SCOTTISH MORTGAGE
INVESTMENT TRUST

Scottish Mortgage Manager Update – November 2022

Tom Slater and Lawrence Burns

Tom Slater and Lawrence Burns discuss three topics on shareholders' minds – portfolio performance, China, and the future outlook.

All investment strategies have the potential for profit and loss, Your or your clients' capital may be at risk.

Stewart Heggie (SH): Hello and welcome to the Scottish Mortgage update. I'm Stewart Heggie. And today, I'm joined by the managers Tom Slater and Lawrence Burns. In our conversation, we're going to focus on the three most popular topics that you have been contacting us about recently, the current market environment, China and the future outlook.

Tom and Lawrence, hello. There's a feeling of anxiety present in markets now. Whether that be driven by geopolitical concerns or macroeconomic concerns, a lot is taking place that is beyond the control of an individual investor. And Scottish Mortgage has not been immune to this market anxiety. The current fall in the share price ranks in the top ten of all time. And as a measure of sentiment, the share price is stubbornly sticking below the net asset value for a share. Or in other words, the supply for Scottish Mortgage shares exceeds demand.

Tom, coming to you first, you're a long-term investor, but how do you view the current environment from a Scottish Mortgage perspective?

Tom Slater (TS): Thanks, Stewart. I think the first thing to say is thank you, as always, to the support of our shareholders, because we couldn't take the approach that we do unless we had buy-in to this approach of long-termism and really sticking to our guns, regardless of the market environment. I think the follow-on point is, it's really important at times like these to have a clear understanding of your purpose.

And what we are trying to do, what has driven the long-term appreciation in the net asset value of the fund is by providing patient, long-term supportive capital to entrepreneurs. And giving them the time and space to invest in new ways of doing things in new technology. And it's only over really long periods of time that the impact of that can play out and create value. And I think it's easy after a period where there's been broad economic expansion and growth to think that investors passively benefit from that.

I believe, absolutely, that the opposite is true. The causation flows the other way. It is only by having long-term, patient capital support that you get periods of expansion and growth and change and create value in society. And so much of what is going on at the moment has nothing to do with long-term supportive companies. It's an environment

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where people talk about risk off, where people are myopically focussed on two or three economic variables and share prices jump huge amounts in either direction, depending on what the monthly update is.
And that is not what we're about. Really, in this environment, there are two things that are important. Firstly, getting into the detail of the companies that we own. Just making sure that the engines of growth that have driven the performance that we've seen over the past ten years are still in place, are still robust. And at the same time, looking for new ideas, looking for the companies that are adaptable, that are dealing with this difficult environment and are building the foundations of the next decade of growth.

SH: I suppose slightly tied to that, we've been receiving questions from shareholders that really point to this tension that exists between short-term market volatility and long investment horizons. And if I was to try and tie them together, I think the question is, from an investor perspective, is it difficult to maintain a long-term outlook during extended periods of volatility? And ultimately, might the investment process change as a result of the recent environment?

Lawrence Burns (LB): I think it is challenging to maintain that long-term approach in the face of markets lurching downwards, the large volatility that you mentioned. It is difficult for us, but it's also difficult for our shareholders. It's difficult for the entrepreneurs that are managing the companies. But it is in periods like these where it's also really valuable to be long-term. Because the market as a whole, its time horizon contracts in periods like these. It's harder to be long term.

And I think the ability to do that or not do that can really create or destroy quite large amounts of value in periods like these. And I think it's important to remember that as you see some precipitous falls in share price, it doesn't automatically mean those won't be great businesses going forward. Markets aren't efficient in that way. Just consider Apple's had falls of 70 per cent or more in the past. Amazon, 90 per cent. You said we've had one of the ten largest falls in the Scottish Mortgage share price.

Unfortunately, these are periods that markets go through. I think, for us, we've got a responsibility, really, to do two things. The first is to do an almost reappraisal of our investment cases. Remaining long-term, but being open to the possibility of the ways in which the world has changed and to modify the portfolio based on that, where some investment cases may have dimmed in the circumstances that we're in.

And then I think the second one is to make sure that we're able to take advantage of the volatility for shareholders. To be able to find new opportunities. Like Roblox, like Climeworks that's doing carbon sequestration, they're really important for the future. And to add to the positions that we're able to do. Now, really attractive valuations such as Mercado Libre, the Latin American e-commerce and fintech platform.

Because this is an environment where innovation still will matter five to ten years from now. It will still be valuable. But it's a market where we can take this as both an opportunity and challenge because innovation is effectively today on sale.

SH: Another area that has been in focus for shareholders is the private company allocation. Just to clarify, the limit is 30 per cent measured at the time of purchase. The exposure can go above 30 per cent. But that means that you cannot make any additional investments. For much of 2022, you've been at or around this 30 per cent limit. What impact is that having from a portfolio management perspective and the relationships with investee companies?

TS: The impact from a portfolio management perspective is just really simple. If we're over 30 per cent in private companies, we don't deploy new capital. Peeling it back a layer, I think the dynamic that you have is that this 30 per cent limit is influenced by a number of factors. It's influenced by deploying new capital into private companies, but also by the valuation of the publicly listed assets, which has been obviously very volatile, by companies moving from private to public and then the marks that we take against the private companies themselves.

And we're obviously very proactive about doing that to reflect market movements. What we've been doing is really working with our private companies. That’s a really important part of being a shareholder in a private business. That you can't sell and move on. You have to work at being a really good owner. And when there are issues that arise, you work with these companies. That's really important. It's also about just thinking about, where do new ideas come from?

And if you're more limited in private markets, actually, the flip side is public markets have been hit so hard that there are a number of companies that we've been following for long periods of time which we're now able to get access to at really interesting valuations. Roblox will be one example of that in the online gaming slash metaverse space. Or something like Cloudflare, which is enterprise IT infrastructure company.

Actually, whereas new ideas have often come from the private sphere over the past four or five years, with the declines in public markets, you're actually seeing more of the ideas come from that area at the moment.

SH: Let's move the conversation on to our next topic, which is China. We are filming this discussion shortly after China's national party congress and the subsequent negative market reaction. But before we address the congress and its impact, let's first of all just bring everyone up to speed on the China exposure. Over the last decade, some of the Chinese names have been some of the largest contributors to the performance of Scottish Mortgage, be that Tencent, Alibaba, Baidu, Meituan.

And the overall China exposure has at times exceeded 20 per cent. It started the year at around 17 per cent. And as at the end of September, it's about 16. Around about the same. I think it'd be fair to say that the investing environment in China has become more complex, particularly over the last couple of years. Lawrence, how have your thoughts been developing on China?

LB: I think, firstly, the word complex is right. I don't think there are easy answers or straightforward answers when it comes to China. But at a high level, what we've been dealing with is really two issues. The first is the potential outputs and impacts on our holdings of the US-China relationship. And that's been coming forward in different ways, whether it's US cutting China off from technology and the impacts that has on holdings.

Or whether it's the increasing, but still low risk of, eventually at some point, US sanctions on China, which would have a catastrophic impact, but it is a non-zero probability. The second element has been the Chinese actions towards its own companies that we own. And that's raised questions of, are there now limitations to scale, to profitability, to the ability to do second acts, which is to go into new areas and disrupt and dominate?

And that's what's given a lot of our holdings actually those long-term returns that you were referencing earlier. And we don't know for sure there are those limitations, but they would be very impactful because what we're looking for is that uncapped upside as much as possible. And I think as we go and we talk to our Chinese founders and CEOs, it's clear that there aren't easy answers here.

We ask them how they're thinking about it, they go, actually, I'm not really sure how much we really can help you because I myself, they say, am trying to work out what this all means and navigate it. But one thing I think that has come onto our radar is the cultural impact of some of those potential limitations. Because if there are red lines within the business environment and the cost of crossing them is severe, then the natural reaction if you're one of our holdings is you don't raise your take rates just because you can.

You don't allow profitability to go upwards just because you can. You don't go into those big, new areas to dominate. And I think there's a concern, therefore, that this is potentially impacting the culture of these companies. That they become more cautious and less ambitious. Silicon Valley used to have the phrase of, move fast and break things. And I think the risk here is that you might have companies in China that go more to move cautiously and break nothing.

That might be right for the environment they're in, but does that make them the right companies for Scottish Mortgage going forward? I think that's a very, very important question. What have we been doing about it? We've been selling a couple of our smaller holdings where we don't have the same level of conviction, Full Truck Alliance, KE Holdings. And we've been making material reductions to some of our largest Chinese companies, Alibaba and Tencent.

Where does this go from here? I think that's always difficult to say. But I think we are now more cognisant of what the portfolio's overall exposure to China is. At the same time, and here's the nuance, we still own companies within China that we're very excited about, that we think are on the right side of change, that we think are aligned with society, whether it's NIO driving electrification or Horizon Robotics with deep tech and AI.

I think it would be wrong to cut our Scottish Mortgage shareholders completely off from the upside of the world's second largest economy at this point still.

TS: Maybe what I would add to that, and it's actually reflected in your question, is that we've taken quite a lot of money out of our Chinese investments this year. But as you mentioned, that our weighting in China is not far below where it was when we entered the year. The counterintuitive conclusion from that is that, actually, our Chinese holdings have been outperforming the rest of the portfolio. Again, it doesn't fit neatly with the narrative that China is this big source of concern.

And I think it's really important at the same time to focus on individuals and companies and not get sucked into this great power competition between the US and China. That we're investing with founders that we've often invested with for more than a decade, individuals that we have huge respect for, that are interested in building value for their customers, for their shareholders. Nothing to do with any of the headlines that we read about in the paper.
And it's really important also to retain that bottom-up, company by company, relationship by relationship focus.

SH: And, I suppose, talking a bit about geopolitical environment, as I mentioned, we've just come off the back of the congress. We know that Xi is progressing into a third term and appears to be becoming yet more dominant. I appreciate it's very early, but do you have any reflections on the congress? Or has it changed your thinking in China in any way?

TS: My reaction would be that we just need to be wary of jumping to rapid conclusions about this. That actually, there are very few outside observers that can really give you valuable insight into what's going on at the top of the Chinese Communist Party. There's a lot of trying to attribute a great deal of meaning to individual words and statements. No knee-jerk reactions to the congress, unlike the market. But I think it's seeing it in this continuum of it being a less business-friendly environment in China that the government are prioritising other issues at the moment.

And that's just making it incrementally more difficult for companies.

LB: I think I'd agree with all that and I suppose I'd see it as that continuum. In some ways, it was marked a consolidation of power. That wasn't particularly unexpected, but it is going further down that path. And if you think about China after Mao, there was still a rejection of the Western liberal democratic model. But there was a desire to make it not a one-man rule's model. To make it more consensual. To make it we have checks and balances.

Yes, there was one party, but there were different factions and views within that party. I think this is about a continuum of a changing of China's governance model somewhat to one that is more centred around one individual. And there are positives and negatives around that. There is less checks and balances.

But I think I completely agree with Tom in that it's quite important that we don't jump immediately to different conclusions without having some of those conversations with people that have those deep insights that we've been having over the last few months and we'll continue to have.

SH: Let's move on to the final topic, which is the outlook. But before companies can enjoy the sunlit uplands, our future cash flow's resilience is going to be required. And it looks as though accessing affordable capital is going to be challenging for some companies. And there is a fear amongst the market that for high-growth companies, that somehow or other, the cash is just going to run out. I suppose, first of all, is that a problem?

And what's your assessment of how resilient the Scottish Mortgage portfolio actually is?

TS: I'll start on that. The vast majority of our portfolio is profitable and generates cash. For those companies, the difficult stock market environment, it's just that the price moves up and down. It has no bearing on the fundamental progress of the company. We then have a set of companies that run at around breakeven. And I categorise those companies as breakeven by choice. That they take all of the profits and the cash flows that are generated by the business and reinvest them back into growth.

And I really don't want those companies to stop doing that at this point in time. That you've seen this withdrawal of capital, you've seen the restriction of access to capital. Those companies that are able to fund their growth and still see a big opportunity ahead of them have that real opportunity to push themselves way ahead of the competition in this environment. And then you have a set of companies which are still dependent on external investors to provide financing.

It's small as a proportion of Scottish Mortgage's portfolio, a single-digit percentage. But when you look at those companies, the questions that you're asking are, is this investment valuable? Is it going to drive returns in the long run? And if you can answer yes to that question, then actually, that being there and being able to supply capital is really important to the company, but it's also likely to generate returns.

And what I would say is that in a more buoyant environment where capital supply is easy and valuations are going up, it's easy to get carried away by the headline numbers. But actually, in periods like these are often when real, long-term, competitive advantages are formed. And our job, where we see that happening, is just to continue to support and enable that progress.

And the ones where we become less convinced, where maybe some of the advantages were just a reflection of the buoyant environment that we were in and aren't really building into something more meaningful, there, you're more cautious. You make sales. You restrict the supply of ongoing capital.

SH: If we broaden out the next few years, from an economic viewpoint, it appears as though higher inflation may remain for some time and economic growth forecasts look pretty poor. Whilst I recognise that you're not macroeconomists, but if we take that as a backdrop, what makes you optimistic as you look out over the next few years?

LB: I think that just comes from, is the macroeconomics in a difficult place? Yes. But are the drivers of innovation and change in a difficult place? No. We're not seeing companies that are coming to us and saying, we're not seeing the technological advances that we saw before. We're not seeing the advances in computing power. We're not seeing the advances in the energy transition, in biology. We're still seeing those things.

And I think that's what really matters and drives that long-term opportunity set for Scottish Mortgage, is the ability to invest alongside innovation. And innovation is valuable, whether an economy is booming or whether it's in a recession. I'll probably just share two examples I found helpful that bring this to light. The first is, if we think back to when Intel, the chip manufacturer in the US, IPOed, it was in 1971.

The 1970s were a decade that now seems eerily familiar to us, high oil prices, high inflation, shock interest rate rises. But by the end of that decade, if you'd held shares in Intel, you would have returned something like 18 or 20 times your money, because that's the power of innovation even in the most difficult of macroeconomic environments. Admittedly, during that decade, the semiconductor cycle was viciously cyclical.

And I think there were a couple of points where it was 50 per cent fall in the share price. One where it was 70 or 80 per cent. It would have been difficult to go through that period. But ultimately, innovation won out in terms of the returns for shareholders. Another example, just one that's in the portfolio today, is Mercado Libre. When I first met Mercado Libre in 2010, there was concerns around the Brazilian macro and political environment.

And it's been absolutely dreadful over that period. Brazilian GDP has fallen about 40 per cent in US dollars. The Brazilian currency has fallen about 60 per cent. You've had inflation. You've had impeachment. It's been a really difficult period. Yet, because Mercado Libre was driving that innovation and that disruption, in US dollar terms, it's returned about twentyfold for shareholders over that period. I think it's just important, as I think Tom was saying earlier, to make sure we're focussing on the right things that really deliver growth.

It will be this innovation and change more than it will be, in the long run, macroeconomic factors that I think really determine Scottish Mortgage shareholders' returns over that long period of time.

SH: You've often cited the importance of the outliers, the small number of companies that can generate transformational returns. We know the names that have driven the portfolio returns over the past decades, such as Amazon and Tesla. And some shareholders have been in touch and they want to know, which are the companies in the portfolio that you have the highest conviction on and you really think can drive shareholder returns over the next decade?

TS: I think if you look at our top ten shareholdings today, they are not a representation of the things that have really worked for us in the past. Tesla's there or Tencent's there. But actually, there are a lot of names that aren't household names in the same way. Moderna is our largest holding. And I really believe that the technology platform they have is going to drive fundamental change in healthcare over the next decade.

Then something like a Northvolt, the European electric vehicle battery producer, we see the electrification of the passenger vehicle fleet really accelerating across the world. But all of the geopolitical events that you're referencing earlier, domestic or local supply chains are becoming more and more important. It seems to me much, much more likely that we have a European battery champion ten years from now.

And this company looks phenomenally well placed to drive that change. We've talked about SpaceX. This company could have a monopoly on access to space. That is just incredible to have gotten to that point and what is likely to become a much, much bigger industry and move out of the public sector into the private sector over the past decade. I think, to link it back to the previous question, there is so much to be excited about.

There is so much progress going on, the number of areas in which we're seeing the accelerating impact of technological change. And, yes, it's depressing to be in this stock market environment. But if you look at the fundamental progress, it really is very exciting.

LB: I agree totally with that. And I think the other thing, and it comes from what you were saying, is the number of holdings that have that potential, it's important to have a number of shots on goal. Not everything we own will work out. But when you have a large number of companies that could really drive returns over the next decade, that's what matters, companies that have huge upside potential. SpaceX, I think, is a perfect example of that where the sky is very much not the limit.

SH: I think my takeaways would be that the investee companies that can drive transformational returns are going to require patient ownership through these volatile times. That the China situation is complex and you're thinking your way through this. And I suppose more optimistically, for investors with long time horizons, the opportunities that lie ahead seem to be really quite plentiful. Tom and Lawrence, thank you very much for your answers.

Finally, if you would like to find out more about Scottish Mortgage, it has recently launched a new website and it could not be easier to find. The address is www.scottishmortgage.com. There, you will be able to find out more about the trust and its holdings and sign up to keep informed about new developments. Enjoy and many thanks.

Scottish Mortgage Annual Past Performance To 30 September each year (net %)

2018	2019	2020	2021	2022
29.0	-6.4	97.8	44.5	-45.0

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

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