

EMERGING MARKETS: COMING OF AGE

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COMING OF AGE

BY WILL SUTCLIFFE

*'Here be giants'. Or dragons, or monsters ...
apocryphal phrases that have become synonymous with
the early cartographical practice of drawing all manner
of terrifying mythological creatures on uncharted areas
of maps to represent the dangers that lurked there.
Where there is ignorance, there is fear.*

...titans of the memory and processing technologies that make our world a better, smarter and safer place.

Emerging Markets (EM) have always been regarded as the investment equivalent of terra incognita. While the very term ‘Emerging Markets’ was originally created as a clever piece of marketing to make it seem a less scary place – the bankers at JP Morgan knew that no-one in the early 1980s would buy the ‘Third World Equity Fund’ that Antoine van Agtmael was proposing – the connotations have been hard to shake.

Just open a newspaper: you can still read about the region’s apparent over-dependence on trade and dollar debt (never mind that external balances are the healthiest they have been in decades), the vulnerability of basket cases such as Argentina or Turkey (never mind that outliers like these are now a fraction of our investable universe), or the imminent collapse of the Chinese banking system (never mind that it didn’t happen amid bridges to nowhere in 2010, or the anti-corruption campaign in 2014, or the trade wars of 2017...).

For a more accurate picture of where the asset class is going, however, just look at what’s happening on the ground. For sure, there are giants: they are the titans of the memory and processing technologies that make our world a better, smarter and safer place. They are the colossi of the new energy supply chain that are helping to clear the skies from Shanghai to São Paulo. They are the hecatoncheires of the internet world, pivoting from one sector of the economy to the next with

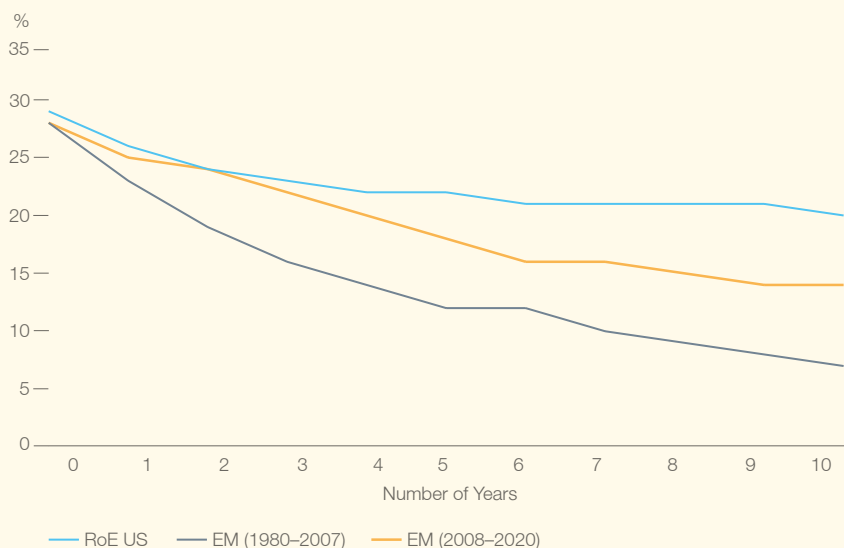
customer offerings that vastly outstrip anything that has come before. They are getting bigger and better. And they are multiplying.

This feels like an important coming-of-age for the asset class. After all, one of the longest-standing complaints that equity investors have had is its dearth of truly world-class companies. For too long, stock-picking in EM has often felt like trying to select the best-looking horse in the glue factory: investors could choose between trying to surf the cycles in a series of me-too national banks, resource plays and utilities, or pay eye-watering multiples for the relatively predictable but much more staid growth on offer at a cluster of multinationals in the

consumer staples sector. Where are the impregnable moats, the visionary management teams, the products that people buy because they want to, not simply because they lack alternatives?

This dearth of ‘quality’ is sometimes illustrated by comparing the progression of returns on equity from emerging and developed equity indices. For example, as the chart below suggests, US companies that start with RoE in the top quintile tend to see relatively glacial declines in profitability over the years – the inference being that the best US companies are well-equipped to fight off the perils of obsolescence, competition and mean reversion. In EM, however, the decline in RoE

RoE Trajectory (Top Quintile)



Source: Bloomberg, factset and BoA.



© Bloomberg/Getty Images.

tends to be much more rapid. The rationale? Take your pick from a lack of decent brands, a lack of scale beyond home markets, a lack of innovation, a tendency of governments to attack excess returns, or a bias towards sectors that are hostage to swings in macro fortunes. This is probably also why EM has historically been assumed to be more fertile hunting ground for value investors, as the promise of persistently high growth and returns in EM turns out to be a chimera. Indeed, while growth has had a better time of late, it's worth remembering that for most of the 1990s and 2000s, value strategies in EM were generally on top.

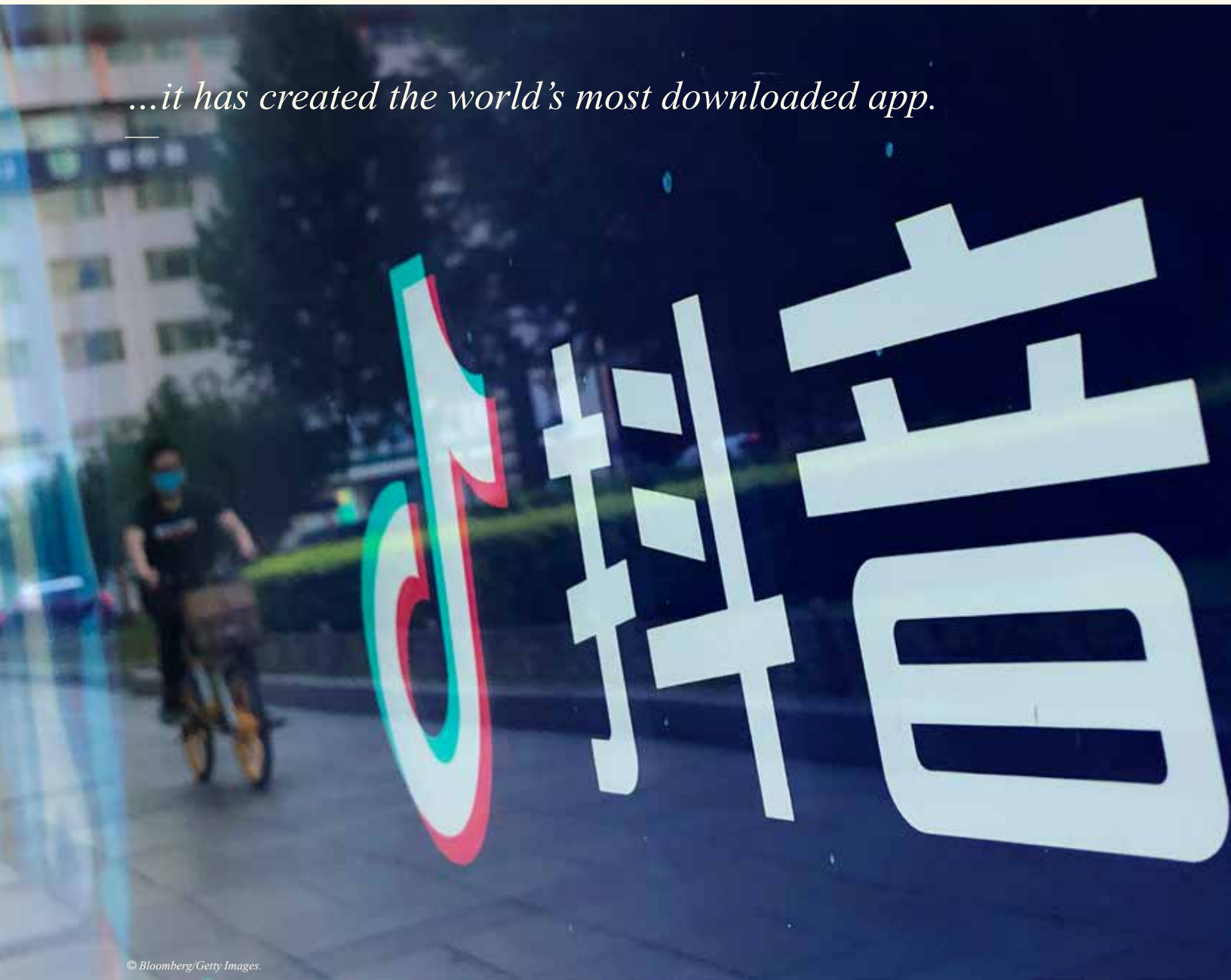
But is this changing? As we can see, the persistence of returns from the highest quintile of stocks in EM over the last decade or so has been much more enduring than it was in previous

decades. The relative performance of growth stocks makes sense in this context. However, it also jibes with our sense that there has been a meaningful upgrade in the quality of the investment opportunities available to stock-pickers in EM. We wonder if investors are paying enough attention to this shift: after all, most of the debate around emerging markets over the last decade has focused on the region's failure to deliver much in the way of growth at the macro level. But if this bottom-up trend continues – and if, as we suspect is quite likely in the coming decade, it is accompanied by a far more benign top-down outlook – then the implications for the asset class could be profound.

The first generation of truly 'world class' EM companies came from Korea and Taiwan – the only two economies of any size to have made it all the way

from low- to high-income in the last 50 years. The road map mirrored the export manufacturing-led development model: embrace global markets at cheap price points, then work your way up the innovation ladder. The companies that succeeded usually had one thing in common: founders willing to pursue martingale strategies, doubling down after every cyclical setback. Samsung and TSMC's ambitions have never been limited to simply copying what their developed market peers did; they've been mainstays of our EM portfolios for the better part of two decades for precisely this reason. Nonetheless, it's hard to resist the symbolism of the recent revelation from Intel – a company that has negotiated Moore's Law better than nearly everyone else in the world for most of the last 30 years – that its technology now lags that of its Taiwanese rival by at least two years.

...it has created the world's most downloaded app.



© Bloomberg/Getty Images.

The next generation of world class EM companies was different. Most have come from China, a country whose initial development largely followed the North Asian export manufacturing model successfully pursued by its neighbours. However, when the flywheel is a billion-plus home market, the need to go abroad is less pressing. But it's not just domestic scale that has made world-class giants of Alibaba and Tencent. Any lingering suspicion that they were mere copycats benefiting from large and protected markets should have been removed by Mark Zuckerberg's admission that Facebook was far too slow to learn from WeChat.

The existence of four indisputably world class companies is a great start, but it hardly makes a compelling case for active allocation to the broader asset class, especially when those four already account for 25 per cent of the MSCI EM index, and appear in pretty much every manager's Global EM portfolio.¹ This can certainly be an inconvenience for a manager like us, given our belief that all four remain badly mispriced, and our desire to retain substantial active positions. But what's really exciting us is the fact that this list is growing.

If there's one consensus that has emerged from the wreckage of Covid, it's that our future is online. There is, of course, a more heated debate as to whether the gains from the internet revolution will continue to accrue to a relatively small number of outsize winners, or whether these winners will themselves succumb to the curse of bigness. Like Saturn, revolutions have a habit of devouring their own children.

As observers of the Chinese Internet, we've become much more relaxed over the past year or two about the risk of Alibaba and Tencent losing their dynamism and lack of challenge. Meituan, for example, appears to be managing to out-compete Alibaba in food delivery. If the company can retain leadership in an addressable market that founder Wang Xing has defined as more than 2 billion meals each day – it currently manages around 30 million – it's recent success should continue.

Of perhaps even greater interest is ByteDance. Could this be the world's most important company? For most people over the age of 30, the company's rise to prominence reflects its status as a totem of Sino-US tension amid Mike Pompeo's campaign to cleanse American networks of Chinese influence. But the company's real significance was apparent well before this. In less than five years, ByteDance has not only developed a domestic ecosystem second only to Tencent in size, but in TikTok – developed in China for a global audience – it has created the world's most downloaded app. In one fell swoop, Bytedance has forced us to rethink two investment shibboleths: that regulation is the only way to ensure a competitive internet industry, and that Chinese companies can't produce globally sought-after brands.

1. Although interestingly Copley aggregate data suggests all four remain among the top stock underweights in GEM funds.

This feels like a watershed moment. One of the most common rules-of-thumb you will hear as an EM investor is that aspirational brands come from the west. This has effectively put a ceiling on growth for EM equity investors – once income per capita reaches a certain point, consumers switch to foreign brands, and the upside accrues to companies listed elsewhere. Why bother allocating to EM when you can play catch-up consumption through western companies like HSBC or LVMH?

This is starting to change. Chinese brands accounted for only 40 per cent of search queries on Baidu in 2009; by 2019 this was 70 per cent. Nielsen surveys confirm a similar uptick in interest. Our holding in Li-Ning reflects this shift: although the Chinese sportswear market remains dominated by Adidas and Nike, Li-Ning appears to have been gaining ground on the back of revitalised brands that incorporate traditional Chinese embroidery.

Do these shifts in consumption patterns reflect a new-found confidence from home-grown brands that have finally become more adept than the multinationals at capturing the imagination of local audiences, or is it simply down to a surge in nationalist sentiment and patriotism? The debate over the resurgence of national brands in EM has become entangled in yet another post-Covid consensus: that globalisation is now at an end, to be replaced by a more fractious era of rising balkanisation and localisation. Unsurprisingly, the verdict from most commentators – having spent their entire careers extolling the virtues of unfettered trade and capital flows – is that this is unlikely to be a good thing. We don't wish to trivialise this debate: geopolitical shifts can be unsettling, and the costs of miscalculation horrific. But surely this will offer up vast opportunities for our universe. After all, convergence theory has always emphasised the role of crisis as a catalyst for change – what Moses Abramovitz referred to in 1986 as “ground-clearing experiences that open the way for new organizations and new modes of operation”. The most obvious example is Chinese technological catch-up, which US sanctions have pretty much guaranteed to be one of the most powerful investment themes of the next decade, as China seeks to fast-track the development of domestic know-how and cutting-edge research. As a recent report from the Boston Consulting Group pointed out, US leadership of the global semiconductor industry – one that relies on a virtuous innovation cycle of R&D scale to stay ahead – could now be lost within as little as three years.

*...within two decades,
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So far, our conversation has focused mostly on North Asia. Where should we look for our next wave of world-class EM titans? If sheer force of numbers were enough, the argument could be extended across most of our universe. Within the next decade, 2 billion emerging consumers will join the ranks of the middle-classes; within two decades, all three of the world's most populous countries will have come from those currently defined as emerging. With home markets on this scale, it's hard to resist the idea that our universe will account for a disproportionate number of the trillion-dollar companies created in the years ahead.

However, as jaded survivors of Jim O'Neill's BRIC-mania will recall, large populations alone are insufficient precondition. The long-standing debate around India's prospects captures this tension. Optimists point to the demographic dividend that is being unleashed as most of the population enters working age, pessimists counter that this will make little difference when the country already has the largest pool of underutilised cheap labour in the world yet remains entirely unsuited to export manufacturing. Sure, there are some terrific companies in India, where high skill levels and low costs have helped the country's IT and pharma sectors achieve global renown, but neither are particularly big employers. Surely it will be decades before the potential of the next billion is truly unleashed?

One of the common investment narratives around EM is that countries climb the hierarchy of needs identified by the psychologist Abraham Maslow one layer at a time, with basic needs at the bottom, and innovation and creativity at the top. This is presumably why so many foreign investors still prefer to cluster around Hindustan Unilever (on a mere 60x forward P/E, having grown earnings at 8 per cent pa over the past decade), while sneering at the idea that Bangalore could ever seriously become the next Silicon Valley.

Growth of 5G is subverting this narrative, as leap-frogging goes into hyperdrive and the backwardness of latecomers becomes their very source of strength. Entrepreneurship, education and brand-building have never been easier or cheaper; unhindered by sunk investment in legacy systems, companies are coming up with creative ways of meeting domestic challenges. Remember that it took 25 years for half of the world's population to come online: that milestone was reached in 2019, and it was mostly about users in the developed world (and China). The internet's second act will be about the world's least affluent people. And if you thought part one was disruptive, just wait for the sequel.

Reliance has provided us with a glimpse of this future. While all the incumbent telecom operators were focused on layering 2G and 3G solutions on top of their legacy voice networks for India's affluent urban population, Reliance – in a very Silicon Valley-esque move – spent over US\$ 30 billion building a world-class broadband network from scratch that now makes outside returns despite rock-bottom pricing thanks to the sheer volumes that were attracted at zero marginal cost. It now looks set to fulfil the dream of moving up the stack from infrastructure to services, a dream that has eluded every other telecom service provider in the world.

For now, India's internet sector is dominated by the multinationals, but a number of recent collisions with the regulator have left investors questioning the sustainability of this model. The new playbook, once again, is being written by Reliance. The aim is not to usurp Google and Facebook, but to secure their investment and partnership. Of course, if this locks India's internet into a monopolistic model, it is unlikely to be an unmitigated positive. But to the extent that Jio and its partners are able to bring new services and efficiencies to hundreds of millions of Indians who didn't even have access to basic telephony a year or two ago, the trade-offs may be worthwhile.

In the meantime, those big numbers are finally kicking in. India now has the largest pool of IT engineering talent anywhere in the world – 8 million students have graduated in the last five years alone – and a long and growing list of start-ups and IPO candidates in the fintech and consumer internet space that are already valued at tens of billions of dollars. There will surely be no shortage of Indian representation in our third wave.



CONCLUSION

It's time to stop looking in the rear-view mirror when it comes to emerging markets. Conventional wisdom always extrapolates recent experience, but after a decade in which both economic growth and equity returns have been lacklustre relative to the rest of the world – and with relative valuations now back at multi-decade lows – we worry that investors have badly misunderstood the depth of the transformation that has been taking place in our asset class. It is highly likely that the world's centre of economic gravity will shift back towards emerging markets in the decade ahead. It is also highly likely that the beneficiaries of this growth will be almost exclusively home-grown. To return to the question we posed at the beginning, where are the impregnable moats, the visionary management teams, the products that people buy because they want to, not simply because they lack alternatives? Our answer finally has strength in depth. Welcome to the land of the giants.

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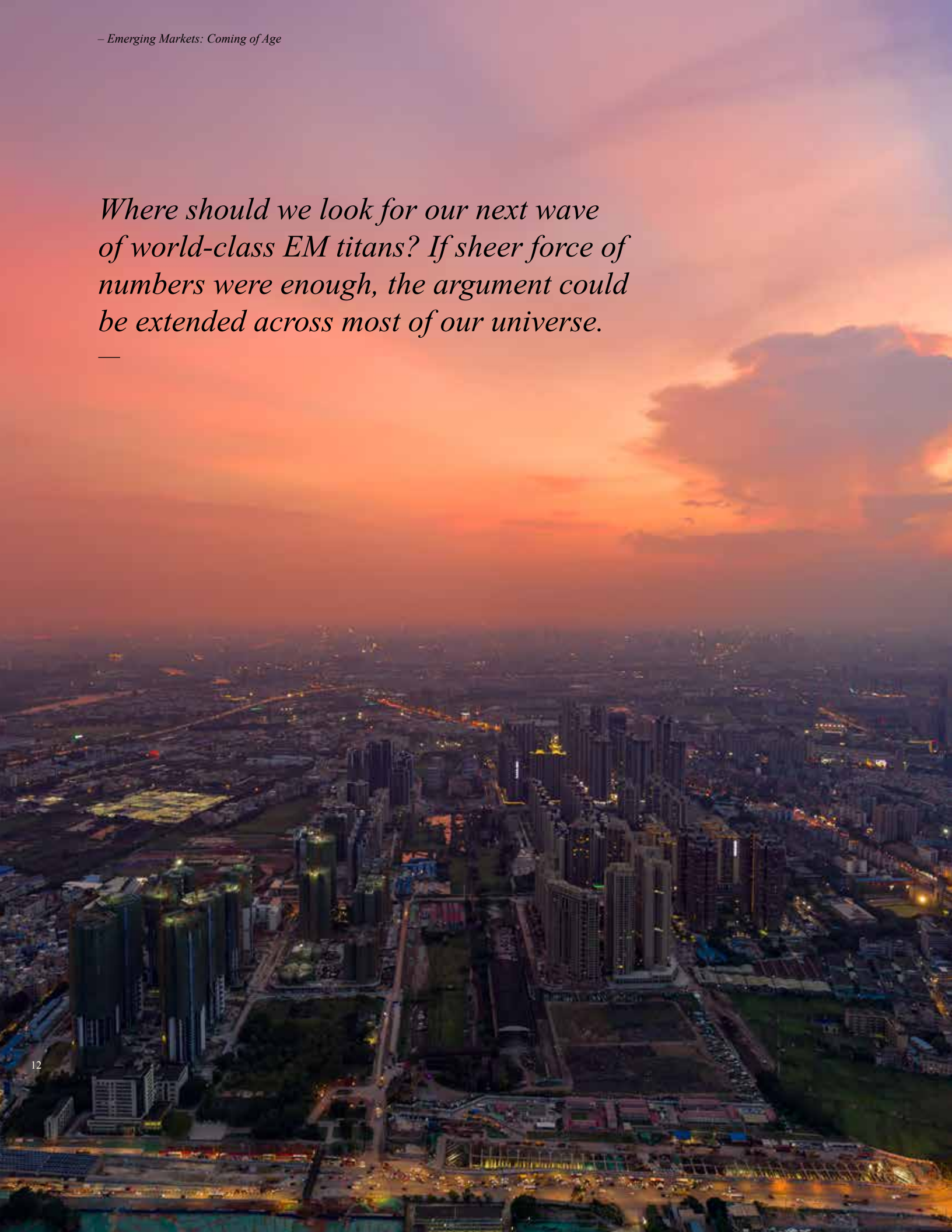
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