WALTER SCOTT

QUARTERLY COMMENTARY

EAFE

Ending 31 December 2024

COMMENTARY

In a fourth-quarter client report of 25 years ago, Ian Clark, one of Walter Scott's founders, expressed a strongly held view which continues to represent the essence of our investment philosophy.

"INVESTMENT NIRVANA = COMPOUND GROWTH x TIME"

This was Ian's pithy way of extolling the virtues of buying leading, attractively valued, financially strong companies capable of delivering durable growth with excellent profitability, and applying the requisite amount of patience. Our view then, as it is now, was that such compounders of wealth over the long term represent the best way of maximising returns whilst mitigating risk.

There are times when our fundamental approach does not accord with a particular theme or style that may capture the market's attention. But we always maintain our discipline. If a company does not meet our rigorous investment criteria, irrespective of its influence on an index (or its equity market voguish-ness) it will not be bought.

Resolute in our long-term focus

Our long-term perspective sometimes stands in contrast with a market environment where the investment horizon is increasingly defined by a focus on near-term gratification in a world of fast-flowing information and quick opinions. Earnings growth is rarely linear. A quarterly 'miss' or near-term disappointment can often trigger an adverse market reaction. But we are resolute in our long-term focus, analysing and debating the ability of a company to both deliver the returns we seek over our multi-year, multi-cycle investment horizon, and weather any short-term challenges.

This reaffirmation of our ideals should not be construed as complacency or inertia, but as a statement of conviction in our process, which remains as valid today as it was when Walter Scott was founded in 1983. Since that time, the Research team has consistently applied a bottom-up investment approach based on rigorous fundamental analysis and collective decision making. Ideas and counter ideas continue to be put through the mill of scrutiny and debate, with company engagement a key component of our research endeavours. In 2024, we had 744 meetings or calls with portfolio and non-held companies.

In the long run, earnings growth drives share prices

At the heart of our process is the belief that the return achieved from a portfolio is a function of the earnings growth of each of the individual stocks held in it. The three main dynamics we consider when examining any business are:

- Growth prospects
- Profitability and return on capital
- Balance sheet strength

They are important because the combination of durable growth, high levels of profitability, and the flexibility and protection afforded by financial strength, represents the key driver of investment return.

We look for high-quality businesses that have a long growth runway, with a product or service that endows them with a strong competitive advantage. We seek market leaders at the forefront of trends that will drive growth over the many years of our lengthy holding periods. Some may not be exempt from cyclicality, but we are not troubled by short-term turbulence if we have a strong, positive conviction regarding their long-term growth trajectory.

Durable growth

We would differentiate between companies which enjoy durable growth and other business to which a broad growth label is often applied. For some companies, growth can be fleeting, reflective of business models that may not stand the test of time and cycles, rely on too much debt, or that have weak competitive moats with products or services that are insufficiently differentiated. They may have their periodic moments in the sun, but our quest is always focused on the durability of growth.

Though rarely seen as glamorous, industrial gases are key components in processes across a variety of sectors, ranging from manufacturing and chemicals to food and beverages production. The global industrial gases market size was valued at US$100 billion in 2022 and is expected to grow at a compound annual growth rate (CAGR) of over 7% from 2023 to 2030.

Air Liquide is an exemplar of the durable growth and the ‘control of destiny’ we seek from a business. The company enjoys diversification by end-product use and geography, with the industry marked by rational competitive behaviour. Barriers to entry are high due to the high level of capital expenditure required each year, the complexity of the business and the long-term nature of customer contracts. Combined with input cost pass-throughs to customers and steady pricing, this makes for predictable and relatively economically insensitive earnings and cash flow streams.

The pursuit of profitability

Adaptability and innovation, a differentiated product, a competitive moat, strong pricing ability, good cost control and excellent management are key components in determining the profitability of a business. We look for companies that leverage on these attributes to sustain consistently high levels of return on capital. High levels of profitability endow a business with financial resilience to external shocks, underpin investment in growth from internally generated means, and can often result in surplus capital which can be returned to shareholders for reinvestment.

ASML is a prime example of a high-return business we seek, well positioned in an expanding and developing market with a defensible business model that should offer plenty of growth ahead. The company’s extreme ultra-violet (EUV) tool is critical to semiconductor chip manufacturing and, consequently, all things AI.

Capable of producing incredibly small and complex patterns, EUV allows manufacturers such as TSMC and Intel to compress more transistors on a single semiconductor. Without it, securing the massive computational power demanded by AI chips would be impossible. ASML is one of the few companies that can legitimately claim to be indispensable to the AI revolution. It has a quasi-monopolistic position, with a market share of over 90%.

With its mission-critical technology and deep competitive moat, ASML's profitability will benefit as the company leverages the significant R&D and manufacturing investments it has made over recent years.

The merits of balance sheet strength

Despite recent interest rate cuts, the world has retreated from a period of extreme monetary stimulus. The cost of capital has risen, so the importance of financial strength and good cash generation has all the more resonance.

Having a strong balance sheet and high or steady profit margins can cushion the blow from rising costs, while conservative levels of debt mean that companies are less impacted by rising interest rates. We also like companies that invest in their businesses to sustain market-leading positions and to develop new avenues of growth. Far better to do that from a position of financial strength.

Over more than a century, Hong Kong-based AIA Group has secured a reputation as one of Asia Pacific's leading and most trusted insurance companies. Helping to underpin that position is a balance sheet that gives AIA's millions of customers confidence that the company will be to meet its long-term commitments.

AIA's balance sheet is much stronger than required under the stringent rules of the Hong Kong regulator. At the end of 2023, the company's LCSM (local capital summation method) coverage ratio, which measures the ratio of available capital to minimum capital requirements, was 275%. And while reducing the ratio would boost AIA's return on equity, the company understands the important role this robust financial profile plays in maintaining customer confidence.

This conservative financial philosophy is not purely for 'safety' reasons, however. It also gives AIA the flexibility and fire power to better capture what the company itself describes as "the tremendous growth potential in the world's most attractive region for life and health insurance." Across Asia Pacific, a growing yet ageing population that is increasingly prosperous is seeking improved financial security through savings and protection products. At the same time, state-funded provision has proven insufficient to meet escalating demand, driving the need for private sector solutions to close the gap.

The importance of valuations

We can't control macro or market events nor predict their twists and turns. What we can control is what we buy, and how much to pay for it. We look for companies with profitable and durable business models that can endure different market and economic cycles, but we are not 'growth at any price'.

Not only do we debate the qualitative and fundamental merits of stocks, but we challenge ourselves on what valuations are appropriate relative to the growth we envisage. Such debates are ongoing, and we will not hesitate to trim our positions if we determine valuations to be excessive.

Resolute long-term optimism

Not that we are governed by macro perspectives, but 2025 may prove a more volatile environment for equities. Economic growth across much of the world paints a mixed picture. President Trump's fiscal largesse could provide a shot-in the arm for the already resilient US economy. The prospect of import tariffs in the US muddies the waters. Such tariffs would pose a hurdle for economies where manufacturing activity has been moribund.

This includes China, where the government's efforts to stimulate the economy and promote export growth come at a time of stickier Sino-Western relations. While negativity on China abounds, it is still a major supplier and demander of the world's goods.

Conflicts in the Middle East and Ukraine remain only in the market's peripheral vision but could become a greater concern if there was an unexpected escalation. Events in France have highlighted the risk of bloated budget deficits, and perhaps higher bond yields, with a concomitant impact on the cost of capital, await countries that have displayed excess fiscal abandon.

We will stick to our investment process. In a potentially volatile world, our focus on durable growth, profitability, and balance sheet strength has all the more resonance. We remain optimistic over the long term on the prospects for our held companies and consequently for portfolio returns. Our conviction derives from the rigour of our approach and the consistency with which it is applied.

Many of the world's leading companies are veterans of economic and political cycles, although they are not immune to earnings or share price volatility. But over time, their financial strength and market leadership will enable them to take advantage of long-term growth trends that will outlast the vagaries of such cycles.

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