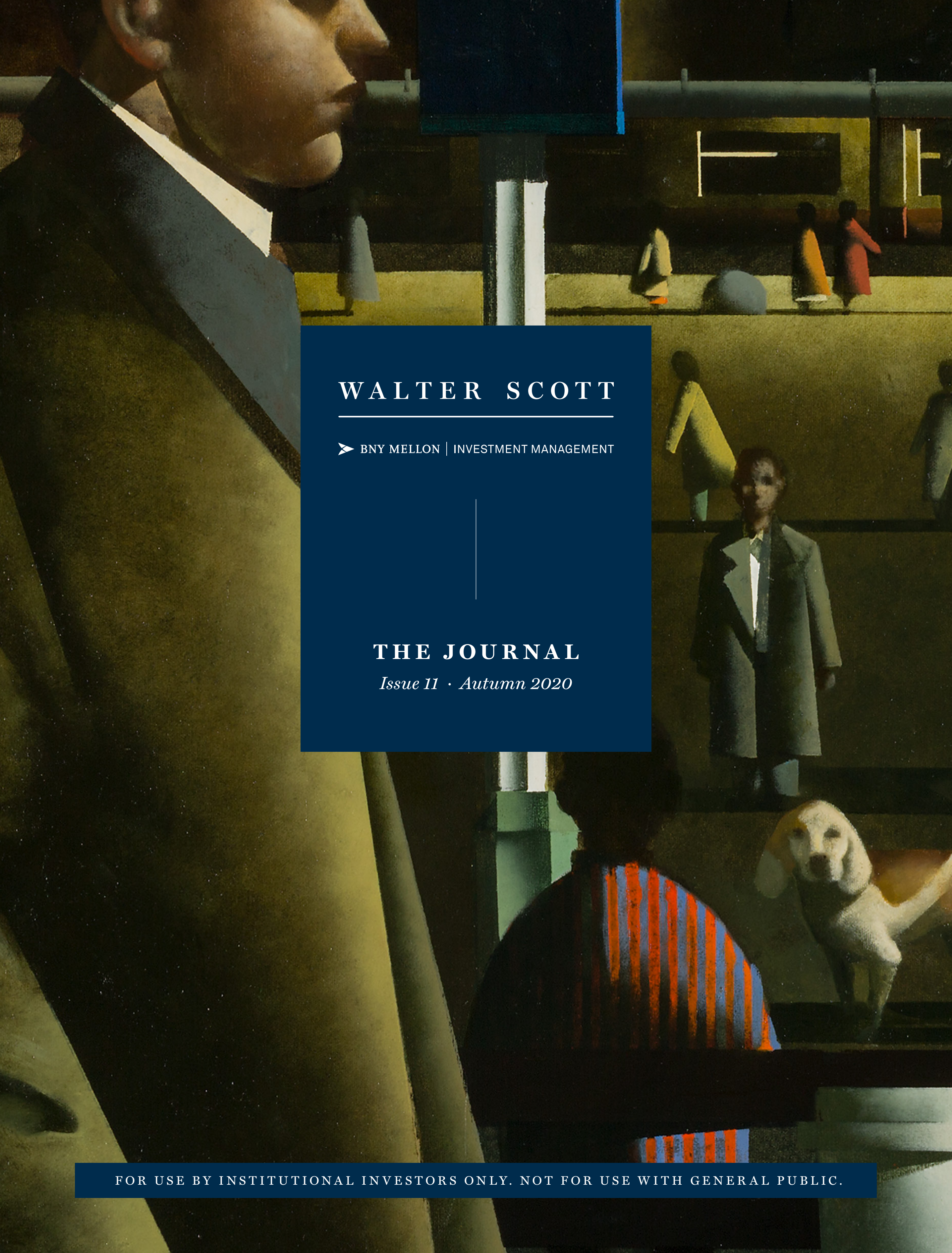

WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

THE JOURNAL

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Stock examples – The information provided in this *Journal* relating to stock examples should not be considered a recommendation to buy or sell any particular security. There is no assurance that any securities discussed herein will feature in any future strategy run by us. Any examples discussed are provided purely to help illustrate our investment style or, are given in the context of the theme being explored. The securities discussed do not represent an entire portfolio and in the aggregate may represent only a small percentage of a strategy's holdings.

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FOREWORD

This 11th edition of *The Journal* has been planned and produced by our Research and Communication teams, all working from home. That ability to share ideas, challenge each other and get things done has been replicated across the firm in countless ways over the past six months. While no one would wish to be in this situation, I am immensely proud of everyone at Walter Scott, not only for working together, but also for doing so while still striving for the highest standards across our operations.

I hope you agree that this edition meets the high bar set by previous Journals. We are delighted that the University of Oxford's Professor Dieter Helm agreed to be interviewed. He has something of a fan club within our Research team and the environment is, as you'd expect, an area we spend significantly more time debating than we did even a few years ago. Environmental and social issues have always been integrated into our research process but, with ever more data, they bring more complexity. And, of course, more debate among our Research team. Over the past few months, that team has come together to review and research all aspects of a much discussed net-zero world. The aim has been to reassess and challenge our current assumptions, and test our investment positions and decisions.

That shared learning and robust debate is central to our team-based investment approach, which is supported by our culture. I read with interest Ellie Hearn's article in this edition. Ellie is, like me, a graduate of the University of St Andrews. Having founded her own consultancy in New York, she now writes extensively on nurturing workplace culture and getting the dynamics of office life right for all.

Walter Scott's culture has always been central to its success. It has proven its strength and its worth over recent months as we have worked together to serve our clients. But we understand that we need to protect our culture, and it can be the small things that matter. Our annual summer barbecue was replaced this year by treat-filled food parcels delivered to every member of staff to enjoy at home. When government guidelines have allowed, we have hosted small and appropriately distanced lunches in the office to bring colleagues together again. We know we must continue to support each other.

For the individuals responsible for this Journal, agreeing on themes and contributors is always lots of fun. There is never a shortage of ideas, nor of ambition. As we begin to think about our next edition, the Research team has as many projects in the works as ever, and our conversations every day with world-leading companies, at the forefront of their industries, offer inspiration and original ideas. These are not just passing fads but trends that will shape all of our lives over the coming years. For now, I hope that you enjoy reading about the people, places and issues that we chose this time. As ever, do get in touch if you want to talk about any of the subjects in more detail. Discussion is integral to our research meetings, whether in person or by video call, and we hope that it can also be an important part of this Journal and its exchange of views.

With best wishes,

Jane Henderson, Managing Director

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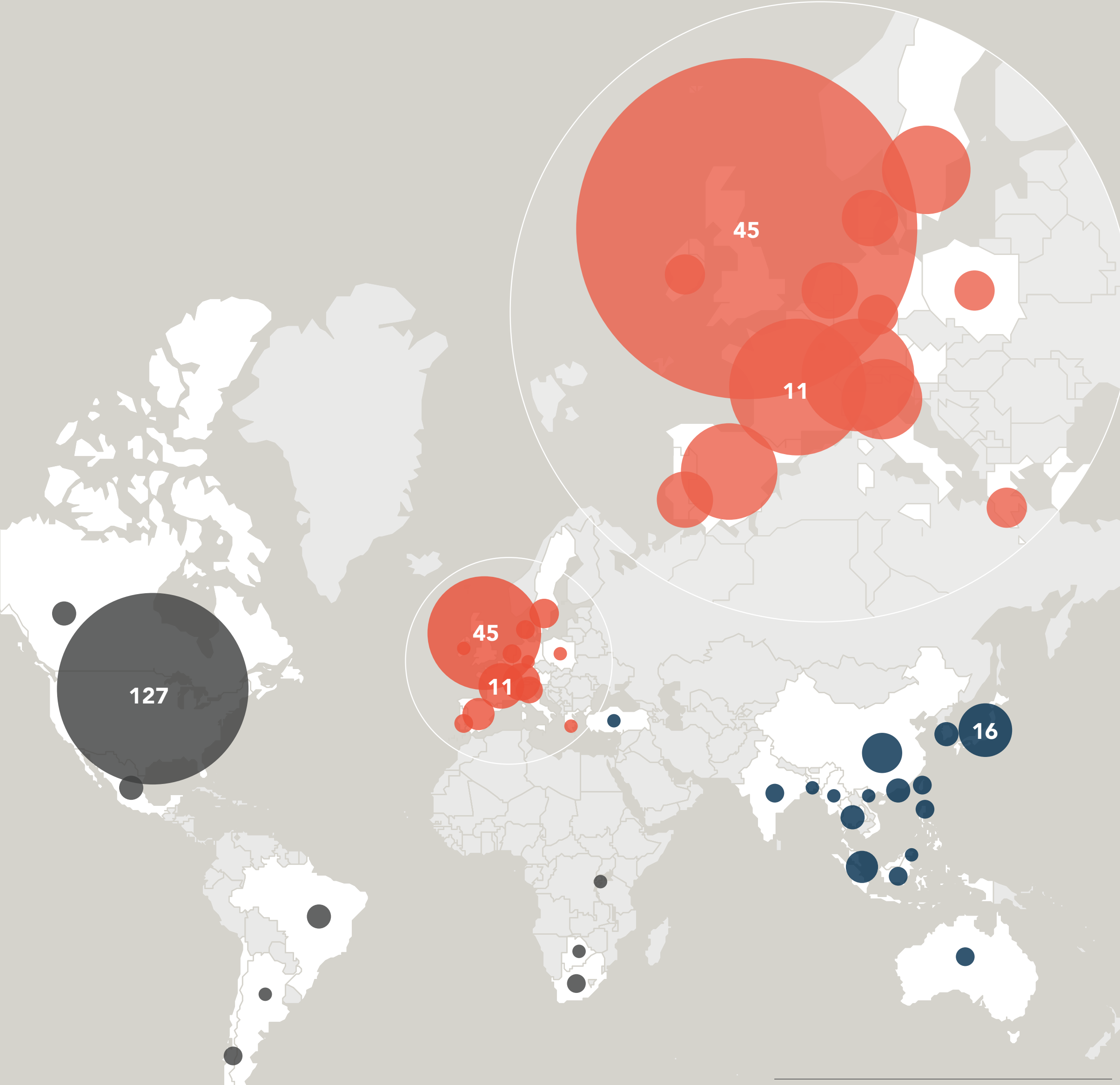
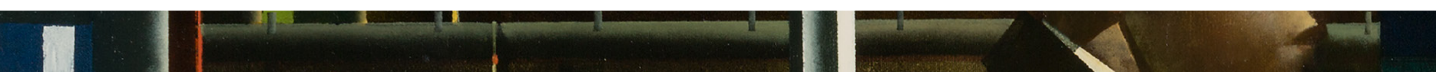
ON THE ROAD

International research trips are integral to Walter Scott's investment philosophy. Here is how our team has covered the world.[1]



[1] Walter Scott research trips 2012-2018



OUT OF OFFICE

Looking back at more than a decade of international research trips.

Ask Jamie Zegleman where he would like to visit on his next investment research trip, and he struggles to choose between the US, China and Japan. For Alan Lander, it is Asia and the US. For Max Skorniakov, Mexico, Brazil and Chile. These decisions reflect our research methods: the Walter Scott office might be in Edinburgh, but our approach is global. That means field trips are a vital part of our work: they get us out of the office and help us to understand more about the regions, countries and companies we are investing in.

Covid-19 has put a stop to these fact-finding missions for now. We look forward to the time when we can log out of our video-conferencing tools and dig out our passports. But in the meantime, let's look back at some of our more memorable moments on the road, and find out why there is nothing like being on the ground for learning what makes markets and companies tick.

"The streets had flooded. It was a perfect example of what people mean when they talk about infrastructure being a hindrance to growth in emerging markets."
Jamie Zegleman

GET OUT OF TOWN

Investing does not happen in a vacuum: there are so many factors that play into our decision-making process, and first-hand experience of companies and territories adds an important layer. "We do a lot of desk-based research back in the office (now the house)," says Zegleman. "But we've always valued getting out and meeting management teams on the road. I've been at Walter Scott for 11 years, and I can count at least 16 trips during that time – all over the place because I've been in all three regional teams."

Why do we put so much emphasis on these trips? For Zegleman, it is about immersion. "I find it really interesting to get out into the world and see how different economies and the markets function on the ground," he says. "And then obviously the benefit of being out there for a week, or more often two weeks, is you get a solid period of time just to focus on companies, hearing new ideas, meeting existing holdings, checking up to see how things are progressing, and really just immersing yourself in that research task without the distractions that naturally come with the office and day-to-day work."

Alan Lander agrees. "It's the opportunity to immerse yourself in those countries and regions," he says. "And spend a week or two understanding more about the macroeconomic environment, which does have a bearing on the individual investments we then make."

On one trip to Jakarta, Zegleman gained a new, deeper understanding of the issues faced by businesses there. "We were driving along from one meeting to another, and it started to rain, as it often does in Jakarta," he says. "But it was a tropical downpour. And it struck us that within about five minutes of it raining, all the streets had flooded. It was a perfect example of what people mean when they talk about infrastructure being a hindrance to growth in emerging markets. Because the roads flood, no one can get anywhere and traffic grinds to a standstill. And the economy is trying to grow in that environment! I would never really have been able to contextualise that if I hadn't been there."

UP CLOSE AND PERSONAL

These trips are not just about understanding the macroeconomic factors that affect our investments; there are also benefits to getting a closer look at the companies themselves. "Investors often say it is important to look management in the eye and try and work them out," says Zegleman. "And I totally agree with that. You get to meet management in their environment, where hopefully they're relaxed and comfortable and you can get a sense of the direction that they want to take the company in. And certainly I think it adds to our research process."

Lander agrees that it is vital to meet companies on their turf – but also to ensure that that means the whole business. "One of the key reasons we do these trips is not just to sit in an office with management teams, but to visit the operations of businesses on the ground," he says. "We like to get to know companies very well before we invest in them. And a great way to do that is to visit the operations of the company and speak to people on the ground working in that factory, shop or plant. And you end up going to some weird and wonderful facilities over the years as a result of that."

ABANDONED ON THE MOTORWAY

We were in China on our way to meet Tencent on the outskirts of Beijing, so it was quite a drive on the motorway. Quite far into that journey and on the motorway, without warning, the taxi driver changed his mind and decided to go home, so he kicked us out at the side of the road and said, "That's it, find another taxi."

Max Skorniakov

"We could see the depths of the crisis as we drove along the road in Texas – all this equipment lying idle alongside the road."
Max Skorniakov

That human aspect, says Skorniakov, is crucial for gaining perspective. "It's great to actually go and see some of the countries where companies are operating – not just the country they happen to be domiciled in. In these regional or country offices or factories we can actually meet the real people behind these businesses, and get their energy," he says. "That really gives you confidence in the business – to see the people, facilities and processes, and get a deeper understanding of what their business is about."

It is an understanding that might be even more important during the bad times. "I remember when we went to Texas in 2009, in the middle of the financial crisis and oil crash," he says. "We could see the depths of the crisis as we drove around – all this equipment lying idle alongside the road. And then we talked to oil service companies laying off tens of thousands of people. You can read it in the news, but when you see it with your own eyes it has a much more profound impact on your thinking."

CULTURE SHOCK

Some markets are more inscrutable from a distance than others, so our Research team stress the value of visiting them in person as a way to truly understand how they function – the risks and the opportunities.

"I've done a lot of trips around the emerging markets, and that's where I find it particularly helpful to actually be on the ground," says Zegleman. "I think Jakarta's probably the best example of this. Unless you've been to that place, you have no idea how chaotic it is, how crammed in everyone is, how poor the infrastructure is. But also how vibrant the city is. I don't think that's something you could do

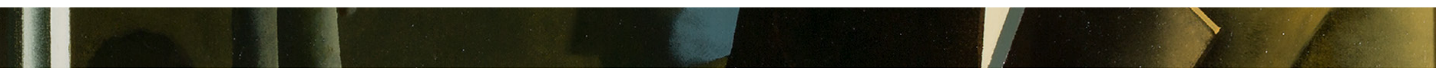
"Unless you've been to Jakarta, you have no idea how chaotic it is, how crammed in everyone is, how poor the infrastructure is. But also how vibrant the city is."
Jamie Zegleman

A STATE TAKEOVER

We were in Spain on a research trip. Completely by coincidence, we had a meeting with the management of [Spanish oil and gas company] Repsol. And that day it was announced that Argentina was nationalising – essentially seizing – its stake in YPS, the Argentinian oil and gas business, which for historical reasons Repsol had a majority stake in. This is a meeting we had arranged long in advance, but it just so happened this news broke the morning of our meeting.

We expected the company to cancel, but to their credit they honoured the meeting. We were sitting in the foyer at their headquarters, this massive, open-plan building with a big lobby, and you could just feel the tension in the air – it clearly wasn't business as usual. This was a national scandal: it was front-page news in Spain, and the shares were down 10% or 15% on the day. But the management took time out of their day to speak to us, and we ended up having a fascinating discussion about the history of Repsol's investment in Argentina, and how it had come to this.

Alan Lander



purely from an office in Edinburgh – or any Western city.

"People say all these clichés," he adds. "But when you're actually there and trying to get around from meeting to meeting, meeting with fantastic companies in sometimes odd situations, there are quirks and oddities that you kind of get used to. There's certainly not the Westernised style of presentation."

> *"A meeting with Repsol certainly continues to influence my perception of risk around investing in companies that then invest in some of the more exotic emerging markets."*
> Alan Lander

LONG-LASTING BENEFITS

Do these experiences really help our work in any tangible way? For Lander, one particularly unusual meeting had a lasting impact (see **'A state takeover'**). "A meeting with Repsol certainly continues to influence my perception of risk around investing in companies that then invest in some of the more exotic emerging markets," he says. "It was 90 minutes of research that I'll never forget. And it's certainly one of those experiences that continues to influence the way you think about things."

A visit to Ferrari's HQ and its single production base in Maranello, Italy (see **'A day at Ferrari'**) might sound like an opportunity for fun, but for Lander it provided vital context. "One of the most interesting things about Ferrari is how it expands its portfolio of products," he says. "With a particular focus on improving the price and the mix of its sales, and really taking advantage of the customer base and the loyalty of those customers. And that trip gave me an incredibly useful insight to the company's ability to do that. Although it wasn't a one-to-one meeting with the company, it was invaluable in terms of building my understanding of Ferrari."

RECEPTION WITH A DIFFERENCE

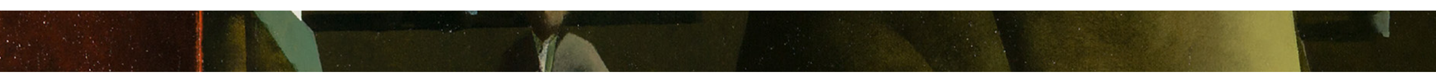
One meeting we had was with a Turkish real estate company. We checked in with the receptionist and then we were told to sit and wait in the waiting area while they contacted the person we were meeting. So far, so normal. And then a guy walked in, and he reached into his trousers and pulled out a handgun and handed it over to the receptionist. That was part of the check-in process – to hand in your weapons on the way in.

Alan Lander

PLANS THAT DON'T GO TO PLAN

We flew overnight to the Philippines a few years back so that we would arrive early for a morning meeting with a central bank official. When we arrived, it took us a while to find our contact point. And when we did, it turned out that he had parked his car at the airport in the open air – which meant it was there for a couple of hours in the 50-degree heat. And it didn't really have a properly working conditioner. So when we got in, it was like a wave of heat coming out of the car. By the end of the fairly long drive, we were soaking wet, so we had to cancel the meeting: we simply were not in any state to meet anyone.

Max Skorniakov



"We walked out of those meetings thinking that they were really excellent companies doing something genuinely unique. It was great to have the opportunity to meet the two passionate individuals who are at the helm."
Jamie Zegleman

For Max Skorniakov, the benefits of one memorable trip to Crawley in the UK were particularly informative – and moving. "We were visiting a company that produces linear accelerators – equipment to treat cancer," he says. "We talked to different professionals at the company, and we were energised by their passion to help treat cancer. I think they were probably overstretched, because it was a small company back then, it was struggling and the share price was depressed. But the visit maintained our confidence in the business.

"Then I visited the company last year in Germany," he says. "The company demonstrated its new linear accelerator with magnetic resonance imaging. It gives clinicians much better visibility on what they are treating, and allows them to save tissue and reduce side effects – it's a ground-breaking, revolutionary product. We were also given the opportunity to watch the real-life treatment of a patient in surgery, which helped me to really understand how integrating machine learning and AI into clinicians' work can save time."

Relationship-building is another important benefit of meeting companies face to face. "I remember doing a trip to the West Coast of the US a few years ago and meeting two companies that we invest in," says Zegleman. "We met the CEO of a company that makes small replacement valves for your heart. And the founder of another company, which makes robotic surgery devices. In both cases, we walked out of those meetings thinking that they were really excellent companies doing something genuinely unique. It was great to have the opportunity to meet the two passionate individuals

A DAY AT FERRARI

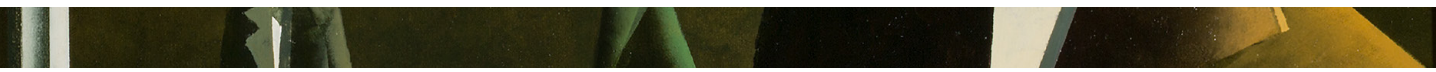
A couple of years ago I was invited to attend an event at Ferrari's HQ. Very often, these kinds of events are pretty turgid affairs where you get everyone into a big conference room together to look at some PowerPoint slides. This one was completely different.

It was held at the launch of a new series of very high-end, limited-edition cars. It was primarily a customer event for their best customers, with a small group of other guests also invited along. It was a big fanfare event – red carpet, champagne reception – against a backdrop of half-built Ferraris. And these customers had essentially signed up to buy these not-yet-finished cars that cost a seven-digit sum in euros.

So you've got these people wandering around who are multimillionaires, and over the course of the evening these individuals mingle with the other guests. And I remember speaking to one chap who told me he was building a house with a Ferrari built into it – in the front hall or lobby. He bought a Ferrari and just built the house around it. So it was now stuck in his front lobby, with no way of getting it out and driving it.

It was such a valuable event for me in understanding the power of the Ferrari brand, how it invests in nurturing its most important customers, and the complete loyalty of those customers to the brand.

Alan Lander



"You don't get that from annual reports, or press releases, or even watching videos."
Max Skorniakov

who are at the helm, and the CEO of one of the companies has become a regular contact for us and has given us a lot of his time, sharing his expertise and his passion for what the company does.

"Building a working relationship with the management teams of our invested companies is something we think is helpful," he adds. "It allows us to feed back our thoughts about what we like in their company, and where we think they can change to improve."

ONE FOR THE TEAM

There is another kind of relationship that the research trips help to build. "Walter Scott's investment approach is a very collegiate, team-based approach," says Lander. "We make decisions as a small group. And research trips are typically done in pairs. So a colleague and I would spend a week, potentially two weeks, out of the office together. And I think the team-building element that that brings to the setup of Walter Scott is very important.

"Spending time with a colleague, over dinner – or quite often over breakfast, lunch and dinner – plus sitting in a car or on a plane for hours, in airports for hours, having a beer in the evening, are opportunities to build relationships," he says. "Which can end up having quite significant consequences when it comes to how we work together and make investment decisions as a team."

The Zoom calls of today are no substitute for a chat over lunch in Jakarta, and they certainly will not provide our investment team with the same stories, but there are some aspects of the research trips that the team do not miss.

"In some of these markets, some of these cities, travelling between meetings might be an hour and a half drive," says Zegleman. "There can be very long days. And over time I think I and others have come to the conclusion that less is more – you get more out of these meetings if you have time to stop and think between them. I now tend to do only three, maybe four, meetings a day. Especially in some of these big cities where you're stuck in traffic a lot.

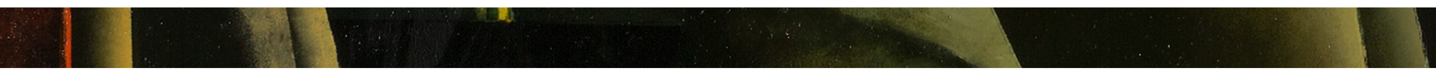
It is all worth it, however. As Max Skorniakov says when he describes the effect of seeing a linear accelerator at work on a real cancer patient: "You don't get that from annual reports, or press releases, or even watching videos."

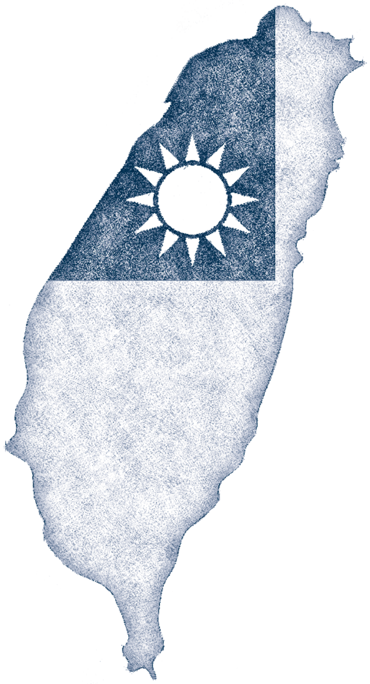
PASSPORT PANIC

I remember arriving in Jakarta, and when we arrived at the airport it was complete chaos. There were people literally everywhere, there was no obvious queue – we had no idea where we were going. And we were met by someone with a board with our names on it. And he basically said, "Right, give me your passports." So we handed over our passports to this total stranger, and he disappeared – he just ran off. And we stood there with all our bags thinking, "We could be stuck in Jakarta Airport for the rest of time."

Fortunately, he reappeared about five minutes later and said, "Come with me." And we basically walked past all the queues and straight through customs. I'm not even sure we spoke to anyone.

Jamie Zegleman



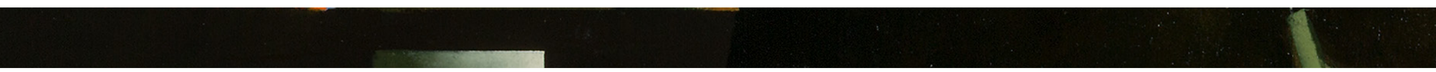


MADE IN TAIWAN

Is its handling of Covid-19 a sign that Taiwan can emerge from China's shadow?

There was a time when it seemed like every electronic item bore the hallmark of one nation. Taiwan was highly regarded as industrious, efficient and innovative, and it reaped the rewards. Fast forward a few decades, though, and there is a new ubiquitous label on our electronics: 'made in China' now prevails. Taiwan seems to have slipped behind – steamrollered by its heavyweight neighbour.

But this is no time to write off this prosperous island. There is a good chance that most of us still possess electronic devices that contain a key component that was made in Taiwan: the microchip. And 2020 has seen Taiwan emerge as an international pioneer in a different arena. Its effective approach to handling the Covid-19 crisis has become a recognised model for others to follow.



Here, we look into these two very different success stories and gain an insight into modern Taiwan's capabilities and opportunities. But we also look beyond the successes and find an island facing some singular challenges; the question is whether it can overcome them and recover the dynamism of the 'made in Taiwan' years.

READY FOR ANYTHING?

Taiwan was unusually alert to the news coming out of Wuhan in late 2019. Why? Ironically, it is a consequence of its difficult relationship with China. Taiwan is not permitted to be a member of the World Health Organization (WHO), because of China's long-stated position that it is a Chinese province rather than an international state. That, combined with its experience of the SARS outbreak in 2003, meant that Taiwan had its own pandemic early-warning system and robust action plan in place.[1]

Once it picked up on the signals coming out of Wuhan, Taiwan acted decisively. "Taiwan saw the early warning signs at the end of 2019 and immediately started isolating people coming from or via Wuhan," says Walter Scott Investment Manager Tom Miedema. "They were very early in stopping the spread."

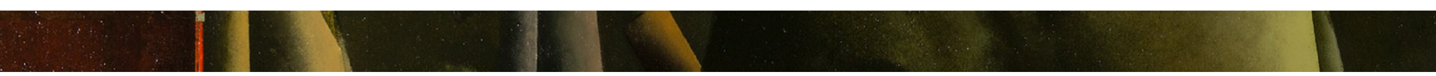
In mid-September 2020, Taiwan had reported fewer than 499 confirmed Covid-19 cases and only seven deaths out of a population of nearly 24 million. That is just two cases per 100,000 people. Australia, with a similar population, had recorded nearly 27,000 cases and more than 800 deaths – 107 cases per 100,000 people. Even New Zealand, which is considered a pandemic success story, had cases (1,801) and deaths (24) between three and four times those of Taiwan.[2] In May, New Zealand's foreign minister[3] risked irking China, its biggest trade partner, by calling for Taiwan to be given WHO observer status due to its handling of Covid-19.

How did it do it? Proactive protocols and an expert-led, apolitical approach to health policy were key factors in Taiwan's ability to act swiftly. Health officials were able to track citizens' online medical records and link them to travel histories, alerting doctors to potentially higher-risk patients. It is a level of state monitoring that might raise concerns in some other parts of the world, but for Taiwan it has proved effective in containing the virus.

Another crucial element was a willing population. "The Covid success was down to the rapid response and pre-planning, but also having a population that was ready to comply," says Miedema. "The health system has lots of protocols in place, but also people generally wear masks as a matter of course whenever they get sick. It has always been viewed as the right thing to do. Mask purchasing went up tenfold in a month."

This pulling-together and a social sense of duty and responsibility to your fellow citizens relates to the island's business fundamentals, says Miedema. "There's a parallel to industry in terms of how people in Taiwan organise, how they work together and are prepared," he says. "When there's a crisis – and that crisis might be trying to get the next technology done, or adapting to the threat of an earthquake – you don't go home until you fix it. People will literally sleep in the factory if there is essential work to be done or an important deadline to meet.

"The Covid success was down to the rapid response and pre-planning, but also having a population that was ready to comply."
Tom Miedema



"When crises hit, you need hard work, brain power and diligence," he adds. "So the fact that, when compared with others, Taiwan has sailed through this crisis so far reflects well on it."

THE CHIPS ARE UP

Not only has the pandemic raised the international profile of Taiwan, but it has also boosted the profits of its leading multinational. Taiwan Semiconductor Manufacturing Company (TSMC) announced strong Q2 results, thanks to healthy demand for technology, particularly communication hardware and infrastructure and cloud services, that was strengthened further over the period by WFH (working from home) investment.

TSMC was born out of Taiwan's electronics boom of the 1980s. While much of its industry domination of that era has now dwindled, the computer-chip manufacturer has gone from strength to strength and is now one half, alongside Korea's Samsung, of what could become a global semiconductor-producing duopoly.

How much of that success is down to TSMC's geographic home? Taiwan has only been an independent state (albeit one that is not recognised by China) since 1949, after being part of Japan for half a century and then briefly reunited with China until the acrimonious split. It had to work hard, and strategically, to establish a place for itself at the global table.

"Taiwan is relatively young and doesn't have a lot of natural advantages," says Miedema. "Most of the island is mountainous. Almost all the population lives in a relatively thin sliver of land that tracks along the west coast, and there's very little happening on two-thirds of the island."

It came to be a major player in the electronics market through a three-pronged strategy: liberal government competition policy, internationalisation of skill and talent through links with the likes of Silicon Valley, and an ability to combine high quality and low cost with innovation.

"The government put a lot of money into giving advantages to industries initially, and was very proactive in its industrial policies," says Miedema. "It's very well-managed in terms of industrial policy, education and healthcare."

That brings us to TSMC and the computer chip. "TSMC was established with government support," says Miedema. "Taiwan had a very successful diaspora – particularly in the US. Taiwanese entrepreneurs were coming back from the US, including TSMC founder Morris Chang, who had been at Texas Instruments. He had a concept for outsourced manufacturing. This nascent company tied up with Philips and the Taiwanese government, deciding that Taiwan's main assets were ambition, a bit of money and some talented people. Put together, that formed the basis for the chip industry."

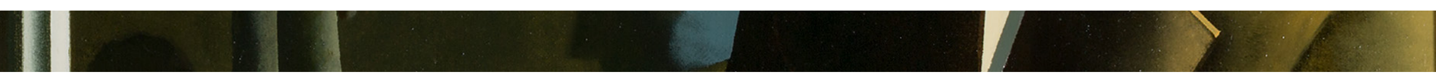
TSMC's approach was unusual. "The idea was that it would only concentrate on manufacturing," says Miedema. "So any company could design a semiconductor chip, bring it to TSMC and they would manufacture it."

Over time, other companies followed the same model, but as each new generation of technology became more complex and costly, the industry naturally consolidated around a smaller number of players; some manufacturers fell away as they exited the manufacture of leading-edge chips and others decided to focus only on design and exit manufacturing altogether. TSMC, meanwhile, maintained its focus on chip manufacturing, and its commitment to leading-edge manufacture. "TSMC has just over 50% market share in the overall industry," says Miedema. "But it's dominant in the latest generation of chips – an 80% to 90% market share.

"In terms of the number of players doing their own manufacturing at the leading edge, GlobalFoundries dropped out two years ago, and Intel, recognising that it had fallen behind TSMC in the race towards developing new technologies, recently announced that it was looking at outsourcing at least some of its manufacturing," adds Miedema. "So that leaves TSMC and Samsung as the only global manufacturers able to make the leading-edge technology."

"TSMC has just over 50% market share in the overall industry," says Miedema. "But it's dominant in the latest generation of chips – an 80% to 90% market share."

Tom Miedema



> *"It's incredibly complex how Taiwan tries to manage its relationships with the rest of the world when China is so explicit in restricting its ability to do so."*
> Tom Miedema

WHERE ARE THE UNICORNS?

TSMC has managed to remain a flagship Taiwan success story, but the same cannot be said for others in its tech industry. "There was a time where the cliché of 'made in Taiwan' was very real, but it hasn't sustained that success very well – with the exception of semiconductors," says Miedema. "TSMC has become and remains a world leader, but it's not obvious where the next TSMC is going to come from today."

The reasons for this apparent stagnation are multiple and complex, but one of the material factors is the way Taiwan is being pushed into the margins by the rise and dominance of China. To have good relations with China, countries must largely acquiesce to its position that Taiwan cannot be regarded as an independent nation.

"It's incredibly complex how Taiwan tries to manage its relationships with the rest of the world when China is so explicit in restricting its ability to do so," says Miedema.

That in itself is enough of a problem, but China's enormous industrial advantages of scale and cost also present other challenges. As a result, many tech firms that boomed in Taiwan's 'Asian tiger' years (1960–1990s) have shifted across the Taiwan Strait, as have many of its graduates.

"A lot of these industries are still Taiwanese-owned, but the vast majority of what they do happens in China or other countries, so the innovation in Taiwan to a large extent seems to have dried up," says Miedema. "There are no Taiwanese unicorns as yet."

Miedema says that some Taiwanese companies also struggle because of the unusual focus that made them a success in the first place. Another Taiwanese company, Largan Precision, is the top global manufacturer of optics of lenses for smartphones. "It is now a large business, but one that is very niche and focused on just one area," he says. "Which is another classic Taiwanese business characteristic – they tend to be so specialised. When that industry is going well, it's great, but when it declines, there is little escape.

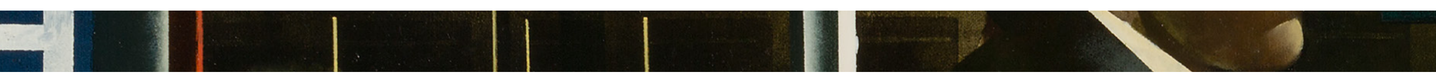
"Largan is dominant, really specialised, high tech, and focused on moving lens technology forward," he adds. "But that comes with its own risks – there is no disguising its focus on smartphone lenses."

A FOOT IN TWO CAMPS

Taiwan, more than most, constantly has to position itself somewhere between China and the US. That balancing act has never been easy, but recent developments have been particularly uncomfortable. TSMC's experiences with Huawei are a useful example of Taiwan's quandary.

"Huawei is one of TSMC's biggest customers, and TSMC is working hard to continue supporting its Chinese customers – including Huawei – so it's in a very difficult position when the US explicitly says, 'You can't do business with Huawei'," says Miedema. "On the flip side, many of TSMC's main customers are in the US. So it also has to be friendly to the US and show that it is independent, separate and autonomous. It has to try to be all things to all people."

How has TSMC handled the Huawei problem? "The assumption is that



Huawei will no longer be a customer for TSMC," says Miedema. "Initially, there was concern because TSMC operates with very long lead times, so it is quite hard to switch out one customer and bring another in. But it said very quickly that it had other customers lined up and that it is not going to have an impact on its business."

In parallel, there are signs that the US is becoming more open in its dealings with Taiwan. In August, the US health secretary visited Taipei, the highest-profile official to do so in more than 40 years, and President Trump has passed laws aimed at supporting Taiwan.[4] It remains to be seen whether this is the beginning of a positive upward shift in Taiwan's international standing or part of the US's posturing against China, but there are other signs that the renewed US interest in Taiwan is more than just a flash in the pan.

In the US, for instance, there are concerns about the semiconductor supply chain. Although it leads in chip design and sales, only 12% of advanced chips are manufactured there,[5] and Intel's revelation in July that it was 12 months behind schedule on its next generation of chips caused alarm.[6] TSMC is poised to fill the gap, and plans are under way to build a TSMC plant in Arizona that will begin production in 2024.[7] "Taiwan's 'silicon shield' makes it the 51st [US] state," said one analyst. "The US [...] can't afford to lose it to China."[8]

For its part, Taipei is seeking to redress Taiwan's slowdown in innovation and the brain drain to China with incentives designed to encourage advances in smart machinery, clean energy, biomedicine, defence and aerospace, and agricultural technology. It has also introduced policy aimed at attracting skilled Taiwanese abroad back home, as well as 'golden employment visas' to make the country more attractive to foreign talent.

None of this has yet translated into an upturn that mirrors its 'made in Taiwan' boom time, but if it can combine its pro-entrepreneurial policymaking with the preparedness highlighted by its Covid-19 response, and at the same time perfect its delicate geopolitical balancing act, Taiwan's international star could be on the rise once again.

[1] https://www.theguardian.com/world/2020/mar/13/how-taiwan-is-containing-coronavirus-despite-diplomatic-isolation-by-china

[2] https://edition.cnn.com/interactive/2020/health/coronavirus-maps-and-cases/ [Accessed 15 September 2020]

[3] https://www.theguardian.com/world/2020/may/12/new-zealand-backs-taiwan-joining-the-who-despite-china-rebuke

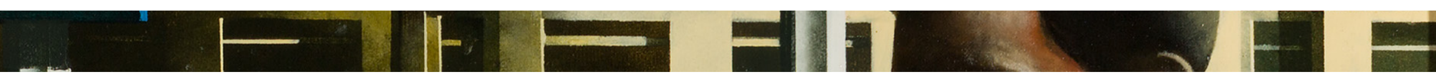
[4] https://www.reuters.com/article/us-taiwan-usa-idUSKBN21E0B7

[5] https://www.ft.com/content/ff7996bb-1309-4921-89c1-11aa8e6507de

[6] https://www.ft.com/content/051b2c80-d53b-410e-8e80-f433d25a82dd

[7] https://edition.cnn.com/2020/05/15/tech/tsmc-arizona-chip-factory-intl-hnk/index.html

[8] https://www.ft.com/content/ff7996bb-1309-4921-89c1-11aa8e6507de



CONSISTENCY AND FORETHOUGHT: THE TSMC SUCCESS STORY

One of the reasons TSMC has been so successful, according to Tom Miedema, is its consistency. “Intel, after being metronomic in its own progression, has had a number of misses over the past five years,” he says. “In contrast, TSMC has really tightened up. I can’t remember the last time they made any sort of misstep.”

That consistency is in part due to the company’s strategic use of resources. Rather than using all of its ‘A team’ to work on the latest technology, it spreads out its talent, with teams working on multiple technological generations and advancements in the future.

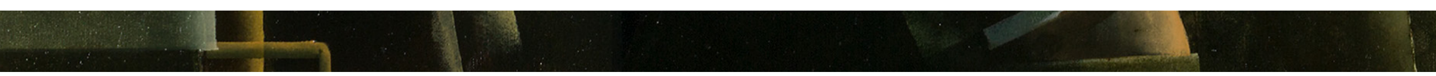
“Today, the main technology in chip design is 7-nanometre,” says Miedema. “There are many pathways in a very complex pattern, and ‘nanometre’ refers to the width of the lines that you are creating to make that pattern.”

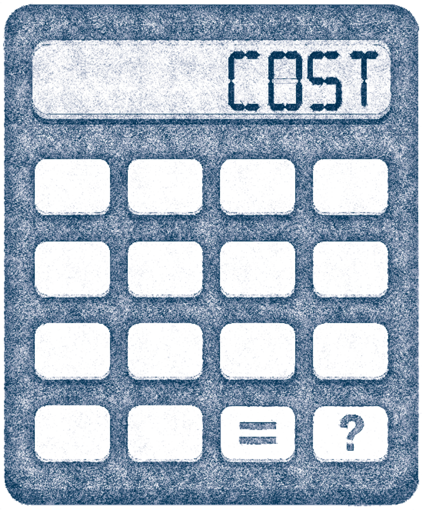
The aim is to achieve smaller and smaller advancement lines over time – from seven today to five, and then to three. “TSMC has a team that is working on five, a team that is working on three, a team working on two, and even beyond that,” says Miedema. “Rather than just having the ‘A team’ move from one tech to the next, it is planning so much further ahead.”

The planning also extends to natural disasters, which could derail the company’s careful work. Taiwan is prone to earthquakes, and they are factored in to how it operates. They are also high on TSMC’s list of priorities.

“You can imagine the impact of an earthquake when you’re trying to create patterns on top of one another that are so small and exact in a chip,” says Miedema. “We are talking about something that takes months, creating patterns with lines that are more than 100,000 times finer than a human hair.”

So the company has been working on its resilience and preparation for natural events. It can immediately detect when an earthquake is coming, shut its plants down, let the earthquake pass and then reset the equipment so that it can align everything back to that exacting accuracy. “TSMC does a lot of preparation,” says Miedema. “But it is also incredibly good at reacting very rapidly to the unexpected.”

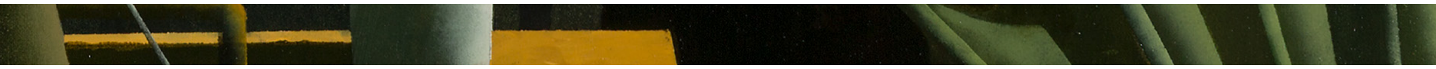




NET ZERO OR GROUND ZERO?

Dieter Helm pulls no punches in his latest book, *Net Zero: How We Stop Causing Climate Change*. He believes the world has wasted the last 30 years in the fight against the climate emergency – now it is time for us, as consumers and therefore polluters, to stop blaming companies and governments and pay the price. We spoke to him recently about why it is time for a new approach.

Dieter Helm is Professor of Economic Policy at the University of Oxford and Fellow in Economics at New College, Oxford. He has written several previous calls to action, including *Burn Out: The Endgame for Fossil Fuels*, *The Carbon Crunch*, and *Natural Capital: Valuing the Planet*, but this is his most urgent – and angry. In it, he argues that the way to achieve the global goal of net zero carbon emissions is through a carbon cost that is applied to everything. Only by doing this can we start to unilaterally reduce our carbon consumption and make our continued existence sustainable.



Your new book, *Net Zero*, focuses on individuals being concerned with carbon consumption over carbon production. Can you explain this approach?

The current approach isn't working. I don't believe that 'one more heave' will solve the problem. What I try to provide is a bottom-up approach to the problem, which may be more successful. Ultimately, if we want to be unilateral, both as individuals and countries, what we're saying is 'I don't want to cause any more climate change'. Therefore the only thing that matters is whether what we're consuming contains carbon or not. People can blame companies, but things are produced for our consumption. The fundamental shift of the focus and obligations on to us as individuals is quite deliberate. Then the question is: what does business do in response?

I want us to be brutally realistic and realise that we as consumers are ultimately the polluters, so the right economic approach is to make polluters – us – pay more for carbon-intensive goods and less for low-carbon goods.

"I want us to be brutally realistic and realise that we as consumers are ultimately the polluters, so the right economic approach is to make polluters – us – pay more for carbon-intensive goods and less for low-carbon goods."

You encourage people to keep a carbon diary. How important is this?

I want people to understand what's really at stake. We have to understand that climate change is not solved just because we close some nasty power stations; it's about the carbon-intensive economy we have created. Carbon is in everything we consume, from our breakfast to our clothes, and not everyone realises that. The carbon diary aims to get people to see it's about consumption, and then to get people to educate themselves.

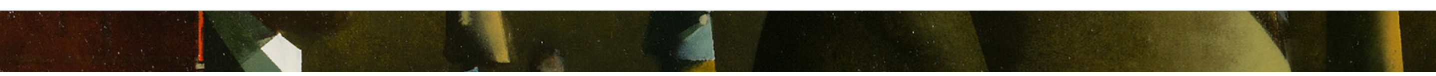
But it's hard, because we live in an almost entirely carbon economy. Your carbon diary gives you a scale of what's involved in making these transitions. I want to steer people away from trite, easy answers that suit lobbyists, towards a more profound thought about the heart of human consumption and what we humans do to the planet.

What role can companies – for example those that are part of the numerous, now high-profile, net zero initiatives – play in communicating their actions to help individual consumers make their decisions?

In simple terms, they can say 'We take net zero seriously, so buy our stuff'. But the important point is that they're clear what they mean by net zero.

Some companies may say that they're net zero, but what they actually mean is that their building is low carbon because they bought some renewable energy to run it. That's fine, but it's trivial compared with the real problem. Take a company like Microsoft. It is part of a net zero imperative alliance, but look at how much pollution is caused by all the high-tech communication stuff we now use. What Microsoft and others are purveying is a technology that is amazingly carbon intensive. In fact, ICT equipment is the fastest-growing source of emissions in the world.

The real problem is how we can have modern communication systems that are in themselves low carbon. That's altogether more demanding. One of the things in your carbon diary that will show up very strongly is consumption from your laptop and phone use.



So we need transparency over which net zero target a company is referring to, and the emissions should be measured properly.

Is there a problem with the loose definition of net zero then? Who is actually scrutinising those targets and achievements?

It's difficult – there's a lot of green-washing and box ticking to satisfy ESG investors. But what constitutes an ESG measure is not a science. You need to start off with a baseline, and ask whether the company is making net improvements or going backwards – not just asking 'Is it an oil company?'. For example, you might disinvest from a European oil company, but the consequence could be environmentally worse, because the result is that the stuff gets bought from a more polluting company in another country – and that's where the battle against climate change is really being lost.

How optimistic are you that people are willing to pay the price that you've outlined?

I am quite optimistic, but the way in which I see this is not persuading you or me to behave in some moral way. I want to have a system in which we as polluters have to face the price of our pollution. And central to that is a carbon tax. I'm pragmatic. I've never thought that I'm going to persuade any government in the world that a carbon tax is the right thing to do. But right now, they need the money, and they've run out of all the other tax options available to them. That's why it's very likely.

There's a good chance that at the beginning of 2021, after it leaves the EU-Emissions Trading System, the UK will have a carbon tax, and the EU is proposing a border tax. Can I get people to instantly adjust to a much lower-carbon lifestyle now? No, it's going to take time. But are we heading in the right direction? Yes, we are. And part of that is because people have to realise that the current route isn't working. More of the same isn't going to solve the problem. It'll give us another 30 wasted years.

I think the politics, the financial circumstance we find ourselves in, and the drip, drip, drip of people understanding that climate change matters and we're not getting anywhere – that's the point. So brutal realism is the necessary condition to get something done.

In terms of systemic change, what else needs to happen?

You have to go to the heart of why we're not making any progress. Emissions from power stations are a fraction of the problem. We have to understand that it's also about our transport, our food, the way the land is used. Take the UK: agriculture is 0.6% of GDP. Its recorded emissions, before you take the soil and peat factor into account, are 11%. There's virtually no industry I can think of that's more polluting per unit of GDP than agriculture.

It's not just about what's going into the atmosphere, it's also what's coming out of the atmosphere. Nature has been sequestering carbon for millions of years. When you burn down a chunk of Amazon rainforest, you don't just put the emissions from the burnt wood into the atmosphere; you kill off its ability to reabsorb. But people still buy their beef from Brazil.

Armed with that knowledge, it comes back to moral and personal

"I think the politics, the financial circumstance we find ourselves in, and the drip, drip, drip of people understanding that climate change matters and we're not getting anywhere – that's the point. So brutal realism is the necessary condition to get something done."

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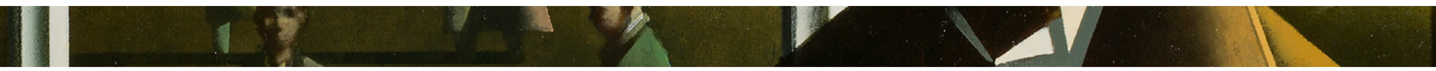


responsibility. But it's easier to make that choice if you can afford it. For the average household in Britain, already struggling to pay the bills, it's not so easy. You need an economy where personal choices are mediated by the different prices that confront you. If we inflate the price of carbon through the carbon tax, that improves the efficiency of the economy – and it can also raise a lot of money.

How can we tell whether we're starting to make tangible progress?

The two great environmental challenges, biodiversity and climate change, are measurable. It's easier to measure climate change than it is to measure biodiversity, but we can see what we're doing; we're engaged in a large-scale extinction project, and we're engaging in adding two parts per million of carbon to the atmosphere every year.

Measuring climate change is really quite easy as it's about a small number of gases that have concentrations in the atmosphere. When we have a year in which it doesn't go up by two parts per million, then we're making progress. Of course there'll be a lag, so if we start to put in place policies which move us in that direction, that will be good.

But it doesn't matter where the carbon is emitted, it has no borders – and that's the delusion about unilateral policies. If you close British Steel, for example, and import the steel from China, you might reduce your territorial emissions but you increase climate change because it'll be more polluting to produce the steel in China than it is in Britain. If you think that unilaterally you're no longer causing climate change, it's nonsense. You are. In fact, you're making it worse.

The reason I want carbon pricing is not just because it's the right thing to do – it makes the economy more efficient, it makes the polluter pay. It's also bottom up. It's a much better strategy than top-down, Kyoto and Paris-type agreements.

How would carbon pricing work?

Take the steel example. Say a Chinese company sends steel into Southampton docks and is confronted with a carbon tax bill, payable to the UK government, unless they can show a certificate of exemption because they've paid a carbon tax in China. The Chinese government then thinks: 'Do I want to pay the UK Treasury a carbon tax or do I want it paid to the Chinese government?' It's a no-brainer.

The really heartening thing in all the trade discussions at the moment is that everyone's talking about environmental standards – because free trade is not fair trade. If you have a country that doesn't price carbon, it distorts trade. That's why I want that price to be there – then we start to make progress, bottom up. You can have your own carbon price without decimating your own industry, and you can be sure that you're not causing climate change as a result, provided you treat imports that go into your consumption on the same basis as you treat domestic production.

You've said previously that you didn't think you would have to write this book. What prompted it?

Because I'm angry. People are being convinced that if they get to net zero, they'll stop causing climate change. That's a very dangerous illusion. If everybody got to net zero in every country in the world in 2050, then it would be fine. But look at what's going on in China, in India, in Africa – the idea that they're going to get to net zero production of carbon by 2050 is naive and dangerous.

We don't actually need to get to zero. But as long as we're buying carbon intensive goods from abroad, and we're not paying for the pollution that's being caused, we're not even going to get close.

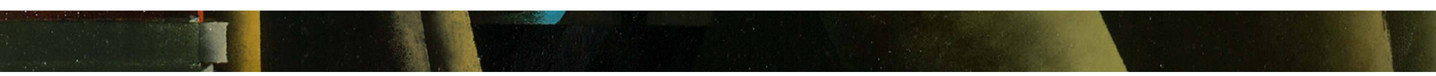
Do you think *Net Zero* can convince policymakers and world leaders?

There's a difference between convincing someone an argument is correct and getting them to actually act upon it, but I think the penny is dropping on carbon imports.

The danger in all this is the sea of lobbyists from all directions. Both sides of the argument are not neutral. Just because somebody makes something that works in a low carbon economy does not make it the right or best investment. If you pick winners and pick technologies, you get lobbied. If you pick a general instrument like tax, you don't.

As to whether it's all happening quickly enough – probably not. But the baseline is so low and I'm interested in finding ways to make things better.

"But look at what's going on in China, in India, in Africa – the idea that they're going to get to net zero production of carbon by 2050 is naive and dangerous."



FUTURE STATES

Microsoft, Unilever and Nike are founding members of Transform to Net Zero, a cross-sector initiative to accelerate the transition to a net zero global economy. Each has set targets for how it can minimise its impact on the environment.

TODAY 2030 2040 2050

Microsoft

CARBON NEGATIVE BY 2030

By 2050: Remove all the carbon the company has emitted either directly or by electrical consumption since it was founded in 1975

Unilever

ACHIEVE A DEFORESTATION-FREE SUPPLY CHAIN BY 2023

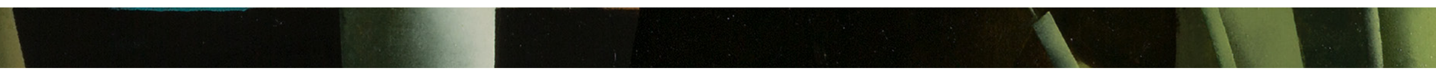
ACHIEVE NET ZERO EMISSIONS FROM ALL PRODUCTS BY 2039

Nike

100%
Aiming to ensure that 100% of the cotton it uses comes from the most sustainable sources by 2025

USE 100% RENEWABLE ENERGY
in owned or operated facilities globally by 2025

TODAY 2030 2040 2050



LUXURY WE CAN'T AFFORD?

When a global crisis hits, what does it mean for the likes of Chanel, Ferrari and Louis Vuitton? We find out how the luxury goods sector is faring as the Covid-19 pandemic turns the world upside down.

"Luxury is a necessity that begins where necessity ends." As Covid-19 closes city centres, slows production to a crawl and deals a body blow to the travel industry, do Coco Chanel's words still hold true? Just how much of a necessity is luxury to its traditional consumers when a recession of historic magnitude looms on the horizon?

The *Financial Times* reports that HSBC has forecast that luxury goods sales will fall by 17% this year, Bain has predicted a decline of between 20% and 35%, and analysts expect it to take until 2022 or 2023 for sales to return to last year's €281 billion.[1] These statistics are grisly, but they conceal a more nuanced picture.

17%

Forecasted drop in sales of luxury goods in 2020

Source: HSBC/FT

THE REAL DEAL

Luxury is aspirational, so the word is overused by many companies. Luxury-goods consumers and investors need to be alert to imitators. Alistair Green, CMO of British haute-couture house Ralph & Russo, says that there are four ways to identify a luxury brand: craftsmanship, heritage, aspiration and symbolism.

"For a luxury brand and a luxury consumer, craftsmanship is part rational, part emotional," he says. "It's the justification for paying the huge price tag." Heritage, meanwhile, is a particularly powerful selling point for founder-owned brands such as Chanel and Dior, and it tends to go hand in hand with craftsmanship.

"A real heritage brand will be handcrafted, because mechanisation didn't really exist when it was founded," says Green. "Dior and Chanel have in-house ateliers. There's no real reason for them to have a button or feather atelier – at great cost – but it keeps them at the top of the pile because other couture brands don't have that heritage."

Brands qualify for Green's third criterion, aspiration, through exclusivity. High prices and limited stock guarantee that not even the super-rich can secure, for example, a Hermès Birkin bag. It also means careful product placements with online influencers and celebrities. "That's something that's part of the challenge now," says Green. "Because what made a brand aspirational to a luxury consumer 20 years ago is not the same as it is today."

Finally, symbols, which are even more important to luxury brands than to other brands. "A symbol is the status and the badge of the brand," says Green. "If you're trying to build aspiration and you have a story that represents craftsmanship and heritage, you need something to stand for all of those things." Symbols are also a commercial necessity. They allow luxury brands to charge premium prices for goods such as sunglasses that sit at the more accessible end of the market and represent a sizeable revenue stream.

Today, there is another hallmark of luxury to add to Green's craftsmanship, heritage, aspiration and symbolism: relevance and the 'cool factor'. "Essentially, that means being relevant to what's going on in today's culture, and today's luxury consumer's mind and life and behaviour," says Green. "An old craftsmanship, aspirational brand can very easily find itself irrelevant to a younger, newer luxury consumer, and that will start to affect the bottom line. The best luxury brands do a very good job of maintaining relevance."
To this list of luxury criteria,

> *"An old craftsmanship, aspirational brand can very easily find itself irrelevant to a younger, newer luxury consumer, and that will start to affect the bottom line. The best luxury brands do a very good job of maintaining relevance."*
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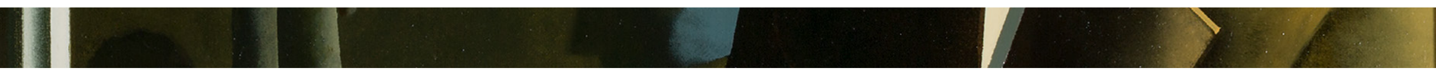
> Alistair Green, CMO, Ralph and Russo



Lindsay Scott, Investment Manager at Walter Scott, would add one more: a sense of belonging to something special. "The CEO of Louis Vuitton describes it as a club," she says. "Once you join, you want to stay in the club forever. If you're carrying the brown bag from Vuitton or have the H of Hermès on your bracelet, it speaks to your personality and what you want people to think of you."

A CRISIS LIKE NO OTHER

The brands that do tick all of these boxes have proved to be remarkably resilient in the face of previous economic downturns. According to Bain & Co, the global financial crisis slashed 9% off the size of the personal luxury goods market,[2] but heritage luxury brands weathered the storm; some – Louis Vuitton, Hermès – even increased their brand value.[3]

This time, it is different. "This crisis is different from any other I've experienced in the luxury sector in the past 20 years," says Claire Kent, luxury goods consultant and founder of Iffley Road, which produces high-quality men's running wear. "Previous crises had a short-term impact on travel and tourism. This seems more structural and probably long-lasting."

The slump in Asian tourism, which is the source of much of the luxury goods sector's revenue, is one reason why recovery is likely to be tougher this time. The big flagship shops in European capitals welcome a large share of tourists through their doors, and with tourism down on last year the stores are quiet – and will be for the foreseeable future. "I can't see Asian tourism returning to previous levels," says Kent. "Until a vaccine is found."

She believes that attitudes towards conspicuous consumption have also changed – certainly among Baby Boomers. "I feel it has fundamentally affected people's attitudes towards spending," she says. "And I think a lot of people would prefer not to flash their wealth.

"As a sector, we do move in cycles," she adds. "It could be that that [attitudinal shift] remains the case for three or four years before we move into a different cycle."

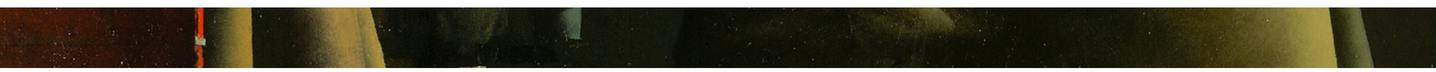
Linked to these sensitivities are uncertainties surrounding the future – and how they affect people differently. Concerns over job security will reduce spending on discretionary items, and this will divide consumers of high-end luxury for whom redundancy is not an issue and those for whom discretionary spend becomes something to be careful about.

STRUCTURAL CHANGE DRIVES INNOVATION

The possibility of longer-term changes to the market is a cue for luxury brands to assess their positions. For the past decade, they have all followed a similar strategy: opening more – and larger – stores catering for the Asian market, and withdrawing from department stores. Now, the crisis is forcing management to assess the size of their store networks, including flagship stores, and their store expansion plans. It is also focusing their attention on e-commerce and innovations that could improve the user experience. This is nothing revolutionary, of course – it is accelerating an existing trend. "I think Covid-19 has really just been a catalyst for what would have happened anyway over a three-year period," says Kent.

"Previous crises had a short-term impact on travel and tourism. This seems more structural and probably long-lasting."

Claire Kent,
luxury goods consultant



The luxury giants ought to be comfortable with taking an innovative approach. Innovation intertwines with relevance and the ability to appeal to younger generations, and luxury companies have a good track record here. One example of their innovative approach is the way that some are partnering with unexpected brands.

"Supreme is a street label brand, but Louis Vuitton has partnered with it because it's probably one of the coolest brands on the planet right now," says Alistair Green. "It doesn't really come from the luxury world, but because of its cool factor it's still incredibly expensive and covetable – and is worn by a lot of the right celebrities and influencers."

Lindsay Scott agrees that this kind of combination is what makes a successful partnership. "It makes the brand interesting to a younger cohort," she says. "While retaining that core mainstay of heritage."

Innovation is a key reason why some luxury companies have grown faster than others over the past decade. Not only are they exploring new partnerships, but they are also innovating their products and transforming the way they communicate with customers.

Green agrees that brands need to ensure they can stay up to date. "I'm surprised by how much potential luxury brands are still sitting on," he says. "There are also still parts of the luxury world that are almost inaccessible and closed. If they can open up more while still retaining exclusivity, and be willing to bring in new skills from outside, it can be a really potent combination."

WHAT LIES AHEAD

In normal times, innovating their strategies, thinking beyond bricks and mortar and recruiting young talent to the team would stand luxury brands in good stead. But these are not normal times. As the pandemic continues to cause turmoil, what else should be on CEOs' to-do lists?

"The footfall in European stores is down on last year, so cost control is paramount," says Kent. "They should also be taking a view on what happens next. If there is a vaccine, will things return to normal – or has there been more of a structural shift? Will Asian customers start consuming European luxury more locally, or buying it more online? All of those things will determine the investments they make in future stores.

"For smaller designer brands, the whole issue will be one of survival," she adds. "But most of the European luxury powerhouses are cash rich and well protected, and they will be able to manage any blow."

Luxury should continue to be a "necessity" – at least for high-net-worth customers – but Covid-19 is changing the way those customers buy it. This is a crisis like no other, but the brands that can keep up with these changes while holding on to their special craftsmanship, heritage, aspiration and symbolism look well-equipped to survive it.

"If there is a vaccine, will things return to normal – or has there been more of a structural shift?"
Claire Kent,
luxury goods consultant

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[1] https://www.ft.com/content/149c4be8-9fd9-46ff-a161-86f3ef86a2d6

[2] https://www.voguebusiness.com/companies/luxury-recession-saks-bond-yield

[3] https://www.luxurysociety.com/en/articles/2013/02/why-some-luxury-brands-thrived-in-the-us-despite-the-recession

SURVIVING THE CRISIS: THE VIEW FROM THE GROUND

We talk to three investment managers from Walter Scott about how luxury companies are coping with the Covid-19 crisis.

Alan Lander

Lindsay Scott

Paul Loudon

Alan Lander: In the high-end luxury market, the pandemic has had very little impact on demand. Ferrari customers, for instance, are high-net-worth individuals whose spending decisions are not dependent on their annual income. Ferrari has waiting lists of 12–18 months for production models, and people won't choose to step off the list.

It comes back to what makes a luxury brand. If you look at the financial crisis, volumes for Ferrari dropped about 5% from the peak to the very worst quarter. Compare that with other supercars – two-door sports cars costing more than €150,000, such as high-end Porsches, Lamborghinis and the like – and those peers saw volumes drop 40% in the same period. Ferrari is just at a different level.

When we're looking at what makes the very highest-quality luxury company, the most important element is the financial track record and seeing how the company performs during a downturn. If it continues to grow during an economic downturn, that's the real proof of the pudding – hard evidence of brand strength and customer loyalty.

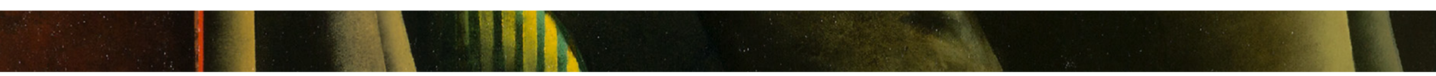
"If there is a structural shift towards working from home, then obviously people are going to be less inclined to buy silk ties."

Supply is slightly different. This particular crisis has had a big impact on supply, whether that is shops being forced to close, or in the case of Ferrari manufacturing being halted. When Ferrari's factory was closed due to coronavirus restrictions, it lost around a fifth of the year's production. But it's being quite careful about how it recovers from here, and is accepting that 2020 will be a year with limited supply. Conversely, I think the impact on demand is muted.

Lindsay Scott: With the high-end brands – particularly in Asia where the stores opened up earlier – we started seeing huge increases in the numbers of people coming to the stores. That suggests there was a bit of pent-up demand.

Having a digital presence was enormously important – certainly in the first period of the pandemic when all the stores were shut. Louis Vuitton had already made huge investments in its digital presence, which it was able to leverage. With Hermès, 75% of online customers were new to the brand, and that was achieved without cannibalising their store sales. Its e-commerce will continue to play an important role.

But there's going to be a lot of pressure on the lower-end elements. Looking at Hermès' results for the first half of the year, by far the hardest hit part of the business was the silk and textiles, which represents entry-level products like scarves and ties. In each one they



were down almost 40%; in Q2 that was down 60%. Compare that with leather and saddlery goods, such as high-end bags, which were only down about 20% in the first half.

Paul Loudon: And I think there are nuances within that. Those brands that have exposure to formal wear are going to be facing bigger challenges. If there is a structural shift towards working from home, then obviously people are going to be less inclined to buy silk ties.

LS: Louis Vuitton and Hermès have cleverly spanned the spectrum in terms of price point. The high-end, profitable element is more protected, which is good, but the lower end will suffer for a prolonged period. It's a question of pulling those elements together.

PL: Looking at supply, I think the closure of stores and the travel market will highlight the need to build up alternative channels within countries. A lot of consumers of luxury goods often encounter brands for the first time in airports. So the luxury brands are investing in digital initiatives, trying to reach consumers online if they can't get them in that retail travel environment.

Looking beyond the ultra-high end, the likes of Estée Lauder will have to think very hard about how they can replace that obvious interface and introduction with alternative methods. A lot of that will be digital, and I think that's not necessarily a bad thing.

Being able to introduce a brand to a consumer digitally can be more efficient and effective, although there may be short-term pain.

LS: It's different. If you're shopping online, you are looking for something that you know you want. But if you're wandering around an airport, you can stumble across something, which is less likely to happen in the digital realm. It changes the dynamic quite dramatically.

"Less travel retail spend and greater domestic spend may cause a bit of disruption in the short term, but ultimately it's about demand."

AL: I think it depends on the category of products. Certain products may fall into the category of impulse buys in an airport, but when you're talking about spending a few thousand pounds on a handbag, it's probably less so.

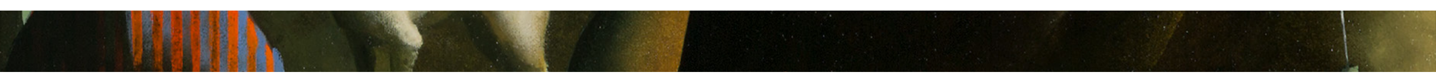
But I think that channel shift is already happening. One portfolio holding is a luxury mall operator in China, and it's been reporting good results from more consumers shopping domestically and from doing less in the travel retail channel. Less travel retail spend and greater domestic spend may cause a bit of disruption in the short term, but ultimately it's about demand; provided that demand is there, the brands have just got to find a way of serving it.

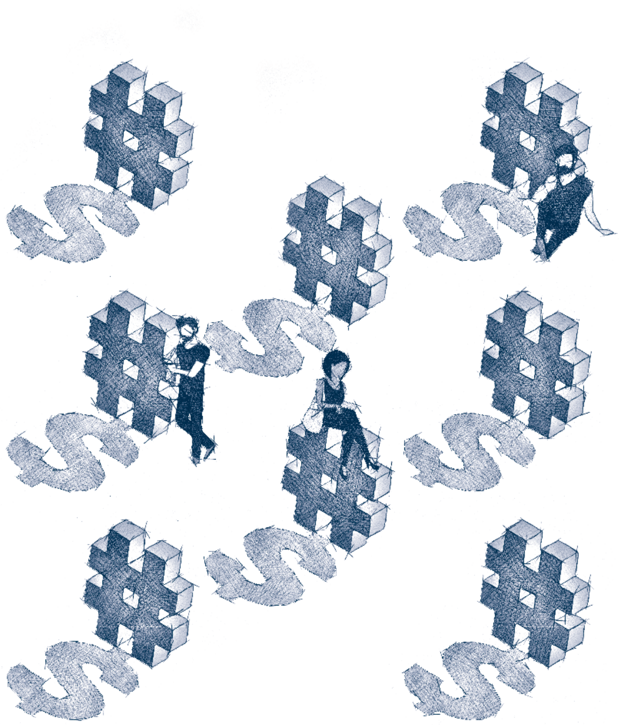
LS: This repatriation is something that LVMH talks about specifically with regard to Dior and Louis Vuitton – particularly in China. People buying locally is an ongoing trend, although the spend is not nearly offsetting what has been lost. And they are very clear that this will take time.

They're also clear that you can't separate the digital and store consumer. Inevitably, customers will have done some online research about what they want to buy. They have probably been into the store, touched a few things if they can, felt and held handbags, maybe got an idea of the weight. Then they will have gone back, had a look online, and compared it with some others. LVMH believes that there's a meeting of the two mediums and they work very nicely together.

Having a personalised experienced is much harder if the stores are taken out of the equation. Louis Vuitton was having one-on-one chats with its VVIPs [very very important people]. The sales assistants who knew those customers would text, WhatsApp, or FaceTime them to show them the new products that were coming in. But for some luxury brands, social distancing in stores is not a problem. A Louis Vuitton store, for instance, is like an art gallery: there's so much space that it can still operate as normal even with social distancing in place. It's the smaller brands that are tighter on floor space that will struggle.

PL: The ultimate human impulse of buying luxury goods to show off – which is a very raw, human, emotional desire – has not changed. So I think the long-term dynamics are still very positive for the industry, regardless of the channel.

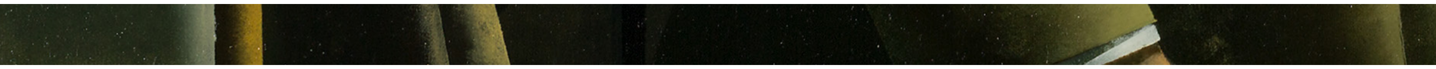




VIRAL TRENDS

Dr Eliza Filby specialises in the history of generations and the evolution of contemporary values. She helps companies, governments and the third sector to understand how people are changing as citizens, workers and consumers. Dr Filby's second book, *Kidults: Why we are younger for longer and what it means for our future*, is due out in 2021.

Here, she talks to us about the particular impact of Covid-19 on Generation Z and Millennials, and how the pandemic may change every generation's behaviours and values for good.



30,000

Klarna customers have already had their credit scores damaged because of missed payments

DEFINING THE GENERATIONS

Baby Boomers, born 1945–1965
Generation X, born 1966–1980
Millennials, born 1981–1996
Generation Z, born 1997–2010
Generation Alpha, born 2011–

"THE PANDEMIC WILL DEFINE GENERATION Z AS A GENERATION"

The pandemic is unique and will lead to lasting consumer change. Simply because of the amount of time it has gone on and the profundity of it – it has affected every aspect of people's lives. Whether it is the education of their children, their work life or their ability to leave the house, this has had an impact on people's lives to an even greater extent than the financial crisis.

And it is global. The financial crisis was not global in the way that this pandemic is. It has affected countries in different ways, but it has been a global experience. In that sense, it is really going to solidify Generation Z in particular as the 'corona generation'. Generation Z are the ones whose schooling has been affected; whose social lives have been majorly curbed; for whom this pandemic is really the marker of their entry into adulthood and will define them as a generation. They will be the ones most affected by job losses, the recession and the recovery in the wake of the pandemic. It is their generational moment.

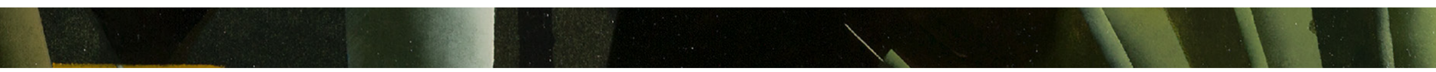
"GENERATION Z IS ALMOST CONDITIONED TO TAKE ON DEBT"

Generation Z are digital natives for whom e-commerce and specifically mobile purchases are an instinctive way of consuming, with a fluidity between social media and e-commerce: 'I see it. I like it. I want it. I buy it.' Companies like [post-purchase payment company] Klarna offer real flexibility, because it enables you to try before you buy. Under lockdown, when all the shops were shut, that was an absolute godsend for Generation Z, because it enabled them to buy several items at once and send back the unwanted items without actually having paid for them.

That whole rhythm – particularly in respect to fast fashion and online buying – is ingrained in Generation Z. But so too is a slightly dismissive attitude towards debt. They have grown up in a period of financial uncertainty, but they are also almost conditioned to take on debt because of the rising costs of higher education. Not just in the UK, but globally. There are real dangers to this: you have to really be on top of consumer debt as it accumulates, and as payment deadlines come in. These are still young people, who perhaps are not fully in control or have not been immersed in good financial practices. An investigation by *The Daily Telegraph* in the UK, for instance, found that 30,000 Klarna customers have already had their credit scores damaged because of missed payments.[1]

But perhaps it is hypocritical of us as an older generation to say that Generation Z do not know how to be responsible with money. Because that whole culture of 'buy now, pay later' or 'one-click' purchases is inherent in all of us now. There is no longer that social shame, as there was with my grandparents' generation, of living on the never-never.

And while Generation Z are, on the one hand, completely consumed by social media and the consumerist urge that is fuelled by the triangular relationship between e-commerce, fast fashion and social media,



90%

Increase in traffic since April to Depop, an app which enables you to buy and sell secondhand clothes

"A 17-year-old might have a private Instagram account, shared with the people in their private, condensed social group that they trust, and a public Instagram account to which they upload just one curated image."

they are also incredibly savvy. They are using apps like Depop, which enables you to buy and sell secondhand clothes and has seen a 90% increase in traffic since April.[2] In many ways, Generation Z are more entrepreneurial and resourceful than Millennials were at their age.

So there is this dichotomy within Generation Z between that Instagram fast-fashion world and the Depop, secondhand, resourceful and financially savvy world.

"GENERATION Z HAVE GROWN UP AT A TIME OF POLITICAL AND ECONOMIC CHAOS"

In many ways, Generation Z were the best prepared for lockdown of any generation. Firstly, because they spend an awful lot of time inside on their phones. Secondly, they have grown up at a time of political and economic chaos. Their youth has been shaped by the financial crisis, and the ripples emerging out of that: economic uncertainty, instability and chaos, and austerity in the case of the UK. Also populism and the rise of China, Brexit, Trump and Black Lives Matter. And climate change.

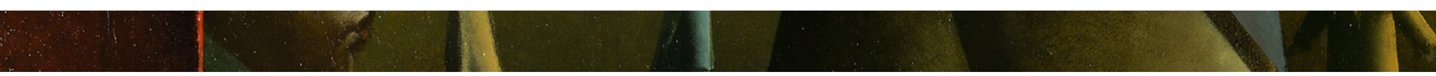
These are moments of political upheaval, and it feels like a real turning point. Generation Z are the first truly 21st-century generation. Whereas Millennials came of age during the longest consumer boom in history, and a period of relative political stability in the aftermath of the Cold War. And they have different, higher expectations as consumers and as workers. Generation Z in contrast are more pessimistic about their future but also much more resilient.

The average member of Generation Z has had a phone in their pocket since they were 13 and has lived their adolescence on social media. Because of this, they are much more aware of technology and have a sophisticated relationship with it. They are more conscious than any other generation of the downsides of technology and oversharing. They have a filter in a way that a Baby Boomer on Facebook just does not. A Baby Boomer will upload 30 poorly taken photos of their grandchildren on Facebook and wait expectantly for the likes. Whereas a 17-year-old might have a private Instagram account, shared with the people in their private, condensed social group that they trust, and a public Instagram account to which they upload just one curated image.

"THERE IS SOMETHING REALLY AUTHENTIC AND FRESH ABOUT GENERATION Z"

Generation Z are much more conscious of their mental health than Millennials were when they were young. Millennials grew up with fitness on TV and the growth of the gym – they were urged to focus on their physical health. Then that was exacerbated by social media and airbrushed images. Generation Z, in contrast, have TikTok, which is not about airbrushing; it is very authentic. It is about showing your real self, doing funny things or saying something important.

Tech means that Generation Z have been exposed to everything from a young age; the wonder and innocence of childhood has been taken away from this generation, and that is where their cynicism about institutions, economics and politicians comes from. They do not have that sense of wonder at the world, because they have been overexposed to its hypocrisy, double-



"Tech means that Generation Z have been exposed to everything from a young age; the wonder and innocence of childhood has been taken away from this generation, and that is where their cynicism about institutions, economics and politicians comes from."

speak and lack of change through technology and social media. Most 17-year-olds are cynical and also incredibly worldly – certainly more so than I was at their age.

The notion of us older generations needing to guide them through this time is patronising: they are instinctive hustlers. The more interesting thing is going to be watching them adapt to the new post-Covid normal – and adapt they will, more readily and quickly than the rest of us. That may mean they set up their own businesses because they cannot get a job. Or it may mean they miss out on university, because they do not think it is worth £9,000 a year if they are only going to get virtual lectures. Or it may mean they set up political movements, or join political campaigns, because they do not think that issues are being adequately addressed.

"GENERATION Z CAN SNIFF OUT A LACK OF AUTHENTICITY"

Where companies are in real danger is in trying to reflect Generation Z's values. 'Synthetic activism', as it is sometimes called, is an attempt to pay lip service to these political and social movements while not actually doing anything within their own organisations – specifically anything that costs them money or power.

You can put a Black Lives Matter logo on your website, or on social media, but what are you doing within your company to hire people from more ethnically diverse backgrounds? What are you doing within your company to ensure that those people are paid well, promoted and not taken advantage of? Gen Z can sniff out a lack of authenticity.

It is completely understandable that companies are engaging in corporate activism – Lego, for example, pausing promotion of police-related sets because of the Black Lives Matter movement,[3] or Ben and Jerry's questioning UK Home Secretary Priti Patel's immigration policies.[4] But there is a real danger that if it is lip-service activism it will be called out by consumers.

Dr Eliza Filby spoke at Walter Scott Lecture Series events in Australia and Canada in 2019.

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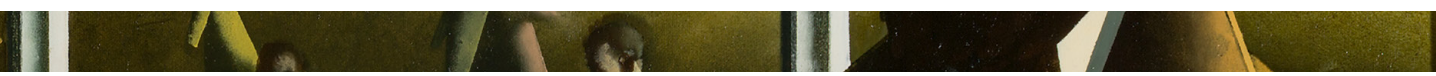
[1] https://www.telegraph.co.uk/money/consumer-affairs/buy-now-debt-later-lure-klarna-encourages-young-people-spend/

[2] https://www.theguardian.com/fashion/2020/may/25/shopping-habits-of-generation-z-could-spell-end-of-fast-fashion

[3] https://www.vulture.com/2020/06/lego-pulls-advertising-for-police-toys-donates-usd4-million.html

[4] https://www.campaignlive.co.uk/article/ben-jerrys-hits-priti-patel-migrant-crossings/1691665



MILLENNIALS MAKE THEMSELVES AT HOME

"COVID-19 HAS DOMESTICATED MILLENNIALS"

One thing that identifies Millennials as a generation is what was cheap when they came of age. What became cheap at the turn of the century? Travel, technology and eating out. Three things that Millennials love spending their money on. What became expensive as they came of age? Education, housing – both buying and renting – and childcare.

There are some who are fortunate enough to be able to rely on their parents – the 'bank of mum and dad' – for these things. So the real divide within Millennials is not between those who have a degree and those who do not, but those who can rely on their parents financially and those who cannot.

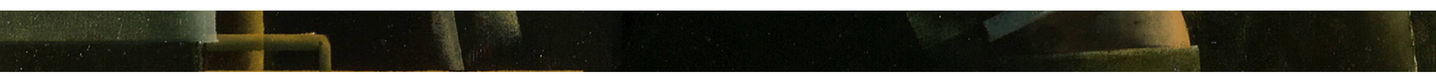
"The real divide within Millennials is not between those who have a degree and those who do not, but those who can rely on their parents financially and those who cannot."

Covid-19 has coincided with Millennials entering middle age. Despite the popular perception, Millennials are no longer young – the majority are in their 30s, and many have kids. You can already see how this is starting to trigger new consumer habits. Millennials are being forced due to Covid-19 to reprioritise the home, which is a trend that was happening anyway as they became parents.

Those two factors combined are triggering a growing-up in the Millennial buying mentality. They are starting to think about the home very differently. Unable to do the things that have traditionally been status symbols, such as travel and experiences, they are starting to look elsewhere – and almost relive the domesticated suburban process that their parents experienced in the 1980s. They are growing gardens, baking bread and having dinner parties.

One thing that is going to typify the Millennial generation as they move into their 40s is technology being increasingly associated with convenience and work. There is already a reaction against too much screen time for children, and as Millennials get deeper into parenthood there is going to be a real desire to keep children away from technology and really immerse them in other experiences – such as nature. You are already seeing that in the popularity of forest nurseries.

There will be a renaissance in DIY trends of the 1990s, and a growth of allotments and balcony gardens. But Millennials are also embracing DIY in a broader sense: not just home improvement, but also different hobbies, such as cooking and crafting. Brands should see a real opportunity here to help people do something that they want to do on their own, which feels like an achievement. By providing the resources, like the ready-to-prepare meal delivery company Hello Fresh does, for example.



LOCAL THINKING

"PEOPLE FEEL A SENSE OF LOCAL AND SOCIAL RESPONSIBILITY"

Covid-19 has created a renewed belief in the home as a haven but also a practical space for the whole family. All generations are thinking about the home very differently, and are therefore consuming in different ways.

Meanwhile a lot of people are talking about a flight from the city. In every pandemic throughout history there has been a movement away from the city, where diseases spread more easily – there is nothing new in that. Certainly, business districts will suffer as more people work from home, and young professionals might skip buying the one-bedroom flat and go straight for the three-bedroom house in suburbia.

As travel becomes a lesser part of our identity, for work or play, there is going to be a reappreciation of the local. That is already happening, but really investing in the local environment could take an interesting political edge and obviously a consumer edge.

More than half of customers globally have shopped locally since lockdown. If people are invested in the home, they also become invested in that area. You find out who your neighbours are – just look at the number of local WhatsApp groups that started up under lockdown, and the number of people doing shopping for fellow residents. And people feel duty-bound to help local businesses survive. People feel a sense of local and social responsibility – helping those in need on their street, shopping in smaller stores that offer greater safety but also more human connection. They perhaps did not feel this in the pre-pandemic age, where speed and convenience dominated. That is not going to go away.

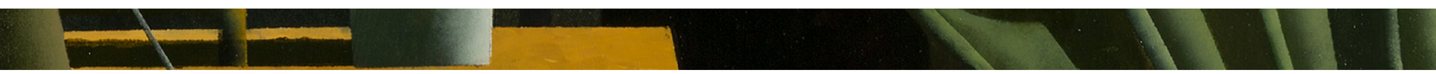
"THE ARRIVAL OF THE DELIVERY DRIVER HAS BECOME THE KEY EVENT OF THE DAY"

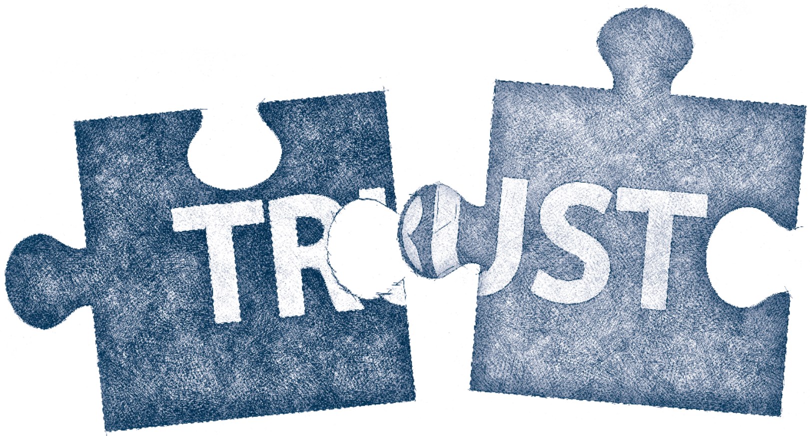
If people are working from home, they will start to need things less – office clothing, for example. If you are only going into the office two days a week, do you really need those clothes? And the future is in Zoom beauty: I know one woman who could not be bothered to groom her hair every day for video calls, so she purchased a wig!

During lockdown there was obviously an explosion in e-commerce, which the UK in particular was already well placed to do, because it has the most advanced e-commerce economy in Europe. People of all ages flocked to internet shopping. Under the current restrictions, with the joy sucked out of real-life shopping, the arrival of the delivery driver has become the key event of the day. Will that continue?

And the future is in Zoom beauty: I know one woman who could not be bothered to groom her hair every day for video calls, so she purchased a wig!

There are limitations to internet shopping. When you go into a shop, you pick it up, buy it and take it away. And online, when you click to buy it, you want it immediately. This is where Amazon, which is the best logistics company in the history of consumption, has such an advantage over every other company – not only because of the ease of the platform but because of the speed at which it can get to you. That is the key thing about e-commerce: it is not just the level of choice, it is how quickly can you get it to me?



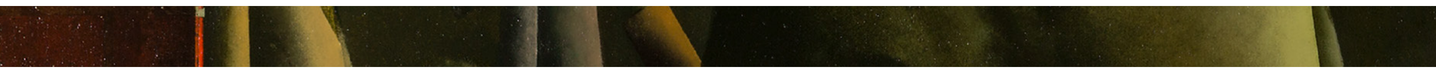


CONFLICTING ACCOUNTS

Accounting scandals such as Enron, Parmalat, Carillion, BHS and, more recently, Wirecard, have been widely blamed for eroding investors' confidence in the audit industry and damaging the public's trust in business. Auditors, rather than being seen as watchdogs, are often now perceived as part of the problem.

UK regulator the Financial Reporting Council (FRC) has been considering recommendations for audit market reform after a series of critical reports on the industry, and recently announced that the separation of the Big Four firms' audit divisions from other services must take place by 2024. A new regulator – the Audit, Reporting and Governance Authority – is in the offing.

But regulation is only one part of the picture. What should audit firms themselves be doing to repair their



reputations and the standing of audit as a profession? Some see the current calls for a reimagining of the role of the corporation as a way for audit firms to expand their role in non-financial reporting and corporate responsibility, while others argue they should concentrate on getting the basics right – holding to account the client's reporting on business performance and prospects, and fostering trust in markets.

Karthik Ramanna is Professor of Business and Public Policy at the University of Oxford's Blavatnik School of Government, and author of the recent PwC report *Building a Culture of Challenge in Audit Firms*. He talks to us about the systemic conflicts of interest in the audit industry, and how firms can work to regain their status and support the resilience of markets amid the current crises of capitalism and Covid-19.

There has been a long list of accounting scandals over the past few years. We now have Wirecard, which saw EY fail to identify a €1.9bn fraud despite signing off its accounts for a decade. Why did no one notice?

There were a number of clues along the way that things were amiss, including the fact that a substantial fraction of this company's cash reserves were being held in a bank in the Philippines that few people had really heard of. If it were being held in Citibank or HSBC, maybe you would say "Okay." But in a bank that's mostly unheard of? One should be somewhat sceptical. And the auditors were seemingly not sceptical enough.

On one hand you could argue the corporate governance food chain did work because the media and the activist investors played their role. But there are supposed to be many other checks and balances before those, including the auditors, which failed.

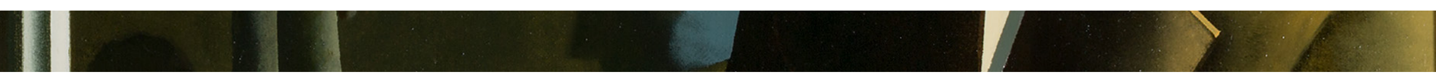
That's the first issue. And that speaks to the insufficiency of the culture of challenge in audit firms. But there's another issue in Wirecard, which is the seeming collusion of the German regulators. As far as we can tell, it was not an explicit collusion in that the regulators were paid off or supported Wirecard with mal-intent, but a sense among regulators that "this is one of the crown jewels of Germany, and we need to protect it".

You mentioned the need for "a culture of challenge". How does that work in practice?

I have had conversations with leaders in the audit profession, and I have asked for examples of juniors in their firms who had been whistleblowers – who had called out something that was dysfunctional within the firm or in its client relationships – and have since been promoted to partner. So far, no one has provided me with an example. Not one. So what does that say about the culture?

Contrast that with, say, financial journalism. Take the example of Bethany McLean from *Fortune* magazine, who is widely credited with uncovering the Enron fraud. When she did that, she was a relatively junior journalist calling out the demi-god Enron CFO Andy Fastow and saying, "Look, the numbers don't make sense."

The culture in financial journalism is a culture of challenge. That is much less the case in the audit firms. That's your problem. And changing culture is very hard.



How do you change culture?

It's art, not science. I can't give you a list of 10 boxes to check and say, "Now you've got the right culture." But for instance if the audit engagement team is having a conversation with the client financial team, and while the audit juniors are raising questions I see that the engagement partner and the client CFO are sharing a joke, I can tell you that's a terrible culture right there. Because every other audit junior there is thinking, "Oh, raising questions is not what I'm supposed to do." And word will get around.

Organisational culture is formed with those sort of subtle cues. As a manager, you have to be acutely aware of your presence, not just in an explicit sense, but also in an implicit sense. And when you promote someone to audit partner, you should be looking for those sorts of things.

You say in the report that client non-executive directors (NEDs) are well-placed to drive the demand for a culture of challenge among auditors.

NEDs are there precisely because we need a second set of eyes representing the limited partners or the non-controlling shareholders.

I have met with a number of NEDs of listed companies. And I have asked how many of them have met face to face with the audit engagement teams of the companies they served as director. Not the engagement partner and not the engagement manager, but people below that level: the juniors who do the field work. Zero.

Now, perhaps my sample of NEDs is not representative, but if I were an NED, and my reputation and legal liability depended on some 23-year-old doing their job, I'd want to see them in person, and I'd say, "Here's my email. If you think anything's out of the ordinary, know that you can email me directly." That seems like common sense.

If it's common sense and part of the corporate governance system, why isn't that happening?

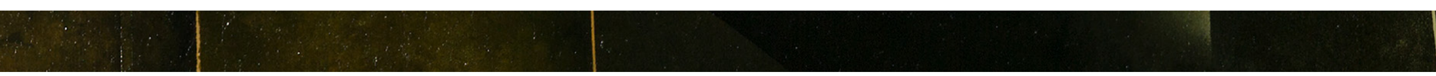
You look at the selection process for NEDs and it's mostly ex-CEOs and CFOs. They have, perhaps, too much empathy for people on the job. Now, the boards are getting more diverse, but still, there isn't as much of a culture of challenge.

I remember having a conversation with a group of NEDs, and one of them said, "Oh, whenever I join a board, for the first year, I never say a word." And this person said this with a sense of pride. Like, "I'm a team player." And I'm thinking, "Gosh, that means by the time you think it's right to open your mouth, you've already drunk the Kool-Aid."

The whole point of being a NED is to come in with a fresh pair of eyes. If anything, you have the most impact in that first year, when you're looking at things and scratching your head and saying, "Wait, why are you doing this?" I would rather have NEDs over-inquire than under-inquire – it's the same thing I would say to the 23-year-old audit junior.

What about the responsibility of the client to create the right culture around the audit relationship?

The whole purpose of auditing is because not all managers are going to be straight, all the time. So, we can't really say, "Oh, but what about the clients?" Of course, there are going to



be clients cooking the books – that's why the audit firms are in business.

I've met CFOs who have boasted about how they have appointed their auditors. Now, in theory, they shouldn't be involved in the process at all, but the idea that you would appoint the auditor without the CFO's consent is considered a vote of no confidence in the CFO in some boards. But that's absurd. The whole idea of the auditor is to have an independent vote of confidence in the CFO.

You have said that audit firms need to reclaim their position in society. How can they do this?

If it had been the audit firms that had called out Wirecard, it would have done the profession enormous good. If the audit firms had been calling for companies to be more prepared for a pandemic, to have more resilient balance sheets, we'd have been very impressed with them today. The fact is, they didn't.

And you could say, "Nobody could've predicted Covid." But we had Ebola in 2014 and Zika in 2016. So it's not that we haven't had warnings. Part of what an audit firm could do is say, "Look, something like this can happen. How can you prepare for it? Where are the reserves for it?"

It's not just pandemics; it could be a trade war, or a massive cyber-attack that shuts down the supply chain or infrastructure in a key market. Where's the resilience in the financial statements to allow you to weather that kind of threat?

Those are the kinds of questions that we'd love for auditors to be asking. Quite frankly, if all the clients of one audit firm were systematically or structurally better prepared for big shocks than the clients of the others, that audit firm would be enjoying all kinds of fruits from that right now.

You say in the report "If we do not save auditing, we cannot save capitalism". Is it really that serious?

According to a recent Harvard survey, among Americans aged 18 to 29 more favour socialism than favour capitalism. I think that's actually really dangerous. There's an existential threat here to free-market society, and to reverse that free markets need to be seen as working for the great majority of people. Today, rightly or wrongly, many people see capitalism as an inside job that makes the rich even richer.

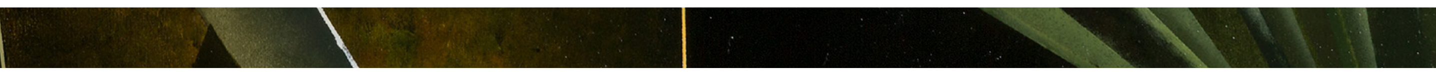
Auditors can play a big role here, in calling out expropriation and fraud, and getting capitalism to work like it should.

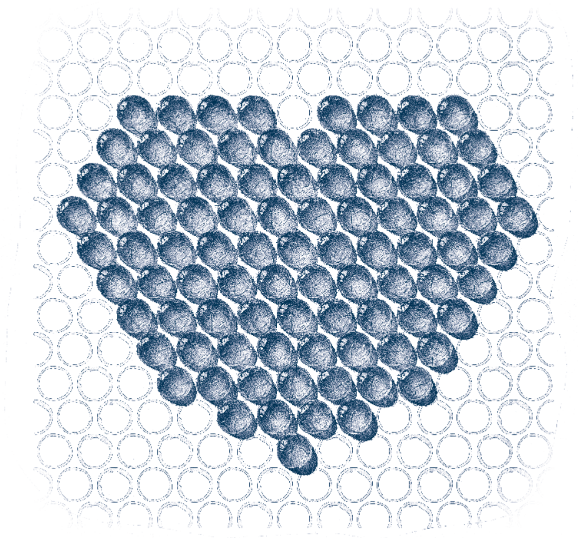
Should audit firms focus on traditional audit responsibilities?

There's a lot of talk these days about the audit firms doing something in the CSR space. My view is: focus on your core competence. That's what you really know how to do. Traditional audit firms don't have a comparative advantage in environmental audits – they will be learning as they're doing it – and that's fine, but quite frankly, AI might be much better doing that than traditional financial auditors.

There's unsatisfied demand for traditional financial audits. People are angry with the audit firms because they don't call out managers who cook the books. So, go after the guys who are cooking the books and people will be less angry with you. Your job as an auditor is to challenge. Just do that, and do it really well.

"Among Americans aged 18 to 29 more favour socialism than favour capitalism. I think that's actually really dangerous. There's an existential threat here to free-market society, and, to reverse that, free markets need to be seen as working for the great majority of people."





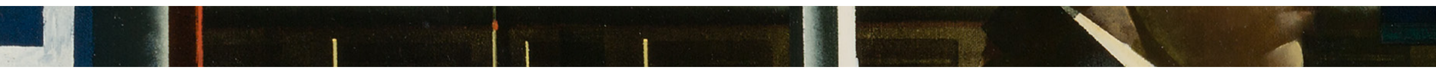
THE NEW E IN ESG

The way companies approach employee wellbeing is a critical test of their culture. Can they come through the current crisis with a strong and more meaningful workplace culture – or will Covid-19 expose it as an empty gesture?

'Our people are our greatest asset.' Never has a corporate cliché been so tested. When revenues dried up, shops closed and demand stalled during the coronavirus crisis, just how much of an asset were those people?

The response from businesses to the economic shock of Covid-19 was a test not only of their financial durability, but also of their values and culture. Analysis of saints and sinners – their corporate policies, practices and benefits – has been forensic, and includes the work of Just Capital, whose Covid-19 Corporate Response Tracker assesses the response of America's largest employers.[1]

The spotlight has been kinder on some than others. IBM, for instance, was praised for its Work from Home pledge, penned by CEO Arvind Krishna, which promised to help colleagues adjust to



the new situation.[2] Slack CEO Stewart Butterfield, meanwhile, said in an internal memo to staff: “Take care of yourselves, take care of your families, be a good partner. It is fine to work irregular or reduced hours. It is fine to take time out when you need it.”[3]

Google and Microsoft were among many companies that have been alert to the particular pressures on working parents, offering additional paid leave for parents who had to work without access to their usual childcare arrangements and while home-schooling.[4] And Google, like many others, also offered additional payments to staff to alleviate any financial burden associated with working from home, recognising that financial pressures on top of other factors might impact mental health.[5] Much closer to the virus frontline, NHS staff were given free access to a range of wellbeing apps until the end of 2020 to support their mental health.[6]

“There’s no doubt that there are good actors and less good actors that have been exposed by the pandemic,” says Alan Edington, Co-Head of Research at Walter Scott. “It’s that ‘tide goes out’

“It’s that ‘tide goes out’ moment: who has got really robust models that mean that even through this really difficult time they are doing the right thing?”

Alan Edington

REMOTE WORKING AND PRODUCTIVITY

“Without an office, without a body of people beavering away at the same place and time, it is hard to know how a company could ever create any sort of culture or any fellow feeling – let alone anything resembling loyalty,” wrote Lucy Kellaway in the *Financial Times* recently.[7]

Many companies are grappling with this potential loss, as they either operate fully from home or manage hybrid models. There are competing voices on how remote working affects productivity. A much-cited randomised experiment by CTrip, China’s largest travel agency, measured the productivity of employees working at home compared with those working in one of its call centres. It found that the home-working group increased its productivity by 13% over the trial’s nine-month lifetime, “with no measurable difference in the quality of calls”.[8]

However, it also found that rates of promotion for home workers were almost 50% lower – “possibly because they were not visible to office-based managers”.

Nevertheless, experts on the topic, including Nicholas Bloom, a senior fellow at the Stanford Institute for Economic Policy Research (SIEPR), who analysed the CTrip experiment, fear a “productivity disaster for firms” and “a slump in innovation”.[9]

“There is something wrong in the way that capitalism works today for those at home versus those in an office,” says Edington. “If we are going to pursue a new model, what do we need to change to ensure that everyone has equal opportunity, that we’re rewarding the right people in the right way? How do you make sure that creativity and innovation are not lost?

Edington says that businesses have to address these questions now. “You can’t wait three years and find out that your creativity’s gone,” he says. “You’ve got to find out what drives creativity in your business today and make sure that however it’s fostered, it can be fostered in a virtual environment.”

"Everyone will have their own take, but if the response from the CEO, management team and office floor is broadly similar, and delivered with enthusiasm, you can see that it will pervade the culture."

moment: who has got really robust models that mean that even through this really difficult time they are doing the right thing? As with green-washing, there is danger that rhetoric does not equate with action when it comes to employee wellbeing."

That gap can often be great. A company that promises to look after its employee wellbeing one moment talks about cost-cutting and automation in the next. "A company may say, 'We've got an extensive wellbeing programme for our employees with access, through our outsourced provider, to all sorts of support', says Edington. "That might be meaningful, and it might not." It may even be a way to distract from other serious workforce issues.

The pandemic is a real test for the stakeholder capitalism model, and how well companies define the 'Social' in ESG – in particular, how they treat their staff and protect their physical and mental wellbeing. Recent research suggests that investors are also watching carefully, and a significant majority say that it is important that their money is invested in companies that care about employee wellbeing.[10]

UNDER PRESSURE

Such scrutiny comes at a time of heightened anxiety among workers. A survey of 500 employees in the UK conducted at the start of the pandemic[11] revealed that a fifth had increased their alcohol consumption, a third were eating a less healthy diet, and over half were exercising less. The majority reported losing sleep because of worry. A survey of more than 2,000 employees in Australia, France, Germany, New Zealand, Singapore, the UK and the US, meanwhile, found that 44% of those who were now working from home said their mental health had declined.[12]

These findings come less than 12 months after the World Health Organization recognised burn-out as an official workplace phenomenon.[13] And according to a report from the UK Health and Safety Executive, stress, depression or anxiety were the cause of 44% of cases of work-related ill health and 57% of working days lost due to ill health in 2017/18.[14] In August this year, more than 30 businesses signed a pledge to prioritise mental health as employees returned to work.[15]

What can businesses do to spot the warning signs of employee burn-out and anxiety? How can management teams, and the investors who place their trust in them, sense a problem with employee wellbeing?

"One of the questions we ask of a company is: is it run just a bit too hot?" says Edington. "When you see margins marching up year over year, when you see a company's operating profit per employee march upwards year over year, you start to ask the question: Is this actually a good thing across stakeholder groups? Are proper procedures being compromised? What does the culture look like?"

EARLY-WARNING SYSTEM

Businesses can look at KPIs, of course, such as the rate of employee attrition, or how a company is addressing staff turnover. But one of the best ways to get a sense of the culture is to experience the company at every level. "It's one of the great reasons to walk a factory floor or go to a company's store," says Edington. "Is what we're hearing from the management team filtering down throughout the organisation?"

Often a good litmus test of a coherent culture is the use of language within the organisation. If you ask a range of employees what the company does and what it stands for, you should be able to see signals of a set of shared beliefs. "Everyone will have their own take, but if the response from the CEO, management team and office floor is broadly similar, and delivered with enthusiasm, you can see that it will pervade the culture," says Edington. "You can use it as a proxy."

Some say that it is the ability of employees to have their ideas heard that can help create this shared sense of purpose. "Devolving decision-making to the front line and increasing localisation forced leaders [during the pandemic] to trust their people to know what to do," say Cath Bishop and Margaret Heffernan in the

Financial Times.[16] "They haven't been disappointed. Where sharing responsibility might have felt a risk, now it's an obvious asset."

This is why it is impossible to separate culture from the financials of a business. "We take a holistic view of a company and if it has a questionable culture, then that feeds into the perspective on how we think about it," says Edington. "The reason we're asking these questions is long-term sustainability: is the business building a workforce that will allow it to be successful in the future? And that comes down to how you treat them.

"Keeping employees healthy and happy and productive just makes business sense."

[1] https://justcapital.com/reports/the-covid-19-corporate-response-tracker-how-americas-largest-employers-are-treating-stakeholders-amid-the-coronavirus-crisis/

[2] https://www.linkedin.com/pulse/i-pledge-support-my-fellow-ibmers-working-from-home-during-krishna/

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[5] https://www.cnbc.com/2020/05/26/google-will-give-employees-up-to-1000-to-buy-work-from-home-gear.html

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[7] https://www.ft.com/content/6a84c3a0-9440-11ea-abcd-371e24b679ed

[8] https://www.nber.org/digest/sep13/w18871.html

[9] https://news.stanford.edu/2020/03/30/productivity-pitfalls-working-home-age-covid-19/

[10] https://www.lcp.uk.com/media-centre/2020/02/lcpyougov-employee-wellbeing-tops-list-of-esg-concerns/

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[12] https://www.qualtrics.com/blog/confronting-mental-health/

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[15] https://www.thetimes.co.uk/edition/business/mental-health-is-a-priority-lfd27dr3b

[16] https://www.ft.com/content/84d92de1-3eff-4178-b070-cd9eb013dba3

AN EYE FOR RESPONSIBLE BUSINESS

Fielmann is a German eyewear company and Europe's largest optician. It closed all of its stores as Covid-19 cases increased across the country.

Alan Edington praises its long-term approach to the crisis."They were very clear," he says. "No one's going to lose their job, because at some point our stores are going to be open again, and we're going to need our employees."

Those employees who were at home on shorter working hours received employee association support. This was topped up by Fielmann to make sure that everyone received the equivalent of 100% of their salary.

"I think this is exactly the right approach to the use of a government subsidy," says Edington. "Ultimately it will create lots of positive responses from your employees, and that will drive shareholder value over time. "Some other companies are talking about paying back some of their employees' short-time working payments because they've come through this better than they anticipated," he adds. "Is it the right thing to do for a shareholder strictly speaking in the short term? Perhaps not. Longer term, it's absolutely the right thing to do. These companies recognise that they don't operate in a vacuum."

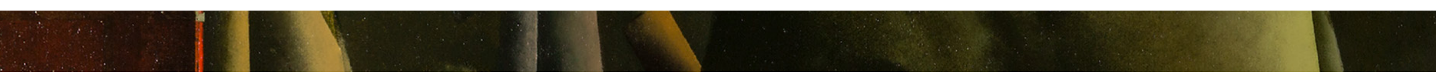
THE END OF OWNERSHIP?

Subscription services were on the rise before Covid-19 plunged economies into crisis; now, they are booming. What is driving this growth and what makes a successful subscription model?

When the dust settles on the Covid-19 crisis, subscription services will emerge as one of the big winners of the pandemic. Four in five subscriptions companies, spanning multiple sectors, have continued to grow despite the devastating economic impact of Covid-19.[1]

That makes perfect sense, says Michael Mansard, Principal Director – Subscription Strategy at subscriptions platform Zuora. In times of uncertainty, companies and customers want freedom to alter their plans. "Covid-19 has changed people's perceptions," he says. "Many are facing cash constraints and feel less able to commit to investment; they value flexibility – they may be willing to pay in order to be able to stop at any time."

That said, this is another area – like the move to remote working and the rise of ecommerce – where Covid-19 is accelerating an existing trend rather than changing the dynamics of the market. Data published by Royal Mail last year suggested that the UK subscriptions market alone would



double in size between 2017 and 2022, with more than a quarter of consumers already signed up to a least one service.[2]

THE LOCKDOWN LIFELINE

Then 2020 arrived, and people in many countries found themselves in lockdown, stuck at home and with stores closed. Suddenly, subscription services became a lifeline, and more and more people sought out regular deliveries of everything from toys and beauty products to coffee and wine. At least 57% of people in the UK now have a subscription – up by about 10% on last year.[3] Disney+ was another beneficiary of life in lockdown. Disney launched the service in November 2019; in August 2020 the company announced that the service had more than 60.5 million subscribers globally, "far exceeding our initial projections".[4]

Retail is now moving increasingly towards the subscription model, but entertainment and other services have been there for years. Many of us now receive regular deliveries to our doorstep, but we have long been welcoming other products – films, TV, music – into our homes on a subscription basis.

So what was driving this shift before Covid-19 came along? Above all, consumers – and particularly the younger generations – now appear to prize access to assets over owning physical possessions. These trends are well documented as income is increasingly directed towards experiences rather than assets. Many commentators have talked about 'peak stuff'. With urbanisation has come space constraints, further underpinning the trend. Traditional, and often restrictive, rental agreements are being spurned in favour of subscriptions, with the number and range of subscriptions becoming a growing part of an individual's monthly outgoings.

Technological advances are another factor. Broadband makes it possible to build digital services at scale, and for businesses it brings the opportunity to study customer behaviour in real time, adjust products and services accordingly, and develop new revenue streams.

BUSINESS BENEFITS

Every industry is now recognising the potential opportunities. Automotive, for example, where Volvo expects as much as 20% of car sales to be accounted for by its subscriptions service by 2022.[5] In IT services, for companies including Cerner and ADP, recurring income represents approximately 90% of total revenues. Adobe is another example of a company that has successfully pivoted to a subscription model over the past decade, with subscription income now 90% of revenues. Medical product and device companies have also adopted subscription models, providing both products and services, smoothing out what might once have been lumpy revenue streams. Recurring revenue streams for companies including Intuitive Surgical, Coloplast and Illumina now represent between 70% and 80% of total revenues. And in financial services, challenger brands are spearheading this model.[6]

Rolls-Royce has known the benefits of the model for much longer than most. It developed the concept of 'servitization' – fully maintained engines sold on a power-by-the-hour basis rather than by the unit – in the 1960s.[7] Now, modern data analytics tools are making that kind of model

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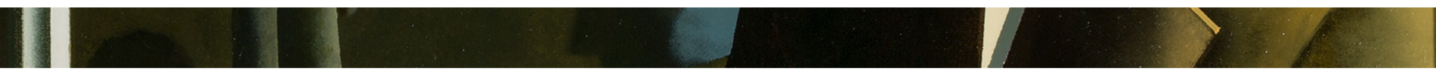

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even more appealing. In addition to supplying equipment, parts and upkeep, business-to-business firms like Rolls-Royce can monitor how customers use the products using internet of things (IoT) technology. This puts them in a position to advise customers how to use their products more efficiently, and even build new products and services for their own customers.

According to Mansard, we have reached a tipping point. "We are seeing the end of ownership," he says. "There is a global preference from both consumers and businesses for innovative recurring services – what is happening in the household is also happening in companies."

Many businesses will welcome this shift. It reduces their dependence on the uncertainties of customer churn, whereby they have no way of knowing whether a customer will buy again, and moves them to a position where customer retention is the default mode.

This is particularly valuable now, when the basic product in most industries is increasingly commoditised and pricing is transparent. With margins pared to the bone, businesses were finding themselves in a race to the bottom; a subscription service gives them one way out – a chance to build relationships with customers and prove their value beyond price. And as they do this, their revenues become more regular and predictable.

"There's no one object with subscription – it can take many shapes and forms," says Mansard. "The common trait is the focus on building customer relationships. In some cases, subscription will also complement the core business, adding an additional revenue stream or fostering sales of the core products. In others, the subscription itself might become the core revenue stream."

GET IT RIGHT

For those businesses that have not yet taken steps towards a subscription model, the pandemic could represent a catalyst. "Covid-19 is making it more important to start to investigate subscriptions," says Mansard. "The question is no longer should they – it is how do they start to at least tip-toe into that area. Because many customers will be asking for more flexible consumption models."

And those customers are the starting point. "Ask them," Mansard says. "Instead of telling them what they need, try to understand what they want to achieve – and with subscription you're interacting with customers every day."

To do this, businesses will have to invest in digital capabilities that allow them to develop more customer-centric ways of working. Many have already started that process – often in search of transformational benefits they have not yet realised.

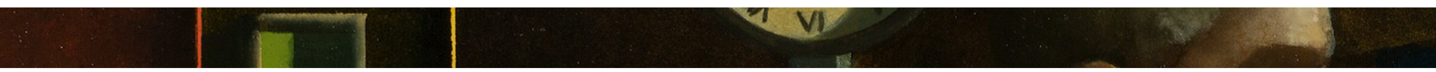
Mansard says that the most obvious product segments to target are the ones where commoditisation and competition are advancing most rapidly. It is here where businesses desperately need to stand out, and business model innovations such as transitioning to subscription-based products and services can give them the opportunity to set themselves apart.

LEARNING FROM EXPERIENCE

One attraction of the subscription model is that it gives businesses room

"We are seeing the end of ownership. There is a global preference from both consumers and businesses for innovative recurring services."

Michael Mansard, Zuora



to manoeuvre – to pivot and tweak in an iterative process that responds to customer feedback.

Another important point about online subscription models is that every new initiative, whether or not it proves successful and sustainable, generates fresh data that gives businesses insights. In media, publishers have experimented with a series of models that have thrown up the data they have needed to work out the best way to proceed and profit.[8]

THE NEXT FRONTIER

This is not the only way subscription services can be transformative, says Mansard. He says they can be crucial to competing in marketplaces where the traditional boundaries between industries are blurring. “Subscriptions are about capturing the experience, rather than capturing the market,” he says. “And in capturing the experience, there is a strong chance that businesses will be able to do more than what we expect them to do – to launch services that take them beyond their core business.”

After all, Amazon Prime now encompasses services that are some way outside the retail realm where it began: it now offers, for instance, cloud storage and video on demand. Instead of sticking rigidly to a specific vertical – retail – Amazon has focused on the experience of customers paying its Prime subscription fees.

There will be no shortage of opportunities to emulate that kind of success story, particularly through collaboration. Netflix, Spotify and YouTube, for example, are all embracing partnerships with telecommunications networks in order to build out their customer experience.[9]

Mansard sees parallel opportunities in areas such as financial services – for banks, say, to offer a one-stop-shop for small businesses looking for everything from current accounts to accounting support and access to finance.

That means we could now see a race to become the aggregator of such services – to become the subscription service of choice. As subscriptions increase, and more and more industries enter the market, potential subscribers could reach a point where they do not want to manage additional subscriptions. Though market saturation in areas such as consumer packaged goods appears to be some way off, the success of Amazon Prime’s diversification shows the appeal of ‘one-click ordering’.

Each business will face its own challenges. But the imperative to act started well before – and goes well beyond – the Covid-19 crisis. The pandemic is accelerating the trend towards subscription services, but it would be misguided to assume that when the pandemic passes things will return to how they used to be. “What we have seen from previous crises is that they lead to changes in behaviour,” says Mansard. “Some may go back to their old ways of behaving, but this is a longer trend.”

If the end of ownership really is upon us, time is running out for conventional business models. From Amazon Prime to car-sharing clubs before the pandemic, to coffee clubs and wine deliveries in lockdown, the current boom in subscriptions may only be the beginning.

“Subscriptions are about capturing the experience, rather than capturing the market.”
Michael Mansard

[1] https://www.zuora.com/press-release/subscription-businesses-remain-resilient-amid-covid-19/

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[8] https://reutersinstitute.politics.ox.ac.uk/sites/default/files/2020-02/Eduardo_Suarez_Digital_subscriptions_fellowship_paper.pdf

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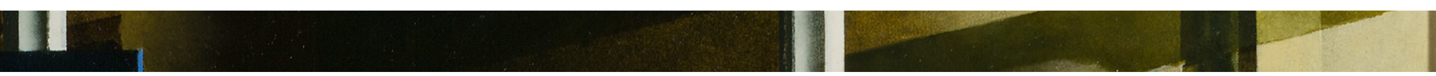


HOW TO LAUNCH A SUBSCRIPTION SERVICE

Starting a subscription service is not easy – particularly for businesses that have legacy businesses with their own structures and conventions.

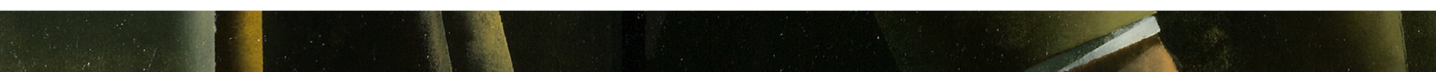
Michael Mansard says there are five stages of establishing a subscription model: “In the first stage, you prove the model – prove that there is customer appetite,” he says. “The second is about customer acquisition, launch, and expanding the footprint. In the fourth, you retain and expand the customer base. And in the fifth, you’re building for scale and achieving operational excellence.”

Measuring the success or otherwise of the new venture in traditional ways does not make much sense. Instead, businesses need relevant key performance indicators that look at measures such as customer retention rates as well as revenues. “The new entity should be managed and judged more like a series A start-up than a scaled-up business,” says Mansard. “It’s a brand new business.”

There might be tensions between the legacy operation and the subscription model, so management teams have to communicate the strategy.

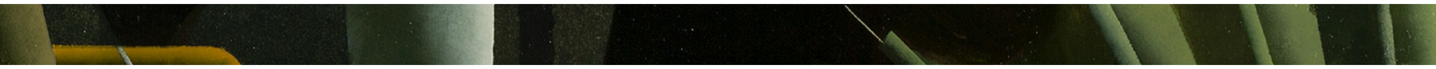
“There has to be a clear articulation of value: why the business is doing this on the side, and why it complements the core,” says Mansard. “That has to include why people in the existing business, which might be generating 90% of total revenues, are as important as ever.”

If the business gets it right, there will eventually come a time when the subscriptions business has the resilience and value to be integrated into the whole.



DIVERSITY IN ADVERSITY

Are conglomerates better positioned than other businesses to withstand the impact of the Covid-19 pandemic? Walter Scott Director Roy Leckie and Co-Head of Research Alex Torrens discuss diversification, corporate structure and whether the conglomerate is a thing of the past.



In times of crisis, are conglomerates more resilient than companies with more streamlined corporate structures?

Alex Torrens: Corporate structure might be helpful but there are plenty of other things that give a company resiliency that are unrelated – a conservative capital structure to name just one. That is where the real winners have been in this crisis so far. If you look at the performance of stocks depending on their credit rating, you see the AAA companies came down less and have bounced back quickly in contrast to BB-rated companies, for example. That shows that capital structure has been important for resilience. Another way to increase resilience is with a recurring revenue business model; whether the business is a conglomerate or not, a subscription service will make it stronger.

Roy Leckie: In share price terms it's quick and easy to see which companies are being judged by the market to be doing well. But I think we are going to need two, three or four quarters' worth of financial results to really assess which companies have true resilience. We will need more time and data to see which companies, business models and corporate structures actually prove to be resilient.

Understandably, management teams across a range of sectors are talking about resilience much more than they might have done in the past. Corporate leaders, who often focused on 'just in time' processes, now refer more to 'just in case' planning. Part of that is because management teams now recognise a need to diversify supply chains, or expand manufacturing footprints that might previously have been deliberately, and very efficiently, positioned.

From an investment perspective, have you changed the way you think about conglomerates?

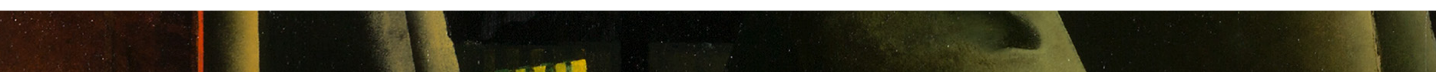
AT: My definition of a conglomerate is a group that owns different businesses and business lines with potentially no operational synergies between them. Some conglomerates we invest in have been incredibly successful. It's been great at various points for those businesses to have diversification but the question we need to ask is: could we have done better by instead owning more focused businesses and creating that diversification ourselves in the portfolio? Perhaps.

RL: If you look back over 25 years, we typically invest in significantly above-average-growth companies with certain profitability and balance sheet characteristics. When you think about the typical conglomerate, it wouldn't necessarily align to our approach. That said, where we have occasionally considered some conglomerates favourably is in emerging markets. These widely diversified structures can be a very good way to access a range of different growth dynamics across difficult-to-access markets.

There is a Hong Kong-based conglomerate that is a good example. Its revenues and returns are driven by a number of non-covariant factors. I've heard the senior management of the company say that every once in a while, management consultants come along and tell them that they have to 'focus on core competencies', and reduce diversification by disposing of assets. As they pitch their advice, the company's management team march them out of the room saying that the

In share price terms it's quick and easy to see which companies are being judged by the market to be doing well. But I think we are going to need two, three or four quarters' worth of financial results to really assess which companies have true resilience.

Roy Leckie



firm has successfully existed as a diversified conglomerate since 1832! They remind the consultants that the company's objectives, focus and culture have always centred on the medium to long term, and that remains very deliberately unchanged. This is a pan-Asian investor with a broad exposure to a range of the fastest-growing vectors of the global economy today, and with almost 200 years of capital allocation expertise.

What would be the investment case for a conglomerate?

AT: There are three reasons that you might cite. First, as we have discussed, there is the sector and geographical diversification within a single security, or share. Second, there can be access to investment in private companies. And third, the management team might be brilliant capital allocators. That third factor is very difficult to judge. It would be hard to draw reliable forward-looking conclusions on a management team's ability to allocate capital across a diverse range of opportunities, over time and repeatedly.

"When you think about a typical conglomerate, it wouldn't necessarily align to our approach."
Roy Leckie

RL: There is another reason. If the market is valuing the conglomerate at a significant discount to a sum-of-the-parts calculation. You might hope that over time that the under-pricing of the constituent parts will be realised and the stock re-rated, upwards. Conglomerates also have defensive characteristics. Johnson & Johnson is a good example of this. While it might not be classed as a typical conglomerate, its diversification can add a degree of stability in challenging market conditions.

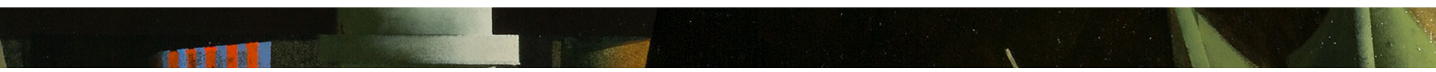
My view is that there will always be a place for conglomerates. I suspect many companies that we consider to be very focused do allocate some R&D dollars to investing in things that are non-core, and every once in a while something will work and management then have something new and exciting to talk about. I think at any point in time there is probably more diversification than management will routinely discuss with investors.

If the current trend towards greater focus continues, will conglomerates cease to exist over time? Or will the conglomerate structure endure as it has done for so long, and new conglomerates emerge?

AT: Many fast-moving consumer goods companies have been trying to focus more. We see it with companies such as Nestlé and Unilever. We have also seen it with some pharma companies moving in and out of consumer health. Interestingly, I think Covid-19 has probably reversed some of those plans, as companies have seen the benefits of areas of the business that might have been considered dull but that are stable, cash generative and perhaps less economically sensitive.

That might reduce the pressure on companies to divest of assets. It may also temper alarm at the mere suggestion of a broadening of a company's operations. When Starbucks removed the word 'coffee' from its logo, market commentators got particularly exercised, worried that the company was no longer a coffee company which, of course, was not the case. That was an instance where you needed to look at the materiality and substance of what was going on rather than the marketing.

RL: I think we generally view too much diversification with a degree of scepticism. If we're invested in the



business and management tell us that they're going to either acquire or invest in a business line that is really quite distinct from where current returns are generated, we will certainly question that move. But that doesn't mean we would ever rule out investing in a conglomerate due to a blanket exclusion. Successful investing requires an open mind, at all times!

And, yes, I do think new conglomerates will emerge that might go on to rack up the history of a company like Jardine Matheson, Samsung or Hutchison Whampoa. Alphabet is sometimes referred to as a technology conglomerate. I understand why that label might fit and don't see it as a bad thing in and of itself. That being said, 90% of revenues and 100% of profits still come from one line.

AT: When I think about why we own certain businesses that might be categorised as conglomerates – it is because they own the very best assets in their respective sub-sets or markets. The breadth of these businesses can dilute returns. It can also dilute growth at any one point in time. It can make these businesses less focused. But within their mix they have assets that have more potential to generate future cash flows than anything else out there and compared with any of their more focused peers.

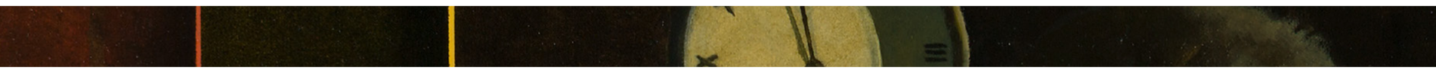
RL: Several of the big technology companies, such as Alphabet and Amazon, have clearly diversified their interests over time, if not yet their profits. But they retain what Warren Buffett likes to describe as a very clear and obvious operating moat. We concur with that. Chemicals and electronics company Shin-Etsu Chemical has an operating moat in more than one area: in the production of PVC, particularly in the US, as well as the production of semiconductor wafers. It's a great example of a conglomerate, and it does show world leadership in more than one of its business segments. That is unlike many other conglomerates, which might have global leadership in one area but not multiple.

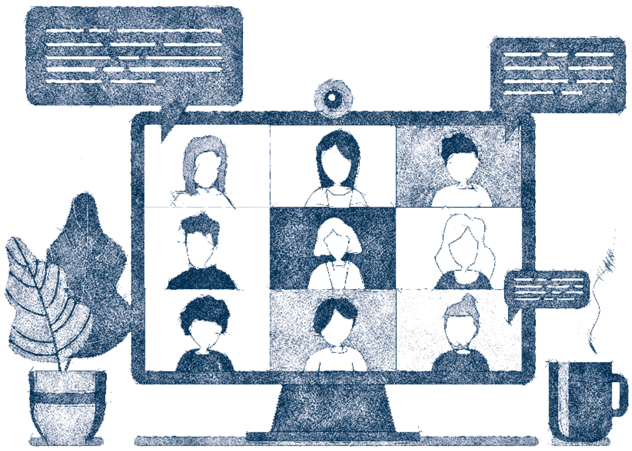
So has the death of conglomerates has been exaggerated?

RL: I think in the US and Europe, the conglomerate structure will come in and out of fashion. And activist shareholders will influence that, as will investment bankers and academics. If we get a little bit more harmony of taxation structures around the world, that could have a big impact on corporate structure. I think that for a lot of the big complex corporate models today, the motivation is playing tax arbitrage – especially as we enter a period when people are increasingly asking who is going to pick up the tab for all the Covid-19-related public expenditures. I think corporate taxation is rightly going to come under the spotlight, at the same time as people are questioning the traditional capitalist shareholder model.

AT: I think it's very unlikely that a portfolio will ever consist of 50 mono-line businesses. I think we will always own companies that generate revenues and profits from more than one economic source. Over the next 10 years, can I imagine that the businesses we find that meet all our criteria are more focused? Yes. Will that put pressure on the conglomerates held in the portfolio? Yes. But I wouldn't count them out.

"When I think about why we own certain businesses that might be categorised as conglomerates – it is because they own the very best assets in their respective sub-sets or markets."
Alex Torrens





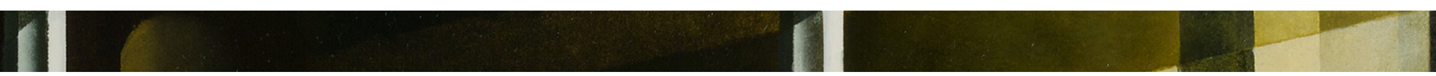
OF CULTURE AND CULTIVATION

Workplace culture. You cannot see, hear or touch it, but it is ever-present, informing how we approach our relationship with work: Do I reply now or later? What would the boss do? Should I collaborate or compete? It shifts when a leader fails to model a company's values, evolves when an organisation grows, and strengthens or weakens in challenging times.

Observer of workplace dynamics and business coach Ellie Hearne explores what corporate culture means and why it matters.

High-performing companies invest in their cultures. They facilitate retreats, clearly define and model their values, and perhaps even design their offices to support cultural traits like collegiality. Apple's circular glass headquarters, for instance, were built to encourage impromptu meetings and innovation (with mixed results – the new building also caused an injury or two before employees got used to the transparent walls).

Why such a focus on culture? And what does it look like when workers have to stay away from the traditional workplace, glass-walled or otherwise?



THE CULTURE SHIFT

Workplace culture was first studied in the mid-90s and was seen as novel and optional at that time – companies had it, or they did not. Now, the field has evolved to recognise that culture is more like an accent: everyone has one, even if we no longer hear or think about our own. Anecdotally, in the past 10 years my clients have gone from asking for one-off interventions such as coaching or training, to first asking about how to address specific cultural dynamics like accountability and empowerment.

Since the mid-1990s,[1] we have seen societal shifts, more generations represented in the workforce, and greater recognition of the 'human side' of work. Younger workers have demanded more flexibility, and technology has helped deliver it. In just the past three years, we have seen companies respond to the spotlight #MeToo shone on sexual harassment, and in the past six months alone we have seen brands and businesses rush to follow through on diversity and inclusion promises. We will have to file those last two under 'overdue progress'.

EATING STRATEGY FOR BREAKFAST

Though culture is all too often an afterthought, successful companies recognise its power. Culture, they say, eats strategy for breakfast. Just look at Away – the luggage company whose marketing touted self-care and relaxation as vital values, but whose leaders drove their people to burnout.[2] Even that company's lauded business strategy could not counteract a problematic culture.

Strategy and culture must work together. No company is perfect, and each employee has their own unique experience of its culture, but we see broad successes at companies like Zappos, the online shoe retailer. Famously, its founder had no interest in footwear, but that mattered little: he built a successful business by prioritising standout customer service and offering the workforce an entirely flat, collegial culture. The guiding goal, internally and externally, is to make people happy, and good business results have followed.[3]

The flipside of this is companies whose cultures propel weak strategies – or whose robust business plans are hobbled by cultures that lower morale or harbour inefficiency.

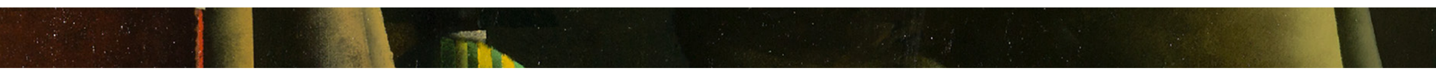
Addressing cultural issues can be tricky. While industry, financial success and business goals inform both strategy and culture, the latter is more often shaped by intangibles – the norms, values, behaviours and beliefs that define what it is like to work in a particular organisation.

LIVE THE VALUES

In practice, every company-values poster that celebrates work-life balance will be rendered meaningless by a leader who responds to emails late at night or who does not take parental leave. Similarly, every company that claims to embrace diversity is undermined when its biases go unchecked. These actions and inactions send silent but deafening signals about the company's expectations of its people.

In the early days of the pandemic, I was analysing the culture of a financial-services company. Its stated values included 'work-life balance', but a few employees mentioned a leader who said, "You should work from home if you would feel more comfortable" –

"Culture is more like an accent: everyone has one, even if we no longer hear or think about our own."



but then continued to go into the office himself. No one in his organisation worked from home until he ultimately did so first.

Defining values is of course an important step, but it is just that: a single step. To be meaningful, values must be lived or actively worked towards. Rather than merely listing them on websites and posters, companies must also ensure that they are talked about, modelled, questioned and evolved – throughout the organisation. Without action to bolster them, a list of values serves only to lower morale.

Suddenly, creating a winning business strategy seems like the easy part.

CULTURE SHOCK

Culture has been described as what people do when no one is looking, so what of culture in the era of widespread remote work? How does this invisible part of work support or sabotage organisations and people? How can we all get the most from it?

Company culture is both more distant and more immediate when we are away from the office. We are routinely bringing our companies into our homes out of necessity. Business often feels personal, but never more so than when our commute takes us right back into our bedroom or our pets gate-crash our performance review.

Beyond blurring the line between work and life, this rise of home-working has also removed those impromptu interactions that fuel culture – chance meetings in the lift or office kitchen, side conversations after tense meetings, and extracurricular activities designed to improve connection, trust and loyalty.

Typically, when I ask clients what defines their work culture, they use words like ‘accountable’, ‘driven’ and ‘fun’. But picking up on cultural cues via scheduled video calls is tough. No longer do we see how people behave in their unguarded moments – save for the occasional sighting of their children. And even the more introverted among us miss those social interactions that come from being ‘at work’ instead of just ‘doing work’.

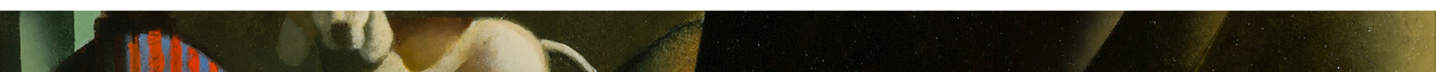
DISTANCE LEARNING

As many companies start to phase their teams back into in-person working, new considerations come up. Can we have impromptu meetings when there might not be a room available with space for social distancing? Will meetings with new colleagues and clients be quite the same without handshakes? Can we ask parents to remain engaged when a child’s fever means they have to pull them out of childcare for days? And how family-friendly are we as a company after all? Questions like these are being asked across the world. When you factor in the mental-health toll of living through a pandemic, things only get more complicated.

As inconvenient as these changes have been, this moment is also an opportunity to rethink workplaces and their cultures. For years, forward-looking businesses have talked about embracing culture and encouraging people to be authentic – to ‘bring their whole selves to work’. Now that we are bringing work to our whole selves, it is time to reconsider the role of culture in our working lives.

When companies invest meaningfully in their culture, they perform better.

“Business often feels personal, but never more so than when our commute takes us right back into our bedroom or our pets gate-crash our performance review.”



We also know that positive cultures enhance productivity and retention,[4] and that few things hamper performance like presenteeism and attrition.

'My manager expected us to work weekends.' 'There wasn't anyone in leadership who looked like me.' 'The CEO's micromanaging set the tone.' These different rationales for leaving a company are all, ultimately, attrition-by-culture. Culture is also a means to model and embrace diversity, to provide connection and solidarity – which are key tools in building much-needed resilience – and to differentiate from competitors.

Many of these aspects of culture are available to remote teams, too, with just a little innovation. Companies are already changing their approach to communications to help their cultures adapt and thrive. Managers have experimented with virtual exercises to spark meaningful connection. Peers have brightened their weekly video meetings with Zoom-background competitions, seeking to bring back the 'fun' that is no longer a natural part of the day. And HR leaders have helped celebrate achievements by sending treats to people's homes.

Such innovations do not have to carry direct costs. Taking a moment to ask people about their experience of the culture can begin a helpful discussion about where it stands now – and where it is going. On an individual level, we can check in with our colleagues and make sure that values like 'supportive', 'authentic' and 'trusting' are not lying fallow. We can also ask ourselves an important question: what sort of cultures do we want to help shape?

To succeed, culture, much like strategy, depends on people. It remains to be seen which aspects of 'Covid culture' will endure post-pandemic. My suspicion is that the savviest organisations will offer their people more flexibility and cultivate cultures that evolve with the times. If we get this right, business results will follow – even in the current climate. And innovation will return too (glass walls optional).

Ellie Hearne is founder of Pencil or Ink, a leadership-communications firm in New York City. She works with leading companies to enhance performance through culture and is currently studying at the University of Oxford's Saïd Business School. Hearne is also GlobalScot business ambassador for the Scottish Government.

"For years, forward-looking businesses have talked about embracing culture and encouraging people to be authentic – to 'bring their whole selves to work'. Now that we are bringing work to our whole selves, it is time to reconsider the role of culture in our working lives."

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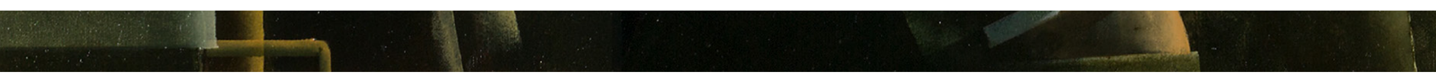
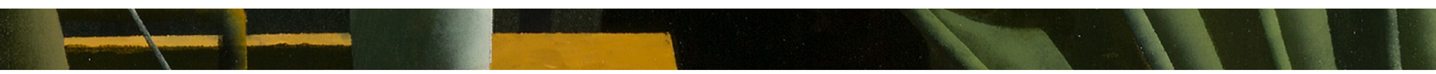
1 https://hbr.org/1996/11/what-holds-the-modern-company-together

2 https://www.theverge.com/2019/12/5/20995453/away-luggage-ceo-steph-korey-toxic-work-environment-travel-inclusion

3 https://www.forbes.com/sites/chriscancialosi/2017/05/30/preserving-a-culture-people-love-as-your-company-grows-lessons-from-zappos/

4 https://hbr.org/2015/12/proof-that-positive-work-cultures-are-more-productive





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Stephen Mangan
Night Station

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