SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 9

REASONS TO BE OPTIMISTIC ABOUT EMERGING MARKETS

MB – Malcolm Borthwick

CP – Charles Plowden

MB Hello and welcome to *Short Briefings on Long Term Thinking*. Thanks for joining us. I'm Malcolm Borthwick, managing editor of Intellectual Capital at Baillie Gifford.

Investing in emerging markets is like Marmite. It divides opinion. Pessimists point to the fact that emerging markets have stagnated over the past decade while US markets have powered ahead. Optimists point to projections that in ten years' time, emerging economies will account for two-thirds of global GDP.

I'm joined in our Edinburgh studio by one of these optimists, Charles Plowden. Charles is manager of both the Monks Investment Trust and the Global Alpha Growth Fund.

But before we start, some important information. Please remember that as with all investments, your capital is at risk. We'll be talking about emerging markets, which can be more volatile than developed markets.

Charles, why the optimism?

CP Why the optimism? It's really the scale of the opportunity here and the momentum. There are some unstoppable forces in the world at the moment, and one of them is the improving health, wealth, welfare, the energy in emerging markets. This is where the young populations of the world are.

This is where education is improving and is often well ahead of already what we can do in the west. It's where a lot of the new technologies are being adopted at much bigger scale and much greater speed than they are in the west. We see it as being where the best and largest opportunities are.

Part of that, actually, I would say, comes from a little bit of pessimism about what's lacking in the developed world. We are already developed. There's none of this catch up. We're stuck in our ways. There's a lot of legacy issues. There's a lot of old decaying infrastructure. And you contrast that with some of the parts of the world where a lot of new investment is going in for the first time, and it's really very striking.

MB As a global portfolio manager, how do you decide how much of that portfolio to commit to emerging markets, Charles?

CP Everything we do is stock specific. So, it's bottom up, one company at a time. But where we look for those companies will often dictate how many we'll find and how successful we'll be.

So how many? Our emerging market exposure has varied from high single figure, seven or eight per cent of the portfolio, up to mid-20s. And we're currently towards the top of that.

Of course, there is one thing. Just how do you measure your emerging market exposure? The indices would tell you the companies that are listed in emerging markets, that's one measure. About 12 per cent of the global index is said to be emerging markets.

MB On that measure, we're at about 20 per cent, so we're nearly double. But of course, there are a lot of western companies whose main market, sometimes their only market, will be an emerging market. So, companies like Pernod Ricard, the French spirits company - very big in China, very big in India. We think of that as an emerging market consumption-exposed company. That's why we own it. And on that measure, we're around about 24 or 25 per cent, if we look at companies that might be British or French or American but still sell predominantly into emerging markets.

MB There's often a perception — if we read the papers, we see reports about corruption in Russia, riots in Hong Kong, unrest in South America — that emerging markets are more risky to invest in. Is that the case?

CP It's definitely a strong perception, and I think a lot of that is based on fear. Most of us are less familiar with those economies. They are developing faster, and that does lead to more imbalances that can come and also be addressed in the short term. But I think it's a lazy western perception that the markets are more volatile. The economies are more volatile. But are they riskier?

Our view at Baillie Gifford is very much that the volatility is not a bad thing. It provides as many opportunities as it causes problems. What we're worried about is the long term, and whether things are getting better in the long term or are they getting worse in the long term? In emerging markets, I would say, there's much more certainty where we'll be in ten years' time than there is maybe in Europe or America. So, I would say, taking a ten-year view, they almost feel less risky.

MB Less risky than developed markets?

CP Less risky, yes, possibly than developed markets. Who knows what the economics, the politics, the fiscal position is going to be in developed markets? Whereas I think we've got a clearer idea in emerging markets. And it used to be that the political uncertainty was all in Latin America and Africa, and we could always say 'that's not investable'. 'We don't know who's going to be in charge in Venezuela or Brazil or Argentina'. But I think, no, we've got serious issues here in

Europe and in North America at the moment about the direction of political leadership there.

The cohesion of the social fabric is under question almost everywhere. And I think, in somewhere like China or Indonesia, there is a much clearer national will and a national project to repeat what has effectively been the success of a country like South Korea. There's lots of emerging markets that would like to replicate that success.

MB And this is really interesting, because you studied history. It's something that you think about in terms of your investment decisions, but what can we learn from history through the direction of travel of emerging markets?

CP There's a danger here because I was a mediaeval historian. So, when I think of history, I actually think of history in 400-year periods.

I think you don't have to be an expert on the history of the world to realise that Asia was the leading driver of world culture, sophistication, science, economic activity for centuries and centuries and centuries, principally based on China. And it's really only in the last 300 or 400 years, or since the 16th century, that the west has become the leading world power. Of course, they largely did that by stealing resources, gold, slaves, whatever, from the emerging world that they discovered, principally in Latin America. It wasn't because we were cleverer. It was because we had more gold that allowed us to buy in all the expertise that we might need or to build universities or so on. It wasn't bottom-up economic development.

So, I think with all that's happening now, particularly in Asia, I'd say it is less the case in Africa or Latin America at the moment, the statistics point that out that India and China are becoming the world leaders in many aspects. And I suppose it is really explicitly about China.

And I think a lot of what we're seeing at the moment, with Trump and trade war and so on, and tariffs, is the final throes of America, reluctant to give up its leadership. But it's an inevitability. I suppose the historical perspective is that the west had its own way for 500 years, but that's now changing.

MB And presumably that's why Baillie Gifford is opening an office in Shanghai.

CP It's one of the reasons that we're opening an office in Shanghai. We think we need to get closer to the companies because, and this actually ties in, a lot of Chinese companies are not going to make the trek to Edinburgh, or even to London, to visit us. Edinburgh and London, and the UK, are going to be increasingly irrelevant if you're running a multibillion-dollar company from China. It's not where the money is. It's where you go on holiday, not where you go on business.

We think we need an office staffed by locals who understand the culture, who can speak the language, who can go out and put Chinese companies through our research framework, our research lens and then pass their views back to Edinburgh.

It'll inform our decision-making. But I think it's going to be very hard to remain close to Chinese companies from however many thousands of miles away Edinburgh is — 6,000 miles. I think you're going to have to be there, so we'll start with a small research office. I think there's going to be four investors initially, but it will grow.

MB And looking at your portfolio, Charles, I see Prudential, AIA Group, Ping An Insurance. There a lot of companies there that are focusing on insurance in Asia. Why that focus?

CP It's quite simple really. As people across Asia start to become more wealthy, they move from subsistence — have they got food, have they got a roof — to education, to health, to consumption. They eat better food. They drink branded beer. They become aspirational.

And then you get to the stage, at approximately the levels of wealth that exist in China and across much of Asia today, that people start thinking about the future. It's not about 'what are we going to eat today', it's about 'what are we going to do in five years' time when our children want to go to school'. And that's when they start saving. And so, there are two big attractive macro themes, I think, across emerging markets at the moment, and one is consumption.

But the interesting one, or the more interesting one, I think, to us, is the long-term savings play. Because it's very regulated, it's quite difficult to do. It's quite a sophisticated part of the financial services sector, and there are relatively few players. So, you've got a similar growth dynamic as you have on the consumer side. But on the savings side, there are fewer players because regulators keep the weak ones away.

So, what you tend to have is a small number of very strong financial companies, tightly regulated, who get a disproportionate share of what is an enormous market, and not just enormous, but a 30-year growth market. And it's quite obvious why the Asian population need long-term savings.

It's also quite clear why their governments are very supportive, because they don't want to take on the whole burden. They've seen what pensions are doing in America and across Europe. If there's a private sector solution, they'd much rather encourage and subsidise and educate and regulate to make sure that happens.

You've got government support, you've got demand for the product, and there are a limited number of players. And, I think, looking at competition between them misses the point that this is a market that can grow 20 percent a year for the next 20 years and be many, many multiples of its current size. Actually, it's quite a microcosm of the way we think about emerging markets.

MB So Charles, we talked a lot about China so far, but what about India? Because one of the exciting companies that you are invested in is Reliance.

CP I think a good word to attach to Reliance is exciting. It's a buccaneering business led by, I think he's now India's richest man, Mukesh Ambani and, yes, excitement. What we really want is growth, and I think Reliance is very well placed to deliver it. The story of the Reliance is quite interesting. It started as an agricultural business. It then moved into fabrics. From fabrics, it moved into oil refining to make nylon and the artificial materials.

It now has one of the world's largest most efficient and most modern oil refineries, recently completed. And it is intending to use the cash flow, which is about $10 billion a year, from its oil refineries to develop a range of other businesses.

The one that is already very, very well-known is called Jio, and it's India leading mobile telephone operator with somewhere around 300 to 350 million subscribers. But it's a business that's four years old, and basically by throwing money at heavily subsidising mobile data costs and call charges, they've become the leading mobile operator in India very quickly.

The plan now is not just to limit their activities to mobile telephones, but to connect their mobile telephones to retail. They're also India's leading formal retailer. Ninety per cent of all retail trade in India is informal. It's mostly street stalls and markets and so on. But of the 10 per cent that isn't, Reliance has the leading share, about a 25 per cent share of formal retail, which is what we would think of as shops and supermarkets.

They're trying to come from a smartphone angle into ecommerce and retail, and they're not only interested in formalising the market. They're also tying up with 10 million mom-and-pop shops all over India. They're installing EPOS - electronic point of sale - equipment, which means that people will pay using the Jio payments app.

They'll be on the system, and these small retailers will also become the delivery and logistics hub for online ecommerce for the likes of Amazon. They're not going to reinvent UPS in India. They're just going to use the small local shop as the delivery hub. And there's 10 million of them.

So, the ambition of Reliance over a ten-year period will be to convert itself from an oil refining business to the largest and most modern ecommerce and communications and media network in the world. And because this is India, it's a very protected market. Amazon are trying very hard, but they're finding at every step that foreigners have slightly more regulations to cope with.

Reliance is the local champion. It's bringing jobs. It's bringing wealth. It's bringing choice to millions and millions of Indians who haven't really had access to this service before. It has government patronage. It has local power and knowledge, and it seems highly likely to us to be a success.

MB Charles, I think that's a good place to end. Thanks very much for joining us in the podcast, and I hope you'll join us again soon.

CP Thank you, Malcolm.

MB You can find our podcast *Short Briefings on Long Term Thinking* at bailliegifford.com/podcasts, and you can subscribe on Apple Podcasts, Spotify, and TuneIn. And if you enjoy the podcast, please spread the word.

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And there's more about Charles's thoughts on Asian insurers in the autumn 2019 issue of *Trust*, which is Baillie Gifford's investment trust magazine. You can subscribe to this and read this article at bailliegifford.com/trust.

And many thanks to Lord of the Isles for the music. The track we've used is called *Horizon Effect*, which was released on Permanent Vacation.

Until next time.