Baillie Gifford™

Why emerging markets have changed

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Short Briefings on Long Term Thinking – Episode 39

Malcolm Borthwick (MB): Names matter. In 1981, after a spell in Thailand, a young World Bank economist became certain that a group of fast-developing countries represented a fantastic investment opportunity.

So, he pitched the idea of creating what he called the Third World Equity Fund to a group of Wall Street insiders. 'Great idea, terrible name' was their response. Over the following weekend, he brainstormed alternatives, landing on emerging markets as a more dynamic description.

It proved popular. The World Bank's private sector development arm set up a fund which adopted the name and the label caught on more broadly, framing a multitude of investments.

Despite criticism about the term being too broad brush, the name has stuck.

Welcome to *Short Briefings on Long Term Thinking*. I'm Malcolm Borthwick, managing editor of Baillie Gifford and I'm joined by Will Sutcliffe, head of Baillie Gifford's Emerging Markets Equities Team and co-manager of our Emerging Markets Leading Companies Fund.

Over the next 30 minutes or so, Will and I will discuss why investing in emerging markets requires a different approach to other regions, and we'll highlight some of the most exciting companies we invest in.

But first, a quick reminder: as with all investments, your capital is at risk and your income is not guaranteed.

Will, welcome to *Short Briefings on Long Term Thinking*.

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Will Sutcliffe (WS): Lovely to be here.

MB: So in our introduction, we talked about how the term emerging markets came about. In terms of Baillie Gifford, the first dedicated emerging markets mandate we had was 30 years ago in 1994, and you joined in 2001. What was it like then?

WS: Well, it wasn't a glamour posting when I joined the Emerging Markets Team in 2001. UK equities were really the centre of the universe as far as Baillie Gifford was concerned in the 1990s, and that was still the case in the early 2000s, and I would guess that EM was probably less than 1 or 2 percent of our funds under management. And again it goes back to that point you made about the launch of our first dedicated emerging market strategy in 1994. The timing of that was almost comedically bad in retrospect. We of course hoped would benefit from the so-called Asian economic miracle and the ongoing opening up of the global economy. And what of course we got was a crisis that began in Mexico in 1995, then spread across Asia into Brazil, into Russia, and only ended in 1998 when the Fed finally pulled out the big guns. So yeah, a bit of a baptism of fire for our emerging markets product. We got our first client in 1994, but it wasn't until, gosh, it wasn't until 2001 that we got our second client. So when I joined the team in 2001, really all the talk wasn't about economic miracles or sexy dynamic emerging markets. It was really all about stagnation and the failure of development theory, and that was the department that I joined in 2001.

MB: And what did you learn from that baptism of fire as you describe it?

WS: I mean it was terrifying to be honest, We take the same approach to graduate training then really as we do now, which is we try and rotate our graduates through a couple of different departments in their early years to give them that breadth of perspective, working in different market conditions with different investors and experiencing different companies and from my own perspective, I'd spent my first two years in our UK team and then in our US equity team. And the philosophy, the indoctrination I guess at the time, was quite a sort of Buffett-esque philosophy of buying wonderful companies at fair prices. And then when I joined the emerging markets team, it felt like we spent all of our time talking about capital inflows and current account deficits and movements in interest rates in the US as much as we did talking about emerging market companies. So it was a really steep learning curve and it felt as if I'd sort of felt as if I'd started to know what I was doing in the US equity team at the end of my second year and then all of a sudden you're right back to square one on the side of a whole new learning curve.

MB: And there are lots of different teams across Baillie Gifford but what attracted you to emerging markets?

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WS: Well, partly I had no choice in that the chief investment staff at the time evidently decided that emerging markets would be a good contrast for someone who'd had the first two years' experience that I'd had. But I did have a bit of a personal interest. I specialised in Russian history at university and then prior to joining Baillie Gifford I spent a couple of years living in Prague, travelling quite extensively through the former Soviet countries in Central and Eastern Europe. So there was definitely a personal angle that I was keen to revisit.

MB: And what's changed about emerging markets? I mean it's quite an open question since you joined in 2001.

WS: The obvious change has been in the composition of the index and the countries that we spend our time visiting to look for opportunities. And I would love to say that that has changed because all of the countries that were emerging when I first started doing this in the early 2000s, have now-been promoted to developed markets. But of course, that's not the case. And in fact, the dirty little secret of emerging markets investing is that it is incredibly difficult to go all the way from emerging to developed. And I think over the last 20 years it's Greece, Israel, perhaps Portugal that have done it. So, it is hard.

MB: Wow, that's not many. How do you get promoted from emerging to a developed market?

WS: Well, this is the other point. We are investing in emerging *markets*, not investing in emerging *economies*. So, there's this perennial debate about Korea and Taiwan. They are some of the richest economies in the world. Again, the Gulf states, they are some of the richest economies in the world. But the key point is markets. So, there's issues around access, ability to trade in these companies, disclosure and so forth. That means they are still considered emerging markets, at least as far as the index provider is concerned. But the countries have definitely changed. And even if you hadn't had many being promoted to developed, you've certainly seen big shifts in the relative growth trajectories of countries.

So China's the obvious example of a market that was 0 per cent, I think, of the MSCI EM index when I first started doing this and is now about 25 per cent, having peaked at a little over a third a couple of years ago.

And then the other countries, the big countries when I joined the team, would be Malaysia and Mexico, which are now much smaller relative parts of the overall index. So definitely big changes there.

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I suppose the other change that's worth highlighting is in the calibre of the companies that we're investing in. I mentioned that in the US we were looking for wonderful companies and then I joined emerging markets where the companies didn't feel particularly wonderful. It was all these sort of monolithic monopolies. Every country you had *the* bank and *the* telecoms company and *the* resource company. And it felt like you were trying to make. And it felt like you were trying to make money for our clients by investing in these companies, almost surfing the cycle rather than because anything particularly wonderful that the companies or management teams were doing. And that's definitely changed. We're seeing far more of what I would describe as world-class companies in emerging markets. That process definitely started in North Asia, in Korea and Taiwan with companies like Samsung Electronics, like Taiwan Semiconductor Manufacturing. And then it spread into China and increasingly seems to be spreading into south-east Asia, into India, into Brazil, where I think we are increasingly finding a lot of innovation. Companies that are increasingly capable of taking on and superseding what the best of the rest of the world has to offer. So that I think has been the other very encouraging change.

Then I suppose the third encouraging change has been in the level of macro resilience, I suppose. In emerging markets there's always been this issue that the fundamentals tend to get swamped by the macro. And you've seen huge capital inflows and huge capital outflows that have created booms and busts in emerging markets. And relatively little to do with what's going on in emerging markets, it's really been all about what's going on with policy and developed markets. And that was really what happened in the booms and busts that we've talked about in the 80s, in the 90s and even in the 2000s. And right back to 2013, that was the last mini-crisis in emerging markets when people got to start to worry about what would happen when the Fed began to hike interest rates. So if you fast forward to where we are now, more than 10 years on, and you think about what we've just been through: we've just been through the steepest rate hiking cycle in a generation. And the biggest economies in emerging markets, not only have they survived that rate-hiking cycle, they've thrived through it. And if anything, it seems that all the problems associated with a higher cost of capital, they seem to be in developed markets rather than emerging markets. So that resilience, I think, is a very important change in the backdrop to emerging markets investing.

MB: That's interesting because there's often a perception that emerging markets are riskier. Is that unfair?

WS: Yeah, So I do think that macro resilience is a big part of the investment case for emerging markets today. I mean, it's not clear cut. And I would actually highlight geopolitics as having shifted quite substantially again, since I first started doing this.

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You know, going back to the 1990s, and when people began to really get serious about investing in emerging markets, remember that, of course, this was a point when we all believed in, the end of history. And I think the assumption was that as countries became richer, as they emerged, then, in social and political terms, they would start to resemble what we would recognise as liberal democracies through a Western lens. And that's very clearly not the case now. And it's probably not been the case since, since at least the end of the GFC.

MB: The GFC being the global financial crisis in 2007-8.

WS: Yeah, that's right.

And that's a really interesting one for emerging markets investors, a bit of a double-edged sword. On the one hand, I think there will be huge opportunities that go along with that shift in the geopolitical environment. You know, people talk about de-globalisation. But, you know, that's not really what we're seeing. What we're seeing is designification. So, we're seeing a disentangling of the US and the Chinese economies. But what you're seeing in the rest of emerging markets, in the underlying bits, if you like that 50% of the world's population in the middle, that's where you're seeing almost a doubling down of globalisation as they trade with each other and with each side of the new geopolitical divide. So, there will be opportunities that come with that.

And I agree with this idea that for the Mexicos, or the Vietnams, or the Indias, or the South Koreas, there will be opportunities that come from stepping up into the global supply chain. But then of course, the flipside of that is, is that I think we're at the beginning of a broader reassessment of what responsible investing means in emerging markets.

So, I would say, you know, five years ago, and certainly before the Russian invasion of Ukraine, I would say that we felt comfortable making a distinction between companies doing good things in countries whose regimes, whose values didn't necessarily coincide with our own or those of our clients. And that nuance, that distinction is obviously much harder to make now. So, I do think we have to be open to the possibility that Western investors will increasingly start to marginalise investments in authoritarian regimes, no matter how great the individual companies are. And, you know, you can see from the interest in our emerging markets ex-China product, you get a sense of that change.

MN: You mentioned the geopolitical risk of China. How do you view it as an investment opportunity at the moment? Is that deterring you or do you think it's been overblown?

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WS: Nice, easy question! I think that's really hard, to be honest. With China, there's so much revulsion from investors in China at the moment, the investors seem to be convinced that the economy is a busted flush, they are convinced that authoritarian regulation will stamp out animal spirits, they are worried about geopolitics. And I think the most likely medium-term outcome for all of these things is muddle-through. China has its issues for sure, but this is not Japan, 1989. The problem you have, though, is the longer you extend that time horizon, I think the more difficult it is to see how a lot of these issues are resolved, and particularly the geopolitical one.

It's very clear that what Beijing wants, and what Washington wants, are fundamentally incompatible, and that feels fairly immutable. So I do think that there's a concern there, that that will put a permanent dampener on sentiment in China almost, and there's obviously a tail risk of a very unpleasant outcome indeed. For now, though, I do think the pessimism has been overblown. There are still some fantastic companies operating in China on what appear to be stupidly cheap multiples. And again, just to come back to our China position, China's about 25 per cent of the index. We are a little bit underweight in that sense, and we have actually been ticking up that exposure over the last year or so, just to reflect this fact that there are some great companies, but what appear to be absurdly cheap multiples. But can I see a position where we are substantially overweight, China, in the next three to five years? I think that's a tougher one.

MB: And by cheap multiples you mean the price of some companies' stocks are relatively low when considered against their profits, sales or cash flow**.** I want to move on to companies now, Will. You mentioned some fantastic opportunities in China. Give an example of one of those opportunities.

WS: There are some great e-commerce platforms still. You know, PDD, I think, is a wonderful example of a great Chinese company growing very fast with a very attractive earnings multiple and I think there will be still be-great opportunities that are aligned with Beijing's push to upskill on the technological side. There will be opportunities in renewables, there will be opportunities in semiconductorsAnd there's a really interesting nationalisation story almost, where domestic companies are increasingly taking share from the American companies.

MB: You mentioned PDD, Pinduoduo, I guess probably best known here for Temu.

WS: Yeah, and that's a really interesting example. I think when we first took our investment at the start of last year,-this was regarded as having zero value, potentially even negative value. And it's become very clear to me, you know, I can see from the

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stuff my kids buy on Temu, it's become very clear that that alone is a very substantial part of the overall value.

MB: So one of the most exciting and probably important companies in your portfolio is TSMC. Tell me more about that.

Yeah so it's it's a foundry company. It manufactures semiconductors that go in a wide range of applications and it's the biggest and the best foundry company in the world. It's been around since the 1980s. It's been in our portfolio since the 1990s and gosh, when we first brought it it was about twice the size of its nearest competitor UMC and it's now about six times the size of UMC. And it's got there because this is a cyclical industry and every time there's a down cycle and all their competitors retrench, they just double down. They keep on investing, and that means they come out the cycle in much much better shape. So it's actually a great example of those world-class companies I was talking about, taking on the best from the rest of the world. And I thought it was really interesting in 2020 when Intel admitted that their technology was about two or three years behind that of TSMC. I thought that was a really important moment for emerging markets.

So it's a great company, but why do we like it as an investment given the qualities are so well known? Well, it is cyclical and it's messy and it's hard to predict and it's hard to model. You know, I don't know, nobody knows what the future looks like, nobody knows what the new digital age will look like and which of the AI applications that people are taking bets on at the moment are going to be the most successful ones. But I think we do have a really good idea of who will be making the semiconductors that will be powering it and of course it will be TSMC. So that the fact that it's hard to model means I think that the sell-side are completely missing how much value TSMC could create in the decade ahead. And just to give you an idea, this is a company that has grown its earnings at a high teens rate over the last decade. I would be astonished if it doesn't do at least that over the next decade. And you're being asked to pay a starting multiple of 15 times earnings, so that to me just looks really really badly mispriced.

MB: You mentioned earlier investment opportunities in Brazil. Will, give an example.

WS: Yeah, we've actually just taken a new holding in a Brazilian company called Natura, which is a cosmetic company. Direct sales of cosmetics that are very closely linked to biodiversity and sustainability in Brazil. It's a really interesting company. We actually owned it before in the early 2000s. It’s lost its way a little bit over the last decade. It's pursued a series of di-worsifications away from the core cosmetics brand in Brazil. It's brought Avon's cosmetics direct sales operation. It's expanded into retail with the purchase of the Body Shop in the UK and Aesop in Australia. But it's now

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reversing that and getting back to the bit of the business it does best at that core Brazilian cosmetics franchise and selling off some of these non-core operations. They've got a new management team who are overseeing that. So it's pretty complex and pretty messy. That's the investment appeal from our perspective. That messiness puts people off. But often in investment, it's really about just focusing on the two or three things that really matter. In this case, you've got a great brand, you've got a good management team, and they're doing good things. It's on a stupidly low multiple, reflecting that mess and that complexity. Yeah, that's a new holding we're very excited about.

MB: And India's also a significant asset allocation for you. Tell me about a company there that you're excited by.

WS: India of course is a terrific secular story from a top-down perspective. GDP per capita is less than $3,000. So we've got decades of growth before you have to even begin to worry about middle-income traps or anything like that. And on top of that great secular story, you do seem to have a cyclical one as well because credit growth in India has actually been pretty anemic for most of the last decade and is really starting to motor now. So great top-down. And then from a bottom-up perspective, there's really interesting things happening. If you speak to our private companies team, for example, they will tell you that what's going on in India right now it just feels so exciting. It's one of the most exciting startup scenes outside the US right now.

And why is that? Well, I think a lot of it is simply due to the fact that India finally has a mobile internet infrastructure. Courtesy of Reliance Industries, India's gone from having one of the worst mobile internet infrastructures in the world to one of the best in a relatively short space of time. And that is helping to unlock entrepreneurialism in quite an exciting way. So lots of interesting things happening. The problem, however, is a lot of this is already reflected in valuations. And I'll give you an example of a company we don't own first, Hindustan Unilever, big foreigner favorite. Fine, perfectly respectable company, quite possibly delivering high single digit earnings growth for the next decade or so. But when you're being asked to pay a starting multiple in excess of 60 times earnings, it's a little hard to see how we might make money for our clients in those sorts of opportunities.

So from our perspective, we prefer to focus more on the perhaps slightly less certain growth opportunities, but far more substantial growth opportunities that you see below that. So just to give you an example, Jio Financial Services is a company that's appeared in the portfolio fairly recently Really interesting. It's a fintech company that was spun out of Reliance Industries. And of course, there's hundreds of fintech companies in India. Big deal. What makes this one special? Well, it's the fact that it's

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backed by Reliance. It has the parent's backing. It has the parent's connections. And perhaps most importantly, it's got access to all the parent's data. So we're talking about 400 million telecoms customers, 200 million retail customers that they're able to take advantage of. So I think that's a very, very powerful combination. So that's the whole thing that we've been building up recently and are very excited by.

MB: You mentioned Reliance there, Will, best known originally, probably for its refinery business. Your team invest in quite a lot of fossil fuel companies. Given the energy transition and climate change, are these still growth opportunities?

WS: I would emphasise an aspect of our approach here, which is we don't limit ourselves to only investing in perfect companies. I'm not sure there's any such thing, particularly in emerging markets. Where we can find promising investments, our preference is always to invest in the direction of travel. And actually the academic evidence suggests where you can find these improvers, that's where you make the best returns, particularly in emerging markets. So for example, we will invest in companies that have weak competitive positions, let's say, if we think that that competitive position is likely to improve over the period that we own the shares. And we will invest in companies at weak points in an economic cycle, again, if we think that economic cycle is likely to improve over the next five years or so. And I would say the same thing about companies with environmental issues.

Yes, we do invest in companies that are carbon-intensive, that are carbon-heavy. Where we can find companies that we think are capable of managing that transition and have the intention of managing themselves through that transition, then I think the best thing we can do, the most powerful thing we can do as long-term investors, is to support those companies. And for sure it's not uncritical, for sure we will challenge them, but we will also reassure them that, look, we don't care what your profits are this year, we don't care if you pay us a dividend this year, but if you can reinvest your cash flows into ensuring that that improvement continues and that you will still be a viable business in five years' time, in 10 years' time, then that's a far more important conversation for us to be having. And just to reassure the company that we won't cut and run in that process, just because they're not in a great place right now. So we do invest in companies that don't look great on some of those traditional environmental, social and governance metrics, but again we are buying them in the anticipation of an improvement.

I think Reliance is a good example in that context. They are a big emitter. They're not great in terms of their carbon reporting, frankly, but they are getting better and that's the important point. We are encouraging them about what we would like to see that we think will make them world-class, and they have been responding. And of course the

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most important thing is that interplay of their environmental obligations alongside their social ones, the fact that they are using the cash flows from that big, heavy-emitting, carbon-intensive petrochemical operation. They are investing them in that telecoms network that is changing the life for hundreds of millions of Indians, that is creating a new and efficient form of retail in India and crucially they are investing in billions of dollars in their environmental business with the ambition of becoming India's largest solar company, largest battery company. So, it's a complex issue but I think backing that direction of travel is something that we've always been very keen to do.

MB: We started with how the phrase emerging markets came about. And interestingly, there was a recent editorial in the *Financial Times* that suggested that we retire the term emerging markets on the grounds that it's a bulk of the world's population. Things have vastly changed since the term came about. And these countries are highly diverse. What's your view? Should we retire the phrase emerging markets?

WS: Well, look, I think it's, it's really interesting that you began with that anecdote at the beginning, because it's a useful reminder. This is a marketing concept. And for a lot of people, I think that is the concern. Is it still a triumph of marketing over investment reality?

It is an asset class that to many people doesn't make much sense. You, you have some of the richest countries in the world alongside some of the poorest. That doesn't seem like a particularly academically rigorous way of delineating the world. And from a returns perspective, the case for emerging markets is not clear cut. Since the MSCI Emerging Markets index was set up in 1987, it's given you 9 per cent per annum in dollar terms against the 8 per cent per annum return for the MSCI World. But of course, starting periods really matter within that. Almost all of that outperformance came within a, a single decade, at the start of this century. And of course that was bookended by the Asian crisis that wiped out much of the gains of the 1990s and the most recent decade, which has been much more about stagnation. I understand the criticism of emerging markets as an asset class. I think, however, to moan about the complex of the composition of the index and to moan about the returns of the index does miss the point slightly.

When I think about all the challenges that are facing us in the decades ahead, it strikes me that an awful lot of the answers can be found in emerging markets. If you think about the renewable transition, the fact that we're going to require an awful lot of critical minerals, an awful lot of copper, an awful lot of nickel. If you think about developed market re-industrialisation, we're going to need an awful lot of steel, an awful lot of cement. If you think about AI and the digital age, going to need lots of semiconductors. So all of these things, I think that emerging markets does very well

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indeed. So I think about all of that, and the idea that the world's centre of economic gravity continues to tilt back towards emerging markets in the decades ahead, I think that's a very plausible idea.

I would argue very strongly that emerging markets is a specialist discipline in which a lot the rules and principles followed by developed market investors don't really apply. You know, this is an asset class where macro does matter. It is an asset class where you do have to think really hard about alignment. It's an asset class where you do have to embrace uncertainty in the face of incomplete information. And as I said, you have to be willing to back what might be rather than what is already proven. And that for us is a skillset that, that works, whether you're talking about a very rich manufacturing economy like Taiwan or a less affluent resource-based one like Turkmenistan.

MB: Will, we always end the podcast by asking our guests what they're reading at the moment. What are you reading at the moment?

WS: Oh, gosh. The book on the bedside actually is *Until August*, which is the latest book from Gabriel Garcia Marquez, published 10 years after his death, but I must say I've got some trepidation about reading it, given he didn't want it to be published. But that's the one I'm starting at the moment.

MB: Yeah, it's quite controversial, isn't it? Because his sons wanted to publish it, but he didn't want it published.

WS: No, he didn't. And he was, you know, he sadly had dementia in the later years of his life. So, yeah, I'm a huge fan of his work. But as I say, approaching it with some trepidation.

MB: Will, thanks for joining us on *Short Briefings on Long Term Thinking*.

WS: Great. Thanks, Malcolm.

MB: And thanks for investing your time with us.

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Show notes

Emerging markets have sometimes promised more than they have delivered, but circumstances may be tipping in growth investors' favour. Will Sutcliffe, head of our Emerging Markets Team, explains why it's an opportune time to invest in the asset class.

Background

Will Sutcliffe is the head of Baillie Gifford's Emerging Markets Team and co-manager of our Emerging Markets Leading Companies Fund. In this episode of S*hort Briefings on Long Term Thinking*, he brings his 23 years of experience in the field to explain what makes the specialism different from other types of growth investing.

He makes the case that finding exceptional growth companies at attractive valuations is only part of the equation. Investors must be mindful of the broader macroeconomic environment, he explains, to avoid getting caught out by currency swings or spiralling debt costs. This leads him to conclude that recent resilience in emerging market economies could point to a favourable outlook for the asset class's growth stocks.

All this only matters to our portfolios if there are exceptional businesses to invest in, and Sutcliffe argues that the emerging markets are home to an increasing number of world-class companies. They range from the Taiwanese chip maker TSMC to the energy, retail and telecoms conglomerate Reliance Industries.

Resources

Emerging markets: why bother?
Stock story: Pinduoduo
South-east Asia's rising export stars
Gabriel Garcia Marquez: *Until August*

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Timecodes

00:00 Introduction
01:45 Joining the Emerging Markets Team
03:15 A 'terrifying' baptism of fire
05:00 Emerging markets' 'dirty little secret'
05:45 Qualifying for emerging markets status
06:45 Higher-calibre companies
08:00 Macroeconomic resilience
09:30 US-China tensions and Russia's invasion of Ukraine
12:00 Investing in China
13:45 PDD Holding's Pinduoduo and Temu
14:45 Taiwan's TSMC outpaces Intel
16:45 Natura focuses on its Brazilian business
18:10 Jio Financial Services' advantage in India
20:30 Reliance Industries: investing in improvers
24:10 The case for emerging markets
26:50 Bedside book

Risk factors

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