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PODCAST TRANSCRIPT

TALKING RESEARCH – Q4 2023 UPDATE

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Katie Boyce:
Hello and welcome to Talking Research. I'm Katie Boyce, an investment writer at Walter Scott. This podcast is usually an opportunity to hear directly from members of our Research team but, today, it's a real pleasure to be joined by two of the firm's directors to share their thoughts on the year gone by, and to look ahead to 2024. We're recording this episode 'at home' in Walter Scott's offices in Charlotte Square, Edinburgh. And, given the time of year, we've even got a beautiful Christmas tree right beside us to provide that festive seasoning.

I'm thrilled to welcome directors Charlie Macquaker and Roy Leckie to the podcast today. I hope they won't mind me saying so, but what's remarkable about this duo, particularly within the investment industry, is that they have been at Walter Scott for their entire careers and, between them, have a combined experience of 60 years. Charlie, Roy, thanks very much for joining me today.

Roy Leckie:
Thank you. Katie. Great to be here.

Charlie Macquaker:
Thanks, Katie.

Katie:
As we come to the end of the year, there's a natural instinct to reflect back on the previous 12 months. Roy, perhaps you could kick off with how you'd sum up equity markets through 2023?

Roy:
Yes, Katie, I think there're a couple of ways to think about global equities this year. On the one hand, you might think it's been quite surprising that markets are up 18, 19, 20% – particularly considering all that's been thrown at them in terms of slowing economic growth, wobbles in credit markets, obviously the ongoing situation in Russia-Ukraine and, more recently, the tragedy that's unfolding in the Middle East.

And then, of course, probably most importantly, the lack of profit growth we've had this year. Profits ultimately are the most important driver of markets over the long term. I think we're only going to grow at something like three or four per cent this year. So, against all of that, it's quite surprising, perhaps, that markets have done what they've done. But, another way of looking at it is that, we know that history tells us that on average, after inflation, equity markets rise something like six or seven per cent per annum. When we think that average inflation around the world, so far this year, probably averaged seven or eight per cent, maybe a bit more in some places then a nominal return of 15-16%, which is not far from what we've had, is not all that surprising. So, it kind of depends which way you want to look at it.

Katie:
Charlie, do you have any thoughts?

Charlie:
The thing that's caught my eye this year is really the market concentration, that's been a key feature. Clearly, there's been a lot of coverage of the Magnificent Seven, the technology stocks leading the charge there. When we look at the chipmaker Nvidia, its share price more than tripled in less than six months, and Apple's market value got as high as $3 trillion, so the talk was all about AI [artificial intelligence]. Interestingly, if you strip them out of the index, the returns in the US have been much more pedestrian.

For me, this has got echoes of the TMT era in 1999. Certainly some of the valuations in the AI-related space have a lot of expectation built into them. I think you do have to take into account some of the economic headwinds that are lurking there, but also the geopolitical headwinds. Given that environment, I think the returns have been fairly remarkable.

Katie:
From a Walter Scott perspective, what have been the year's highlights? Roy, if I could put that one to you first.

Roy:
There's quite a number of things we could highlight here, Katie. And I think I speak for the executive of the firm, we were so thrilled at the success of the client conference in May. It was an excellent event, really well supported by clients, and I think the whole team did a brilliant job, showcasing the depth and the quality of the investment research that we undertake.

I think I have to highlight the contribution our colleagues in the US are now making to our efforts to deliver a first-class client service. And then, I think, probably the last thing I would highlight is just the overall strength of the culture across the firm. It tends to come to the fore at times like this when there's been a lot of firm events, including volunteering and a lot of other initiatives, that we've been doing collectively. In an investment firm, I think we would all argue that a corporate culture, or having a really robust, collegiate, inclusive culture, is just so, so important as we come to put our philosophy into practice. So, we'll never be complacent about our culture and will continue to invest in it. I do think we can be really quite proud of the efforts we've made and the results in that regard.

Charlie:
On that note, I'd jump in and say that the intern programme this year was a real success across both investment research and operations. We were spoilt for choice in terms of the candidates.

Katie:
And you've taken a couple on permanently.

Charlie:
We've made the odd offer, which is more than we have in prior years. It's highly competitive, the filtering process and, in fact, next year's intake (or potential intake) is under scrutiny right now as we speak. I think that is something to be proud about because we like to grow our own. Thinking of the younger generation, there's been a fairly steady cultural interchange with people going over to spend time in Boston and vice versa. We've just got to keep that going, in terms of that cultural glue.

Katie:
What about within research? We've heard from quite a few of the team on this podcast so far this year, talking about various trips and topics, but it'd be great to get your thoughts, Charlie.

Charlie:
Yes, you're right, there've been a lot of travellers out on the road. We've had 35 trips this year. I won't list all of them, but I'd probably highlight the semiconductor-focused trips to the US, China and Taiwan. Having just come back from Japan, there's definitely an interesting extension of those projects to be done. There was also a three-week extended research trip to France, meeting with all the constituents of France's CAC 40. Lastly, there were a number of trips across Asia in September, one taking in Hong Kong and China and the other Singapore, Indonesia and Malaysia. So, there's been a lot of traveling.

Katie:
And, as you've just mentioned, you're hot off the plane from two weeks in Japan. I know you've been there many, many times over your career, but how was it this time?

Charlie:
Well, I think I'm just about recovered from the jet lag. From an investment perspective, it's always been like an economics and financial markets laboratory for me. I've lost count as to how many times I've visited Japan over my 32 years at Walter Scott. It's my favourite place and it was great to get back out there.

This time, I was out there with Connor Graham, one of our investment analysts. Over the two weeks, we met with 23 companies in Tokyo, Kobe, Osaka, Kyoto and Yamanashi Prefecture, in the foothills of Mount Fuji. The first thing one could see stepping off the plane was the sheer surge in tourism on the back of the cheap yen. The immigration hall was mobbed and it was certainly clear, when one was out in Ginza and Marunouchi, tourists are there splashing the cash. As an aside, these areas are just so much more vibrant and cosmopolitan as tourist locations nowadays versus 20 or 30 years ago. Elsewhere, the IT and semiconductor sectors, as well as automation and healthcare remain very, very good stock-picking grounds. There's always good stuff to find there.

Katie:
Were there any company highlights on the trip?

Charlie:
Oh, gosh. Well, going to the Yellow Kingdom in Yamanashi for the Fanuc tour is always a rite of passage. We got a good update there. I think things are quite tough. There's a sort of cyclical lull going on there, but they know how to manage their way through things. They're just constantly improving the business and they've got the tailwind of automation behind them.

Shin-Etsu, I thought, was exemplary. Again, they're seeing some headwinds in the semiconductor space but, when you look at how they're managing things both in the semi side as well as in the PVC sector, in downturns they tend to take share.

Another highlight was OBIC and the IT space. We saw a similar IT services business, but OBIC just stood out as utterly world class. There's a good tailwind of growth and they generate remarkable profitability from that.

Katie:
As Charlie mentioned earlier, the Magnificent Seven stocks have dominated so much of 2023. A couple of the team recently returned from the US West Coast, which sounded like a great trip, with lots of brilliant insights, particularly in their discussions with some of the tech names. Do you think the market concentration of such a subset of stocks is likely to continue?

Roy:
Ah, very difficult question, Katie. I mean, the concentration has been really, really stark, but we have actually seen very high levels of concentration before, whether it be with the Japanese banks in the 80s or energy companies in the 50s, and obviously tech companies in the late 90s. As Charlie mentioned, Apple's the biggest stock in the index today. Not all that long ago, General Motors and IBM were once as big a chunk of the indices, if not bigger, than Apple is today.

I'd probably argue that some of the Magnificent Seven outperformance has been justified by their fundamentals, but certainly not all of it. And I'd agree with what Charlie said, I think there's quite a lot of valuation excess in there. I'm not sure I'd call it a "bubble" yet. I've seen worse, over the course of my career, but definitely excess. So, the question you ask, can the Magnificent Seven continue to outperform? Look, I think their fundamentals probably will continue to be better than average in terms of growth and profitability. We like their asset-light business models, the balance sheets and so on. But I think there's got to be risk there, from an investment perspective, simply because of the expectations and where the starting valuations are. I think profits related to this artificial intelligence theme are going to start coming through, in many perhaps

not all of them. But, I suppose my fear is that they're not going to come through quite as quickly as the market's expecting right now.

Katie:
As we approach a new year, a lot of the current macroeconomic uncertainties don't feel that "new". In fact, they feel distinctly similar to a year ago, with lots of talk around inflation, the cost of debt, and, of course, even more geopolitical uncertainties. What are the potential headwinds that are keeping you both awake at night, so to speak?

Charlie:
Well, I'm always cautious about making specific predictions, but I think one of the key changes is just the change in the cost of money going from nothing to 5%. I think we're seeing weaker financial models getting found out bit by bit and I do think the strains implicit in that are still working their way through the system. I'm a little bit wary as to whether inflation has been slayed, you know, that's been sort of let out of the bag a bit. We need to keep a track on that because clearly the cost of money is hinging on that.

The geopolitical backdrop is a very unknown quantity at the moment but, in that context, I think we can be pretty sanguine that our companies have got the broad shoulders to deal with all of these sorts of challenges there.

Roy:
I'd agree with that, and indeed the things that you listed, Katie, as things to worry about and plenty more besides. But, I think, to Charlie's point, much of this is outwith our control. Indeed, trying to predict the outcomes of what happens with monetary policy or the situation in Russia, Ukraine, or just about any macro or geopolitical variable, they're totally outwith our control and therefore not worth spending the time trying to predict.

That being said, we do have to factor a range of different possible outcomes into our analysis and our research, to ensure that we are invested in companies that are well placed to be able to buffet all the different headwinds, side winds, earthquakes and what have you that are thrown at them – companies with very strong foundations.

And I think, to that end, the portfolio should be very, very well positioned to navigate its way through whatever is thrown at it from a geopolitical or an economic perspective.

Katie:
On a more upbeat note, what are you optimistic about for 2024?

Charlie:
Well, I'd reiterate the potential for high-quality, innovative companies to really shine through in a tougher environment. I think we all probably agree that there's a lot to be excited about in 2024 and beyond. In particular, I'd point to long-established companies that spend large parts of their profits on R&D in technology, building out the cumulative knowledge that they've built up over decades, and that's whether it's in factory automation, healthcare solutions, or a shift to a more digital world.

You know, we've been talking about AI but I think the tangible point from that is just greater productivity. I'm looking forward to seeing that coming through. We really picked up on that in Japan. And it's through our investments in these types of companies that we can tap into interesting growth vectors within the global economy. That's despite the current geopolitical and macroeconomic challenges. As ever, it's an exciting time to be a stock picker.

Katie:
Given all that's been discussed, I guess the ultimate question is whether this environment is conducive to Walter Scott adding value in the years to come?

Roy:
We're very optimistic, Katie, about the absolute and relative returns that we're going to deliver over time. I'm not quite exactly sure what the pattern of that is going to look like but, given enough time and, of course, I think one of the great virtues that we have within our approach is patience. The philosophy, the core beliefs that we've stood by since the firm was founded 40 years ago, has proven itself time and time again, and particularly so during more challenging economic times. And perhaps that's what we're heading into. So, in that regard, our laser focus is on finding, valuing, researching, analysing brilliant companies, buying and holding them, letting internal wealth and compound growth do the work for us. We remain very, very optimistic that the portfolio is in good stead.

Katie:
It's the end of the year and, obviously, it's been a busy 12 months. What are you both most looking forward to over the festive season?

Charlie:
Well, I'm just looking forward to a bit of a break after a rather frantic travel schedule in the last couple of weeks.

Roy:
Same. I'm looking forward to a bit of family time, a bit of rest and then come back to work, raring to go at the beginning of the new year.

Katie:
From what you said, it's obviously going to be a busy 2024. Charlie, Roy, thank you very much for your time today. It's been wonderful to get your thoughts.

Thank you very much to you, our listeners. With our best wishes for the festive season and a prosperous 2024, we look forward to sharing more of our research insights with you on future episodes in the new year. Until then, goodbye.

IMPORTANT INFORMATION

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STOCK EXAMPLES

The information provided in this podcast transcript relating to stock examples should not be considered a recommendation to buy or sell any particular security. Any examples discussed are given in the context of the theme being explored.

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