

PODCAST TRANSCRIPT

Talking Research: Navigating Trump's tariffs

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Malcolm Borthwick: Let me take you back to the Paris of 1837. King Louis Philippe I sits on the throne, presiding over a divided society. Grandeur and elegance for the few, hardship and hunger for the many. Just a year earlier, the Arc de Triomphe had opened its gates, a towering symbol of French ambition. And in the cafés and salons, Victor Hugo and Honoré de Balzac were penning words that would echo through literary history.

Amid this backdrop, a modest workshop opened its doors. Its mission was simple, to craft exquisite bridles and harnesses for Europe's nobility, objects of both function and beauty. The founder, a certain Thierry Hermès. A lot has changed for Hermès since then. It has navigated its way through world wars, the Great Depression and the digital revolution to become a global luxury powerhouse. However, some things haven't changed – the firm's focus on exceptional craftsmanship. Axel Dumas, the sixth-generation descendant of the family, serves as the company's executive chairman.

Today, Hermès faces new challenges: US import tariffs. However, it's at times like this that the resilience of the French firm stands out. It's profitable, has pricing power and has consistently demonstrated its ability to both innovate and adapt.

Welcome to Talking Research. This is a special edition where we will be discussing what our Research team has been doing post Donald Trump's Liberation Day tariffs. We've deliberately waited a few weeks to record this to allow for some time to reflect. I'm Malcolm Borthwick, Head of Marketing and Strategic Communications at Walter Scott, and I'm joined by Investment Manager AJ Kyle and Executive Director Roy Leckie. AJ, Roy, good to have you on the podcast.

AJ Kyle: Thanks for having us.

Roy Leckie: Thank you.

MB: Before we start, a reminder that this podcast is intended for investment professionals only and should not be construed as investment advice or a recommendation. Any stock examples discussed are given in the context of the themes being explored, and the views expressed are those of the presenters at the time of recording.

AJ, what are your reflections on Donald Trump's Liberation Day a few weeks on?

AJK: So I think the biggest thing is the uncertainty and the volatility that we have seen in both markets, but potentially in the economies as well. I think one of the things that became apparent was the speed of the initial moves of the market. So to put that into context, the S&P 500 fell 12% in just four days. And that's really quite a historic move. But I think what's really evolved is we've had lots more information released over the last three or four weeks, but really no more certainty from that information.

MB: So, Roy, you've been through a number of these events. What's different and what's similar about this one?

RL: There has been a huge pick-up in volatility and uncertainty. And in many ways, this crisis – if you want to call it that – is quite different from others. But actually, you know, as AJ said, markets fell initially. Year to date though, global equities are flat. So yes, there was a sharp sell-off but we've had a bounce back since then, so things could be a lot worse. I mean, that 12% decline probably only just sneaks into the worst ten drawdowns that I've experienced. I think possibly what's different about this is just the consternation. And AJ used the word 'uncertainty,' it's causing right across the global economy, for politicians, policymakers, company management, consumers, and of course, for us as investors. So hugely challenging from an analytical perspective but one I think, well within the capabilities. I think we can navigate portfolios

through the volatility and the uncertainty. And I think we're helped by just some of the key tenets of our investment approach, which is to invest in very high-quality companies with strong financial characteristics and companies we think have got real pricing power.

MB: And you've been through the Asian financial crisis, the great financial crisis, the dot-com crash, lots of different seismic events. What have you learned from those that you take into dealing with something like this?

RL: Well, I've kind of referenced some of it already, I think just sticking to our tried-and-tested investment philosophy is absolutely crucial. So don't compromise on the kind of qualitative and quantitative characteristics of the companies we invest in. Now, we obviously have to keep on top of the news and events as they unfold, and that's happening at a quicker rate at the moment than it's done for a while. So, whilst we don't want to be whipsawed and caught up in the daily volatility or the noise, we do have to be nimble enough to take advantage of opportunity and opportunities always present themselves in times like this. So, companies that we've watched and monitored and liked for a long time, there's a good chance that we will get a pricing or a valuation opportunity. So, it's that kind of balance of not getting too sucked into the emotion, but being right on top, and ready to act when these opportunities are in front of us.

MB: So AJ, what type of things have we been doing over the last few weeks in terms of changing the way we look at things as a Research team?

AJK: I think the first thing I would say is we've really increased the intensity of the research discussions. We've gone from having on average two to three research meetings a week to now having one, sometimes two research meetings a day; so really having those discussions much more frequently. And then I'd point to probably three major exercises that we undertook over the last three to four weeks. The first of which was really analysing every single company that we hold in our portfolios. So looking at the facts and figures around the tariff impact, what do we think as a team and what are the companies saying as well?

And then the second exercise was really about projects. We had around 14 projects that we worked on, and this was really trying to assess every

angle towards tariffs: so the biggest risks we're worried about, be it industry specific or right back to the macro picture, and then also what are the opportunities? Where are we seeing the potential sort of excitement for new ideas? And that really nicely fed into the last activity that we did, and that was new idea generation. Over about a week to two weeks, we discussed over 20 new ideas that we're hopefully going to see in portfolios at some point in the future.

MB: So, let's take the first element that you mentioned there, AJ, which is looking at stock by stock analysis, and I think there's a common theme there which is the interconnectivity of supply chains. Earlier, I spoke with investment manager Des Armstrong about his conversation with Intuitive Surgical, a leader in robotic surgery.

Des Armstrong: One of the opportunities we have is to speak with the leadership teams of these companies. Intuitive Surgical is a great example that's been very helpful. When we engaged with them, following the results, they were able to talk us through all the moving parts of the supply chain challenges they're facing. For example, they have a very big production base in Mexico, but they're also facing potential tariffs from products coming in from the likes of Europe and, to a little degree, China. But they're able to explain how they're approaching that challenge; things like dual sourcing, looking at other ways to mitigate the cost. I think they're coming from a very strong position when you think about their business and the pricing power they have, if that is indeed one way that they have to go with this. But, yeah, a great example of where you've got a brilliant business, but being guided by a very thoughtful leadership team.

MB: So adaptability and pricing power are obviously key. Roy, you talked about balance-sheet strength earlier in our discussion. Out of other companies, which ones do you think are maybe more exposed to the tariffs?

RL: Well, clearly those who export a significant amount into the US. We're engaging very intensely with our companies to establish just how they're seeking to mitigate tariff risk. It's challenging. It's a really challenging analytical undertaking because companies have got to try and figure out what it means for their costs. And it's not just their primary level of costs; it's their suppliers and their suppliers' suppliers and so on and so forth. So it's a complex

ask for a company just to establish, what is your direct impact on costs from tariffs, particularly when we don't know exactly what tariff levels are going to be.

Then companies have got to obviously try and work out what are they going to do with pricing ultimately. So we think we're in companies with strong pricing power where the elasticity of demand will see consumers not change behaviours too much, but we just don't know for sure. And then, of course, we don't know what the competitive response is going to be. And also could or will there be retaliatory tariffs? So, you know, whilst companies might be confident that their businesses will cope and continue to thrive in the US, maybe opportunities are going to arise in other markets where US competition is going to wane because of retaliatory. So it's a kind of multifaceted, analytical undertaking just to try and work out exactly what's going on here.

One thing I think is quite interesting. At the moment, a lot of companies around the world in certain industries – not every industry – but a lot of companies are withdrawing guidance. And I think that should play to our strengths. That gives us an analytical advantage, a comparative advantage. We know a lot of investors use company guidance as their cornerstone for stock picking. These – or many of these – investors are going to be flying blind now.

So for us, as an investment firm, who does pride itself on the depth of research that we undertake, I think this higher level of uncertainty, across economies and across the corporate sector, plays to our strengths, actually.

MB: And that's really interesting the point you raised there about companies not giving guidance, because it almost means that the type of companies that we're looking for are the ones that can deal with lots of different eventualities.

RL: Yeah. Look, I think, many of the companies in our portfolios have actually been around for a long time, which means that, by definition, they have innovated and adapted to different market conditions through the ages. That suggests that they've got a kind of deep institutional DNA across their management, across their supply chains, across their distribution network, that knows how to cope with uncertainty. And actually, it's quite interesting, some of the interactions and

the discussions we're having with management, they're not quite saying it outright, but the tone of discussion is very much "look, don't worry about us. It's our competitors that you need to worry about. We know what we're doing here. We're actually very happy for this uncertainty to prevail, because we are going to come through this in a much stronger competitive position than we went into it."

So, yeah, aligning companies that are doing something special, comparative advantages that are difficult to replicate, have a buffer with their margin structures, they operate a long way from break-even levels, and they've got this financial resilience that will see them through.

MB: So we often focus on answers, but often it's the question that's more important. AJ, what is the most important question to ask companies right now?

AJK: So we've really been asking the question of flexibility, so how flexible are you? And that covers a whole host of things but really understanding not just your supply chain but how flexible is the setup? Can you move it? But also decision making. So do you have a decentralised decision-making setup so that managers, people on the ground in the various countries, can make the decision quick enough to be able to react to what's going on? And I think what's really interesting about this is it actually stemmed from one of our projects.

So we had two of our board members in the office, and the Research team spent the whole day with them, really sharing ideas, could we learn from each other. And actually, this was one of the recommendations that came out of it was: can you try and ask your companies about their flexibility, understand do they really know their flexibility.

MB: And give an example of what interesting conversations you've had with a company recently and what you've learned?

AJK: So I recently hosted a company called Assa Abloy in the office. And in their most basic form, they are a locks company, but they touch all parts of our lives, going right up to security and entrance for data centres, your offices, etc. And I think what was really quite sobering, actually, from speaking to them was: although China is not a huge source base for their supply for their US business, what they have done since Liberation Day is essentially stopped all shipments from China. So they are not

taking any shipments now for supply into the region, and that's meant they've been working down their inventories in the base in the US. And what they said has really been echoed by peers and broader industries as well. And they said, "really, we're heading towards a bit of a 'copy and paste' scenario to what we saw in Covid with regards to supply chain challenges and shortages of components." And, potentially, the winners in that scenario will be the companies who've stockpiled as much inventory that they can.

MB: So you touched on the second element there in terms of some of the project-based analysis that we've been doing, looking at defensive and offensive opportunities; one of which is identifying domestic champions, companies more immune from tariffs. Earlier, I asked the joint leader of this project, Jay McLeod, to give me an example of a company he'd identified.

Jay McLeod: I've been working on a Japanese IT service company recently. Being a services company, it's not subject to the tariffs that have been imposed on physical goods, but being an IT services company within Japan specifically is very attractive. The reason being that Japanese corporates for a number of decades have underinvested in their IT infrastructure, so you really have a situation where there is a whole market of companies within Japan that need to upgrade their IT infrastructure and systems. That's independent of what's going on in the global economy to an extent and therefore you have a relatively well insulated growth story that isn't going to be upended if we see more US tariffs or a range of other global economic situations unfold.

MB: Jay McLeod there talking about a domestic opportunity in Japan. Tell me a bit about the other projects that you and your team have been working on, AJ?

AJK: So why don't I start with a little bit of the defensive nature and some of the risks that we identified? So firstly, if I take sort of more company specific looking at an industry. And we undertook a project around the healthcare industry more broadly, so understanding what is the potential for tariffs to come. But what could they look like? And we identified that potentially European pharmaceutical companies could be at risk in that area. But this risk comes with increases in health care costs for consumers, for patients.

We also looked at things like the medtech industry. So far they've been under exemption so they haven't felt the heat of the tariffs. Is that likely to continue? And also, what about the capex landscape for capital equipment in the life sciences industry? And I think this really is still a moving feast so we haven't seen all of the announcements yet from Trump. And really it is about us just analysing this on an ongoing basis.

MB: And what are companies telling us?

AJK: So we actually hosted the management team of Roche in the office recently. Roche being a global pharmaceutical company. And they were saying, firstly, they're in a really good position with regards to tariff and their supply chain setup and what they do manufacture in the US. They were quite confident that actually we should hopefully see the pharmaceutical industry be exempt going forwards as well.

MB: I mean, that's quite specific, but what about the big picture?

AJK: Yes. So we tried to take a step back and look at some of the broader macro or policy risks out there as well. And we mentioned it earlier: the risk of retaliation. And really this is probably covering in the most extreme scenario, China, which we have seen already, come out with some sort of retaliatory tariffs there. But also looking at regions like Japan that have sort of said we're open for negotiation. And then looking at places like Europe and how they might be tackling the tech industry. So identifying where there potentially could be risks.

On the flip side, looking at some of the opportunities and where we potentially could be a little bit more excited. We were looking at dividends, so understanding the importance of having income streams during periods of uncertainty and identifying – of our companies – are there ones out there that have really good resilient dividend yields and income streams that potentially could be more important going forwards? And again, taking that step back, looking at policy, where could there be beneficiaries. So thinking about stimulus, and it's funny actually mentioning Europe and China, those two popped up again. China has already shown that they are pretty willing to have some stimulus to support both the economy, and the Chinese consumers. But I think the biggest question is, can they do enough? Whereas we've seen a lot of information coming out of Europe. So Europe is

really trying to increase the competitiveness of the region. We've seen Germany already come out with stimulus. And so it's about understanding how will that play into companies; how will that impact businesses? And that actually feeds really nicely into some domestic champions. And again, we've heard a little bit more about that.

MB: Roy, in your view – looking at the bigger picture – are there any areas or sectors here that you'd avoid or be concerned about?

RL: So rather than sectors, it's types of companies. I'm going to answer this as a stock picker and it's the opposite of what we look for. So, you know, we've been very nervous about highly leveraged businesses, very nervous about companies that don't have any obvious comparative advantage and therefore any obvious pricing power. Companies who are not in control of their own destiny, companies who have got flimsy supply chains, and so on and so forth. So, we're really avoiding companies that have got obvious fundamental weaknesses, that are increasingly being exposed in this more challenging operating environment.

I mentioned upfront, Malcolm, this thing about getting caught up in the daily noise, the changing sentiment. So you'll no doubt have noticed that the defence sector in Europe has been on fire (and not literally). The stocks have been performing very well over the last few months, and it's starting to roll over. You can understand the theme. Trump says "you in Europe need to pay a lot more for your own defence, I want you to increase the proportion of GDP that you allocate to that." Therefore many of the defence stocks took off. But, unsurprisingly to many, myself included, all we've seen is rather than a huge build-up in orders at these defence companies, we're seeing much more, kind of national accounting jiggery pokery. Particularly in southern Europe, where some of these countries are just allocating all sorts of spurious costs to their defence budgets now, such as soldiers' pensions. I've even heard that some climate change related expenditures are going into the defence budget now. So, you know, that sort of thing is a short-term theme, trading dynamic that we just have to avoid getting caught up on. We have to stick to the fundamentals.

MB: So some concern over defence there, Roy, but what about other areas?

RL: Well, two other things I might mention; one of which is just this wariness around banks, particularly European banks, which have been on a tear for a number of years actually. Some of the tailwinds that they've been exposed to, the rerating and higher net interest margins and low credit costs, I think that's rolling over quite clearly. Credit costs are going up, policy rates are coming down, so net interest margins are contracting. And I think the multiples, the rating that that sector has been afforded is going to be seriously challenged going forward. So that should be a positive dynamic, at least for our relative performance.

MB: And the second point; you mentioned two points?

RL: Well not necessarily our area of expertise, but quite often, in my experience, when the world's attention is focused on one thing – which right now is tariffs and growth and policy – something else happens: an accident or something explodes elsewhere. And I think that the pressures are mounting around the private equity industry, actually. There's been a number of warning signs, that, had I an allocation to that area, I'd be really pretty nervous about it.

MB: What are those warning signs?

RL: Oh. I mean, things that have been building, some of the big investors in the area, the big US endowments, some of the universities have been trying to get out for a number of months now. The Chinese saying, we're not throwing any more money at this and, by the way, we'd like some back. Just the number of IPOs. People kept saying, "oh, you know, US public markets are at an all-time high or very high levels of valuation." Well, if that was the case, why were there not more IPOs at the end of last year or the beginning of this year? There's been very little realisations of cash, very few deals, much fewer than we thought might happen.

I think higher interest rates have disrupted the valuation models of many private equity funds and so much of the activity in that area is fund to fund, it's continuation funds. It's a fund run by one manager being sold to another fund run by the same manager. And that's just a rope trick that can't continue for too long. So I think there's a number of signs that suggests so much money has flooded into this area at extreme valuations, and they're now realising that those valuations are extreme. I always felt one of the great fallacies of our industry is some

people consider or define risk as volatility and public equity markets are obviously volatile, private equity markets much less volatile because...

MB: Much less liquid often as well.

RL: Obviously much less liquid. But because they're less volatile, people have assumed that they're therefore less risky, which is clearly a nonsense.

MB: So let's look at the third element, AJ, that you mentioned earlier, which is new ideas and our focus on new ideas. Has there been an uptick in activity here at a time like this?

AJK: Yes, definitely, I'd say there has been an uptick. I would also say that often through periods of uncertainty and volatility, sometimes the right decision is the decision to do nothing, and that in itself is a decision to make. But I would actually say we have really been active in both discussing a whole bunch of new ideas, but also actually trying to trade them and take the opportunities – as Roy referenced earlier – where we've seen some disconnect in share prices, some really big pullbacks. And we've actually said, you know what, that's unwarranted, these are fantastic businesses. We need to own them or we need to own more of them.

MB: So how do you calibrate that? That's a fascinating point that you've raised about hold discipline. At a time like this, how do you calibrate your protection as a patient, long-term investor with the market opportunities out there?

AJK: So it is definitely a balancing act. I think it comes back to ourselves as stock pickers having the long-term view of what do we think our companies are able to deliver over that long-term period. So again, Roy referenced the fact that companies are pulling their guidance. We as stock pickers need to have a thought of what we think a company can deliver, and often you'll see a share price react very negatively to short-term news flow, a quarterly earnings report. And if we still think the companies that we invest in can still deliver on that longer-term growth trajectory then, for us, that's an opportunity, and we should seize the moment on that and look to either buy or top up. And so it's really about thinking three, five, ten, 15, 20 years into the future, but understanding that potentially there is a little bit of noise in the short term, a little bit of pain in the short term, but as long-term

investors, you should be able to look through that and take that opportunity.

MB: So give me an example of a new idea you've been looking at?

AJK: So one of the ideas is Mettler Toledo, and this is a great business. What it does is it has precision measurement and analytical equipment. And the best way to describe it is you have a microwave meal and it's getting scanned to check for any bones or any fragments of something that shouldn't be there; right to measuring every single pill that comes out of a pharmaceutical manufacturing site; right up to a giant coal truck being weighed before it goes out somewhere. And so this is a really good example of a business that we knew, really liked, but we said, "you know what, we would love to see a pullback in the share price chart, before we add to it." And this is exactly what we saw, from the Liberation Day announcements. And so, as part of the discussion of every company that we hold in the portfolio, we identified this as one of the ones as saying, "you know what, we really like this business, the long term still looks really good."

MB: So the long term looks good. Roy, why is this a good time to be an active investor?

RL: Well, I think the flood towards passive investing is abating. Actually, the flows towards passive investing, in line with the concentration that we've seen, a small number of stocks overwhelmingly contributing to market returns, I think that's rolling over. So the benefits of diversification and the benefits of – frankly – fundamental analysis are being realised once again for the first time in a while.

So, this idea of US exceptionalism, you have to be in the US, and you have to be in this small number of stocks, that's been challenged. I think partly due to valuation extremes being recognised, partly due to people waking up to the fact that China is at the table when it comes to innovation – so the DeepSeek announcement obviously changing some perceptions – plus just a realisation that the US having led market returns for so long is starting to look a bit compromised with its leadership. And as AJ referred to earlier, places like Germany are starting to actually potentially get its kind of economic house in order, so looking less bad. I think we're in for a period where market conditions that

we've been used to over the last three or four years are not going to prevail. Fundamental analysis is going to come back into fashion and those investors who've got a proven philosophy and a proven track record of identifying the difference between good companies and not so good companies, and being able to value them appropriately, should fare quite well. So I'm cyclically bearish on passive investing and structurally very bullish on active investing.

MB: So very bullish on active investing but are you still bullish on US exceptionalism? Is it the end or a pause?

RL: So, look, we as a house tend not to opine on such things or nail our colours to the mast, so we don't tend to articulate house views. However, my personal view is that US exceptionalism is on hold but not over. I mean, how do you define exceptionalism? So is it just America's position as the world's leading liberal democracy, or is it the US dollar as the world's reserve currency? Or is it the fact that the US dominates global stock market cap? I think it got up to 70% or 65%, something like that, and that's an all-time peak. I mean, it depends how we define it. I suppose, on all three counts, actually, I would say, exceptionalism is on hold, but it ain't dead, it ain't over. That would be my hedged answer.

MB: So we talked about active investing. One of the legends – the legend of active investing – Warren Buffett, aged 94, announced he was stepping down as CEO of Berkshire Hathaway recently. What can we learn from him? AJ?

AJK: So I would probably pull out one of his quotes where he said once "you want to be greedy when others are fearful and you want to be fearful when others are greedy", because I think that is such an important quote in today's markets. We've seen the fearful essence of the markets and really that's our time to shine. That is when we should really prove the benefit of our stock-picking capabilities, and so, hopefully, that is something that we can really take, and be greedy when markets are fearful.

MB: So it's about exploiting inefficiencies in the market. Roy, what about you?

RL: So I remember very well, very fondly, going to the big AGM in Omaha. It was 2018, it was a real highlight actually, and I can't remember

exactly where I flew in from but I had quite a trek getting there. And there were people wearing their lanyards like they were kind of Olympic gold medals for like a couple of days before the whole event took place. It was fascinating watching people, how proudly they were to say, I'm a shareholder in Berkshire Hathaway. But it was absolutely fascinating, a real privilege to sit and listen to him for a number of hours. And, like many investors have, I've followed everything he's done very closely and read much of what he's written, with great kind of diligence and interest.

If the question is what are your favourite quotes, well, the two things I like: I obviously like his long-termism. I'm so kind of aligned to that, that investing is a long-term undertaking and, all my career, it's been a frustration that people occasionally say, "how was your performance last month," and that's just noise. It tells you nothing about an investor's skill, what their performance is over a month or even over a quarter or over a year. You really need to measure investment performance over longer time periods, a full market cycle, to be honest, to judge skill.

Then the other one I like, "it's a great company at an okay valuation will serve you much better over the long term than an average company at a great valuation." We put so much energy into finding, identifying, valuing, buying and holding great companies. We do, on occasion, I think, probably overpay but that's when patience is required, because if the company does the internal compounding of wealth that we expect it to, that valuation premium that we might have paid will depreciate eventually.

MB: That's a lovely way to end the podcast, Roy: the compounding of wealth, key for long term investors. And AJ and I now super jealous that you've been to go and see him live in Omaha. So thanks very much for joining us on Talking Research.

AJK: Thanks very much for having us.

RL: Thank you.

MB: Thanks for investing your time with us. You can subscribe to Talking Research at Apple Podcast and Spotify. And I hope you enjoyed the podcast. If you'd like to hear more from our Research team, check out walterscott.com/insights. Until next time, goodbye.

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