SCOTTISH MORTGAGE AGM – MANAGER INSIGHTS

TOM SLATER

In this AGM film, Tom Slater, co-manager of the Scottish Mortgage Investment Trust, discusses the lessons learnt from the Covid-19 pandemic, and looks to the areas where we have seen, and could continue to see, growth opportunities arising.

All investment strategies have the potential for profit and loss. Past performance is not a guide to future returns.

A Key Information Document for the Scottish Mortgage Investment Trust PLC is available by contacting us.

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Tom Slater: The year to the end of March 2021 was an unusual one by most standards as the pandemic hit us. I'll leave it to the virologists to talk about those events and instead I'm going to focus on what we learned from an investment standpoint.

I think the first observation would be that there really is no link between economic predictions and share prices. The strength that we saw in stock markets despite the pandemic I think illustrates the challenges that come firstly from trying to predict the outcomes of a complex system like the global economy, but then taking that next step and trying to link those predictions to the outcomes for individual securities or for markets as a whole.

There are lots of very bright and very well paid people trying to do that and we stay away from trying to make those types of predictions and instead would observe that there are actually a lot of trends which are much more important for the outcomes for individual companies that are really quite predictable. So things like predictable trends in communication, in computation, in machine learning, in energy generation and storage, gene sequencing and synthetic biology, and as some of those trends compound over time, they can have a huge impact.

If you think about the emergence from the COVID pandemic and the vaccines that we've had, those are a consequence of these compounding trends in genetic sequencing, in RNA synthesisation that have led to the solution to the situation we find ourselves in. So ignore the macro economy, but there are important trends that are predictable and have real consequences.

The second learning is the impact of big winners. In any period we should expect that a small number of companies will have a dramatic impact on our returns and that was the case this year with Tesla. It is a predictable outcome of the power law distribution of returns that drive stock markets. We are focused on trying to identify the companies with the potential to be one of those big winners and to own them for long enough that our shareholders can accrue that return.

The third observation from what we've been through is that there really is no such thing as normal. We listen casually to the media talk about the return to normal, but I strongly believe that normal does not mean things go back to the way they were before the pandemic. Sure, there are important facets of human nature that don't change, but the way in which we work, the way in which we consume, the way in which we socialise are things that are subject to change.

When you go through a period like this, it does cause people to reconsider historic habits and many of those will be superseded. I think that creates lots of opportunities for entrepreneurs and it creates lots of challenges for people whose investment approach is based on reversion to the mean, the idea that things go back to the way they've always been.

So if those are some of the lessons, where do we go next? Well, one observation would be that scientists have talked about the potential for a global pandemic for some years, but we've nevertheless been unprepared or not sufficiently prepared to deal with one. There's an obvious parallel there to scientific warnings about climate change. I think just as we've seen the corporate sector lead the way out of the Coronavirus pandemic through the production of vaccines, I think we've also seen the impact of the corporate sector in the ability to move forward our path towards a sustainable energy future.

So the value that Tesla has created in addressing the electrification of transport has in the face of huge scepticism forced the investment community to reconsider the potential here. Tesla continues to make fantastic progress in improving its products, reducing their cost, increasing its ability to manufacture them at scale, at the same time as rapidly iterating and improving the software that drives those products.

As we've seen that success, it creates a more buoyant funding environment for other companies to address some of the same challenges and so that gives me some optimism that we could see a similar impact from the corporate sector in addressing this big challenge. We focused on looking for ideas in this area. One addition to the portfolio in the year was Northvolt, which is a company led by a former Tesla engineer, and it is looking to become one of Europe's largest supplier of batteries for electric vehicles.

I think as we move towards a world where people are using electric rather than gasoline powered cars, we will also need to think about a completely different model of powering those vehicles. You are much more likely to power your vehicle at home or at work or in a garage or parking lot than you will be to go to a petrol station. ChargePoint, another new holding, is the world's largest network of electric vehicle charging points and we think the software that they have will play a critical role in powering some of this infrastructure.

Northvolt and Tesla are perhaps a segue into the broader field of transportation and logistics, which is an area we think holds huge promise. With the scale that some of these companies have achieved, and that acquisition of scale has been accelerated by the pandemic as people have been at home and ordering more at home, we've seen delivery companies able to build out capabilities to service faster and more efficiently with a greater selection of products.

So looking at companies like Meituan in China or Delivery Hero in Southeast Asia, they've moved from delivering prepared meals at massive, almost unbelievable scale, to adding grocery and convenience into those offerings. Customers are getting very used to these services and we think you're seeing a change in the model of food consumption as a result.

We see companies like DoorDash doing that in Western markets and we see companies pursuing slightly different models but again addressing the same principle of on-demand, convenient, cost-efficient delivery in other areas. So Ocado in grocery delivery is running profitably in the UK and then selling that technology into other markets.

More nascent opportunities like GoPuff are looking at replicating the convenience store and taking that model online. It has a different set of challenges, but you can see in early cohorts of users that there's real demand for that convenience service. And the clue is possibly in the name, is it actually convenient to go out to a local store or is it much more convenient to get a product delivered to you cheaply, on demand in your own home? So those companies are logistics companies, delivery of goods.

Transportation of people is another area where we're seeing interesting progress. So our holdings in flying taxi companies Lilium and Joby both continued to make progress through the year. They took advantage of that buoyant funding environment that we've seen to set out on a path to public markets. They both will require substantial capital if they are to build out that flying taxi service and get accreditation from the Federal Aviation Authority. We're a little more cautious that going public at this stage is the right path for them given that it's still some time before you see the business model become more tangible.

On a similar vein in terms of companies that are pursuing opportunities once considered the realm of science fiction, we've been adding to our holding in SpaceX which has continued to make real progress in driving down the cost of access to space. As that cost continues to decline, it's opening up a significant commercial market. I think the first application of that is in telecommunications, but there are lots of subsequent interesting opportunities here that become available as you drive cost of this system.

We also took a holding in a second space rocket company, Relativity Space. While SpaceX focuses on large cargo capacity aircraft, Relativity is focused on smaller loads and it is using 3D printing technology, which is an area that's fascinated us for years but we haven't yet found a killer application. This company is using that technology to dramatically lower the cost of launching smaller payloads, so in this field of burgeoning interest we think there are significant opportunities.

So transport is an area which we're finding lots of opportunities. Maybe a bit closer to home I'd highlight healthcare as an area which is really exciting in the sense that it's a really big industry and has not seen the types of application of technology and pace of development that we've seen elsewhere. But we're now seeing companies that are operating at the intersection of healthcare and information technology and as a result are able to move very rapidly, drive down cost very rapidly, and we think have the potential to really change the investment opportunity within healthcare.

So Moderna would be one example of that. It's become a household name because of its COVID-19 vaccine. What the company's core intellectual property is, is technology for writing RNA sequences and that allows it to produce vaccines.

We've seen that in COVID, but there are lots of other big areas of unmet clinical need in vaccines which we think they now have a much greater chance of approaching. Flu as one example, HIV as another, and then there are lots of other applications of this technology, for example in oncology. As we move towards this world of programmable biology, there are some really big problems to solve that create really exciting opportunities.

There are other companies in the portfolio that are also benefiting from this similar trajectory, so I point to Tempus and Recursion. Recursion is a company that we've owned as a private company which listed earlier this year and what they're doing is automating lab bench experiments that used to take PhD scientists months. They're able to do them at an enormous pace and then instead of using humans to collect the data, using images and image processing and machine learning to really accelerate the process of discovery and also significantly reduce the cost. So I think that's a really exciting change in model.

What Tempus is doing is actually starting to collect data on a really significant scale, matching patients' disease and symptoms to their genetic profile, and then using machine learning to process all of that huge body of data and then to help provide physicians with a personalised roadmap for treatment of that individual. Again, that's a technology which is effective today but is also on a trajectory of serious cost decline and capability improvements, and those are the type of trajectories that we just haven't seen in healthcare to date.

The trust's exposure to China grew over the year. Our largest holding, Tencent, is Chinese. We think there are still some really big opportunities in that market. Tencent in particular is continuing to make real progress in its core business of social consumer-facing application, building all sorts of new opportunities on top of those social and commercial services.

But what I'd highlight about Tencent which I think is really quite remarkable is that in addition to operating that core consumer business, they've built up a portfolio of investments in all sorts of different exciting companies around the world which has been a hugely value creative experience. That investment portfolio from nothing worth close to $200 billion today and I think it points to that team as, in addition to being great entrepreneurs, being a group of some of the world's greatest investors.

The other thing that's really exciting to us about China is seeing that next wave of entrepreneurs coming through and able to innovate at real scale. I mentioned Meituan, but I point to a company like ByteDance in social media. They're the owners of the TikTok platform. They built one of China's largest advertising businesses from scratch in a very short period of time. So there's all sorts of innovation going on outside of the big players in Chinese internet at real scale, which is a trend that we haven't really seen in Western markets.

If there was a note of less positive news from China over the year it was our holding in Ant Group which was going to list and become a public company, but the intervention of the Chinese authorities stopped that event. We think the company has a track record of working with regulators and eventually resolving some of their challenges over quite a long period of time. So speaking to the team there, we think they are really focused on understanding what the agenda is of the authorities in China and moving the business to be compliant with that, so we think that they will work through those issues over time.

As we've looked at funding some of these new ideas, we've sold or reduced some of the holdings that have been important for us in the past. We no longer own some of the big Western online platform companies. We sold Apple some time ago. We sold Facebook, we sold Alphabet, and for the first time we've made reductions to Amazon that weren't just driven by diversification concerns in the portfolio.

These companies are phenomenally strong businesses. They've been able to grow whilst generating huge amounts of cash flow and the questions for us now are about how they redeploy that cash flow in the future, particularly in certain cases when they're, quite rightly, under much greater scrutiny from governments, from competition authorities, given the scale and importance they've achieved within societies.

We think those issues are less acute for Amazon, which has still some really big opportunities in areas like grocery or in geographic new markets like India to deploy some of that cash. But we think that the growth opportunities that are coming through in some of these new areas represent a more compelling risk reward opportunity for investors than Facebook or Alphabet do at this time. That speaks to the fact that competition for capital within the portfolio remains intense and that really is the barometer of the health of our strategy.

We think there are opportunities out there to reinvest from some of these big online networks into companies which hold huge promise for the next ten years, which address really big opportunities and where we see founder leaders with significant amounts of their own wealth tied up in the capital of the business really driven to exploit those opportunities. So we look forward to the future with a great deal of optimism that there are some really attractive opportunities for our shareholders. Thank you.

Scottish Mortgage Annual Past Performance To 31 March each year (net %)

2018	2019	2020	2021	2022
21.6	16.5	12.7	99.0	-9.5

Source: Morningstar, share price, total return.
Past performance is not a guide to future returns.

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