the first investment trust company, meaning structured as a limited liability company. That was really important. It now seems sort of slightly archaic and what does that really matter? But it was really important because it essentially meant that investors or shareholders knew that they wouldn't personally be ruined if the company went wrong because of the limited liability structure.

And so, although there were a couple of investment trusts that slightly predated SAINTS, that were set up as legal trusts, they later converted to SAINTS' form of the investment trust limited liability company, because that was what was really needed to allow savers to, you know, with some confidence, invest in these great investments overseas.

MB: So, one of the stories I love, James, looking through the trust's history, probably my favourite one, is going back to the sixth AGM back in 1879, where one shareholder, a Mr. A R Gray dared to stand up to address the board. And he said:

"I beg to ask the chair if there's any reason why the values of the securities should not be given" – that is in his portfolio – "I cannot for the world see any objection to it being published."

The chairman seems to be taken back by this humble request and he blustered:

"It has never been done. The value fluctuates. Unless the meeting thinks it ought to be put in, I think it best to pursue the course which has formally been taken."

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So Mr. A R Gray was effectively told to sit down and shut up to a degree. So not a huge amount of transparency into shareholders not being able to see what they were actually investing in.

JD: Indeed, but Mr. A R Gray had a very good point, which is, after all, it's shareholders capital. And doesn't he have the right, in a way, to see where the company is investing his money? He should at least get a list of the securities they're investing in so he can check over them and see what he's getting. That was the way of the day.

You know, it was felt that, for example, publishing the list of investments might give a competitive advantage to some of the competing trusts. They might think 'we'll have a bit of that as well', you know, so they wanted to keep it closed. One might argue that it also protected them from investments that went wrong. You know, if shareholders just couldn't see them, they just got a number at the end of the year, then there'd be fewer difficult questions to ask, if not all investments work out.

So maybe the board were just trying to protect themselves from difficult questions, if some of their investments went wrong. But I think the fundamental point that the shareholder was making was this very good one, which is, 'come on, it's my money, let me see where it's invested.' And that's something that we take to heart today.

It's interesting that even today, you know, if you look at a fund or trust, often you might be able to find the top ten holdings. But it's not always easy to find where all of the capital is invested. It's sort of buried away somewhere. And on SAINTS for a long period of time now, we've taken the view, 'look, let's be transparent about this.' It is shareholders money. They have a right to see where they're investing and they should challenge us if they think, 'you know, what on earth are you doing investing in that?'

Well, let us know about that. You have every right to speak up about that and that's why we're very transparent. In the annual report, every year we lay out all of the holdings so you can see where everything is invested. Hopefully shareholders see that and feel encouraged when they see the names that are in the portfolio. But that was quite a critical point, I think, for SAINTS to be challenged on that.

MB: And you're often on the road talking about SAINTS to shareholders.

JD: Yes indeed. And you know, we get these questions and that's all part of it. Recently, quite rightly, shareholders have come up to me and said, 'how are you thinking about the geopolitics' and 'how much exposure there is to corporates in China or in Taiwan?' And that's all part of the debate that we should have with shareholders, with the board, with all of those involved in SAINTS.

I think that's important to another 150 years, to have that ongoing debate and

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discussion and conversation to try to find the best way forward for the company and the trust. Ultimately, as manager, I'm making some of those decisions and I'm saying, 'look, I think on the balance of risk and probabilities, this is a good way to go', but I welcome those inputs.

MB: When we look back at the trust's history, it's been through extraordinary times. It's been through two world wars, numerous crises, oil shocks, stock market crashes. If you were to pick out one or two inflection points, James, what would they be?

JD: Oh, there have been a few. But I think when I look back at the history, and it's a great opportunity with the 150th anniversary book to take the time to sit down and think about some of the lessons from over the years, I think a couple that stand out to me are the 1973 bear market in equities.

You know, the shocks that happened at that time and the huge fall in equity values. A lot of people remember '73. '73 was terrible, you know, the FTSE was down. But what fewer people remember is the two years leading up to it had been fantastic years. And the board, feeling sort of emboldened in the prior two years, had actually taken on quite a bit more debt and the gearing of the trust had gone up and they were feeling rather gung ho.

Then of course they have the '73 bear market. And with the gearing the trust, the debt had got to an inappropriate level. It really hurt the trust and the net asset value fell a lot further than it would have done absent the gearing.

To bring that to the current day, when we had discussions – this is going back only three or four years ago – about the level of gearing in SAINTS, how much debt is appropriate, one of the things that we did is we stress tested the portfolio and the gearing levels against a replay of that '73 bear market. We said, 'What if we have seen this before? A 76 per cent fall, I believe it was, in the value of equities, will that put SAINTS shareholders in an uncomfortable position? Will the gearing be too high at that point?'

And so that's a critical learning about how severe a really bad 1-in-a-100-year event is and making sure that SAINTS is resilient enough and robust enough that it can survive even that extreme outcome. We want to make sure we get that learning and take that forward for the decades ahead.

So that would be one that I'd pick out. I guess another one would be, there's a risk with these things, because the closer you get to the current time, the more you start to make people feel slightly uncomfortable. But as recently, I would say, as the late 1990s – this is before the trust came over to be managed by Baillie Gifford in 2004 – there was a challenge on the back of the fallout of the dot com boom.

And I'm sure there will be shareholders listening to this, who will have owned SAINTS and remember this period because we have some very longstanding individual shareholders in the trust. The discount to NAV had widened out dramatically at the end of the dot com boom and with equity markets falling.

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And I think SAINTS was, you know, more than a 20 per cent discount. Now the interesting learning from that was the board decided at that point to buy back stock quite aggressively to try and close the discount. The problem was the underlying issue that was worrying shareholders didn't go away by buying back stock. That wasn't a solution. All it actually did was, by shrinking the equity base of the company, it actually raised the gearing levels to quite uncomfortable levels.

Now, the way that that ultimately played out was the board decided in a change of manager and that's when the SAINTS came over to Baillie Gifford. But again, something that is in SAINTS history is remembered. You know, buying back stock isn't necessarily the answer to closing a discount. It's these kind of lessons over a very long period of time that I hope that SAINTS knows. It's learned them. It's been around the block a few times and hopefully we can avoid some of those tricky situations, we'll be able to handle them with some experience going forward.

MB: You mentioned that Baillie Gifford took over the trust in terms of managing it in 2004. What's changed since 2004?

JD: One of the biggest things is we have doubled down, if you like, on being a global investment trust. There was a period before the trust came over to us that the weighting had drifted quite heavily back in favour of UK investing and when we took it over, the equity portfolio was pushing something like 70 per cent invested in the UK.

And one of the big changes we've made is we've taken it back global again to the point that now I think maybe sub 10 percent of the equity portfolio - 9, 8 per cent - is invested in the UK and everything else is invested overseas. And the logic of doing that is really that there are some great companies in the UK that can grow and pay resilient dividends and are well-managed. They are there, but are there enough of them for a properly diversified global portfolio that will serve SAINTS' objectives?

You know, the UK doesn't have a monopoly on great businesses. Guess what? There are some amazing businesses in Europe, in America and all around the world, and we can take advantage of those. We should be doing that. And so, we have very much driven the portfolio back towards being a globally invested trust to take advantage of those opportunities.

I'd say the other big change that we have enacted over, and this is really more the past decade, I would say, is we've focused on what I'd call long-term dividend compounding. And what I mean by that is we've made the bedrock of the portfolio, the equity portfolio in SAINTS, these companies that have really good odds of steadily compounding their profits and dividends higher year after year after year. Rather than in other approaches where you focus on just high yield to generate an income stream, which has all kinds of problems in the long term. Or the historic SAINTS way, which I would say was more opportunistic.

So it was, 'well, this looks like quite an interesting investment. Let's have a bit of

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that.' And what we've said the past decade is SAINTS objective is primarily around that kind of steady, long-term compounding of dividends and capital.

Why don't we invest the portfolio in investments which also are likely to deliver steady compound of dividends and capital? Rather than trying to be clever and do a bit of this and a bit of that and hoping it all adds up in the end. So, to give you a couple of examples of that long-term dividend compounding, that would be names like Atlas Copco, the Swedish industrial manufacturer, with its incredible long-term record.

Or let's talk about Analog Devices, the US chip designer. Again, all kinds of interesting new designs it's been able to come up with over time has driven that long term compounding in earnings.

MB: So, a decent past decade. What about the next decade and beyond?

JD: Well, I'm biased, You know, I guess you ask any fund manager, 'how did you feel about your portfolio?' 'I feel great about my portfolio. I've handpicked it myself!'

But I think if you looked at the portfolio, you see very high-quality companies with good growth opportunities that are well-managed. I feel more optimistic about it today than even ten years ago as we were embarking on that transition. I think the quality and the nature of the companies we have in the portfolio is the best it's ever been.

So, I can give you a few examples. Let's take last year, after watching from the side-lines for ten years, there was quite a fall in the share price of L'Oreal, the cosmetics company. Now that is a classic example of a company which, you know, the Bettencourt family are fantastic long-term stewards of that business.

They encourage long-term investment by the management. It's a very cash generative business, has great opportunities to grow globally, very strong balance sheet committed to paying a progressive dividend. It's a perfect fit in terms of that steady long term dividend compounding for SAINTS. We watched it from the side-lines for a decade because we always felt while the valuation is a bit, you know, it's kind of pricey. Last year finally we got that chance. It pulled back a long way as people were panicking about a variety of things, and it's now in the portfolio.

But that or let's say Cognex is another one we bought last year. Another one we really like. I was out last week in Massachusetts spending the day with those folks. And that's a machine vision company. It has a tremendously strong position making these little cameras that go on things like package delivery centres or assembly lines, where very high-speed things are being scanned and checked with this little camera.

And there's a lot of sophisticated software on the back end of it to help process things and check that quality is good and the right things are in the box and so forth. So automating manual processes basically tremendously strong in that field,

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very strong and distinctive culture of the company, great technology pipeline of new products that are coming out, very cash generative business.

That's what's in SAINTS portfolio now. And that's why I'm optimistic about the next ten years. It's those underlying investments which I hope will drive great returns for shareholders.

MB And that imagine both of those companies, like you're saying, cash generative and have pricing power.

JD Yes, we've seen that really tested, of course, across the portfolio, not just with those two in the past couple of years with higher inflation. You know, do companies genuinely have real cash profit and do they have the pricing power and the ability to continue growing? And happily, that is what we've seen play out.

MB Inflation has been a huge issue for the last couple of years, James, not just the rate of inflation, but how quickly inflation has increased. How do you think of that as an income investor?

JD: I don't think you can do it on the fly, to be honest. You have to have picked the portfolio. We talk a lot about having an all-weather portfolio or a resilient portfolio, the kind that is made up of really strong companies that are able to adapt and change and pivot whatever is thrown at them. So, whether it's a phenomenally quick increase in inflation or whether it's breakdown of global trade links because of war in Europe or whatever it might be, it's less about me or our team reacting and 'oh quick, let's sell this and buy this.' I'm sceptical about whether that really works.

It's more about us having done the groundwork over the years of making sure the portfolio consists of great companies which can adapt and thrive, whatever the weather. That doesn't mean they'll always go up in straight line, that doesn't exist. But it does mean that we can have confidence. And we saw the results again come through the last few years that they will be able to weather the storm, whatever is thrown at them.

We saw it in 2020 when nobody had game planned a global pandemic. Nobody had thought about that. And it wasn't that we as managers said 'oh quick, change the portfolio to pandemic resistant stocks!' It just doesn't work like that.

But we had got a portfolio of really strong companies, cash generative, adaptive, but that was all the work that had been done the prior decade making sure the portfolio consists of those really strong and resilient and adaptive companies.

That's the solution, I think, rather than me being some clever clogs who can suddenly churn the portfolio. I just don't believe in that.

MB: So, the solution is to look at the company probably more than the macro environment and other things.

JD: Yeah, absolutely. And that's why we're so sort of bottom-up driven. We're so

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focused. I've just come out of a discussion of a potential new holding only 60 minutes ago, and our sole focus has been on the board of that company and the management and their skill set and are they genuine long term managers and stewards of the company?

What are the examples we can point to where they have adapted and thrived? How do we think they would react in various different scenarios? Because that's exactly what we're looking for. It's that kind of bottom-up analysis. We're kind of delegating to these great companies and their management and their boards and saying, You're the experts in your business.

We're providing you capital. We believe in you. We believe that our judgment is that you'll do a great job, whatever the world throws at you. Now on you go and deliver that. So, yeah, that's crucial really to our analysis.

MB: And I know you and many other investors at Baillie Gifford also help to improve your analysis by reading a lot. So, what are you reading at the moment?

JD: I'm one of those terrible people who is normally reading four or five books at the same time, and people say, 'well, how can you possibly follow that?' But depending on what I like to dip into or be looking at right now, I've just finished a book called *Shoemaker* by the founder of Reebok, the trainer company, Joe Foster. If you remember back through the 1980s, Reebok had this enormous surge of success and became kind of world famous and was like a Hollywood brand and so forth.

And then latterly, it sort of struggled a bit and declined. But he's written his autobiography of how the brand came to be, the story, that journey. So that's been a fascinating one.

I'm reading a chap called Carl Hahn who was famous for taking Volkswagen to the US market in the fifties and sixties where it went from a kind of nothing – 'who the heck would buy a German car' – to everybody wanting to buy a beetle. So, his story of how his journey at Volkswagen, and what they did there to be able to deliver that growth.

You can probably tell I'm a fan of business autobiographies. I think that's one of the best tools that we've got as investors is to learn some of those signals about how great managers have done things and be able to recognise them when we see them today.

I've often got several of those kind of books on the go. Those are a couple right now.

MB: Reebok are a fascinating company. I remember in the eighties they were huge. They sponsored a lot of football teams. I think of Bolton in particular, I think of Sigourney Weaver in *Aliens*. I think of, you know, moving into America. What happened with Reebok?

JD: It's a great story. I'll try to give it a condensed version. So, Joe Foster and his

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brother Jeff, they were very driven individuals from around the Bolton area, which is how they ended up sponsoring the football team. Their dad and even grandfather were shoemakers from the prior decades, and the grandkids were determined to take this brand and make it big and go global and make it world famous and a household name with the shoemaking experience.

And the amusing thing is, as is often the way, they put in huge amounts of hard work to try and make that happen, but it was luck that got them over the line. So, what specifically happened was they had an employee from Mexico whose wife was attending - this is in the early eighties - aerobics classes and he worked for Reebok.

And he kept saying to the founders, 'guys, there's amazing opportunity here. All these trainers that folks are wearing in aerobics classes, they're having to wear football and running shoes. We need something more like a ballet shoe, something really flexible that we could sell to them' And they were like 'oh, I don't know about that.'

So eventually, almost to humor him, they ended up making a pair of these new shoes. And I think the stats were that they thought maybe in the first year they might sell 5000 of the things. They ended up sending something like 100,000 in the first week. They tapped into this new niche, where there was an unmet need, and then they did a lot of development around soft materials in the shoe, which really changed the way shoes were made.

And for a time they overtook Nike, and they were the by far the kind of the brand that was appearing on the red carpet at Hollywood dinners and all this kind of thing. But a lot of it was kind of that preparedness and dogged hard work to put the company in position. When Lady Luck called, as it were, they were ready to take advantage of that opportunity.

But that's ultimately what propelled that brand forward and made them a huge success globally.

MB: That's a great story to end on. James, thanks so much for joining us on *Short Briefing on Long Term Thinking*.

JD: You're welcome. My pleasure.

MB: And you can find our podcast, *Short Briefing on Long Term Thinking* at bailliegifford.com/podcasts, or subscribe at Apple Podcasts, Spotify or on TuneIn. And if you enjoyed the podcast, please spread the word.

And if you'd like to read more about the history of the Scottish American Investment Company, the SAINTS board has commissioned a new history. In *SAINTS: the first 150 years*, the financial historian John Newlands tells the story of the trust's progress through a century-and-a-half of global booms and busts, and it will be published in digital form in late May.

So, if you're interested in getting a copy, please request it via this link:

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bailliegifford.com/saints150th. That's the number one five zero t h. And you can also find this address in the show notes for our podcast. We're also linking to the books that James was chatting about earlier in relation to Volkswagen and Reebok.

Now, if you're listening at home, you're listening in the car. Wherever you're listening, stay well. We look forward to bringing you more insights in our next podcast.

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