HOW DO WE DO WHAT WE DO?

ASIA EX JAPAN INVESTING

Andrew Keiller and Tim Campbell

BAILLIE GIFFORD

RISK FACTORS

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Annual Past performance (Net %) to 30 September Each Year

	2017	2018	2019	2020	2021
Asia ex Japan Equities*	29.9	3.9	1.0	50.0	33.4
MSCI AC Asia ex Japan	23.0	1.7	-3.2	18.2	14.7

Source: Baillie Gifford & Co, MSCI. US Dollars. *Pooled fund entities.

Annualised total return as of September 30, 2021 (%)

	1 Year	3 Years	5 Years	10 Years
The Baillie Gifford Worldwide Asia ex Japan Fund	33.4	26.4	22.2	15.6
MSCI AC Asia ex Japan	14.7	9.5	10.4	8.8

Source: Baillie Gifford & Co and relevant underlying index provider(s). Net of fees returns have been calculated by reducing the gross return by the highest annual management fee for the composite. All investment strategies have the potential for profit and loss. Past performance is not a guide to future returns.

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Stock Examples

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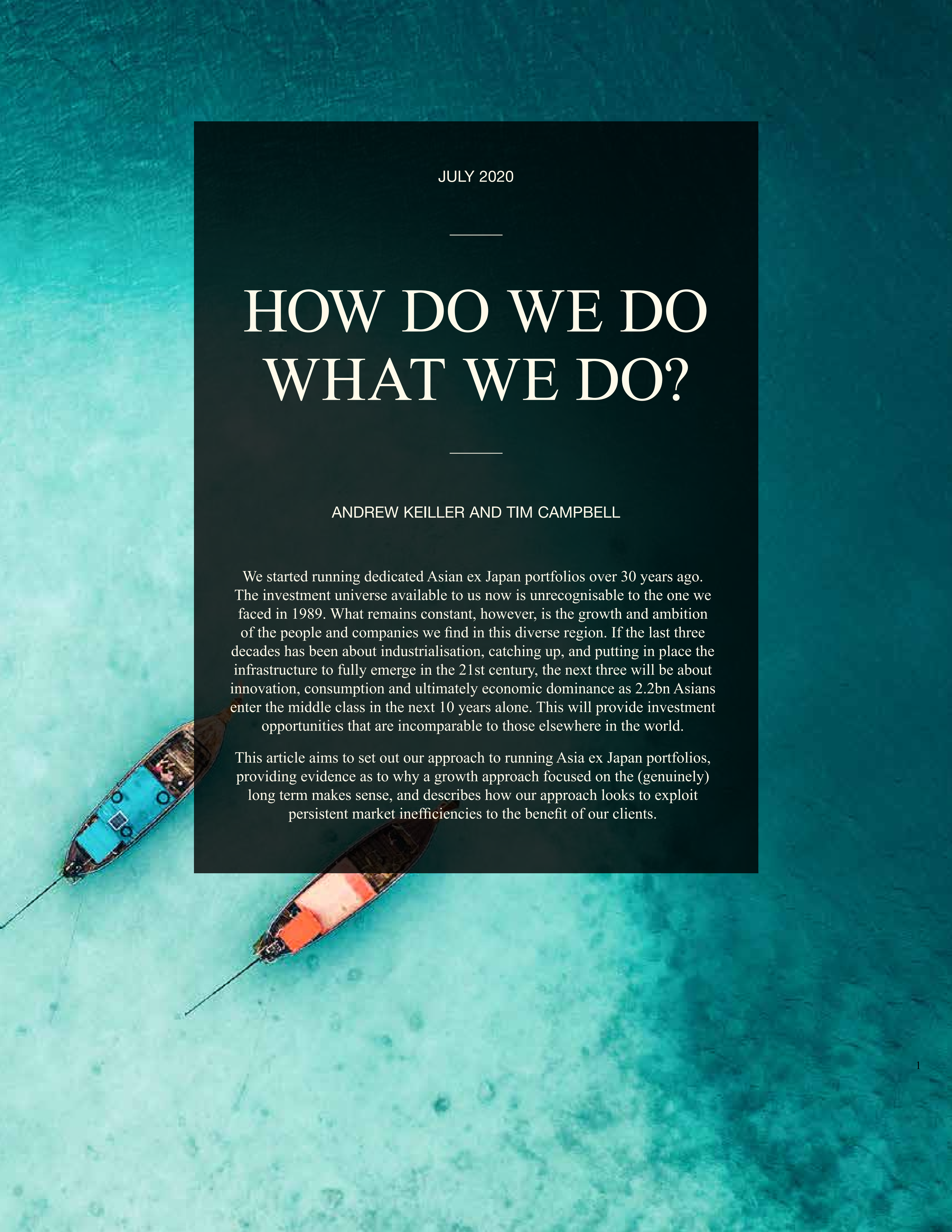


JULY 2020

HOW DO WE DO WHAT WE DO?

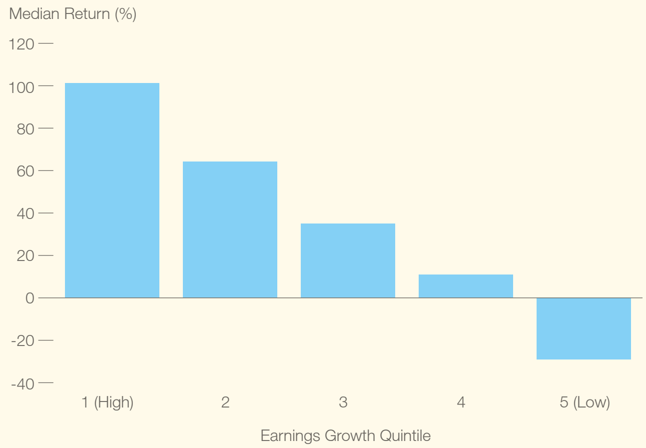
ANDREW KEILLER AND TIM CAMPBELL

We started running dedicated Asian ex Japan portfolios over 30 years ago. The investment universe available to us now is unrecognisable to the one we faced in 1989. What remains constant, however, is the growth and ambition of the people and companies we find in this diverse region. If the last three decades has been about industrialisation, catching up, and putting in place the infrastructure to fully emerge in the 21st century, the next three will be about innovation, consumption and ultimately economic dominance as 2.2bn Asians enter the middle class in the next 10 years alone. This will provide investment opportunities that are incomparable to those elsewhere in the world.

This article aims to set out our approach to running Asia ex Japan portfolios, providing evidence as to why a growth approach focused on the (genuinely) long term makes sense, and describes how our approach looks to exploit persistent market inefficiencies to the benefit of our clients.

Arguably it's growth that attracts investors to the region in the first place. But growth investing only works over sensible time frames, a point that is often overlooked. Over short periods share prices bear no relation to earnings. Over periods of five years however, you start to see the true correlation between earnings growth and total return in dollar terms. Based on over 25 years of data, we found that, on average, an Asian business in the top quintile of five years' earnings growth, will reward its shareholders with a doubling in dollar return over five years.

Returns Follow Earnings Over the Long Term
in Asia ex Japan



Source: Baillie Gifford & Co and Factset.
Median 5-year USD returns from Asia ex. Japan stocks as of the end of December of each year between 1994 and 2019 and with a market capitalisation larger than time-adjusted US$1bn.

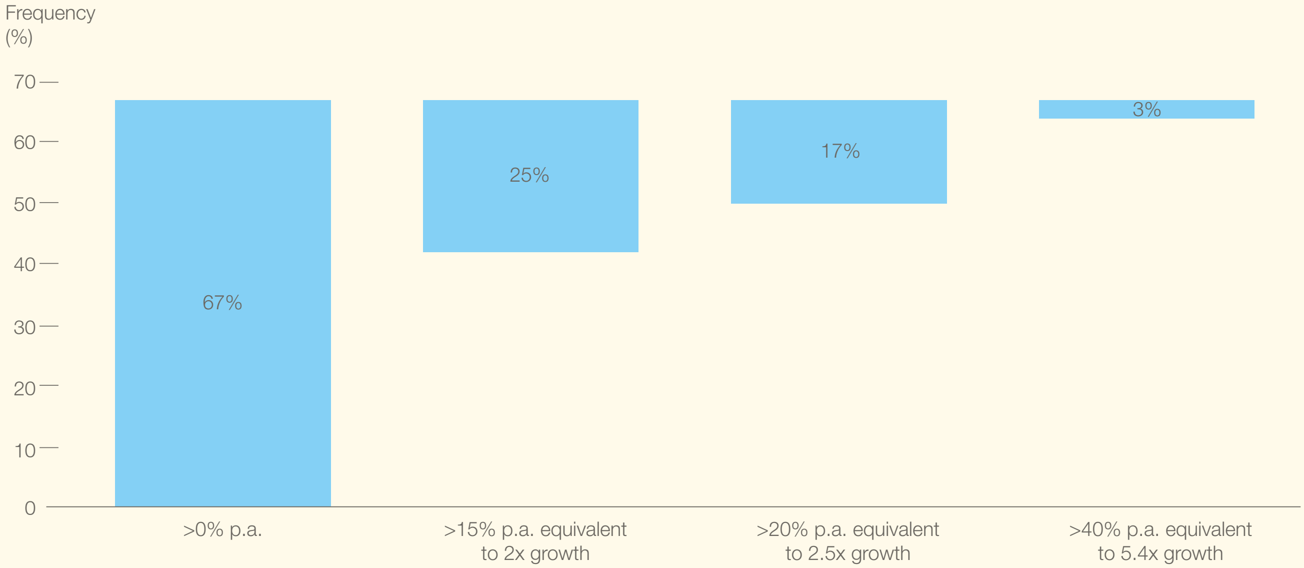
This search for long-term growth governs what we do. But distilling this process into something that fits neatly into a diagram is a challenge. By its nature, much of our process relies on the interplay of data, experience, educated creativity and probability. This does not lend itself to a matrix or a flowchart.

IN SEARCH OF FAT TAILS

Our investment criterion dictates that for a company to be put into client portfolios, we must be able to envisage at least a two-times total return in hard currency terms over five years. This doesn't mean we are looking for companies to grow in a straight-line, at 15 per cent per annum, but we do look for it to come from underlying earnings growth rather than simply a re-rating of the shares. The cruel truth, however, is that only 25 per cent of stocks in our universe meet this criteria (based on a 20-year sample size of rolling five-year periods from 1999 to 2019. In fact, 33 per cent fail to generate a positive return at all. Our criterion is highly ambitious.

Pacific Index Constituents - Range of Rolling 5-Year Returns Per Annum

Pacific Stocks in the MSCI AC Asia ex Japan and FTSE Asia Pacific ex Japan. Dec 1999 to Dec 2019



This graph covers a 20-year period, split into rolling 5-year periods rebalanced at the end of every year. It shows the proportion of EM Pacific index stocks in the MSCI AC Asia ex Japan Index and the FTSE Asia Pacific ex Japan Index that delivered 5-year share price growth in each of the four different quantums. For instance, 67% of the stock observations grew positively and 25% exhibited growth of more than 15% per annum over 5-year periods. Source: Factset and relevant underlying index providers. Data from end December 1999 to end December 2019 in US dollars. Market cap adjusted for minimum $1bn

Going further, it is evident that only a small selection of companies contributes to returns over meaningful time periods. Over the 10 years to December 2019, for instance, there were over 1,500 stocks in the MSCI Asia ex Japan index. Just six per cent of these made up 100 per cent of the total return in US dollars. While many of the others were positive, in aggregate, the other 94 per cent simply netted off to zero. Clearly, finding the strongest requires us to be ambitious and demand a lot from the companies in which we invest.

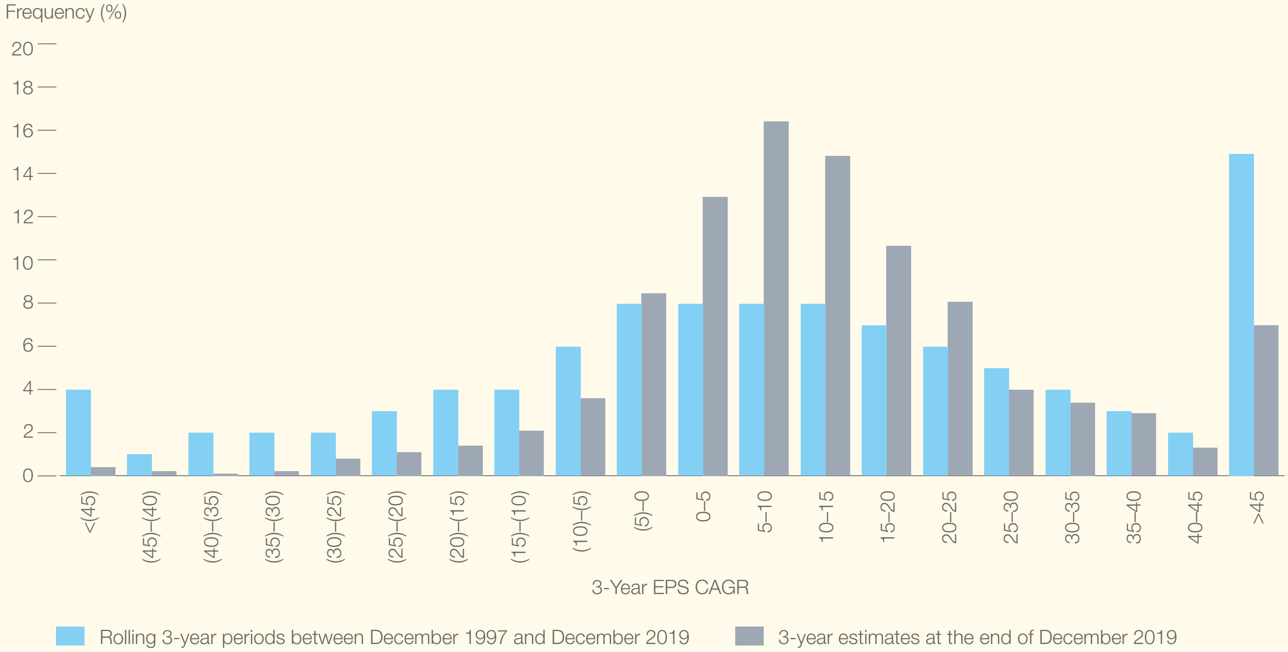
How do we do this? We look for fat tails. Or, to put it another way, we look to exploit the market's consistent refusal to accept the possibility of extreme outcomes. Consider the following chart which compares the average sell-side forecasts on earnings growth to the reality.

Looking at three-year forecasts[1], we immediately see that the majority of sell-side broker research predicts 0–20 per cent p.a. growth from companies in Asia (grey bars). The reality (blue bars), is far more widely spread. We present this chart not as a dig at forecasting skill, as we would be the first to admit that forecasting precisely is impossible. It does, however, show a few interesting things.

To begin with, the inherent bias in the sell-side means negative estimates are very uncommon compared to actuality (there is far more blue below zero than grey!). More importantly, market participants consistently underestimate the possibility of extreme growth, as shown by the blue bar at the right-hand side of this chart.

Asia ex Japan Stocks

EM Stocks in MSCI EM Index or FTSE EM Index



Source: Baillie Gifford & Co, Factset and relevant underlying index providers. US dollars.

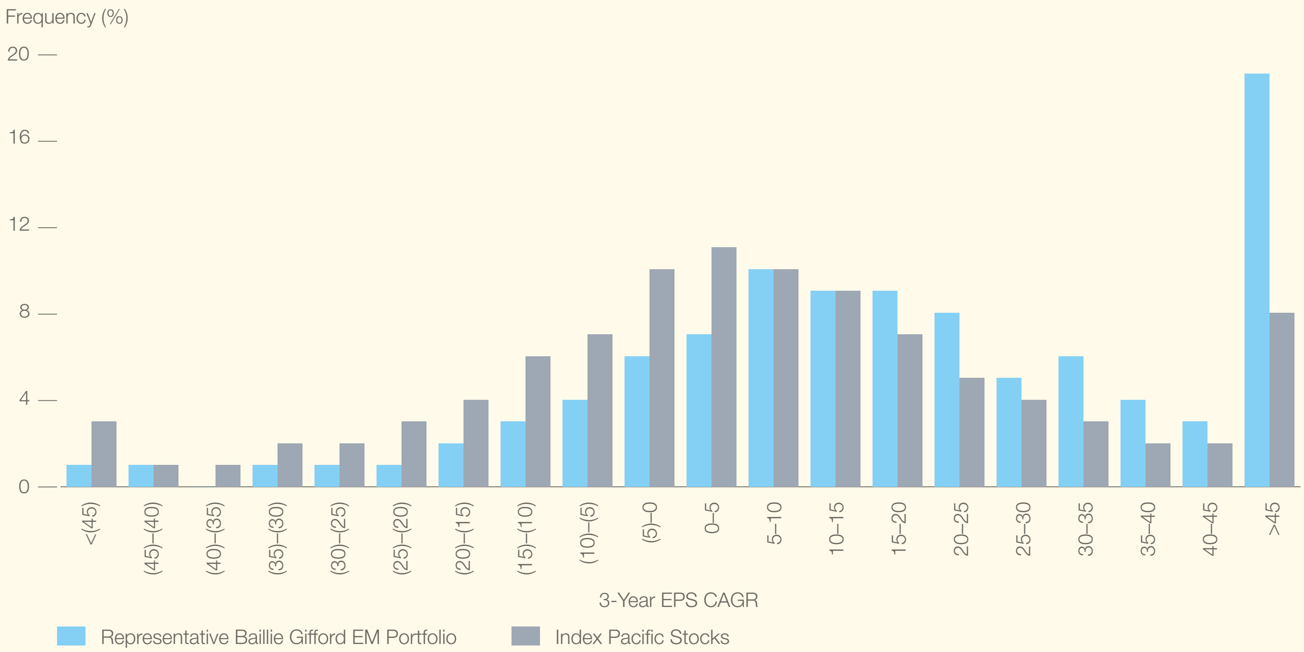
1. We'd ideally have used longer-term forecasts here, but most forecasts don't go out longer than this.

Time and again we see examples of where the market refuses to recognise the likelihood of rapid growth. It may be that this growth is lumpy, or that it represents a step change from a company's recent history or maybe it simply flies in the face of the law of big numbers, but regardless, the evidence is there that our universe does present opportunities for those willing to break out of the confines of simply extrapolating recent history.

Looking at our own client portfolios is instructive here:

Range of EPS 3-Year Compound Annual Growth Rate (CAGR)

EM Stocks in MSCI EM Index or FTSE EM Index vs Baillie Gifford EM All Cap



Source: Baillie Gifford & Co, Factset and relevant underlying index providers. Data from December 2005 – December 2019 in US dollars.
EPS 3-year CAGR rebalanced at every 6 months.

First, it is far more profitable to spend time considering what could go right rather than what might go wrong. Portfolio returns will be overwhelmingly driven by a small number of companies that do extremely well, so making sure you invest in these companies is critical. It matters more than obsessively worrying about all the risks that are inevitably present in any investment decision. But this can be uncomfortable, because it requires a conscious rejection of our natural tendency to loss aversion.

Our analysis of companies must be more than the extrapolation of the most recent trends, and it must give proper weighting to the possibility of extreme outcomes, of fat tails. And when we are faced with a small but credible chance of profits increasing by far more than the market expects, in a portfolio context, we should invest in size. It means too that many traditional financial information sources are unlikely to provide the insight we need to claim any sort of edge.

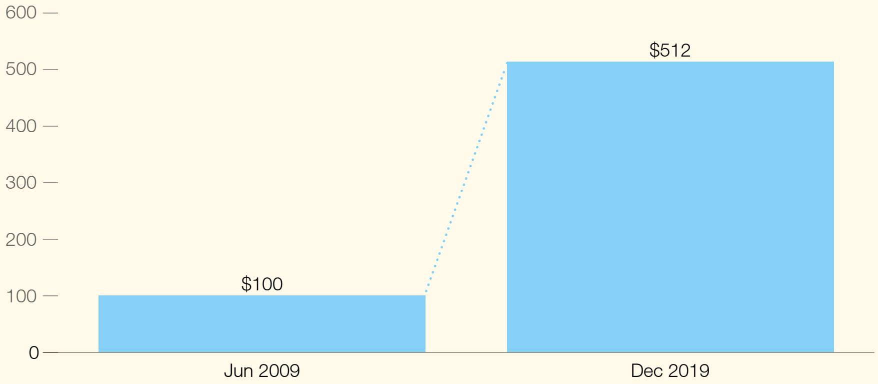
To perform differently, you need to behave differently too. In our investment process, we are more likely to take insights from non-financial industry specialists, private companies, our team on the ground in Shanghai, or the senior management teams at companies that we've invested in for decades, than from any market commentators. There is very little we think we can benefit from sell side analysts in Seoul who have been covering the quarterly results of Samsung Electronics for the last 20 years. Our edge is in thinking about the next five years and more, using differentiated insights that originate away from financial markets, and we leave the short-term micro-forecasting to others.

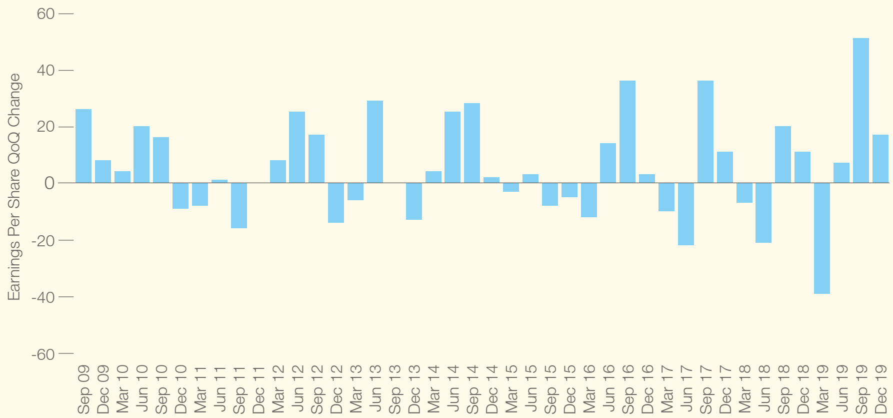
IGNORE THE IMMEDIATE

Experience has taught us that any attempt to forecast the near term with any level of precision can be seriously damaging to your wealth. Consider the following long-standing holding in our Asia ex Japan portfolio.

Taiwanese Semiconductor Foundry Company Earnings Per Share

Normalised to $100 as at 29 June 2009





Source: Bloomberg. As of 31 December 2019, USD.

It would hardly be motivating or stimulating for an investor to be questioned every time a target was missed or there was a big short-term swing in earnings. Nor would this have been a profitable use of time. The volatility of short-term earnings masks a significant rise in earnings power over the long term. We spend all our efforts trying to understand the drivers of the latter, which requires a discipline in ignoring the former.

We would go further, arguing that some of the greatest inefficiencies we encounter in EM are in companies where profits will be volatile from one quarter to the next, often as a result of investment or product cycles that are years in the planning. The market has shown a disdain for such companies, preferring the predictability of smooth profit generation even if the long-term growth rate turns out to be a fraction of that which is achieved by those with greater ambition and a willingness to reinvest in their business. This presents us with fantastic investment opportunities, but it requires an approach and culture that allows you to ignore near-term volatility.

You cannot invest in this way if you pay your investors for generating short-term performance. Quarterly or even annual earnings releases matter if you're paid on annual performance but ultimately, this is likely to be counterproductive. We pay our investors exclusively on rolling five-year performance. This ensures that we remain focused only on what really matters, bearing in mind the next year or two have very little bearing on the terminal value of a company.

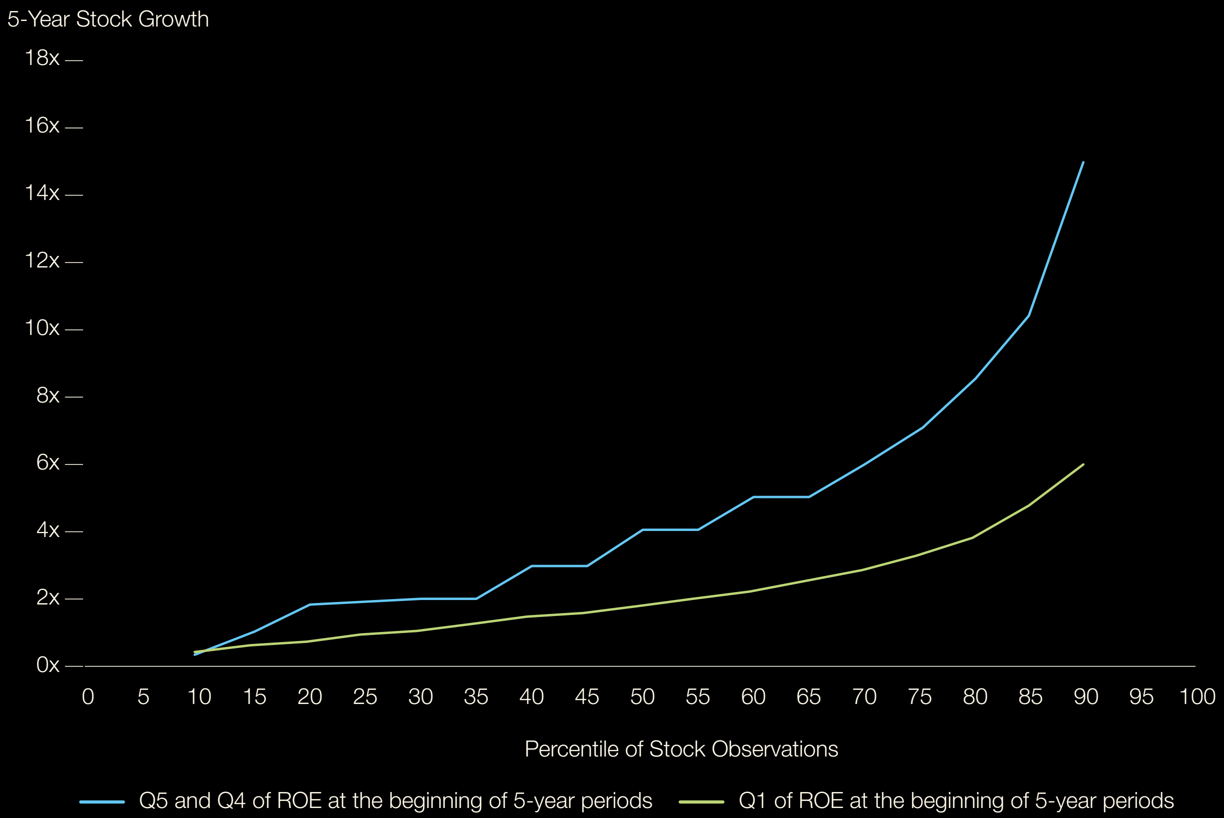
INFLECTION POINTS MATTER

Another great inefficiency resides in the interaction between top-down and bottom-up investing.

Investors in emerging economies do not have the luxury of ignoring the macro. Purely bottom-up investment is a path to ruin in a universe where industrial and economic cycles can dominate investment returns over multi-year periods. This also provides opportunities.

Our analysis shows that while it may pay to invest in those companies that display consistently high levels of profitability (as defined by those in the highest quintile of return on equity), the strongest returns are to be found in those companies that transition from poor levels of profitability to high (i.e. those that transition from the bottom two quintiles to the top quintile).

5-Year Stock Growth Percentiles by Quintile of ROE at the Beginning of the 5-Year Period
Stocks in Q1 of ROE at the end of the 5-Year Period



The graph above shows the results of our analysis of Asia ex Japan returns data from 1996-2020. We split this into 5-year return periods, rebalanced annually, and we studied quintiles of 5-year US dollar ROE. It shows that stocks transitioning from low ROE quintiles to the top quintile have often displayed strong returns. For example, 20% of the observations grew more than eight times over 5-year periods, as shown by the purple line. 5-Year Stock Growth Percentiles by Quintile of ROE at the Beginning of the 5-Year Period Stocks in Q1 of ROE at the end of the 5-Year Period.
Source: Factset. As at 31 March 2020.

This may seem obvious – rising levels of profitability are normally accompanied by a re-rating, thereby providing a two-fold kicker to share price performance – but identifying the drivers behind this change is key. We don't think you can stop at the company level. Take our position in Vietnam as an example. Our analysis must go well beyond the individual companies as the economic context in which they operate is so important. It is our view that this country is likely to be the best export manufacturing story in Emerging Asia over the next decade or more as trillions of dollars of low-end manufacturing transition from China. Our views are backed by a deep understanding of the regulatory and governmental support for this transition, not to mention the investment in education and infrastructure required to ensure its sustainability. Identifying and understanding drivers behind these long run transitions has been a valuable source of alpha over the years.

It is largely impossible to time these inflection points perfectly but when you have an investment horizon measured over many years, successfully anticipating the future direction of travel is hugely valuable. As one of our investors put it, we're not interested in the weather, but in climate change.

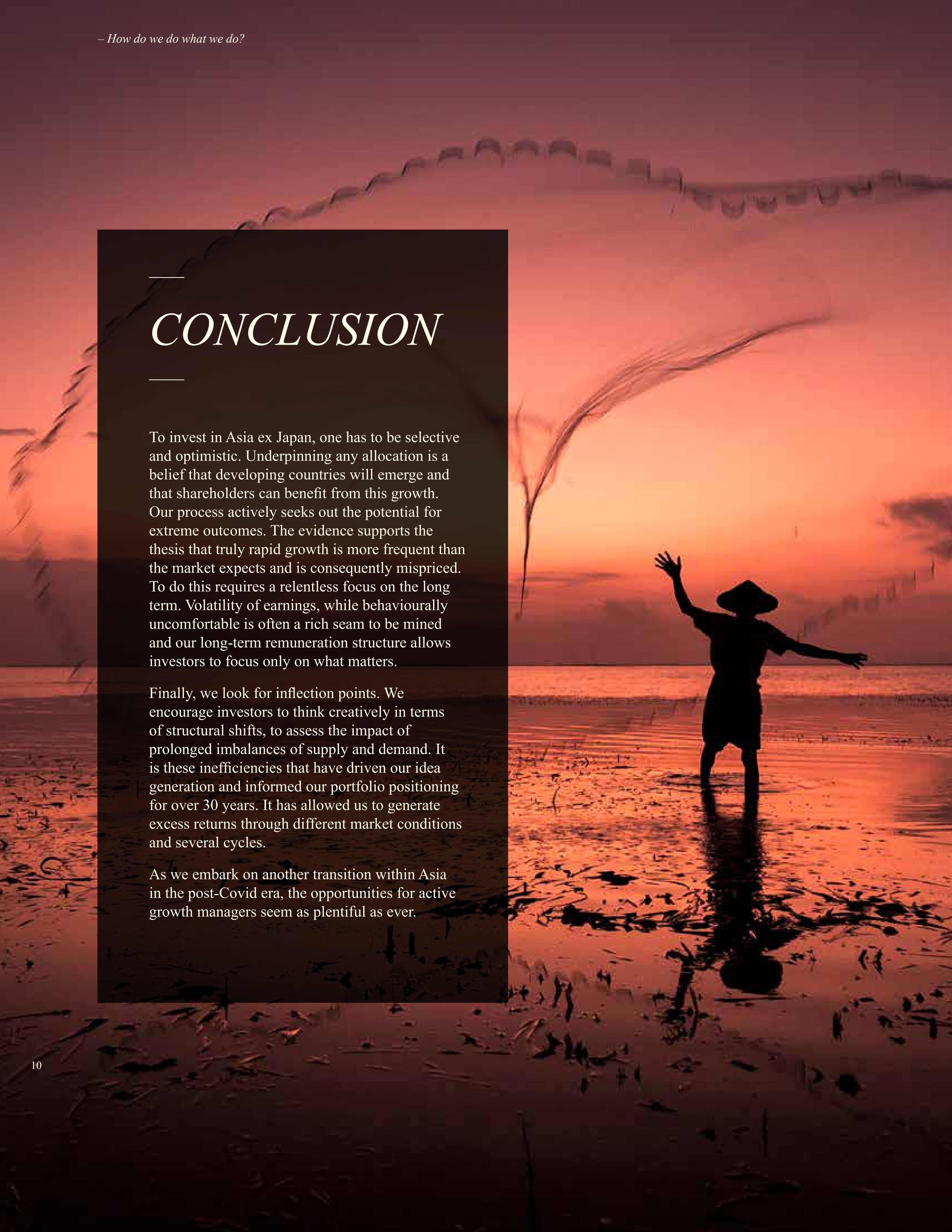
So how do we identify these inflection points? The first thing to say is that if you wait for all the evidence to be there that something has changed, you've already missed it. You will find very few estimates that assume a step change in return on equity. Dealing with incomplete information is the norm. Many Asian economies are still vulnerable to commodity shocks and volatile politics (albeit perhaps less so than in the west!), but there are reasons to suspect the balance of probabilities is now more in favour of hard currency growth than further retrenchment than we've seen for many years.

A good recent example of an inflection point we have identified is in nickel where we think the price is far too low and there are companies in Asia that will benefit. While many market participants obsess over GDP growth in the near term and changes in the stainless steel market demand due to the coronavirus (Covid-19), factors that contributed to our more positive view include:

— The level of capex being spent on greenfield projects (many of the largest miners are scarcely covering maintenance capex, let alone expansionary capex)

— Changes in demand (beyond the obvious global growth, what does a marked increase in electric vehicles mean for nickel?)

The ability to research these sizeable topics on a global scale, then join the dots and work back to the companies that stand the greatest chance of benefitting from these shifts in cycles has been one of the great strengths of our process. It is also why we would politely question those who argue Asian investing can be purely bottom up or those who rely heavily on backward-looking quant models. Cycles are frequently long duration, which in turn means they can overwhelm strong company fundamentals for multi-year periods. So, our process explicitly encourages our investors to make time to understand and anticipate cyclical change. Portfolio management and pure stock picking are very different skills and experience has taught us that marrying the macro with the micro helps not just with idea generation but ultimately it maximises the chances of consistent outperformance.



CONCLUSION

To invest in Asia ex Japan, one has to be selective and optimistic. Underpinning any allocation is a belief that developing countries will emerge and that shareholders can benefit from this growth. Our process actively seeks out the potential for extreme outcomes. The evidence supports the thesis that truly rapid growth is more frequent than the market expects and is consequently mispriced. To do this requires a relentless focus on the long term. Volatility of earnings, while behaviourally uncomfortable is often a rich seam to be mined and our long-term remuneration structure allows investors to focus only on what matters.

Finally, we look for inflection points. We encourage investors to think creatively in terms of structural shifts, to assess the impact of prolonged imbalances of supply and demand. It is these inefficiencies that have driven our idea generation and informed our portfolio positioning for over 30 years. It has allowed us to generate excess returns through different market conditions and several cycles.

As we embark on another transition within Asia in the post-Covid era, the opportunities for active growth managers seem as plentiful as ever.

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