WALTER SCOTT

QUARTERLY COMMENTARY

# GLOBAL

*Ending 31 December 2024*

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## COMMENTARY

In a fourth-quarter client report from 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 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 holding such compounders of wealth over the long term represents the best way of maximising returns for our investors whilst mitigating risk.

However, there are also 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. We are long-term investors, and we align ourselves with businesses that share a long-term vision of wealth creation.

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 businesses 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$100bn in 2022 and is expected to grow at a compound annual growth rate (CAGR) of over 7% from 2023 to 2030. Sector leader Linde is an exemplar of the durable growth and the 'control of destiny' we seek from a business, and of the ability to weather cyclical challenges. The company enjoys diversification by end-product use and geography, with the industry marked by rational competitive behaviour. Barriers to entry are considerable, due to the high level of capital expenditure required each year, the complexity of the business and the long-term nature of customer contracts. Coupled with its ability to pass through input costs to customers and steady pricing with management looking to increase prices at a greater rate than inflation, this makes for predictable and relatively economically insensitive earnings and cash flow streams.

Macro conditions are still challenging, with volume expansion currently remaining subdued, although growth in the biggest markets, the Americas and EMEA, is being driven by low-single-digit price increases. Long-term growth of the industry is driven by rising industrial output, new applications, emerging markets, the widespread adoption of cleaner energy and the growth of the hydrogen economy. Linde recently landed a large new 'blue' hydrogen project worth US$2bn, which boosted its project order backlog to US$10bn.

## 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 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.

While not immune from cyclical ebbs and flows, less-than-truckload (LTL) transport operator ODFL has a history of solid revenue growth and profitability. LTL refers to the transportation of multiple smaller shipments from different customers. Despite being an asset-intensive business, it has a strong balance sheet with cash flow returned to shareholders through dividends and share buybacks. Financial strength has been a boon to the company at a time of subdued industrial activity in the US economy, allowing it to make strategic investments and "be responsive to the needs of our customers and our business" according to the CEO. It is well positioned for recovery, and is capitalising on the bankruptcy of Yellow, one of its former peers. Yellow's demise was a consequence of its failure to refinance its debt.

A strong balance sheet is a key component in the success of a business. Automatic Data Processing (ADP), a leading provider of human capital management software and solutions, meets the needs of over 1.1 million employers in over 140 countries, delivering payroll services for 42 million workers around the world. Its customers have access to a comprehensive range of services including payroll processing, tax and benefit administration, and human resource services. This is an asset-light business which makes it easier for the company to avoid using debt. Having a strong balance sheet instils confidence amongst its customer base and is vital when the company is required to handle the payrolls of millions of corporate employees worldwide.

### 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. Against a backdrop of stock markets that have posted strong gains since the end of the Covid pandemic, particularly in the US, the spotlight has been thrown on equity valuations in some areas. 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 be afraid 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-elect 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. Aside from rekindling inflation fears in the US, 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. 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, in our view. 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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