EMERGING MARKETS Q1 INVESTMENT UPDATE

Client Service Director Andrew Keiller and Investment Manager Andrew Stobart give an update on the Emerging Markets Strategy covering Q1 2023.

As with any investment, capital is at risk. Past performance is not a guide to future returns.

This communication was produced and approved in April 2023 and has not been updated subsequently. It represents views held at the time and may not reflect current thinking.

Andrew Keiller (AK): Hello, everyone, and welcome to our latest Emerging Markets (EM) Client Update Video. I'm here today with Andrew Stobart. Andrew's one of the longstanding investment managers in the Emerging Markets Team here.

We'll be discussing investment performance, the positioning of the portfolio, the portfolio characteristics, as well as some of the topics that may well be on your minds, be that the banking exposure in the portfolio, or geopolitics, and how our discussions have been going around the tensions between the US and China. So, Andrew, perhaps I'll start just by asking you to share some comments on your perspective on the current investment environment, please.

Andrew Stobart (AS): Thank you, and hello, everyone. Yes, I think there's quite an understandable phenomenon going on right now, which is that in times of stressed market conditions, and in particular right now, when things seem particularly unpredictable, time horizons tend to constrict. And the focus becomes on the here and now, or, at best, the next few months, and it's really important that we guard against this.

We've been hired to think over the long term, on our clients' behalf, and we continue to do that, and it's only over the long term that returns will follow fundamentals.

There's a lot of institutional memory in the team of EM crises. My grey hairs are very much testament to that, whether it be the Asian Crisis of the late 1990s, or the 2008 Global Financial Crisis, or more recent events such as the Taper Tantrum and the violent swings in markets over the last two years.

And it's critical, when the market moves against you to that extent, to take it seriously, to go back to first principles on all investment cases. And the team has been focused on that over the last few months and quarters.

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It's also, though, important to remember that what seems really unpleasant at the time, will ultimately appear as a temporary blip and setback, in a pretty relentlessly predictable upwards trajectory of economic and human progress. And if anything, most of the hard-to-find good news right now is happening in emerging markets, whether you look at growth or innovation or, dare I say it, economic resilience.

AK: Thanks, Andrew, that's really helpful context. So, maybe we can move to talk about investment performance now?

AS: Yes, of course. We tend to look at performance over long-term time periods, so I'm hesitant to draw any conclusions from the first quarter of 2023, which has been marginally better for growth investors.

We can't avoid the fact that the last two years have been really difficult, and so the five-year numbers are behind where you'd like them to be. It's now over a year since the outset of the war in Ukraine.

Our Russian exposure hurt last year, as we've discussed before. And otherwise, 2022 was a period where the very rapid growth companies, in particular, hurt performance. That would have included in particular the ecommerce companies, whereas more cyclical companies, such as in energy, held up much better.

And so far, in 2023, the reverse has been true. Fast-growing companies such as Sea and MercadoLibre, both of them with ecommerce at their core, have performed more strongly. That's thanks to decent results and an ongoing improvement in profitability, and that's been taken favourably by markets.

By contrast, energy holdings such as Petrobras have performed poorly. That's been largely as a result of softening commodity prices, but in truth, none of these cases has really much changed in terms of our views.

And as it happens, we've met all of these three companies over the last few months, and they remain holdings we're enthusiastic about.

AK: Thanks, Andrew. Can you maybe tell us a bit more about some of the other company meetings that you've had? And I know there's been a fair bit of travel in the team, in the first few months of the year.

AS: Yes, one of the bonuses of the post-Covid world has been that travel has been normalising. There've been several companies travelling to the UK and coming through Edinburgh, so we've taken advantage of that, to meet with them in our offices.

And several members of the team have been on trips over the last few months, to countries such as India, Thailand, and Indonesia and Southeast Asia, to Brazil and to South Africa. And many of these trips have been to catch up with existing holdings, as well as to meet potential new ideas and other sources of differentiated information.

One or two trips have had specific themes. So, Ben did a trip to India focused on the IT services industry, and our holdings and the potential other ideas in that industry there, and I recently visited South Africa for an extended trip. We've been very negative on South Africa for some time, and it was really to test that negative hypothesis, and again, to meet with people from a range of different sources.

And then, one other trip closer to home that I'd mention, would be that earlier this quarter, several people in the team visited Oxford University and their China Centre, to meet with a number of academics there and talk about a range of topics around China. And this was particularly useful- differentiated views, different perspectives, and in particular, people who are well away from the noise of financial markets.

AK: Okay, let's spend a bit of time on China, then. I'm not sure we'll do it justice in [the] short period we have just now, but there's been a huge amount to digest recently, whether it's unidentified flying objects, whether it's the data issues around TikTok.

Do you get the sense that geopolitical tensions are rising? And how much have the team been talking about that?

AS: Yes, I'd maybe start by saying that I think if we were to try to react correctly to every line item on the tensions list over the last year or two, we would just fail miserably. I think at the core, our approach to investing in China remains the same, to focus on the companies, to be highly selective, and to try to invest in line with government policy.

And we do think that with the US elections coming up next year, we expect, if anything, the news flow and the headlines to ebb and flow even more. We need to remain focused.

And beyond the worry about the potential for military conflict, which would be, we think, both irrational and really devastating, one of the key threats in all of this is direct divestment and the splintering of trade relations. And in fact, on both these scores, the news flow has been pretty decent.

So, if you look at both US foreign direct investment into China, or Chinese exports to the US, both of these numbers are at or near all-time highs. But we definitely do need to acknowledge at the moment that, on fundamentals alone, we would probably have more money in China in the portfolio.

There are a number of very attractive growth businesses in the country, valuations in some cases are pretty cheap, and, if you like, ultimately it boils down to the fact that it's become much more of a portfolio construction and risk management question. So, despite those bottom-up attractions, we need to acknowledge that it really doesn't feel like the right time to be too brave on the portfolio's China weighting.

The risk of exogenous shocks, be they sanctions, regulations, politics, any number of other influences just overwhelming fundamentals right now, is extremely high, so the team are continuing to restrain the China weighting, accordingly.

And we've also been thinking about which countries would benefit from supply chains moving away from China. We've added to Mexico over the last few quarters. Vietnam is a clear beneficiary, and we're working through market openings for clients there. And we're also getting more excited about India as a beneficiary of supply chain shifting out of China.

AK: Thanks, Andrew, that's really helpful. There's a lot in there to digest. Maybe if we change gears a bit. We've had a lot of news flow on US banks, on European banks in recent weeks. Are you worried about some of these issues spilling over into emerging markets?

AS: No, I don't think so. The problems here seem to have stemmed from the rapid move away from zero interest rates in developed markets, to much higher interest rates, in a relatively short space of time. And there's been a resultant impact on a few banks' balance sheets, which were mismatched.

By contrast, in emerging markets, most banks have been operating against a different backdrop for some time, so rates have been higher, structurally, and they've been more volatile.

And so, for EM banks and in particular the highest quality ones, which these include the ones that we own, you've seen lending and deposit growth rates just much more steady on average. Last year for the portfolio, for example, growth in deposits and loans was around 10 per cent. And that contrasts, for example, to SVB (Silicon Valley Bank), which grew its deposits in both 2020 and 2021 in the high double-digits.

AK: Thanks, Andrew, that's very helpful. So, as we bring this to a conclusion, I just wondered if there's anything you'd want to highlight on any recent trading you've been doing, or any changes to the positioning?

AS: Sure. Yes, it's been another relatively quiet quarter. One new purchase I would highlight is Silergy (Corp). This is an analogue semiconductor designer. It has significant exposure to the power management sector, but it sells into a diverse range of industries.

And it's a Taiwan-listed business, but the bulk of its assets are in China, so we think it's well placed from a geopolitical perspective. It's consistently invested in research and development, and in particular human talent, its engineers, and that's been critical to developing the new products which drive its future growth. So, we do think it can grow faster than the average industry growth rate, which was around 10 per cent for many years.

Elsewhere, we've been reviewing the commodity exposure. We've added to First Quantum (Minerals), the copper miner. I visited their Panama mine last September. This is one of the bigger new mines in the world to come on stream in the copper industry. It accounts for about 2 per cent of global copper supply. And it's a company and a management team that we have very high regard for, and we still think the long-term outlook for copper is very positive.

Otherwise, the portfolio, the broader positioning really remains pretty well balanced, between different types of growth, the long duration, the rapid, and the cyclical.

And I'd finish off by pointing to the portfolio characteristics. We've made this point before, but I think right now in particular it bears repeating. On various metrics of growth and quality, the portfolio seems to be in a very strong place versus the benchmark, so the likes of earnings growth, sales growth, returns on equity. And last year, despite a weak year for share prices, the portfolio on average did around 30 per cent earnings growth, and that compares to the index achieving around 15 per cent earnings growth.

So, the companies are, by and large, delivering in terms of operational performance and doing what we would want them to do. But what's really interesting is when you compare this to the valuation data. So, the portfolio valuation is around the same as that of the benchmark. And this is really unusual and, we think, really remarkable given the growth on offer.

It's very rare, in the history of the strategy, for the valuation not to be at quite a premium, whereas now it's exactly the same. So, we do think we're at an anomaly, and it feels like a good opportunity, low valuations combined with high growth.

So, when you add in a good macro backdrop in Emerging Markets, and a huge number of ideas coming across the desk, I'm happy to report that the mood in the team is one of real optimism about the future.

AK: Great. Thanks, Andrew, that's a brilliant note on which to end. And thanks very much for sharing your thoughts today. Thanks to everyone for watching, and if you do have any questions, then please don't hesitate to get in touch.

Annual Past Performance to 31 March Each Year (Net %)

	2019	2020	2021	2022	2023
Emerging Markets All Cap Composite	-3.3	-17.7	77.3	-20.5	-10.7
Emerging Markets Leading Companies Standard Unconstrained Composite	-3.5	-13.0	77.2	-20.5	-8.6
MSCI Emerging Markets	-7.1	-17.4	58.9	-11.1	-10.3

Annualised returns to 31 March 2023 (Net %)

	1 Year	5 Years	10 Years
Emerging Markets All Cap Composite	-10.7	0.0	4.4
Emerging Markets Leading Companies Standard Unconstrained Composite	-8.6	1.6	5.1
MSCI Emerging Markets	-10.3	-0.5	2.4

Source: Baillie Gifford & Co and MSCI. USD.
Net of fees returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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