FSSA Investment Managers

June 2022

Quarterly Manager Views

FSSA Global Emerging Markets Equities Focus

Thinking about risk

Albert Einstein famously said, "Not everything that can be counted counts and not everything that counts can be counted." This holds true in many situations, but we think it is especially true when it comes to risk management. While the practical reality is that risk management means different things to different people, if it were only about managing deviations from a benchmark or focusing on the historical swings in share prices ('volatility'), then the recent events in Russia and Ukraine have underscored why this is not a good measure of *actual* risk, i.e. the loss of capital.

Loss of capital can come in many forms, but the key distinction to make, in our opinion, is between temporary and permanent losses. A temporary loss of capital is what we see in markets every day. Daily price movements occur not because the fundamentals of a business is changing, but because market participants have decided to price the business slightly differently. While it can be painful to experience the occasional price declines, such movements often do not reflect changes in the fundamental value of the business and should instead be viewed as good buying opportunities for long-minded investors.

The more worrying version of capital losses are the ones that are permanent. This usually occurs when a management team defrauds investors or makes value-destroying capital allocation decisions; or when a franchise deteriorates because its competitive advantages have been eroded; or if we significantly overpay for what is otherwise a good business. It is these types of losses that keep us up at night and what our investment process is designed to help us identify and avoid.

Our investment philosophy is inherently conservative and instead of focusing on what needs to go right for an investment to be successful, we spend much of our time identifying what might go wrong – and how to mitigate those risks. Firstly and most importantly, we try to gauge the **governance standards** of companies we are interested in. We look far into the company's history and its key turning points to glean insights about the organisational culture. Questions we commonly seek to answer are: is it a meritocracy or is there a "glass ceiling" by way of family members calling the shots? Do they bet the farm at the top of business cycles? When the going gets tough, do they abandon minority shareholders?

However, there is only so much one can learn from reading past annual reports and news articles. We prefer to conduct in-person meetings at the company's premises to pick up clues about their culture. We spend time with management teams discussing long-term issues such as strategy, capital allocation, succession, professionalisation, board quality and environmental/social impact; and we find their replies often provide the best insights. (On this note, we are excited by the gradual lifting of travel restrictions in most parts of the world and have already resumed research trips to meet companies.)

Alignment of interest is another critical point and we look for familiar red flags: is the corporate structure overly complex? Are there differential voting classes of shares? Is the listed company the main source of wealth for the controlling shareholders? What are the key performance indicators (KPIs) and does the incentive program encourage long-term behaviour? Is the board of adequate quality and independence to provide proper checks and balances? One of the main reasons we have not owned any Russian companies in the portfolio for a number of years is exactly because we could not get comfortable with the alignment of interest. What we often found was an overly complex and opaque ownership structure pointing to an oligarch at the top to whom a *quid pro quo* relationship with a government official was evident. Additionally, the quality of independent directors on the boards of such companies was never good enough (by design?), which prompted us to stay on the sidelines.

Secondly, we believe that focusing on quality companies with strong **business fundamentals** is another important step to mitigate risk. Charlie Munger said, half-jokingly, "All I want to know is where I'm going to die so I'll never go there." The same can be said about investing. If you start out by knowing how to lose money, you have already gained an advantage as you can avoid investing in these poor businesses. This also explains our starting point for finding suitable investments: companies that have long-term tailwinds with clearly defined competitive advantages. Investing is not easy in the first place so why make it more difficult? Creative destruction and industry structures with low entry barriers dictates that any profit pool that exists today may be stolen by a competitor tomorrow — unless a company finds ways to protect it. We are focused on finding the latter group of companies who have the ability to *protect their growing profit pool* over the long term.

We believe that there are 160-180 such companies that exist in the global emerging markets (GEM) universe today. However, it is important not to be complacent about their prospects and instead frequently think about what could go wrong for them. Pre-mortems are very helpful in this regard — if a stock went to zero in 10 years, what would be the main reasons? What would it take to start a business today offering the same product or service? Can these be bought quickly with money? Why is this company NOT a Nokia in 2007, or an eBay vs. Amazon? These kinds of discussions prompted us to sell out of Chinese pharmacy retailer Yifeng a few years ago, despite its good governance and strong business fundamentals. In particular, we became increasingly concerned about the threat from online pharmacy retailers and the impact they would have on Yifeng's long-term margins and returns.

We also assess environmental and social risks as part of the business fundamentals. Management quality and franchise strength should be viewed in a broader stakeholder context and not purely in relation to profit maximisation and shareholder value. There are two questions which we believe are highly revealing about the potential sustainability risks in the business: what would a best-practice ESG[1] profile look like for the company in question; and would we as investors and owners be aligned with that vision? For example, a few years ago when we analysed the after-school tutoring industry in China, one of our major concerns was the high fees and margins enjoyed by key players. The debate centred around the exploitative aspects of the industry in a highly competitive society and the pressure it placed upon parents and students alike. A holistic assessment of such risks prompted us to avoid the sector; and the subsequent ban on the industry tells us that in this instance, we were not far off the mark.

Quality of **financials** is the third area we look at to minimise risk. We regard financials as the output of business fundamentals and management decisions and as such, we look for consistency between the two (and if there is a conflict between CEO-speak and the financial statements, we always trust the latter!) Excessive leverage, for example, is a red flag that we believe investors should pay serious attention to. As tempting as it may be for a company to increase returns by ramping up debt, it naturally reduces the operational margin of safety and leaves the company with only bad options during times of stress. Aggressive use of accounting practices (depreciation policy, inventory valuation, ageing of working capital and provisioning for bad debts are good places to look) and negative/negligible free cash flow (FCF) generation are all signs of poor financial quality, which seldom ends well for minority investors. As of 30th of April 2022, 77% of holdings (ex-financials) in the FSSA GEM portfolio had net cash balance sheets.

Although **valuations** is typically the last area we look at before investing, it is a critical step in our risk management process. We are particularly wary of "growth traps" and "value traps". While we love growth in *free cash flow*, other forms of growth do not always equal value creation. Just think about some of the fastest growing businesses in recent years such as ride hailing, fintech or delivery companies. While Wall Street loves everything that is moving fast, this can often be a recipe for investment disaster as investors lose track of what is sensible. Similar to driving a car – the faster it goes, the more difficult it is to predict what is around the corner. Recent market events have again given credence to this point.

We are equally mindful about "value traps", or optically cheap business which are not growing or have deteriorating fundamentals. For the typical value investor looking at single-year valuation multiples in the hope of finding a "50 cents on the dollar" type of investment, the clear risk, in our opinion, is not just getting the thesis wrong and being stuck with a cheap-yet-depreciating asset. It is that they miss out on something potentially far more important — future value creation. Long-term sustainable growth is often poorly understood by markets and most investors tend only to focus on what happens in the next one or two years, when the real drivers of value creation are the cash flows beyond this period. For a business

[1] Environmental, social and governance

with growing free cash flows, we are being paid to wait; but being disciplined about the price to pay for this is an essential part of risk management.

Having subjected our holdings to these tests, we are fairly confident about the potential risks to the portfolio. Indeed, our conviction has been tested regularly over the past two years as lockdowns severely impacted many of our holdings, but we are pleased to see most of them emerging stronger from this chapter.

In the following, we will discuss some recent examples of temporary losses of capital in the portfolio and how we have taken advantage of these situations.

Changes to the portfolio

2022 so far has been sobering for China companies, with the impact of lockdowns and regulatory headwinds. While the country is currently experiencing a challenging period, if there is one lesson to be learned from lockdowns in other places it is that they are relatively short-lived. While several of our China holdings have corrected sharply as this year's growth and cash flow generation is likely to be muted, we believe this presents an excellent opportunity for long-term investors like us to accumulate leading franchises at attractive prices. After all, the intrinsic value of a business consists of 20-30 years of earnings and cash flows, not just a single year.

We hold this same view for our Chinese holdings listed on American stock exchanges (through American Depositary Receipts — ADRs). The recently introduced US law — the Holding Foreign Companies Accountable Act (HFCAA) — stipulates that all foreign companies listed on US exchanges must provide full audit drafts to the Securities and Exchange Commission (SEC) upon request. This, however, is in conflict with national Chinese law, which does not allow audit drafts to be released outside of China. Should a compromise not be reached, Chinese companies that do not comply with US regulations will be delisted from US stock exchanges within the next two years.

While the dispute is clearly not helpful for our China ADR holdings, we are hopeful that the ongoing discussions between regulators in the US and China will be concluded in a positive manner in the coming months. However, even if an agreement does not materialise, the ADRs that we own (JD.com, Yum China and Huazhu) have dual listings in Hong Kong and are fully fungible, meaning that they can be converted to Hong Kong-listed shares at a fixed ratio at any given point in time. This suggests that the risk to our holdings is more sentiment- rather than fundamentally-driven. We see this as an opportunity to buy attractive businesses at discounted prices and have been adding to our positions over the past few months.

We also initiated a new investment in Silergy, China's leading fabless analog integrated circuit (IC) design company, which we have known and monitored for a number of years. We have been impressed by the operational capabilities and strategic focus of the founders, who are regarded as one of the most experienced teams in China by a wide margin. Silergy was founded in Hangzhou in 2008 by a group of Chinese-Americans with extensive experience in global analog companies. It has built an impressive client base (which increasingly consists of blue chip companies) and has made strong inroads into new applications like 5G, autos, cloud computing and others. This has allowed the company to grow at a 36% compound annual growth rate (CAGR) over the past decade while generating returns on invested capital (ROIC) of between 75%-190% over the same period.

Unlike most other hardware technology subsectors which tend to be positioned in the lower parts of the value chain (and thus have limited ability to generate decent returns over the cycle), the analog semiconductor sector is quite the opposite. While average selling prices (ASPs) are relatively low, these are mission-critical components that compete less on price and more on quality. Once an IC chip is designed into an application — a process in which the manufacturer and the analog company often collaborate — replacing it is costly, as the whole production process has to be revised. These high switching costs improve Silergy's pricing power over the product lifecycle (often 10 years or more) and the degree to which revenues are recurring. In addition, the analog production process is less standardised than for other technology components and thus far less vulnerable to obsolescence, which reduces the capital intensity. For many of the more mature players in developed markets, more than a third of sales comes from products which are more than 10 years old.

In addition to these attractive industry features, Silergy's track record and strong reputation attracts some of the best talent in the industry. This advantage is not to be underestimated — it takes many years for an employee to become an expert in analog semiconductor design, creating natural barriers to entry and scale. The design process is based more on trial and error and is less reliant on computer modelling and simulation — companies with the best talent can build a strong base of intellectual property that others simply cannot match. In addition, each analog company's process technologies are quite distinct (digital utilises a more generic process), and thus it is difficult for an engineer to be poached by another analog company without his or her productivity being significantly impaired. New science graduates prefer to pursue jobs in the digital semiconductor field, which means that research capacity in analog semiconductors has been (and will likely continue to be) constrained. We believe this means that the best brand names in the analog industry should continue to outperform and we would expect the gap between Silergy and its closest peers to continue to widen.

Despite its impressive growth rate over the last decade, Silergy's market share within power management ICs (the largest subsector within analog chipsets) is just 2.7%. We believe the company should be able to grow comfortably at double-digit rates for the next decade, as it benefits from secular industry tailwinds (new product launches and the China localisation drive) as well as continued market share gains. Despite these attractive features, the share price has fallen 50% year-to-date (though admittedly from lofty levels) as investors are increasingly concerned about near-term demand headwinds and disruption fears from the lockdowns in China. While we can certainly see how revenue growth and margins might weaken in the near term, we think it is one of the most interesting technology companies we have come across and believe it has excellent prospects. At the time of purchase, Silergy was trading at a free cash flow yield of 2.8%. While clearly not a bargain, we expect Silergy to continue generating solid cash flow growth for many years, which should support longer-term share price appreciation. We look forward to holding this company long into the future.

Outlook

As we approach the middle of the year, it is clear that 2022 is progressing very differently to what we expected just four or five months ago. Stagflationary pressures are clearly building in many countries and this usually results in few winners and many losers. Having said that, we are confident in our holdings' ability to navigate the situation, as they have done in the past. Competitive advantages in the form of strong brands, distribution advantages, cost leadership, or simply providing a service or product that customers cannot live without, are the main traits that characterise our companies. Historically, this has given them superior pricing power and the ability to preserve margins despite adverse headwinds.

This is also why, on balance, we think that the valuation for the FSSA GEM strategy is attractive relative to the mid-to-longer-term growth potential. The portfolio's weighted average FCF yield and prospective price-to-earnings (P/E) ratio is 4.4% and 22x, which we believe should offer some cushioning against potential de-ratings, particularly considering the mid-teens level of medium-term earnings growth that we anticipate for the portfolio in aggregate. We are optimistic on both an absolute and relative basis and believe this should bode well for longer-term returns.

In this letter, we have tried to cover points which we thought might be of interest to the strategy's investors. If there are any questions or feedback concerning the strategy, our approach or operations, we would welcome hearing from you.

Thank you for your support.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 31 May 2022 or otherwise noted.