WALTER SCOTT

QUARTERLY COMMENTARY

EAFE

Ending 31 March 2025

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COMMENTARY

This has been another challenging quarter. A market move towards value stocks and away from growth has hindered performance. So too has our underweight exposure to banks, aerospace and defence stocks. The quarter also saw a number of stocks face some short-term headwinds. These are detached from our long-term investment rationale but have weighed on recent performance.

However, our search for companies capable of meaningful, and profitable, growth over the long term doesn't change when 'value' comes into vogue as it will always do from time to time. Nor will we invest in a particular sector because it falls into favour. Our approach is grounded in investing in companies, not markets, geographies, or sectors. Those investments are based on our own research, directed by our consistently applied and rigorous framework, and where we have high conviction in the prospects for long-term, resilient growth.

Retaining a long-term outlook

Over the firm's 42-year history, there have been a number of periods where performance over a three- and five-year view has lagged, on occasion notably so. What we learnt in those times is that we must maintain our investment process and remain disciplined in our approach. That isn't the easiest course of action and in the current performance cycle it is also deeply uncomfortable, but we know that it is essential.

Our job is to invest in companies that meet our investment criteria, to buy, and to hold. The team's research rests on a 10-to-15-year horizon, if not longer. Walter Scott's longer-term track record continues to give us confidence that our approach works. We have always known that time and patience are key ingredients.

Uncertain tariffs

Tariffs are arguably the biggest uncertainty facing companies around the world today. We may now have more information but much is still unknown. As the CEO of Canadian National Rail put it back in January: "I don't know what's going to happen and how it's going to play out. I would guess that none of us do".

In the face of any uncertainty or unexpected event, our first step is always to reassess our thinking. We challenge our assumptions. Since tariffs were first mooted as one of President Trump's strategic levers, we have spent time trying to understand the myriad of risks and outcomes.

First-order effects

Our starting point has been to analyse potential first-order effects, looking at those companies with notable revenue exposure to the US market. However, those with the most significant exposure often have well-established domestic operations which mitigate the risk around tariffs. For Compass Group, a global leader in contract food services, 85-90% of its purchasing across its major markets is from domestic sources. Convenience store operator, Alimentation Couche-Tard also relies on domestic sourcing. Companies including KONE Corporation, the elevator and escalator manufacturer, and science and technology company Merck KGaA, have

production facilities in the US. KONE has referenced its work over recent months to secure supplies of critical components mitigating both potential delays and the impact of tariffs where possible.

Other companies are confident in their ability to pass on at least some of the costs that will come through tariffs. Again, our research framework is one that places great store in market leadership and the ability to set prices. Ferrari, for instance, has expressed confidence that higher costs can be passed onto its US customers, although the company hopes to limit increases in the price of its lower-end models to 10%, with the additional 'cost' being shared between the company and the car dealership. Diageo has expressed similar confidence, noting that in past tariff cycles the company has been able to pass on all additional costs. That said, with 45% of the company's net sales coming from products manufactured in either Canada or Mexico, there is recognition that the company can't rely on passing on costs. Like other companies, Diageo has talked about steps already in train to move inventory and redirect supply chains - "supply chain optimisation" - as the company puts it. The Covid-19 disruptions showed us that such operational re-engineering is possible, but, equally, it would be wrong to assume such steps are easy. Re-positioning supply chains is only a route for the most agile companies.

Second and third-order effects

We must also consider second and third-order impacts. Inflationary pressures are an obvious concern. Rising inflation in the technology supply chain would be bad news for SAP, Wolters Kluwer and Sage. But all these companies have deep client relationships and their services are market leading, all of which offers protection that isn't shared by all in their respective sectors. The management of Compass Group, as another example, has also been clear that cost inflation can be advantageous. Not only is the company able to mitigate costs but cost inflation tends to accelerate moves to outsourcing of the kinds of services provided by Compass.

Where there is perhaps reason for most concern is around consumer confidence. This is where analysis is perhaps most difficult. As the CEO of Couche-Tard noted in mid-March: "It's certainly a moving feast as we look to continue to analyse tariffs. We are pretty confident that tariffs are not going to have a big impact to our business. We source most of our products in our countries. I think the larger impact is what it means for inflation and what it means for consumers that are already very stretched and really struggling with disposable income. That's the big unknown that we'll be watching very closely. It's about bringing value, being really laser-focused on how we can provide value to customers".

Those sentiments were echoed in our conversation with the management of Inditex towards the end of March. CEO, Óscar García Maceiras reiterated his view that the company's globally diversified and highly flexible supply chain leaves it better positioned than peers to deal with tariffs. Where the conversation turned less upbeat was in regard to the weakening consumer environment globally. It is not often that you hear Inditex's management talking about weather and calendar effects as excuses for subdued sales performance. That said, the business continues to outperform peers, investing more than most in building an increasingly differentiated consumer experience to drive growth and help meet its key goal of maximising full price sales.

Looking to fourth and fifth-order effects

Possible fourth or fifth-order effects have also been part of our research discussions. What will tariffs mean for global trade, and economic growth, over the short, medium and long term? As ever there will be winners and losers. Kuehne & Nagel sits at the apex of global trade and the company remains confident it will be amongst the former. At its capital markets day in late March, management addressed the myth that trade barriers or customs are bad for its business, instead stressing that complexity is generally a good thing. It not only provides pricing opportunities but also drives demand for their higher margin value added services, just the sort of services needed in an operating environment that is both complex and uncertain.

Outlook

The future is never certain. Where events are known, even if problematic, companies can make plans. When unexpected events happen, crisis planning can kick in. That planning might not protect a company from all ill-effects, but it can mitigate risk. Planning for possible tariffs has been much more difficult. Post 'liberation day' we might now have more information, but things are still far from certain. Are we on the cusp of prolonged negotiations and clarity around a long list of exceptions? Or are we on the brink of an all-out trade war? It is very difficult to tell.

That is not to say, there is no scope for confidence or optimism. We can't yet precisely quantify the first-order effects far less the fourth and fifth-order impacts, just as we, regrettably can't predict short-term portfolio performance. But where we can have confidence is in the ability of companies that meet our investment criteria to navigate this uncertainty better than most. Challenging periods often present opportunities. We remain convinced that the companies that meet our standards are better placed than many to seize those opportunities.

Through our conversations this quarter, we know that our confidence is shared by the management of the companies we speak to day-to-day. Our job is to continue to engage with those teams to ensure that companies continue to be well-placed for the short term, whilst keeping their focus very much on long-term growth.

The CEO of TotalEnergies perhaps put it best in February: "As I said to the Board yesterday, we are entering a new world with tariffs. None of us have ever worked in a world of tariffs or tariff wars. That was the old world. We built a global world with almost no tariffs, and we thought everything was easy to move. I think we have pragmatic guys who are able to take decisions and change their minds. That is good leadership. It is true we could have some difficulties, there are some value chains, not only for refining or downstream but also car manufacturing, where a lot of spare parts are moving across the border between Mexico and the US. So, you could have this strain, which is not good news. [Conversely] there could also be some good effects for European refiners. [They] will benefit if there is a tariff on heavy crude oil in Canada. But, at the end of the day, I think the US administration will be pragmatic in the interests of the businesspeople. Fundamentally, it is a country where business comes first".

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