

WALTER SCOTT

 BNY MELLON | INVESTMENT MANAGEMENT

Quarterly Report

**GLOBAL
COMMENTARY**

Quarter ending 30 September 2020

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Overall, the third quarter of 2020 further burnished the emphatic recovery in global equity prices that has taken place since the lows of March. For much of the period, ongoing monetary support, evidence of recovering economic activity and hopes for a Covid-19 vaccine trumped concerns about renewed US-China tensions and the long-term challenges posed by the pandemic. Although a more cautious tone entered markets in September, this did little to assuage concerns that the disparity between asset prices and the real economy is now so stark as to be unsustainable.

Whether September's pullback marks the first step in a more realistic alignment between Wall Street and Main Street remains to be seen. Hypothesising on the trajectory of markets is not something to which our Research team commits much time, however. Speculation is a poor substitute for rigorous company analysis and, accordingly, the day-to-day focus of the team has been on the long-term corporate fundamentals that underpin the investment case of each and every portfolio holding.

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To date, this analysis has cautioned against wholesale changes to the composition of the portfolio, despite the significant changes the pandemic seems likely to engender in the global economy, and by extension the investment landscape. This extends as much to those companies that we don't hold as it does to those that we do. As reflected by the outperformance of the NASDAQ index relative to broader global equity indices, markets have bifurcated sharply since the lows of March. The reader will need no reminding that much of this disparity has been driven by the ubiquitous FAANG stocks, of which the portfolio holds only one.

We have written previously about why we have not had greater exposure to this small sub-set of stocks. By way of a brief reprise, these companies have regularly been subjected to the collective scrutiny of the Research team. On each occasion, however, we could not build an investment case with sufficient conviction to merit their inclusion in the portfolio. Growth, profitability, balance-sheet strength, ESG considerations and

valuations are key pillars of our analysis, and if we do not believe the dynamic between these factors favours long-term sustainable growth, we will not invest.

None of this is to say that we will never invest in these companies. Should these stocks begin to meet our investment criteria, then we would consider them as investment candidates. To paraphrase John Maynard Keynes, we're happy to change our mind when the facts change. For now, however, we have full confidence in the prospects of our current investee technology companies and their ability to deliver sustainable growth for the portfolio over the long term.

The flipside of this is those companies we do hold which have found themselves out of favour as investors have been quick to anoint the post-pandemic 'winners' and 'losers'. We don't dissent from the view that some of the long-term trends already at large in the global economy have been given added impetus by the events of 2020, but we would warn against lazily ascribing winner or loser status on the basis of sector.

At Walter Scott, we have always invested in companies that we believe are exposed to secular growth vectors, irrespective of sector or geography. Importantly, these are companies with the adaptability and resilience to prosper as new challenges arise; they are not simply reliant on the continuation of the status quo to grow earnings. Change may bring challenge, but it need not spell the end of a long-term growth narrative.

As evidenced by its most recent results, a leading US-based discount retailer finds itself in an incredibly tough trading environment, unsurprisingly perhaps for a company that relies almost exclusively on a physical retail model. A more financially challenged consumer and the relentless shift from offline to online shopping appear likely to hasten the demise of many a traditional retailer. But while we certainly wouldn't disagree with this prognosis, we believe this company is an example of a business model that can continue to prosper, even in the face of these twin challenges. Not only does its 'off price' value offering continue to take market share from more established retail concepts, but customers' desire for high-quality goods at bargain prices means they are still happy to shop in-store rather than look online. Furthermore, as well as offering a high degree of resilience in economic downturns, the compelling value on offer ensures many newly converted customers become loyal fans, even when the economy strengthens.

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A storied US entertainment and communications company is another business that has felt the full force of the pandemic, with earnings hit hard by the closure of its iconic parks for long periods and the cessation of live sport broadcasting and TV & film production. Although activity has resumed in these areas, the ‘new normal’ will bring restrictions and associated costs that will prevent a return to pre-pandemic levels of profitability in the near term. The company, however, is making huge strides in its Direct-to-Consumer business division, as it continues to acquire subscribers at an impressive rate and with ‘big ticket’ content in the pipeline. The launch of an international general entertainment offering in 2021 also promises another growth avenue for the firm.

Elsewhere, we continue to be encouraged by the performance of many of the management teams of our investee companies, as they leverage resilient and flexible business models to navigate this uncharted terrain. A Canadian convenience-store operator is a case in point. Despite the very real challenges the pandemic poses consumer-facing businesses, the evidence so far suggests it is coping admirably. Reporting on its most recent quarterly results, the company could point to rising same-store-sales across all its major markets, a three-month period that included some of the most severe lockdown restrictions in the US, Canada and Europe.

Just as impressive was the company’s level of cost discipline, with overall expenditure falling despite some US\$80m in Covid-related spending, an outlay which included ‘Thank You’ bonuses for staff who worked during lockdown. With the four founding members of the business retaining seats on the board, the company’s long experience of negotiating economic downturns appears to be paying dividends.

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Management at a Minnesota-based fastener manufacturer can also point to an impressive track-record of negotiating challenging conditions.

Distributing industrial supplies to manufacturing and construction firms across North America, the company operates in exactly the kind of cyclical part of the economy susceptible to a marked downturn in activity. That sales have actually accelerated in the midst of the crisis is therefore nothing short of remarkable. Key to this has been a pivot to safety and healthcare equipment, such as disposable garments, foot and eye protection and respiratory equipment, which has more than compensated for the drop-off in demand for manufacturing fasteners. While admittedly lower margin business, it has been an incredibly valuable offset to the weakness in the company’s core market.

Some six months on from the intense volatility of the first quarter of 2020, investors can look back with some satisfaction and relief that much of the ground lost during that period has since been recovered. However, the re-emergence of volatility in September should serve as a timely reminder of the very real risks that continue to stalk markets. This is especially true given valuations have been driven to relatively lofty levels on a variety of measures.

Looking ahead to the final quarter of the year, the persistent tensions in US-China relations and the impending US presidential election are likely sources of further volatility. The possibility of an inconclusive result in November has certainly begun to weigh on sentiment. Meanwhile, the resurgence of Covid-19 in Western Europe, and the subsequent reintroduction of social restrictions, serves as a reminder that it is premature to suggest the current crisis is coming to end. The future course of the disease is the subject of significant speculation, with numerous potential scenarios touted. In truth, nobody can predict with any degree of confidence how this will play out. This, in turn, leaves equity markets exposed to a wide range of outcomes, some positive, many far less so. Are equities priced appropriately for this level of uncertainty in the short term? We suspect not.

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Over the medium term, however, we believe that equities remain the asset class best placed to capture the fruits of a sustained economic recovery. Experience shows that a disciplined focus on buying and holding attractively valued companies capable of delivering

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sustainable growth can deliver excess returns for investors, irrespective of events or changes in sentiment that might impact markets over any short-term period.

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