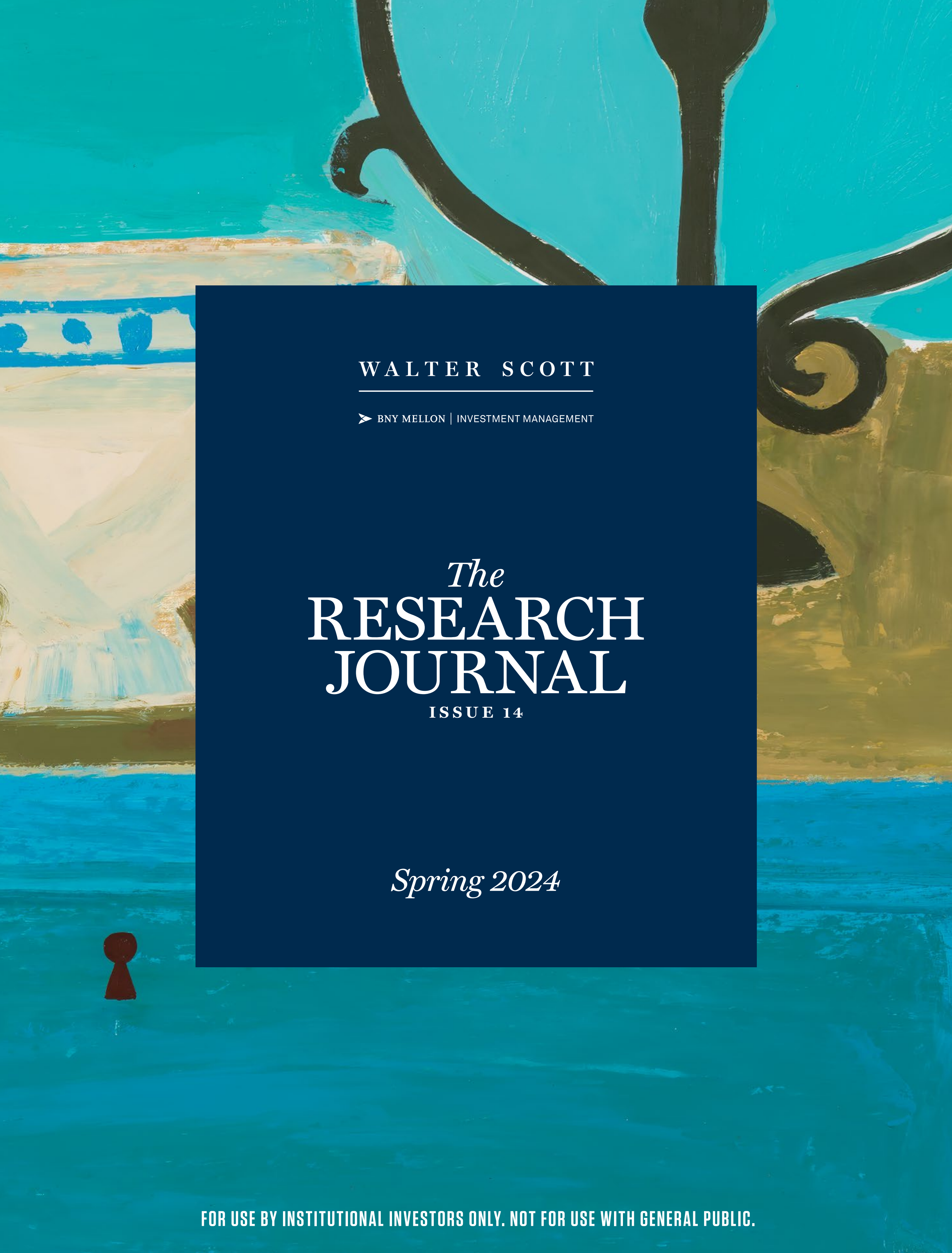

WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

The RESEARCH JOURNAL

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WELCOME

I am delighted to welcome readers to the 14th issue of our *Research Journal*. Looking at the wider world, it seems there is a lot to keep us on our toes. Yet this has always been the case, even if for most of my career, geopolitical tension has not been quite so close to home.

These tensions and inflation have challenged us to ask slightly different questions of management teams but have not led us to change our philosophy or, for the most part, our portfolio. Many of the businesses we invest in have been around for at least a century and have had to contend with many challenges, including wars and inflation. It is in their DNA to adapt and remain relevant.

At the same time, we stay close to companies and continue to visit them. Alan Lander's return to Inditex's HQ in A Coruña in Spain for the fifth time reinforced his impression of a company maintaining its entrepreneurial ethos despite dramatic growth, while Charlie Macquaker recounts promising signs of a more modern approach to governance during his recent trip to Japan in the company of one of our younger analysts.

Research trips provide insights not just into the businesses themselves but into the trends likely to shape the future beyond the next decade. Last year, Tom Miedema travelled to China, Taiwan, and the US to assess the global semiconductor industry's attempts to reduce its dependence on Taiwan and China.

Of course, we don't always have to travel such long distances to conduct valuable research, and much of our information comes from meetings in our Edinburgh office or more informally in catch-up calls or online. Three members of our Research team describe their investigation into which businesses might be affected by the impact of the introduction of revolutionary weight-loss drugs over the last couple of years.

We also benefit from the expertise of outside analysts, as a thought-provoking account of tensions on the Korean peninsula by Chad O'Carroll of the consultancy Korea Risk Group reflects. Closer to home, however, the firm is fortunate to have a Chairman with such an exceptionally long-term perspective at hand. Alex Hammond-Chambers has experienced several inflationary cycles since the start of his investment career in the mid-1960s. Here he explains why we may have entered a more volatile but sustained period of inflation.

We also examine why debt is causing such a headache for so many companies and economies. While we make no claim to be experts on monetary policy or geopolitics, understanding the risks businesses may encounter is essential. I hope you will enjoy these insights.

Best regards,

Jane Henderson, Managing Director

CONTENTS

WALTER SCOTT CONTRIBUTORS

JANE HENDERSON

Jane has been Managing Director since 2010. Since joining the firm as an Investment Analyst in 1995, she has had a range of investment, management, client service and governance responsibilities and was instrumental in developing the firm's US investment strategy.

TOM MIEDEMA

Tom is an Investment Manager. Before joining the firm in 2007, he worked in Taiwan and over his career at Walter Scott has had a particular focus on emerging markets. He holds an MFin in International Finance from the University of Glasgow. Tom is a CFA charterholder.

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Oriana is an Investment Analyst who joined Walter Scott in 2023, having participated in the investment intern programme. She holds a MBBS in Medicine and Surgery from University College London.

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After an internship and working as a contractor with the firm, Connor became a permanent employee in 2021 in the Investment Operations team. He transferred to the Research team in 2022. He holds a commission in the Army Reserve.

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Charlie is Executive Director, Investment. Having joined the firm in 1991, he has held a wide range of roles and has had extensive experience in analysing companies around the world, particularly in Europe and Japan. Charlie joined the Board in 2009 and co-chairs the Investment Management Committee.

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Fiona is an Investment Manager, who joined the firm in 2014. She began her career as an investment manager in 1987 and before Walter Scott worked at Alliance Trust, where she was responsible for European equities.

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Alex Hammond-Chambers has been Chairman of Walter Scott since 2020. He spent 27 years with Ivory & Sime, latterly as Executive Chairman and has been a governor of the NASD in the US and chairman of the Association of Investment Companies in the UK.

ALAN LANDER

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GUEST CONTRIBUTORS

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Since 1989, David Smith has been Economics Editor of *The Sunday Times*, for which he writes a weekly column. His books include *The Rise and Fall of Monetarism* and *Something Will Turn Up*. He is a visiting professor at Cardiff and Nottingham universities.

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Dr Sean Brocklebank is a Senior Lecturer at the University of Edinburgh's School of Economics, where he teaches macro and microeconomics and econometrics. He also works as a consultant and since 2014 he has regularly contributed to Walter Scott's research training programme.

CHAD O'CARROLL

Chad O'Carroll founded and runs Korea Risk Group. A journalist and analyst based in Seoul, he specialises in North Korea and geopolitical risk on the peninsula. He contributes to NK Pro, Korea Pro and NK News and manages several Korea Risk Group consulting projects.

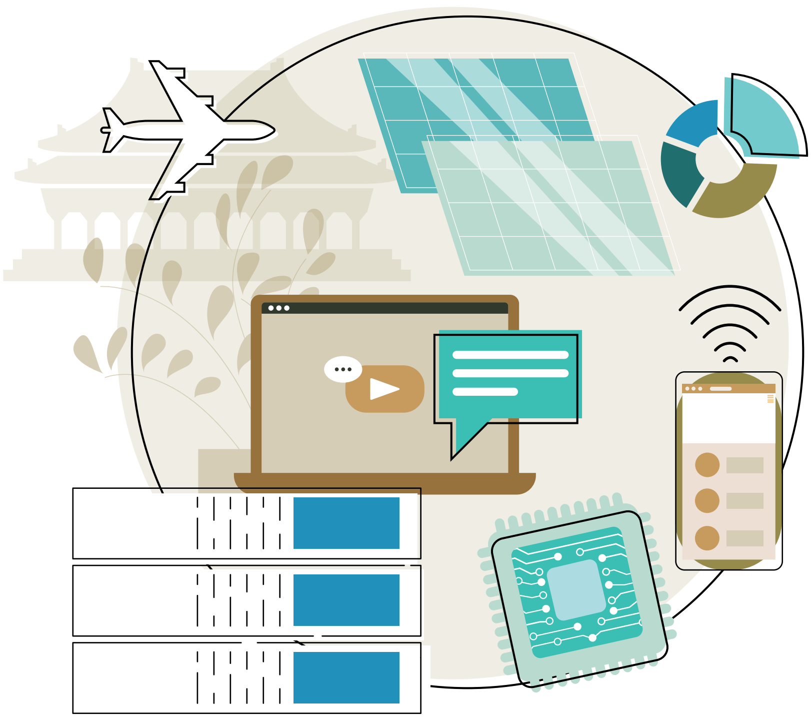
ARMIDA VAN RIJ

Armida van Rij is a Senior Research Fellow at Chatham House and heads its Europe Programme. She advises governments on a range of foreign, security and defence policy issues. Previously she was a Research Fellow at The Policy Institute, King's College London.

INVESTMENT THINKING

DE-RISKING
IT'S COMPLICATED

Threatened by geopolitical tensions and protectionist trade policies, globalisation, the multi-decade megatrend which has done so much to shape today's economy, appears to be in retreat. Investment Manager Tom Miedema explains why this shift has significant consequences for the global technology industry, one of the most potent symbols of our interconnected world



If I were asked to name a poster child for globalisation, I might select the semiconductor supply chain. Geographically diffuse yet deeply interconnected, this archipelago of hundreds of thousands of worldwide suppliers and manufacturers is a hymn to specialisation and comparative advantage. Hyper-efficient and cost effective, it was a model that served the technology industry and wider economy well for decades.

The fragilities inherent in such a dispersed and, at times, opaque structure were not much discussed. This was perhaps understandable in an era of increasing globalisation when the risk of severe disruption to such a well-oiled machine seemed remote. In the present era of pandemics, protectionism and elevated geopolitical risks, however, this optimism can look a little like complacency.

As the merits of this hyper-globalised supply chain come under increasing scrutiny, any conversation about its future is today more likely to involve talk of resilience and 'de-risking' than efficiency. It is a shift in emphasis that could have profound consequences. But how realistic is de-risking really and what might it cost financially and in terms of efficiency?

To build on our existing understanding of this process and its trade-offs, last year I travelled to various locations integral to the semiconductor and technology supply chains, including the US, China, Taiwan and some of the critical assembly hubs in South-East Asia, to speak with management teams, policymakers and industry representatives (see map).

From Silicon Valley and Washington DC to Shanghai and Hsinchu, these trips were also an opportunity to question those at the sharp end of the industry about the geopolitical risks that have precipitated the current desire for greater supply chain security.

NVIDIA'S MASTERPIECE

The new Nvidia DGX B200 is a wonder of modern technology. A single, unified AI platform enabling businesses to handle vast datasets at every stage of the AI pipeline, it is the most powerful system of its kind ever assembled, significantly more so than its predecessor the DGX H100.

Underpinning the DGX B200 is the Nvidia-designed GB200 semiconductor, which whilst unquestionably a testament to the innovative genius of Silicon Valley, also happens to be manufactured by TSMC in Taiwan. So, too, the overwhelming majority of the tens of thousands of components that comprise the DGX B200 system.

In truth, the DGX B200 is only possible because of an elaborate global supply chain comprising myriad stages. So too any number of today's technological products and systems, from data centres and commercial airliners to medical equipment and solar panels.

Take the humble smartphone. Its semiconductors are likely to have been designed in the West

"Routing hundreds, or even many thousands, of parts through a network of dispersed suppliers is hugely complicated"

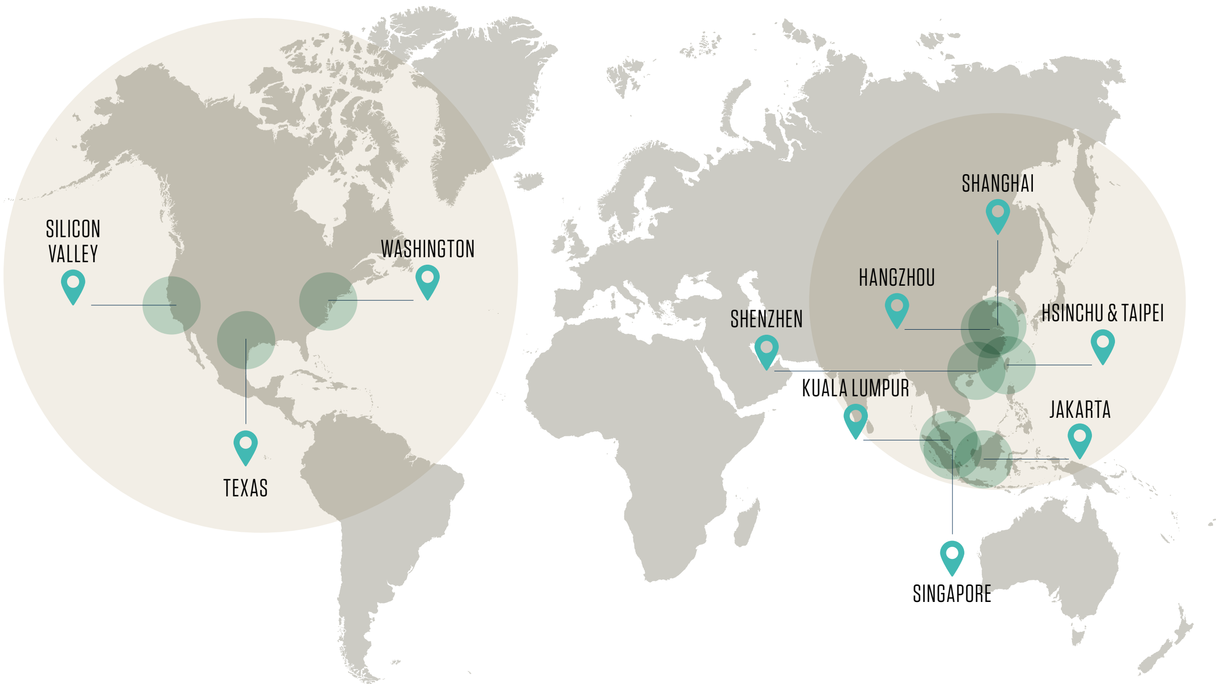
15-20%

LEADING-EDGE FABRICATION OUTSIDE TAIWAN AND CHINA BY 2027

SEMICONDUCTOR SUPPLY CHAIN RESEARCH

UNITED STATES OF AMERICA
FEBRUARY & MARCH 2023

ASIA
JUNE & SEPTEMBER 2023



Source: Walter Scott

but manufactured, packaged and tested in Taiwan or China. The finished product was probably assembled in a factory in China, India or Vietnam.

This routing of hundreds or, in the case of the DGX B200, many thousands of parts through a network of dispersed suppliers is hugely complicated. Even if just one component fails to turn up on time and in the correct location, disruption ensues. Yet the efficacy of today's supply chains has concealed their complexity, leading some to underestimate the challenge of de-risking.

TIME AND MONEY

Reorienting the existing technology supply chain to materially reduce reliance on specific geographical areas, most notably China and Taiwan (the so-called China Plus One strategy), will take time and involve a considerable amount of expense. What we have in situ today has evolved over many years, a hyper-efficient structure driven by the rigorous logic of market forces. Unpicking it is akin to swimming upstream.

TSMC's founder and former chairman Morris Chang may have exaggerated to prove a point when he stated that TSMC chips manufactured in the US would cost twice as much as those produced in Taiwan, but he was not wrong to imply that they would be considerably more expensive.

To some extent, this will be the result of extra upfront capital expenditure. When complete, TSMC's fabrication plant (fab) in Arizona is expected to have cost as much as four to five times more to build than a fab in Taiwan. It is anticipated, however, that government subsidies and tax credits will offset a good proportion of this. This should also prove the case in Japan and Europe, where governments are similarly providing significant subsidies and tax breaks to encourage onshore manufacturing. More onerous are likely to be the higher operating costs incurred by manufacturing outside Taiwan. To understand why, a trip to Hsinchu, Taiwan's Silicon Valley, is explanatory.

TAIWAN'S SILICON VALLEY

A short bullet train-ride from the capital Taipei, Hsinchu is home to thousands of companies involved at various stages of the technology supply chain, suppliers of everything from plastics, ceramics and speciality chemicals to passive components such as the resistors, capacitors, printed circuit boards, and advanced cooling systems used in Nvidia's DGX B200. Hsinchu is also home to a highly specialised workforce that runs into the hundreds of thousands. This clustering of companies and people is incredibly efficient and cost-effective. Replicating such an ecosystem elsewhere would take decades.

But there is another operational factor at play in Hsinchu that other countries may struggle to recreate. In Hsinchu, the fabs run all day and all night, manned by an army of people prepared to work long and antisocial hours. In short, the work-life balance of the average semiconductor engineer in Taiwan could best be described as sub-optimal. It is hard to imagine US and European workers embracing such a gruelling work culture. So, on top of structurally higher wages in the US and Europe, TSMC will also likely be dealing with a structurally less productive workforce. Inevitably, this will lead to higher chip prices, at least in the near to medium term.

There are similar challenges at the 'downstream' stage of the process. Speaking with companies such as Foxconn and Pegatron, both heavily involved in manufacturing products such as smartphones, consumer electronics and electric vehicles, it was clear that whilst there is real impetus behind the efforts of downstream players to diversify production, they are still heavily reliant on China. In time, the likes of India, Vietnam, Malaysia, Mexico and Indonesia should all prove alternative sources of low-cost manufacturing, but for now none can match China for scale and productivity.

This should disabuse anyone still labouring under the assumption that de-risking is a quick fix. It is unrealistic to think that production can simply be picked up and moved elsewhere easily, or alternative suppliers readily sourced in other

> **"It is unrealistic to think that production can be picked up and moved elsewhere, or alternative suppliers readily sourced in other locations"**

locations. The supply chain is too specialised, and capacity is not interchangeable. The process will create friction, generating cost inflation and inefficiencies as manufacturers push against natural market forces. Consumers do not want to pay more for their electronics and companies do not want to sacrifice margins. It is unlikely that both will get their way.

THE VENEER OF DE-RISKING

Nothing in my conversations with companies at all stages of the production process made me think the industry is anything less than fully committed to the process of de-risking. Management teams are acutely aware of the need to adapt to the demands of geopolitical reality and to do so quickly. They may not like it – after all, many are being asked to make their businesses less efficient – but they understand the rules of engagement have changed and will not be changing back anytime soon.

On the current trajectory, some 15-20% of leading-edge semiconductor fabrication will take place outside Taiwan and China by 2027. Nvidia will be able to say that some of its chips are made in the US. Apple can tell its US customers that some of its phones are made in India rather than China. But in truth, this will be akin to a veneer of de-risking; Western companies will still depend heavily on Taiwan and China. Even on a ten-year horizon, whilst a more material degree of de-risking is possible with a lot of hard work and plentiful government subsidies, both countries will continue to have a significant presence across the supply chain.

RISKS WITHOUT FRONTIERS

This leads us to geopolitical risk and how investors should think about it in the context of technology. To take a very high-profile example, there is a tendency to view the risk of a Chinese invasion of Taiwan through a rather narrow, localised lens, to see a potential conflict as a Taiwan-specific risk.

Certainly, a full-scale war between China and Taiwan would be devastating for TSMC. It is, understandably, something about which the company is regularly grilled. Rarely, however, does Nvidia or Apple or Tesla have to field comparable questions.

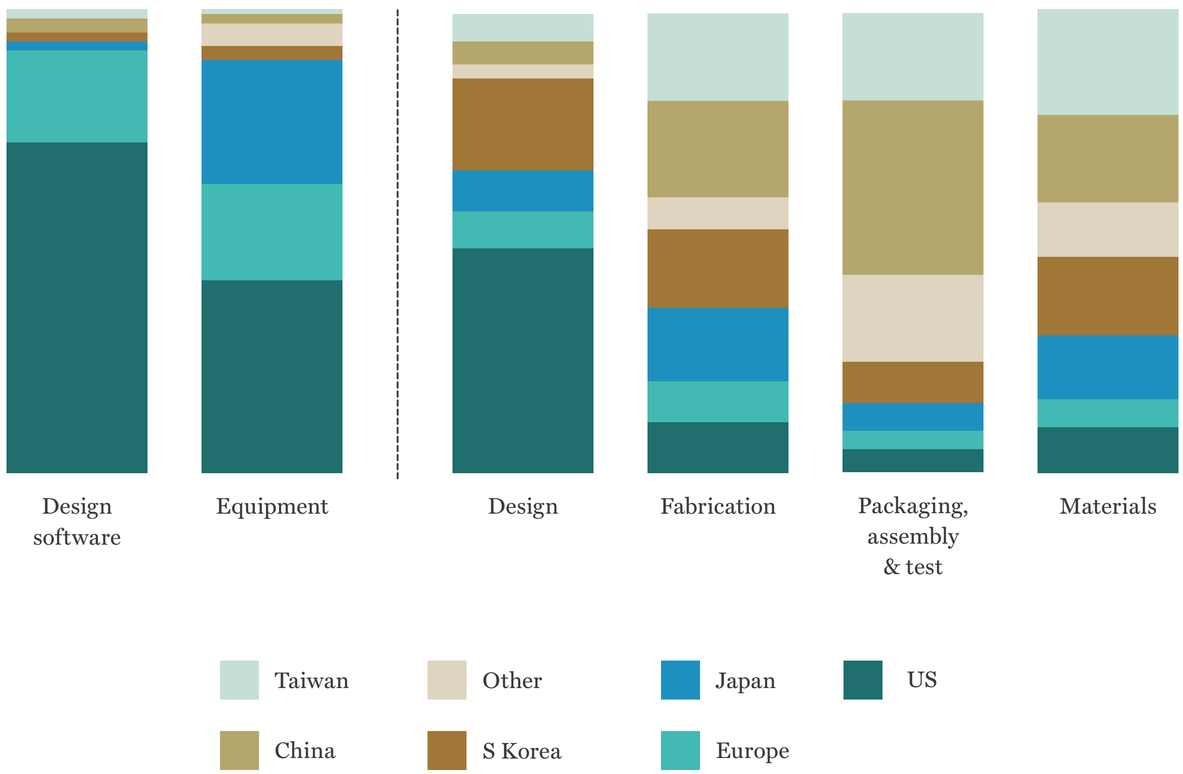
Yet, if Taiwan were to be invaded, these Silicon Valley behemoths would see production go close to zero for multiple years. This would be an economic disaster for countless US tech companies, the global economy and global stock markets. Some estimates put the cost to the world economy at US$2.5 trillion per year, significantly worse than the impact of the Global Financial Crisis.

In an ecosystem as interconnected as the semiconductor supply chain, risks have scant respect for borders, so we must consider them holistically. In recent years, management teams globally have had to reacquaint themselves with the old saying, “a chain is only as strong as its weakest link”. Investors would be wise to do the same.

“The cost of conflict between China and Taiwan to the world economy could be US$2.5 trillion per year, significantly worse than the impact of the Global Financial Crisis”

HOW LONG WILL IT TAKE TO DE-RISK?

SEMICONDUCTOR INDUSTRY VALUE ADDED
BY ACTIVITY AND REGION 2021 (%)

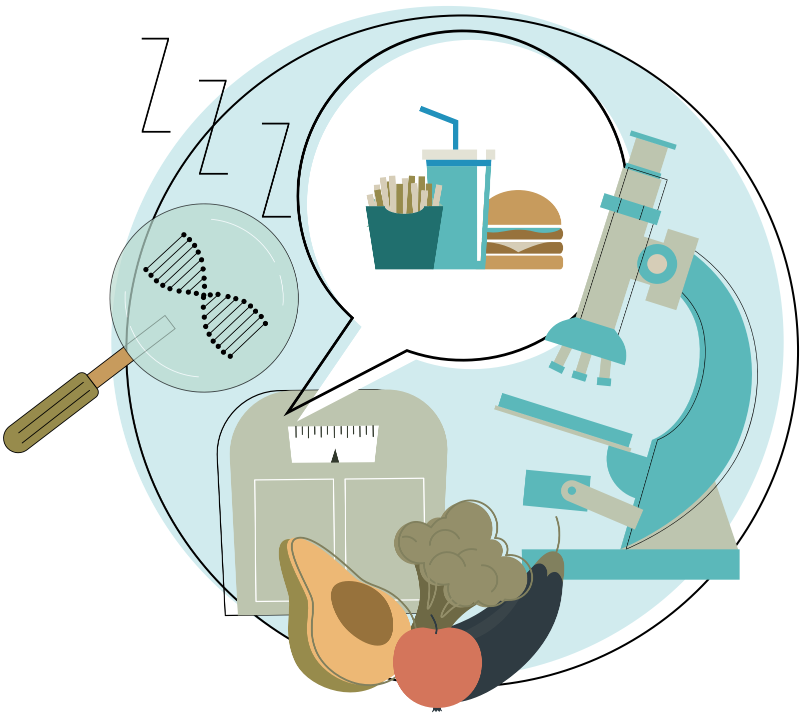


Source: Semiconductor Industry Association

INVESTMENT THINKING

WEIGHING UP THE EFFECTS OF WEIGHT-LOSS DRUGS

Novo Nordisk and Eli Lilly's ground-breaking anti-obesity drugs look set to transform the lives of millions of people across the globe, but what impact might they have on other companies in healthcare and beyond?



In September 2023, the previously low-key Danish healthcare company Novo Nordisk became Europe's largest company by market capitalisation. In December, the company's largely unheard-of CEO, Lars Fruergaard Jørgensen, was crowned the FT's Person of the Year.

Novo may have been founded all the way back in 1923 but 2023 was the year the company and its GLP-1 treatments, Ozempic and Wegovy, became household names. Discussion around these treatments and the resultant weight loss spread from the medical and financial press to tabloid and celebrity magazines and, of course, social media.

Alongside Novo Nordisk, Eli Lilly's GLP-1 treatments have also taken a lead in this market. Mounjaro and Zepbound might not yet enjoy the same name recognition, but Eli Lilly's financial performance and its share price have followed a similar trajectory over the past year.

The importance of these treatments should not be underestimated. It isn't only the size of this market – by 2030 obesity will affect an estimated one billion people worldwide[1] – but also the public health benefits. As Investment Manager Lindsay Scott explains, "It is hard to think of another drug with so many important and positive effects, both for the patient and for society at large. For morbidly obese patients, whose quality of life has been poor, GLP-1s are proving life-changing."

SEPARATING THE WISHFUL THINKING FROM THE REALISTIC POTENTIAL

As relatively new treatments, there isn't yet robust clinical evidence on either the very long-term results or side-effects but, given the potential magnitude of the take-up of these treatments, early studies have been seized upon and attention has unsurprisingly turned to second-order effects. If these treatments are the winners, who and what loses?

Much has been made of initial evidence, mainly from self-reported surveys, that GLP-1s may dampen the desire to drink alcohol and reduce cravings for sweet and salty snacks, highly processed foods and carbonated drinks. Without much evidence, some have then extrapolated those possible signs to suggest that a desire to gamble or scroll through social media may also be limited, and in effect controlled, for those taking these treatments.

On the merry-go-round of quarterly earnings calls, companies across healthcare as well as the food and beverage industries have in turn faced a litany of questions on how worried they are and what they are doing to address the potential impact of GLP-1s.

But, as observed by Investment Analyst Dr Oriana Beaumont, answering these questions with any degree of confidence or legitimacy is very difficult. "Whilst we have trial data to show that these treatments work, studies of the resultant side-effects are less robust."

68%

PERCENTAGE OF COCA-COLA'S PRODUCTS THAT HAVE LOW OR ZERO CALORIES

BRAND NAMES

Novo Nordisk and Eli Lilly have a virtual duopoly on GLP-1s (glucagon-like peptide 1 receptor agonists). Novo markets its GLP-1, semaglutide, as Ozempic for type-2 diabetes and Wegovy for weight loss. Meanwhile, Lilly's GLP-1, tirzepatide, is marketed as Mounjaro for diabetes and Zepbound for obesity. Whilst both Ozempic and Mounjaro are diabetes treatments, they do also result in weight loss and so are often mistakenly referred to in the media, and particularly across social media, as anti-obesity treatments.

“It is hard to think of another drug with so many important and positive effects, both for the patient and for society at large”

Oriana joined Walter Scott’s Research team in the summer of 2023, having successfully completed a degree in medicine. Putting her years of reading medical literature and assessing clinical evidence to almost immediate use, she has spent considerable time looking at the evidence.

“My goal was to get back to the basics. What is hard evidence? What is hysteria? And, taking that evidence, how might that fit into the real world?” she asks. “Not only are most of the current studies small but we just don’t yet have data on real-world patient groups. Access to these treatments to date has been mainly through self-pay or insurance, which skews the data. We don’t yet have sufficient data on patients achieving significant weight loss and who perhaps don’t have the support of dieticians or fitness coaches alongside these treatments.”

But, regardless of the lack of robust or definite data, the impact on the share price of several companies has been very real.

NO MORE BARIATRIC SURGERY OR KNEE REPLACEMENTS?

For medical device companies, it has been widely surmised that these new treatments will in time severely reduce, if not eliminate, the need for certain surgical procedures and medical interventions linked to obesity.

Intuitive Surgical, a leader in robotic surgery, has faced questions on the outlook for bariatric surgery, one of several procedures where robotic surgery is particularly effective. The conclusion that such procedures may decline in prevalence seems a reasonable one, but the context and market size are important.

As Lindsay Scott points out, “it is estimated that only 1-2%[2] of patients eligible for bariatric surgery actually go ahead”.

Fellow Investment Manager Max Skorniakov agrees. “Surgery is far from the default option and, as of today, there will continue to be specific circumstances where it is the only option,” he says. “It should also be remembered that bariatric surgery is currently estimated to be only about 4-5% of Intuitive’s total global procedures.”

Medical device manufacturer Stryker is another company that has been hit by claims that these drugs will mean a decline in knee replacements, and therefore a collapse in demand for Stryker’s knee implants. But here too, the situation is more nuanced, and the advent of the weight-loss drugs might even be a positive.

As Max explains, “you often need to lose weight to get a knee replacement, so these treatments might actually increase the potential audience for Stryker”. He adds that the bigger driver is degenerative disease. “If you live longer and use your knees more, you are more likely to need a replacement,” he says. “That only 10% of Stryker’s sales relate to products and services used in knee replacement procedures must also be remembered.”

ResMed is another medical device company that has come in for scrutiny, given that around 75% of its revenues come from devices and masks that treat obstructive sleep apnoea, a condition commonly linked to obesity. ResMed's continuous positive airway pressure (CPAP) device delivers pressurised air to patients, typically through a nasal mask, to prevent collapse of the upper airway during sleep.

But, in its response to what became widespread concern related to GLP-1s, ResMed has presented data[3] showing that patients prescribed obesity drugs are more, not less, likely to initiate positive airway pressure treatment. Mask resupply rates were also shown to be higher after one and two years on CPAP therapy for these patients. The results, based on tracked patients using GLP-1s since 2021, were drawn from a dataset of more than 500,000 patients, close to 90% of whom had been prescribed newer GLP-1 drugs.

As Max notes, "as with all studies in this emerging field, these findings will need to be confirmed by longer-term usage as GLP-1s become more widely available, but they did go quite some way to dispel the view that the new medication was a clear and certain negative for ResMed".

The company has also said it remains confident future data will show that patients following a course of combined CPAP and GLP-1 therapy are those who will enjoy the most optimal outcomes.

"Sleep apnoea is a widely under-diagnosed condition," stresses Max. "As patients become increasingly aware of the advantages in taking GLP-1s, they are more likely to consult their physicians, and it is their responsibility to diagnose all possible comorbidities, of which sleep apnoea is one of the most common. Relatively few patients are likely to achieve enough weight loss to render solutions such as CPAP machines for sleep apnoea redundant."

POSSIBLE SECOND-ORDER EFFECTS ON FOOD AND BEVERAGE COMPANIES

Few would have anticipated that the success of these GLP-1s and of Novo Nordisk and Eli Lilly would have weighed so much on companies outside the healthcare sector. The possibility that these treatments might dampen consumers' desire for certain foods, drinks and possibly behaviours is of course potentially very significant.

But it is far too early to jump to the conclusion, as many have, that GLP-1s herald the end of fast food and fizzy drinks. As Oriana explains, "There was a study in 2021[4] that suggested that GLP-1 receptors are expressed on adjacent nerve fibres in the tongue and therefore might impact taste and desire to consume certain types of food. But, as I have said before, we just don't have sufficient data."

Unsurprisingly, Diageo has attracted scrutiny as more extreme voices declare the long-term demise of its markets. The team at Walter Scott disagrees. For public health,

"Whilst we have trial data to show that these treatments work, studies of the resultant side-effects are less robust"

10%

PERCENTAGE OF STRYKER'S SALES RELATED TO KNEE REPLACEMENT PRODUCTS AND SERVICES

social and regulatory reasons, Diageo's strategy has already moved the company from mass-market, mass-consumed alcoholic drinks to more premium products. As Lindsay reminds us, "A strategy that encourages consumers to drink less but drink better is now very much in place at the company, a strategy that should also counter any possible GLP-1 impact, where indications are not a desire to not drink at all, there's just less interest in drinking a lot."

Walmart's CEO Doug McMillon has given some support to early evidence that consumption of salty, sugary and highly processed foods and drinks may decline. In October 2023, he commented that when looking at customers on GLP-1s, the company had seen "a slight change compared to the total population", with "a slight pullback in the overall basket with less units and slightly less calories".[5] For Walmart, that isn't necessarily bad. Basket constituents might change but a higher proportion of higher-margin fresh produce could instead be good news.

For many commentators, making a positive case for Nestlé seems more difficult. But, with only 15% of global revenues coming from either centre-of-plate or snacking products, the Swiss multinational considers any potential revenue loss to be limited.

In fact, in its third-quarter results call in November 2023, CEO Mark Schneider laid out not only a defence but a case for optimism. He stated, "Recent interest in GLP-1 agonists has underlined the public's desire to combat obesity rates [and] I believe we have important contributions to make. For the time that patients spend on these drugs, and after, we are already developing a number of companion products. The goal will be to address the risk of malnutrition and the loss of lean muscle mass while on the GLP-1 therapy and to avoid or limit weight rebound after the therapy. These innovations are right in our wheelhouse, where we can bring our deep understanding of nutritional science and appropriate supplementation to the table."[6]

ADAPTING TO CHANGE

The risk is arguably more significant for Coca-Cola, given the nature of its products and the fact that North America, which is expected to be the largest market for GLP-1s, is its biggest market. In surveys of people taking GLP-1s, there has been some suggestion that carbonated, sugary drinks is one of the food categories with the greatest reduction in consumption.

But, like others, Coca-Cola took the opportunity to address this perceived threat head-on in its communications around its third-quarter results in October 2023.[7] The company said that it considered itself to be well positioned to provide choice and options for people's respective motivations and needs, highlighting that 68% of Coca-Cola's products had low or zero calories.

Lindsay is confident Coca-Cola has already anticipated the GLP-1

"To paraphrase Mark Twain, the team at Walter Scott deems reports of the death of the Big Mac or the 'Diet Coke break' to be greatly exaggerated"

4-5%

PERCENTAGE OF INTUITIVE SURGICAL'S PROCEDURES ACCOUNTED FOR BY BARIATRIC SURGERY effect. "Whilst much of Coca-Cola's brand rests upon consistency and heritage, the company has proven itself able to navigate societal change for many decades," she says. "Just as a recent example, we've begun to see a move away from people buying litre bottles of Coke and instead purchasing more expensive boxes of six mini-cans as a treat. The company may lose sales over time in those large serving sizes, but those smaller cans are highly profitable."

In Lindsay's view, a similar case can be made for McDonald's, which has a long record of adapting to social change and a phenomenally strong brand. To paraphrase Mark Twain, the team at Walter Scott deems reports of the death of the Big Mac or the 'Diet Coke break' to be greatly exaggerated.

In attempting to address the global obesity epidemic, Novo and Lilly's GLP-1 treatments have provoked publicity and understandable hope unlike anything that has been seen before. The potential is unquestionable. However, as Lindsay concludes, "just because Sharon Osbourne has suffered side-effects and is talking to E! News about it, that isn't evidence".

Brand recognition also isn't evidence. Just because those who have become unofficial ambassadors for these drugs – from Oprah Winfrey to Elon Musk, Kim Kardashian and the British celebrity Jeremy Clarkson among many others – have huge social media followings and therefore an ability to turn these treatments into household names almost overnight, it doesn't mean we have robust data and evidence on likely impacts. Gathering that data both in the clinic and in the real world will take time, and analysing and assessing it will be just as important.

[1] World Obesity 'One billion people globally estimated to be living with obesity by 2030'

[2] National Library of Medicine 'Reasons for underutilization of bariatric surgery: the role of insurance benefit design'

[3] ResMed Q1 2024 earnings call transcript

[4] National Library of Medicine 'Glucagon-like peptide 1 and taste perception: from molecular mechanisms to potential clinical implications'

[5] Fortune magazine 'Walmart says shoppers taking Ozempic buy 'slightly less calories' as retailers brace for the financial consequences of weight-loss drugs'

[6] Nestlé 2023 nine-month sales conference call transcript

[7] Coca-Cola Q3 2023 earnings call transcript

ON THE ROAD

TEA AND TRAVELS IN JAPAN

Japan is a fascinating country that has been a source of interest and investment opportunities for Walter Scott over the firm's 40-year history. Another consistent hallmark of the firm has been the value placed on research trips. Executive Director Charlie Macquaker and Investment Analyst Connor Graham reflect on the value of their different perspectives on a recent visit to Japan

Towards the end of 2023, Executive Director Charlie Macquaker and Investment Analyst Connor Graham went to Japan for two weeks of meetings with 23 companies as well as one with the Bank of Japan. Charlie, who has been with Walter Scott since 1991, undertook his first research trip to the country the following year. Over the subsequent 30-plus years, he has visited Japan more than 20 times for work (plus a few times with family). For Connor, who joined the firm in 2020 and the Research Team in 2022, this was his first time in Japan and only his second research trip.

Perhaps unsurprisingly, Charlie says Japan has changed "beyond recognition" since his initial visits in the early 1990s. He vividly remembers "the stock market downturn unfolding, the property market shake-out and the banking crisis gradually unfurling". He adds, "There was a sense that these were a cyclical phenomenon, with a great deal of denial from many of the people we met back then, at a corporate and policy level, that it was anything more."

In the intervening years, as other crises, such as the dotcom bubble and Global Financial Crisis, have hit stock markets around the world, he reckons Japan did a good job of recognising and repairing many of its structural issues and, in the case of the financial crisis, emerged relatively unscathed by comparison with other developed nations.

Walking around central Tokyo on this latest trip with one of the city's largest landowners, Mitsubishi Estate, Charlie was struck by the extent to which the landscape has been transformed. As a newcomer to Japan, Connor described the benefit of travelling with Charlie as "rather like a camera lens, widening the angle beyond your own view". Since the early days, Walter Scott teams "have hunted in pairs", he observes. Charlie said: "With research trips, one's knowledge increases exponentially in the early years. I feel it's very much part of my role to share my experiences with younger members of the team because I had the good fortune of travelling with our founders."

CORPORATE THEATRICS

The real value of travelling together comes to the fore in the meetings with companies. Preparation is always key, and the benefit of being with a senior colleague is hearing their thoughts in advance of these engagements, particularly regarding lines of questioning. This is even more important in a country like Japan, where corporate culture differences are well documented. Having already met several Japanese companies in Walter Scott's offices in Edinburgh, the formal element of these exchanges did not faze Connor. "There is a very defined structure to how things are done, whether it's handing over a business card or the order in which you introduce yourself to people. It's important to start off on the right foot, to be authentic, in order to build a respectful relationship," he said.

Charlie is all too aware of the protocols and complexities of

"There is a very defined structure to how things are done, whether it's handing over a business card or the order in which you introduce yourself to people"

these meetings. It is not simply the management teams but also the translators who could make or break a meeting. By working with the same translators over the years, the team has built a robust rapport, so the translators understand the specific line of questioning and can push the point when required. Charlie suggests that it is important to understand that you will never get all the answers in these meetings. “It is naive to go into these meetings with a list of 40 questions,” he said. “Given the time usually allocated to a meeting, plus the requirement for translation, it doesn’t take a mathematician to realise you’re going to be up against the clock.”

Regardless of the time constraint, Charlie and Connor agree that the power of being in the same room beats an online meeting every time. “Even without anything beyond the most basic Japanese, you can get a sense of the facial expressions, the confidence or enthusiasm with which people came back to ideas, reinforced them or tried to dismiss them. It was very powerful,” Connor said. Or, as Charlie put it, “You can read the subliminal signals that don’t come across through a screen.”

By travelling together throughout, the post-meeting debriefs provide a useful opportunity to share and cross-check initial thoughts. For Connor, “to directly learn the skill of the job from Charlie regarding his questioning technique with companies and also to discuss each meeting immediately afterwards was hugely valuable”.

TIME-HONOURED TRADITION

In the same way that Japan’s economic backdrop has changed considerably over the course of Charlie’s career, so too has the corporate governance landscape. When visiting the headquarters of factory automation manufacturer Fanuc near the base of Mount Fuji, Charlie was struck by the very visible progress that had been made over the course of his career.

He recalled having previously “reached a point of deep frustration” regarding the time the company took to publish its annual report. “I made a concerted effort, nipping away at them in the politest possible way,” he said. Today, it’s clear that the message was taken on board. Fanuc has a detailed integrated report, as well as an ESG report, providing plenty of information. The company even has an investor relations team, which would have been unheard of only a few years ago.

This type of long-term rapport has real resonance in Japan, enabling Charlie and others to engage companies in robust discussions on all issues. Shin-Etsu Chemical offers another good example of a dialogue built up over decades. When Charlie and Connor met the company’s president Yasuhiko Saitoh, he recalled a meeting that Charlie and others, including Walter Scott’s Managing Director Jane Henderson, had had with the former Chairman Chihiro Kanagawa in 2015, which prompted a transformation of Shin-Etsu’s capital returns policy.

“With research trips, one’s knowledge increases exponentially in the early years”

Connor observed that this history had provided “an additional dimension to the discussion, in terms of that trust which has been built up with the management team.”

There was a similar experience with Sysmex, the haematology diagnostics business. Following an hour-long discussion with President Kaoru Asano, he took them to a traditional tea house in a beautiful formal garden beside the company’s R&D building. Connor described the scene: “There was real thought in the design process. An example of this was the path to the tea house, which was paved with a deliberate crookedness, so you had to consciously think about where you were putting your feet. It’s very similar to how considered many Japanese management teams are, always thinking about the long-term impact of their current actions.”

Instances such as this really stood out for Connor, who is relatively early in his career. He said the meetings with the various companies were made all the more worthwhile because he had “the benefit of Charlie’s experience and well-honed perspective, which was invaluable”. For all the reasons mentioned and many more, visiting Japan to meet world-leading businesses is a unique experience and a real privilege.

INVESTMENT CONTEXT

THE DANGER POSED BY THE **WORLD'S DEBT** MOUNTAIN

Successive crises have led governments around the globe to borrow with abandon, and businesses and individuals have followed suit. David Smith examines the perils of this approach

As Benjamin Franklin might have said, in this world nothing can be said to be certain, except debt and taxes.* The first of these, debt, has started to preoccupy investors, and with good reason. Global debt – cumulative borrowing by governments, households and businesses – has reached "dangerously" high levels, according to a briefing updated by the World Economic Forum for this year's Davos summit.[1]

In similar vein a recent Reuters report[2] focused on the central issue, which is that higher interest rates have significantly increased the costs of debt. As the report put it: "Record debts, high interest rates, the costs of climate change, health and pension spending as populations age and fractious politics are stoking fears of a financial market crisis in major developed economies. A surge in government borrowing costs has put high debt in the spotlight, with investors demanding increased compensation to hold long-term bonds and policymakers urging caution on public finances."

The International Monetary Fund noted recently that global debt had returned to its rising trend, which raised questions about its sustainability, and highlighted the effects on poorer countries.

"More than half of low-income developing countries are in or at high risk of debt distress, and about one fifth of emerging markets have sovereign bonds trading at distressed levels," it said while launching an update to its Global Debt Database in September last year.[3] "Governments should take urgent steps to help reduce debt vulnerabilities and reverse long-term debt trends."

How worried should we be by this? The numbers are certainly striking. According to that IMF Global Debt Database, total debt is some $235 trillion (£185 trillion), or 238% of world GDP. Within this total, public debt averages 92% of GDP, having risen from 62% in the 1990s. The rest is private sector debt.

America, as you would expect from the world's biggest economy, has high levels of debt both in dollar terms and as a percentage of GDP. The Biden administration, in its efforts to expand the economy after the pandemic, has added significantly to the country's debt. An American government website called Fiscal Data updates the figure for accumulated US government debt daily. The total stood recently at $34.3 trillion. That is larger than America's GDP of about $28 trillion.

Federal government debt is, though, lower than private debt. America's overall debt is 274% of GDP, with private debt more than 150% of GDP.

While high debt in an advanced economy like America is perhaps to be expected, more surprising is the rapid build-up of debt in China, still an emerging economy. China stands out for the rise in its private debt, which barely existed 50 years ago but is now 195% of GDP. Total debt is 272% of GDP, similar

"High and rising levels of debt raise two questions, whether debt taken on under the assumption that low rates were here to stay can now be serviced and whether the global economy could be caught in a 'debt trap'"

to that of America. The People's Republic is also markedly different to other emerging economies, which have average total debt of 124% of GDP. Some economists regard the combination of China's high debt and ageing population as a key vulnerability.

Japan is the world's undisputed debt leader, with debt an extraordinary 441% of GDP, 261% of it in the form of government debt. It has so far proved to be sustainable because Japanese financial institutions and individuals have been ready buyers of Japanese government bonds.

Not all countries are accumulating debt. Germany, vying with Japan to be the world's third largest economy, has public sector debt of some 64% of GDP. Unlike other countries, its public debt fell relative to the size of the economy after the financial crisis. Private sector debt, 78% of GDP, is lower than it was in the early 2000s.

NEW PATTERN EMERGING THIS CENTURY

More generally, high and rising levels of debt raise two important questions. The first is whether debt taken on in the expectation that very low interest rates were here to stay can be serviced now that rates have returned to more normal levels.

The second is whether, partly because of higher interest rates, levels of debt themselves could see the global economy caught in a 'debt trap'. This trap, which is concerning policymakers, arises when excessive indebtedness constrains the ability of governments, households and businesses to borrow further to fund investment and consumption. Debt can also affect the stability of the financial system.

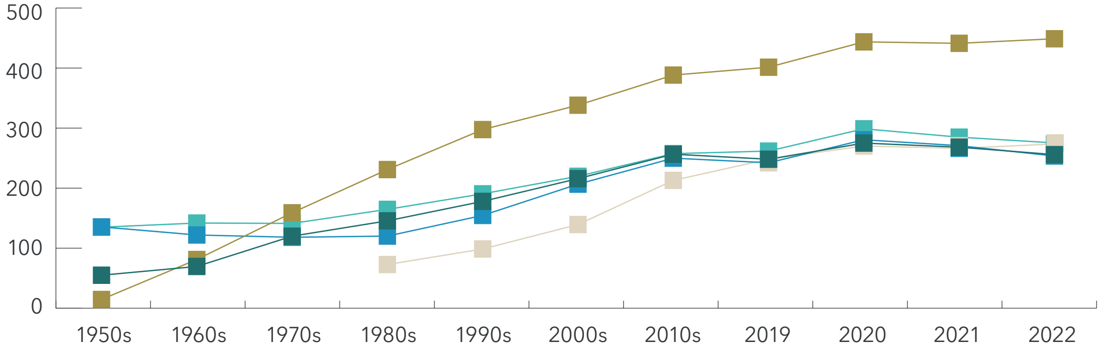
The concern is justified. The pattern so far this century has been for successive economic shocks to add to debt, particularly government debt, and for any fiscal consolidation once the shock is over to be insufficient. This contrasts with the experience after the Second World War, which was followed by half a century in which government debt to GDP ratios were reduced very significantly in most countries. That was a programme for re-establishing debt sustainability. Something like that may be needed again.

The UK, as so often, is caught in the middle of these concerns. UK government debt, here called 'public sector net debt', did not rise above £500 billion until 2006, the eve of the financial crisis, before quickly doubling to £1,000 billion, £1 trillion, in four years partly because of that crisis.

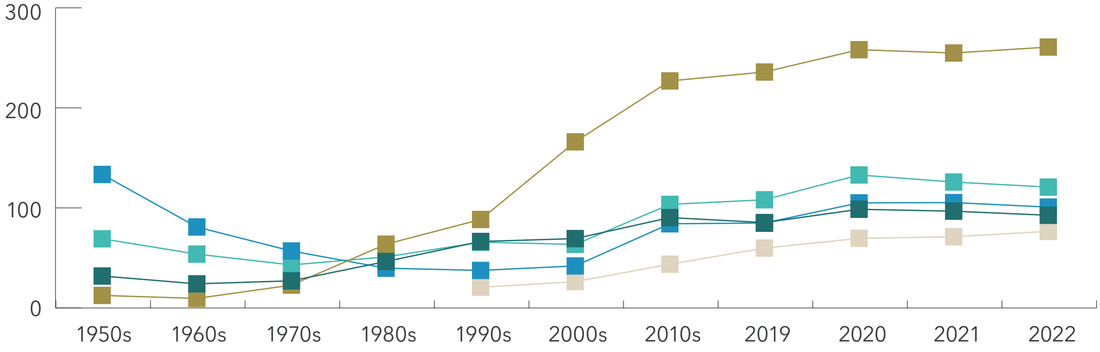
Those figures, though, merely represented the foothills. Ten years later, at the end of the 2010s, the debt had doubled again to £2,000 billion, £2 trillion, rising again to its current £2.7 trillion because of the pandemic and its aftermath. In other words, UK government 'net' debt is more than five times what it was less than 20 years ago. Some of that, of course, reflects inflation, but it has also increased from 34% to almost 100% of GDP.

"How worried should we be by this? The numbers are certainly striking. According to the IMF Global Debt Database, total debt is some $235 trillion, or 238% of world GDP"

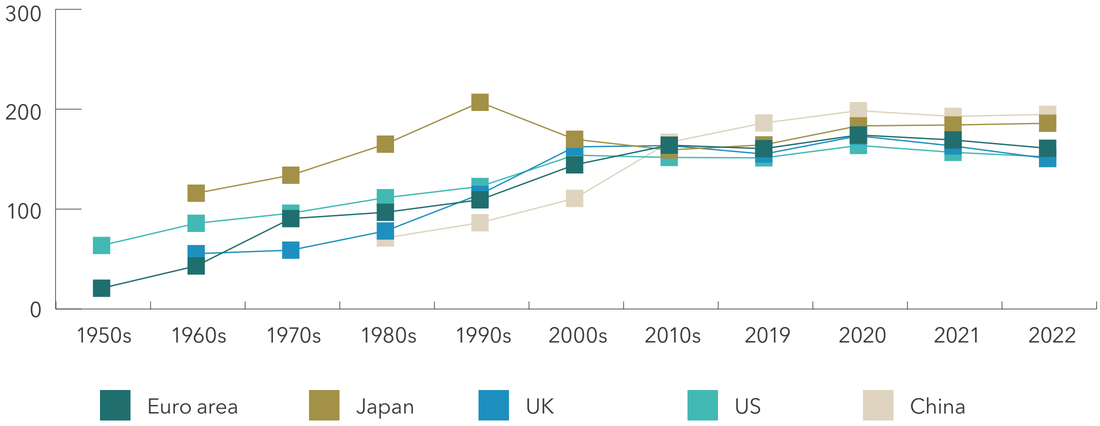
GLOBAL TOTAL DEBT AS % OF GDP



GLOBAL PUBLIC DEBT AS % OF GDP



GLOBAL PRIVATE DEBT AS % OF GDP



Source: IMF Global Debt Database, 2023. Weighted averages 1950-1922. Values in columns indicating decades report the average debt level during that decade

The UK's household debt has also increased, though not as rapidly as government debt. It stands at £1.84 trillion, up from £1.1 trillion in 2006. That is another 80% of GDP. To government and household debt it is necessary to add corporate debt, another £1.5 trillion, or 66% of GDP.

Add these three up and you quickly get to a total of more than £6 trillion, or between 240% and 250% of GDP. These are large numbers, and the troubling thing is that much of this debt was built up during the period of near-zero official interest rates. In the case of public sector debt, its burden was made all the easier by the fact that much of it was bought by the Bank of England under quantitative easing (QE), effectively providing the government with interest-free borrowing.

IMPLICATIONS FOR HOUSEHOLDS AND BUSINESS

While government debt has risen to new highs relative to GDP, household debt is lower as a percentage of disposable income than it was at the time of the Global Financial Crisis. This suggests that when times were tough, governments stepped in and supported incomes, as happened during the pandemic, taking some of the debt burden away from households and businesses. There was a similar phenomenon for the banks during the financial crisis.

The Bank of England has nevertheless identified vulnerabilities for both household and corporate borrowers. In its most recent Financial Stability Report, it said "Household finances remain stretched by increased living costs and higher interest rates, some of which has yet to be reflected in higher mortgage repayments." For businesses, "the full impact of higher financing costs has not yet passed through to all corporate borrowers, and will be felt unevenly, with some smaller or highly leveraged UK firms likely to remain under pressure".

There is also a big challenge to governments from the rise in debt interest costs. David Miles, a member of the Office for Budget Responsibility's fiscal responsibility committee, set out the problem in recent evidence to the House of Lords' Economic Affairs Committee: "The funding of the existing stock of UK government debt has already become a substantially greater burden. This reflects not just a much higher stock of government debt relative to GDP than in the past but also a recent substantial rise in the real interest rate on that debt."

The picture is further complicated by the unwinding of QE and its evolution into quantitative tightening (QT): selling back to the markets the assets, mainly government bonds, acquired under QE. This will crystallise QE losses, which could amount to very substantial sums, and will require large-scale transfers from governments to their central banks. Debt raises major issues and concerns, not just for individuals, but for companies and the wider global economy.

*Benjamin Franklin actually said, "In this world nothing can be said to be certain, except death and taxes."

[1]World Economic Forum 'Global debt is at $307 trillion. Why does it matter?'

[2]Reuters 'As global debt worries mount, is another crisis brewing?'

[3]International Monetary Fund 'Global Debt Is Returning to its Rising Trend'

UNDERSTANDING BORROWING RISK

Investment Manager Fiona Macrae explains why Walter Scott pays unusually close attention to debt

Every year, a small group within Walter Scott's Research team, of which I am certainly one, eagerly anticipates the Annual Economic Report from the Basel-based Bank for International Settlements.

"Financial engineering is a term that makes many of us instantly uneasy"

The team's longstanding reluctance to invest in bank stocks is well-known, but that is not to say we ignore banks. Understanding bank balance sheets is critical to understanding a vital pillar of global financial security. Debt can be a dangerous weapon. It can quickly unravel, and knock-on effects can be as unexpected as they are rapid.

We need to understand systemic risk to understand the context in which companies worldwide operate and may have to operate in the future. While our investment decisions don't rest on macroeconomic calls or best guesses on monetary policy, we must understand the risks associated with sovereign, corporate and personal debt.

Our investment approach is grounded in conservatism. We are ambitious in our search for world-leading companies, but we look for prudence alongside evidence of innovation and inspirational cultures. Financial engineering is a term that makes many of us instantly uneasy. We have never been convinced by complicated explanations as to why gearing is great. Efficient financial management has its place, but as investors we prize strong cash generation and self-funded investment.

I am unusual within the firm in that I had a career in fund management before I joined Walter Scott in 2014, managing funds for over 25 years at three other investment companies. In my experience, I can confidently say that the Walter Scott team not only reads more about debt but also spends more time thinking about and discussing the ramifications of debt than elsewhere. Robust balance sheets are a prerequisite, and we spend a great deal of time understanding debt tenure and cost.

Given the current environment and higher debt levels on almost all fronts, our approach doesn't only seem sensible and prudent; it seems more relevant and vital than ever.

ECONOMIC CONTEXT

WHY INFLATION FORECASTS ARE ALWAYS WRONG

Over the past 10 years, Dr Sean Brocklebank from the University of Edinburgh's School of Economics has shared his knowledge and insights with Walter Scott's investment team as part of the firm's research training programme. He's covered over 60 topics, ranging from the metaverse and Chinese real estate to taxes and cognitive diversity. Although he has revisited several topics, there is one he is asked about repeatedly – monetary policy and how to assess what is really happening from the volume of data available

Britain's Meteorological Office proudly declares that its five-day weather forecasts are now as accurate as its one-day forecasts were 30 years ago. This highlights two features of predicting the weather: firstly, the improvement over time, and secondly that it is easier to make short-term than long-term forecasts. Is it the same with forecasting inflation? You would be forgiven for guessing so, but it turns out to be the opposite. The first inversion is that it's harder to forecast inflation in the short term than in the medium to long term, and the second is that we've collectively become worse at forecasting inflation over the past few decades.

Forecasting inflation is something I've discussed often with Walter Scott's Research team. I've run 60-odd training sessions in the firm's offices in Charlotte Square over the past 10 years and monetary policy is the topic that has come up most frequently. Part of the reason we keep coming back to it is that predicting inflation and interest rates is something I can rely on to provoke lively debate among the team at Walter Scott. They often ask me to pick sides and then do their utmost to persuade me to support their view.

However, the main reason we speak about it so often is that inflation and interest rates clearly matter for equity markets, and predicting them, difficult as it is, feels like it should be straightforward: there's one main tool (interest rates) controlled by one agency (the Fed*) which that agency moves up or down to achieve one desired target (inflation of 2%). If inflation is too high, raise interest rates; if it's too low, cut them; if it's bang on target, keep rates steady. It sounds so easy. You can have years in a row in which inflation every quarter is within about half a percentage point of its target. In these times, it feels as simple as predicting a white Christmas in Greenland.

The accuracy of inflation expectations matters not only because we want to make good forecasts for ourselves; it also matters for policy because there is a feedback loop. Higher inflation expectations can become self-fulfilling if they lead firms to increase prices and contribute to rising inflation. In testimony to Congress in 2019, when he was already Chairman of the Fed, Jerome Powell said: "In our thinking, inflation expectations are the most important driver in actual inflation." And because central bankers believe that their own words and actions can in turn influence inflation expectations, they think about expectations a lot.

There are basically three kinds of inflation forecasters, and the Fed pays attention to all of them. There are financial market indicators, surveys of firms and households (these two have similar issues so get lumped together), and professional forecasters. The Fed relies on all three sources because each has its own imperfections.

Financial markets can be hard to read because they often give a signal on more than one thing with a

"Part of the reason we keep coming back to it is that predicting inflation and interest rates is something I can rely on to provoke lively debate among the team at Walter Scott"

single price. For example, the spread in yields between the American Treasury's Inflation-Protected Securities (TIPS) and the vanilla Treasury securities is supposed to indicate the market's inflation expectations. But the problem is that during times of crisis the lower levels of liquidity in the smaller TIPS market can mean that TIPS trade at a discount, and the liquidity premium gets blurred with the inflation expectation and makes it hard to quantify either of them.

Surveys of firms and households, in contrast, suffer from a variety of cognitive biases. These forecasts were systematically biased upwards for the 2000s and 2010s, but then were not nearly high enough as inflation began to climb dramatically in 2021. Both households' and firms' short-term forecasts tend to be too close to their long-term ones, so they miss turning points. Both groups also seem to pay too little attention to policy announcements, making the turning points yet harder to foresee.

Household forecasts are artificially volatile because people often base them on just a handful of goods whose prices are easily remembered (men tend to think about the price of gasoline and beer while women tend to think about milk and bread).

One bright spot from Finland – where all military draftees, in other words all the male population, take an intelligence test – is that household forecasters with higher IQs tend both to forecast more accurately and to respond appropriately to those forecasts (e.g. by making large purchases sooner when higher inflation is expected in the future).

The professional forecasters tend to be a lot better than households and firms as they lack most of the obvious biases, but they still suffer from two problems: their forecasting methods are similar to those already used at the Fed, so they add little value, and, despite being more accurate, they are still not very accurate in an absolute sense. They generally misjudge short-term dynamics (though medium-to-long-term forecasts are reliably good).

Ominously, these three forecasting groups not only are relatively poor at forecasting short-run changes but have become worse over time. Over the entire 1981 to 2021 period the correlation between future inflation and household expectations was about +0.2, while for professional forecasters it was about +0.5. But the correlation for both groups over the 2011 to 2021 period was essentially zero. Why are forecasts becoming less accurate? Are we entering a new dark age of forecasting – will we soon fall back on crystal balls and animal entrails?

No. Perhaps the most important difference between inflation and the weather in this regard is that while the atmosphere is not actively working to subvert our expectations about rainfall or sunshine, the Fed is doing exactly that. When the consensus forecast is that long-term inflation will be 3% or 4%, the Fed takes measures to bring both actual and expected inflation back down to the 2% target.

"The main reason we speak about it so often is that inflation and interest rates clearly matter for equity markets, and predicting them, difficult as it is, feels like it should be straightforward"

"Professional forecasters tend to be a lot better than households and firms as they lack biases, but their forecasting methods are similar to those used at the Fed, so they add little value"

Powell's job is to make sure that forecasters are wrong when they forecast anything other than 2%. But when everybody forecasts 2% all the time, the correlation between predicted and actual inflation (which has some white noise even when the targets are met) will be zero. One interpretation – my interpretation – of the declining accuracy of inflation forecasts in recent decades is that the Fed has become better at doing its job. It wants that correlation to be zero. So, forecasting inflation is not at all like forecasting the weather.

Whatever the consequences for the economy and markets, this at least guarantees many more spirited but good-natured debates about monetary policy for me and the Walter Scott team over the years to come – a prospect that pleases me enormously.

"Household forecasts are artificially volatile because people often base them on just a handful of goods whose prices are easily remembered (men tend to think about the price of gasoline and beer while women tend to think about milk and bread)"

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*At least for Americans and the 100 million or so people living in countries pegged to the dollar

INVESTMENT THINKING

A LONG PERSPECTIVE ON INFLATION

As Chairman of Walter Scott, Alex Hammond-Chambers lived through the inflationary spirals of the late 20th century. He draws out some lessons learned from the past

Measuring the column inches devoted to the semantics of inflation has become an almost full-time occupation.

We have had commentary on headline inflation (it has subsided), underlying inflation (not so much) and regular assessments of where central banks are in the "last mile" in the current inflationary cycle (the jury is out).

Inflation matters to growth investors, of course, because it affects portfolio returns over time, and results in poor relative returns as price/earnings and other value ratios contract. Assets under management also shrink as investors migrate to other asset classes.

So, where are we with inflation, and what does this mean for today's asset management community?

I think it's valuable to step back from the running commentary and attempt to extrapolate what may be happening by applying the lens of historical perspective. To look back to look forward, in other words.

I also think it can help to have seen a version of this movie before. When in the mid-1960s I joined Ivory & Sime, the predecessor company of Walter Scott, it was a time when the investment culture was still very much influenced by the Depression. People were far more concerned about dividend yields. Bonds were preferred to equities, and people were very risk averse.

But over my career this changed. While we saw inflationary cycles driven by the oil crisis of 1973, and later in the 1980s, we then enjoyed an extraordinary 30-year period of good economic growth globally accompanied by remarkably low levels of inflation (with a few bumps along the way).

The Cold War came to end with the fall of the Berlin Wall, globalisation took off, China became the world's low-cost factory and technology – chiefly the internet – as well as relatively liberal immigration and labour movement policies helped keep a lid on the cost of living. All the tea leaves were in the right place, and monetary policy drank from that cup.

But now, another big shift is happening. Globalisation is in a version of retreat, supply chains are regionalising amid trade frictions, and China is no longer the force it was in keeping labour costs down. Market capitalism has come under question, while labour mobility has reduced.

In 2021, I shared my thoughts at that time with our Research team and cited some of these factors to argue that there had been a build-up of policies, structures and practices that could form the basis of a sustained cost push – in other words structural, as opposed to cyclical, inflation. And that could be hard to unwind.

Fast forward to today and three further factors lead me to sharpen my view that, on balance, we may have indeed entered a period of sustained inflation that will affect

"It's valuable to step back from the running commentary and attempt to extrapolate what may be happening by applying the lens of historical perspective"

"There are few benign inflationary scenarios inherent in the current trajectory of our fractured geopolitics"

the nature of equity markets we experience in the next decade.

The first is climate change, and the potentially inflationary implications of the trillions in investment needed to reverse or at least halt global warming. Some of the solutions being proposed are also somewhat experimental in nature, and minds have been changing on what constitutes "green" or sustainable investment. For example, in 2022 the European Union added gas and nuclear power plants to a list of investments that could be considered "green", after Brussels had at times earlier come to the opposing view.[1]

The second is artificial intelligence. To a large extent I feel this falls into the category of Rumsfeldian "known unknowns" at the moment. I am not making an explicit link with inflation here, but the scale and depth of AI's impact on productivity, business efficiency, even on human life as it is currently lived, will be irreversible.

The third, and possibly most powerful, is geopolitics. In the late 1960s, as the Vietnam conflict was sucking in ever more American men and materials, US President Lyndon Johnson issued a stark warning to Congress that the country would have to choose between spending on social welfare programmes and war – "guns or butter", as the now famous phrase went. History shows how war in many ways set the stage for the inflation of the 1970s.

The war that rages as a result of Russia's invasion of Ukraine, Israel's campaign against Hamas in Gaza, and other conflicts (including Sudan's civil war) have the potential to be inflationary. Any Chinese invasion of Taiwan almost certainly would be. Then there is the still under-appreciated wild card risk of a conflict on the Korean peninsula. The bottom line is that there are few benign inflationary scenarios inherent in the current trajectory of our fractured geopolitics.

There are valuable lessons from all of this for asset managers.

One is that it pays to think about the context of your investing. When I started in the investing world, we didn't have spreadsheets. Instead, we wrote down numbers in rows and columns and figured out what we could discern from that. But we also had to think about the world we were in. Sadly, it's the case today that a tremendous amount of fund management is just run off the data on a screen, which is used to build a model for a company. But I always ask: Do you really know your company? Have you visited it, and met the people who run it?

At Walter Scott I'm pleased to say we do get out of the office, get away from the screen, and get to know our companies. That's very important when you're trying to understand the context of an investment. By talking to companies about things other than quarterly earnings, we obtain a very good feel for what is going on in the economy. A retailer in Des Moines, Iowa can tell you a lot about what's happening in Iowa. Take all the conversations that Walter Scott has with companies across sectors and countries every day or every week, and you can build up a very good picture. A picture you don't get just sat behind a computer screen perfecting a financial model.

Another lesson is that it is unwise to dismiss a risk just because you don't want it to be a risk. We asset managers don't particularly like inconvenient truths and can be inclined to dismiss them when they crop up. But that's not a smart reflex. (To their credit, central bankers learned in this recent inflationary spike that previously unforeseen or unheeded risks needed to be taken more seriously in their forward-looking assessments of interest rates.)

A generation that has not experienced inflationary cycles, war or some other major dislocation can best equip itself against investment uncertainty by keeping these two lessons in mind.

[1] Reuters 'EU parliament backs labelling gas and nuclear investments as green', 6 July 2022

ON THE ROAD

UNIQUE **INSIGHTS**

Research trips are an integral part of our bottom-up approach. Through written notes and the occasional video our Research team hopes to give you a sense of what those trips entail and what we mean by in-depth research

CONFOUNDING THE CRITICS: ON THE ROAD IN ITALY

In September 2023, Investment Managers Lindsay Scott and Jamie Zegleman travelled to Italy to meet with companies across the healthcare, industrial, technology and luxury sectors.

SCAN TO WATCH

NOT FRAGILE AFTER ALL THESE YEARS: ON THE ROAD IN INDONESIA

Ten years on from the turmoil of the taper tantrum, Indonesia is enjoying a period of sustained growth and stability. In September 2023, Fraser Fox and Michael Scott travelled to the country to dig a little deeper into this Asian success story.

SCAN TO READ

HOLD THE OBITUARY: ON THE ROAD IN HONG KONG

A turbulent few years for Hong Kong have led many observers to suggest the city's star is on the wane, particularly with Beijing exerting greater influence on day-to-day life. But on a research trip to the city in September 2023, Investment Manager Alan Lander heard a very different story.

SCAN TO READ

INVESTMENT CONTEXT

GROWING GEOPOLITICAL RISK AT A **CRITICAL** TIME

The Korean peninsula has seen conflict many times. However, with an ominous recent change in North Korean policy towards the South, Chad O'Carroll from Korea Risk Group argues that investors and observers need to pay close attention

ON THE ROAD IN SOUTH KOREA 2024

Investment Manager and Head of Research Alan Lander explains how geopolitical thinking will be incorporated into the Research team's preparation for a forthcoming trip to South Korea

Later this year, members of the Research team will head back to Korea. For investors, the country may perhaps be best known for its family-run chaebols, or conglomerates, companies such as Samsung, Hyundai and LG.

However, South Korea is also home to less well-known companies that enjoy an established and entrenched market position in particular niches. This research trip is a chance to meet both kinds of businesses and assess the outlook for those companies, as well as to understand where investment and innovation are being focused. South Korea's global leadership in technology and engineering is unquestionable, but how will that competitive edge be maintained over time?

Corporate governance will be another agenda item. While globally accepted best practice is increasingly being adopted, the responsibilities of stewardship better accepted, and considerable improvements made in simplifying often complex corporate structures, there is more to be done. It would be a mistake to underestimate the degree of cultural and organisational change needed to bring that about, but we must understand management's commitment to further change.

As investors, we consider all kinds of risks carefully to understand the context in which companies operate. Among all the conflicts and geopolitical issues around the world, tensions in the Korean peninsula may perhaps be one of the least understood but potentially one of the most serious. Here, Seoul-based commentator Chad O'Carroll assesses the current political climate and explains why it merits careful consideration.

Over 2024 so far, the situation on the Korean peninsula has been marked by escalating tensions, strategic shifts and growing concerns about the potential for confrontation between North and South Korea. While most commentators believe any such confrontation would be limited, statements from the most recent plenary meeting of the committee of the Workers' Party of Korea, the government of North Korea,[1] and South Korea's increasingly assertive defence posture,[2] have contributed to a heightened risk environment that demands close attention from the international community.

North Korea's plenum last December revealed a concerning strategic recalibration in the North's approach to inter-Korean relations and a shift in its attitude towards the United States. Abandoning its long-standing goal of reunification and reframing South Korea as an enemy state, Pyongyang signalled a fundamental shift in its foreign policy. It has an unprecedented strategic motivation to take actions that will demonstrate to its citizens that the South is a true foe.

These changes, coupled with North Korea's hardened stance towards Washington and its strengthening

"By abandoning its long-standing goal of reunification and reframing South Korea as an enemy state, Pyongyang has signalled a fundamental shift in its foreign policy"

of ties with China, Russia and other like-minded countries, suggest that the North is preparing for long-term acrimony with the South and the US while insulating itself from external military and economic pressures.

The risk of some form of military confrontation on the Korean peninsula – even if likely to be limited in scale and length – has become particularly acute in the current climate. Furthermore, there is growing evidence[3] to suggest that North Korea may deliberately seek to exploit the South's assertive defence posture, potentially baiting Seoul into taking military action that could be used to justify a direct counterattack. Escalating rhetoric and the frequency of tit-for-tat military responses on both sides have heightened the risk of miscalculations and accidents, with minor incidents having the potential to spiral out of control.

THE NORTH REARMS

One key factor contributing to the heightened immediate risk is North Korea's significant advances in nuclear weapons and missile capabilities. Its successful test launches of four types of liquid and solid-fuel intercontinental ballistic missiles since 2017, as well as efforts to enhance targeting capabilities through the ongoing deployment of reconnaissance satellites,[4] have bolstered Pyongyang's confidence in its ability to deter US involvement in any local conflict between the two Koreas. In other words, the North may judge that it now could limit any US military response by using its long-range missiles to threaten cities in North America.

Combined with a changing geopolitical landscape, marked by Russia's war against Ukraine and China's growing acceptance of North Korea's nuclear status, it is possible that Pyongyang also perceives a reduced likelihood of international consequences for future military actions – such as deliberately engineered border incidents – that it takes against the South.

A DOUBLE CHALLENGE

For South Korea and Japan, the current situation poses significant security challenges. Both countries are within range of North Korea's nuclear and missile capabilities, and in the event of a broader conflict on the peninsula, there would be devastating consequences for the region. It's also possible that a future conflict over Taiwan could drag the peninsula into a broader geopolitical crisis, with North Korea supporting China directly or indirectly and the South supporting the US. As a result, South Korea faces the dual challenge of deterring North Korean aggression while managing the risk of escalation. Japan, meanwhile, has expressed growing concerns about North Korea's military advances and has sought to strengthen its own defences in response.

One critical factor often overlooked in discussions about the Korean peninsula is the potential impact of domestic South Korean politics on the security situation. In South Korea, the Yoon administration's hawkish stance and assertive defence position have raised this author's concern about the risks of overreaction and escalation in the event of an incident involving North Korea.[5] While a strong deterrent

"The risk of some form of military confrontation on the Korean peninsula has become particularly acute in the current climate"

is necessary to maintain stability, there is a delicate balance to be struck between firmness and flexibility in managing tensions with the North.

The outcome of the forthcoming US presidential election could also have significant implications for the situation on the Korean peninsula.

On the one hand, the North might see a window for military opportunism – that is, it might engineer a limited inter-Korean skirmish before the election, which could help draw attention and make it a priority for the next US president, after four years of being overlooked. On the other, if former President Donald Trump is re-elected, it could signal a shift in US policy towards North Korea in the years ahead.

Trump's previous engagement with North Korean leader Kim Jong Un, including high-profile summits and a willingness to offer concessions, raised hopes for diplomatic progress during his presidency. However, the failure to reach a substantive agreement and the subsequent breakdown of negotiations have left the future of America's relations with North Korea uncertain. A second Trump administration could revive the prospect of direct dialogue, but Kim Jong Un might not be interested. Trump 2.0 could also lead to a return to maximum pressure tactics or a more transactional approach to denuclearisation, further complicating the already fragile security situation in the region.

As the international community seeks to navigate growing risks between the Koreas, it is becoming increasingly important for those with interests in the peninsula and the wider region to keep a close eye on the evolving situation. Potential events that could trigger some weeks of confrontation include US-South Korean military exercises in August, the South's response to planned North Korean satellite launches and tests of weapons of mass destruction, and the lead-up to the US Presidential election.

In the current geopolitical landscape, North Korea has become increasingly bold and erratic, fuelled by unwavering support from Russia and China at the UN Security Council and the distractions posed by various global crises. This confluence of factors has created a security environment on the Korean peninsula that is more intricate and potentially explosive than before. History also demonstrates that significant incidents between North and South Korea often occur without warning, decoupled from the intensity of inter-Korean rhetoric and planned military exercises. Monitoring efforts may not be enough to predict a clash between the two Koreas in the weeks and months ahead.

"North Korea has become increasingly bold and erratic, fuelled by unwavering support from Russia and China"

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[1]NK News: 'What to make of North Korea's upbeat plenum on its big plans for 2024'

[2]Yonhap News Agency: 'Yoon vows multiple-times stronger punishment in event of N.K. provocation'

[3]NK News: 'How North Korea could set a trap to bait South into a military clash'

[4]NK News: 'In orbit: Everything we know about North Korea's new spy satellite so far'

[5]NK News: 'Is current North Korea risk comparable to previous periods of high tensions?'

ON THE ROAD

RETURN TO A CORUÑA

Between the 16th and 19th centuries, A Coruña was the political capital of the Kingdom of Galicia. Today, it is the 'capital' of Inditex, one of the world's most successful retailers, and its most important retail format, Zara. Following his fifth visit to this 'capital', Head of Research Alan Lander reflects on what has changed over the years and what has stayed reassuringly consistent

Last year, I returned to Inditex's headquarters in Artexio just outside A Coruña for the fifth time and was once more struck by the pace of expansion, the efficiency of its operations, and the enduring ambition so central to its success.

The A Coruña campus is Inditex's corporate headquarters as well as the home of Zara, its most important retail concept, which accounts for over 70% of group sales. It is the growth of Zara and, more specifically, the growth of its physical footprint across the campus since my first visit in 2012 that has made for the most striking changes over those years.

In 2012, alongside a humble HQ housing Inditex's central functions, Zara's commercial departments resided in a 90,000sqm facility. To the rear was a building site. When I returned two years later, that building site had become a 75,000sqm extension housing Zara Men, Zara Kids and Zara Home, with the original space turned over solely to Zara Women. More development followed and, by the time of my visit in 2018, Zara's commercial departments covered more than 300,000sqm.

CONFOUNDING THE SCEPTICS: THE GROWTH OF ONLINE SALES

In looking at that widening product offer, as well as the expansion in physical space, the standout change relates to Zara's online business. In my notes from 2014, I remarked that the space devoted to the online business had grown from 400sqm to 4,000sqm. In 2023, I noted that, since my previous visit in 2018, a new 70,000sqm building had been added to house this growing operation. This new building will house studios and be home to all those working on website design, optimisation and logistics. Every product shot and model image that appears on Zara.com is shot in this centralised location.

In 2014, online sales figures were not disclosed as such, but I estimated they were less than 5% of the total. A commonly held view at that time was that Zara had fallen behind with its online business and catching up would be difficult. Those fears proved misplaced, and by 2023 online sales, now formally disclosed, accounted for 24% of the total. Inditex is now among the largest online apparel businesses globally.

Those early naysayers also warned that online sales would erode in-store sales but instead Zara has successfully evolved its physical store base, so that in-store sales sit profitably alongside the online operations. In a pre-online-shopping world – one that, I often have to remind myself, wasn't that long ago – physical stores needed to be close to customers. Zara online now provides that convenience and for nearly a decade the company has deliberately moved away from smaller local stores to larger ones in key locations. With that shift has come a change in the layout and feel of those stores, with improved lighting and product display and the ability to promote the broader Zara offer.

"A commonly held view was that Zara had fallen behind with its online business and catching up would be difficult. Those fears proved misplaced"

There is less stock on the shop floor, mannequins have been replaced by video screens and window displays are no more, with the preference now for large open entrances to draw customers in, attracted by products displayed in the front of the store. There are click-and-collect areas, self-checkouts, and 'old-fashioned' tills.

In conversation during my most recent trip, management explained this development in the context of an arguably more profound social change. During the Covid-19 pandemic, countless commentators predicted deep-rooted and long-lasting social change, much of which has not materialised. However, management confirmed what we've heard from others, that the pandemic added impetus to more consumer spending on experiences – holidays, eating out and entertainment – instead of more 'stuff'. That may seem like bad news for Inditex, but on the contrary, fashion is one physical product category that is bucking the trend thanks to its connection with spending on experiences. That doesn't only support Zara and other apparel formats but explains Zara's expansion into sport, as well as beauty and hair.

THE POTENTIAL OF A GARMENT CHIP

The growth in online isn't the only technology-related change I've seen since 2012. RFID (radio-frequency identification) is another subject I've discussed with management on my various visits and have seen implemented and expanded.

RFID might not have the glamour of the latest fashion, but it is another example of Inditex's leadership and the benefits of scale. It is also another example of the company's long-term development and investment – it is, in fact, something I first spoke about with management during my visit in 2012.

The initial phase of this development involved incorporating chips into security tags and investing in infrastructure across the supply chain and store base to collect and analyse data. The objective at this stage was to improve efficiency with transparency of inventory data to give customers accurate information about availability. Phase two was to drive full-price sales. With digital transparency across all inventories, stock held in stores could be used to fulfil online orders, rather than sit in stores waiting to be marked down.

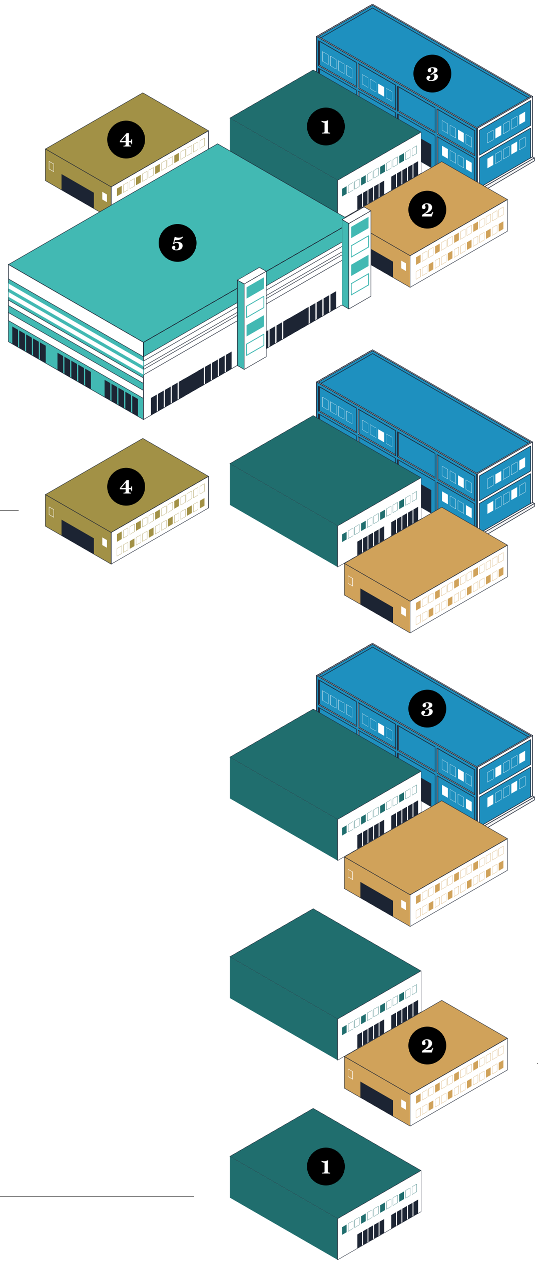
On my most recent visit, I heard more about the third phase, in which security tags will be phased out and instead RFID chips will be sewn into garments. This benefits both the company and the customer. Self-checkout becomes much quicker by removing the often cumbersome tasks of removing security tags and scanning barcodes. For those who would still rather queue for an 'actual' checkout, the new technology is estimated to cut the normal checkout time in half. And, of course, RFID isn't just about efficiency and customer service in-store, it also quickly builds a highly valuable data source.

"In a pre-online-shopping world physical stores needed to be close to customers. Zara online now provides that convenience"

"The buildings may be bigger but the atmosphere inside those buildings has not changed"

INDITEX HEADQUARTERS EXPANSION 2012-2023

From 90,000 square metres to more than 430,000 square metres*



5
ONGOING CONSTRUCTION TO REHOME ZARA COMMERCIAL DEPTS

4
2019
EXTENSION TO HOUSE ZARA ONLINE

3
2016
EXTENSION TO HOUSE IT, CAFETERIA AND AUDITORIUM

2
2014
EXTENSION TO HOUSE ZARA KIDS, MEN AND HOME

1
ORIGINAL INDITEX HQ AND ZARA COMMERCIAL DEPT

Source: Walter Scott, Inditex. *Approx square metres and includes buildings under construction

JOIN LIFE

During the same trip, time was also again spent discussing sustainability. Fast fashion is a somewhat derogatory phrase thrown at Zara and Inditex, so it matters not only to sustainability and operational efficiency but also from a brand standpoint. In addition to my conversations with management on this subject, I visited the garment factories of one of Zara's key suppliers in Portugal in 2020 after visits to factories in Bangladesh and Vietnam in 2019 and Bangladesh and Myanmar in 2014. While I would not claim to be an expert, this is a subject I have considered in depth over many years, and from that standpoint I have always believed that the fast fashion label was too generally and generically applied to Inditex.

On this recent visit to A Coruña management provided an update on its Join Life initiative. Launched in 2015, the Join Life label was attached to a product created with sustainable materials or manufactured in environmentally sustainable facilities. By 2022, the proportion of products sold under that label had risen to 60% with further success bringing this initiative to what perhaps despite appearances is a successful end point: the company is now removing the label altogether because, laudably, it intends to make all its products sustainable. The company has also very much moved on to what next.

Management shared an update on garment recycling technology, where there was evident excitement and sense of potential, as well as on the growth in capacity of natural viscose materials such as Lyocell. The company's 'Sustainability Hub' now partners with 350 different start-ups working across all of these areas, work that will be key in meeting its self-imposed target of sourcing all fibre from sustainable sources by 2030, and 25% of that total coming from innovative fibres that did not exist at commercial scale in 2023. I feel sure these are subjects that I will return to in future visits.

NEXT TIME YOU VISIT A ZARA STORE

Looking back at my notes from my five visits to A Coruña, while the physical expansion of the site and technological changes stand out, it's equally striking how much has stayed the same. Perhaps this is the most important observation of all. The buildings may be bigger, but the atmosphere inside those buildings has not changed. The designers, sourcing and product specialists still all sit together, allowing close collaboration and communication. You still see huddles of people in break-out areas with bundles of clothes everywhere. Product teams report back real-time information on what is selling in stores and online and this constant flow of information enables designers to tweak successful designs by adding a new colour or making subtle changes. There are also mocked-up stores where product presentation is reviewed and tweaked.

That consistency in culture and atmosphere has without doubt been central to Zara and Inditex's success over the years. So too has the consistency in message and execution. The many developments I have heard about and witnessed on my visits, all the innovation and progress, aren't just chat or the content of a verbose strategy document but are visible in any Zara store.

Next time you pass a Zara store, go in and look at the deliberate scarcity of product, the mannequin-free windows, the beauty products on display, the automated click and collect areas, the self-checkout and the collection containers for pre-owned clothes. Look inside a garment and see if you can spot the RFID chip. These are all technologies and changes that I've heard about over the years. And look at how customers are engaging with the product. Those huddles of people in A Coruña continue to deliver what consumers around the world want to buy. Happy shopping!

RESEARCH THINKING

UNIQUE **INSIGHTS**

Company research is at the heart of what the team at Walter Scott does every day. Through regular articles and short videos, we try to share some of that research and give a sense of the scope of that work and the opportunities and challenges we consider. Those contributions from our Research team are posted on our website and shared on LinkedIn

DIGGING DEEPER – UNDERSTANDING WOLTERS KLUWER

With roots stretching back to 1836, Wolters Kluwer has navigated profound changes in the publishing market, moving from print to digital to value-added information services. In this most recent phase of the company's history, artificial intelligence has helped further cement strong customer ties and we believe that this evolving technology will also strengthen Wolters Kluwer's future competitive position.

SCAN TO WATCH

DIGGING DEEPER – UNDERSTANDING NOVO NORDISK

Novo Nordisk celebrates its 100th anniversary this year. In the past year or so, it has become a household name thanks to Wegovy and Ozempic. What are the risks that stem from that attention, and just how significant is the long-term opportunity? In the first of a series of Digging Deeper conversations, Investment Manager Lindsay Scott shares her thoughts on the obesity and diabetes markets and the outlook for Novo Nordisk.

SCAN TO WATCH

LAP OF LUXURY

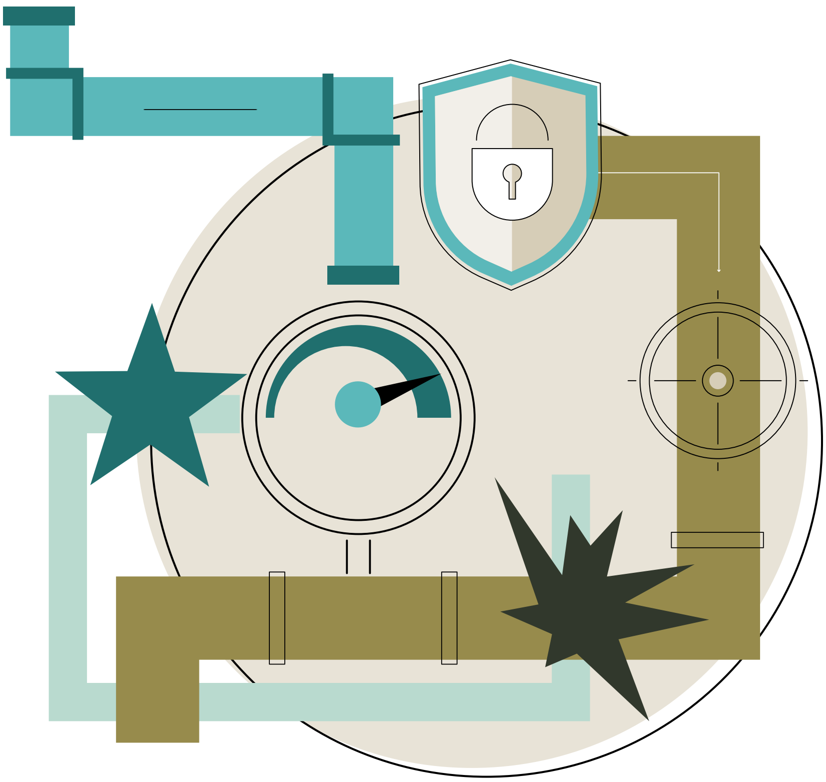
After a period of extraordinary growth, the luxury sector is showing signs of slowing. An inevitable normalisation or evidence of something more fundamental? Lindsay Scott considers the long-term outlook for the industry and some of its most illustrious exponents.

SCAN TO READ

INVESTMENT CONTEXT

BUILDING
RESILIENCE

Russia, China and various shadowy groups hostile to the West have pipelines, oil and gas platforms and subsea internet cables in their sights. Senior Chatham House Fellow Armida van Rij assesses the risks



RISK MANAGEMENT

Investment Manager Jamie Zegleman explains why the concept of resilience matters so much to the team at Walter Scott

As long-term investors we aim to be cognizant of all the material risks that might face the companies in which we invest. Yet there are always risks that are hard or even impossible to identify. Further identifiable risks may be deemed unlikely, but such risks do, on occasion, materialise. So we look for companies which are able to deal with the unexpected. To tackle this challenge, our research process seeks to identify as many of the specific risks to a company as possible, through rigorous research and informed team debate.

For those less stock-specific and less identifiable risks, our philosophy provides protection. Corporate resilience is, we believe, built into the companies in which we invest as a result of the characteristics that are central to our investment framework.

Amongst others these include diversification (by geography and end market, and with regard to supplier and customer concentration), financial resilience (strong balance sheets, strong profitability, high levels of pricing power and low demand cyclicality) and robust organisational structures and governance (which support contingency planning and give companies a better chance of responding successfully to unexpected shocks).

With these attributes in place we saw, in many instances, remarkable resilience in the face of the lockdowns and disruptions that stemmed from the Covid-19 pandemic. As companies have contended with increased interest rates and inflationary pressures so too those companies with financial strength and market leadership have not just coped but often prospered.

More recently geopolitical issues and military conflicts have very regrettably risen up the list of risks that we must consider. With war on the border of Europe, we have become increasingly aware of the impact of events closer to home. As well as the human impact of the war following Russia's invasion of Ukraine, we have seen disruption to Europe's oil supplies and inflationary worldwide shortages of grain. While these eventualities might have arguably been foreseeable, others are less obvious.

Warfare comes in many different guises and many of today's attacks on Western society and economies are below the military threshold, as the following article by Senior Chatham House Fellow Armida van Rij explains.

Consider the challenges a global company would face if it were suddenly impossible to contact colleagues and clients on the other side of the world. Imagine financial transactions consistently being declined. Energy supplies being so scarce that populations cannot afford the sky-rocketing costs. Such scenarios would not only cause disruption to global markets but would also risk social unrest. These scenarios become likely realities if critical infrastructure such as pipelines, oil and gas platforms, and subsea internet cables are compromised.

And yet the West's adversaries have been building up their arsenal

"While the West is currently rightly focused on conventional warfare, it risks overlearning the lessons from Russia's invasion of Ukraine"

of hybrid warfare tactics, combining military and non-military attacks to do exactly this. All without firing a single shot into NATO territory. Many such attacks are in the so-called 'grey zone': attacks below the threshold of war. Russia, China and non-state actors have used such tactics for espionage purposes, to cause disruption to communications and energy supplies, and to fray societal cohesion.[1]

While hostile actors cannot launch a full-scale attack on a NATO country without prompting a response, they have successfully used grey zone warfare instead. These attacks are more difficult to attribute and respond to and are therefore a popular weapon for adversaries who seek to disrupt societies without triggering a fully-fledged response. Attacks of this kind are not carried out only by states – there has also been a proliferation of state-affiliated groups that perpetrate grey zone attacks, as well as continued attacks by non-state armed groups.[2]

THE RISKS TO OFFSHORE AND SUBSEA INFRASTRUCTURE

While the West is currently rightly focused on conventional warfare, it risks overlearning the lessons from Russia's invasion of Ukraine. For Russia in particular, deploying grey zone warfare against the West has become more important as it seeks to undermine the West's response to its war in Ukraine. For the Houthis in the Middle East, targeting subsea infrastructure in the Red Sea is a low-cost, high-impact form of attack. Europe needs to better prepare for this kind of accelerating warfare by increasing the resilience of its offshore and subsea infrastructure. It also needs to build societal resilience against the effects these attacks could have on social cohesion.

Attacks on offshore and subsea infrastructure are not new, but they are becoming more common. A year after the Nord Stream pipelines sabotage of September 2022, attacks on the Balticconnector pipeline drove European gas prices up by 12.5%.[3] Damage to four subsea cables in the Red Sea earlier this year impacted 25% of communications traffic between Asia and Europe, and the Middle East.[4]

These examples highlight the vulnerability of offshore and subsea infrastructure. While countries in Europe and North America have been vigilant about cyber-attacks for a long time, the vulnerability of physical infrastructure such as pipelines has become a prominent concern more recently. Offshore and subsea infrastructure is essential for energy supplies and global communication.

THE VULNERABILITY OF ENERGY INFRASTRUCTURE

The sabotage of the Balticconnector and Nord Stream pipelines highlighted the vulnerability of pipelines, and with that the vulnerability of nations' energy security. As Europe reduced its dependence on Russian energy in the wake of the invasion of Ukraine, Norway became the continent's most important source of energy.

A YEAR AFTER THE NORD STREAM PIPELINE SABOTAGE OF SEPTEMBER 2022, ATTACKS ON THE BALTICCONNECTOR PIPELINE DROVE EUROPEAN GAS PRICES UP BY

12.5%

As a result, it also became a more significant vulnerability. If Norwegian energy infrastructure or gas distribution networks were to be disrupted, prices would rocket, and Europe would struggle to find an alternative gas supplier quickly.

There are indications that hostile actors are watching energy infrastructure in Europe closely. In 2022, multiple unidentified drones were seen flying near Norwegian oil and gas platforms, triggering a military surveillance response.[5] Dutch intelligence services have warned of Russia mapping gas pipelines and wind farms in the North Sea as potential targets.[6] The impact is psychological as much as physical. Energy companies are concerned not just about attacks on their infrastructure, but also that their employees may become reluctant to travel to platforms if they fear for their safety with increased attacks on the infrastructure or the helicopters used to transport them.

THREATS TO COMMUNICATIONS INFRASTRUCTURE

As for communications infrastructure, as the world has become more connected, and the global economy has become digitised, subsea communications cables have also gained prominence as strategic assets. They are essential for global internet traffic and financial transactions. At least 99% of the world's digital communications travel through the subsea cable network.[7] Military and intelligence agencies also rely on these cables for intelligence gathering, although the ease of doing this has been overstated.[8]

The threat here is two-fold: first is the impact of sabotage on global digital connectivity, and second is the risk of espionage. As there is no viable alternative to these cables for data transmission, any attacks have the potential to be high impact.[9] When it comes to espionage risk, Russia clearly is not the only adversary the West should be concerned about. Subsea cables are largely laid and owned by the US, France and Japan. China has tried to break into the market but has largely been unsuccessful.[10] Yet a cable is most at risk when it is repaired following a fault: hostile actors can exploit the opportunity to install data extraction devices for espionage purposes.[11] In instances of faults on US cables in recent years, repairs were carried out by a Chinese engineering company.

THE WEST NEEDS SOCIETAL RESILIENCE

The risk and impact of the threat to energy and subsea cable infrastructure are clear. NATO, the EU, individual European countries and the US have responded with a flurry of initiatives aimed at increasing resilience, detecting suspicious actions and responding to incidents. Safeguarding energy and telecommunications security is now as important to national security as deterring hostile states and counter-terrorism efforts. Ultimately, however, the biggest priority has to be building resilience against these threats, both in the event of physical attacks on infrastructure and in fostering societal resilience should they occur.

"Energy companies are not only concerned about attacks but are also worried workers may become reluctant to travel to platforms to work because of them"

[1]UK Government 'Pervasive pattern of hacking'; Chatham House 'Hybrid warfare on the EU'; The Economist 'France uncovers vast Russian disinformation campaign'; Euronews 'European hospitals targeted by pro-Russia hackers'; NATO 'Countering hybrid threats'

[2]University of Reading 'Non-state actors in hybrid warfare'

[3]CEPA 'New attack on Europe's energy pipelines'

[4]CNN 'Red Sea cables have been damaged, disrupting internet traffic'

[5]Reuters 'Norway oil safety regulator warns of threats from unidentified drones'

[6]Politico 'Russia 'mapping' critical energy infrastructure, say Dutch intelligence agencies'; Ministrie van Defensie (Netherlands) report

[7]European Parliament 'Security threats to undersea communications cables and infrastructure'

[8]The Guardian 'GCHQ taps fibre-optic cables for secret access to world's communications'

[9]CCDCOE (NATO Cooperative Cyber Defence Centre of Excellence) 'Strategic importance of, and dependence on, undersea cables'

[10]Financial Times 'How the US is pushing China out of the internet's plumbing'

[11]Financial Times 'How the US is pushing China out of the internet's plumbing'

[12]Chatham House 'Our History'

"Safeguarding energy and telecommunications security is now as important to national security as deterring hostile states and counter-terrorism efforts"

DAMAGE TO FOUR SUBSEA CABLES IN THE RED SEA EARLIER THIS YEAR IMPACTED

25%

OF COMMUNICATIONS TRAFFIC BETWEEN ASIA AND EUROPE, AND THE MIDDLE EAST

THE CHATHAM HOUSE RULE

Chatham House is one of Britain's most respected organisations in the study of international affairs. Conceived in the aftermath of war on the fringes of the 1919 Paris Peace Conference, the organisation has promoted mutual understanding ever since through its research and analysis, championing positive solutions to some of the world's most complex issues. Since 1927, the Chatham House rule, signifying that 'participants in its discussions are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed',[12] has supported trusted dialogue that allows the understanding and resolution of contentious and challenging issues.

Bronwen Maddox, Director and Chief Executive of Chatham House, has spoken at several Walter Scott Research Conferences and Lectures. Previously, Bronwen was Director of the Institute for Government, editor and chief executive of *Prospect*, the monthly current affairs magazine and before that, she served as chief foreign commentator, foreign editor and US editor at *The Times*. Those roles followed a period at the *Financial Times* where she ran award-winning investigations and wrote economic editorials.

TALKING RESEARCH

UNIQUE **INSIGHTS**

Through our *Talking Research* podcast series we bring together members of our Investment team to discuss topical market developments and, more importantly, to discuss subjects at the top of the team's research agenda

TALKING RESEARCH PODCAST – ON THE ROAD IN ASIA

We hear from Head of Research and Investment Manager Alan Lander, Investment Manager Fraser Fox and Investment Analyst Michael Scott, who've all recently returned from Asia. During discussions with companies across mainland China, Hong Kong, Indonesia, Malaysia and Singapore, they garnered plenty of valuable first-hand insights, including on the reorganisation of global supply chains.

SCAN TO LISTEN

TALKING RESEARCH PODCAST Q3 2023

Investment Manager Paul Loudon considers current goings-on in China. He also shares insights from recent debates and the team's latest travels before fellow Investment Manager Lindsay Scott joins him to talk about the groundbreaking, hugely topical and often controversial obesity drugs that have been developed by Novo Nordisk and Eli Lilly.

SCAN TO LISTEN

TALKING RESEARCH PODCAST Q4 2023

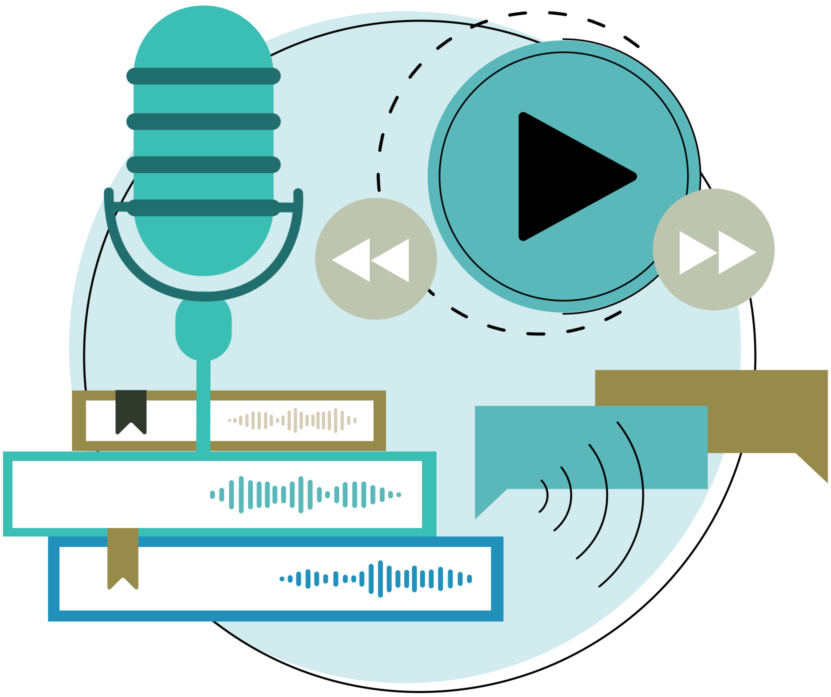
Directors Charlie Macquaker and Roy Leckie discuss the remarkable performance of equity markets in 2023. They also reflect on some of the year's research trips, including Charlie's recent visit to Japan, and ask if the outperformance of the Magnificent Seven has been justified by fundamentals, and if it can continue.

SCAN TO LISTEN

END NOTE

THE **PODCAST** PHENOMENON

It seems that everyone is now listening to podcasts – even when they last for hours. Katie Boyce, Investment Writer and host of Walter Scott's *Talking Research* podcast, considers why



"You can access podcasts anytime, anywhere"

Conversations with colleagues in our office kitchens, Walter Scott's equivalent of the classic water-cooler chat, are now almost as likely to centre on a recent podcast episode as they are the newest Netflix drop or cinema release. Be it a documentary series or tapping into an esoteric subject, listening to podcasts has become part of our daily lives, whether we are walking to work, running at the gym or looking to make domestic chores a little more enjoyable.

In an era when all kinds of impressive technology exist, who'd have thought that a relatively simple and straightforward audio recording would have been so successful and so quickly become part of everyday life?

It is estimated that there are now more than four million podcasts worldwide, and Spotify, one of the two biggest platforms (alongside Apple Podcasts), claims to have 100 million podcast listeners in 170 markets. Almost two thirds of Americans over the age of 12 have listened to a podcast.[1]

NON-FICTION STORYTELLING

The first podcast that really made it to the mainstream was the investigative journalism series *Serial* in 2014. Over the course of 12 episodes, it told the story of a 1999 high school murder, and was downloaded by millions around the world. It was the first podcast to win the prestigious Peabody journalism award.

One-off investigative series have continued to capture the attention of many, with the likes of the BBC's *Cryptoqueen* and Tortoise Media's *Londongrad* becoming global hits. In some cases, the stories have even migrated to the screen. The 2019 Bloomberg podcast *The Shrink Next Door* was turned into an AppleTV+ series while the ABC Audio podcast *The Dropout* about Elizabeth Holmes and Theranos was followed by a Hulu series of the same title.

Recurring shows have also found engaged and broad audiences. In the UK, the BBC's success with its Brexitcast format inspired a series of regular news programmes, with the objective to go beyond the headlines and share with audiences how a particular story has been sourced and how it may develop. Following the UK's exit from the European Union, there was evident appetite for the series to continue and it became *Newscast*. The BBC team has since added *Americast*, *Ukrainecast* and, most recently, *The Conflict: Israel-Gaza* to its catalogue.

It's not just the BBC, with all other mainstream media companies adding podcasts to their repertoire. From *The New York Times*'s *The Daily* to *New York Magazine*'s *Pivot*, as well as upstarts including *The Rest is Politics* and *The News Agents*, these podcasts have established loyal and engaged audiences.

POPULAR PASTIMES IN PODCAST FORM

But not only can podcasts offer the suspense of a series, or an alternative take on the news, the most successful ones span comedy and commentary as well as the sharing of knowledge, often in what might be considered niche subjects. For instance, the *Huberman Lab* and *ZOE Science and Nutrition* podcasts, both focused on the latest thinking on optimal nutrition, are regularly among Apple Podcasts' top 15 downloads in the US. The UK podcast *The Rest is History* is also often high up on that US list, alongside a new breed of thinkers who have created huge followings thanks to podcasts and Instagram, from Mel Robbins to Steven Bartlett and Joe Rogan.

So why have so many podcasts captured our time, interest and imagination? Ease has certainly played a part. Most podcasts are available on a host of platforms, easily accessed from a phone. There isn't a need to subscribe to yet another provider, as with broadcast channels, or to remember yet another password. It is easy to find an episode and to subscribe to be alerted to new content that interests you. You can access podcasts anytime, anywhere and press play or pause.

Tortoise, a UK-based media company founded in 2019 by ex-*Times* editor and former Director of BBC News James Harding and ex-US ambassador to the UK Matthew Barzun, originally produced long-form 'slow news' journalism, articles that might take 30 minutes to read. However, when data showed that many of its subscribers were only making it to four minutes, the company pivoted to an 'audio-first' approach where podcast episodes can last an hour or longer. Podcasts are now front and centre of Tortoise's offering and as a means of sharing its award-winning investigative journalism.[2]

Another compelling attraction of podcasts is that audio content is usually cheaper and easier to produce than visual content. Not only has this made it possible for just about anyone to produce a podcast but, more pertinently from our Research team's perspective, it has given experts and commentators a means to share work that might otherwise have remained in closed academic circles. For example, during the team's recent work in the field of synthetic biology, podcasts became one of the most important, and valued, avenues of accessing specialist insight. Conversations and discussions between academics that might have been previously shared in specialist journals or closed conferences are now available to all through podcasts.

CREATING COMMUNITY

Podcasts have also created connections. Like radio, which has also had a surprising resurgence, there is an intimacy and connection in listening to a voice in your ears. During the pandemic, when people craved connections, podcasts found a market in those

"There is an intimacy and connection in listening to a voice in your ears"

looking for conversation. Podcast hosts often encourage feedback, which adds to a sense of a two-way communication and community.

Some podcasts have now introduced visual experience. The BBC's *Newscast* is now filmed and features weekly on one of the BBC's primary TV channels. Recent research from Reuters[3] suggests that video-led and hybrid news podcasts are on the rise.

THE POWER OF THE HOST

Regardless of whether they are on screen or not, what comes across loud and clear on the most successful podcasts is the authenticity of the relationship between the hosts and their guests. There is something surprisingly intimate in listening to a conversation through headphones and anything overly scripted or rehearsed can fall flat. It is all in the hands of the host and many have built up loyal fan bases.

Some podcasts have catapulted their hosts to such celebrity status that they sell out in-person events. British journalist and author Elizabeth Day, who hosts the very successful *How to Fail* podcast, has taken her show on the road across the UK and recently toured Australia, taking in venues such as the Sydney Opera House and Melbourne's Hamer Hall. Fans of the hit political podcast *The Rest is Politics* have flocked to illustrious venues such as London's Royal Albert Hall and the O2 Arena to listen to hosts Alastair Campbell and Rory Stewart in person.

Another intriguing aspect of podcasts is that there is no set format. It all depends on the story and the best way for that story to be told. Likewise, there is no set length. Podcasts are free of the shackles of radio programme scheduling and can be as short or as long as is appropriate for the content. We are told that our attention spans have been decimated and that, if it is to grab interest, an article or video needs to be short. But podcasts have bucked that trend with episodes often passing the one-hour mark. Indeed, each episode of *Acquired*, a podcast that has become a firm favourite of our Research team, can be three to four hours long.

TALKING RESEARCH WITH WALTER SCOTT

It was that enjoyment of the medium across the firm that prompted us to launch our own podcast. Long-term clients of Walter Scott might remember the regular letters written by the firm's founders. Those letters morphed into the monthly and quarterly commentaries we share with our clients. In time, we established our Research conferences and lectures to share our research and thinking alongside external experts on subjects that we expected to become more important. This Journal seeks to meet that same aim in written form.

Through our podcast, *Talking Research*, we hope to do all that, providing listeners with the opportunity to get to know the team a little better, hearing what

“Podcasts are free of the shackles of radio programme scheduling”

they're working on and why. While many short-term concerns might not be relevant given our long-term investment lens, our podcast is a way for us to share our thoughts and explain why we might be less worried than most, or where we think greater concern is warranted.

Since the first episode in March 2023, it's become a valuable medium for the team to share their thoughts on a whole range of topics, from the intricacies of synthetic biology and semiconductor supply chains to the challenges facing luxury brands and expectations around the 'Magnificent Seven' technology businesses.

Our podcast is now on the Spotify and Apple podcast platforms, which we hope will make it easier to access. Beyond the convenience, we hope that our podcast will also create a community of interest. We really do welcome all feedback so please get in touch if there are subjects you'd like us to cover. And while episodes are currently shorter than 30 minutes, perhaps multi-hour episodes may feature in the future.

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[1] Edison Research The Infinite Dial – The Podcast Consumer 2023

[2] Press Gazette 'How Tortoise podcasts became the more profitable part of the slow news start-up', October 2022

[3] Reuters Digital News Report 2023

PODCAST RECOMMENDATIONS

We asked our Research team for their favourite podcasts. Beyond a few sporting podcasts, including one in Dutch on the Netherlands' football scene, there were podcasts that featured on almost everyone's list

ACQUIRED

With the tagline Every Company has a Story, each episode recounts the story and strategy of a great company. Described as a 'depth-first' podcast, episodes are three to four hours long.

FOUNDERS

With the stated ambition that listeners 'learn from history's greatest entrepreneurs', each episode examines the biography of a leader or entrepreneur across time from Napoleon to Kobe Bryant and David Ogilvy to Bernard Arnault.

BUSINESS BREAKDOWNS

'Learn how companies work from the people who know them best.' This is the promise of this in-depth podcast, another to feature interviews with industry veterans, investors and company executives, examining the strengths and weaknesses, financial and strategic, of companies across different sectors and geographies.

LIBRARY OF MISTAKES

Hosted by the Keeper of the Library of Mistakes, Professor Russell Napier, this occasional podcast is based on interviews with a diverse range of academics, historians, authors and investment practitioners, all centred on the same theme of understanding the past to try to inform future decisions and avoid mistakes.

Walter Scott has supported the Library, an Edinburgh-based charity, over a number of years and Russell has shared his views on markets and economics at a number of our events. At our 2023 Research Conference in Edinburgh, he also led a walking tour of sites connected with Edinburgh's proud, but sometimes questionable, financial history.

THE RACHMAN REVIEW

The *Financial Times' Rachman Review* is hosted by its chief foreign affairs columnist, Gideon Rachman. He shares his working life meeting and interviewing decision makers and thinkers, politicians and statespeople from around the world. Gideon was a guest at our virtual Research Conference in 2022, where he shared his thoughts on Asia's role in a new macroeconomic and geopolitical era.

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SIMON LAURIE, ALTAR NO 2
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Walter Scott has been supporting emerging Scottish talent since 1988. In the same way that we believe that different perspectives within the team generate the best investment ideas, so we believe that our art collection should incorporate a wide range of work from an eclectic group of contemporary artists.

Our commitment to that community is reflected in our longstanding partnership with the Royal Scottish Academy and in particular our support of its annual 'New Contemporaries' exhibition that showcases the work of emerging artists from across Scotland's five main colleges of art and of architecture.

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