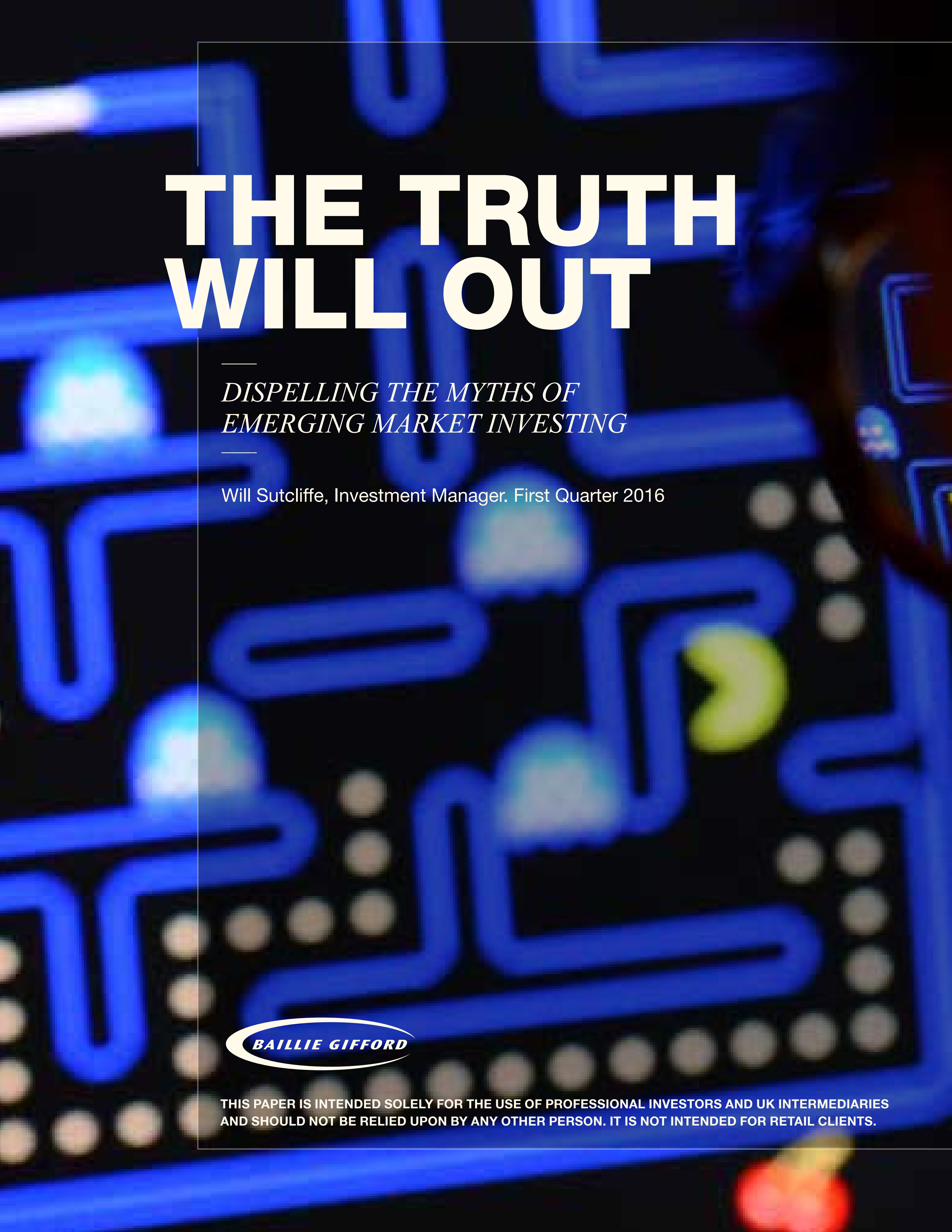

THE TRUTH WILL OUT

DISPELLING THE MYTHS OF EMERGING MARKET INVESTING

Will Sutcliffe, Investment Manager. First Quarter 2016

BAILLIE GIFFORD

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MSCI Emerging Markets Index Annual Past Performance
To 31 March each year

2014	2015	2016	2017	2018
-10.2%	12.8%	-9.1%	34.7%	11.4%

Source: FE and underlying index provider. Total return, GBP.

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THE TRUTH WILL OUT – DISPELLING THE MYTHS OF EMERGING MARKET INVESTING

BY WILL SUTCLIFFE

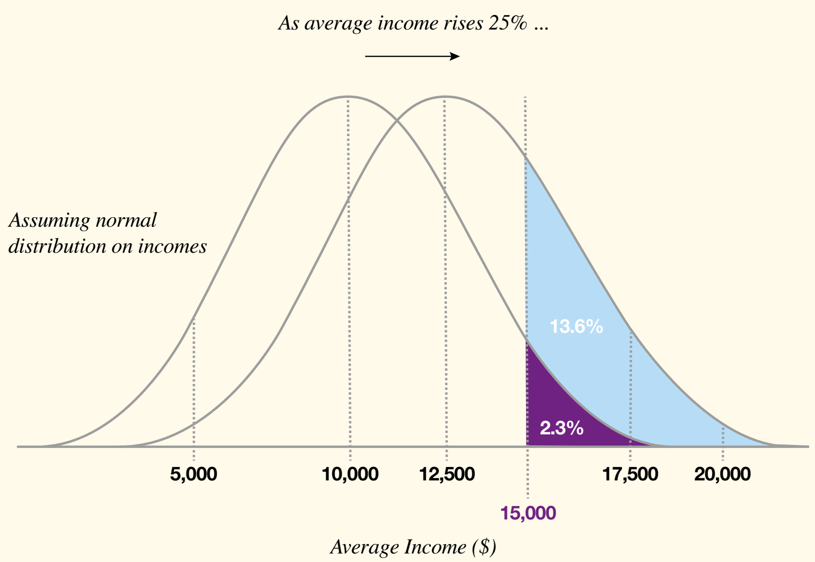
It is inevitable, after many years now of poor returns from emerging market (EM) equities, that investors are asking why they should keep the faith. Reasonable relative returns are of little comfort when the absolute numbers are so weak. What follows in the next few pages is our assessment of where we are in terms of the attractiveness, or otherwise, of the EM asset class.

The generally accepted rationale for allocating to Emerging Market (EM) equities can be broadly summarised as follows: if EM income levels gradually converge with developed markets (DM) income levels, then that should provide a powerful tailwind for earnings per share growth for a whole range of companies. Does this basic intellectual justification for holding EM equities still stack up?

The chart below neatly illustrates the premise. It is one that will be familiar to every seasoned EM investor, demonstrating what the French economist Albert Aftalion called *'l'effet accélérateur'*. That is: assuming steady growth in (normally distributed) incomes, the number of affluent people grows exponentially. In this example, a 25% increase in average income (from US$10,000 per capita to US$12,500) leads to a seven-fold increase in the number of people earning above US$15,000 per capita.

This matters, because as poor peoples' incomes rise, their patterns of consumption are thought to change in a fairly predictable manner. At US$1,000 per capita, people start to buy branded toothpaste and washing powder; at US$5,000 per capita, they start to buy TVs and mobile phones; at US$10,000 per capita, they start to buy cars and put down payments on houses; at US$15,000 per capita, they start to buy luxury goods and take foreign holidays.

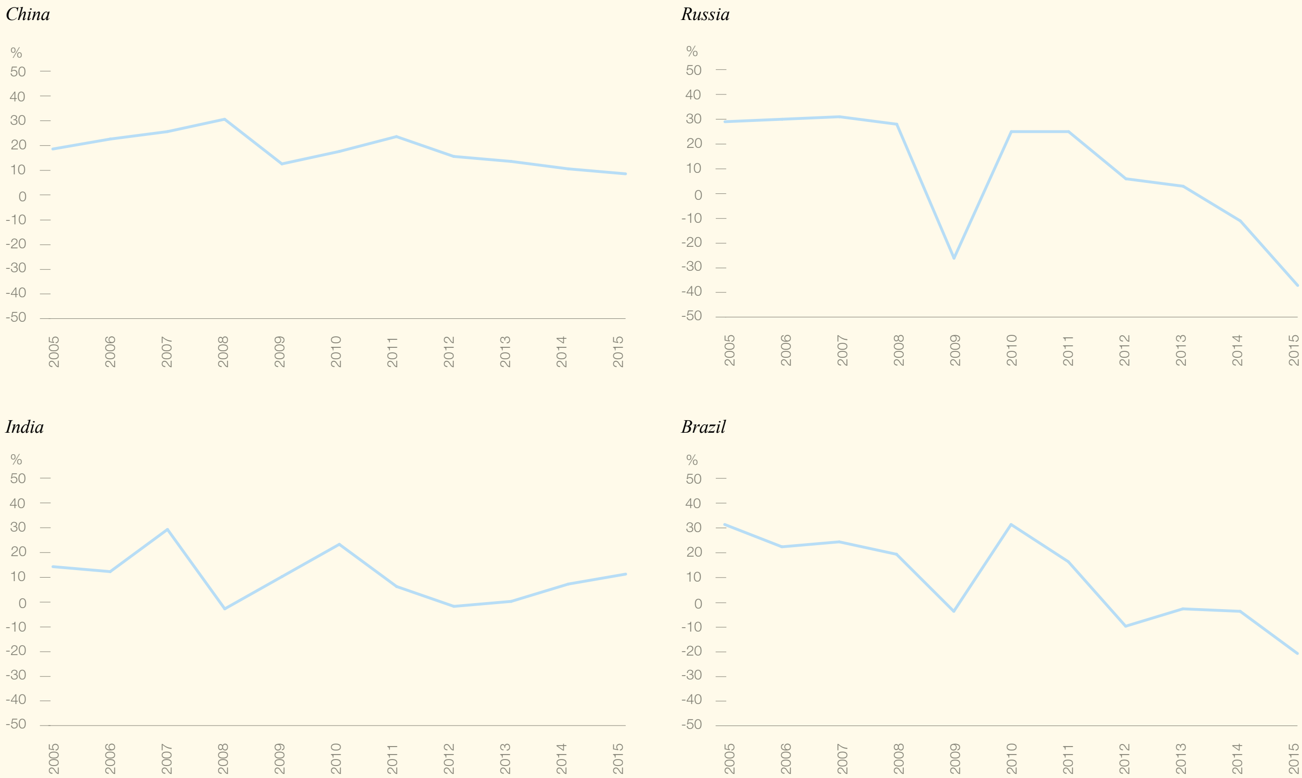
And for EM portfolio managers, the best thing about this is that it means you don't have to think very hard! After all, predicting what poor people will buy when they get richer is much easier than predicting what people who are already rich might buy in the future.



... the share of the population with incomes above US$15,000 jumps nearly 7 times, from 2.3% to 15.9%

Source: Gavekal, 'Chinese Equity Demand and the acceleration phenomenon', 29 June 2015.

Nominal GDP Growth in US dollars (YoY,%)



Source: International Monetary Fund, World Economic Outlook Database, April 2015.

So the seemingly foolproof recipe for success as an EM manager is to simply cram your portfolios full of Indonesian supermarkets, Brazilian beer companies, Indian car manufacturers and Chinese airlines, and then sit back and wait for the compounding.

Unfortunately, there's a rather large flaw. As has become abundantly clear in recent years, income levels in EM do not always go in one direction...

The charts above show GDP growth in nominal USD terms for the BRIC economies over the past decade. The crucial bit here is to look at these charts in dollars because hard currency growth is ultimately what should matter to foreign investors, and yet people still fall into the trap of thinking about EM growth in only local currency terms.

This can make a huge difference; one only has to look at Brazil. During the glory years, Brazilian GDP was growing at 4% p.a. in real, local currency terms, and is forecast to fall by 1% this year, again in real local currency terms. That doesn't seem like much of a swing factor, which is why plenty of bottom-up investors will tell you that macro doesn't matter: it's all about buying great companies.

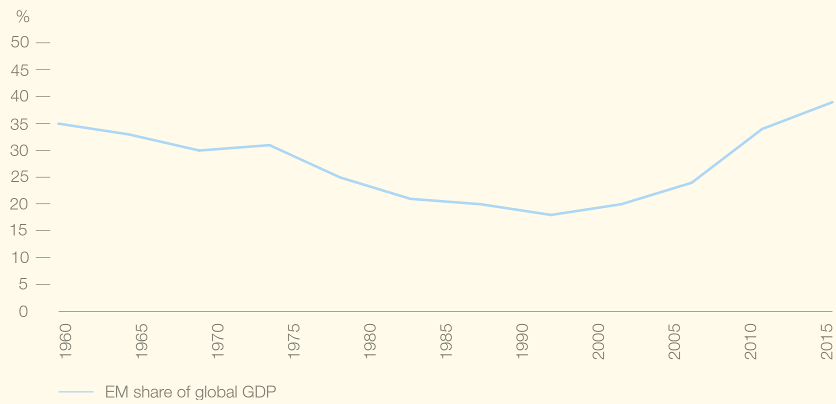
But look at these growth rates again in nominal dollar terms. When Brazil was growing GDP by 4% p.a. in local currency terms, a massively positive terms of trade shock from high commodity prices meant that in USD terms the economy was growing closer to 30% p.a.. In 2015 the economy shrank by around 20% p.a. in USD terms. In Russia, with oil going from US$140/barrel to about US$40/barrel, the fall from grace has been even more dramatic. In 2015 the Russian economy shrank by around 40% p.a. in USD terms.

We agree with the rationale for buying great companies, but no matter how great the company is, be under no illusion as to just how helpful this was for earnings and share prices on the way up, and just how much of a hindrance it becomes on the way down.

This is a problem. Because the dirty little secret of EM investing is that periods of strong economic growth appear to be the exception, rather than the norm.

Income levels in EM do not always go in one direction...

EM Share of Global GDP, current dollars.



Source: International Monetary Fund, World Economic Outlook Database, June 2015.

This graph shows EM's share of global GDP over the past 55 years. As you can see, the last decade or so has been absolutely terrific: EM has gone from 20% of global GDP to nearly 40%. But the longer-term history is far less illustrious. Yes, we've had occasional periods of excitement in local currency terms, but when you look at it in dollar terms, the region has spent most of the post-war period going backwards.

Let's go back further. Over the past 150 years, how many countries have managed to sustain elevated growth rates over multi-decade periods? We can probably count them on one hand. Argentina managed it between 1870 and 1920, and has been sliding backwards ever since. The USSR managed it for about 40 years before running out of steam in the 1980s. And, of course, a number of the North Asian tigers have successfully emerged in the last 50 years. But the clear lesson of history is that managing the transition all the way from third-world to first-world is a remarkably difficult thing to do.

But markets love to extrapolate from the recent past, which of course is why it was such a positive shock to asset prices when growth began to accelerate in the early 2000s, and such a negative shock now that growth has slowed, or even gone into decline. Our industry is full of investors for whom it is axiomatic that poor countries inevitably become richer over time.

Remember that it wasn't just the scale of EM growth over the past decade that was remarkable: it was the breadth of that growth. Asian exporters were doing fantastically well by selling goods to western consumers, exporters in the rest of EM were doing fantastically well by selling commodities to China, and alongside this great pan-EM export story was a great pan-EM consumption story, which was turbo-charged by debt, as all of the banks that had gone bust in the Asian crisis in 1997 were recapitalised and started to lend again.

Today, the commodity super-cycle is over. The export manufacturing model is under question. Credit cycles are long in the tooth. With the advent of Fed tightening, all of those dollars that flooded into EM have been flooding back out.

So let's be absolutely clear. The golden age for EM economic growth is over.

Today, the commodity super-cycle is over. The export manufacturing model is under question.

The good news is that there should still be plenty of growth to be found in EM over the next decade.

GREAT OPPORTUNITY SET

That's the bad news. The good news is that there should still be plenty of growth to be found in EM over the next decade. We can go further: for some individual stock-specific winners, we think it is quite possible that the growth opportunity may be far larger than anything EM investors have seen before. For sure, it will be a far less forgiving environment than the previous decade. The gap between the winners and the losers is likely to be far more profound, and there are large chunks of the index that still appear vulnerable.

Of course, as active investors, you would expect us to say that. But it is consistent with the way we have approached the asset class since we first began running Global Emerging Markets mandates more than 20 years ago. There have been times when much of the index has appealed to us from an investment perspective: the mid-1990s, for example, or 2003–2008, when we were finding lots of attractive investment ideas from a range of countries and sectors across EM. Conversely, there have been times when our investment enthusiasms have been far more narrowly concentrated, which was the case in the late 1990s, and which has again been the case since 2011 or so.

But let us put this in perspective. Yes, falling commodity prices and spiralling dollar debt will be problematic for some of the larger EM economies such as Brazil, Russia or South Africa. But in much of Asia it is a very different story. The two behemoths of China and India, in particular, have massive scope to offset the external liquidity squeeze with countercyclical monetary policy.

In the current environment, Mr Market may not be in the mood to discriminate, and there are plenty of babies being thrown out with the bathwater. But as long-term investors, hopefully this need not trouble us too much and indeed should provide fertile ground for stock-picking.

So what are some of the new themes that we think will really matter for EM investors over the next decade?

Despite what you may read in the press, China still matters. We read a lot of commentary on China. Over the past 12 months, we've read an awful lot about volatility in the A-share market, the so-called 'devaluation' of the renminbi and the slowdown in headline GDP. However, we're not convinced that any of this matters all that much.

Far more important than the size of China's GDP is its shape, and Beijing's ability to pull off a 'benign rebalancing' from the turbo-charged, investment-led model of recent decades, towards a more consumption-oriented model.

Again, there's been lots of commentary on this, and confusion about whether economic reform is heading in the right direction. We do not claim to be Sinologists; but nor are we convinced that it is particularly helpful to view China's economic reform through a Western prism. Rather if we can simply take Xi at his word, and look at what he's actually done since ascending to power in late 2012, he seems to be giving a pretty clear signal about where China has been and where it needs to go.

China, after all, was a great world power for 2,000 years. Under the Song dynasty, China led the world in technological innovation: clocks, gunpowder, paper, porcelain and blast furnaces were all developed in China well before they came to Europe. When the Jesuit missionary Matteo Ricci visited the Middle Kingdom in 1602 with European maps that had China relegated to the margins, he was instructed to re-draw them, putting China right at the centre of the world. And getting back there – albeit in political and economic terms, rather than cartographical ones – is the essence of Xi's China dream. Rebuilding began with Mao's victory in 1949, and ended in 2012, by which time the massive investment in infrastructure and export manufacturing had helped China to leapfrog Japan as the world's second-largest economy. For Xi, the next stage of national revival appears to be heavily rooted in promoting technology.

This is apparent in the sectors that Beijing has highlighted for special attention: robotics, internet infrastructure and semiconductor hardware. It is apparent in the state-run media that is full of all articles about 'innovation'. Equally, it is apparent in Xi's promotion of home-grown tech companies as champions of the new, liberalised China to which he aspires.

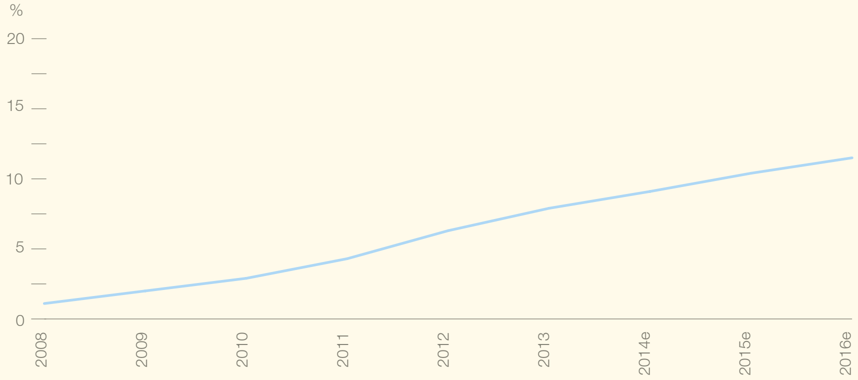
It strikes us that the Chinese internet sector has always represented something of a conundrum for the China bears. How on earth can an economy that is apparently hopelessly mismanaged possibly have produced an internet sector that is so staggeringly successful? One possible answer to this conundrum is that the prospects for China's internet sector are so good, precisely because legacy competition in the old economy is so woeful.

China, after all, was a great world power for 2,000 years.

Imperial Tombs of the North Song Dynasty at Gongyi, Henan province, China.

Online Shopping Penetration in China

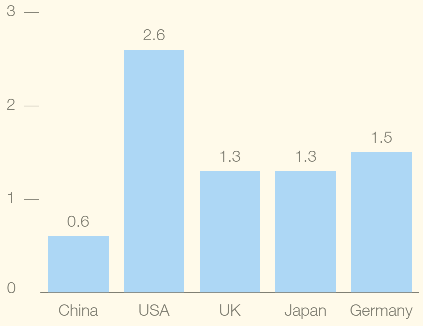
Online shopping as % of total consumption



Source: SEC/iResearch.

Retail Infrastructure

Retail space per capita in square meters, 2013



Source: SEC/Euromonitor International.

Retail is an obvious example of this. Americans do 6% of their shopping online, and it has taken about a decade to get there. China has already got to 8%, and it has taken less than five years. Now, maybe this is just cultural. We all know of the Chinese affinity for shopping: they spend about ten hours a week doing it, compared to four hours for the average American, and we all know about the Chinese affinity for spending time online: over three hours a day, compared to two hours in the US.

But remember also that for a lot of Chinese consumers, 'going shopping' may not be that pleasant. The traffic is a nightmare, the crowds are awful, and all so you can end up in some dingy, state-run department stores selling overpriced lipstick. No wonder so many of them are logging on to online shopping sites instead: it is convenient, cheap and you have chat rooms where your buddies can recommend what they're buying. The offline retail sector just cannot compete.

Hence this idea of 'leapfrogging' that has become a key theme in EM. Physical retailing infrastructure still may not be particularly developed, but perhaps it stays under-developed as consumers simply leapfrog to the next stage of development. In this environment, the large Chinese e-commerce companies should be the big winners. Of course there will be big losers too.

One trend that is worth highlighting is the apparent disconnect between what the official economic statistics are telling you, and what corporate results are telling you. According to the top-down numbers, the industrial sector is in deep recession, and yet consumption appears to be holding up well, with retail sales still growing at close to the level of the mid-2000s. However, corporate results tell a different story, with same-store sales at department stores and supermarkets in deep negative territory, and double-digit declines in volumes for some consumer brands.

One interpretation is that the official numbers are all made up, and the downturn is far worse than they suggest. But when you bear in mind the very strong top-line growth that we continue to see at the internet companies, another possibility is simply that the big listed behemoths of China Inc. are struggling to cope as physical capacity is being rapidly cannibalised by the move online.

> *Why e-commerce in the US is not that good is because the infrastructure of commerce was so good... In the US, e-commerce is a dessert. In China, it's a main course.*
>
> JACK MA, FOUNDER OF ALIBABA

Of course, the losers will not just be confined to bricks and mortar retail or consumer staples. Some of China's large internet companies are behaving more and more like Pac-Men: increasingly moving away from their core monopolies, starting to gobble away at every market imaginable, from autos, to healthcare, to luxury goods. Now finance is the latest battleground. And the end game, of course, is data. The more terabytes of data you can gather, the easier it becomes to pivot into new industries and offer new services to new customers. And the longer that process goes on, the harder it becomes to disrupt.

This affinity with technology has been one of the most distinctive characteristics of our EM portfolios for a number of years now, with 'tech' (as defined by MSCI) accounting for around half. We would argue, however, that this is a pretty unsatisfactory way of describing a disparate range of companies with very diverse drivers, from the global hardware champions through to local internet companies.

However, in broad conceptual terms this probably makes sense. We are growth investors: in an era where economic growth is far scarcer than the previous decade, it seems rational that we focus on those parts of the market where we can find the most powerful secular growth trends. And many of these companies are prime beneficiaries of our view that the revolution in mobile data is likely to have an even more profound impact in EM than it will have in DM.

In 2014, there were 2.5 billion people on the planet with access to high speed mobile internet; by 2020, this number will have trebled, and nearly all of these incremental subscribers will be in emerging countries. Not only will they be leapfrogging legacy infrastructure that is far less developed than it is in most DMs, they will be leapfrogging the desktop era completely. They will be far more comfortable using the mobile internet than most of us probably are, and it is quite likely they will use it in very different ways.

Of course, it is quite possible that we are wrong about all of this. Or, more plausibly perhaps, that we are right about the themes, but that we don't make any money for our clients by holding the stocks. After all, received wisdom is that all tech stocks blow up at some point. The industry has claimed plenty of prominent carcasses, from Nokia and Blackberry to Pets.com. The Buffett doctrine famously suggests that investing in the tech sector is not something that serious investors should contemplate, and plenty of economic theory from Adam Smith onwards tells us that innovation is unlikely to be profitable for investors over the very long term.

Yes, technology may be easy to replicate; great cultures and great business models are far harder.

The lesson of history is that the deflationary force of innovation can be great for consumers, and great for economic productivity, but is it great for the owners of the assets? James Montier at GMO talks about 'The Siren of Growth'. The problem with growth investors, he says, is that we tend to get sucked into stories at the wrong point of the cycle, and overpay for growth. So, where are we in the current cycle?

We can start by observing that valuations of the stocks we invest in are very far from the 'EV/eyeballs' madness of the late 1990s. The MSCI EM tech sector currently trades on around 1.9x book, down from 2.5x six years ago. One of our largest tech holdings trades on 9x forward earnings before stripping out the cash. Clearly, the market sees very little chance that this company will be able to quintuple earnings over the next decade, as it did in the previous one. Our view, of course, is different.

Even the racier internet companies, now trade on less than 23x our estimate of next year's earnings: similar to the multiples attached to many of the supermarkets and department stores in the region whose very existence they are threatening. To us, this looks deeply anomalous. Ultimately, our enthusiasm for these businesses comes back to our earlier comments on great companies. Yes, technology may be easy to replicate; great cultures and great business models are far harder.

But what do we mean by 'great businesses'? When people in our industry refer to 'quality' companies, what they usually mean is businesses that are likely to generate steady, predictable growth in earnings and cash flows. And it is precisely these sorts of businesses that have become so sought after by investors in the wake of the Global Financial Crisis, particularly in EM. We can observe, for example, that the multiple on the MSCI EM Consumer Staple sector is currently at a 20-year high of 3–4x book, having nearly doubled in roughly the past five years.

Whenever we hear investors extolling the virtues of predictability and stability in EM, we are reminded of Nassim Taleb's story of the Thanksgiving turkey. Every day, for 1,000 days, the farmer brings the turkey food. And every day the turkey becomes more and more confident that it will always be loved and cared for by the farmer. Right up until the last day!

How many turkeys will be uncovered in EM over the next couple of years? There are plenty of companies in EM with apparently illustrious track records. To what extent does the track record reflect genuinely high-calibre management and excellence in brand building? Or does it simply come down to being a well-connected local champion that has benefited from a rising macro tide? Now that the economic tide has turned, and competition is coming fast from new and unexpected sources, we suspect this distinction is really going to matter.

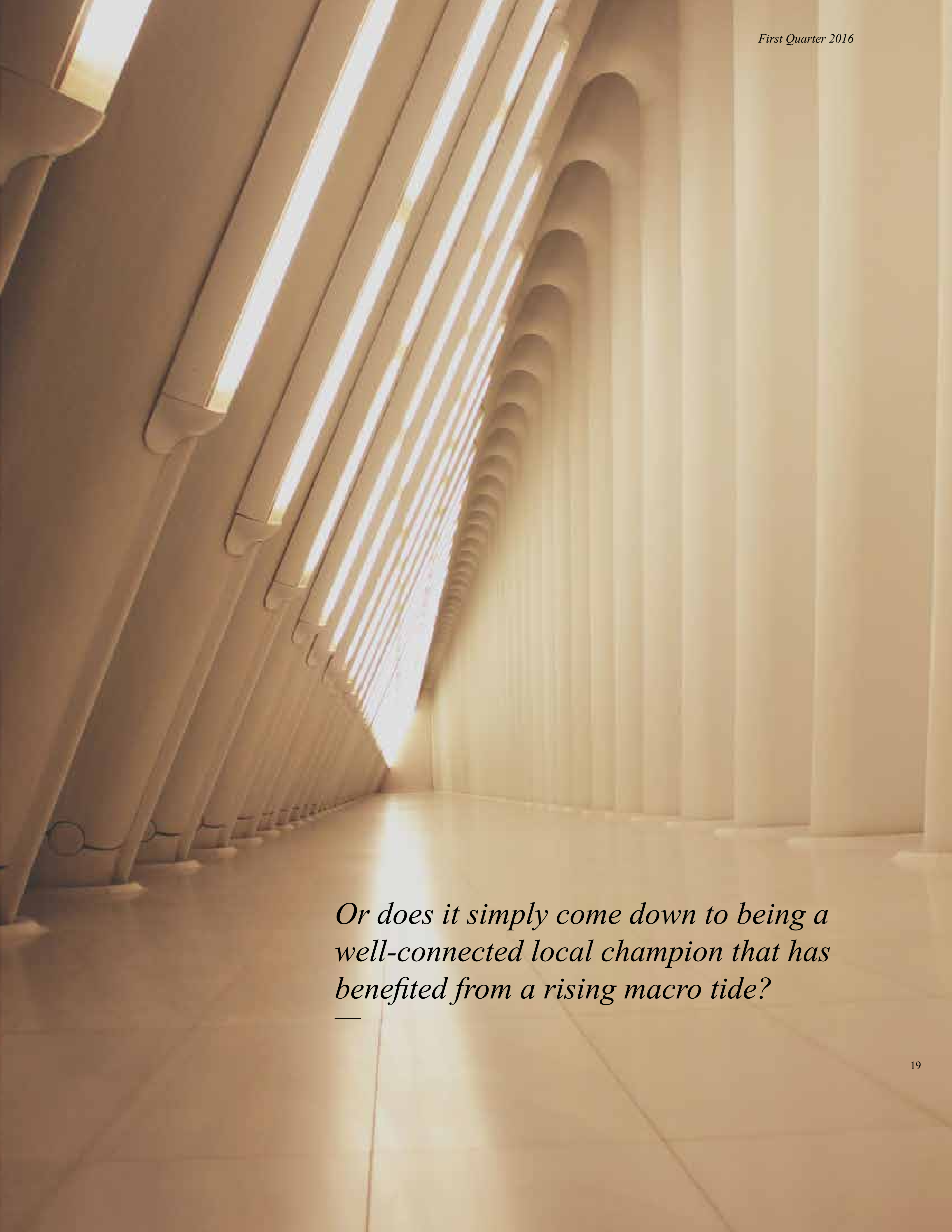
Phil Fisher, the 'godfather' of growth investing, set out what he looked for in companies back in 1958. He wanted companies with a substantial existing growth opportunity. He wanted management with the courage to invest both in the existing opportunity, and in new opportunities that might sustain longer-term growth. And when he found companies like that, he wanted to hold them for a long time. As a basic philosophy for growth investors, few people have articulated it better.

A determination to invest in long-term growth opportunities, even if it depresses profits and cash flows in the near term: this is exactly what has attracted us to most of our longstanding holdings over the past decade or two. Jack Ma, for example, made that absolutely clear when he laid out his priorities as 'customers first, employees second, shareholders third'. To the extent that this rejects the Friedmanite mantra of market fundamentalism that has endured for the past 30 years, this may be an uncomfortable thought for many of us. But as a statement of ambition, it is quite astonishing.

So, to return to the question posed at the beginning – 'should we keep the faith?' – hopefully our own answer to this becomes clear. In short, yes, but not for the reasons many will cite. The attraction lies not in the headline multiples attached to the EM universe, nor in the simplistic belief that poor countries always become richer, but rather in the chance to invest in fantastic businesses with colossal growth opportunities in front of them.

To conclude, it is perhaps worth answering the most frequently asked question we have received from clients and consultants over the past few months, 'surely EM equities are far too cheap now?'. If only it was that simple. Sadly, however, looking at the valuations of the EM equity universe as a whole is not very informative. At the risk of stating the obvious, remember that the headline discount to DM that is often used to expound the value available in EM is the aggregation of local currency earnings from hundreds of companies. These earnings estimates tend not to adequately factor in currency depreciation versus the dollar and it is often overlooked that about a quarter of the MSCI Global Emerging Markets market capitalisation is State Owned Enterprises. So, despite the MSCI EM index both on a price to book and price earnings basis being near historic lows both in absolute terms and relative to DM, we remain cautious on large swathes of the index that will struggle to grow their earnings, in dollar terms, over the coming years. As such, it is hard to enthuse wildly as to the prospects for the universe overall. That said, it is clear to us that the horrible performance of EM equities over the past few years has provided some striking opportunities to buy terrific businesses at very cheap valuations.

Ultimately, this is where investors will recoup their returns from EM and why, more than ever, it is worth spending the time to distinguish those businesses that do not rely simply on a favourable macro backdrop or seek growth by merely replicating the successful business models of the developed world. What encourages us to stay the course is the emergence of a small number of companies with the courage, patience and imagination to match and perhaps even supersede what the best of the rest of the world has to offer. Furthermore, current markets have ensured that the asking prices for these businesses are as attractive as we can recall.



Or does it simply come down to being a well-connected local champion that has benefited from a rising macro tide?

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