EMERGING MARKETS Q2 INVESTMENT UPDATE

Investment specialist Tim Campbell and investment manager Will Sutcliffe give an update on the Emerging Markets Leading Companies and Emerging Markets All Cap strategies covering Q2 2023.

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

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Tim Campbell (TC): Hi everyone. Welcome to the Q2 EM update. I'm joined by Will Sutcliffe, the head of the team. And as usual, the plan is to tackle performance, and look at transactions. The team has been traveling quite a bit as well, so we're going to touch on that and then we'll finish up with an outlook. The idea is to do this in around 15 minutes or so.

Perhaps we could just start off with your view on recent markets and what this has meant for both recent performance, but also longer-term performance?

Will Sutcliffe (WS): Sure. Well, it's obviously nice that the portfolio has been outperforming of late and we're pleased that the longer-term numbers remain healthy, in relative terms. And we can come back to the lackluster absolute performance of the asset class in due course.

But look, as ever, we would caution against reading too much into short-term attribution, which is random noise at the best of times. It's particularly topsy-turvy at the moment. So, if you look at Petrobras or B3, for example, they were among the biggest detractors from performance in Q1 and then they were among the biggest positive contributors in Q2. Same thing with Sea and MercadoLibre, which were just the other way around. So, in all four cases, nothing material has changed. And as long as they continue to deliver operationally, that's really all that we care about.

But look, this remains a policy-driven market and I've got no doubt that markets will continue to oscillate wildly in response to every shift in the yield curve and every shift in inflation expectations. And that's fine, because what ultimately drives portfolio returns is the ability of those holdings to deliver hard currency profit growth and everything else is just noise.

One final point I would make on performance that does please me, though, is that the portfolio does seem to have quite a lot of different drivers and the performance isn't being dominated by one particular sector or geography. We very deliberately built a portfolio with as many idiosyncratic drivers as possible. The common theme, of course, is growth. But beyond that, we're pretty agnostic as to the countries or the industries that we source that growth from.

TC: Yeah, growth is an interesting one. Some clients have certainly picked up on the fact that, I think, the value index has now outperformed growth both over the last year, but actually going back, if you go back three years, I think value has trumped growth as well. Is that something you think about in terms of how you position the portfolio? Is it something that worries you?

WS: I mean, it's interesting. I guess, in the context of growth indices doing a bit better of late in global markets, it's interesting that that's not been the case in emerging markets where the value index, as you said, has held up a lot better.

The one thing I would caution is that the logic behind the composition of these indices is a complete dark art as far as I'm concerned. So, if you take a company like Reliance Industries, for example, Reliance, I think is the third biggest member of the MSCI EM Value index. It's not in the MSCI EM Growth index. And yet this is a company that's currently growing its top line, high teens, low twenties. And it's a company whose management team, I would say, are one of the most growth, or have one of the most growth-oriented mindsets, of any company in our universe in terms of that willingness to deploy vast amounts of capital into massive under-penetrated markets like retail, like fintech, like renewable energy. You know, even the company's motto is “Growth is life”. So, the fact that MSCI doesn't think it's a growth company, it's maybe a bit odd, but it's not something we lose too much sleep over.

For us, growth is about those companies with that potential to at least double their profits in dollars over a rolling five-year period. But we're openminded as to where that growth might come from. It just so happens that a number of those companies right now are trading on what strike us as very depressed multiples.

One final aside I'd make on growth and value is that it is worth remembering that although growth indices had a very good run between 2010 and 2020, for the vast majority of the time that we've been running GEM mandates going back to the 1990s, it's been the value indices that have tended to have the upper hand. But hopefully our own track record of outperformance during those years, hopefully that speaks for itself.

TC: Yeah, well you were sort of taking us back to the late 1990s with some trading of late. I saw FEMSA, the Mexican company is making a reappearance in portfolios, but it's quite a different beast to the one that we were looking at the turn of the millennium. Do you want to just touch on that?

WS: Yeah, it is. The story back then, when you had hair, you'll remember the story, was about the Mexican beer assets, but those have gone. The story from here is mostly about retail and fintech. The background is that FEMSA had this terrific convenience store operation called OXXO, which has carved out a space for itself, was the only national player in a market that is dominated by the informal players and OXXO has, we think, still got a multi-decade growth opportunity ahead of it. And they are supplementing that growth by offering basic financial services from their physical store base. And remember, this is a market where 40 percent of the population is unbanked and cash remains king. I don't think it takes too much imagination to see how powerful a trusted brand like OXXO could be in penetrating this space.

So, FEMSA are currently in the middle of this restructuring process, which involves selling off the non-core businesses and using that capital to reinvest in these potentially very attractive growth opportunities. So, there is uncertainty. Markets don't like uncertainty. They're not great at coping with inflection points. They prefer to extrapolate from the recent past. So, I think the inefficiency here is for us to look past that uncertainty, to the very different company that FEMSA might be in five years' time, in ten years' time. And I think there's very little in the current valuation to capture just how exciting it could be.

TC: Well great, we'll watch that one with interest. As I mentioned at the start, the team have been traveling a lot. I know you were in Latin America and I think we've had people in Indonesia and India and Thailand, South Africa, China certainly. So, do you think that will lead to any uptick in trading or is there anything in particular coming back from those trips that you'd like to mention?

WS: Sure, I mean, it's nice to be back on the road, but it's also, I think, been a very helpful reminder of just how fertile the EM investment universe appears right now in terms of new buying ideas. As you said, I was in Brazil and came away with a very strong sense of just how vibrant that opportunity set is. And the extent to which all the innovation we've been talking about in recent years, now that's becoming more of a virtuous circle. As the first generation, who cut their teeth at MercadoLibre or NuBank, they're now forming that next generation of entrepreneurs. So lots going on there.

Similarly, in Taiwan, where Alex has just come back from, everyone in the markets right now is desperate to talk about AI. Now, I don't think that we can have much edge in predicting which applications will be the next big thing in AI. But one thing I think we can say with a fair degree of confidence, is that we're going to need a lot more picks and shovels, lots of semi[conductor]s, lots of hardware, and that's an area where companies in emerging markets, and Taiwan in particular, do have a competitive edge.

So, there's a lot of interesting Taiwanese names on our radar, and even South Africa. Andrew came back from an extended trip to South Africa recently, and that's a country where we've had very little exposure within the Emerging Markets portfolio for quite a few years now. And that's been the right call. It's been a lousy decade for the economy and in the stock markets. But there are some bright spots. You know, this is a resource-rich economy. Institutions are robust and there are some decent companies. And yet sentiment is just so negative. It reminds us a bit of 2001 when everyone was talking about South Africa as the next failed state and the next Zimbabwe, and absolutely no one predicted the boom that followed from a pretty similar starting point in terms of deep pessimism and depressed valuations.

So yeah, lots of ideas from the trips that we're currently working on. So yes, watch this space.

TC: All right, we will. We obviously can't get away without touching on China. I know we're still obviously running with a modest underweight to the country, despite the fact that it's seeing its own, I guess, modest recovery. It's disappointed some, but nevertheless, it's not bad. How are you thinking about positioning there? Any update to our thoughts?

WS: No huge change to our position over the last year or so. And as you say, we're running with that modest underweight. We're not particularly worried about the macro. Yes, as you said, the recovery has been a bit more modest than some had been hoping for. But the growth is fine, and the fact that the government hasn't really gone for it in terms of stimulus is probably a pretty good thing from a structural perspective. And there's a lot of fear and a lot of pessimism right now around China, which on one level, of course, is very appealing, from an investment perspective. But the problem with China, even from a very long-term investment perspective, is that so much depends on regulation, on geopolitics, on sanctions, on areas that I think we have to be honest about what our edge might be and how differentiated our insights are.

So frankly, from a portfolio perspective, I'd rather take that risk in areas where we think we do have differentiated views, where we do have a much higher degree of conviction. So, using that current small underweight position in China to fund those other areas, that seems to us a sensible way to set the portfolios up.

TC: Yeah, makes sense. Okay. So, before we finish off with the outlook, I was going to try something slightly new. We were going to go for a quickfire round of questions I've got written down here that do come up from time-to-time in client meetings. But the plan is you're allowed a sentence and that's it. So, on each one, and we're going to get through maybe ten or so in 5 minutes.

So, let's try that. So, why are you so overweight in Brazil?

WS: Great companies, stupid valuations, far too much pessimism on macro.

TC: Okay. What do you make of the re-election of Erdogan in Turkey? And can you see us having anything in the portfolio there in the near term?

WS: No.

TC: If you could have a portfolio of five EM stocks you couldn't touch for the next ten years, what would they be?

WS: Oh, this will probably be the kiss of death. First Quantum, TSMC, MercadoLibre, Reliance and FEMSA.

TC: Will India be considered a developed country within the next 20 years?

WS: Ooh. Probably not. Perhaps not. Probably not. But I think that illustrates the scale of the opportunity, in that India has grown GDP in dollar terms twice as fast as the rest of the world over the last 20 years. And yet per capita GDP is still, what, $2000, $2,500? So if it manages to do the same again over the next 20 years, terrific. But it will still be a middle-income economy. So, perhaps, but I'm not sure it matters from an investment perspective.

TC: Okay. That was far too many sentences. If you – this is quite a polarizing one – if you could only hold an index fund of US stocks or EM stocks, and similarly not touch either for ten years, which would you pick and why?

WS: Nice try. But as an active manager, you're not going to trick me into recommending an index fund.

TC: All right. So you're allowed an active one of both, but you still need to say why.

WS: You don't tend to make a lot of money betting against the US. Well, on the statistics one that amazes me most was that the US was 25 per cent of global GDP 30 years ago. And after everything that's happened, the rise of China, the rise of India, it's still 25 per cent global GDP. But I do think we're due a good decade in emerging markets. So, I would have high-quality active exposure to both.

TC: Chicken. What sort of macro or market conditions would best suit your existing portfolio over the next five years, and why?

WS: I wouldn't say the portfolio is making a call on a particular macro outlook. Yes, I buy the idea that the decades ahead will be quite a different investment environment to the one that we've been in for the last 30 years or so. But I don't see anything that jeopardizes our ability to, as growth investors, find companies with the requisite resilience and adaptability to continue to prosper in that environment. So, it's an optimistic portfolio. We don't have much interest in stodge or value preservation. So, when markets worry, for sure, share prices of the companies we invest in will often underperform. But, if we maintain our discipline, maintain our faith in the primacy of long-term earnings growth, then I think that's fine.

TC: Right. I think you've maybe answered largely the outlook question. Is there any parting thoughts you'd like to leave us with, on what you're thinking about EM in the next five years or so and how the portfolio is positioned?

WS: Yeah, I mean, just to go back to the relatively underwhelming performance of the asset class for a long time, as clients know, we don't consider ourselves EM perma-bulls. But having said that, I would be disappointed and surprised if we didn't see stronger absolute performance from the asset class. I mean, whatever metric you look at, whether it's fiscal health or inflation or access to natural resources or demographics or valuations, then EM does look in a good place right now, not just in a relative sense, but also in in absolute terms.

So the portfolio is positioned with that in mind. As I said, it's an optimistic portfolio because we are optimistic about the potential that the asset class has to provide us with exposure to a number of what we think are the world's most important, multi-decade structural growth drivers. Whether that's a reacceleration in consumption in some of the world's fastest growing companies or the commodities that will drive the next renewable age or, as I said, the semi[conductor]s and hardware that will be the building blocks for the new digital age. So yes, I think it is a good time to be an EM investor.

TC: Well, I'm glad. Thanks Will. Well, hopefully that's given everyone a bit of a flavour of what we're thinking about in EM. I'm glad to see some decent relative outperformance and some reasons for hope for a slightly better absolute from here. So, as ever, please do get in touch if you've got any questions, but other than that, have a good summer and thanks for listening.

Annual past performance to 30 June each year (net %)

	2019	2020	2021	2022	2023
Emerging Markets All Cap Composite	7.8	-0.7	51.0	-35.9	8.6
Emerging Markets Leading Companies Standard Unconstrained Composite	7.2	3.7	50.1	-34.4	8.9
MSCI Emerging Markets	1.6	-3.1	41.4	-25.0	2.2

Annualised returns to 30 June 2023 (net %)

	1 year	5 years	10 years
Emerging Markets All Cap Composite	8.6	2.4	5.4
Emerging Markets Leading Companies Standard Unconstrained Composite	8.9	3.6	6.0
MSCI Emerging Markets	2.2	1.3	3.3

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