11th February 2020

GuardCap Emerging Markets Equity Fund

To our investors:

The team at GuardCap has been managing emerging markets equities in a variety of investment vehicles for a number of years. 2019 was the third full calendar year for the UCITS version of our emerging markets equity strategy. Since 2017, we have written to our unitholders and published this letter on our website for others who are interested.

Investing in emerging markets

The structural case for investing in emerging markets remains clear to us: favourable demographics, rising disposable incomes, a growing consumer class and rapid technology adoption. This continues to lead to significantly higher rates of economic growth in emerging markets compared to developed markets. The IMF forecast GDP in emerging economies to grow at a 4.8% CAGR over the coming five years compared to a 1.7% CAGR for developed economies. In an IMF list of the fastest growing countries 2019-20, the first developed market country appears at number 98[1].

The definition of emerging markets is broad and encompasses much of Asia, South America, Eastern Europe, the Middle East and Africa. It is a vast and rapidly changing collection of economies, which are by no means homogenous, although they share some common characteristics.

Emerging market equities, in aggregate, have significantly underperformed developed market equities and in particular US equities over the last decade. The MSCI Emerging Markets Index returned 44% in the ten years since 2010 compared to 256% from the S&P 500. The previous decade had seen a similar divergence of performance but with emerging markets returning 154% and the S&P 500 -9%. Over the twenty years since the turn of the millennium, the MSCI Emerging Markets Index has returned 265% and the S&P 500 has returned 224%.

The challenge for emerging market equity investors has been to find companies that can turn superior economic growth into sustained growth in shareholder value. Returns from the index have been disappointing. Most passive emerging market solutions are highly diversified, featuring hundreds of companies that have weak fundamentals. Many active equity funds investing in the region hold upwards of fifty or one hundred different investments.

Investing long-term in a focused portfolio of high quality companies, each with good growth prospects, can reduce the risk of capital losses and increase the chances of realising excellent returns from the region. This is what we are trying to do.

The strongest growth trends in emerging markets

We observe that there are a number of long-term structural growth trends unique to emerging markets. Many of these relate to the growth of the consuming class in the region, which is still at an early stage of its development.

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[1] Emerging and Developing Countries / Advanced Economies, Annual Real GDP Growth (%), IMF, 2019

Consumption Growth

At its broadest, we consider the growth of consumption in emerging markets to be the highest potential and longest duration growth trend in the world. It should underpin higher rates of economic growth in the region over the coming decades and give rise to some significant investment opportunities.

As economic development progresses, disposable incomes rise and more of the region's huge population moves into the middle-income bracket, demand for consumer goods and services will increase. It is impossible to make precise forecasts but one broad study estimates that more than 99% of the growth of the middle class over the coming decade will be from outside the US and Europe[2].

The most direct beneficiaries of this trend are the companies that meet the demands of the growing and increasingly discerning consumer class: those selling goods and services to the consumer. These companies make up more than half of our portfolio. Within this opportunity set, we count companies that reach the consumer via technology including e-commerce businesses, digital payment providers and social networks. We frequently observe the 'leapfrogging' effect where digital technology is enabling less mature economies to bypass stages of development seen in the West. China, for example, has skipped part of the build-out of 'bricks and mortar' retail to become a world leader in respect of e-commerce as a percentage of retail sales.

A more sophisticated consumer class becomes wealthier and better able to adopt new technology. In turn, the rapid adoption of technology taking place in emerging economies is giving rise to the growth of digital companies that serve local consumer demands. Companies such as Tencent and Alibaba in China and MercadoLibre in Latin America are becoming the dominant e-commerce, payments and digital content companies in their respective regions, with their reach extending well beyond the online world. Their platform business models tend to lend themselves to beneficial network effects and economies of scale, affording them strong competitive advantages. And they are willing to invest in order to reinforce their long-term competitive position even when this means lower profits in the short-term.

Investment in Science and Technology

In tandem with increasing consumer sophistication, a second major growth trend that we see is the significant ongoing investment in science and technology. A large part of this is coming from emerging market businesses that are investing in advanced manufacturing capacity. We find that technology-focused manufacturing companies in emerging economies are producing the value-added goods that the technology-hungry consumer in the region and the rest of the world requires.

Samsung Electronics, for example, had the highest annual capital expenditure budget of any company in the world in 2017 at $44bn[3]. Samsung is not investing in low-value, high-volume manufacturing facilities as companies in the region might have done twenty years ago. Instead, they are investing in high-value capacity that their developed world competitors cannot afford to build or do not have the R&D capability to deliver. This investment ultimately lends itself to greater manufacturing efficiency and significant long-term competitive advantages. We see this as part of a long-duration trend of investment that is upgrading the quality of the industry in the region.

Alongside this, there is significant ongoing investment into the quality of the workforce in the region, helping to increase labour productivity. Skilled workers are required to design and operate new technology. In 2016, the number of STEM graduates was 4.7m in China and 2.6m in India compared to 0.6m in the US[4]. Outsourcing is no longer simply about putting a call centre in the Philippines or a back office function in India. We see companies in developed markets increasingly outsourcing high value software development to companies that find most of their skilled software engineers and computer scientists in the emerging world.

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[2] The Unprecedented Expansion of the Global Middle Class: An Update, Brookings Institution, 2017
[3] Hey Big Spender, Wall Street Journal, 2018
[4] The Human Capital Report 2016, World Economic Forum, 2016

Formalisation of the Financial System

This brings us to the third major growth trend that we see in emerging markets: the formalisation of the financial system. In many cases, the digitally native companies are leading the way in providing financial products and services to those that previously did not have access to them. Less than 20% of people borrowed formally in developing economies in 2017 compared with 60% in high-income economies[5]. Traditional financial institutions such as banks and exchanges are also playing a central role in financing the growth of both the corporate and consumer economies. HDFC Bank in India is benefiting from the increasing penetration of financial services, growing its loan book at 20% a year while taking an appropriately conservative approach to its capital reserves and loan loss provisioning. The countries in the region are for the most part on a much sounder financial footing than they were two or three decades ago, which is supportive for the banking systems but we still need to tread carefully when investing in banks given the risks inherent in their business models and the often opaque nature of their businesses. As a result, we focus on high quality and conservative financial institutions that have straightforward business models and a long and consistent record.

Three major investment opportunities

It follows that the growth of the region presents us with three major investment opportunities: consumer goods and services providers; technology manufacturers; and certain financial intermediaries. We think about these sectors of the economy more broadly than the narrow sector definitions that we find in index classifications.

For the most part, we can assign the companies in our portfolio to one of these three structural growth areas, although there is a blurring of the distinctions in some cases. MercadoLibre, for example, is a technology company that operates a digital marketplace for consumers. It also offers payments and financial services to consumers and businesses. Its logistics division develops warehouse management software and leases warehouse capacity for its own distribution centres. We think of it as a consumer company because most of its technology and facilities operate to serve the consumer.

Other companies are simpler to classify. Venture Corp – a technology manufacturer - provides advanced design and engineering services to corporate clients from its facilities in Singapore and Malaysia. Yum China operates quick service restaurants and food delivery services to millions of consumers throughout China, including a strong digital offering. HDFC Bank, established in 1994, is the leading private sector bank in India, servicing both consumer and corporate clients.

In aggregate, we find that the portfolio, though relatively concentrated in terms of the number of holdings, provides diversified exposure to the attractive growth trends that we observe in emerging markets.

Investing in high quality companies

We take the uncontroversial view that we should invest in the companies that are best positioned to take advantage of the region’s long-term structural growth. These are the companies that can turn the superior economic growth of emerging economies into sustained growth in shareholder value. These are what we consider the high quality companies. In many cases, these companies have the opportunity to establish themselves as regional market leaders and potentially global market leaders, as the region grows in economic importance.

Helpfully, the consumer, technology, and parts of the financial sector tend to lend themselves to high profit margins, higher returns on invested capital and high levels of net profits converted into free cash flow. With the exception of financial intermediaries such as banks and insurers, these returns are typically unlevered.

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[5] The Global Findex Database 2017, The World Bank, 2018

In some cases, however, the financial ratios of the companies that we invest in are not perfect. The important point for us is that their executive leadership focuses on building sustainable competitive advantages in an intelligent manner. This usually involves reinvesting free cash flow to grow the business and to reinforce their competitive position.

We think that by identifying and investing in these companies – whose addressable market is still at a relatively early stage of development - and by holding their shares for a long time, our investors can benefit from the compounding of their growth over many years.

Simply put, this is the approach that you should expect from us: to buy good companies and to hold them for a long time.

The median and the mean

Some of the most interesting insights into investing that we read come from James Anderson, manager of the Scottish Mortgage Investment Trust.

In a series of articles critiquing Ben Graham's 'The Intelligent Investor', he tackled the question of whether mean reversion occurs as frequently as conventional wisdom might expect:

"It's a simple statement of fact that there have been great growth companies that have defied the scepticism of Graham and the mantra of mean reversion. They have endured for decades even at massive scale. I don't see this as a contention but as an observation. Ironically they've altered the patterns of stock market return sufficiently that the very utility of the 'mean' has been undermined. The mean is now so far above the median stock that our entire notion of the distribution of returns has to be reviewed. The first chance to reassess came with Microsoft over 30 years ago." (James Anderson, Graham or Growth?, Resolute Optimism, 2019)

We are interested in the idea that growth can be sustainable over long periods for certain companies. It is something that we observe in emerging markets. The gap between the mean and the median in the MSCI emerging markets benchmark is significantly larger today than it was 20 years ago but there are other factors at play here, including changes in index composition.

Sustainability of profitability is also of interest to us. Credit Suisse's HOLT, which is one of the tools we use to identify potential investments, identifies certain companies whose returns do not exhibit conventional patterns of mean reversion. What HOLT describes as an "unusual persistence in profitability" is something that we look for because, when combined with growth, it can produce persistently attractive investments, something that sits comfortably with our buy and hold approach.

Increasing returns to scale

One of the ways to explain the occurrence of persistent growth and profitability is the notion of increasing returns to scale. Writing in 1996, when Professor of Economics and Population Studies at Stanford University, W. Brian Arthur noted:

"…steadily and continuously in this century, Western economies have undergone a transformation from bulk-material manufacturing to design and use of technology—from processing of resources to processing of information, from application of raw energy to application of ideas. As this shift has occurred, the underlying mechanisms that determine economic behavior have shifted from ones of diminishing to ones of increasing returns." (W. Brian Arthur, Increasing Returns and the New World of Business, Harvard Business Review, 1996)

He attributes increasing returns to scale in the technology sector to factors such as a significant upfront R&D investment combined with network effects amongst a product's user base. These observations seem very relevant today. As the technology sector has become a bigger part of the economy, the number of companies exhibiting these characteristics has grown.

We find that portfolio companies that operate digital platforms - such as Tencent, Alibaba and MercadoLibre - have benefited from very strong network effects. These companies' core platforms have built loyal and active user bases, helping to attract more users who in turn attract developers, merchants and advertisers. The initial platform development requires an investment in technology but platforms are often cheap to scale up because the marginal cost of additional usage is very low. Arthur's article cited the example of Microsoft, one of the pioneers of the software platform:

"The first disk of Windows to go out the door cost Microsoft $50 million; the second and subsequent disks cost $3. Unit costs fall as sales increase."

When the article was written, in mid-1996, Microsoft had a market capitalisation of about $70bn, which compared to its original IPO valuation of just over $0.5bn a decade earlier. At the end of 2019, it had a market capitalisation of more than $1 trillion.

High returns at huge scale

We observe R&D economies of scale for the advanced technology manufacturers in emerging markets such as Samsung Electronics and Taiwan Semiconductor (TSMC), albeit on a much larger scale of capital investment.

TSMC, for example, incurs massive upfront development costs for each new semiconductor fabrication plant, while unit costs of production are low and diminish as sales and production increase. Its latest manufacturing facility is reported to cost as much as $20bn, while the future price of a wafer rolling off the production line is forecast to be in the region of $15,000. With such huge scale and technological skill required to compete in this industry, this creates barriers to entry, such that the industry tends towards oligopoly or in this case a duopoly between TSMC and Samsung. This is more in keeping with traditional theories of economies of scale.

All of TSMC's recent investments have been financed by internally generated cash flows. Since its IPO in 1994, its market capitalisation has risen from $5bn to more than $250bn, which is not quite as spectacular a return as Microsoft, but very decent nonetheless. An important difference here is that TSMC's business requires regular, significant additions of capital in order to grow whereas Microsoft's incremental capital investments are much lower. Whereas Microsoft has exhibited increasing returns to scale, we see TSMC as delivering high returns at huge scale.

The Amazon effect

Much like TSMC, Amazon generates high cash flow returns at huge scale. Amazon, however, has taken quite a different approach from most other businesses with respect to the breadth of its ambition. It has chosen to invest widely, often in ventures that are at best indirectly related to its core retail business. In doing so, it has gone against the prevailing Western managerial model of specialisation, profit maximisation and a focus on cash returns to shareholders. Instead, it is investing for growth with a focus on the long-term, even when there is a significant risk of capital loss. Not every investment will have a positive outcome but the bet they are making is that the good ones have significantly more upside than the bad ones have downside. As CEO Jeff Bezos has explained:

"Most large organizations embrace the idea of invention, but are not willing to suffer the string of failed experiments necessary to get there. Outsized returns often come from betting against conventional wisdom, and conventional wisdom is usually right. Given a ten percent chance of a 100 times payoff, you should take that bet every time. But you're still going to be wrong nine times out of ten." (Jeffrey P. Bezos, Founder and CEO, Amazon.com, Inc. 2015 Letter to Shareholders)

Here he was describing the success of Amazon Web Services (AWS), Marketplace and Prime, while acknowledging expensive failures such as Kozmo.com, Auctions and the Fire Phone. Although this might sound like a risky approach, it is carried out with a strong commitment to delivering sustained growth in shareholder value. His focus is long-term cash flow generation, not this year's reported profit. Consider all the R&D investment that went into building AWS. Most of this expense was charged upfront, reducing reported profits, while the value of that business became apparent much later when it reached scale. To quote Bezos again:

"When forced to choose between optimizing the appearance of our GAAP accounting and maximizing the present value of future cash flows, we'll take the cash flows." (Jeffrey P. Bezos, Founder and CEO, Amazon.com, Inc. 1997 Letter to Shareholders)

We observe a similar approach at a number of the emerging market companies that we invest in or monitor. They have seen what Amazon achieved and are following elements of the same playbook. They too are more likely to set aside the conventional Western management approach in favour of investing with the ambition of becoming long-term winners in new areas of business, sometimes with the encouragement of government or regulators. They often have founders with large shareholdings who are still closely involved with the business and willing to take the type of risks that Bezos describes. We have seen it, for example, with Alibaba and Tencent investing the cash generated from their core businesses of e-commerce and gaming respectively to become leaders in digital payments, digital video and more recently to develop cloud services businesses.

MercadoLibre, similarly, has invested the cash from its marketplace business to develop a payments business and more recently a logistics operation, albeit these have a significant overlap with the core marketplace business. Our conversations with MercadoLibre management give us confidence that their investments are focused on improving the user experience on their platform, increasing user engagement with the platform and acquiring new users that will become repeat customers of the company's services. Management look carefully at what has worked for similar companies in other parts of the world and are willing to invest in high potential initiatives but with a suitable amount of caution and a grasp of the need to make suitable returns over time.

Sustainable growth businesses in emerging markets

The best companies in emerging markets are not building scale for the sake of scale but are investing to create long-term competitive advantage and with it sustainable growth and profit potential. These companies can achieve good returns at increasing scale and some may even achieve increasing returns to scale.

This is very different from twenty years ago when the biggest companies in emerging markets were state-owned enterprises that had a mandate to invest to create employment, even if it meant low returns on capital. Nor are they the resource-intensive companies who spent enormous amounts of capital extracting commodities whose prices are subject to unmanageable fluctuations in global supply and demand. Today we identify a growing number of private corporations operating in structural growth industries, managed by innovative and incentivised management with a long-term vision. These are reasons to be optimistic about emerging markets, while we wish to remain selective in our approach.

2019 performance

For the twelve months to 31 December 2019, the GuardCap Emerging Markets (UCITS) Fund USD I Share Class returned 20.6%. This compares to a return of 18.4% for the MSCI Emerging Markets Index. Since inception, the USD I Share Class of the Fund has produced an annualised return of +11.0% compared to an index return of +12.0%.

The emerging markets index is very different to our portfolio, with 1,404 companies represented in MSCI's version as of the end of 2019. Our portfolio ended the year with investments in 27 different companies.

Our aim is to invest in a high conviction portfolio of companies that, in aggregate, deliver double-digit long-term growth in earnings and cash flows. We expect our investments to produce similar absolute returns over time, providing we have not overpaid for them. This absolute return objective, if achieved, should comfortably exceed emerging markets index returns over the long-term (the MSCI Emerging Markets Net Total Return Index in US dollars has delivered 6.7% per year since the end of 1999 and 3.7% per year since the end of 2009). The portfolio should also deliver its returns with lower risk than the index, given the higher average quality of the companies in the portfolio compared to the index.

As we have written before, not all of our investments are listed on emerging market exchanges. We look for companies that enjoy above-average growth because they sell into emerging markets or have a competitive advantage because they are located in emerging markets. Of the Fund's NAV at the end of the year, approximately 62% was invested in companies that are represented in the MSCI Emerging Markets Index, 37% was in companies that are not represented in the index and 1% was in cash. Considering the portion invested in non-index companies, approximately 10% of the NAV was in companies domiciled in emerging market countries but are not currently part of the index for different reasons. In addition, MSCI continues to categorise MercadoLibre - Latin America's largest e-commerce company and the largest position in the Fund - as a developed market company.

A small number of investments benefiting from the emerging markets opportunity

The first three calendar years for our UCITS fund have delivered double-digit annualised returns for our investors (in US dollar terms).

We continue to believe that thoughtful long-term investing in a small number of excellent businesses is a sensible approach to the emerging markets opportunity. We hope that others will choose to invest alongside us.

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