6 July 2024

Dear Equity Client

GLOBAL BEST IDEAS EQUITY FUND ("the Fund") – 2nd Quarter 2024

Performance

World equity markets delivered another positive quarter – the third one in a row. The MSCI World Index (including Emerging Markets and dividends) grew by +2.9% (in US$ terms, +2.7% in UK£ terms). The Dollar/Sterling currency remained relatively stable over the quarter. This brings the Index's year to date return to +11.3% (in US$ terms, +12.4% in UK£ terms).

Macro Backdrop

Investors increasingly perceived US inflation to be under control. Whilst headline inflation (CPI) remains somewhat sticky at just over 3%, core CPI and rented accommodation (the main inflation culprit) continue their downward trajectory (currently at 5.4%). Excluding the latter, headline inflation at 2.1% is close to the Federal Reserve (Fed)'s target rate of 2%.

The well-respected Conference Board US Leading Economic Index suggests a potentially improving economic outlook. Against this, softening employment data indicate a growing risk of a tiring US consumer market, while PMI data, at the end of the quarter, moved into contraction territory.

US interest rates were stable over the quarter, reflecting sanguine investor expectations. Similarly, expectations for the Fed to cut their target rate (twice this year) remained stable.

The US reporting season delivered another positive overall result, again ahead of consensus expectations. As before, those companies' shares that disappointed in their outlook commentaries were marked down materially.

Portfolio Comments

Following the market's strong returns in the first quarter, we highlight three themes that influenced our portfolio in the second quarter:

Digital Momentum
The global digital revolution continues unabatedly. More than a third of the portfolio is exposed to this momentum in some or other form. Increasingly smaller, more powerful, and more efficient semiconductors are the driving force of future technological innovation. **ASML** and **Cadence Design Systems** play a critical role in their production. Material organic growth acceleration is anticipated for both businesses in 2025. ASML has started to ship its most advanced lithography equipment to TSMC and Intel as they expand capacity to record levels, benefitting from the Biden administration's subsidies to onshore chip manufacturing capacity. Cadence Design Systems is benefitting substantially from AI, selling both software to customers designing AI chips, and its own AI-enabled tools that revolutionise chip design.

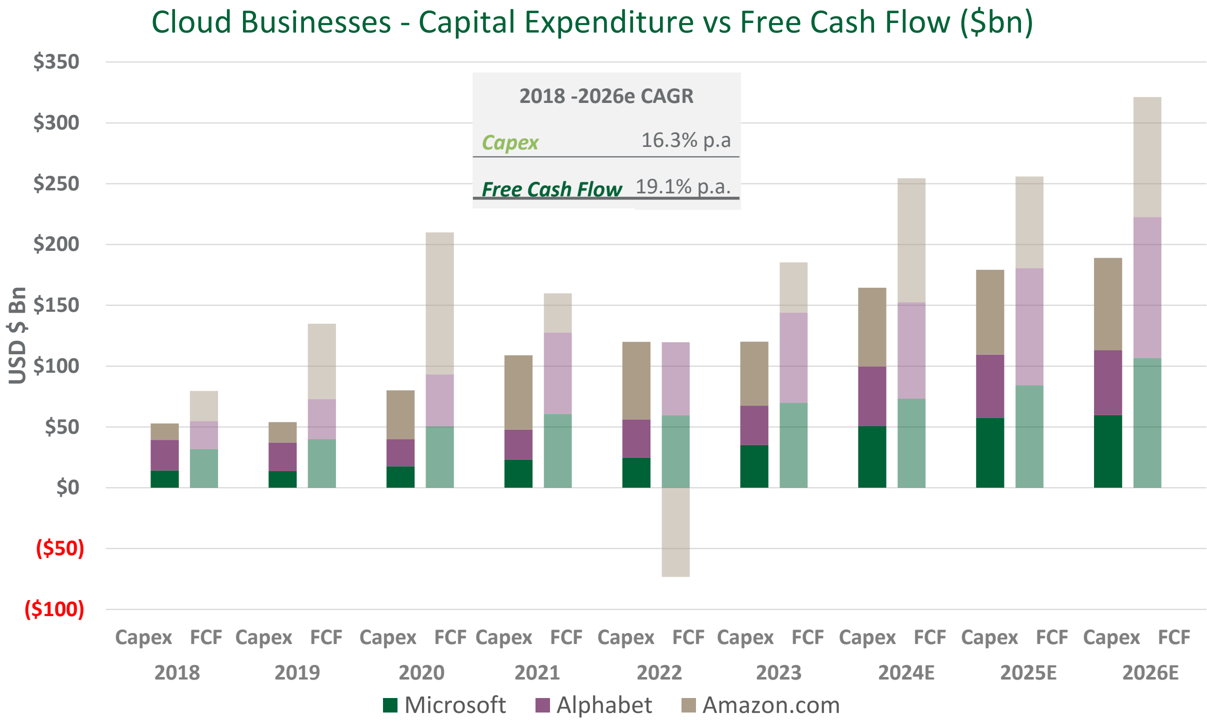
Adobe offers innovative software solutions with embedded generative AI capabilities. Investors had been cautious that new AI competition may emerge and that the company would struggle to monetise its AI Firefly tools. Adobe put these concerns to rest following its results, noting that its sales and profits are accelerating due to their Firefly solutions and that customers had generated over 9bn images since it was launched late last year. The company continues to release new AI tools and it has established a substantial technological lead over its rivals in all areas. Adobe's stock gained 25% in June.

Cloud Recovery

The cloud hyper-scalers (Amazon AWS, Microsoft Azure and Google Cloud Services) have all reported accelerating revenue growth and profits after a period of clients 'rationalising' their subscriptions in 2023. Along with the overall digital theme, this supported our portfolio performance.

Cloud operational performance is now further supported by AI-imbedded tools and capabilities in their offerings. These businesses are all increasing their AI investments, which include the building of new data centres. The committed capital investment plans of the three companies currently totals more than $160bn, of which some may ultimately flow to our holdings in ASML and Cadence Design Systems.

Another important feature of the Cloud industry deserves a highlight:



Source: Bloomberg, Stonehage Fleming Investment Management, June 2024. Forecasts shown are indicative only and based on consensus projections; they are not guaranteed.
Note: Data has been calendarized

The above chart depicts the total capital expenditures over time of Amazon, Microsoft and Alphabet (the stack-bars on the left), along with their Free Cash Flows (the stack-bars immediately to the right). The striking feature is that these businesses, on average, generate well in excess of 1.5 times more Free Cash Flow than their Capital Expenditures, largely because of the cash generative nature of their Cloud businesses. This clearly puts them in a strong position to remain leaders in the digital revolution, and especially in AI.

Consumer Weakness

Having finally spent their COVID-19 savings, there is growing evidence that US consumers are reining in their discretionary spending. This is especially the case with low income consumers, as was evidenced in a number of companies' quarterly results. We are also seeing this theme play out in China.

McDonald's noted weaker US traffic and lower sales of value menu offerings. Their shareholders are partially protected from the impact of this temporary trend, as the company earns the majority of its income in the form of rent (as it owns the majority of the restaurant properties). The businesses' value proposition also provides protection as it may gain from consumers downgrading from some more upmarket competitors. The company is also currently increasing its store footprint. Compared to its peers, McDonald's offers investors defensive qualities and sustainable growth prospects, at industry-leading profit margins.

As indicated, stock market performance over the quarter was again largely driven by the Digital/Cloud/AI industry theme. Three of the four best contributors to our Fund's performance over the period are from this category. Alphabet, Microsoft and Amazon are all trading at record levels, with Cloud revenue accelerating at all three. Alphabet and Microsoft are increasingly seen as the AI leaders, with huge free cash flow generation. Amazon's AWS annualised revenue run-rate is now at $100bn, with a best-in-class operating margin of 38%. The margin recovery in the rest of its business is now a main feature. As the leading data provider to insurance underwriters and an AI adopter, Verisk Analytics reported strong growth and the stock made a top-three contribution to the Fund's second quarter performance.

Of the three worst contributors to performance over the quarter, two are in the global consumer space. Estée Lauder has been the largest detractor following a continuing weak China market and a peer referencing to a slower overall beauty market. Accenture announced a weak order book and outlook, with sentiment on LVMH weakening from the surprise France election and a weakening consumer market outlook.

We have started to build a new position in the Industrial sector. It is a less cyclical type of business. We have not yet reached our target weight.

<u>Performance Concentration</u>

As a feature to highlight, stock market performance remains to be concentrated in a handful of predominantly technology-related stocks. For reference, the top three stocks (by market capitalisation) in the S&P 500 Index accounted for 45% of the Index's performance year-to-date (YTD). NVidia alone accounted for 30% of the index performance, followed by our holdings: Microsoft at 9% and Amazon at 6% of the Index performance. The top ten stocks contributed 71% to the Index's overall return. Only 24% of the number of index stocks outperformed the Index. The S&P 500 equal-weighted Index, which provides a clearer picture of broader stock performance, rose only +5.1% YTD, a full 10 percentage points (or two-thirds) behind the market-capitalisation weighted Index.

This level of performance concentration has impacted active fund managers, and possibly more severely than ever before. Clearly, those who do not own NVidia, by implication, have had a meaningfully lower probability of outperforming the Index over this period. This may entice some investors to buy such stocks without the necessary fundamental conviction.

Such severely narrow performance is unlikely to be sustained longer term, especially if it is driven by more cyclical stocks. We are adequately exposed to the dynamic companies that power the Digital Revolution, and focus on those with diversified and non-cyclical revenue streams and sustainable strong long-term growth. We therefore believe that we are well positioned to capture excess returns as market performance broadens again.

Business Quality & Valuations

As a broad comment, we believe that many businesses' quality characteristics have improved over time. The S&P 500 Index's Return on Equity ratio is in a long-term rising trend, and is currently at 18%. Along with this, its Net Debt / EBITDA ratio has dropped from around 4 times earlier this century to the current 1.5 times. Many companies' operating margins are in rising trends. Logically, many businesses have become more productive than others by utilising evolving technologies.

Furthermore, during the Pandemic, investors learnt how resilient and competitive some businesses are, with many thriving shortly after that very testing time. From all this information, a solid case can be made that current valuation multiples for many quality businesses should be higher than their respective historic averages.

The S&P 500 forward P/E ratio, currently 16% above its average since 2000, may seem elevated. Along with the above important point about better quality businesses, it is also important to stress that the index today is much more skewed towards the high-quality large capitalization businesses in the booming technology sector. Clearly, we should consider each business's valuation multiple on its own merits, but as an overall statement, we are not overly concerned about the S&P 500's 16% premium to average current P/E valuation.

Our Fund remains well exposed to the strong momentum in the Digital Revolution, including the current in focus theme of AI. Seven of our holdings offer good exposure, with quality characteristics that are far superior to major indices, including an average ROIC of 27%, an average ROE of 35% and net cash on the balance sheet with an average net debt to EBITDA of -0.3 times.

Price/Earnings to Growth (PEG) Ratios

Holding	PE Ratio	3 year expected EPS Growth p.a.	PEG Ratio
Accenture Plc A	23.9	9.1%	2.6
Adobe Systems Inc	40.3	13.3%	3.0
Alphabet Inc C	27.4	14.5%	1.9
Amazon Com Inc	50.3	20.7%	2.4
ASML Holding NV	46.6	22.5%	2.1
Cadence Design Systems Inc	64.0	17.9%	3.6
Microsoft Corp	38.8	14.3%	2.7
Average	**40.5**	**16.3%**	**2.6**

Index	PE Ratio	3 year expected EPS Growth p.a.	PEG Ratio
MSCI World Index	20.3	7.7%	2.6
S&P 500 Index	24.0	9.6%	2.5
MSCI World ex US Index	14.6	4.9%	3.0
MSCI Emerging Markets Index	15.0	14.2%	1.1

Source: Bloomberg; Stonehage Fleming Investment Management. June 2024. PE ratio quoted calculated using prices correct as of 18 June 2024 and based on trailing 12 month Earnings Per Share (EPS). 3 Year Expected EPS Growth p.a. based on our internal analyst projections and is not guaranteed. PEG ratio is computed as trailing P/E ratio divided by 3 Year Expected EPS Growth p.a. Average reflects a Portfolio Weighted Average

Apart from their quality characteristics, they also enjoy a strong outlook for both revenue and earnings growth. We estimate an average compounded +16.3% p.a. expected EPS growth, placing them on a PEG ratio of 2.6 times (dividing the trailing P/E by the expected earnings growth). This PEG valuation is in-line with the World and S&P 500 indices, and lower than the World ex-US Index. On this basis, we do not believe that these high-quality Digital Revolution businesses are overvalued, and we expect them to continue to deliver a strong contribution to our Fund's performance.

US Election

Almost half of the world population lives in countries that have had or are scheduled to hold a national election this year.

When Trump was elected President in 2016, the S&P 500 dropped 5%. Within a day, US markets had recovered their losses, leading to the 'Trump rally' whereby expectations of lighter regulation supported markets. This was further supported by a more reflationary outlook following the 2015 manufacturing downturn.

Stock markets tend to, on average, rise more in election years than in non-election years. Nevertheless, our investment process is bottom-up driven and focuses on finding areas of underappreciated organic growth protected by wide economic moats. Typically, this type of sustainable growth is less dependent on fiscal or monetary policy. Microsoft, for example, grows earnings by making its customers more efficient, and this is less dependent on the extent of green investment, how protectionist the US is, or even on the level of corporate tax (to name a few current political issues).

As strategic investors, we believe that the most responsible way for us to spend our time is rather by focussing on best-in-class businesses and tuning out the election noise. Of course, we always consider new facts when they emerge – as may happen following the appointment of the next administration.

Outlook

On balance, we believe the US economy is in a maturing process with a growing risk that more consumers are struggling with the cost of living increases. Odds are increasingly moving from a 'No Landing' scenario (GDP above potential and inflation remaining around 3%) to a 'Soft Landing' scenario (GDP below potential and inflation dropping further).

Fortunately, the Fed has created the necessary reserves to stimulate the economy should it become necessary. They have thus far acted responsibly through challenging times, and hopefully will be able to act both in good time and to the necessary extent when cutting their target rate, and thereby preventing a 'Hard Landing' recession.

A maturing US economy supports our Quality Growth investment style.

Summary

Our overriding perception is that US economic growth is stable, but with risk of softening. We therefore expect investor focus to shift from inflation and interest rates to securing sustainable growth. This plays directly into our investment philosophy and we continue to ensure that we own only the best-in-class growth businesses, and at attractive valuations.

Thank you for all your support.

With best wishes.

Gerrit Smit
Partner – Head of Global Equity Management

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