Baillie Gifford™

Upfront

Asia's emerging markets with Roderick Snell

February 2024

Financial journalist Cherry Reynard asks investment manager Roderick Snell about the opportunities and challenges for investors in Asia's emerging markets.

Your capital is at risk. Past performance is not a guide to future returns.

Cherry Reynard (CR): So, welcome, Roderick. Now, you joined Baillie Gifford in 2006, and you're a partner in the firm and have managed the Baillie Gifford Pacific Fund since 2010. Now, we just heard from Linda Lin there, who leads your China Equity desk. There's obviously been a lot of unease about China over the past year or so. I wanted to get your view on whether the negative sentiment in China has gone too far, or whether you can still find opportunities amid the problems.

Roderick Snell (RS): Sure. I think the short- to mid-term actually looks really interesting in China at the moment. The longer-term outlook, China has two key challenges, really. Firstly, geopolitics, and secondly, the ultimate direction that Xi in China wants to take the economy.

But if we start with the immediate outlook, I think it looks really good at the moment. Firstly, if we take valuations, they just look extreme. I was reading my valuations yesterday. The price-to-earnings on the Chinese index is currently lower than the price-to-book of the Nasdaq. That's an extraordinary situation. People have just been pulling money out of the county.

But despite that, the macro situation doesn't really reflect what we're seeing in those kind of valuations. Where else in the world can you find a $17tn economy growing 5 per cent per annum? And that, Cherry, that's before they really started to support the economy. And they're just starting to do that now. And they've got a lot of firepower if they need it. Let's not forget, China hasn't done any quantitative easing. It's had sensible real interest rates for many years. So it's been run in a very orthodox manner. So they have a lot of levers to pull if they need to.

So I think fears of a hard landing are overdone. I think that's a very unlikely scenario. And we're finding really good opportunities at the moment. The index is down nearly 60 per cent. There are a lot of world-class growth businesses on low single-digit P/E multiples. There's actually quite a lot trading below the value of the cash on their balance sheet. So a lot of opportunities. And on a one-to three-year view, yes, very optimistic on the opportunities that we're seeing.

CR: Okay. And sorry to have to put the Eeyore side of it, but talk me through some of the challenges.

RS: Yes. So I think those two key challenges I mentioned earlier are the areas to focus on. So that's the geopolitics. And to be honest, all the research I've done and the contacts we've spoken to, that suggests the geopolitical situation isn't probably going to improve from here. That's going to remain a headwind. And that's really actually irrelevant of what China does. It's the direction of US policy, which is really like a giant oil tanker, and it's just not going to change direction, whoever's President, and that's going to be a headwind for the next several years.

And then secondly, what direction does China want to take the economy over the next decade? And specifically, what role does it want the private sector to play? And to be honest, that isn't clear at the moment. And that makes long-term forecasting actually quite difficult.

CR: Okay. And a lot of investors have turned to India instead, and that's been seen in the astonishing performance of the Indian market over the last 12 months. But that's left valuations looking quite stretched. What are your thoughts on that comparison?

RS: Yes. So we like India. And actually, if you look at the reforms the Modi government has put through, combined with the very positive demographics of India, it has, along with Vietnam, probably the best potential of any country in all the emerging markets. And there are two areas at the moment that we're finding particularly exciting.

The first would be that, really for the first time, we're seeing genuine, mass-scale innovation in India. It's really being catalysed by the 4G networks that have been put into the country that have brought the internet to the masses. And that means we're seeing ecommerce taking off rapidly in the country, a number of world-class companies, like Dailyhunt, which is a social media business like TikTok, starting to sprout up.

And that means that, first, I think growth could actually surprise a lot over the next five to ten years, given all that innovation. And it also provides us with a lot of really interesting ideas and places to invest. For example, we own Dailyhunt, sorry, Delhivery, which is the largest private logistics company in the country. It's got a 50 per cent market share of ecommerce deliveries and is a big beneficiary of that shift to the online marketplace.

And then the second key change that we're seeing is that, finally, India is starting to build up an export manufacturing base. This is what it should've done 10, 20, 30 years ago. And we're starting to see early signs that it's doing it. Apple, for example, are starting to set up manufacturing bases in the country. Now, it's not definite that they're going to make this work. As I say, they failed previously. But if they can, this could make India the next manufacturing powerhouse, like China's been for the past 10 and 20 years.

CR: Okay. And what about that valuation issue?

RS: Sure. So certainly, India's done very well, and there are areas of the market that we do find very expensive, for example, the small and mid-cap space and quite a lot of the consumer-related companies. But there are other areas, when you look hard, that still look very attractive to us. So, for example, we've got quite large holdings, perhaps 6 or 7 per cent of the portfolio, in Indian real estate.

Now, property prices in India haven't actually really gone anywhere for a decade, while wages have gone up a lot over that period. So affordability has actually never looked better in the past 20 or 30 years in terms of property. You've had a big consolidation in industry. A lot of players went bust over the past five or six years, so there's just a handful of players to take advantage of the boom that we're seeing at the moment.

We've also got a lot in the private banks, which are competing against very poor state-owned enterprises. And finally, a few individual holdings like Reliance, the energy company, but they've actually really digitalised India and are also the largest retailer in the country. So a lot of overpriced stuff that we're avoiding but [we] are finding pockets of really interesting businesses in India.

CR: Okay. So something to like in both India and China. Have you got equivalent portfolio positions in both countries?

RS: There or thereabouts. China would be about 26 per cent of the portfolio at the moment, which would be a slight underweight. And that's predominantly on private companies, listed companies but private in that they're not run by the state, focused on technology. Also got quite a lot in energy companies, like CNOOC, and finally, a few copper companies, which is really our play on the green transition in China. And then in India, that would be about 23 [or] 24 per cent of the portfolio, which would be a slight overweight versus the index. And that's in those areas that we just discussed.

CR: Now, you mentioned Vietnam just then. You've got quite a substantial allocation in the portfolio versus the index. Can you talk a bit about that and what kind of opportunities you're seeing there?

RS: Sure. So we've been invested in India for... Oh, sorry, Vietnam, for quite a few years now. And the story hasn't really changed much. Ultimately, this is arguably the best structural growth story of any country in all of the emerging markets.

And the reason for that is because they've got great geography in terms of location, a young, cheap workforce about a third of the price of China, and a government that can get things done. And that's all come together to make Vietnam have a successful export manufacturing base. As I say, it's what India's trying to do now, but Vietnam's made it work. And that is absolutely crucial. Because, do you know the sad truth, Cherry, about most emerging markets?

CR: No. Tell me.

RS: It's that most never actually emerge.

CR: Yes.

RS: The only ones that have, Japan, Korea, Taiwan, arguably China, it's because they've had a successful export manufacturing base at the start of their development. And really, it's only Vietnam that's doing that of any scale at the moment across Asia and the broader emerging markets. And it's a big beneficiary of what's going on in China.

A lot of people, post-Covid, have looked to dual-source, and a lot are actually just trying to get out of China altogether. And the big long-term story is that China's probably got $2tn worth of low-end manufacturing that it wants to move away from anyway. And a lot of that, I'd say the lion's share, is likely to end up in Vietnam.

CR: And so is that where you're focusing, on that manufacturing base, or are you looking to other areas of the economy?

RS: Yes. So in terms of the opportunities for us, there aren't actually that many exporters, direct exporters, you can invest in. Most of those are actually multinational companies like Samsung, which would be the biggest foreign investor in the country. So the vast majority of our holdings are actually in the domestic Vietnam. So we're in a lot of the country's leading banks, and we've got a number of consumer names.

CR: And then on the flip side, you've sold out of some of your nickel and mining names recently. Why was that?

RS: Sure. Well, firstly, it's because the investment case had started to, or had worked out, and we'd made a lot of money on those stocks. So, you might recall we started investing in nickel actually about five years ago, really as a play on electric vehicle demand in China going up, and nickel would be needed in those batteries. Now, we had to wait a few years, but EV penetration in China went from 3 or 4 per cent to nearly 30 per cent today. The nickel price did very well, and we made three or four times our money out of those stocks.

And then secondly, the supply side, which was also part of the investment case, has actually changed a bit. The Chinese have been putting tens of billions of dollars into specifically Indonesia to increase nickel supply. But more crucially, it looks like they've cracked a technology called HPAL, which is high-pressure acid leaching. And that's used to convert non-battery-grade nickel into battery-grade nickel. And it looks like they've got it to work, which is actually a great surprise to us. But that could really transform the supply of nickel, battery-grade nickel, over the coming five years.

And then finally, there are some question marks on actually the demand for nickel. The Chinese, for example, they make a battery called LFP, which doesn't require nickel. Now, the view was that this wasn't such a high-quality battery and wouldn't be used outside the emerging markets. But actually, a lot of Western manufacturers are saying, actually, these LFP batteries, they're good enough.

CR: Yes.

RS: And they're starting to use them. So a question mark of actually the long-term demand for nickel if batteries don't really require it in the future.

CR: Okay. And just one final question, before we move to the Q&A, on semiconductors. Now, they've obviously become very strategically important across the globe and something of a geopolitical football. Some of your top holdings are in the semiconductor value chain. I wonder if you can talk us through the sector's risks and opportunities.

RS: Yes. Well, you've probably heard a few people describe semiconductors or chips as the new oil. It's what is needed to fuel the digital revolution. And I think that's completely correct. And actually, with AI, ChatGPT, I think these are revolutionary changes on par with the PC computer coming in, the smartphone. I think this is a seminal moment that is really going to structurally lead to greater demand over the coming decade. So we're invested in several areas.

Overall, semiconductors would probably be about a quarter of the portfolio today. A large portion of that is in memory, so DRAM and NAND, which is really the key, one of the absolute key areas for computer and computer processing. Now, DRAM, for example, used to be a terrible industry. You had about 10-12 players a decade ago. It was a bloodbath. No one made any money. It's now a really cosy oligopoly, with three players, Samsung and Hynix being the number one and two players. So we own both of those in fairly large quantities.

And then we've got quite a few individual companies involved in the various manufacturing processes. A really interesting one that we've been adding to is EO TECHNICS. This makes lasers for the manufacturing of semiconductors. And what's really interesting here is that quite a lot of the processes today are still quite old-school, if you like. Cutting and drilling, for example, uses ceramic blades.

But as semiconductors get more and more complicated and smaller and smaller, at some point, you're going to have to start using lasers instead. So over the next three, four years, there's going to be an inflection point, and we think EO TECHNICS's lasers are going to be at the forefront of that, and we could see revenues grow tenfold when that happens.

CR: Great. Okay, thanks, Roderick. We're going to turn to the Q&A now.

Okay. So, questions through from the audience. First one, what is the impact of a strengthening dollar, and does that worry you as an EM investor?

RS: That's a great question. And typically, a rising dollar has been bad for Asia and the emerging markets. It sucks liquidity away from the region. But what I think is interesting this time around is that we've actually had the strongest dollar in 40 years. And do you know what's happened across

Asia?

CR: No, I don't.

RS: Nothing.

CR: Yes.

RS: We haven't had any crisis. If this had happened at any other time in history, the past 20-30 years, you would have had a massive emerging markets crisis. Yet they've seemingly sailed through. And I think that tells you the strength of where Asia is at the moment. Its macro position is just much better compared to developed markets than it's really ever been.

And that's because they've been run very sensibly. There hasn't been any quantitative easing, money printing during Covid. They've had sensible real interest rates. Inflows into the region, well, there have actually been net outflows for the past decade, so there's not huge amounts of hot money in the region.

And you combine that with the greater growth that we're going to see over the next five years, then it seems anomalous, actually, that Asia is on a discount to developed markets. So I'd be actually very optimistic. And if the dollar starts to weaken, that will be a major, major tailwind for the region.

CR: Okay. Another one on Pinduoduo, which was the stock story. Are you comfortable with the company's ESG practices?

RS: Yes, that's obviously an area that we've looked at in a lot of detail before taking a holding. We're actually very lucky we've got a very large ESG team at Baillie Gifford, coming up to 30 people, and our own ESG analysts actually integrated into the Emerging Markets Team, where we run the Asian portfolios.

So it's an area we've done a lot of work on, particularly the supply chain and where the materials are coming from, with a lot of engagement from the, with the company. So it probably took us 6 to 12 months of investigating before we were happy with that and took a holding. So yes, but it's certainly one that we researched in detail before getting to that comfortable position.

CR: Okay. And then just finally, are you concerned about an escalation between China and Taiwan?

RS: Concerned in the sense that if it happened, it would be a very serious event in the region and globally. It would not be good for the region. It's a low probability but high impact event, so it's one we've done a lot of research and thinking about and commissioned a lot of various reports on. But ultimately, we think any major escalation, an invasion being the ultimate event, is actually very unlikely over the next five years.

There are quite a few reasons for that, but two probably most obvious. Firstly, the military capabilities of China just probably aren't up to an amphibious assault across the Taiwanese Straits, which has a very sophisticated military capability. So we think that's very unlikely. And secondly, you've got to remember the view of the CCP. If they failed in any form with Taiwan, that would be a systemic risk to their survival.

So I think, for those two reasons, a major escalation is unlikely at this stage. But certainly, tensions will most likely rumble on over the next few years. But I'd say that's more than taken into account the share prices we're seeing in Taiwan, which still look really very attractive to us.

CR: Okay, great. Right, we're out of time. But thank you so much for joining us today, Roderick. It's been lots of insights.

And thank you all for joining us as well. To find out more about the topics we've discussed on the programme, please do go to the website, **bailliegifford.com**. Until next time, goodbye.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

Risk factors

The views expressed should not be considered as advice or a recommendation to buy, sell or hold a particular investment. They reflect opinion and should not be taken as statements of fact nor should any reliance be placed on them when making investment decisions.

Portfolio discussions are based on a representative account for the Asia ex Japan strategy.

This communication was produced and approved in February 2024 and has not been updated subsequently. It represents views held at the time and may not reflect current thinking.

All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk. Past performance is not a guide to future returns.

This communication contains information on investments which does not constitute independent research. Accordingly, it is not subject to the protections afforded to independent research, but is classified as advertising under Art 68 of the Financial Services Act ('FinSA') and Baillie Gifford and its staff may have dealt in the investments concerned.

All information is sourced from Baillie Gifford & Co and is current unless otherwise stated.

Important information

Baillie Gifford & Co and Baillie Gifford & Co Limited are authorised and regulated by the Financial Conduct Authority (FCA). Baillie Gifford & Co Limited is an Authorised Corporate Director of OEICs.

Baillie Gifford Overseas Limited provides investment management and advisory services to non-UK Professional/Institutional clients only. Baillie Gifford Overseas Limited is wholly owned by Baillie Gifford & Co. Baillie Gifford & Co and Baillie Gifford Overseas Limited are authorised and regulated by the FCA in the UK.

Persons resident or domiciled outside the UK should consult with their professional advisers as to whether they require any governmental or other consents in order to enable them to invest, and with their tax advisers for advice relevant to their own particular circumstances.

Financial intermediaries

This communication is suitable for use of financial intermediaries. Financial intermediaries are solely responsible for any further distribution and Baillie Gifford takes no responsibility for the reliance on this document by any other person who did not receive this document directly from Baillie Gifford.

Europe

Baillie Gifford Investment Management (Europe) Limited provides investment management and advisory services to European (excluding UK) clients. It was incorporated in Ireland in May 2018. Baillie Gifford Investment Management (Europe) Limited is authorised by the Central Bank of

Ireland as an AIFM under the AIFM Regulations and as a UCITS management company under the UCITS Regulation. Baillie Gifford Investment Management (Europe) Limited is also authorised in accordance with Regulation 7 of the AIFM Regulations, to provide management of portfolios of investments, including Individual Portfolio Management ('IPM') and Non-Core Services. Baillie Gifford Investment Management (Europe) Limited has been appointed as UCITS management company to the following UCITS umbrella company; Baillie Gifford Worldwide Funds plc. Through passporting it has established Baillie Gifford Investment Management (Europe) Limited (Frankfurt Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in Germany. Similarly, it has established Baillie Gifford Investment Management (Europe) Limited (Amsterdam Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in The Netherlands. Baillie Gifford Investment Management (Europe) Limited also has a representative office in Zurich, Switzerland pursuant to Art. 58 of the Federal Act on Financial Institutions ("FinIA"). The representative office is authorised by the Swiss Financial Market Supervisory Authority (FINMA). The representative office does not constitute a branch and therefore does not have authority to commit Baillie Gifford Investment Management (Europe) Limited. Baillie Gifford Investment Management (Europe) Limited is a wholly owned subsidiary of Baillie Gifford Overseas Limited, which is wholly owned by Baillie Gifford & Co. Baillie Gifford Overseas Limited and Baillie Gifford & Co are authorised and regulated in the UK by the Financial Conduct Authority.

Hong Kong

Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 is wholly owned by Baillie Gifford Overseas Limited and holds a Type 1 and a Type 2 license from the Securities & Futures Commission of Hong Kong to market and distribute Baillie Gifford's range of collective investment schemes to professional investors in Hong Kong. Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 can be contacted at Suites 2713-2715, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. Telephone +852 3756 5700.

South Korea

Baillie Gifford Overseas Limited is licensed with the Financial Services Commission in South Korea as a cross border Discretionary Investment Manager and Non-discretionary Investment Adviser.

Japan

Mitsubishi UFJ Baillie Gifford Asset Management Limited ('MUBGAM') is a joint venture company between Mitsubishi UFJ Trust & Banking Corporation and Baillie Gifford Overseas Limited. MUBGAM is authorised and regulated by the Financial Conduct Authority.

Australia

Baillie Gifford Overseas Limited (ARBN 118 567 178) is registered as a foreign company under the Corporations Act 2001 (Cth) and holds Foreign Australian Financial Services Licence No 528911. This material is provided to you on the basis that you are a "wholesale client" within the meaning of section 761G of the Corporations Act 2001 (Cth) ("Corporations Act"). Please advise Baillie Gifford Overseas Limited immediately if you are not a wholesale client. In no circumstances may this material be made available to a "retail client" within the meaning of section 761G of the Corporations Act.

This material contains general information only. It does not take into account any person's objectives, financial situation or needs.

South Africa

Baillie Gifford Overseas Limited is registered as a Foreign Financial Services Provider with the Financial Sector Conduct Authority in South Africa.

North America

Baillie Gifford International LLC is wholly owned by Baillie Gifford Overseas Limited; it was formed in Delaware in 2005 and is registered with the SEC. It is the legal entity through which Baillie Gifford Overseas Limited provides client service and marketing functions in North America. Baillie Gifford Overseas Limited is registered with the SEC in the United States of America.

The Manager is not resident in Canada, its head office and principal place of business is in Edinburgh, Scotland. Baillie Gifford Overseas Limited is regulated in Canada as a portfolio manager and exempt market dealer with the Ontario Securities Commission ('OSC'). Its portfolio manager licence is currently passported into Alberta, Quebec, Saskatchewan, Manitoba and Newfoundland & Labrador whereas the exempt market dealer licence is passported across all Canadian provinces and territories. Baillie Gifford International LLC is regulated by the OSC as an exempt market and its licence is passported across all Canadian provinces and territories. Baillie Gifford Investment Management (Europe) Limited ('BGE') relies on the International Investment Fund Manager Exemption in the provinces of Ontario and Quebec.

Israel

Baillie Gifford Overseas Limited is not licensed under Israel's Regulation of Investment Advising, Investment Marketing and Portfolio Management Law, 5755-1995 (the Advice Law) and does not carry insurance pursuant to the Advice Law. This material is only intended for those categories of Israeli residents who are qualified clients listed on the First Addendum to the Advice Law.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

91734 10045299