

PODCAST TRANSCRIPT

Talking Research – Why quality still matters

First published: 16 March 2026

This podcast was recorded on 27 February 2026, prior to recent events in the Middle East.

Francis Sempill: Hello, I'm Francis Sempill, Head of Client Service here at Walter Scott. Welcome to our home here in Edinburgh and our podcast *Talking Research*, which we're filming for the first time, so you can either watch it or listen to it.

Our philosophy is simple company wealth creation drives investor returns. Now, in the short term, stock markets are driven by sentiment, which often pushes share prices away from the underlying fundamentals. However, over time, share prices tend to follow earnings growth. And ultimately it's that earnings growth that drives portfolio returns. This is the tried and tested approach we followed since Walter Scott was founded more than 40 years ago.

Now, recent years haven't been easy for quality growth investors. Markets have rotated towards value investing, and returns have become increasingly concentrated in a narrow group of stocks. We think that focus is too narrow. In fact, we believe it's masking a far broader opportunity. Today, dozens of companies with durable earnings growth, strong profitability and resilient balance sheets are simply being overlooked.

Now to discuss this and more, I'm joined by Roy Leckie, Executive Director, and Alan Edington, an investment manager here at the firm. Roy, Alan, thank you for joining me today.

Before we get started, a reminder that the podcast is intended for investment professionals only and should not be construed as investment advice or a recommendation. Any stock examples discussed are given in the context of the theme being explored, and the views expressed are those of the presenters at the time of the recording.

Now it's been a tough period, Roy, for for active investors, particularly those that focus on quality growth companies. What do you really put down as the key headwinds that these companies have been facing?

Roy Leckie: I think so much has been going on in the last few years. It's quite hard to generalise. But if I make an attempt; there's a number of things within any individual or any firm's investment philosophy or core investment beliefs that you hold to be true. And a couple of those, for me or for Walter Scott, are that

over the long term, investing in high quality companies – companies with certain quantitative and qualitative characteristics – tend to do well. They do better than average given time.

And the second thing is that diversification works. You touched on this in your intro. Quality stocks have had a really tough time the last few years, and that's our kind of happy hunting ground. And so we've suffered from being predominantly aligned to what we would call 'quality companies'.

And then markets have been led by a very narrow group of companies, and that's caused challenges. A significant minority of companies have outperformed the benchmark, outperformed the average. It's been a challenging time. We've experienced this before. It happens every once in a while. But it's important that we stay true to our beliefs.

FS: And, Alan, despite that concentration, where are the team finding these opportunities across the market? And where are you confident that we'll continue to find them?

Alan Edington: I guess the big talking point is AI, right? So let's not try and run away from that discussion point straight out of the gates. Roy mentioned diversification and I'll come back to that. But we are significantly invested in AI infrastructure where we think these guys, these companies are the arms dealers to not just AI, but everything in the semiconductor space, which we think will proliferate over time. We're managing the weights in those positions, but we think that's a very sensible place to be. We remain invested in software businesses, which have had a very hard time recently, but we're very selective about those businesses that we're invested in, with a specific focus on those that we think will be AI winners, rather than those that will be challenged by an AI-driven environment.

But as I say, the portfolio is much more diversified than that. When we think about industrial gases within the portfolio – you know, that's a hard asset. It's not going anywhere. It's serving hospitals, it's serving electronics, it's serving various industries. It's going to be there for a very long time. If you think of a business like Shin-Etsu Chemical, PVC going into housing, semiconductors going into TSMC

and others early in the supply chain, but there's also a rare earth materials business in there. These are businesses where AI is not going to be the dominant feature. And we think that's important across the portfolio. So you've got diversification. So yes we're geared into the big theme of the day in lots of ways. But we're also making sure that the portfolio is resilient across the board.

And going back to Roy's initial point, what really drives share prices in time is earnings growth. And we think across that spectrum, we've got a range of businesses that will derive very consistent long-term high earnings growth from a range of different drivers, and that's what's important in balancing the portfolio. And right now it's not been rewarded. But we think over time our core belief – again, as Roy mentioned – is that earnings will drive those share prices. And the earnings we're seeing across the portfolio in a broad range of industries are pretty robust.

RL: Markets are behaving in a pretty unusual way at the moment in and around the AI space, with a lot of nuances being lost here: the market is deciding you're either an AI winner or an AI loser, and there's not much in between. And it's pretty frustrating because our research is coming to much more nuanced conclusions on that right across the board.

FS: And it seems like there's much more narrative driving the market than the fundamentals, which we focus on.

AE: I think it feels wild. It's not like anything that I've seen in my career. You know, people are voting with their feet very, very quickly. Any theme that is mentioned; an article goes viral and suddenly software businesses are moving 20% across the board in a couple of days. That suggests that people don't know what the outcome is going to be, right? People are worried. People are uncertain.

It's interesting that money is not coming out of the stock market. Ultimately, it's staying fairly strong in aggregate, but there are wild swings within it. And I think again, the thing you do in that environment is you robustly check everything in your portfolio and you make sure that earnings growth is going to go from the bottom left to the top right of a chart over time. And as long as you're confident in that, then a portfolio like ours should come good. But during these wild swings in markets, you're either chasing the theme and you're trading regularly, or you're making sure that what you've got is robust into the long term. And of course, we're doing the latter because that's how we've always approached investing. And long-term, it's been a successful way to do it.

FS: Roy, you've been at Walter Scott for over three decades. How does this current market environment

compare to some of the previous volatile periods we've been through?

RL: This is the third big relative drawdown of my career. And there are some similarities and some differences. I think one of the things that makes this downturn particularly frustrating is that actually the fundamentals of the companies we invest in are doing pretty well. When you look at the earnings growth in aggregate of the portfolios, they are at least as good as the market. But it's not being rewarded. So our portfolios are de-rating in a relative sense.

Now, the positive side of that is we're storing up future performance. But it's not a great deal of fun watching companies delivering – by and large – the kind of fundamental wealth creation that they were selected to deliver and it not being rewarded in share price terms. So I think that's a particularly frustrating aspect of this downturn.

There's other stuff going on that I think is really fascinating, and I'm not sure we or anyone has got to the bottom of. Markets are now – we're told – dominated by passive investors who are by definition valuation-agnostic. There's a lot of corporate buying still, companies' share buybacks. Particularly in the US that's valuation-agnostic buying. And a lot of the the retail action is much more about speculation than investing. And I think that's creating some distortions in markets that the long-term investor – the long-term fundamental investor – is finding quite challenging right now.

AE: The market feels like a voting machine right now; a quickly moving voting machine. And while it can do that for periods in the short term, ultimately the market is a weighing machine – to slightly reconstruct a quote from somebody else. But the point is: ultimately earnings drive share prices as long as you don't pay too much. And that's robustly what we continue to do. So as our portfolio gets cheaper relative to everything else, that's great news for us. It's a painful short-term period just now, but ultimately long-term that should store up value in our performance.

FS: So obviously fundamentals over time will out. But is there anything that you guys have been discussing that you think might cause the tide to turn, where people will start to realise that fundamentals play out, or could we see this last for a lot longer?

AE: Markets can always overshoot, and I think we need to recognize that. Timing is also... you know, there's graveyards of people who claim that they can time the market, so I'm not going to be brave enough to try and do that. But ultimately, given time, the truth will out on earnings growth; on the quality of the underlying ability of businesses to compound wealth over time. And so, yes, this could go on longer. Could the banks continue going up from the

prices they're at today? Absolutely, they could. Could the market continue to chase themes; hammer software tomorrow; hammer hardware the day after? Absolutely, it could. But ultimately, if companies deliver and deliver and deliver share prices follow. And I'd never like to say this couldn't persist for longer. But ultimately the longer it persists, the better the longer-term rebound and the longer-term outcome should be.

FS: And obviously, it's been a fairly tough couple of years for the portfolio. The headwinds we're facing are well known and we've talked a little bit about that. But looking back over the last couple of years, is there anything that you think the team have learned from the euphoria we've seen across certain sectors, or was there anything you would have changed with the gift of hindsight?

RL: I think quality stocks in aggregate got quite expensive in hindsight. Two or three years ago, the premium at which quality stocks traded got pretty high. And arguably we should have been more active, taking some valuation heat out of the portfolio. That being said, we always find it challenging to move down the quality curve. And it would have forced us to have done that to a degree. That's something we've been dwelling on, and I think we'll learn from.

Other lessons: Alan referenced earlier some of the choppiness in markets and in some share prices. And while we have always said that one of our attributes is our patience and our ability to see through short-term noise, I do think we probably need to try and be a bit more imaginative on occasion to take advantage of some of that short-term opportunity. Now, I don't want to alarm clients. We're not going to become day traders. And portfolio turnover is not going to shoot up. But if there are obvious opportunities for us to take advantage of the impatience of other investors, we should be in a position to do that.

AE: I think that's a really interesting point. There are a couple of things that I would add to that. So one is we recognize – as everybody did – interest rates were going up and financials have been a headwind to our relative performance for the last 18 months, two years. Would I have loved to have taken a moment and said, should we own a bank today? Should we own a couple of banks today in the portfolio? Absolutely. It was a trade; it was a relatively obvious trade in some ways. But 18 months in, once those valuations have doubled, you've got a very different question on your hands. And so you weigh up, is it worth making that trade for the potential enhancement that you get for short-term performance versus actually do you want to own those things into the longer term. And so could we have been a little bit more interested in banks at the time? Maybe we could. But I think right now then we'd be having this question about "that trade has worked, goodness me, do we want to own these for the next seven years, or will we be much

better off in the rest of the portfolio"? And so I think while painful in the short term, there's something to weigh up in there.

The other thing is that markets, when they do get down on a sector or a down on a particular idea, we've seen that persist for fairly long periods of time. So we have these debates around the office of: we might be right on the fundamentals, but how long will it take to come good? And is it worth sometimes getting out the way of the prevailing trade in the market to allow that to wash through performance and then revisit an idea. And I think the fact that we're having all of these conversations is healthy. I'm not sure we didn't have all these conversations historically either. But during a period like this it reinforces: are we sure? Are we confident? Do we want to get out of the way of this trade? Do we want to make an obvious diversification change here? So with hindsight, I'd like to have done a little bit more. As Roy mentioned, could we have taken a bit of heat out of valuation? Could we have diversified a little bit in that context? I think we could.

But ultimately, from this starting point, I'm very confident that this is where we should be. And that is typically how you feel following a period of difficult performance. This has been difficult for our portfolio. Our portfolio now looks very reasonably valued versus the rest of the opportunity set, in my mind. And if there's something funny in the market in this kind of voting machine rather than weighing machine, it's that everything that we like isn't being weighed appropriately.

FS: And so obviously, when you are considering new ideas, there's a bit of competition for capital, given the relatively fully invested nature of the portfolios. Might be worth just a quick reminder of how we think about selling names in portfolios. When do we decide it's time to walk away? We've touched on the valuation. That's obviously clearly an element that we focus on. Are there any other areas that we put a lot of value on?

AE: It's really simple. There are three things that happen when we sell a name. One is: a new name comes along and it's brilliant. And when something does, we look for the the weakest link in the portfolio. And that might be the stock where fundamentals are the weakest. It might be two of the stocks that are most expensive and we decide to harvest a little bit of profit out of those; or more expensive versus their fundamentals. So option one is you get squeezed out by the next new idea. It's the weakest link idea.

Option two is: we write down on one page – as most of our clients will know – our thesis on why we own a business at the outset of investing in it. And if that thesis breaks down, if the fundamentals of that thesis break down, we can go back and check. That's what our ongoing research is all about, our ongoing

monitoring: go back and check against that thesis. And if the thesis breaks down, then we've got to go.

And the third one: as you mentioned, it's very simply, if it gets overvalued, then the time comes to start harvesting profit. If it gets significantly overvalued, then it's time to go.

FS: I suppose you've articulated a view where you are comfortable or confident around the current valuation of portfolios. We obviously are unlikely to slide dramatically down the quality curve when looking at new ideas, but thinking about the portfolio for the next five or ten years – are there any areas... or how would you see the positioning potentially changing? Are we comfortable with the names we're owning today, or are you seeing small shifts in terms of where ideas are coming from?

AE: It's always a difficult question, we get asked that quite a lot. The idea behind the question is often: is there a sector you're excited about? Or is there a geography that's particularly exciting today? And the answer is – I think candidly, certainly from my perspective – no, we don't - I don't - think in those terms, I think in terms of what do the fundamentals of this business look like and am I excited? So whether that's industrial gases, it's Asian insurance, it's an AI infrastructure business or it's a hyper scaler. The question is: do I think this has got long-term earnings potential, based on the tools that we use for analysis?

And so whether we're seeing excitement in software as we are in some of the software space today – there are some fairly recent purchases in the portfolio; including in video gaming in some instances; or whether it's getting excited about some of the more hard assets around the world. Would I want to own Linde and Air Liquide for the next decade? Absolutely, I would. So I think there's a range of areas, as there always is. And I know it's sort of an unsatisfactory answer because everyone wants you to say: oh, the play is this. But I think that's what the market does. And our job is to avoid working out what the play is for the next 18 months; and [instead] working out what the durable earnings stream is for the next decade.

FS: Just to swing back around to the AI question. We've talked a lot about the SaaS apocalypse and how names are getting destroyed by the emergence of AI. Just thinking about some of the names in our portfolio and some of the conversations we've been having. Do we think that's sort of slightly been overshoot or is there an opportunity maybe to be adding more to these names? Clearly there's going to be winners and losers out of this, and it's the job of the team to really try and work out which they are.

AE: Our current thinking around software is there are a few areas that are far more defensible than others. If you're offering a point solution: I ask a query, a

software provides a solution to that problem/that query - then that's much more replicable than if I'm built into your work stream. So if day-to-day in my function/in my job, I set up a piece of software and spend six hours there, displacing that is challenging because not only do I spend all my time in it, but I also communicate through it with everybody else.

Software that's much more of a platform I think is far more defensible. It also tends to sit on an awful lot of customer data, which is the second part. If you're sitting on proprietary data gathered from being a software provider for many, many years to a specific industry, specific individuals, then you are best positioned to create generative AI to support those individuals. So if you've got a particular industry niche, you own the best data set in that niche, then you should be able to build the best agent. Even if you do have an LLM sitting underneath you. Even if you do use the hyperscalers for some of the computer grunt work there. And so when you've got data and when you're platformed, we think you're much more protected. And we actually also think you're much more likely to be able to build a successful business based on AI. So if you're Microsoft, continue to deliver the best service to your customers and continue to improve and build on AI – your best place to be an AI winner, as it were. That's what we are looking for in our software businesses.

Obviously, there are bits at the periphery of some of the businesses that we're invested in where it's more challenging. And if we think that more than the periphery of a business is going to be challenged by AI in the software space, then I think we would be more likely to get out of those than stick around.

RL: I'm going to give a more succinct answer. I think the sell off we've seen in the last few months in many SaaS, many software businesses, is creating a multi-generational buying opportunity. Not in every company, but in many of them. It's been a classic case – and you see it every once in a while – of 'shoot first, ask questions later', that is just providing tremendous opportunity. So I think the market's getting this pretty badly wrong.

AE: So I think that's really interesting. And I think it's probably right. And I think the question is a timing one. How persistent is this trade of 'software is dead'. And you've got to prove the negative as a software company. You've got to prove you're not dead. So you've got to keep churning out good numbers. You've got to keep convincing people that you're on top of the AI trend and that you're building better for your customers. And I think that's the work we're going through: ensuring that our software companies are in that position.

But I guess I'm a little more reticent on the timing of it, but I completely agree. Some of these... you can't replicate a protected data set with a large language model. So there's got to be advantage in that.

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FS: So a complement rather than a substitute.

AE: Yeah, agreed.

FS: In terms of the overall process internally – we talk a lot about AI and the impacts on a lot of the companies we own. Are we thinking about it internally for the research process and just enhancing what we do?

AE: Of course we are. We've got a couple of tools that we use from outside providers, that are great for parsing and aggregating and research. Those are building and improving over time. For example, I can shove in a series of conference call transcripts from the last decade and specifically request information, a grid, build me a table based on that. There's a lot of time taken out of my day by being able to say, find me this, please. And building simple queries like that. There's a lot of time being taken out of days by transcript, provision, summarising, meeting, all that sort of stuff as well.

I think in terms of deep research, it's much more limited. As I say, producing a chart, finding data – absolutely. But the structure of what we do, while I could ask an AI companion to generate my Seven Sisters for me, I'm not convinced that you'd necessarily get a better outcome than you would if we sit and do the thinking and the analysis. And ultimately, I still have to consume the information. I still have to present the information to my colleagues. And so, whether someone else has summarised it for me, or whether I'm going and fetching it myself and thinking about it as I write it, I'm not sure there's a huge value in that yet today. But certainly, we're on top of what's going on. We've got access to all the latest models, supported by our IT function. And there's a lot of advantage in time saving, getting good information, getting good information quickly and putting it into a useful package.

FS: I suppose just thinking more on a personal level: we're looking ahead to 2026 – what does the year hold in store? Obviously, we want to see a performance improvement and maybe a change in the market environment, but anything from either of you for 2026?

RL: Well, priority number one is, as you say, getting performance sorted out. And despite the recent headwinds, the business – Walter Scott, the company – is in good shape and good heart. Particularly the Investment Team, the Research Team. So the mojo of the team is where it needs to be. There's a real sense of purpose about the place to get this right. We're not being complacent about that. We're going to have to work hard. But I think we're in a good place.

Outside of that on a personal level. Well, so my life has changed a bit. Just in the last wee while with being empty nesters: our kids have left home and

that's changed the dynamic a little bit for us. We've moved into town. A whole new world has been opened up with all that this magnificent city has to offer; with culture and sports and all the F&B establishments that I'm discovering. And lots of travel still to do. So, plenty to keep very busy both inside of the the day job and outside.

FS: Thanks, Roy. And Alan – how about you?

AE: Again – work is at an important juncture now: the investment performance is really meaningful. Hopefully – as you've gathered, from what I've said – I think a lot of what we are doing is the right thing. I think where we stand is a very good place today. But ultimately, in times like this, you've got to be as vigilant as you can be.

Outside of that, I've got three kids, so I don't do a huge amount else. I do a little bit of mediocre surfing, and I'm hoping to catch up a bit more on that during the course of the year.

FS: And neither of you think Scotland is going to win the World Cup this year?

RL: We're delighted to be there. I'll be going over to Boston and Miami to cheer the boys on. Looking forward to it!

AE: I actually watched the highlights of the Denmark game last night just to give me a nice boost. It felt wonderful. I really enjoyed it.

RL: If you haven't seen it, you have to watch the highlights of Scotland versus Denmark; the match that allowed us to qualify.

FS: Excellent. Roy, Alan, thank you so much for joining me today and for sharing some of your perspectives on the questions that we're being faced with from clients all over the world. And thank you for listening or for watching wherever you may be. If you'd like to find out more about the ideas that shape our investment decisions, visit walterscott.com. Thank you.

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