WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

QUARTERLY COMMENTARY

STEWARDSHIP

Ending 31 December 2023

COMMENTARY

For more than two centuries, the elected board of directors has been the bedrock of corporate management. In 1811, the New York state legislature passed the first general incorporation act, decreeing that a company's "stock, property and concerns…shall be managed and conducted by trustees, who, except those for the first year, shall be elected".

Today, the importance of the board of directors to long-term corporate success and the protection of shareholder interests is beyond dispute. Regrettably, it is also abundantly clear that the board can play a central in corporate collapse, whether through wilful malfeasance, negligence or plain old incompetence. From Enron and WorldCom to Parmalat and Wirecard, recent history is littered with tawdry tales of boardrooms failing in their duties.

Given this importance, it's little wonder that a great deal of ink has been spilled over the years defining what a good board looks like. In truth, there is no fixed formula; some of the aforementioned corporate catastrophes happened on the watch of seemingly fit and proper boards. That's not to say, however, that investors shouldn't seek to establish what they believe constitutes best practice. Nor that they shouldn't engage with those companies where they believe board composition is sub-optimal and where changes would be in the best interests of shareholders.

"From Enron and WorldCom to Parmalat and Wirecard, recent history is littered with tawdry tales of boardroom dysfunction"

In that vein, we recently initiated several engagements with companies on the issue of board independence. Good governance demands that boards are composed of individuals with the necessary skills and external experience to bring support, and robust challenge to the boardroom. In our view, this requires strong independent representation. The objectivity and outsider perspective that suitably qualified, high-quality independent directors can bring are assets that can help to minimise the risk of mismanagement and its potential financial implications. Where we believe it to be in the best interests of shareholders, we will not hesitate to actively encourage companies to strike a better balance regarding independent representation.

Typically, we expect a minimum of 50% of directors on the board of non-controlled companies to be independent (we generally presume directors are not independent if they have served on the board for ten or more years). Furthermore, we generally prefer to see an independent chair and/or an independent lead director. Note, however, the presence of the words "typically" and "generally". As with many other ESG-related issues, we would rather avoid a cookie-cutter approach to board composition. Context is everything and, in some circumstances, levels of board independence may not align optically with acknowledged best practice for very good reasons.

"Typically, we expect a minimum of 50% of directors on the board of non-controlled companies to be independent"

A case in point is Costco, the leader in North American warehouse retailing. On first inspection, the Costco board falls short of our stated preferences on independence. We have, however, taken the decision not to engage with Costco on this issue and that change would not be in the best interests of shareholders. We could, of course, be proven wrong and there is no question that the stakes do feel higher when you step away from the standard view, but we put value in our judgement and our knowledge of the companies in which we invest.

At the time we took the decision not to engage with Costco, seven of its twelve board members were 'non-independent' by our definition, short of our preferred 50% threshold. That split has since changed to six out of eleven following the death of legendary investor and long-term Costco director Charlie Munger. A self-confessed Costco "addict" Mr. Munger served as a director of the firm for more than 25 years, bringing not only seven-decades' worth of investment experience but also a deep understanding of business models and, importantly, Costco's culture.

Of the six remaining non-independent directors, three are executives and three are non-executives with tenures in excess of ten years. In our view, these non-executive directors not only boast invaluable experience and expertise but, due to their long tenure, they are steeped in Costco's culture and fully understand the benefits of doing business in the unique Costco way.

The Costco approach to business is built around the concept of delayed gratification – resisting the temptation of immediate rewards in anticipation of greater rewards later. This is a very rare trait in business. In practice, it means paying employees more than you need to, so they stay and perform better over the long term; treating your suppliers well and offering better payment terms than necessary, in order to build and maintain long-term business relationships; and sharing growing economies of scale with your customers, so as to offer better value for money and increase loyalty.

"The Costco approach to business is built around the concept of delayed gratification"

Costco's ways have not always been well understood or appreciated. In the early 2000s, the company was out of favour on Wall Street for 'disregarding shareholder interests'. For analysts, Costco's tortoise was no match for Walmart's hare with its ruthless approach to costs, employees and suppliers. Not for the first time, however, the tortoise has outperformed. Today, Costco is one of the most admired brands in the world and its stock has comfortably outpaced Walmart's[1]. On top of this, employee retention is amongst the highest in retail and the company ranks as one of the most efficient large retailers (including from a carbon perspective). In other words, the Costco way of doing business has benefited shareholders, the company *and* the wider community. It is Costco's people – from board members to in-store employees – who are tasked with preserving this rare but successful culture.

Jeff Raikes, for example, has been a board member since 2008. A well-known philanthropist, Mr. Raikes co-founded the Raikes Foundation and was previously CEO of the Bill & Melinda Gates Foundation – the second largest charitable foundation in the world. Attuned to Costco's community values, his experience makes him an ideal fit for the role of chair of Costco's nominations committee and to oversee diversity and sustainability initiatives at the firm, key factors in employee acquisition and retention.

[1] Source: Factset, Costco +2050.4% vs Walmart 245.1% (total return from 31 December 1999 to 19 December 2023 in USD)

"It is Costco's people...who are tasked with preserving its rare but successful culture"

Similarly, Sue Decker, a board member since 2004, brings invaluable insights in technology and internet business models at a time when Costco is in the early stages of developing its own e-commerce platform and team. CEO and founder of Raftr, a digital media platform used by unions and non-profit organisations, Ms. Decker was also CFO of Yahoo in the early 2000s. As was the case with Charlie Munger, she is a long-standing member of the Berkshire Hathaway board, a company with similar long-term values to Costco.

The final non-executive director is Hamilton James, a board member since 1988 and chairman since 2017. Highly experienced across many global industries, Mr. James was former president and COO of Blackstone, and one of the key individuals credited with growing the company from a small private-equity shop into a global investment giant with nearly US$1 trillion in assets. Importantly, Mr. James' "non-independence" provides better challenge than the combined chair and CEO role that is typical of non-independence in the US. There are few executives with the quality to deliver that challenge more effectively than Mr. James.

Judged solely on the experience they bring to the board, it would be very difficult to advocate for the removal of any of the aforementioned directors. But add in their deep knowledge and understanding of Costco's unique approach to doing business and we think that to do so would be counter-productive for the company and shareholders.

Any of Costco's principles could be sacrificed in the hope of delivering a sugar rush for profits or the share price. To do so would be to prioritise short-lived gains over long-term success and it is vital to have people in place who understand this. Costco is a case study in business success and the current board plays an integral role in preserving the culture that makes it a special business. Best to leave the cookie cutter in the kitchen drawer.

Walter Scott's investment approach: This material contains certain statements based on Walter Scott's experience and expectations about the markets in which it invests its portfolios and about the methods by which it causes its portfolios to be invested in those markets. Those statements are not guarantees of future performance and are subject to many risks, uncertainties and assumptions that are difficult to predict. The information in this schedule is subject to change and Walter Scott has no obligation to revise or update any statement herein for any reason. The opinions expressed are those of Walter Scott and should not be construed as investment advice.

This document is provided for general information only and should not be construed as investment advice or a recommendation. You should consult with your advisor to determine whether any particular investment strategy is appropriate. This information does not represent and must not be construed as an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products. This document may not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such an offer or solicitation is unlawful or not authorised.

Walter Scott & Partners Limited ("Walter Scott") is an investment management firm authorised and regulated in the United Kingdom by the Financial Conduct Authority in the conduct of investment business. Walter Scott is a non-bank subsidiary and 100% owned by The Bank of New York Mellon Corporation. All operations are based in Edinburgh, Scotland with a client service presence in the United States. Walter Scott is responsible for portfolios managed on behalf of pension plans, endowments and similar institutional investors.

Third party sources: Some information contained herein has been obtained from third-party sources that are believed to be reliable but the information has not been independently verified by Walter Scott. Walter Scott makes no representations as to the accuracy or the completeness of such information and has no obligation to revise or update any statement herein for any reason.

Past performance is not a guide to future results and returns may increase or decrease as a result of currency fluctuations. Many factors affect investment performance including changes in market conditions, interest rates, currency fluctuations, exchange rates and in response to other economic, political, or financial developments. Investment return and principal value of an investment will fluctuate, so that when an investment is sold, the amount returned may be less than that originally invested. Portfolio holdings are subject to change at any time without notice.

Investing in **foreign denominated and/or domiciled securities** involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

BNY Mellon Investment Management and its affiliates are not responsible for any subsequent investment advice given based on the information supplied. This is not intended as investment advice but may be deemed a financial promotion under non-US jurisdictions. The information provided is for use by professional investors only and not for onward distribution to, or to be relied upon by, retail investors.

This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorised by Walter Scott.

WALTER SCOTT & PARTNERS LIMITED, ONE CHARLOTTE SQUARE, EDINBURGH EH2 4DR
TEL: +44 (0)131 225 1357 · FAX: +44 (0)131 225 7997
WWW.WALTERSCOTT.COM