STONEHAGE FLEMING

20 January 2025

Dear Equity Investor

GLOBAL BEST IDEAS EQUITY FUND – 2025 Annual Letter

2024 MARKET PERFORMANCE

Stock market[1]

Global equity markets enjoyed another year of strong returns in 2024. The MSCI All-Country World Index (MSCI ACWI), which covers 85% of global listed equities, delivered a total return of 17.5% for US dollar-based investors (equating to a 19.8% return in sterling terms). As in 2023, this was driven primarily by US-listed stocks, with the S&P 500 Index delivering a 25.0% total return in 2024. Technology stocks led the market. The Nasdaq Composite Index delivered a 29.6% total return, while the broader, industrial-heavy, Dow Jones Index delivered 15.0%. As in the previous year, the equity rally was concentrated in large capitalisation stocks, with the median stock in the MSCI ACWI delivering 1.6%. US-listed securities now account for two-thirds of the value of the MSCI ACWI.

Backdrop

The observation about 2023 in our previous annual letter is just as apt for 2024. A year ago, we wrote: "The main feature of the economic backdrop [in 2023] was that, despite fears around the negative impact of high[er] interest rates and inflation, the US economy was much more resilient than expectations." There's been little material change since.

In 2024, a robust US service sector coupled with stable consumer confidence led to US recession fears steadily receding over the course of the year. Meanwhile, tight credit spreads created favourable conditions for corporate borrowers while US consumption grew by over 5%, with overall GDP growth expected to come in at 2.7% over the year. Earnings for the S&P 500 were up 9% by the third quarter; some 6% above consensus expectations.

Although US inflation abated in the earlier months of the year, it remained 'stickier' over the last quarter than the US Federal Reserve (Fed) would have liked. Against the backdrop of a more resilient economy, the Fed made fewer US rate cuts than anticipated; it trimmed just 1% off interest rates over the course of 2024. It also dampened expectations of further rate cuts at its December meeting. This caused anxiety in capital markets with the 10-year US Treasury yield defying expectations to end 2024 at 4.6% - higher than the 3.9% yield at the start of the year.

The picture in China was very different from that in the US. Chinese consumer confidence remains depressed due, to a large extent, to its lack of economic growth and an ongoing property market collapse. Assorted monetary stimulus packages did little to restore confidence, while the growing risk of deflation and uncertainty around potential US sanctions and tariff threats added to the malaise. The two most notable features of its capital markets are the severe underperformance of global consumer stocks, due to the subdued consumer demand and confidence in China, and the collapse of

[1] Source: Bloomberg, December 2024.

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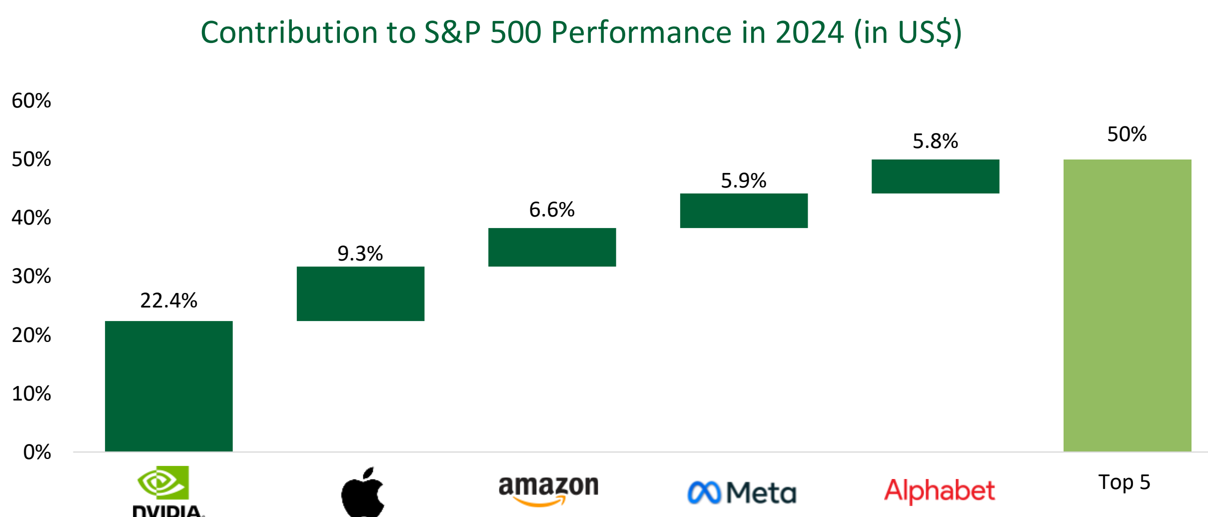
the latter's interest rate to levels below those of Japan (at the long end of the yield curve – duration of more than 20 years).

There are also signs of stress in other areas. With geopolitics dominating the headlines, the value of gold, traditionally a 'fear' asset, rose by 26% in 2024[2], surpassing the returns of the S&P 500 Index.

While US equity markets significantly outperformed US bond markets, the most notable characteristic of the equity market was the extreme concentration of performance in particular stocks. The 10 largest stocks in the S&P 500 Index now account for almost 40% of its total market capitalisation. Meanwhile, just two stocks – NVIDIA and Apple – made up almost a third of the S&P 500's returns for 2024. Such stock concentration made it difficult for most active managers to outperform the main US indices (even in the case of the 'closet' index-tracking managers).

The following chart reflects main contributors to the 2024 S&P 500 performance:



Source: Redburn Atlantic, December 2024.

The main challenge arising from this dominant performance is choosing which stock will continue to deliver from its current high base.

The divergence between large capitalisation technology stocks, and their peers in other sectors, is also made clear in the following table.

2024 Index Changes	
S&P 500 Index	+23.3%
Magnificent 7 Index	+67.3%
S&P 500 Index ex Mag 7 Index	+8.1%
S&P 500 Equally-Weighted Index	+10.9%
Russell 2000 Index	+10.0%

Source: Bloomberg, December 2024.

[2] Source: Bloomberg, December 2024.

2024 FUND PERFORMANCE[3]

Performance

In 2024, the fund delivered a 5.1% return to US dollar-denominated investors (share class B), which equates to a 7.0% return in sterling terms (share class D). This has brought the compound annual return since inception (August 2013) to 9.4% pa in US$ terms. For sterling investors this is a compound annual return of 11.5% pa.

Contributions to performance

The largest contributors to, and detractors from gross performance were as follows (all data in US dollars):

2024 Contributors / Detractors			
Largest contributors		**Largest detractors**	
Amazon	2.2%	L'Oréal	-1.0%
Alphabet	2.0%	LVMH	-0.7%
EssilorLuxottica	0.9%	Adobe	-0.7%
AJ Gallagher	0.8%	Estée Lauder	-0.7%
Microsoft	0.8%	Zoetis	-0.6%
Total	**6.8%**	**Total**	**-3.7%**
% of total[4]	**131.4%**	**% of total[5]**	**72.6%**

The main points to note from this table are as follows:

- The list of our largest contributors is more diverse this year (it was solely driven by technology stocks in 2023).
- Two of the five largest contributors were also on this list last year, namely Alphabet and Amazon.
- AJ Gallagher made it onto the list of largest contributors the year after its introduction to the portfolio in late 2023.
- Netflix almost made it into the top contributors list, despite being a new holding in the fourth quarter of 2024.
- Three of the largest detractors have significant exposure to China, namely L'Oréal, LVMH and Estée Lauder.
- Adobe, previously one of the largest contributors in 2023, became one of the largest detractors in 2024.

The road not travelled

It is also worth reflecting upon some of the popular names that the Fund chose not to own last year. Three stocks in particular deserve comment:

[3] Source: Bloomberg, December 2024.
[4] This figure reflects the contribution, as a proportion, of the top five contributors to the fund's total return.
[5] This figure reflects the contribution, as a proportion, of the bottom five detractors from the fund's total return.

NVIDIA

While we have the highest regard for Jensen Huang, his ability to deliver, and to prepare his business for the next major technology, NVIDIA remains a cyclical stock. As such, it carries a high level of uncertainty as to how long the current cycle can last.

The stock has seen 20% drawdowns three times in just the past year, plus a two-thirds drawdown as recently as two years ago. By comparison, our semiconductor exposures are much less cyclical, 'buy-to-hold' kind of businesses, with strong operational results coming through.

GLP-1 stocks

It is hard not to admire the innovation of Novo Nordisk and Eli Lilly. We have, however, been concerned as to the over-popularity and herd instincts that these stocks attract, with little consideration for valuation. This has recently led to a drawdown of over 40% in Novo Nordisk, following a strong drug result that was only marginally below expectations. Consequently, Novo Nordisk fell 15% in US dollar terms in 2024 (it fell 14% in sterling terms).

That said, we are '*Never-say-Never*' investors. We have the luxury of being able to change our minds if, and when, the facts change. This a cornerstone of our investment philosophy.

FUND ACTIVITY

Our activity in 2024 resulted in turnover of 11.7% (still considered low by industry standards). The notable transactions during the year were as follows:

a.) Sold the remainder of Estée Lauder
Whilst its woes were originally ascribed to the weak Chinese market, it became apparent that it also suffered management challenges when replacing both the CEO and CFO. With China growth continuing to look anaemic, we took the view that the business may take even longer than feared to recover its former glory.

b.) Sold out of Nike
Although it was another victim of declining Chinese consumer spending, the sports giant was also too aggressive with its digital strategy. In the process, it alienated its wholesale distribution partners. It was also too slow out of the blocks with new product development, which cost it valuable market share in a sector driven by innovation.

c.) Sold out of Becton Dickinson
Despite large corporate actions, Becton Dickinson has not been able to deliver comparable growth to its med-tech peers. We no longer believe it is a best-in-class business.

d.) Introduced Copart
Copart is a global leader in online salvage vehicle auctions, mostly for auto insurers. It predominantly acts as an agent, extracting fees from both sellers and buyers for the sales that it facilitates. We believe that few businesses can match Copart in terms of the scale of its competitive moat. In particular, its ownership of a virtually irreplaceable network of 19,000 acres of land zoned for storing salvage vehicles, serves as a huge barrier to entry to potential competitors.

e.) Sold out of Nestlé
The business is struggling to deliver organic growth and this is impacting its profitability. Facing both the threat arising from GLP-1 medications, and uncertainties stemming from the ousting of its CEO, we don't believe Nestlé is a top choice anymore.

f.) Introduced Eaton

Eaton is a premier power management company, manufacturing highly engineered electrical products with exposure across the full electrical transmission and distribution value chain. It benefits from structural mega-trends such as electrification, energy transition, and digitalisation. Ongoing re-industrialisation and rising electricity demand, notably evident in the surge in datacentre construction, is another primary driver.

g.) Introduced Netflix

Netflix is the clear global leader in digital entertainment. After a long period of investment, it has been free-cashflow-generative since 2022 and has entered a new growth phase by offering low-cost subscriptions, which include advertising. With 70 million of its 280 million subscription base already opting for this alternative, strong double-digit growth can be expected over the next few years as this subscription option rolls out globally.

h.) Sold most of Adobe

Since the attempted Figma acquisition, investors have questioned Adobe's competitive position. The emergence of disruptive Generative-AI products has further added to these concerns and the long-term outlook for the company has become increasingly uncertain.

i.) Introduced Amphenol

Amphenol's attraction is its high quality, stable delivery, entrepreneurial culture and its exposure to the 4th Industrial Revolution (4IR) theme. It is one of the world's largest providers of high-tech interconnect, sensor and antenna solutions that enable 4IR. It produces thousands of SKUs (stock-keeping units) for several thousand customers across numerous sectors. As a direct beneficiary of the advent of AI we expect to see elevated medium-term growth.

OUR CURRENT PORTFOLIO

a.) Theme exposures

We hold only best-in-class businesses. Following the somewhat higher than average portfolio activity in 2023 and 2024, and the continuing focus on each potential position's unique merits (including diversification), we believe that our current portfolio will continue to benefit from several attractive long-term growth themes. These include the following:

i. 4th Industrial Revolution

We have been well positioned for growth in cloud and super-computing, generative AI and machine learning, digitalisation, the internet-of-things, augmented and virtual reality, automation and other aspects of this technology driven revolution. Our technology company holdings are the world's leading global innovators in this space. We are, in a conservative way, deeply invested for a modern, technology-driven world. This is our largest single thematic exposure.

ii. Healthcare

Aging populations, longer lives and medical innovations are driving spending growth in choice areas of healthcare. Our names in the sector are at the forefront of helping people live longer, healthier lives, while at the same time delivering improved value for those paying the bills.

iii. Infrastructure

Following technological advancements, growing geopolitical tensions and a deficit of earlier investment, US infrastructure development is now accelerating. The US government is backing investment in a range of critical industries (eg semiconductor

production, datacentres, electricity supply), while increased spend on energy transition and national infrastructure has also become official policy. We are well positioned to benefit from the decades-long investments taking place, notably in the US, EU, Japan and South Korea.

iv. Innovation

Naturally, we seek businesses with strong innovation and product development. Leading examples in our portfolio include Google (Alphabet), which continues to confound expectations. DeepMind and its organic AI developments (Gemini) demonstrate strong capabilities. Meanwhile, Google's new Willow quantum chip is capable of solving a computation in five minutes that would take the world's fastest supercomputers 10 septillion years (10^{25}) to solve!

Google's DeepMind co-founders, Demis Hassabis and Dr John Jumper, have jointly been awarded the Nobel Prize for Chemistry for their work developing AlphaFold, an AI system that predicts the 3D structure of proteins that is already leading to breakthroughs in scientific discovery.

Elsewhere, Amazon's Trainium 2 chip is intended to challenge NVIDIA's dominance in AI hardware, reinforced by an $8bn investment into Anthropic, a compelling challenger to OpenAI. Visa has also developed a palm-payment system with Tencent (not owned by the fund), enabling digital payments simply by scanning the palm of a hand while EssilorLuxottica has developed AI-enabled glasses. The latter are branded as Ray Ban, in partnership with Meta.

v. US exceptionalism

Over 80% of our holdings are US-listed companies, as the country offers the world's best entrepreneurship, innovation, business schools, management, capital market dynamics and the best demographics in the developed world.

vi. Conservative insurance exposure

We continue to find attractive structural growth businesses outside of the 4th Industrial Revolution theme, that are much less in the investor spotlight. The global insurance sector is a good example. Climate change-related events, and issues such as cybercrime, have been driving up the cost of insurance. We are well invested in the broader insurance theme via three differentiated, and relatively low-risk businesses, each of which avoids underwriting risks.

AJ Gallagher is a leading casualty insurance broker, arranging insurance contracts between the insurers and clients. It simply takes a commission percentage in return. It therefore enjoys the benefit of the rising price of insurance, without the downside of increasing claims costs. Verisk Analytics analyses and provides unique data to casualty insurers to support them in correctly pricing risk and reducing fraud. It's a crucial partner to insurers, and enjoys a quasi-monopoly. Lastly, Copart (mentioned above as a new holding) acts as an agent, extracting fees from both sellers and buyers of, mostly, insured salvage vehicles.

b.) Challenges

While we have no reservations as to the quality, and sustainability, of the companies we hold, some are facing short-term challenges:

i. UnitedHealth

There are several headwinds facing the US health-insurance industry, ranging from higher procedure volumes and lower pricing on government health plans like Medicare and

Medicaid, to uncertainties from the political landscape and related policy implications. In December, two further unrelated events unnerved investors. One was the tragic shooting of Brian Thompson, the CEO of the health-insurance division. This brought to the fore the role of health insurers in providing affordable, accessible healthcare. This negative publicity tarnished sentiment towards the shares.

The second event comprised two proposed bills relating to pharmacy-benefit managers (PBMs). While increased regulation around PBMs dampens investor sentiment, our assessment of the potential loss to operating profits is minimal.

We believe that UnitedHealth is well placed to add value through managing the risks around healthcare spending while improving patient outcomes. The company stands out as a leading operator with a strong strategic vision that has benefitted all stakeholders throughout the evolving landscape. The above issues are reflected in an undemanding valuation for what has been a consistent compounder that has outperformed the market in 11 of the last 15 years.

ii. LVMH & L'Oréal

A severe property crisis, weak consumer spending and high youth unemployment are among the challenges facing the Chinese economy. This hurt the ability and willingness of Chinese consumers to spend on luxury items, contributing to slowing organic sales at both LVMH and L'Oréal.

With LVMH, shrinking sales in its Fashion & Leather division – which has the highest margins – disappointed. Meanwhile, L'Oréal faced a slowdown in dermatological beauty, previously its fastest growing segment.

These are two of the best quality and most well-managed businesses in the world. We believe that the shares are undervalued and offer good upside. We view these setbacks as temporary headwinds and remain attracted to the strong fundamentals.

c.) Portfolio diversification

We believe that we have increased the diversification of our portfolio and further enhanced its overall quality, enabling us to enter 2025 on a strong footing.

Our indirect exposures to the China consumer theme and to GLP-1 threats have been moderated. The fund's exposure to industrial and infrastructure-related businesses has been expanded. Apart from further diversification, the portfolio changes (mentioned above) further improve the growth outlook and lower inherent correlations.

d.) Portfolio characteristics

The fund's portfolio currently has the following overall quality characteristics:

- Operating margin: 31.1%
- Return on invested capital (ROIC): 20.4%
- Net debt/EBITDA[6]: 0.6x

[6] EBITDA: Earnings before interest, taxes, depreciation and amortization.

Over the next 12 months, the Fund's portfolio is expected to grow revenue by 9.4%, and earnings per share by 13.5%. The overall operating margin of our portfolio is forecast to expand by 68 basis points over the same period[7].

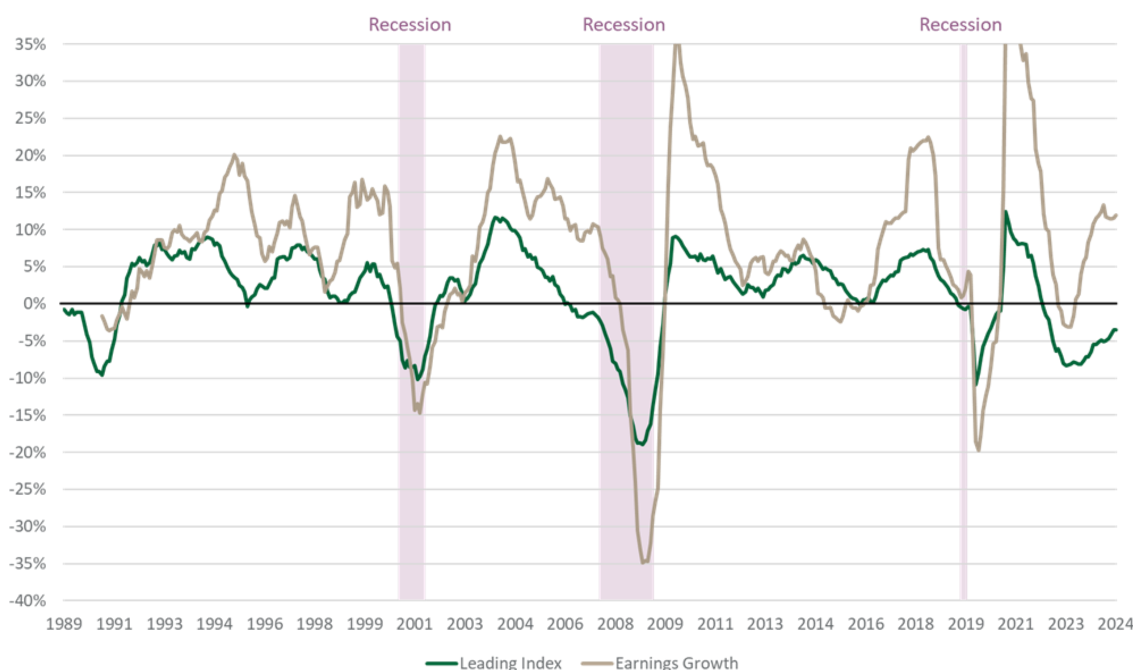
2025 MACRO OUTLOOK

As is often the case, there is widely diverging opinion on the US and global economic and political outlook. The following summary reflects our views on the most pertinent issues:

a.) Soft US economic outlook

The US economy remains more resilient than expected, but with growing uncertainties about new domestic and international trade influences. The following chart historically provided guidance from 10 leading economic indicators:

US Leading Economic Index vs S&P 500 12-month Forward Earnings Expectations (Growth YoY)



Source: Bloomberg, December 2024.

The chart historically bottomed in the midst of the respective recessions. Whilst still in negative territory, it currently reflects an improving economic outlook, with the suggestion that the US will avoid a recession this time. Other indicators are less constructive, with potential trade tariff effects also looming. Consensus US GDP expectations from the Bloomberg panel of 73 contributors vary between +0.5% and +2.9%, with a median of 2.1%. We believe that we should budget for a continuing resilient, but softer, US economic outlook.

b.) US inflation: Under control, but sticky

While inflation has now dropped to levels that are more manageable for business, inflation is likely to remain 'sticky' due to potential trade tariffs. Together with the resilient economy, inflation has become an interest-rate issue, with the Fed clearly indicating its determination

[7] Forecasts are not a reliable indicator of future performance.

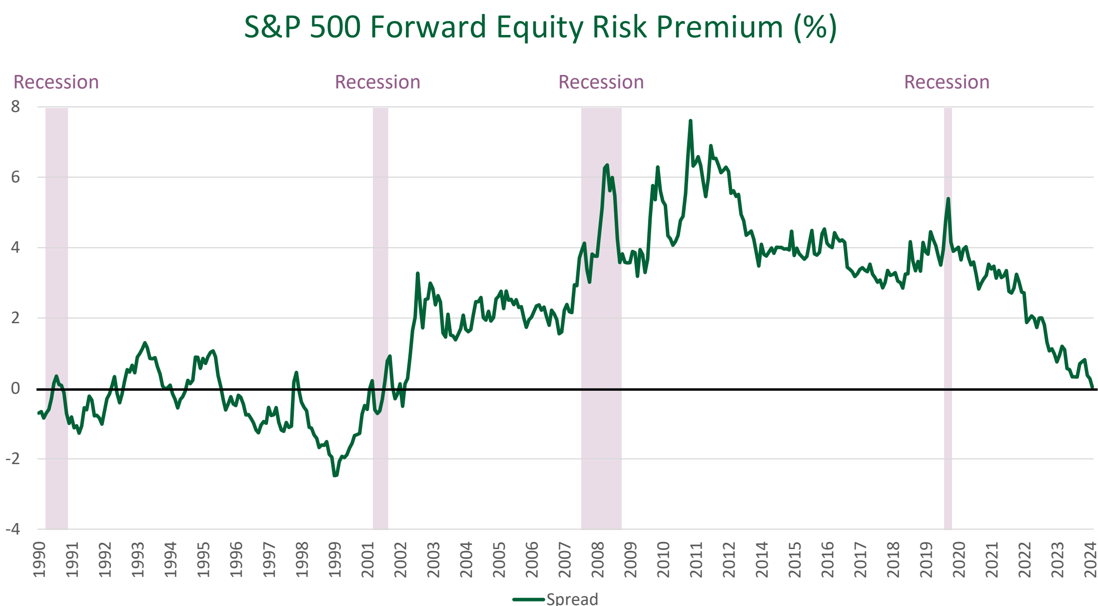
to hit its 2% inflation target and the postponement of further rate cuts. This may keep interest rates at higher levels than previously anticipated.

c.) Competing US bond market
With the potential for the new US administration to increase national debt levels, combined with the inflation scenario above, equity investors need to be conscious of a potentially more volatile bond market – but with attractive real rates on offer.

d.) Anaemic China economy
The continuing weakness of the world's second-largest economy and its ailing currency poses risks to world trade, already in the crosshairs of potential US tariffs. Meanwhile, Europe's main economies are also struggling and offer nothing to compensate for a declining China.

e.) Geopolitical tensions
Investors are increasingly anxious about growing regional polarisations, sanction and tariff threats. A new US administration has the opportunity to help settle some of the political issues, should it choose to do so.

f.) Valuations
US equity valuations are at elevated levels which requires a fundamentally supportive backdrop. Index valuations are however lower than in 1999 and 2021. They are also more justifiable, due to today's profusion of high-quality, highly profitable and cash-generative businesses.



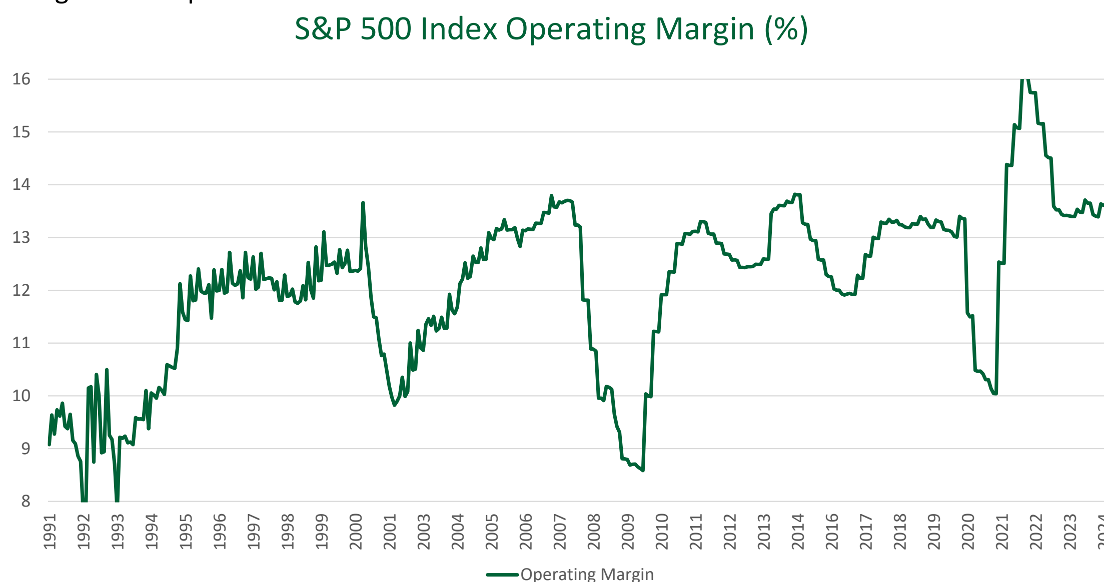
Source: Bloomberg, December 2024.

Considering valuations on a relative basis, the equity risk premium (ERP) chart above provides some guidance. The ERP reflects the spread between forward earnings and Treasury yields. In doing so, it indicates the premium investors demand from equities over bonds. The ERP is currently neutral, indicating investors' belief that earnings growth will provide the excess returns over bonds.

We have to decide whether this conviction is warranted. Whilst we trust that many of these businesses will continue to deliver, it is also clear that we need a supportive and stable bond market, with limited further upside in yields from their current levels.

g.) <u>Profitability</u>

Investors can take comfort in the highly profitable nature of the US business world and its exceptional characteristics (as discussed above). The following chart indicates the operating margin landscape:



Source: Bloomberg, December 2024.

As the chart shows, the average operating margin is currently above pre-pandemic levels. This indicates effective company management. The use of evolving technology clearly plays a material role in achieving this. While investors have to take a view on future profitability, we would warn against some *'reversion to mean'* perceptions. Even so, we expect our portfolio to raise its average operating margin by a further 53bps per annum.

A topical issue around margins is the enormous capital expenditure by the technology majors, and how the subsequent depreciation charges are likely to affect their respective margins. Such expenditures tend to persist for a while before tapering off sharply. Future margin effects will depend on the level and profitability of the additional revenues that these expenditures have stimulated. We will need to be alert to potential stock de-ratings in cases where the results may not adequately justify the capital invested.

2025 PORTFOLIO IMPLICATIONS

Along with the potential macro issues above, we would like to reflect on the following for our fund:

a.) <u>Portfolio projections</u>[8]

We expect the following:

Portfolio Projections 2024 - 2027	
Revenue growth	+9.4% pa
EBIT margin uplift	+0.5% pa
Earnings per share growth	+12.3% pa
Dividend per share growth	+8.7% pa

[8] Forecasts are not a reliable indicator of future performance.

b.) <u>Our team</u>

Our team grew in 2024. We appointed Carolyn Bell as our new deputy portfolio manager. Carolyn has 11 years of portfolio management experience in addition to five years spent as an equity analyst. Prandhana Naidu, who has 12 years of experience, was appointed as a senior equity analyst. Three additional appointments were also made in our Client Services & Communication team.

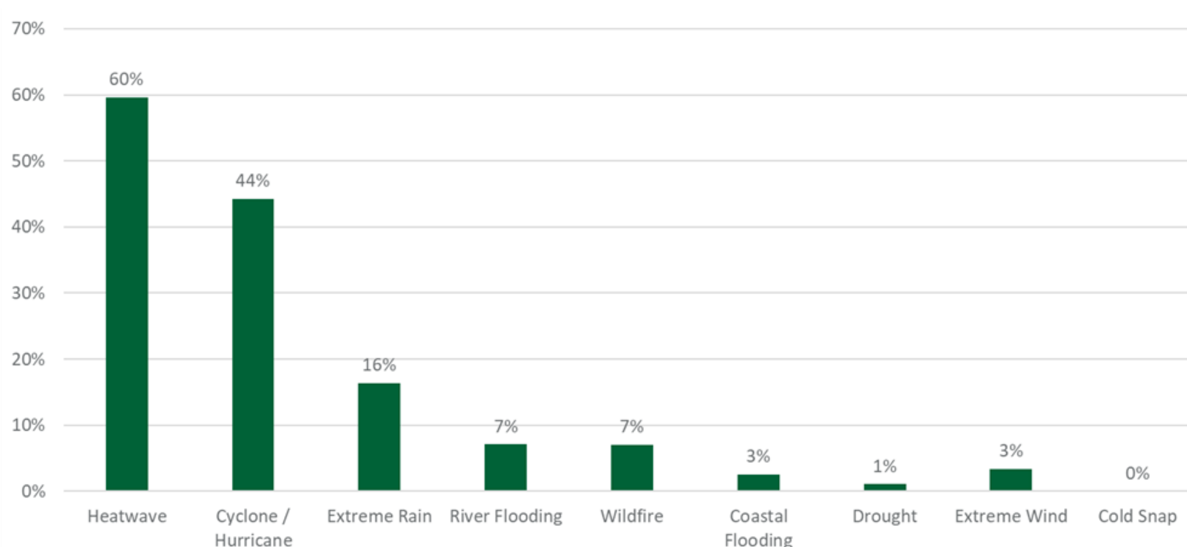
RESPONSIBLE STEWARDSHIP & ENGAGEMENT

2024 was another year of proactive engagement with our portfolio companies. We voted in all AGMs (with the exception of Nestlé and Alphabet[9]), always seeking to promote best-in-class corporate governance. We endeavour to support shareholder proposals that advance social and environmental issues. We note, however, that a growing number of these proposals are poorly researched. For example, it is common to see a request for a report on remuneration at a business that already provides full public transparency on the topic. In these instances, we vote against the proposal for it being an unnecessary use of board resource. As a consequence, it may appear that we are actively voting against an important issue when that is not our intention.

Wild fires have been causing loss of life alongside devastating physical and financial losses in Los Angeles. Last year, flash floods devastated parts of Spain while multiple hurricanes tore through America. These are all examples of the extreme climate events that are becoming increasingly common.

In 2024, we produced our first TCFD report (Taskforce on Climate-Related Financial Disclosures) that included analysis of our holdings' physical risk exposures to extreme climate events. The chart below reflects the number of facilities owned or operated by our businesses that are considered to be located in areas at risk of catastrophic climate events. The numbers are surprisingly large, and highlight some of the potential risks to which we are exposed from climate change.

Aggregate Average Asset Exposure to Physical Climate Risks for GBI Equity Fund Constituents (Equal-Weighted)



Source: Bloomberg, December 2024.

[9] We do not own the voting share class for Alphabet. In order to vote in the Nestlé AGM, we would be required to give up custody of our shares for several days over the voting period. This would make us unable to trade the stock during the voting window and we are unwilling to surrender our liquidity in this manner.

In late 2024, we engaged directly with all of our holdings on their climate-related risks, and sought information on the steps they are taking to mitigate them. The potential financial implications of not appropriately addressing climate-related risks are clearly growing, and we firmly believe that a quality business needs to address these risks if it is to deliver earnings growth that is sustainable over the long term.

We maintained our engagement with businesses across our core universe on financial, operational and strategic issues, including meetings with senior management. With our philosophy of owning high-quality companies, with high-performance management teams, we don't engage with the intention of altering a business's strategy or financial targets. Ultimately, we would rather use our engagement to assess the quality of each management team, and to consider the strategic competitive edge of each business. If, as a result, we form the opinion that either is insufficiently strong, we simply wouldn't invest. We believe this approach should result in better investment outcomes for our stakeholders over the long term.

Investors can find our disclosures on our website (www.stonehagefleming.com/gbi/esg).

IN SUMMARY

Donald Trump's election win, which brought with it the promise of protectionism and lighter regulation of US-based businesses, led to an initial upswing in investor optimism. This may have a near-term beneficial effect on US economic growth. Expectations that some of his policies (tariffs, tax cuts and a tougher immigration policy) will be inflationary, has led the Fed to suggest (and market expectations to embed) very few interest-rate cuts in 2025, with these unlikely until the second half of the year. With the concern about sovereign debt levels and subsequent bond yields, it's important that US exceptionalism, and US profitability, continue to surprise to the upside.

In our view, the exceptional concentration of performance in a small number of stocks during 2024 may have run its course, meaning that active portfolio managers can again add value going forward. High-quality businesses can operationally continue to deliver and they should continue make up the core of any long-term equity portfolio.

The fund's portfolio is both diversified and well positioned for an ever-evolving modern world. Our expanded team will assist in delivering our mandate.

As always, we are most grateful for all the support from our investors.

With appreciation and kind regards

Gerrit Smit
Partner – Head of Global Equity Management

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