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PODCAST TRANSCRIPT

TALKING RESEARCH - Q1 2024 UPDATE

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Katie Boyce:

Hello and welcome to *Talking Research*. I'm Katie Boyce, an investment writer at Walter Scott, and this podcast is an opportunity to hear directly from our Research team on what they've been up to and the topics at the forefront of their debates. Today, I'm delighted to be joined by investment managers Des Armstrong and Alan Edington. Welcome, Des and Alan.

Des Armstrong:

Thank you very much.

Alan Edington:

Hi.

Katie:

Today we're discussing the US stock market's continued concentration, Japan's stellar start to the year, as well as some recent trips to meet with a number of newsworthy companies. In Denmark, colleagues visited Novo Nordisk's facilities where half of the world's insulin is produced. And in Los Angeles, Des met with, amongst others, Disney and Intuitive Surgical.

So let's kick off by talking about what's been happening with the markets towards the end of last year. The prospect of the Fed potentially cutting interest rates sent markets rocketing. And in the US and globally, the "Magnificent Seven" dominated. Three months later, they're still there. Alan, what's going on?

Alan:

I think that's right. The Magnificent Seven have continued to be pretty magnificent in terms of share price. A lot of that is potentially quite justified. These businesses are being driven by AI hype and the growth that they will achieve based around that. And some of them, notably Nvidia, will be very, very successful in that context. Of course, we could get into how sustainable or how long-term is the hype ahead of the reality. It'll be interesting to see whether they take a bit of a breather now, as people are starting to get the

sense from the Fed that perhaps the interest rate cuts – the four that were perhaps expected this year – don't come to pass. But, there are real reasons to like a lot of these businesses, if perhaps not all, and that concentration, as you say, has continued.

If you look at MSCI USA last year, it returned about 27%. If you remove just those seven companies, it only returned around 15%, so there's a really material impact coming from these. And, although we've seen greater market concentration historically, it tended to feel like there's more hype. I don't really think we're in bubble territory personally just yet.

Des:

I think it's also important to highlight that the US market in itself is at an all-time high in terms of its standing in the world order. It does speak to US dominance in equities, which has been a trend for a very long period of time. It's going to be interesting to see how things play out. I think when you look at the fundamentals, to Alan's point, many of those companies within that Magnificent Seven – so think about Nvidia, if you look at that on a three-year forward basis, and the growth there is so exciting that you actually get that company valuation coming back to market multiple levels pretty quickly, given the growth that it's experiencing. There are a lot of positives. It doesn't feel particularly good that the market right now is so concentrated towards so few companies.

Katie:

And a lot of those companies are very much tied into the generative AI theme. Is this hype or is it a genuine theme? What would you say from the companies you're meeting?

Alan:

Yeah, so that's the really interesting question. What you're seeing today is the build out. The reason Nvidia's chips are in such demand is we're building the infrastructure required

to run large language models, to run generative AI at the scale that people are interested in running it at. There's clearly an expectation of demand going into that build, but the question then becomes about the software layer later. How much real demand is there? How quickly will businesses be able to put this into place and be able to develop it and to monetise it? You're seeing pockets where it's really successful.

If you look at ChatGPT and its various competitors, which is really what drove the initial excitement around generative AI, I think the uptake was in a straight line from the bottom left to the top right of a chart. And then there was this real lull in 2023, where people had got very interested and excited about trying it out. But then actual use cases, is it being used in business? Is it writing reports for people? That's still quite new and people are still playing with that and figuring it out.

Des:

I think Alan's spot on. You're definitely seeing the hardware players within the AI space benefit from a lot of demand right now, to build out that sort of related infrastructure spend. But, at the front end, in terms of the software applications, it seems to be a bit more of a question mark about just how quickly it ramps.

Adobe, for example, a leader in creative software tools reported last week and the market reacted quite negatively to the results, not because the results reported were bad. It's just, I think, the market was really looking for more growth from a lot of the AI generative capabilities that they've been talking about. Adobe is at the beginning of an innovation cycle and, specifically, that's focused on the generative AI sort of capabilities that they're starting to put into the market, but a lot of this stuff is still in beta. There's also competition, that's turning up increasingly. So it's going to be interesting to see just how that monetisation story plays out and how quickly it will play out.

Katie:

But it sounds like it's much more of a long-term story. There's a lot of excitement at the moment, but as you say, there's a lot to play for?

Alan:

I think that's right. I mean, there are some very real uses already today. We see it in a number of companies today. ChatGPT is the obvious example people know about, but AI is being used in a detailed way in drug discovery, it's being used in the manufacturing and design of aeroplanes, of EVs. This is a very real technology today. It's just a question of what scale it will eventually reach and how quickly it gets there; how much of a straight line that trajectory is.

Des:

And everyone's focused on proprietary data. There are a number of open AI solutions that have come to the market recently and that's created some issues around the access to that data and what it's leveraging. But I think those companies – and we can talk about this maybe later with some of the companies that we recently met with – those companies that do have that proprietary data set are, I think, in a very strong position to be able to leverage that data relative to some of their peers that don't necessarily have access to that private data.

Katie:

What have been some of the other key features of the year so far?

I mean, Japan has been interesting, for example.

Alan:

The Japanese market's been really off to the races. I think what we're seeing is an expectation that Japan's economy normalises and we're reaching a point where inflation is picking up. A few years ago, that would have been a crazy suggestion in Japan. We saw just this last week with wage inflation when the annual negotiation came through; expectations were for around three,

maybe four per cent, wage inflation came out at 5.3%. The expectation then, of course, is that a consumer with more money in their pocket is prepared to spend more, perhaps that feeds a little bit of price inflation in Japan.

It goes back to what most other economies around the world have looked like for the last few years in terms of a sensible inflation rate and an ability then of the central bank to normalise things a little bit. We've also seen the central Bank of Japan raise interest rates into positive territory for the first time in a very long time. And I think that normalisation is fuelling a bit of excitement.

I think there's a bit more to it as well. Japan's had a number of attempts at corporate governance reform over the years and, actually, what we're seeing is another round of that, but perhaps one that's gaining a little bit more traction than historically. The regulator is strongly encouraging Japanese businesses and their boards to think about capital allocation rather than just about the P&L, to think about what they do with some of that cash on their balance sheets, to rethink their governance structures, to align more with international best practice and to encourage a bit more English disclosure to broaden the Japanese market's appeal. I think all of these, alongside some changes in the underlying economy, could be very positive for Japan in the longer term.

Des/Alan:

Was it 2013 when it was “the three arrows”? Abenomics? It's a decade on from that.

Alan:

I can't remember if it's exactly 2013. You're testing my memory a bit too much there.

Des:

I think it was during 2013. There was a period where a number of Japanese domestic-orientated companies really

benefited from this belief that we're going to see more inflationary trends coming into the market; also, in the context of deeper reforms that are at a corporate level.

But in Japan right now, the other thing that needs to be discussed is the impact that the downturn in China's economy is having on the Japanese exporters. You're certainly seeing those companies come under pressure. But yeah, certainly from a domestic standpoint, I'm sure Warren Buffett's involvement in the trading houses has also been a positive.

Katie:

Going to Europe, the term “Granolas” has been bandied around a lot to describe a group of, I think it's 11, stocks there. They're not all tech, but it's supposedly rivalling that US grouping. I'd love to hear what you both think about that. Is it remotely similar to the Magnificent Seven, or is it really just a bit of a gimmick to put a label on these?

Alan:

Yeah, so I think it's funny that it's been name-checked again. This acronym was talked about in 2020 and so it's obviously experiencing a little bit of a resurgence. The reason I think it came about in 2020 was we were looking at lockdowns, we'd gone into that period, markets had fallen sharply and a few businesses were clearly flocked to as safe havens.

What stands out about those European businesses in particular is they tend to be consistent growers. They tend to do better in downturns because people want their goods and services more than perhaps the competition. They tend to have very strong balance sheets and be leaders in their industries. So, a lot of things that, as an investor, we would tend to look for; that we think lead to long-term success.

Whether aggregating these into a group and pretending there's some sort of competition between them and the

US is a useful construct but I think the jury's out a little bit for me on that one. But, ultimately, what we're saying is there are a group of very large, successful businesses in Europe in the same way that we have some very large, successful and dominant businesses in their industries in the US. It just happens that the bias in the US is more towards the technology space, whereas there's a slightly broader appeal to some of these European businesses.

Des:

Do you think in a way it speaks to a potential sort of concern amongst the investment community about where we are in markets? So, if you have to invest, you invest in companies where you really feel you can sort of take some comfort in the persistency of the earnings of that company. It is the paradox we've got right now in markets where they're at all-time highs but when you look at some of the short, medium or long-term risks – whether that be geopolitics, whether that be energy transition – it feels like there's a lot of things to be worrying about. I think it's a function of just the fact that the market is rewarding those companies that can demonstrate an ability to deliver a persistency of growth that you just might not get elsewhere.

Katie:

One of those companies that is a “Granola” is Novo Nordisk, which I've chatted to one of your colleagues, Lindsay Scott, on here before, about its huge success with its anti-obesity drugs, as well as Eli Lilly's. There continues to be a huge amount of momentum behind these companies and their drugs. Last month, Lindsey and another colleague, Oriana, visited Novo in Denmark and had a great day hearing from the company about the current developments. Des, would you like to say a bit more about that?

Des:

I think it was a very, very positive trip, the Capital Markets Day. The management team at Novo did an

excellent job at convincing the market that there was more to come in terms of the pipeline. The oral GLP-1 opportunity I think is still in the early stages of phase one, but the clinical data looks very encouraging and certainly looks best in class though the penetration of GLP-1s is still incredibly low. I think it's still below 10% and there's enormous upside there. So they're investing significantly in meeting that and reflects some of the corporate sort of actions that we've seen for the company.

Clearly, the company has really sort of been benefiting from its fundamental successes, but I think it's doing it in a very measured way and has done an excellent job at communicating a strategy for growth going forward from here. So, yeah, very positive about Novo Nordisk right now from a fundamental standpoint.

Alan:

It's hard not to be excited about some of these drugs, the GLP-1s and the future pipeline of Novo. When you think about the sort of expansion of use cases for these, it's quite significant. Just again, last week, the FDA approved an adjustment to the label for Wegovy to include that it reduces the risk of cardiovascular deaths, which I think is 32% of deaths, are caused by cardiovascular events. And so this is a drug that's going to permeate more of the landscape. It's going to be used to treat people in a wider range of settings over time.

Katie:

Des, I mentioned earlier that you're recently back from LA. Following last year's writers' strikes and the ongoing battle between the streaming services, it must have been a timely occasion to be there?

Des:

It's always interesting to go to LA, let's be honest about that. There's a lot to see. I also saw my first Tesla Cybertruck go past – and it's absolutely enormous. Tinseltown is going through

a lot of consolidation. I think they've experienced a very favourable period. The vibe that you get there, speaking to people in LA, is that stakeholders want more of a margin from the investments they're making in content.

I had the opportunity to touch base with Disney while I was there. The company's been going through quite a challenging time, but it feels that they're coming out of that. The key issue there has just been profitless prosperity that they engaged in, in terms of rolling out their direct-to-consumer (DTC) Disney+ offering, and that cost them a lot of money, and the business is still not breaking even. But the key point is, I think, since the return of Bob Iger, there've been a lot of steps taken to right-size the type of content spend that they've been making. I think with Bob, there's always been a focus on quality, not quantity, so costs are coming down there. But, I also think they've been focused on how they make their DTC strategy profitable beyond just cost control so they've been putting through price increases.

One of the interesting developments we've seen, industry-wide, is more advertising mix coming into some of these subscriptions. Consumers are willing to tolerate much more advertising than I think people really thought was possible. That's all been good, I think, for direction of travel with regards to making that business more profitable. There's still a bit of a question mark about what the long-term economics for Disney's streaming business will be, but certainly the direction of travel is looking better.

Alan:

Do you think the landgrab's over in streaming services?

Des:

I do, I really do. I think the shareholders are demanding that more of a return is made on these investments. They have to really focus on pricing and thinking about the mix of that subscription

base, in terms of how much advertising they have and, obviously, to the degree in which they're going to invest in content. I think Netflix clearly has a first-mover advantage in terms of the content catalogue that it's developed over a period where, frankly, money was very cheap and so you were in this position where you could invest very aggressively. But, yeah, I do think that the streaming wars are going to ultimately result in a period of rationalisation and, ultimately, consolidation, in my opinion.

Katie:

You also met with Intuitive Surgical, the robotic surgical devices manufacturer. Its newest robot, the da Vinci 5, has just received FDA approval. Tell us, what's new about this latest robot?

Des:

I met with the management team and, at that point, they actually hadn't received FDA approval, but had clearly told the market about the launch of this new robot, the da Vinci 5. That obviously follows on, not surprisingly, from the da Vinci 4, which has been around for ten years, and that really has sort of changed the game with regards to how surgeons operate. But the da Vinci 5 is going to take things further, and it kind of plays into this theme of AI, machine learning and computational power, and how that can really affect change in terms of delivering better patient outcomes.

Ultimately, Intuitive Surgical's vision is not about the robots, it's about making sure that surgeons can do better surgical treatments on their patients, which ultimately is going to deliver better patient outcomes, but also reduce costs as well. It was fascinating to hear them talk about that opportunity. I think robotic-assisted surgery has got an awfully long way to go. It's still only 30% penetrated today, but that's not assuming that more and more procedures are given regulatory approval for robots to be used in surgical operations.

Katie:

Intuitive also has a huge advantage over its rivals, doesn't it? So how does it maintain that competitive moat?

Des:

Well, I think that's what's interesting about the launch of this da Vinci 5. I think it's clearly another step towards them protecting that competitive moat. One of the interesting things about the design features of the robot, in addition to the 150 that they made that allows the surgeon to work better, is that they have more computational power to the tune of 10,000 compared to what the da Vinci 4 could offer. That is all about them starting to layer on top of the existing operational process, all of the AI machine learning capabilities that you can leverage across all of the data that they captured from being in the market for the last 20 years.

In terms of using stimulation, 3D visualisation, best-in-practice learnings from how to do operations and surgical treatments, all of the computational power that this machine can provide is going to allow surgeons to, crucially, do more and more of that. The management team was encouraging us to think about that on a five, ten-year basis; that this is the platform that they think they can really use to leverage the AI machine learning capabilities that they've been developing.

Alan:

I think there are a couple of really interesting points that come out of that. One is this data point, right? Businesses that have a dominant position in data in their industry. Intuitive Surgical has got ten years of operations that no-one else can really aggregate the data around. They're able to build on that. That's where AI can be really useful to them in the future and will extend a competitive moat rather than be a challenge to Intuitive over time.

I think the really interesting second point is, when you think about what AI will do in this context, it's aiding

the surgeon. Everyone's worried about – and in some context rightly – is AI going to remove jobs from the economy? But, ultimately, there's a big portion of the economy for which AI will assist in upskilling people. When you work alongside AI, when the AI can prod the surgeon to do something differently, in order to improve the patient outcome based on its historical data and its analysis of that, that ultimately leads to better surgeons and potentially, in time, will lead to surgeons who were previously less skilled being able to perform more complex operations where they're needed.

Des:

That is 100% behind what da Vinci 5 can possibly do. One of the big bottlenecks is having sufficiently trained surgeons to be able to use the surgical treatment. And so, by having more automation, that allows the period in time for surgeons to be up to the standard to be able to use da Vinci 5, that can come down, so I think it does ultimately improve access to healthcare.

Katie:

And you talk about data within healthcare. You also met with Genentech, which is a subsidiary of Roche. It has a strong foundation in cancer genomics, but it's been moving to computational biologics. For those of us less familiar with some of these terms, if you could just quickly tell us what computational biologics are?

Des:

Well, computational biology is a concept that's been around for a number of decades. And it's just as it sounds, using computing power to really leverage all of the biological data you get from all of the work that's done to better understand the molecular causes of disease.

I met with a gentleman called Andrew Chan. He's been at Genentech for over 20 years, and he runs the research team there and has just been at the forefront of some of the most exciting science that

Genentech's done. He kicked off the meeting by saying the last three years he's had at Genentech have been the most intellectually stimulating but also the most exhausting. In his opinion, Genentech now has one of the leading teams within this area of computational biology, within science. Some of the exciting stuff that he was talking about was how it augments their existing small molecule capabilities.

You mentioned that Genentech had been investing in developing its oncology capabilities for multiple decades. This technology now can leverage that in a way that really allows them to continue to rapidly accelerate their capabilities in that area.

It's also in areas like antibody discovery. If you think about sequencing and how that's been able to basically map out almost 60% of all the protein structures that we have within our DNA – we're now in a position where you can match that up against computational biology techniques that allow you to identify antibodies that might be able to target those specific protein structures.

There's a lot going on here and, ultimately, just the confidence was there that this is going to accelerate their drug discovery process, but also optimise it and allow them to, as much as anything, quickly identify those molecular leads that won't work, but also then put more resources behind

those ones that do. And if you think about that kind of working hypothesis that you might have on some piece of science, his argument was that used to take six weeks to work through to conclusion. We can now, through computational biology, make that conclusion within six hours. So, you get some sense of just how quickly things can move forward on that basis.

Alan:

So, effectively, the way I conceptualise that is, they're writing algorithms for drug discovery, in order to do it faster and better than individuals can do today. Where ultimately this grand vision could lead is to drugs that are specifically effective in certain settings with specific individuals with certain needs. So, your cancer is maturing, metastasizing along a particular route, how do we best treat that route in a way that's much more individualised and much more specific than historically? Now, we're a little bit off that today but that's where the computational power, the algorithms, the AI again – to use the buzzword of the day and the thing we've spent a lot of time talking about – that's where it could lead us.

Des:

It's one of the things that Genentech were talking about is the work they're doing in developing RNA vaccines. The idea behind this is that you make a vaccine for an individual that, say, has a cancer and it has unique mutations. So, you want to activate an appropriate

immune response to that mutation. The patient gets a biopsy, that tumour is then sequenced, and then you select from all of the potential mutations of that tumour the highest chance of eliciting immune response from that individual. So, this is the idea about going down much more individualised ways of treating patients. It is something of a holy grail and I think we're still a wee bit off from that but it's certainly something that is at the forefront in terms of their science. All very encouraging to hear.

Katie:

On that positive note, we'll draw the chat to a close. I think it's fair to say that what's come across in every company that we've talked about is whether or not companies are yet monetising AI, it is definitely omnipresent. Thank you, Des and Alan, for your time today. There are lots of trips coming up over the next quarter, to California, Texas, Mexico, Oslo, Germany, so we look forward to hearing about those on the next podcast.

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