Baillie Gifford™

Emerging Markets Q3 investment update

October 2023

Investment manager Ben Durrant and investment specialist Andrew Keiller give an update on the Emerging Markets Leading Companies and Emerging Markets All Cap strategies covering Q3 2023.

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Andrew Keiller (AK): Hello, everyone, and welcome to our Q3 Emerging Markets investment update. I'm joined today by Ben Durrant. Ben is one of the investment managers in the Emerging Markets Team. Ben's just back from three months traveling Asia, so we're going to spend some time hearing about that trip today as well as obviously discussing the investment environment, investment performance, and we'll spend some time on China, which has dominated questions recently.

Welcome, Ben. It would be helpful to start, if we may, with some comments on the investment environment and what that's meant for investment performance as well, please.

Ben Durrant (BD): Sure. It's perhaps unintuitive, but we feel the investment environment for EM is very supportive, especially relative to developed markets. Developed markets are facing a real inflation challenge that they're just not accustomed to. Well, this isn't the case in EM. Once you exclude a few small outliers, inflation is just 3 per cent across the EM universe, and these economies, most importantly, are used to that.

We've also seen much stronger fiscal discipline by EM governments over recent years. As my colleague Roddy often says, it's now the emerging markets that have been the Orthodox actor since 2020, while the Western countries are behaving like the EM countries of old. And some measures do recognize that. If you look at every major EM currency barring the RMB and the lira, they've all outperformed developed markets since the start of COVID, and we feel most of investors don't appreciate that.

So all of this gives us a great foundation for companies in the EM. We've seen several examples of strong operational performance over recent months. Be that the Chinese internet platforms are returning to growth and beating expectations. Or companies like Petrobras or CEMEX setting new operational records. Portfolio performance it’s been close to the benchmark over the last quarter, but for the year to date and more importantly, over five years or longer, clients have enjoyed good relative performance.

Clearly, we would have liked for more in absolute terms, but when we look at the fundamental strengths of our companies and the lowly valuations the market continues to place on them, we remain confident that remains a question of when rather than if these companies deliver their full potential.

AK: Thanks, Ben. That's very helpful context. So let's talk now about tales from Asia. Can you tell us a bit about your recent travels? Where have you been and who have you been meeting?

BD: Yeah, sure. So I'm recently back from a couple of months meeting companies across seven countries in Asia. Notwithstanding the big-picture uncertainties facing all of us, global growth, China, geopolitics, or whatever else, we deliberately spend the majority of our time looking at individual companies. We're trying to find businesses that can grow their profits stronger over the next five, ten, twenty years.

And that just doesn't feature in much the day-to-day commentary. And so our own on the ground research is critical in this effort, especially in assessing management and also sense checking our own recent research. Some of this trip was groundwork for the future. Such as meeting Vietnamese firms or some very small companies or private ones as well.

Other parts were to explore countries that almost feel overlooked nowadays. The likes of Malaysia, Thailand, South Korea. These countries lack the allure of India's economically untapped population, or the controversy of China, but this may be the attraction.

Some visits were to longstanding holdings such as Indonesia's Bank Rakyat. And this is a rare beast; a well-run, state-owned enterprise. And we visited mainly to test that management continue to allocate capital well.

Historically it's been a competent, though bureaucratic, micro-lender. The best in the country, if not the world. And the company is now grappling with share-based incentive plans for the first time being set by their government owner. And so exploring how the impact of market signals really changes the incentives and behaviour of senior management is a conversation best done in person.

Most of my time, although, was spent on new ideas. Companies that may feature in a portfolio in future. And the breadth of these coming from these meetings defies easy generalization. They range from dockyards to IT companies to laser-based equipment. What does link all of them, though, is a single-minded focus on improving their lot by doing something better than anybody else can.

And the front page headlines of the FT rarely impact the day to day realities of these businesses. So it's always refreshing to get out to remember that for the best companies, there's plenty of growth, irrespective of macroeconomics or geopolitics. While those two concerns will sometimes weigh indiscriminately on valuations, which we find throws up opportunities.

AK: Thanks, Ben. That's very interesting. One of the Asian countries you obviously didn't visit was China, but several of our colleagues have been there recently. I think we can all agree that over the last few years, investing in China has become increasingly difficult.

But I wonder if you could give us a sense of what might have changed in our thinking on China. I can see we started to increase our modest, underweight position.

BD: That's right, Andrew. So, our positioning more broadly across the portfolio hasn't changed too much, which is what you'd likely expect. But as you say, we have been adding a bit back to China. Navigating the Chinese investment environment is complex. The last two years have been challenging. There's been extreme negative sentiment for market performance both in the mainland markets and also in the Hong Kong markets.

But we're continuing to be excited by what we do own. We think that valuations are at depressed levels. So there is an opportunity amongst this gloom to add back selectively to China. So for us, the question today isn't should we invest in China, but rather how should we do so? It's a region where a long-term policy aligned approach has always made sense, especially so nowadays.

The challenge, though, is that policy can be haphazard and when it is supportive to companies, it can be overly so, pushing so much capital into a sector that it drives down returns for all of those businesses. Furthermore, local markets are very momentum driven and can push the obviously policy aligned growth businesses up to valuations that we with a broader opportunity set then see as deeply unattractive.

What does this mean then? The last few years have seen investing in China certainly become harder. The bar is higher, the upside needs to be very strong. But some of the key features haven't changed.

The country still has its ambitious entrepreneurial culture and the sheer size and intense competitiveness creates many world class operations there. And so there are many excellent companies that can add value both to the society in which they operate as well as to shareholders.

The negativity for some of those really feels overdone. And so we've been modestly increasing our positions there.

AK: So at the end of the last video we did, Tim and Will did a rapid fire set of questions and I think Will was asked to give his answers in no more than 5 seconds. I'll spare you the pain of that, Ben, but I wonder if you might in say around a minute, for example, give us some concluding remarks on the views of the team.

BD: Sure, I'll try. So the portfolio remains invested for long term economic growth, not short term is growth. We deliberately have a diversity in how we find that growth. We invest in both the capital light and the capital intensive. In both ideas and in molecules. It's the interplay actually between both of those that we see the most appeal, but we can expand upon that another time.

And the price of those companies also remains low. On a long run PE basis, EM is about one third of the price of the S&P 500. And of course for owners of EM equities over the past decade, living through the expansion of that discount has been very painful. However, looking forward from here, we should take comfort that the price of those companies feels too low rather than too high.

And given that we own a set of businesses that generate both higher returns and higher growth in the overall market, we feel the portfolio is in a very good shape and we're working on plenty of new ideas to keep it strong for the future.

AK: Thanks very much, Ben, and thank you to everybody for watching.

Emerging Markets (including Emerging Markets All Cap and Emerging Markets Leading Companies strategies)

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

	2019	2020	2021	2022	2023
Emerging Markets All Cap Composite	3.5	16.3	17.9	-35.8	18.0
Emerging Markets Leading Companies Composite	5.0	22.6	18.7	-35.2	15.9
MSCI Emerging Markets	-1.6	10.9	18.6	-27.8	12.2

Annualised returns to 30 September 2023 (net%)

	1 year	5 years	10 years
Emerging Markets All Cap Composite	18.0	1.5	4.5
Emerging Markets Leading Companies Composite	15.9	2.8	4.8
MSCI Emerging Markets	12.2	0.9	2.5

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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