INSIDE THE MIND OF A GROWTH INVESTOR - INTERVIEW WITH JAMES ANDERSON, BAILLIE GIFFORD (SCOTTISH MORTGAGE)

Launched in 1909 Scottish Mortgage is a globally diversified investment trust with assets under management of over £2.5 billion. The trust is managed by Baillie Gifford.

Its track record is exemplary returning over 320% over ten years against a sector return of 134% *(of course past performance is no guide to future performance and investments can fall as well as rise).* The trust has been managed by James Anderson since 2000, and he is supported by Tom Slater.

James is a larger than life character and is not afraid to state his views on why he believes his approach to investing is the right way. In fact he recently took a sabbatical to write a book, which we are sure will be hitting the shelves soon!

Much of James' thinking is about pondering the future and then identifying businesses which will thrive in this environment. For example, could open heart surgery be done robotically and who would be the beneficiaries of this change.

On a stock specific side the likes of Amazon, eBay and Alibaba have opened up global customisation and both James and Tom have said that is not just about being early investors of these companies but also looking for other companies which could dominate in the future.

By its very nature the fund is heavily tilted towards technology and the US and investors should not consider this as a short term investment. James will invest long term, ignoring the noise, and investors need to understand his approach and be prepared to play the long game. A minimum time frame of between 5 to 10 years should be considered for investors to reap any potential rewards.

In our latest look at 'gurus' we approached James Anderson to understand more about his investment style to enable potential investors consider whether this trust is right for them as part of a balanced portfolio. His answers provided a fascinating insight to the management of the trust.

Shininglights: *"In his latest memo, Howard Marks argues that diversification all but guarantees average performance but concentrated holdings if wrongly chosen are deadly.*

To outperform he argues, requires investing where others are not, without timidity.

Do you agree and if so can this be achieved by generalist fund managers or can this strategy only be executed by hedge funds? (Marks, Klarman, Tepper etc)"

James Anderson: "A degree of diversification is prudent but like all things, it is best in moderation. I agree with Marks that over-diversification does render mediocre returns a much more likely outcome.

Naturally investors need to consider any individual investment, whether in a single stock or a fund portfolio, in the relation to all the assets they hold. Over the years of managing Scottish Mortgage and meeting investors I have found that the majority of investors hold the trust as part of a broader investment strategy.

Critically, whilst more and more investors have become increasingly short term, desperately seeking immediate results, my approach has remained resolutely long-term. I passionately believe in the vital importance of this long term approach and the need to focus on finding strong and durable businesses which we think offer healthy growth potential over the next five years or more. This is a view shared by my comanager, Tom Slater and together we aim to develop a concentrated portfolio of stocks representing the best opportunities across the globe, for the next five to ten years and beyond.

The trust has around 70 holdings but the weightings of the individual positions vary considerably, reflecting both our relative levels of conviction and share price performance. For example at the end of June 2014, the top 30 investments accounted for over three quarters of the portfolio by weight.

We believe that it is critically important to back your judgment and run your winners in this way if you want to achieve good long term returns. This is due to the asymmetric nature of returns on offer from equity investments.

The downside is capped at the funds invested, but the upside potential is theoretically unlimited. Even in the "real world" you can make many times your money in the right stocks. Our analysis of long run stock market returns clearly shows us that owning these "multi-bagger stocks" contributes the bulk of the returns on offer. *(I will expand on this further when I look at some stock examples).*

Finding these real winners, the extraordinary growth companies, is much more important than avoiding those where we may lose money for our clients. Behaviourally, this is quite hard to do.

Academic research suggests that most individuals dislike financial loss at least twice as much as they take pleasure in gains. We fear that for fund managers this relationship is greatly magnified by the internal and external pressures within the industry. You need to be willing to accept loss if you are to have an equal or greater chance of (almost) unlimited gain. You must also have a meaningful amount invested in the successful individual investments to make a significant impact at the overall portfolio level, hence "back your judgment and run your winners."

Over time, share prices move to reflect such growth in a company's earnings but it requires patience and a willingness to look through short term noise which can significantly impact share prices, even when not directly related to the company itself. You must be a genuinely long term investor to succeed at this type of investing.

Personally I do not believe that this type of investing is solely the province of hedge funds. What is important is that the structure of both the investment vehicle and the investment management company correctly align the interests and time horizons of the manager with those of their end clients. One attractive feature of an investment trust is that there is a robust feedback mechanism in place; any such company which fails to meet the requirements of its shareholders is liable to be wound up.

Scottish Mortgage, with its permanent capital basis, works extremely well for this type of investing. It allows us to access less illiquid investments for our clients than a comparable open ended investment vehicle might be able to do. Further, the company is able to invest in unlisted companies, allowing us to access growth opportunities before they come to the public market *(Alibaba Group is a good example of this)*. We see this last element as being of growing importance, not only because it means we can access companies at an earlier stage, but also because we think many of the exciting growth business of the future will be less capital intensive and therefore can choose to list on stock exchanges later in their lives.

As a conclusion (and hopefully I have answered the question!) I mentioned earlier, the increasing level of 'short-termism" in the markets. More and more managers are being judged on how they perform quarter by quarter. Naturally this places pressure on them to focus on producing quick short term results, but this is actually at the risk of poor long term returns for their clients. I believe, irrespective of whether a fund is over-diversified or concentrated, a focus on the short term is very dangerous for any investment.

Baillie Gifford has a different approach to investment with our private partnership structure. We think about our own business in terms of decades not quarters. This is one of our key competitive advantages, because it allows our investment managers to take a long term time horizon and gives a constructive incentive for our best people.[1] Further because we are a private partnership, we are free from the potential conflicts of interest which can arise from having our own external shareholders. It aligns us with our clients' investment horizons and interests, helping to build and support strong long term mutually constructive relationships. This stability and structure we believe is essential to producing long term success for our clients. Scottish Mortgage has already been a client of ours for over 100 years and we look forward to a long future together.

Shininglights: *"We have invested in Scottish Mortgage since 2009. We were immediately struck by the obvious exceptional intellectual rigour to your work and an equally obvious distaste for certain excesses of the industry (which we share).*

Can you briefly explain why you chose to manage investments and key learnings that have shaped your philosophy over your career?"

James Anderson: "Investing now is more exciting than ever (and I have been investing money for many years), experience is crucial but the challenge of seeking the new opportunities of the future is the reason I still want to come to work everyday, despite having worked for Baillie Gifford for over thirty years.

Why is now so exciting? There are three main reasons I want to highlight.

The first is the truly transformational nature of technology being applied across a widening spectrum of industries. Secondly there is a real shift in business models, away from capital intensive growth, which has long term implications for the capitalist model itself. And thirdly, there is more information easily available today from a much wider range of sources than ever before.

These three things combined together mean the potential rewards on offer for patient stock pickers in the truly transformational growth businesses could be phenomenal. However, in order to participate fully in these rewards, it is vital to be long term in your thinking.

Transformational technology has long been an important theme within the portfolio. We believe that the pace of such change is continuing to accelerate exponentially and impacting across an ever broadening range of industries and business models. There are large stagnant pools of profits ripe for disruption though the new application of technology, where the incumbents have been unwilling, or even unable, to innovate. Further, the power of the networking effects often found alongside these technological shifts, tends to concentrate the rewards in the hands of fewer and fewer winners. In turn, this is a self-reinforcing competitive advantage. It will therefore be ever more important for investors to focus on finding these successful individuals companies.

Today, the main areas where we see these attributes and to which we have exposure within the portfolio are media, mobile communications, retail and healthcare. All of these have much further to go but we are also continuing to seek out other areas of potential, (for example: the traditional auto industry and Tesla/electric cars).

Historically, businesses have required large amounts of external capital for investment in order to generate growth. The fundamental shift we are seeing in a number of new businesses is the ability to grow with a relatively small capital base and to become cash generative at an earlier stage in their development.

Such companies do not need to come to the public markets in order to grow. They are typically undertaking an initial public offering much later in their life and the use of the capital raised has also changed. It tends to be more akin to a liquidity event, with the cash proceeds used to buyout the

[1] James Anderson joined Baillie Gifford in 1983 and has been a partner for many years. Tom Slater joined straight from university in 2000 and became a partner in 2012.

initial private investors rather than to fund capital expenditure to generate further growth. This could have a profound impact on the nature of the traditional relationship between companies and investors under the existing capitalist model.

One of the challenges of the future will be gaining access to such opportunities early enough to participate fully in their growth phase. To this end we see Scottish Mortgage's ability to own unlisted equities as of increasing value. This gives our investors the opportunity to access such growth and to do so at a much lower costs than through the traditional hedge fund and venture capital structures.

There has never been more information available from such a wide variety of sources. The financial press is dominated by the views of London and New York, yet many of the key decision for the future are not taken in these places. For example, the views of the political elite in Berlin are far more important for the future of the "European project" than those of the City of London. We see it as critical to get away from the biases of the financial media and to seek out the opinions of those whose views matter in the real economic and political decisions, in order to understand fully the opportunities and risks out there.

On a more granular level, as fundamental investors clearly company managements' views and long term goals for their businesses are key to the success of our investments. In general, the financial industry's engagement with companies tends to be very short term in focus, with pressures to discuss quarterly earnings and prospects particularly acute. Many management teams find this frustrating and in fact these pressures can lead to perverse decision making by companies to hit the near term goals of the financial industry, at the expense of their own long term benefit. We believe that this is driven by structurally short term incentives in the financial industry itself and has the potential to be highly wealth destructive.

We see ourselves as long term active owners of businesses on behalf of our clients. Our reputation for this is strengthening and has lead to a greater willingness by many companies to engage with us on their long term plans. This affords us a better understanding of the opportunities available, hopefully to the benefit of our clients. It has never been more important to be patient long term investors in growing companies.

In summary the pace of change and outlook for the future is very exciting and as long term investors we believe our investment philosophy is well placed to capture this and benefit investors."

Shininglights: *"Scottish Mortgage invests in a number of disruptive companies. It seeks to identify change, the agents and the beneficiaries.*

Can you comment on the specific cases of Amazon and Alibaba?

As some background I have owned Softbank shares for some time because I am reasonably assured Alibaba is likely to be a force of nature (I understand it as a classic toll bridge in essence), and it has a sizable stake in the business.

I have never owned Amazon because I could not identify pricing power. Amazon is an extraordinary achievement, Mr Bezos is a legend and has built the ultimate disruptive company benefiting consumers enormously, but how does it raise prices?

It is now building fulfilment centres (bricks and mortar), pays sales tax (goods are more expensive) is competing on hardware with Apple and Samsung's content (tough to win) with a number of very rich companies including Google and Apple and cloud services with Microsoft , IBM etc .

There is no doubt it can shift massive amounts of products but up to now (and reading The Everything Store seemed to confirm this) Mr Bezos believes that the way to discourage new competition is to lessen the profits available; the anti-Apple strategy if you like.

What don't we understand?"

James Anderson: "Interesting question, which routes back to our investment style and philosophy. We appreciate that some stocks may be 'marmite' stocks and Amazon is very much of that camp. Let me try and explain our approach to these two stocks.

Scottish Mortgage has owned shares in Amazon.com since 2005 and over time it has become our largest holding. We think it is probably one of the most significant companies in the world today. In Jeff Bezos, it has a truly visionary leader, personally as well as financially invested in the business, who is willing to take genuinely long term strategic decisions. It currently operates in over 40 categories.

Its central mantra is to "make investment decisions in light of long-term market leadership considerations rather than short-term profitability considerations or short-term Wall Street reactions."

As Mr. Bezos has said '[i]f everything you do needs to work on a 3 year time horizon, then you're competing against a lot of people. But if you're willing to invest on a 7 year time horizon you're now competing against a fraction of the people.'

Management aims to make bold investment decisions and accepts that some of these investments will pay off, whilst others will not. Both of these elements translate directly into strong competitive advantages. Amazon is a tribute to the willingness to embrace uncertainty and to accept failure in return for occasional successes of dramatic scale. In this regard, their credo has a number of similar aspects to the cornerstone philosophical beliefs of Scottish Mortgage.

Amazon is a terrifying destructive force. Almost any existing pool of retail profitability is its prey.

From HMV to Comet to Woolworths we have already seen this in our high streets but it is an international phenomenon. In short, it is willing to sacrifice near and even medium term profits for market leadership and volume growth, to earn it the necessary scale and positioning to give it a long term competitive advantage.

The initially free Amazon Prime service, which so bemused Wall Street, now charges but only after a prolonged period over which the strategy bought it dominance in the online retail space. It is not that it can't raise prices but that it believes it is not in its long term interests always to do so.

In fact, Amazon.com now changes its prices more than 2.5 million times a day. Such flexibility shouldn't come as a surprise; their business model is based on being highly responsive to customer demand.

The sheer frequency of this dynamic pricing is highlighted when compared to the traditional retailing giants; Walmart change their prices roughly 50,000 times a month. We have spoken to Walmart about their online offering and whilst it would be possible to have more dynamic pricing this would likely cannibalise sales from adjacent divisions (physical stores). Amazon's agility is due to its asset light internet based operating model and bricks and mortar retail competitors are struggling to compete.

It's willingness to invest heavily for the long term despite the implied low immediate financial returns, terrify competitors away across a range of businesses. An example of this is how Amazon Web Services has come to dominate outsourced cloud computing by making it clear that it was going to price on a commodity basis. We have recently sold its competitor in Web Services Rackspace for precisely this reason, despite it being a well-run company in an appealing growth area. This is the crux, competing with Amazon is just not a good place to be, its scale drives down costs which are passed onto its customers so that it becomes the de facto choice. Any newcomers simply cannot outlast their investment power.

The key to its ability to operate this very unusual, yet highly successful, strategy is the involvement of Jeff Bezos. Not only has he been visionary in terms of strategy, he is a significant owner of the company. Without him it is doubtful that the years of losses would have been tolerated and the company would not have built the dominant position it has today. Would the renewed surge in investment spending of the last few years to fund Kindle devices and content, warehouses etc have been acceptable to Board or shareholders? Yet these are some of the things which we believe will allow it to continue to grow in the future.

Amazon is not entirely alone however and the next gale of creation and destruction is likely to come courtesy of a former schoolteacher in Hangzhou in the form of Alibaba.

Currently e-commerce is around 8% in China, which is about the same level as in the US. Alibaba enjoys a staggering 80% share of this market. China is the world's second largest economy, yet bricks and mortar retail is underdeveloped, particularly outside the major tier 1 and tier 2 cities. Additionally as a whole, the country still has relatively low levels of broadband and smart phone penetration. The lack of existing investment in traditional retail infrastructure and the scale of the potential growth in online access, means that e-commerce levels here are highly likely substantially to exceed those of its developed market counterparts.

Today Chinese e-commerce is dominated by customer to customer trade. The main business in the Alibaba group is TaoBao which is an online market place similar to eBay. Whilst they do capture an element of the value of the goods traded on the site through commission, they generate a proportion of revenues from advertising as well. Alibaba also has other sites which are more like Amazon.com, so should benefit from any shift to more formal online retail.

Interestingly, philosophically Alibaba shares many of the same traits as Amazon. It is not focused on profit at all costs, but takes a long term view, building scale and dominant positioning that will make it harder to challenge. Long term, it aims to become far more than simply China's eBay. Like Amazon, Alibaba has made investments in related areas, including overseas markets and cloud services although these are at the nascent stage. It is therefore far too early to say if these will be successful for them. Again, just like Amazon, it is charismatic founder and leader, Jack Ma, seems to have the vision and commitment to lead them to long term success.

One day it is quite likely that there will be a significant clash between these two companies, but for now there is more than enough growth in the world for them both and we are happy long term holders of each of them."

Shininglights: *"Mr Buffett has taken Ben Graham's value based investment thesis added, an overlay from Charlie Munger of growth at a reasonable price to create Berkshire Hathaway, and a legion of value based investors who reference him.*

His teaching is that great investments require future consistency of growing profits allied to a time when the market offers the stock for sale at a discounted price.

Prediction of future events (FTSE year end values, price movements over short periods) is something you have often commented on as fatuous (and for what it's worth we couldn't agree more, it's moronic). Investing in areas of innovation and creation is to an extent an exercise in predicting the future likelihood of successful outcomes, not just of general aspiration but of Company specific endeavours.

How do you make informed choices on companies and technologies that are rapidly changing, their success or failure is yet to be clear and known (the unknown known!)"

James Anderson: "Dealing with uncertainty is one of the greatest challenges we face as fund managers and one that humans generally struggle with. This may be one (of several) reasons the fund management industry tends to focus on short time horizons. Trying to predict the future on a five year plus investment horizon is hard. We see this as our opportunity to stand out from the crowd and our willingness to look at alternative methods for evaluating companies and our long time horizons as two of our key advantages.

We start with the same frame work of questions for every investment. Broadly we try to answer the following: what is the growth opportunity; how big could it be; can management execute on it; what stops someone else from doing the same and thereby eroding returns; as minority investors will we see the benefits of this; then what is in the price, and finally, as a sense check if it does not appear to be in the price, why don't others see what we do?

So as you say, how do we attempt to do this?

First and foremost, the obvious: it is important to gain a thorough understanding as to what it is you're investing in. As a fundamental investor, naturally the companies themselves are a very important source of information. Management's attitudes and abilities are critical over such long time frames. They must be able to see and to execute on the opportunity. One of the benefits of being known as a genuine long term investors in businesses, rather than stock market traders, is that company managements seems more and more willing to engage with us on these questions. Further, we look for management whose time frames are properly aligned to ours.

It is hard to gain an informational advantage today. We try to get away from the usual fund management sources as far as is possible, talking to those further down the company not just the CEOs and CFOs, getting feet on the ground, going to trade shows, and consulting academics in the field. The financial industry produced information is dominated by the views of London and New York even though the relevant decisions may not be made there, so where possible we try to look at views from other places. As an example I recently provided an update from my visit to Berlin in the recent Annual Report.

So far, we are perhaps not so very different. The crucial question is once you have information, what do you with it?

It is usually not possible, and definitely not sensible, to try to say with certainty that a specific outcome will occur over a multi-year time period, either for a particular company or the broader industry. However, often it is possible to identify with a reasonable degree of clarity the underlying key parameters which are likely to drive the investment case. We focus on identifying these and then flex them within sensible ranges to determine which will matter most and assign broad probabilities to each scenario. This enables us to construct a range of potential outcomes, based on a sound understanding of the business and the environment in which it operates. This scenario analysis is our main tool in appraising potential investments; its flexibility is what helps us accommodate the “known unknowns” in our valuation process.

It is in this last aspect of the valuation, where we see the advantage of our long investment time horizon and willingness to deal with uncertainty come in. Often, despite the opportunities which we see being recognised more widely, it would seem that the unwillingness of many analysts to forecast strong growth out beyond 18 months to two years in the future is a significant factor in the valuation differences. The durability and longevity of extraordinary growth drastically changes what one might be willing to pay for a company. It can mean that we are willing to pay for growth at what seems like "an unreasonable price" based on near term price multiples etc. In fact our willingness to invest for the long term allows us to take advantage of such short term market focus to produce good long term returns and make a difference for our clients.”

Shininglights: *“Thank you for your time today James, really interesting responses (and detailed), we would just like to cover one final aspect of the Trust.*

You have recently lowered the fees of the Trust after a standout year of performance. This is unusual in a number of ways.

We know you have strong views on what you believe to be systemic excess charging, we attended a talk you gave in Edinburgh at which you were forthright on the subject.

Please can you comment on how you view the post RDR world in this regard and what motivated the decision of the trust?”

James Anderson: “Thank you for your questions, I hope the answers have provided more in depth information on how I approach the management of the fund alongside my time.

Taking this final question; in the post RDR world investment trusts are now competing on a level playing field with the open ended vehicles through the unbundling of pricing. Whilst it is true that some of the funds within the investment trust industry are relatively expensive when compared with Open Ended Investment Companies, we believe that Scottish Mortgage has always been incredibly competitively priced. One of the benefits of scale, particularly for a trust of our size, is that costs can be defrayed across a large investor base and are therefore lower on a percentage basis to each individual shareholder.

We are conscious that costs are an important factor in the end returns generated for investors. Not only are they subtracted from the return received each year, but more importantly they significantly erode the benefits of compounding returns over the long term. We are therefore committed to keeping costs low for our shareholders.

As you know, we recently decreased our annual management fee because we thought it right that our shareholders should share in the success of Scottish Mortgage. We intend to continue to grow the Trust in the future, provided of course that this is to the benefit all of our shareholders, both existing and new.”

For more information on Scottish Mortgage visit: http://www.bailliegifford.com/individual-investor/scottish-mortgage-investment-trust.aspx

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