
SCOTTISH MORTGAGE AGM – MANAGER INSIGHTS

LAWRENCE BURNS

Lawrence Burns, deputy manager of the Scottish Mortgage Investment Trust, discusses why he believes the Scottish Mortgage portfolio is on the right side of structural change.

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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Lawrence Burns: The objective of Scottish Mortgage remains unchanged. Our role is to invest in change. We back entrepreneurs who are building future of our economy and radical innovation always matters over the long term. And our time horizon continues to be a five to ten years, irrespective of the environment.

Nevertheless, I think it is important to start by recognising this will have been a discomfoting year for our fellow Scottish Mortgage shareholders. As of the end of May, as best we can tell from our historical records, this is the sixth largest drawdown in the history of the Trust behind the Great Depression, the recession of the 1970s, the onset of the second world war, the great financial crisis and the dotcom bubble.

It is never possible to say in the moment how long such drawdowns will last or even what their ultimate magnitude will be. Nevertheless, what we do know is that such falls are an inevitable part of long-term investing. Even the greatest stock market investments in history have failed to escape this fate. Apple suffered three drawdowns in excess of 70 per cent in its history. Amazon suffered a drawdown in excess of 90 per cent.

However, knowing that drawdowns are inevitable does not, and should not, dispel the uncertainty that accompanies each occasion. As fund managers we must always consider the possibility that the world has changed in ways that invalidate our investment cases for the companies we support.

Our starting point therefore has been to re-visit our three main contentions about structural change that we have spoken to you about before.



The first of these is the continuing digitisation of the economy. Here we have long talked about the importance of Moore's Law in driving the digitisation of a growing swathe of industries as computing power becomes exponentially more powerful and cheaper.

So, has Moore's Law stopped? Well, we don't see any evidence for that. Indeed, when Tom and I visited ASML the Dutch company that has been crucial to keeping Moore's Law going only a couple of months ago, they remained confident in its continuation to at least the middle of the next decade. As a consequence, we should therefore expect to see at least 60 times increase in computing power during that period. This implies radical change. Will the world need fewer chips, less machine leaning or no longer want autonomous cars? We find this difficult to imagine.

The second structural trend is the intersection between biology and information technology. Here we could ask ourselves whether societies and individuals will want less biological data or fewer personalised medicines even as the cost of genomic sequencing via Illumina continues to fall. This again would seem unlikely to us. Indeed, Illumina still hope to take the cost of genomic sequencing down from \$600 to \$100.

The third structural change is the energy transition. Here we could ask ourselves have renewables stopped falling in cost? Has battery technology stopped improving? And has the threat of climate change dissipated? The answer is of course no.

But I would still probably say there has been some mild changes to this structural trend, even since the start of the year. If you have recently gone to fill up your car with petrol you will have noticed it costs a lot more. If you recently paid your energy bill, you will have got a nasty shock. The price of fossil fuels has increased, but of course this only makes the attractions of Tesla and NIO's electric cars greater, not less. As Europe focuses on energy security and energy independence, they will have to look to electrification and renewables. If anything, therefore, the pace of the energy transition has probably mildly accelerated.

We believe we still remain on the right side of long-term structural change. But what then of the individual companies? Well to achieve a long-term vision as a company you need to be able to weather any storm that might come your way.

When looking at the portfolio in percentage terms, over half of it is delivering positive earnings per share. Of those producing negative earnings per share a decent proportion are still actually producing free cash flow, arguably the most important metric.

There is however a proportion of the portfolio that is burning cash. For some of these companies they are unprofitable by choice. They are choosing to invest and gain market share and we would usually support that choice. Some though will be so early in their journey that burning cash is unavoidable, but many of those companies at least have large cash reserves in place to fund that investment. Overall, we remain content that the vast majority of the portfolio should be able to survive a more testing macroeconomic environment and therefore benefit from the trends we've been talking about.

Given this, we have not made wholesale changes to the portfolio. We have however continued to



find a range of companies over the course of the last year that are tackling large problems and that, though still early for them, we hope may have a chance of becoming the outliers of tomorrow.

Companies like Climeworks, which is developing the technology to capture carbon dioxide from the air and store it underground. The potential market for its carbon capture is vast should societies hope to meet global net zero goals on time.

We have also invested in Upside Foods. It produces meat grown in a lab without harming animals and with far less environmental cost. Meat is a trillion-dollar market and they expect to receive pre-market approval in the next year or so from the relevant regulatory authorities. I was lucky enough to get to eat their chicken breast just a few weeks ago. And yes, it tasted just like chicken but that's because it was – it was genetically identical to chicken. What was more impressive though was watching a vegetarian try it after me who hadn't tasted meat in over 30 years, but was now able to, and that was a far more interesting experience.

As a final example, we have invested in PsiQuantum. A company working on commercialising quantum computers. Quantum computers would enable us solve a range of problems classical computing cannot practically address. Such as high-fidelity molecular simulation which could give us faster drug discovery, new fertilisers and superior battery chemistries and much, much more.

We recognise we may be entering into a very different macroeconomic environment with higher interest rates. Higher rates do matter for the valuations of stocks but radical innovation will also still matter in driving returns. If any of those three companies I just mentioned is able to succeed, they will be worth a very large multiple of their current value irrespective of the macroeconomic environment that we happen to be in.

The same is true for Tesla. Tesla will be significantly more valuable should it solve for autonomy and go from delivering 1 million vehicles a year to their aspiration of 20 million.

Of course, we can still never be certain that any holding will succeed. Take Moderna. There are scientific challenges, uncertainties and risks such as how effective will its mRNA technology platform be at combining multiple vaccines such as for flu and covid into a single shot. Or how effective will it be beyond respiratory diseases. But I can't imagine a situation in which Moderna succeeds in addressing a range of diseases such as flu, HIV, Zika and even cancer yet, still turns out to be a poor investment due to the macroeconomic environment.

We can offer no insight as to what the next few quarters will bring. And we would continue to discourage anyone from buying our shares that has a shorter than five-year horizon because we're investing and optimising our portfolio on the basis of a five-to-ten-year horizon and not concerned with the shorter periods which will inevitably emerge. And in this context, we believe the portfolio remains on the right side of long-term structural change and we remain optimistic about the power of radical innovation to enable a small number of companies to continue to drive stock market returns. Thank you for listening.



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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The trust invests in emerging markets where difficulties in dealing, settlement and custody could arise, resulting in a negative impact on the value of your investment.

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