WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

QUARTERLY COMMENTARY

EAFE

Ending 30 September 2024

COMMENTARY

Over the quarter we have seen a short-lived market crash and long-anticipated interest rate cuts alongside heightened geopolitical risk and political uncertainty. In this environment, short-term sentiment has continued to trump long-term fundamentals.

"An unstinting belief in our long-term approach"

Anticipating or reacting to transient market sentiment has no place in our long-term investment approach. We acknowledge that means we will sometimes be on the wrong side of market trends and short-term performance might lag.

In making an investment case for an individual stock we look five, 10 and 20 years out, and beyond. We apply the same lens to our investment returns. Our investment philosophy and process, consistently applied since Walter Scott was founded in 1983, has been tried and tested through all sorts of market conditions.

Central to that philosophy is a belief that companies create wealth, not stock markets and that, over time, share price performance reflects the success of the underlying company rather than any transient market mood or top-down prognosis. Through our in-house, in-depth research, we seek to identify the world's best companies. Those are companies capable of meaningful wealth creation that, is in turn, translated into share price return over time. By 'buying and holding', those returns are then compounded over our long-term investment horizon. Benchmarks play no part in that work, nor sector or industry classifications.

That said, we fully recognise that our short-term relative performance record makes for uncomfortable reading. But just as no investment manager can claim to get every decision right, no single investment strategy will work in all market conditions. What is paramount, in our view, is both discipline and patience. We must, and will, continue to adhere to our stated investment approach, and we must give that approach the time it requires. That does not, however, infer lack of activity, ongoing effort and scrutiny, or vigilance.

"Our travel diary remains busy"

We continue to interrogate our company research and collectively challenge the long-term investment case for every holding. We also continue to talk to companies and other experts. Whilst many of those conversations take place in our Edinburgh home, our travel diary remains busy. Over this past quarter, members of the team have travelled to China and Hong Kong, India, Finland, France and Brazil. There have been trips to California and New York and numerous trips within the UK.

Discussions amongst our team around particular risks or shifts are also part of our diary. That might be a discussion on how interest rate cuts might impact companies, allowing us to understand any portfolio-wide implications and share past experience. Similarly, the team has spent time understanding the risks that international companies might face under a new US presidential regime come November. China is another subject that we regularly devote time to, sharing expertise, discussing new developments and challenging individual perspectives as well as any assumptions baked into our company analysis.

Whilst there is no direct investment in China, many holdings have exposure to this important market. This has had a notable bearing on performance with short-term market concerns winning out over the potential for long-term growth that we are convinced by. A research trip during September was therefore a timely opportunity to assess the current environment and sense check our views.

ON THE GROUND IN CHINA

We travelled to Chongqing and Chengdu, now amongst the fastest growing of China's major cities as well as the tier 3 and 4 cities of Luzhou and Leshan[1]. We visited fully automated EV factories 'staffed' by hundreds of Fanuc robots and saw 400-year-old baiju pits. Baiju, a traditional alcoholic drink, is fermented in these ancient mud pits making use of micro-biomes that have been present since the 1600s. Typically consumed at celebratory banquets, we heard from two of China's biggest baiju producers that discretionary spending has slowed significantly. This tallied with what we have heard from a number of companies operating in the Chinese beauty industry, and that we have heard over recent quarters from international cosmetic brands. However, this more careful consumer spending environment does not appear to reflect plummeting incomes or genuine economic hardship, and seems much more about sentiment and nervousness. In keeping with that prognosis, we know that pan-Asian insurer AIA, for example, has seen particular growth in its savings products as consumers preserve cash. For us, this evident caution is perhaps more widespread than we previously thought and may endure longer than we had assumed. But, equally, we found no evidence to challenge our long-term view and our belief in the growth, and spending, potential within the Chinese consumer market. From our standpoint, this has never been a market where all would prosper and we have long been alert to increased competition. However, for the right company with the right product and the right marketing approach, opportunity certainly exists. In our view, companies such as LVMH, Hermès International and L'Oréal remain well positioned.

DISTILLING OTHER MARKET TRENDS

In recent quarters, weakness in the industrial sector and in regard to Japan also stand out as notable market trends. Again, we see a disconnect between the short-term pressures that have impacted the share price performance of a number of companies and the compelling, in our view, long-term outlook for these companies. Much of the weakness within the industrials sectors relates to a misconception, in our view, about China risk. Leader in lithography technology, ASML, as just one example, has been impacted by concerns around the possible extension of China export controls by the US. Those concerns appear to ignore the breadth of the company's revenue base over time. The difference between the sales of ASML's lower-end tools, which represents most of the company's revenues from China, and those of its most advanced immersion tools is also often unrecognised. And, of course, its critical position in the supply chain of the world's most advanced and strategically important semiconductor chip manufacturers.

In considering Japan, there has been much enthusiasm around a perceived revival in Japan's economic prospects with financials and trading houses, where we have no exposure, being particular beneficiaries. We are more circumspect at this stage but acknowledge our perspective differs from the norm. We didn't 'leave' Japan so aren't 'rediscovering' this market. We have long believed that Japan is home to some of the world's best companies. Companies like specialty chemical company Shin-Etsu Chemical, glass product manufacturer Hoya Corporation or air conditioning leader Daikin Industries have developed impressive market positions through innovation and investment over time. Their success has come despite a turgid economic climate and often difficult structural and societal norms. So whilst, in share price

[1] Investment Manager, Paul Loudon shared further insights from this trip on our recent Talking Research podcast which can be accessed here: https://www.walterscott.com/talking-research-challenging-thinking-on-china/

terms, these companies may not have not benefited from recent investor interest, we continue to believe in their long-term prospects and ability to deliver consistent financial returns.

OUTLOOK

The US presidential election looms large and is likely to continue to unsettle international equity markets as investors try to assess the impact of possible policy change.

"We also look to financial history"

Whilst we too have been closely watching events, we remain alert to the difference between comments designed to attract votes and those that are actionable. As ever, we also look to financial history. In the run-up to past US elections fear has struck indiscriminately. Healthcare is often an area of concern and, given the size of the US healthcare market, that means share prices across the international healthcare sector come under pressure. But we also know that, more often than not, share prices quickly rebound regardless of the outcome and the political leanings of whoever takes power.

Similarly, we are in a period where geopolitical risk seems to rise day by day. Whilst markets have largely shrugged off these risks this year, it would seem unwise to conclude that will necessarily continue.

Our job is to identify, analyse, research and value companies whose business franchises, financial models and management strategies are positioned to drive growth through all economic conditions and in the face of external pressures, anticipated or otherwise. Indeed, we believe that companies with the qualities that we demand including strong cash generation, little or no debt, superior margin structures and healthy returns on equity should navigate periods of volatility better than their peers. From a portfolio management perspective, volatility can also offer opportunity. We will continue to closely interrogate existing positions and, should uncertainty take hold, we are also very much alert to the potential for timely top-ups as well as possible new positions in stocks on our watch list.

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