SCOTTISH MORTGAGE AGM – MANAGER INSIGHTS

TOM SLATER

Tom Slater, manager of the Scottish Mortgage Investment Trust, discusses the current environment, activity in China, and why it is imperative that we stick to our investment philosophy.

The value of shares in Scottish Mortgage, and any income from them, can fall as well as rise and investors may not get back the amount invested. 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: I think it's worth starting with a reminder of what we are trying, and not trying, to do at Scottish Mortgage. Our aim is to find the world's most exciting and promising growth companies when they're under-appreciated and own them from youth through until maturity. We aren't trying to second guess markets. We aren't trying to make macroeconomic predictions. For us, being supportive owners of the world's best growth companies is central to the task.

And the reason that we approach the task in this way, is that we believe over the long run, markets are driven by a small number of exceptional companies. Companies that turn out to be much more successful than investors ever expected. And that is true in good economic times. It's true in more difficult times. It's true in buoyant markets. It's true in weak markets. And so, it's essential that we stick to that core task of being patient owners of growth companies.

We're very conscious that the last year has not been a particularly good one for our shareholders. In trying to understand why that is, I think you need to extend the time frame a bit, and look back to the start of 2020. Now, as Covid began to take hold early in 2020, the value of the portfolio fell dramatically. Around 20 per cent in the space of five weeks. And so, we sat down and were looking at our holdings. We were talking about balance sheets and financial resilience. And what we weren't doing was, like many at the time, trying to become an epidemiologist. We didn't know what was going to happen with the virus. We didn't believe that we could predict that.

Instead, the question we were asking is, has the fundamental investment case for the companies that we own change? Are they in a robust financial position? Can they deal with the difficult environment that they find themselves in? And if we could answer positively to all of those questions, we resolved to do nothing. And of course, over the subsequent 12 months it turned out to be a very strong period for the operating performance of many of the companies that we owned. There were trends that had been in place for some time, that were accelerated, brought forward by the circumstances of Covid. So, the companies that allowed us to socialise when we were stuck at home. The companies that allowed us to work when we couldn't go into the office. And the companies that facilitated commerce in a period where we couldn't get to the shops. And so, these companies grew at exceptional rates through 2020. The good news is that they continued to grow. Now it is a more difficult environment, inflation is rising, interest rates are rising. But these companies are not giving up the gains that they made through 20 and 21. Instead they are stronger, larger businesses. And whilst there is some period of consolidation as consumer habits changes, as we've all got out of the house and started travelling again, these companies continue to grow. And I think that speaks to the strength of the really long run changes from which they benefit.

So, moving the clock forward then, from that Covid period to today, a number of our holdings have seen quite weak share prices. The environment in which they are operating in has changed again. And we find ourselves in a similar position. Looking through the portfolio, thinking about the company's ability to adapt to the changing environment. Are they able to fund themselves? Do they have financial resilience? And does the investment case remain intact? And again, where we can answer those question positively, we aim to be very long-term supportive shareholders. The broader macroeconomic environment is challenging. It is very uncertain at the moment. And we have not moved from being epidemiologists to being experts on inflation. We think it's very difficult to predict the outputs of a complex system. So instead, we stick to focusing on companies.

Now if you look at the portfolio construction over the past ten years, it's been underpinned by two fundamental contentions about the world. The first has been that China's economic emergence into a dominant power has a fundamental impact on all sorts of areas of the global economy. And the second contention has been that technology was leading to significant change and disruption in a whole number of established industries. And I think these two contentions can help us to understand what is going on in the world today. Technology companies have, in certain instances, become very large. Very influential in society. And rightly they are attracting much greater scrutiny from politicians and from regulators. We think it makes it harder for these companies to grow. But when you are at such scale, and you have to make such a large investment in ensuring that your business is fit for purpose, it becomes more difficult to introduce new products and services to delight consumers. And for those reasons we've been coming out of the big western online platforms. We've sold Alphabet, the owners of Google. We've sold Facebook. For slightly different reasons to do with founder Jeff Bezos stepping back, we've also been reducing Amazon.

But it's been a mistake over the past year to have applied that logic to the western online companies, and not to have applied it to their Chinese counterparts. Companies, big holdings like Meituan, like Alibaba, like Tencent, have struggled in the face of a very difficult and hostile regulatory environment in China. And the underlying reason for that is, a government policy to try to address inequality in the Chinese system. And I think, rightly, they've been looking at trying to ensure that the bottom 500 million people in China's income distribution can benefit from the economic progress and prosperity that China has experienced.

And the way that affects our companies is that generally they are marketplace businesses. They sit between consumers and those that they're buying products and services from. And so, the Chinese government is keen to ensure that they aren't extracting any economic rent from that position. And also, that they're paying fair wages to those that they employ. The companies have been adapting to this new environment. Our take is that it doesn't affect their long-term opportunity. So, if you're a Meituan in the food delivery space, there is likely a limit to what you can charge per order. We saw the founder Xing Wang recently and he was talking about a long-term assumption of charging 1RB for a delivery. That's about 16 cents. And he's okay with that. The economics of the business, because of its scale, can work at that size. On the other side of it, the government is also keen to ensure that they pay their delivery drivers properly. Because people in those roles are likely to be in that bottom half of the income distribution. And those are exactly the individuals that the government is trying to target.

So that regulatory agenda seems, to us, reasonably sensible. We think the companies can adapt. The challenge has been that myriad ministries and regulators within China have then set about implementing that direction. And the companies have struggled to some extent with death by a thousand cuts. The Chinese Government has realised this and more recently, have taken measures to try to stop this process. And there are good reasons for doing that. I think geopolitical events, the war in Ukraine, has caused them to take stock of the need for domestic champions and domestic growth but also to retain western investors. And at the same time, this set of constraints on the tech sector has led to a lot of redundancies. And employment is really important to the Chinese government. And it would be counterproductive to their aims if you see continued weakness in tech sector employment.

So, we're pretty optimistic that we're on a more positive trajectory in China now. That the companies have had time to adapt. That the government is satisfied that it's achieved some of its objectives. And these remain really strong entrepreneurial businesses. We see some of the best technology and business model innovation in the world come out of Chinese companies. And so, we're more optimistic on that front.

If you look at some of the processes of change that have underpinned the growth of our companies. It's also worth revisiting whether they are intact in this weaker environment. We've believed that greater understanding of the molecular and genomic basis of disease would lead to better and more personalised treatments for patients. We believe that consumer attention is moving from traditional media to online and digital media. We think the economy is transitioning away from carbon-based fuels, carbon-based transport, to cleaner alternatives. And when I look at these trends, I'm asked well, have those contentions come into question in the weaker environment that we find ourselves in? And for me the strong answer is no. Yes, there may be a more uncertain macroeconomic outlook. But those processes of change will continue. And I think, in some instances, accelerate in response to what we're seeing.

And so, as we start to think about the outlook, having businesses that are resilient, that have strong balance sheets, they're going after big opportunities and benefiting from these fundamental processes of change within the economy, rather than simply overall economic growth, allows to look forward to the future with optimism.

Annual Past Performance to 31 March Each Year (Net %)

	2018	2019	2020	2021	2022
Scottish Mortgage Investment Trust	21.6	16.5	12.7	99.0	-9.5

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

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