



QUARTERLY LETTER | ISSUE 44 | OCTOBER 2024

# The importance of experimentation

## Foreword

Winston Churchill once said “the longer you can look back, the farther you can look forward”. If that’s true, it certainly bodes well for us as a wealth manager with a long-term perspective.

Rothschild & Co’s history stretches back more than 200 years, which provides a deep well of insights and experiences to draw upon when looking towards the future. As a business that has been family run for seven generations, we value continuity and firmly believe our long history is a testament to that.

However, as we’ve mentioned before in our *Quarterly Letters*, it is important to draw a distinction between continuity and constancy. Both words mean ‘enduring’ – but constancy is endurance without change or improvement. Our business, meanwhile, has evolved much over the years, and continues to evolve, in order to best serve our clients.

Adapting to change isn’t easy – it requires a willingness to experiment, get things wrong and reflect honestly about what you need to do to improve. These are qualities that we not only strive for in our own company, but also value in the companies that we invest in.

So, in this *Quarterly Letter*, we’d like to explore the importance of experimentation, and how looking back helps us to get better at looking forward.

Thank you for reading.



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# The importance of experimentation

As the 19<sup>th</sup> century drew to a close, American inventor Thomas Edison was busy in his lab trying to develop a new rechargeable battery. Electric cars were all the rage, but they were powered by heavy lead-acid batteries that often leaked, corroding the vehicle's interior. As a result, early cars had an alarmingly short lifespan on the road.

Edison hoped to solve this problem by inventing a nickel-iron battery that would not only be more durable, but also less cumbersome and better able to store and discharge energy. Unfortunately, despite more than five months of tireless work, he'd made little progress.

Walter Mallory, Edison's long-time associate, found the inventor tinkering at his workbench, surrounded by hundreds of test cells. Edison and his team had carried out more than 9,000 experiments and still didn't have a functioning prototype.<sup>1</sup>

Mallory was quick to commiserate with his friend. "Isn't it a shame that with the tremendous amount of work you have done you haven't been able to get any results?" he asked.

"Results?" Edison replied, smiling. "Why, man, I've gotten a lot of results. I know several thousand things that won't work!"

Edison's exploits teach us an important lesson about experimentation – failure is often a necessary part of the innovation process. What may seem like a setback at first may be the beginning of a breakthrough, with each misstep bringing you closer to an eventual solution.

To paraphrase Nobel Prize-winning scientist Marie Curie: "The way of progress is neither swift nor easy."

## FAILING WELL

Experimentation is about pushing boundaries and trying something new. Sometimes it works, sometimes it doesn't, and occasionally, it even results in happy accidents.

Post-it notes are a good example. In 1968, Spencer Silver, a scientist for technology firm 3M, was attempting to create a strong adhesive for the aerospace industry, but his final product was far too weak for its intended purpose.

Several years later, fellow 3M researcher Art Fry was trying to find a solution for an extracurricular problem – he kept losing his place in the hymn books at church. Fry had a Eureka moment when he remembered Silver's adhesive, and he tested it with yellow scraps of paper, sticking them to the inside of a book to mark his progress.

## POWERING THE FUTURE

Edison finally released his nickel-iron battery onto the market in 1903 after persevering in his experiments for four years. By this time, however, electric cars had fallen out of favour, with motorists preferring gas-powered vehicles because they required less maintenance and could travel further.

Nevertheless, Edison's battery was so reliable that it continued to be used in submarines, mining lamps and train track signals for many decades after. More recently, scientists have rediscovered the battery's potential as a promising renewable energy storage device.<sup>2</sup>

<sup>1</sup> Edison: His life and inventions – Volume II, p150, Frank Dyer and Thomas Martin, 1910

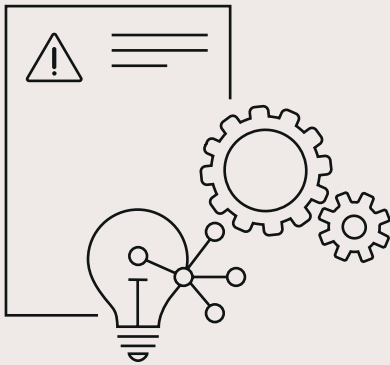
<sup>2</sup> The battery invented 120 years before its time, BBC Future, 24 February 2021

## INTELLIGENT FAILURES

Amy Edmondson, Professor of Leadership at Harvard Business School, believes more organisations should embrace the idea of ‘intelligent failure’ to achieve innovation.

In her book, *Right Kind of Wrong: The Science of Failing Well*, she argues that intelligent failures have four key characteristics that distinguish them from ordinary mistakes:

1. Intelligent failures only occur when attempting to break new ground
2. Experiments are conducted intentionally and could credibly succeed
3. Tests are well-researched and thoroughly planned
4. The cost of failure is as small as possible to produce the desired results



Fry’s makeshift sticky notes stayed in place without damaging the pages, and the Post-it note was born. They would eventually become widespread in offices across the world, making them one of 3M’s most recognisable and best-selling products.

The discovery of Post-it notes may seem like a fluke, and in many ways it is. But it’s a fluke that was made possible because of 3M’s culture of experimentation and collaboration.

Online travel platform Booking.com, which is held in our New Court portfolio, is another company that has built its business around experimentation. One of its core philosophies is that anyone can test anything, without requiring approval from senior management.<sup>3</sup>

Taking a leaf out of Edison’s book, the company reportedly runs around 25,000 tests a year. According to the Harvard Business Review, Booking.com’s website has quadrillions of different landing page permutations live simultaneously, so no two users are likely seeing the same page at the same time.

The aim is to ensure Booking.com’s core service is always optimising without ever going offline. Gillian Tans, former CEO of Booking.com, said that while she wasn’t always confident that certain experiments would work, those failures were priced in.

“If you’re afraid of failure or getting it wrong, you’ll never truly innovate or disrupt the market,” she said.<sup>4</sup>

In other words, experimentation often requires taking considered risks in situations where doing nothing is the far bigger risk.

Prudently balancing risk and reward is a concept that we seek to put into practice at Rothschild & Co, both in our role as a careful custodian of our clients’ wealth and as a business that has itself evolved considerably over the last two centuries.

<sup>3</sup> Building a Culture of Experimentation, Harvard Business Review, March/April 2020 edition

<sup>4</sup> A View from the Top: the Dutch entrepreneur and CEO of Booking.com shaking up the world of travel, The Independent, 23 July 2017

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## A LEGACY OF EXPERIMENTATION

In our view, the most resilient businesses are those that can adapt quickly to change. Companies that evolve where others stagnate are more likely to survive, and often thrive, when faced with inevitable disruption.

This principle is at the heart of our investment approach. We aim to invest in companies with strong business models and sustainable business practices because we have more confidence they will perform well over the long term.

It is a philosophy borne from our own history as a business. In fact, even before N M Rothschild & Sons was established in 1809, our founder Nathan Mayer Rothschild understood the importance of adapting quickly to a new market environment.

Nathan's father, Mayer Amschel, sent him to England in 1798 to expand the family's interests in the country's textiles trade. Within a year, the 21-year-old Nathan had settled in Manchester, and quickly began to make his mark in the city, which had grown into a bustling hub for cotton textiles since the recent invention of new mechanical spinning and printing devices.<sup>6</sup>

His success was in no small part due to his experimental nature. Cotton traders typically relied on large manufacturers, dyers and printers to produce their goods, but Nathan took a more novel approach by working with smaller local suppliers. These firms were cheaper, and Nathan was able to pass on the savings to his clients, building a strong reputation for offering high-quality products at low prices.

<sup>5</sup> Cimory is just one of a number of businesses that Singapore-based Albizia Capital own in portfolios they run on our behalf. For more information, please read our Quarterly Letter 'A global perspective'

<sup>6</sup> The Life and Times of N M Rothschild 1777–1836, p36, Victor Gray and Melanie Aspey, 1998

## INVESTING IN EMERGING MARKETS

The art of experimentation isn't exclusive to well-known brands like Booking.com. Some of the most exciting investment opportunities exist in new and emerging markets where innovative regional businesses are continually adapting to meet local needs.

At Rothschild & Co, we pride ourselves on having a global perspective, and our partnerships with third-party fund managers provide us with access to markets where we might not necessarily have a strong presence ourselves. This enables us to invest in companies that might otherwise fly under the radar, such as Cimory.<sup>5</sup>

As Indonesia's leading producer of premium dairy products, Cimory employs more than 4,000 women who go door-to-door selling the company's wares. 'Miss Cimory' reps not only help to build the brand's reputation, but they also have unique insight into household buying habits from meeting customers face to face. The business can then use this data to shape its long-term strategy and product development.

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## THE ‘COTTON BOOK’

When trading in Europe, Nathan Mayer Rothschild always carried a book brimming with colourful fabric swatches to show to prospective customers. The ‘Cotton book’ wasn’t the first of its kind, but it’s a lasting reminder of Nathan’s commitment to providing exceptional client service – a commitment we strive to uphold today.

He wasn’t the type of person to rest on his laurels, however. While still continuing to trade profitably in Manchester, Nathan set his sights on London’s finance industry and began assisting with his father’s banking transactions in the capital.

By 1808, he’d acquired a London office and had firmly established himself as a merchant banker of high regard. The following year, Nathan bought the lease to New Court, St Swithin’s Lane, which remains the London home of Rothschild & Co to this day.

Nathan’s decision to pivot from commerce to finance was auspicious, with London on the verge of becoming a key global financial hub. It also proved to be a defining moment for the Rothschild family business.

Amschel Mayer, Nathan’s eldest brother, took over the family’s Frankfurt banking business upon his father’s death in 1812. And over the next decade, Mayer Amschel’s remaining sons – James, Salomon and Carl – would go on to establish banking houses in Paris, Vienna and Naples, respectively.

Fast-forward to today, and Rothschild & Co’s desire to do things differently hasn’t waned with time. We aim to continue adapting our business to best serve our clients and achieve our goal of preserving and growing their wealth for future generations – but that doesn’t mean we always get it right.

## GETTING IT WRONG

Every business makes mistakes. Not all of these errors are ‘intelligent failures’ or in the pursuit of experimentation – sometimes, a mistake is just a mistake.

And it’s certainly fair to say we’ve had our share of missteps over the last 200 years. Ultimately we are in the judgement business – and our decision-making occasionally misses the mark.

However, we believe we have a unique culture which promotes reflection and acknowledgement. This enables us to improve over time. When we make mistakes, we try to be open and honest about why we made those decisions, what went wrong and how we’ve adapted as a result.

When it comes to investing decisions there are broadly two types of mistake we can make. Let’s call them errors of commission and errors of omission. The first group can be categorised as decisions we’ve made that didn’t work out, while the latter are occasions where we chose not to invest but where we ultimately should have done.

One example of a holding that didn’t work out as we’d hoped was Wells Fargo, the American bank. The company was considered to have a strong reputation and had weathered the Global Financial Crisis well. However, while the company talked a lot about its great culture and customer-first approach, the

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reality was very different, with staff driven by aggressive sales incentives. We should have sold much sooner than we did.

We held our position because the company's management said the problem of flawed incentives was being addressed, but they ultimately did not address this issue soon enough. It was a reminder to us how important culture is and the need to assess it through our research process. We also learned that we should be more cognisant of how quickly change is occurring, and divest in cases where that change is not being carried out quickly enough.

Another example is our decision to invest in National Oilwell Varco (NOV), a company in the oil and gas sector. While NOV had great business and management quality attributes, it was very sensitive to factors we did not have conviction in, including oil demand, rig productivity, cost inflation and whether unconventional or offshore will be the incremental source of supply. These unknowns multiply uncertainty.

We learnt that we needed to apply more rigour to estimating cross cycle industry demand earlier in our analysis, particularly for cyclical companies and especially in cases which have experienced massive bull markets previously. And we have applied this in our work on Deere & Co, which also operates in a very cyclical industry.

The other type of error is much less obvious. Errors of omission occur when we conduct research into a company but ultimately choose not to invest. In some cases these companies ultimately perform very strongly.

For example, we carried out in-depth research into O'Reilly, an American car parts retailer. We liked the company's business model but were concerned about Amazon building a car parts business and taking market share. We decided not to invest but this was ultimately the wrong call, as the business has performed strongly and delivered what we wanted. We learnt that while we must appraise all the risks, we shouldn't be too cautious when judging the risk and reward, as we were in this case.

Ultimately, like Edison, we believe that our failures provide valuable information that can help illuminate a better path forward. By recognising our mistakes and taking advantage of the learning opportunities they provide, we aim to minimise errors, but they cannot be eliminated in the investment profession. We have been able to meet our client needs in the past and we hope to continue evolving to meet the needs of our clients going ahead.

## ADAPTING TO THE TIMES

From five brothers in five cities, Rothschild & Co has grown to employ more than 4,600 people in over 40 countries across the world. However, our reason for having experts on the ground in the markets where we operate remains the same – we value being close to our clients and partners, meeting them face to face and getting to know their needs and expectations first-hand.

Nathan set the standard for experimentation and new thinking, and we strive to continue this at Rothschild & Co Wealth Management UK today. For example, we launched the Exbury fund in 2018 to meet the growing demand for an investment approach that prioritises sustainable investing.

Admittedly, we may not perform 25,000 experiments a year like Booking.com, but we nevertheless conduct extensive research and analysis into all our investments to ensure we have a high level of conviction before we choose to add (or remove) a company from our portfolios.

As active managers, we also continually monitor and review the performance of each investment closely and, if necessary, update our views on our holdings when new information comes to light.

To make these and other changes, we need to know what works and what doesn't. This is why we seek to embed a learning culture at Rothschild & Co, where our successes and failures are openly discussed and deeply scrutinised, with opportunities to experiment actively encouraged.

# Important information

## Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

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