WALTER SCOTT



QUARTERLY COMMENTARY

GLOBAL

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Global equities rose over the quarter despite bouts of volatility due to the Middle East conflict and rising bond yields. Stubborn inflation and tighter credit conditions lingered as concerns, but the resilience of economies and a buoyant earnings season supported investor sentiment.

From an investment style perspective, quality lagged again, continuing a trend which has persisted over the last few years.

The recent quality lag

MSCI World Quality (ndr) vs. MSCI World (ndr)



Source: Walter Scott, FactSet, MSCI. Data as at 30 September 2026. Rolling 5-year relative return. Historical performance, market returns and valuation measures may not be repeated in the future and should not be relied upon as indicators of future investment results.

Quality stocks have historically generated superior long-term returns relative to broader global indices. Since June 1994, using back-tested data before its December 2012 launch, the MSCI World Quality Index has delivered on a gross dividends reinvested basis, an annualised US dollar return of 12% versus the equivalent figure of 9% for the MSCI World Index[1].

MSCI's measure of quality aims to capture companies with durable business models and sustainable competitive advantages. Consequently, the Quality Index contains companies that tend to have high returns on equity, stable earnings, and strong balance sheets with low financial leverage.

These are metrics with which we strongly align. For us, quality attributes are indicative of an ability to harness sustainable growth trends, innovate, increase profits and profitability, generate cash and defend their competitive positions. As MSCI, the august compiler of indices has observed, "quality has also traditionally served as a defensive factor when a flight to quality occurs".

We believe that ultimately, share prices reflect the earnings, cash flows and the financial strength of a business irrespective of how it is labelled.

Strength in Software

A case in point is the software arena. Over the quarter, the share prices of software and professional services businesses showed further signs of a recovery in sentiment. We remain alert to the AI-related challenges the sector faces. But the rebound in share prices arguably reflects growing investor confidence in these companies' durable competitive moats, the deep integration of their products into customers' operations and their own AI initiatives, despite concerns about potential AI-related disruption.

Microsoft's solid fourth-quarter results saw the company guiding for an acceleration in the M365 Commercial Cloud business, countering the bear argument that Microsoft Office is vulnerable to AI SaaS competition. Additionally, there was further evidence that its AI-related investments are yielding results. Azure cloud revenue grew a better-than-expected 43% year-on-year, while capital expenditure guidance was kept stable, with the company expecting to remain free cash flow positive in fiscal year 2027.

[1] Source: MSCI World Quality Index Factsheet, September 2026.

This is important because markets are not only still sensitive to the potential rate of return hyperscalers will achieve on massive AI investment, but also to how companies are raising funds at a time of rising cost of capital.

The K-shaped consumer conundrum

While investors were warming up to several companies in the software sector, concerns about the health of consumer wallets have been rippling through the market given the debilitating impact of higher energy prices and the feed-through to inflation. Investment manager Jamie Zegleman and investment analyst Harry Gray were in the US this quarter, taking the pulse of a variety of companies, including several in the consumer and travel sectors.

Pockets of weakness are being seen amongst lower-income households, with comments from Colgate, Estée Lauder and off-price retailer TJX Companies suggesting a K-shaped spending pattern, referring to the difference between lower and higher-income groups. Nonetheless, according to TJX management, the recent softness in same-store-sales growth at Marmaxx, the division that includes the US TJ Maxx and Marshalls chains, was laid at the door of buying and merchandising mix mistakes in the wake of personnel rotations in these businesses. This is an atypical blot on TJX's long-standing track record. The company has now taken corrective action but acknowledged that discretionary spending is under pressure further down the income spectrum. Despite these missteps, we think constrained consumers may continue to appreciate the value proposition TJX offers.

The view on K-shaped consumer expenditure patterns is not universally shared. Booking Holdings posted good results despite disruption in the Middle East. CEO Glenn Fogel noted that "despite continued geopolitical and macroeconomic uncertainty during the second quarter, the underlying desire to travel remained resilient." Company guidance for the third-quarter points to continued resilience, albeit Middle East headwinds are likely to persist.

Shifting sands

Consumers are perhaps showing signs of fatigue after the broad-based price increases introduced by companies following Covid-19, making this a less repeatable route to growth. Additionally, the shift to experiences from goods could become more entrenched. There are also signs that luxury is becoming more polarised, with ultra-*luxe* brands such as Ferrari maintaining their cachet among the asset rich and economically insensitive, while aspirational buyers of middle-rank luxury keep their hands in their pockets.

The rapidity with which AI is developing is creating challenges and opportunities for consumer businesses. The extent to which the technology could reshape consumer behaviour, alter the relationship between customers and companies, and transform online distribution channels remains uncertain. Nonetheless, companies are adapting, looking for benefits from AI in areas such as coding, documentation, and customer service.

Innovation remains an important driver for L'Oréal, and an ingredient in its ability to outperform the wider beauty market. Recently hailed by Fortune as the most innovative company in Europe, L'Oréal is leveraging AI across its entire portfolio to enhance its leadership. For instance, the company's researchers deploy predictive AI to simulate formulation chemistry, testing molecules to accelerate sustainable product discovery. As noted by CFO Christophe Babule when we met him in September, AI can reduce thousands of theoretical combinations to perhaps 10 candidates for physical testing, cutting lead times by roughly half. For customers, apps such as L'Oréal Paris Beauty Genius act as personalised digital companions, using 'selfies' to assess skin type and enable users to try out products virtually.

The consumer landscape is evolving, tested by inflation headwinds, potential shifts in spending patterns and technological developments. Given the propensity for economies to grow, incomes to rise and opportunities in developing markets, consumption remains a long-term growth vector. We think that leading companies with strong brands, sound business models and, increasingly, the ability to be nimble and adaptive are in a good place to seize the opportunity.

Quality amid uncertainty

The outlook for global growth and earnings remains broadly favourable, but risks are building. Conflict in the Middle East, heightened inflation, higher bond yields and tougher government fiscal choices could increasingly weigh on economic activity and corporate profits. Against this backdrop, and after a period where quality has lagged, we believe that the benefits of a diversified portfolio of quality companies may come to the fore. Financially strong, market-leading companies with durable competitive advantages and exposure to enduring growth trends may exhibit resilience if conditions get choppier. With press headlines fixed on bond yields, higher interest rates and energy prices, that resilience could start to look a more desirable attribute.

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