

WALTER SCOTT



WHAT WE LOOK FOR IN A COMPANY

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INVESTMENT NIRVANA

Twenty-five years ago, in a client report, Ian Clark, one of Walter Scott's founders, expressed a strongly held view which continues to represent the essence of our investment philosophy.

"Investment nirvana = compound growth x time"

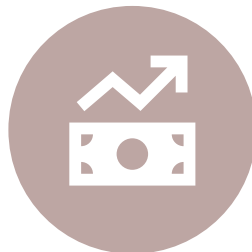
This was Ian's way of highlighting the merits of buying financially strong companies capable of delivering sustained growth with excellent profitability and applying a requisite amount of patience. Our view then, as it is now, was that holding such compounders of wealth over the long term represents the best way of maximising returns for our investors. We believe that over the long run, corporate earnings, not markets, drive share prices, and consequently, portfolio returns are a function of the long-term compounding of earnings growth delivered by each company.

But our investment stance should not be characterised as the outright pursuit of growth or growth at any cost. Thorough analysis of all fundamental considerations, and valuation, lies at the heart of our research approach. Overpaying for growth, or from our perspective, buying value without the prospect of growth, are not conducive to achieving good long-term returns.

While we look at a variety of qualitative and quantitative measures in assessing a company's fundamentals, there are three key dynamics we examine:



Sustainable
growth



Profitability
and returns*



Balance sheet
strength

*Returns in this sense refers to metrics such as cash return on capital employed

They are important because the combination of strong, sustainable levels of growth, high levels of profitability and returns, and the flexibility and protection afforded by balance sheet strength, represents a key driver of durable investment returns. **This paper will take you through each of these metrics. Its purpose is purely to lay out what we look for in a company. We are not suggesting that our approach is an automatic recipe for outperformance.**

Only stocks that meet our strict investment criteria will be bought for portfolios. We are resolute, both in our emphasis on the long term, and in the consistent application of our rigorous investment approach.

SUSTAINABLE GROWTH

We should differentiate between companies that enjoy sustainable growth and other businesses to which a broad growth label is often applied. For some companies, growth can be fleeting, reflective of business models that may not stand the test of time, are over-reliant on debt, have insufficient cash flows to finance investment, or have weak competitive moats with products or services that are insufficiently differentiated. They will have their moments in the sun, but our quest is always to find businesses that exhibit sustainable, long-term growth.

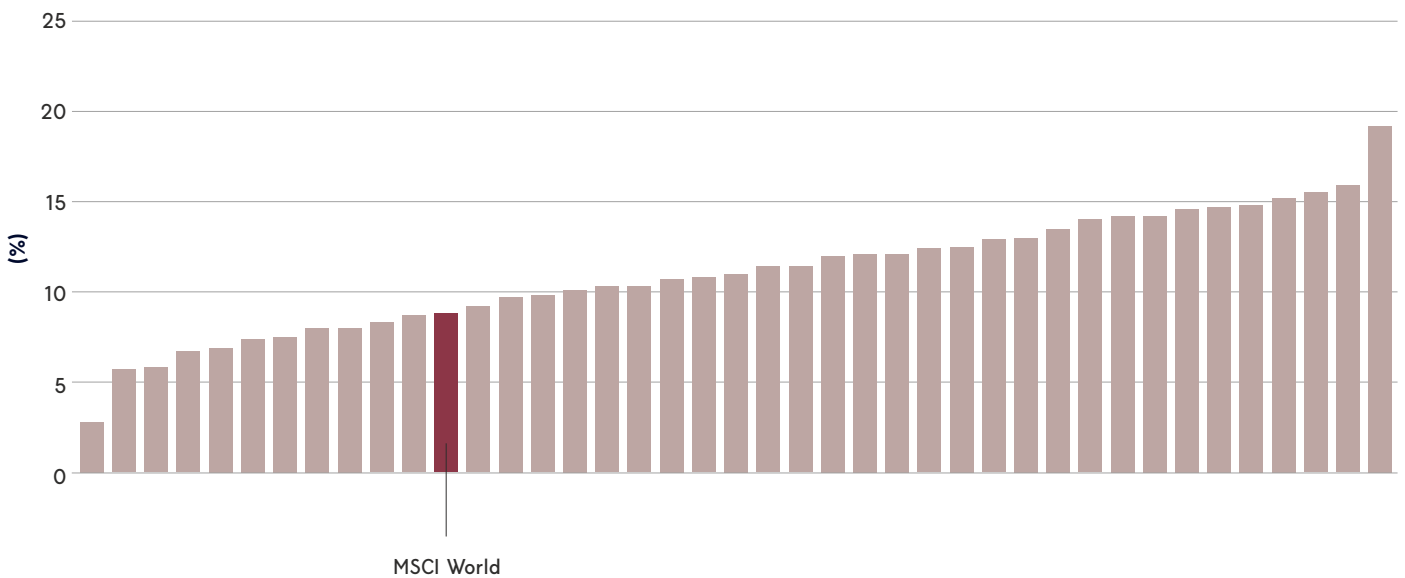
“We are focused on businesses that are in control of their destiny”

Some companies benefit from periodic cyclical tailwinds, such as an economic uplift or a favourable turn in the interest rate cycle, but we are focused in businesses that are in control of their destiny, with attractive growth outlooks that can span many cycles, and are less deflected over time by macroeconomic shifts.

When we refer to “sustainable” growth, we are not speaking in the ESG (environmental, social, and governance) sense of the word. Instead, we use sustainable to describe businesses that enjoy a virtuous cycle of compounding. Companies where profits can grow on a consistent basis over time, and where there is a good level of reinvestment in the business – through capital expenditure or research and development – to help fuel future earnings expansion.

The chart below shows the annualised earnings per share (EPS) growth rate of the companies in the Walter Scott representative global portfolio over the last 20 years. In view of our lengthy investment horizon, we consider this an appropriate timescale. Over this period, these rates have compared favourably with the MSCI World Index.

Walter Scott representative global portfolio 20-year EPS growth



Source: Walter Scott, MSCI, FactSet as at 30 September 2025. Annualised figures. Each bar represents a portfolio company. N.B. 20-year data is unavailable for five portfolio companies.

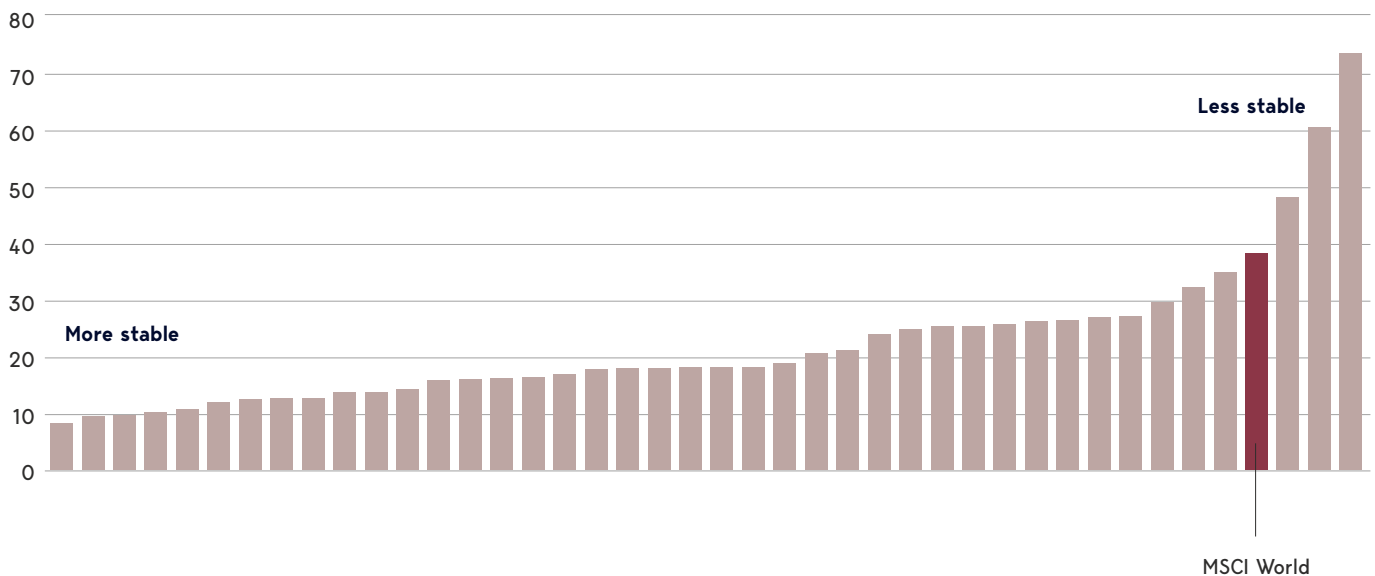
“Investing in companies that are fundamentally resilient is the best way to mitigate risk”

However, this is not the full story. We look for robust levels of growth, and for them to be defensible and repeatable. There will be periods where the growth of portfolio companies may lag relative to other businesses that have more volatile earnings flows due to the scale of their operating or financial leverage. However, staying the course with wealth compounders that grow reliably through business and economic cycles is key to our approach.

We also believe that investing in companies that are fundamentally resilient is the best way to mitigate risk in terms of loss of capital and volatility. This is – and always has been – at the heart of our process. By constructing a portfolio of businesses that offer growth and resiliency, we believe excellent risk-adjusted returns can be achieved over the long term.

Stability of growth not only offers reassurance in challenging times but helps preserve a strong foundation for future growth. As a measure of this, the table below indicates earnings per share stability across the Walter Scott representative global portfolio over the last 20 years, and the equivalent figure for the MSCI World Index.

Walter Scott representative global portfolio 20-year EPS stability

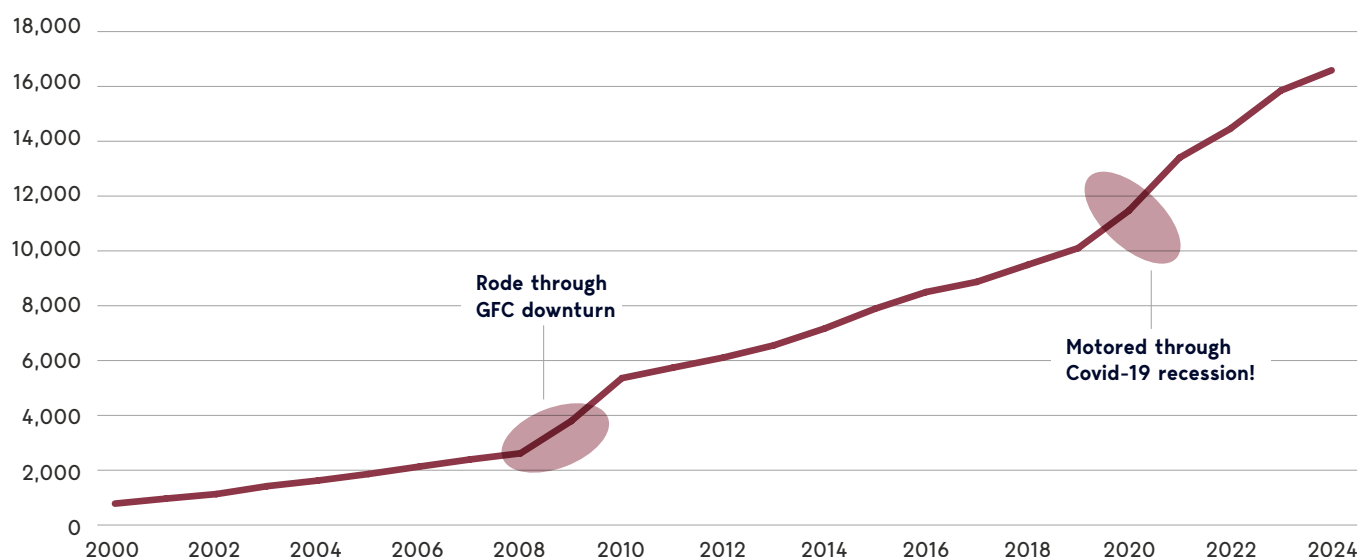


Source: Walter Scott, MSCI, FactSet as at 30 September 2025. Stability is calculated as the mean absolute percentage difference between an actual reported figure and a 20-year historical growth trendline. The lower the number, the less volatile growth has been. Each bar represents a company in the portfolio. N.B. 20-year data is unavailable for five portfolio companies.

For the purposes of illustration, these and subsequent charts refer to our global strategy. However, our considerations and principles are applied across all strategies. Our representative EAFE portfolio has similar characteristics in terms of growth, profitability, and balance sheet strength.

O'Reilly Automotive represents this quality of sustainable growth. It is one of the largest specialty retailers of car parts and equipment in the US, selling to both DIY customers and professional installers. Economic conditions can impact the industry, but testament to the durability of its business model, it has reported over 30 years of same-store-sales, revenue and earnings growth.

O'Reilly same-store sales (in US\$m)



Source: Walter Scott, O'Reilly Report and Accounts 2000-2024. Highlighted area = periods on negative US GDP growth.

Other examples of sustainable growth can be found in the industrial gas industry. Although rarely seen as glamorous, industrial gases are linchpins in processes across a variety of sectors, ranging from manufacturing and chemicals to food and beverages production.

Sustainable growth case study

Linde

This global industrial gas giant was formed through the merger of American company Praxair and German company Linde AG in 2018. The origin of Linde can be traced back to Carl von Linde, who founded the original Linde in Wiesbaden in 1879. Carl was the first person to extract oxygen from the air commercially, thus launching the industrial gas industry. Industrial gases have for many years permeated a vast array of industrial processes, ranging from steel and auto manufacturing to food processing and pharmaceuticals.

As a leader in this industry, the company is well placed to benefit from strong, underlying tailwinds. The global industrial gases market size was valued at US\$109bn in 2024 and is expected to grow to US\$172bn by 2032. Long-term growth of the industry is being driven by rising industrial output, new applications, emerging market demand, and the widespread adoption of cleaner energy. Although some way off in terms of making a meaningful contribution to the company, the development of the hydrogen economy could be of huge benefit to Linde.

The resilience of the business in times of economic challenges speaks to the company's robust business model. Linde enjoys the benefits of diversification by end-product use and geography. Barriers to entry are considerable, due to the high level of capital expenditure required each year and the complexity of the business. Producing gases on a commercial scale is a massive task. While oxygen, nitrogen and argon are all found in the air we breathe, the business of separating them from the atmosphere demands a formidable level of technical expertise as well as massive investment in giant air separation units.

The long-term nature of 'take or pay' contracts and hard-to-replicate processes, endow Linde with considerable pricing power. There are few industries that enjoy 15-20-year contracts with many of their customers. The price for industrial gases rarely goes down, even in times of economic distress. Coupled with its ability to pass through increases in input costs, with management seeking to increase prices at a greater rate than inflation, this makes for predictable earnings and cash flow streams.



PROFITABILITY AND RETURNS

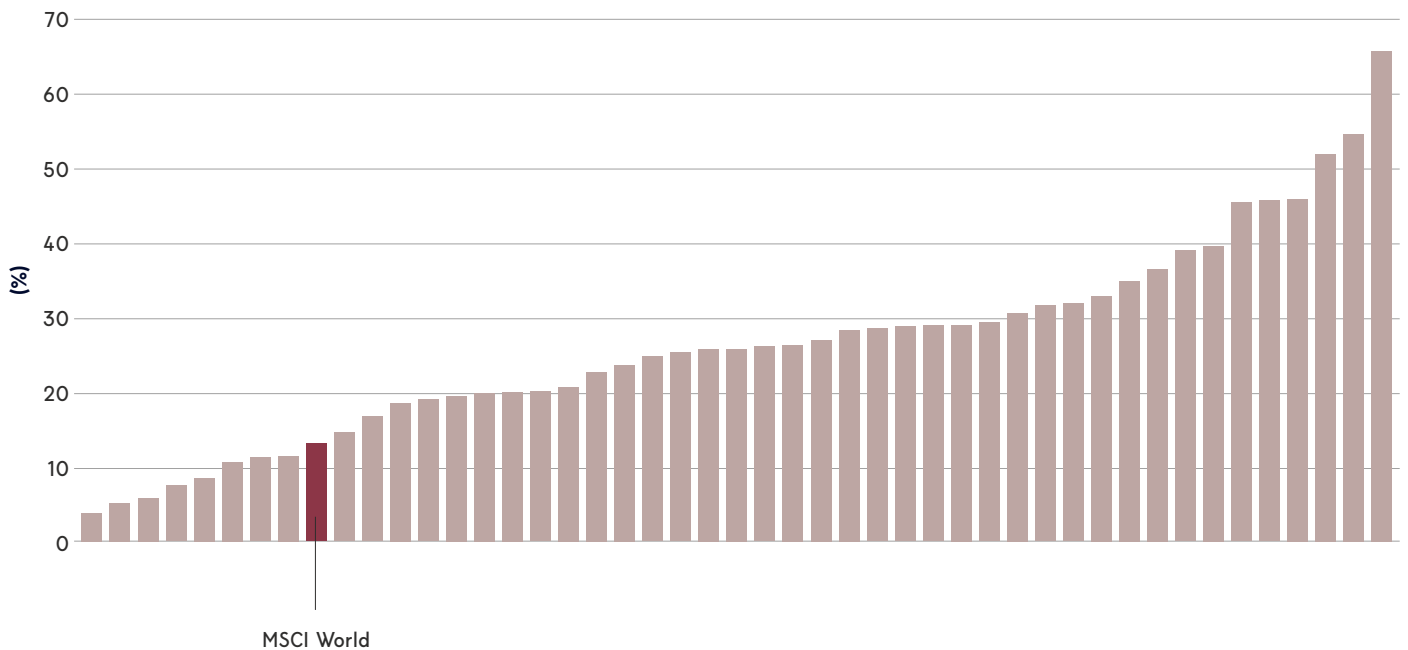
Adaptability and innovation, a differentiated product, a competitive moat, strong pricing power, good cost control and excellent management are key components in determining the profitability of a business. We look for companies that leverage on these attributes to sustain good levels of profitability.

“A company's ability to create wealth comes from consistently earning a return that is greater than its cost of capital”

Profitability is key to a company's returns, and we examine a variety of metrics to assess it. We look at gross, operating and cash flow margins, and how they, and a company's asset efficiency and financial leverage, impact cash return on capital employed and return on equity (ROE). We analyse the level of profits and cash flow being generated by the assets being used in running the business. Fundamentally, a company's ability to create wealth comes from consistently earning a return that is greater than its cost of capital.

As a straightforward illustration of our focus on profitability, the chart below shows the operating profit margins for the Walter Scott representative global portfolio versus the equivalent data for the MSCI World Index.

Walter Scott representative global portfolio operating margin

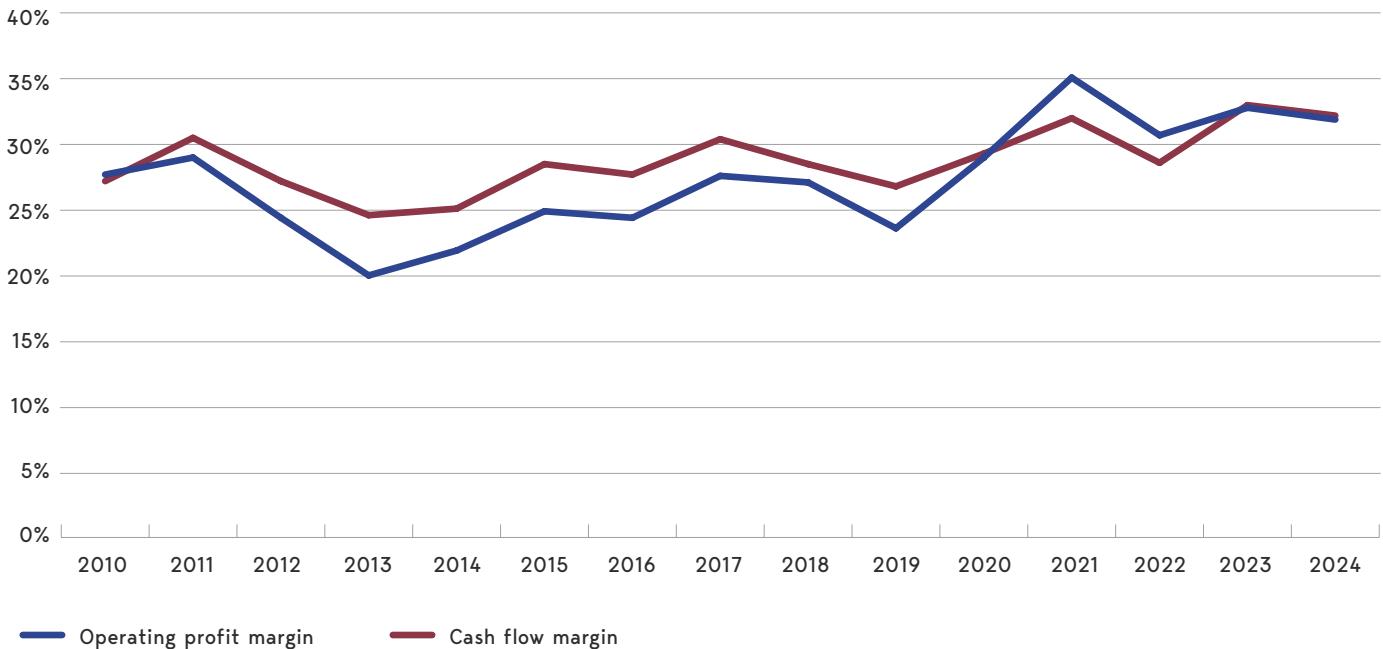


The ability to maintain high levels of profitability gives a business the financial resilience to withstand external shocks and the flexibility to invest in future growth. Such companies can fund research and development or capital expenditure internally, without relying on external financing – and when excess capital remains, they can return it to shareholders.

A strong brand can grant companies considerable pricing power, high, durable margins, and sustainable, long-term earnings growth. LVMH, though not immune to economic cycles, benefits from the enduring appeal of luxury items that convey image and style. Its cornerstone fashion and leather division has maintained stable operating margins which have averaged 33% over the past 20 years.

Technological pre-eminence can maintain a high level of profitability. ASML’s extreme ultra-violet (EUV) tool, a field in which it has a monopoly position, is critical to semiconductor chip manufacturing and, consequently, all things AI. The company’s leadership and innovation have helped it sustain a high level of operating and cash flow margins in the period post the global financial crisis.

ASML operating and cash flow margins



Source: Walter Scott, ASML Annual Report and Accounts 2010-2024.

Due to an asset-light business model, with high barriers to entry in an industry where customer trust and security is paramount, Mastercard has been able to sustain high levels of profitability.

Profitability and returns case study

Mastercard

Mastercard's products are used daily by many millions of people across the world, with the company having 3.5 billion cards in circulation. Along with Visa, the two companies enjoy a near duopoly, outside of China, in a market which is still underpenetrated. Mastercard has been able to sustain an operating margin that has averaged over 50% over the last 15 years, with operating profits rising at a compound rate of 14% per annum over that period.

Mastercard's core business facilitates electronic payments between consumers and merchants. It acts as a fee-based intermediary – earning revenue each time it processes a transaction, much like a toll collector on a digital highway. These charges only comprise a small part of the value of a sale, but multiply that by many millions of transactions a day and given that it is not a capital-intensive business, this is a recipe for high profitability. Mastercard estimates that the addressable market size in this core business is valued at US\$34tn, of which 68% is 'carded'.

This is a business which is driven by technology and innovation and, in an increasingly digitised global economy, there remain huge opportunities. Mastercard is pursuing other money 'flows' including government disbursements, remittances, business-to-business point-of-sale transactions and working capital and consumer bill payments. It is also targeting opportunities in new networks such as digital identity and open banking. Together, these new areas represent US\$100tn of payment flows, a huge opportunity which Mastercard wants to punch the ticket on.

Mastercard is an excellent example of the qualities that we look for in a business: not only high margins, but also a steady compounder of returns, financially robust, and endowed with a strong and defensible market position.



BALANCE SHEET STRENGTH

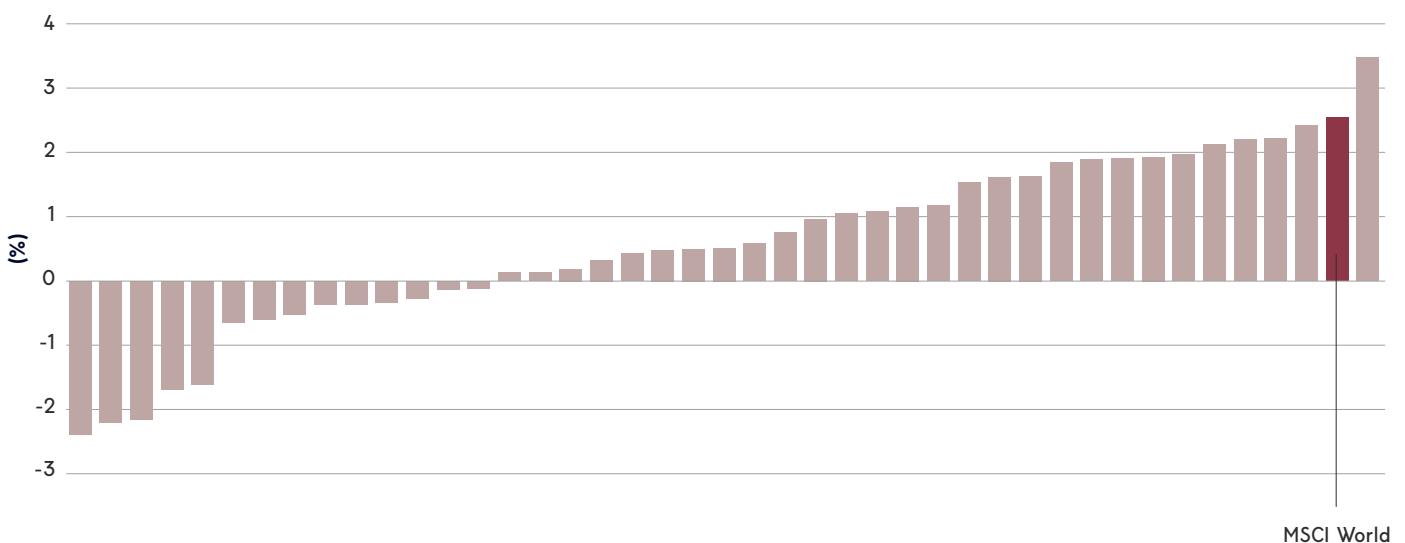
The history of the corporate world is littered with unforeseen events, and having a strong balance sheet mitigates against the unexpected. The Covid-19 pandemic, for instance, was a massive test for businesses and supply chains. In an environment of severe demand contraction, having a substantial buffer helped. Fashion retailer Inditex entered the maelstrom with a cash-rich balance sheet. Over this period the company was able to steal a march on weaker competitors that floundered trying to keep afloat in the wake of the pandemic, while its financial strength gave it a strong platform from which to invest in the business to maintain its advantage.

“A solid balance sheet is not just a defensive quality”

Conservative levels of debt mean that companies are less impacted by rising interest rates and enable them to better weather times of economic stress. There is indeed a strong relationship between company longevity and balance sheet strength. However, a solid balance sheet is not just a defensive quality. Companies need to invest in their businesses to sustain market-leading positions and to develop new avenues of growth. Far better to do that from a position of financial strength.

There are a variety of measures the Research team employs in assessing financial health. Looking at a company's net debt position, and comparing it to its earnings before interest, tax, depreciation, and amortisation (EBITDA), gives an indication of its ability to make its debt payments. Most of the companies in the Walter Scott representative global portfolio have a net debt to EBITDA ratio significantly lower than that of the MSCI World Index.

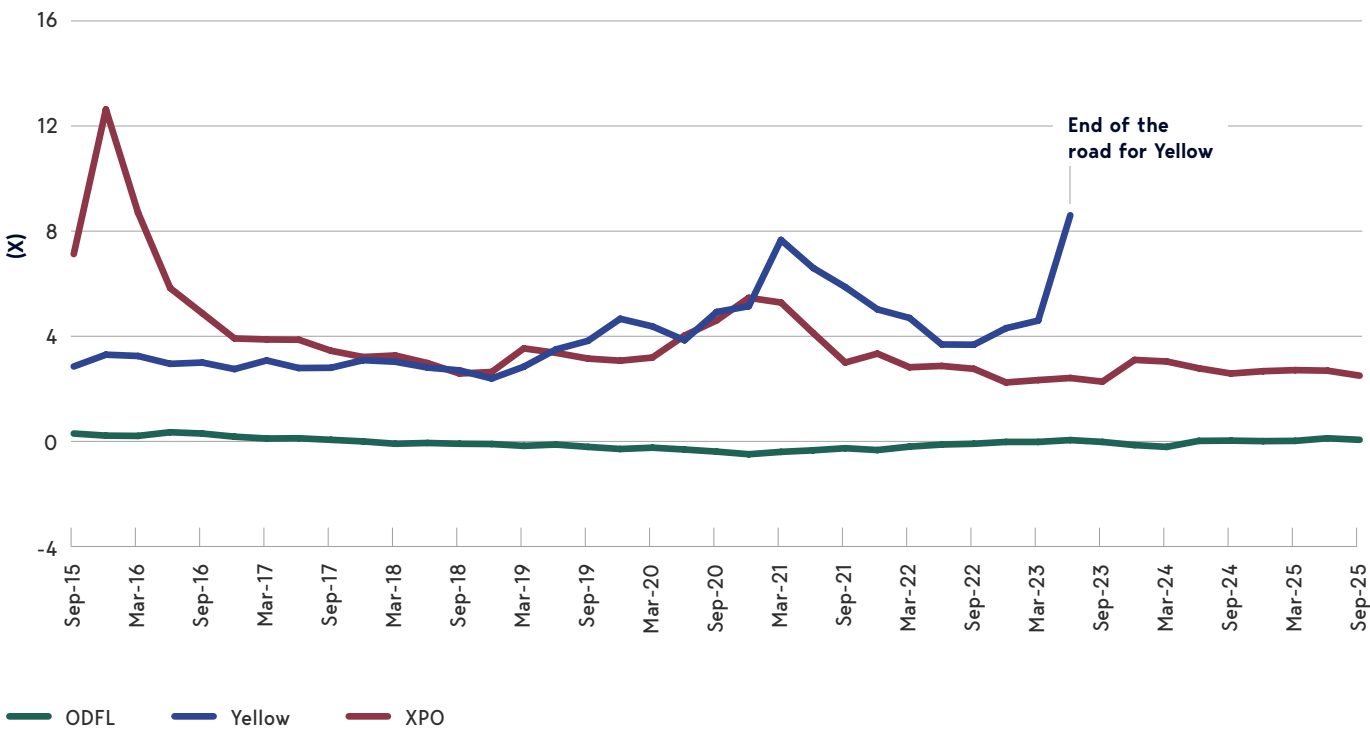
Walter Scott representative global portfolio net debt to EBITDA*



Source: Walter Scott, MSCI, FactSet as at 30 September 2025. Net Debt to EBITDA is total debt minus cash and cash equivalents divided by earnings before interest, tax, depreciation, and amortisation. *Excludes financials. Each bar represents a company in the portfolio.

Financial strength has been a boon to US less-than-truckload company Old Dominion Freight Line (ODFL) at a time of subdued industrial activity in the US economy. It has allowed it to make strategic investments and be responsive to the needs of its customers and its business. It has also been a critical differentiator. In addition, ODFL is capitalising on the bankruptcy of Yellow, one of its former peers. Yellow's demise was a consequence of its failure to refinance its debt. The respective net debt to EBITDA data for ODFL, Yellow and competitor XPO is shown below.

Net debt to EBITDA



Source: Walter Scott, FactSet. Figures as at 30 September 2025.

Balance sheet strength case study

Keyence

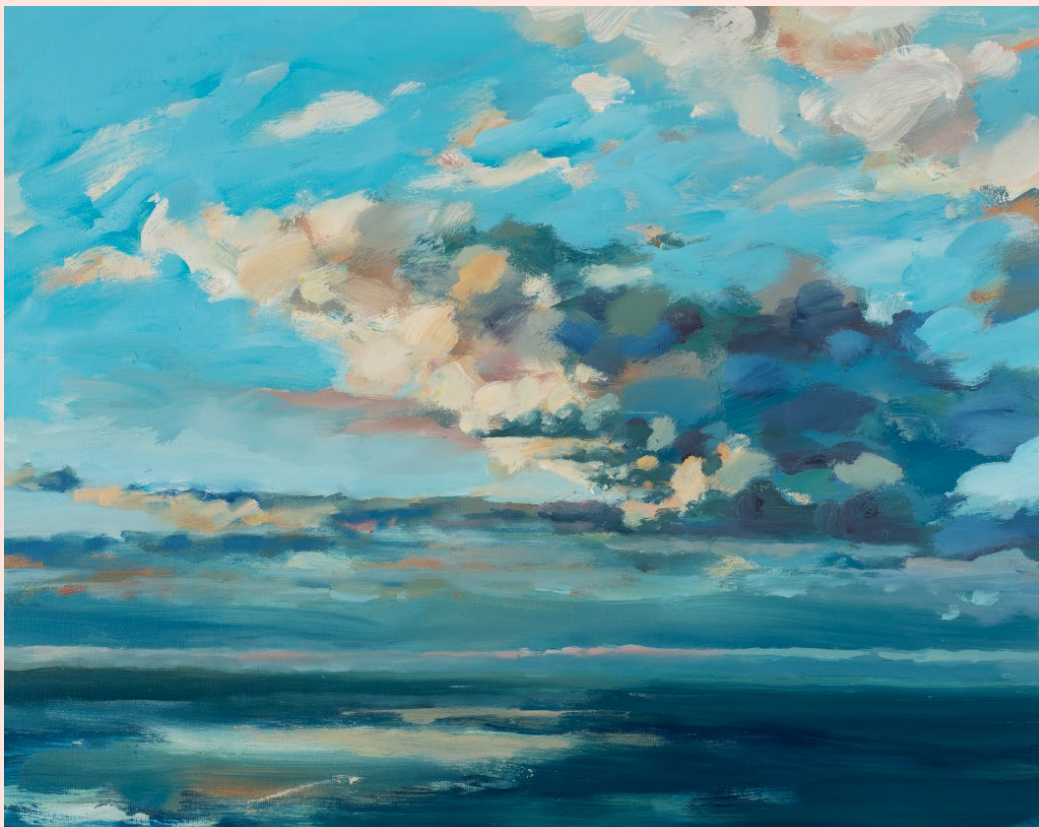
Keyence is the world's leading supplier of sensors and measuring instruments which are mainly used in factory automation. For example, their sensors are used to check whether bottle tops are screwed on properly on production lines. The Japanese company has an impressive track record, growing its revenues at a 12% compound annual growth rate over the last decade, with operating margins averaging around 50%. At the same time, it has maintained a very conservative, cash-laden balance sheet.

Keyence's products are used by 350,000 clients in nearly every industry, including automotive and logistics, electronic and IT devices, information communication, iron and steel, entertainment, food and medical, and even space exploration. Factory automation, and therefore sensors, have moved into just about every industrial application, but there are still plenty of opportunities for Keyence. Many international markets are still underpenetrated, but new applications are emerging. For instance, the development of e-commerce has resulted in heavy investment in automation within the logistics industry.

It is a 'fables' business, as its products are manufactured by subcontractors. This allows Keyence to focus on research and development and innovation, and has been an additional factor in the creation of a highly cash-generative business.

Indeed, cash and equivalents were over 80% of shareholder equity as of the end of their last fiscal year (March 2025). Granted, this protects the business during economic downturns and allows it to continue to invest through periods of weakness. However, the consequence of holding a huge cash pile is that it has suppressed its ROE which sits at 13%. If Keyence were to pay all the cash on its balance sheet out as a dividend, its ROE would jump to nearly 100%. Consequently, its preservation of cash has been an ongoing point of engagement between the Research team and the company's management.

We've welcomed recent increases in the dividend payout ratio but have still questioned management about its parsimony. Retaining its cash hoard at least speaks to its ability to generate it, but is also indicative of the conservatism of a management that has long memories of what happened when the Japanese asset bubble burst in the late 1980s and the company faced considerable challenges.

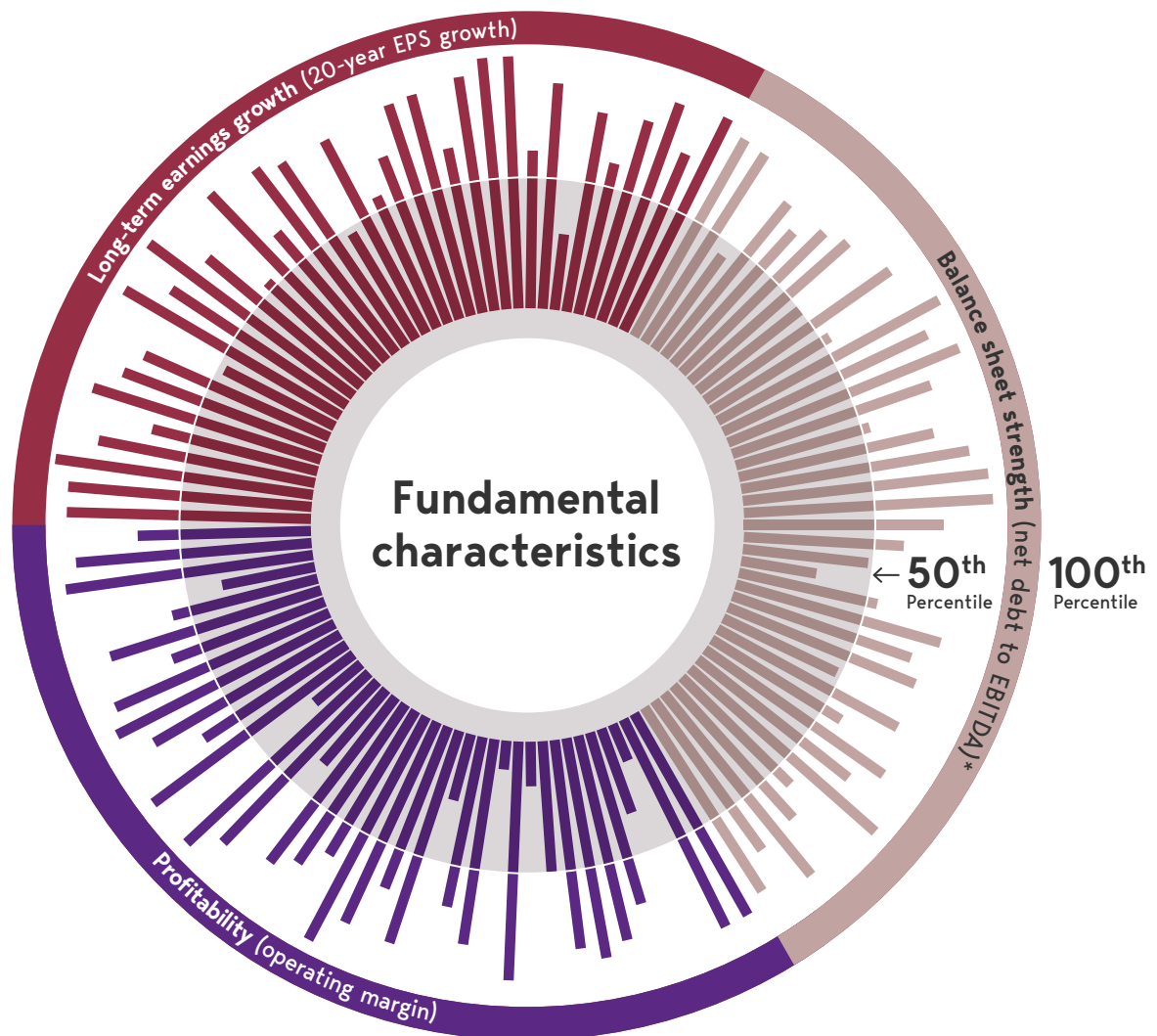


A QUESTION OF BALANCE

The dynamics of growth, profitability and balance sheet strength should not be seen as mutually exclusive, and they are not assessed in isolation. Strong profitability supports a robust balance sheet, and both underpin the resilience of growth. We are looking for companies in the portfolio to have all of these attributes, acknowledging it will be to varying degrees.

These characteristics have to be examined in the context of the industries companies operate in. To take the aforementioned gas giant Linde as an example, it is inevitably an asset-intensive business and uses debt to help finance its operations. It might not feature as a low-leverage company, but through its pricing power, the long-term nature of its contracts and high barriers to entry, the company has historically been able to deliver sustainable growth while maintaining a healthy capital structure.

The graphic below shows where the constituent members of the Walter Scott representative global portfolio sit in terms of earnings growth, profitability and balance sheet strength relative to the median (50th percentile) and 100th percentile of all companies in the MSCI World Index. Each spoke represents a company's percentile position in the respective measure. The majority of portfolio companies have above-median growth, profitability, and balance sheet strength.



Source: Walter Scott, MSCI, FactSet. Data as at 30 September 2025. Ranked based on constituents within the MSCI World Index.
*Excludes financials

Three in one: growth, profitability and balance sheet rigour case study

Amphenol

Amphenol has shown sustainable growth over the years and enjoys good profitability and a sound balance sheet. People use a product or service that is enabled by Amphenol on a daily basis. Its high-technology interconnection, sensor and antenna products are used in mobile phones and telecommunication networks, automobiles, aeroplanes, data centres and a host of industrial applications.

Growth has been driven by the steady proliferation of electronic devices, new technologies and demand for integrated systems solutions, augmented by accretive acquisitions. While some customer end markets are cyclical, product and customer-base diversification have dampened cyclicality. Over the last 10 years, operating profit has trebled, while operating margins have been steady at around 20% over the same period.

Amphenol is not debt averse, using it as a strategic tool to support its growth and accretive acquisition activity. It is a balanced, manageable use of leverage, with interest expense coverage of 15x, and it is one which has helped returns. The company has been a steady generator of free cash flow, which last year was US\$2.2bn on US\$15bn of sales, while ROE has averaged around 25% over the last decade.

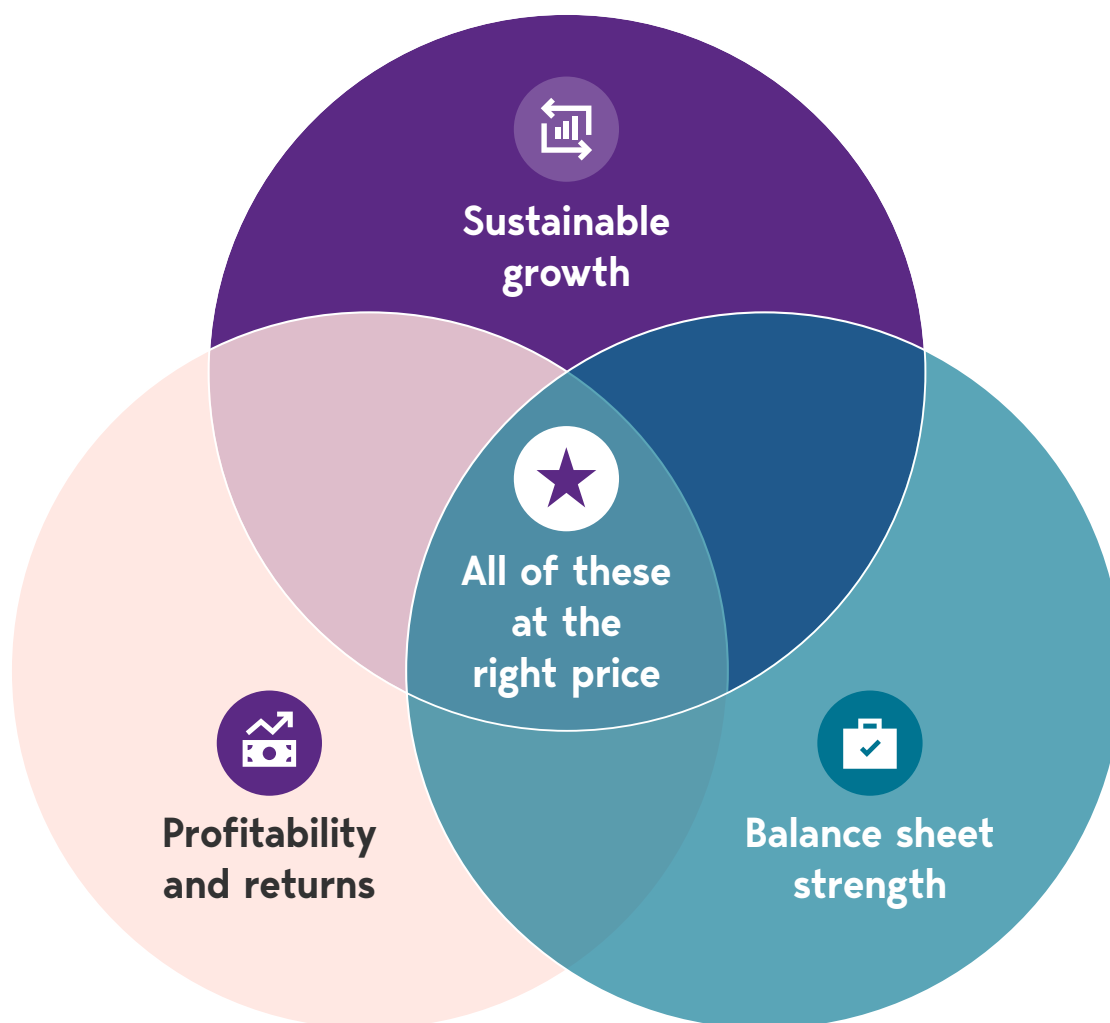
The success of the business model in sustaining growth is partly attributable to a highly decentralised structure, with local, on-the-ground expertise facilitating close relationships with customers. This is reflected in the company's focus on application-based rather than standardised products.

Manufacturing is predominantly in-house through vertically integrated facilities. Two hundred and fifty locations in approximately 40 countries allow Amphenol to be close to its customers, thus helping them to manage their supply chains and reduce production and logistics costs.

There is still plenty of scope for growth, as it gains market share in a highly fragmented market. Developments in technology will sustain demand for more sophisticated and innovative products. Such long-term tailwinds include an increase in product connectivity, 5G, the ongoing development of electric vehicles, factory automation and the AI revolution.



THE IMPORTANCE OF VALUATIONS



We can't control macro or market events nor predict their twists and turns. What we can control is what we buy, and how much we should pay for it. Against a backdrop of stock markets that have posted strong gains since the end of the Covid pandemic, particularly in the US, the spotlight has been thrown on equity valuations. We look for companies with profitable and durable business models that can show resilience in different market and economic cycles, but always in the context of paying an appropriate price for them.

“Our focus is on fundamentals”

A key reason for maintaining valuation discipline is to increase the probability that internal wealth creation will be reflected in share price appreciation over time, and also diminish the chance of earnings multiple compression. This is important because:

**Dividend yield + earnings growth + change in earnings multiple
= total shareholder return**

Our focus is on fundamentals, namely the ability of a company to grow earnings on a sustainable basis over the long term. However, an inappropriate entry price for a stock relative to fundamentals can represent a valuation headwind, undermining expected returns, or at least delaying their delivery.

The rigorous analysis and debate that is applied in gauging the qualitative and fundamental merits of stocks, is equally applied to determining what valuations are appropriate relative to the growth we envisage. We always look at ‘how’, and not just ‘how much’ in terms of growth, believing that durable, long-term growth deserves a premium. For each unit of valuation we pay, we seek to get more in terms of sustainable growth, profitability and returns, and balance sheet strength.

Weighing the balance of fundamentals and valuation is of prime importance in achieving good long-term returns for our investors. Extreme rates of growth are seldom permanent, perhaps due to factors such as changes in the demand environment or competitive intrusion, so we are wary of valuations that imply otherwise.

We will sell a position if we determine valuations to be excessive relative to our growth expectations, or where they are no longer appropriate given a material threat to our investment thesis.

We first bought Colgate, the well-known maker of oral, home and pet-care products, for the global portfolio in 2011, given the company’s focus on lifting organic sales through pricing and product premiumisation. However, while the pet-care business maintained its vigour, we felt the onset of volume and margin declines pointed to a fundamental loss of momentum, with the business losing some of its brand power. Our disposal of the holding reflected our view that its valuation was too high relative to the growth offered by the business, and indeed relative to faster-growing and better-quality companies in the portfolio.

“There is always competition for capital in the portfolio”

Our assessment of valuations relative to growth sometimes prompts a decision to trim a position rather than conduct an outright sale. In an environment where there is always competition for capital in the portfolio, proceeds can be reinvested into existing or new holdings.

For example, we ‘top-sliced’ Shin-Etsu Chemical in early 2023 on the basis that the two core businesses, silicon wafer and PVC production, had been performing well. Low-cost US gas had provided the company with a significant global competitive advantage in the latter business. As the fundamental performance of both these segments tends to be cyclical, we decided to take profits at a time when the wind was clearly in the company’s sails, with the valuation not acknowledging the eventual ebbing of these cycles.

RESOLUTELY LONG TERM

Ian Clark's view on compounding and the application of time and patience, sometimes stands in contrast with a market environment where the investment horizon is increasingly defined by a focus on near-term gratification in a world of fast-flowing information and quick opinions. Earnings growth is rarely linear. A quarterly miss or near-term disappointment can often trigger an adverse market reaction.

There have been and will be periods where the portfolios are not aligned to prevailing market themes or investing styles. Also, our process does not eliminate errors of judgement – not every idea is successful. But our focus on these fundamental characteristics and our collective decision making and analysis, remains as valid now as it did when Walter Scott was founded over 40 years ago.

Consequently, we remain consistent and resolute in our long-term approach. Our research is focused on the ability of companies to deliver desired returns over an investment horizon that may span decades while also demonstrating resilience during tougher times. We look for world-leading companies that enjoy sustainable growth, good levels of profitability and returns, and robust balance sheets. Investing in such businesses and harnessing the power of compounding remains the cornerstone of our strategy.



Alan Lander, Head of Research

Alan is Head of Research and Co-Chair of the Investment Management Committee at Walter Scott. He joined the firm in 2006 and holds a BSc (Hons) in Mathematics from the University of Nottingham and an MSc in Financial Mathematics awarded jointly by the University of Edinburgh and Heriot-Watt University, Edinburgh. Alan is a CFA charterholder.



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