FSSA Investment Managers

December 2022

Five principles for investing in emerging markets

Rasmus Nemmoe
Portfolio Manager
FSSA Investment Managers

Rasmus has more than 18 years of investment experience, latterly focused on global emerging markets. He joined the FSSA team in 2016 and is the lead portfolio manager for the FSSA Global Emerging Markets Focus strategy, which launched in December 2017 and recently passed its 5-year anniversary.

As long-term, bottom-up investors, our starting point for finding suitable investments is to seek out companies that benefit from structural tailwinds and have clearly-defined competitive advantages. We look for sustainable business models that are attractive not only from a one to two year perspective, but throughout the business cycle.

In the FSSA Global Emerging Markets Focus strategy we have invested in quality businesses that have proven management teams and leading franchises. We believe they are well positioned to capitalise on the long-term secular trends that make emerging markets an attractive investment choice.

Whether it is the formalisation of the Indian economy, the continued financialisation of the South African population or the growing adoption of enterprise resource planning software by small and medium-sized companies in Brazil, we believe the investment opportunities are plenty.

Yet, these kinds of businesses are often not well represented in broader indices and therefore we believe a bottom-up active investment approach has much value to add. This is especially important when markets are volatile, as they are today.

Our investment philosophy does not require us to follow an arbitrary index, nor does it entail buying poor-quality companies at 50 cents on the dollar. Instead, we focus on these five core principles that we believe will help us deliver attractive returns for our clients over the longer term.

Principle 1: "Time in" the market is more important than "timing" the market

The first principle for investing in emerging markets – particularly for long-term buy-and-hold investors like us – is patience. It is rare to identify companies that have both a quality management team and a franchise that compounds free cash flows (or book value per share) at attractive rates for long periods of time. Where we have managed to find such companies, we believe the most important thing is to hold on and do nothing.

MercadoLibre* is a case in point – we have owned the company since inception of the strategy. It is one of the top contributors to performance over the past five years. As Latin America's leading e-commerce company, sales have grown nearly eight-fold over the past five years, while free cash flow (FCF) has grown five-fold. This has driven the 28% CAGR[1] total shareholder return over this period. Though we kept an eye on valuations and trimmed our position when it looked particularly heady, we have since bought back at lower prices. It remains one of our largest holdings.

Principle 2: Being bottom-up investors doesn't mean ignoring the macro completely

As bottom-up investors, we look to identify companies with great management teams and strong franchises that are able to grow sustainably over the long term. We don't

* Reference to specific securities is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell the same.
[1] Compound annual growth rate

pay too much attention to short-term macro forecasts or political events. They are outside of our control and we do not think we have any great ability to predict such events. However, in some rare instances, external macroeconomic issues can completely swamp even the best-run company.

Our investment in the Argentine bank Grupo Financiero Galicia* is one such example. During 2017, our meetings with the CEO and several other members of the senior management team pointed to a strong culture and franchise – the bank had averaged 37% return on equity (ROE) for the previous 5-year period, with performance underpinned by a good deposits franchise.

With the election of a new leader, President Mauricio Macri, it seemed as if Argentina would regain its former glory and the issue of hyperinflation would finally be controlled. However, politics in the country took a dramatic U-turn and the economy, which had been improving, was destabilised yet again. Intense currency headwinds meant that we subsequently sold out of our position at a loss.

This was an expensive lesson, with the outcome being that we now systematically check and limit our portfolio exposure to so-called "high-risk" economies (simplistically defined as those with adverse macroeconomic conditions).

Principle 3: Stay disciplined through market mania

When it comes to investment performance, avoiding mistakes is just as important as selecting potential winners. During late 2020 and through 2021, there was a frenzy of initial public offerings (IPOs), most of which had dubious business models and sketchy financials. Meanwhile, valuations lost all relation with fundamentals as companies that were beneficiaries of Covid-induced work-from-home strictures were bid up to stratospheric levels.

Most of the "stars" of this time were businesses that we call "Growth Traps". They are characterised by a business model wherein a constant supply of capital is needed to fuel growth despite mounting operating losses. There is no evidence yet of such companies being able to capture the profit pool they have destroyed in their quest for scale.

In these phases, it is important to stay disciplined and not be enticed into overpaying for stocks. Our team helps us stay grounded and avoid mistakes in times like these. We have not participated in any IPOs for the GEM strategy over the past few years, most of which are now languishing below the listing price. Nor have we bought into flawed business models that promise a "path to profitability".

Principle 4: Conviction comes from thinking long term

The Covid-19 pandemic has dominated most aspects of life and business for nearly three years now, with places like China still battling the spread of the virus. Several of our holdings were also significantly challenged during the pandemic as the unprecedented lockdowns took its toll on their businesses.

For instance, the Mexican Starbucks operator, Alsea*, had never experienced same-store sales declines of more than 4% prior to the pandemic, but during the second quarter of 2020, sales declined by 60-70%! For some of our travel-related companies, like Mexican airport operator Grupo ASUR*, or Latin America's leading online travel agent Despegar*, the year-on-year sales decline was even greater, at 95%.

At this point, we took a step back and conducted a deep-dive review of our holdings. We had calls with management teams and re-evaluated their businesses. This gave us greater conviction in the longer-term trajectory of our holdings. The majority of them are market leaders and we realised that if they were struggling, their competitors would be even worse off. It became increasingly clear that when the lockdowns eventually ended, our holdings should have even higher market share and face less competition.

As such, even though the early stages of the pandemic were particularly challenging, we tried to look beyond the immediate situation – and we found some very attractive bargains.

Principle 5: Stick to the process

In seeking companies to invest in, we apply our competitive advantage framework on prospective holdings, looking for those with good governance, strong business models, solid long-term prospects, clearly-defined competitive advantages and high cash generation. Our fundamental company analysis incorporates both qualitative and quantitative research that is designed to assess a company's ability to compound cash flows sustainably and at high rates over the medium to long term.

As a team, we are all generalists with a focus on certain countries/regions. We travel together and conduct company meetings in small groups with people from different offices and nationalities. This means that several team members will analyse the same company over time, which provides different perspectives on the investment case.

* Reference to specific securities is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell the same.

Our process is designed to identify portfolio opportunities and reduce risk. The idea is to draw upon the experience of the whole team so that we can achieve our goal of preserving our clients' capital and growing it sustainably. Over the more-than-30 years since the establishment of the FSSA team, the investment process has been honed continually, learning from (sometimes painful) lessons along the way.

Conclusion

To sum up, investing can be deeply frustrating in the short term, but highly rewarding over the years. It takes patience, a strong team culture and process, a focus on evaluating great management teams, and investing in companies with clearly-defined competitive advantages and sustainable and predictable growth.

We believe these core principles remain as relevant today as they did 30 years ago with the founding of the FSSA team, and we strive to apply them systematically on a daily basis. The result is a portfolio of high-quality companies from across emerging markets that offers attractive growth compounding opportunities. Our analysis suggests that our group of companies can grow earnings at 13-15% CAGR[2] on a weighted average basis over the medium term, while aggregate valuations, at around 5% FCF yield[3] and a PER[4] of around 21x prospective earnings, seem reasonable (and sustainable) to us.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 30 November 2022 or otherwise noted.

Important Information
References to "we" or "us" are references to First Sentier Investors (FSI). The FSSA Investment Managers business forms part of First Sentier Investors, which is a global asset management business that is ultimately owned by Mitsubishi UFJ Financial Group, Inc (MUFG), a global financial group.

In Hong Kong, this document is issued by First Sentier Investors (Hong Kong) Limited (FSI HK) and has not been reviewed by the Securities & Futures Commission in Hong Kong. In Singapore, this document is issued by First Sentier Investors (Singapore) (FSIS) whose company registration number is 196900420D. In Australia, this information has been prepared and issued by First Sentier Investors (Australia) IM Ltd (ABN 89 114 194 311, AFSL 289017) (FSI AIM).

This document is directed at persons who are professional, sophisticated or wholesale clients and has not been prepared for and is not intended for persons who are retail clients. The information herein is for information purposes only. It is not intended to provide you with financial product advice and does not take into account your objectives, financial situation or needs. Before making an investment decision you should consider, with a financial advisor, whether this information is appropriate in light of your investment needs, objectives and financial situation. Some of the funds mentioned herein are not authorised for offer/sale to the public in certain jurisdiction. Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell the same. All securities mentioned herein may or may not form part of the holdings of First Sentier Investors' portfolios at a certain point in time, and the holdings may change over time.

Any opinions expressed in this material are the opinions of the individual authors at the time of publication only and are subject to change without notice. Such opinions: (i) are not a recommendation to hold, purchase or sell a particular financial product; (ii) may not include all of the information needed to make an investment decision in relation to such a financial product; and (iii) may substantially differ from other individuals within First Sentier Investors.

Please refer to the relevant offering documents in relation to any funds mentioned in this material for details, including the risk factors and information on requirements relating to investor eligibility before making a decision about investing in such funds. The offering document is available from First Sentier Investors and FSI on its website and should be considered before any investment decision in relation to any such funds.

Neither MUFG, FSI HK, FSIS, FSI AIM nor any of affiliates thereof guarantee the performance of any investment or entity referred to in this document or the repayment of capital. Any investment in funds referred to herein are not deposits or other liabilities of MUFG, FSI HK, FSIS, FSI or affiliates thereof and are subject to investment risk, including loss of income and capital invested.

To the extent permitted by law, no liability is accepted by MUFG, FSI HK, FSIS, FSI AIM nor any of their affiliates for any loss or damage as a result of any reliance on this material. This material contains, or is based upon, information that we believe to be accurate and reliable, however neither the MUFG, FSI HK, FSIS, FSI AIM nor their respective affiliates offer any warranty that it contains no factual errors. No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of FSI.

Any performance information has been calculated using exit prices after taking into account all ongoing fees and assuming reinvestment of distributions. No allowance has been made for taxation. Past performance is not indicative of future performance.

Copyright © First Sentier Investors (Australia) Services Pty Limited 2022

All rights reserved.

[2] Compound annual growth rate
[3] Free cash flow yield
[4] Price-to-earnings ratio