

THE IMPORTANCE OF FUNDAMENTAL RESEARCH

A TRIP TO ASIA

Jenny Davis. Investment Manager. Third Quarter 2019.



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A TRIP TO ASIA

BY JENNY DAVIS

‘Human spirit is the ability to face the uncertainty of the future with curiosity and optimism. It is the belief that problems can be solved, differences resolved. It is a type of confidence. And it is fragile.’

BERNARD BECKETT

Growth investing is an inherently optimistic pursuit. To invest in growth is to say that society will achieve more tomorrow than it does today. It requires ‘the ability to face the uncertainty of the future with curiosity and optimism’, as the novelist Bernard Beckett put it. Curiosity should be at the heart of all good investment research. Research should both dream big about the future, and provide detailed examination of today; it should be considered, reflective, insightful. Spending time to get to know a company, its business model and management is critical to understanding its long-term potential.

That is what fundamental research is all about at Baillie Gifford. We start from the ground

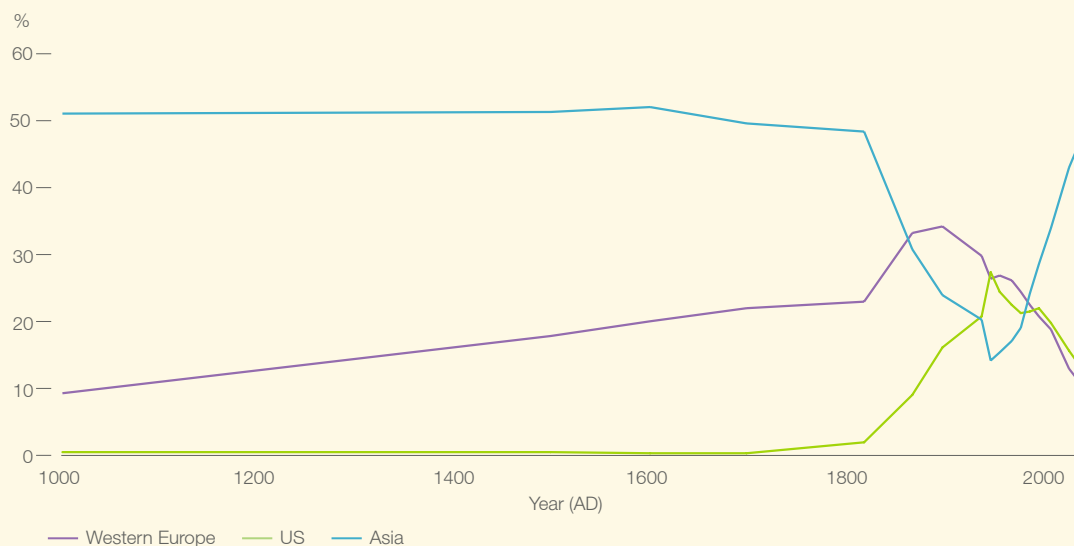
up, choosing our investments according to the strength of the opportunity irrespective of domicile or weighting in any index. We believe this gives us an advantage, particularly where markets are too short term in their outlook, thereby incorrectly pricing the potential for long-term value creation. It was this belief in the value of fundamental research that led me to spend a few months in Asia on an extended research trip. Those of us willing to think differently in this region can find significant opportunities. We consider where and what those opportunities are, and how by generating our own fundamental investment research we are well-placed to take advantage of them.

THE CHALLENGE AND THE OPPORTUNITY


The investment industry faces a challenge. Most of the money is managed in the West, yet an increasing proportion of investments are likely to be in the East. Of the \$18 trillion in global equity funds, 72 per cent of it is US-domiciled and 20 per cent European-domiciled. Yet Asia is home to half of the world's population, and almost all its growth. Asia is of huge importance already to global companies, accounting for nearly 45 per cent of revenues made by companies in the international benchmark. We will see even more Asian-domiciled businesses springing up: three-quarters of the world's family-owned firms worth over \$1 billion are in Asia, and many of these will seek public listings as first-generation wealth exits. The region is forecast to be larger than all the other regions combined in 2020 on purchasing power parity GDP, for the first time since the 19th century.

The geographic concentration of who runs the money is an aberration of history. Our industry was born in 1822, when King William I of the Netherlands launched the first closed-end investment companies. The goal was to finance industrial expansion of the Low Countries amidst the first industrial revolution. The chart below, built from the wonderful Angus Maddison's huge economic data project, gives some context to that moment in time. Over the past millennium, it is Asia that has dominated global GDP, apart from a blip following the industrial revolution when that world order was temporarily upended. And it is towards Asia that we can expect heads to turn again now.

Share of world GDP as purchasing power parity



Source: Actuals to 2010 (source: Angus Maddison data base, Economist Intelligence Unit); 2030 and 2050 are EIU and author forecasts.



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However, there are several behavioural biases which make it difficult to embrace the opportunity this presents. Our industry involves a lot of white, middle-class, Western managers running portfolios for pension boards of similar demographic profiles. That can give rise to insularity and home bias, leading to more research being written on the familiar companies in Europe and America than on lesser known businesses in Asia. No-one looks silly writing a report on IBM; there is a lot more personal risk in making a call on a completely unknown stock where the range of possible outcomes is much wider.

We are fortunate at Baillie Gifford to be able to do things a bit differently. The company's first investments in 1908 were in Asia. We saw the growing demand for automobiles in the West, but realised the interesting investments were in the East, in the supply of rubber for tyres. I believe we can continue to be at the forefront in the region today. The stability of the firm, the long tenure of staff, and the holding periods of our portfolios enable us to take time to think about where we can really add value over the long term. Our view is that we can add significant value for clients through fundamental research in markets which exhibit inefficiencies.

FROM THE GROUND UP

This belief in fundamental research led me to spend a few months on an extended research trip based in Hong Kong earlier this year, with an intention to research Developed Asia and Mainland Chinese companies. It was a particularly interesting time to be there, as the political climate became progressively febrile. Protests were springing up against the proposed Extradition Bill, throwing into sharp relief the changing power dynamics between Hong Kong and China. Hong Kong represented nearly 30 per cent of China's GDP in 1993, but that proportion has steadily declined. Now it is only 3 per cent, due to the rapid economic growth of Mainland China. It is no surprise, therefore, that Mainland China has been an increasing focus for the investment community.

China is vastly under-represented in the investment world: it generates 20 per cent of global GDP and yet domestic stocks only represent around 1 per cent of the world index.

However, we are at a very early stage of developing mutual understanding between Mainland Chinese businesses and long-term professional Western investors. Few Chinese companies have an annual report in English, and the level of disclosure in those reports is inconsistent and typically poor. Common sources of information, fact-checking, and discourse are either absent or have compromised independence. There are idiosyncratic complications such as separated economic and legal entities, costs of doing business that do not appear

in listed financial statements, and state ownership which makes the competitive field uneven. One must be extremely thorough in examining data. For example, the historical financial statements of one healthcare company I researched when in China did not refer to healthcare at all! They actually referred to the sale of motorcycle parts business by an accident of its listed entity. Not only is reliable information sparse, but the A-share markets contain some of the most volatile, highly-levered, poorly governed stocks in the world, with a nasty penchant for diluting minority shareholders, and an average investor holding period half that of the global average at only around six months.

Fear not, for therein lies the long-term opportunity for fundamental research. There will be a small number of less-discovered, mispriced gems for investors willing and able to put in the time for thorough analysis. We find that earnings drive share prices over the long term, and that this correlation strengthens as the holding period of investors increases. Our fundamental analysis, therefore, focuses on long-term earnings potential. A good investment is in a company that can weather storms and take advantage of market cycles or unforeseen events, getting stronger as the time passes. To achieve that, there needs to be a reason why its revenues and profits will grow, it must have a durable competitive advantage, and its management must be aligned with the long-term success of the business.



We find several Chinese companies which meet our criteria for further work, and my time in the region was the perfect opportunity to dedicate time to understanding them within their home context. China is a country of such magnitude and relative homogeneity that businesses can achieve things seemingly impossible elsewhere, such as the monetisation of a vast number of very small transactions. This was abundantly clear from the companies I met while there. China's leading food delivery platform delivers the largest number of lowest value food orders in the world; in cities it is often cheaper to have food delivered than to make or buy it yourself. Its leading e-commerce platform can process a phenomenal \$30 billion of orders in a single day, with each order only ~\$30 on average. Its largest payments platform has 900 million users, nearly triple the entire American population, making high-frequency small-ticket transactions. Because of this ability to monetise small interactions at scale, we see totally new business models cropping up. For example, who would have guessed that China's largest online music platform makes most of its profits from users spending around \$1 a month to do things like send virtual rotten eggs at a fellow user's particularly bad karaoke performance? There are ways of doing things that are totally different in scale and scope which the fundamental analyst needs to understand from the bottom up.

Much as Baillie Gifford's first investments were not in Western cars but in Asian rubber, we look across sectors and regions to find the best-placed businesses. In China, there is a huge unmet need for better healthcare: a vast range of diseases are under-diagnosed, certain drugs are overprescribed due to bribery



and kickbacks, and reimbursement is low with nearly 40 per cent of costs being met out of pocket. It is to insurance that we look for some of the best-placed businesses to meet this growing demand for healthcare. Insurers fill the gap of health, life and critical illness cover that the State is unwilling to cover. Moreover, there is a hotbed of innovation here, ranging

from wellness schemes to incentivise healthy behaviour and thereby lower insurance claims, through to AI-powered online diagnoses and prescription purchases which reduce the need to visit the hospital. This innovation is often evolving along quite different paths from those of Western businesses, and often doing so far more rapidly.

WHAT IS RESEARCH BUT CREATIVITY?

How do we go about this research?

At Baillie Gifford, there are two steps in our process. The first is to cast the net wide in reaching for data and differing opinions. We widen the net of information sources by, for example, consulting with academics who are outside the echo chamber of our industry and have different incentives driving their thought processes. Most recently, I have been communicating with an academic based in Shanghai on the sociological impacts of WePay and AliPay: these are more than simply tools for monetary exchange; they are methods of ascribing social credit to an individual's character, and that has huge implications for the fabric of society. We seek diverse opinions and lateral transmission of wisdom by, for example, inviting colleagues in other teams to our stock discussions in order to combine specific expertise with global perspectives.

The second step in producing good research is the hardest to pin down, because it is transmutation, turning today's information into tomorrow's insight. In his book, *Farsighted*, Steven Johnson describes the process of making complex decisions as running multiple mental simulations, imagining how the future will unfold. It is the same process one would undertake if writing a piece of science fiction, which is why Bernard

Beckett's quotation at the beginning of this paper is fitting, as it comes from a sci-fi novel. Steven Johnson finds that those people best at making complex decisions read a lot of novels. And we would concur, having actively hired a far higher proportion of humanities graduates than is typical of our industry.

It is highly worthwhile us investing now in building up our institutional understanding of high-quality businesses in inefficient markets. We are opening an office in Shanghai to be dedicated to investment research, populated by Baillie Gifford investors trained in Edinburgh, who also have local language skills and knowledge. This recognises both the magnitude of the opportunity and the specific challenges the region presents. We will certainly be judicious in how we invest our clients' money, and will have done thorough research in advance, but there are good reasons to be brave. Academic research indicates that the presence of long-term investors has a positive impact on strengthening governance and corporate decision making, as well as creating a more stable base from which companies can innovate, in turn delivering higher shareholder returns. We can have a positive impact on markets by participating in them, and on businesses in which we take holdings.



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FUNDAMENTAL RESEARCH IS THE KEY TO UNLOCKING OPPORTUNITIES IN ASIA

Our industry faces a challenge: it will have to address its Western bias if it is to fully embrace emerging opportunities and deliver long-term outperformance for clients. To do that will require a firmly active and bottom-up philosophy. It is not sensible to become a passive investor in markets which have such patchy data. We assess the quality of a business model from the bottom up, and compare it globally through team-based collaboration, rather than simply buying a play on theme x or y and churning the portfolio to chase hype. Our competitive advantage at Baillie Gifford is having time to think. The stability of our firm, long tenures, deep institutional memory, and lengthy holding periods enable us to undertake thorough fundamental research. We believe that gives us the ability to explore a region abounding with opportunities.

ABOUT THE AUTHOR



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Jenny is a portfolio manager for International Alpha clients, having been a member of the Portfolio Construction Group (PCG) since 2016. She joined Baillie Gifford in 2011 and worked on two of our global equity strategies, having started her career at Neptune Investment Management. Jenny graduated MA in Music from the University of Oxford in 2008, and latterly undertook postgraduate studies in Psychotherapy at the University of Edinburgh.

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