GUARDCAP

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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. 2020 was the fourth 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.

A review of 2020

2020 has been such an unusual year that it is difficult to draw too many definitive conclusions at this stage. It is easier to observe some of what has changed and to try to assess how likely those changes are to become permanent. One of the ways to gain an understanding is through the prism of the companies that we research.

For us, the pandemic has highlighted that the best investments are those companies whose management teams have thought much more broadly than the prevailing Western managerial model of profit maximisation and balance sheet optimisation, which has long prioritised cost minimisation and cash returns to shareholders over investing in future growth.

A relentless focus on short-term shareholder interests at the expense of all other stakeholder interests has exposed the flaws in many businesses. What was the value in outsourcing your manufacturing workforce to a cheaper overseas location if it meant you could not get hold of your product from your suppliers? What was the good in putting debt on your balance sheet to repurchase shares or pay your owners a huge dividend if revenues could disappear overnight and leave the company with no means of meeting its financial obligations?

A long-term approach

The best equipped companies during these moments of huge upheaval have been those that have invested. Martin Lau of Tencent, whose business model was built for the digital world, described the lack of urgency that many businesses had previously shown when it came to embracing a digital future.

"*I think a lot of the consumers' mindset is already very much on mobile internet. But the businesses, there is some sort of inertia for them to make changes… I think there is an inertia especially from the side of established businesses to say how much investment we're going to be making in order to make the change. And if I want to make the change, it requires money, it requires people, it requires a change in my organization, and overhaul on my supply chain. There is a lot that needs to be changed*." (Martin Lau, President, Tencent Holdings Ltd, May 2020)

Such investments require a longer-term mindset and many companies with a focus on shorter-term objectives have avoided them. Lau explains, however, that "*having experienced COVID-19, I think awareness for change would be much stronger*" and that Tencent is committed to remain at the forefront of change and invest "*to take advantage and facilitate, and even lead these structural changes*".

Tencent is one of a number of pre-eminent consumer technology companies to have originated in the emerging world, and these companies are becoming increasingly dominant in the markets where they operate. Others include Alibaba in China, MercadoLibre in Latin America and Sea Limited in South East Asia. As we observed last year, their platform business models tend to lend themselves to beneficial network effects and economies of scale, affording them strong competitive advantages. They have been willing to invest in order to reinforce their long-term competitive position even when this means lower profits in the short-term.

Tencent, for example, started as an instant messaging service in 1998, added online gaming soon afterwards, moved into social networks and digital content on PCs then smartphones, and more recently developed offerings in payments, cloud and transactions. Most of the core businesses that it has developed have become or are becoming global leaders. It has also seeded or invested in a wide range of companies that have overlapping interests, some of which have already grown to significant scale, including JD.com, Meituan, Sea Limited and Pinduoduo. While other companies paid lip service, Tencent invested hugely in a digital-led future and the pandemic has helped to demonstrate the wisdom of these investments.

NetEase is another company whose approach is quite different to what the textbooks have taught us. The company found success in gaming in China and subsequently expanded into cross-border e-commerce (Kaola), online education (Youdao) and music streaming (NetEase Music). It is also developing a promising D2C e-commerce platform (Yanxuan). Founder and CEO William Ding's 2020 *Letter to Investors* is refreshing for its lack of corporate jargon. His explanation that "*our business strategy is by no means derived from some grand masterplan*" would no doubt cause some consternation amongst the strategy consultants.

"*Before embarking on new businesses, we usually ask ourselves three questions: Does this product truly address user needs? Are we passionate about it? Are we capable of delivering superior services and products compared to our competitors?*" (William Ding, Founder & CEO, NetEase, June 2020)

There is no mention of margins or return on invested capital or free cash flow, more an assumption that all that will follow if you get the product right. As investors, we are conditioned to be sceptical of 'di-worsification' but NetEase has taken the opposite approach: "*we don't define ourselves as a specific type of company nor limit ourselves to one particular field*." It is difficult to argue with the success the company has had in its new ventures. "*When there is a clash between idealism and practicality, our approach is to lean toward the former*." It is hard to imagine too many professional CEOs at FTSE 100 companies saying this.

This approach would not work for all companies but it is illustrative of the innovative and long-term mindset that we often find at companies where the founder is still closely involved with the business. There is a strong belief in investing to create long-term value, rather than worrying about the business cycle or short-term profits. To quote from Ding's letter again:

"NetEase has experienced and withstood numerous market cycles. Our resilience through difficult circumstances is not a result of wit or luck, but a testament to our respect of and adherence to the fundamental driver of long-term business success: the creation of true value for our users and society at large."

Reassuringly, the NetEase approach also recognises the company's limitations and helps to guard against the 'di-worsification' tendency. The company sees itself as a content provider: be it games, music, education or physical products. Its strength comes from a focus on users and creating content that users want. The internally developed cross-border e-commerce business, Kaola, proved popular with users and became successful in its own right, but ultimately, the company believed they were not the best at maximising the full potential of this business. On selling Kaola to Alibaba for $2bn in 2019, Ding explained that:

"We are pleased to have found a strategic fit for Kaola within Alibaba's extensive ecosystem, where Kaola will continue to provide Chinese consumers with high-quality import products and services. At the same time, the completion of this strategic transaction will allow NetEase to focus on its growth strategy, investing in markets that allow us to best leverage our competitive advantages."

MercadoLibre's Chairman and co-founder Marcos Galperin also remains closely involved in the day-to-day operations of the company. In a rare interview with the FT in November 2020, Galperin explained that the company's biggest challenge is to double the number of developers and engineers at the company over the next year. "*It's a huge challenge…that's what keeps me awake at night*". The CFO Pedro Arnt, who represents the company on conference calls, gave an insight into the company's business philosophy when explaining the rationale behind investments in their Mexican operations, which are beginning to bear fruit.

"This is exactly how we want to manage our business, which is to take a long-term view and invest behind the kind of things that we know generate long-term value." (Pedro Arnt, CFO, MercadoLibre, November 2020)

As shareholders, this is exactly how we would like our companies to be managed. It is rare that we are able to find companies, such as MercadoLibre, that have such a large opportunity ahead of them and that are very effective at executing on the opportunity. These type of investments make life relatively straightforward for us because we can buy and hold with confidence for the long-term.

'Fast-forwarding' into a 'digital-everything' future

On the many company conference calls that we listened to in the past year, a frequently cited consequence of COVID-19 is the acceleration of change that was originally expected to occur over the next ten years or so. Pedro Arnt of MercadoLibre described a "*fast-forward from physical to digital*" in their main markets. COVID-19 seems likely to provide a pivotal impetus to e-commerce in Latin America – where penetration rates were approximately 5% in 2019 - much like SARS did in China in the early part of this century. It is allowing companies such as MercadoLibre to scale up far more rapidly than they otherwise would have done. Sea Limited's CCO Yanjun Wang used similar language when he spoke of the pandemic resulting in a "*fast-forwarding into the future*" in their South East Asian markets.

This is not simply a 2020 event. Microsoft's CEO Satya Nadella described the past year as "*the dawn of a second wave of digital transformation sweeping every company and every industry.*" Dr Jon Liao, Chief Strategy Officer of JD.com, argues that if the last ten years were about the rise of the consumer internet and increasing the efficiency of transactions, "*the next ten years are the years of the industrial internet*", which will see a corresponding improvement in the efficiency of industry. This echoed the words of Pony Ma, Chairman and CEO of Tencent, who in 2018 announced a new strategic approach to prepare the company for the "*second stage of the internet, the Industrial Internet era.*"

Alibaba's Chairman and CEO Daniel Zhang contends that "*the world is moving toward digital-first and digital-everything*" and describes digitalisation as the "*biggest opportunity of our time*". Alibaba has large and growing businesses in payments, cloud services, logistics and healthcare, a reminder that the digitalisation opportunity is much broader than just the retail sector. On a similar theme, Tencent's Martin Lau explained how education has benefited from increased digital adoption during the pandemic and that digital healthcare is an area where patients "*are getting used to having their disease diagnosed online either by AI or connection with medical professionals*". Lau also highlighted that these changes are not just happening to the private sector but that "*different government and municipal government services would need to bring themselves online*".

One of the most impressive aspects of the performance of some of our portfolio companies during the crisis has been their ability to 'pivot' their businesses at short notice and strengthen their competitive position. This is especially the case for businesses that are not 'digital natives'. Yum China, for example, which manages the KFC and Pizza Hut restaurant franchises in China pioneered the 'contactless delivery' method. It delivered 32% of all KFC orders and 48% of all Pizza Hut orders during the first quarter, at the height of the pandemic in China. Fast food restaurants outside China have not come close to this scale of delivery capability. It was only possible because of the significant investments that the company had made in digital and delivery in recent years. In the fourth quarter of 2019, Yum China had signed up more than 240m digital members and was already delivering 23% of all orders, using its own riders rather than relying on aggregators.

Another example of an agile business in our portfolio is Chinese after-school tuition company New Oriental Education, which has 10m+ student enrolments in its classrooms across the country. During the pandemic, it was more or less able to move all of its classes online. This was only possible because of the previous efforts made to develop a strong digital offering. The company also offered free online broadcasts to the public during lockdown.

Many other companies stepped up to help during the pandemic, trying to be part of the solution and not part of the problem. E-commerce operators such as Sea, MercadoLibre and Alibaba delivered essential goods and services to their customers. Companies donated money and equipment, delivered medical supplies, hired furloughed workers and offered relief to suppliers and customers. You can argue about the extent to which these actions were in their own self-interest but at least they showed enough self-awareness to recognise that they need to offer support to their communities and government if they are to receive similar in return.

The 'Asian Century'

It is often said that the twenty-first century will be the 'Asian Century', a time when Asian economies, politics and cultures come to the fore, following on from a century of American hegemony and before that a period of dominance of British and European imperial influences.

It seems that the pandemic has accelerated these shifts. It has been the Asian countries, particularly those in North Asia, that have responded most effectively to the public health challenges of COVID-19 with mass testing and contact tracing. This is not the result of overnight changes. It is the consequence of decades of investment in public services, infrastructure and the machinery of government as well as a greater willingness to enforce strict lockdowns than in many Western countries.

Before COVID-19 struck, we felt that the most glaring example of the difference in the quality of public infrastructure between East and West was the ease with which we could travel around in Asian countries such as Korea and China using public transport and internal flights. This compared favourably with our frequently miserable travel experiences in the US where much of the public infrastructure is suffering from years of under-investment. On a recent trip to Hong Kong and China we travelled on the new high speed rail network between Kowloon and Guangzhou, reaching speeds of more than 300 km/h and with the choice of more than thirty services in both directions each day. The gap between the effectiveness of public provision in the US and North Asia appears to be getting wider and this has far-reaching implications.

This was evident in the stark contrast between the muddled response to the pandemic in the US and the highly co-ordinated response in China. It is difficult to characterise China as an emerging country in this context and the economy was more or less back to normal by the fourth quarter of 2020 with GDP growing 6.5% year-over-year. For 2020, GDP grew 2.3% and interest rates are just below 4%, low by historical standards but reasonable in the international context. Western countries have struggled in comparison, endured huge recessions, their governments have added trillions of dollars in debt onto their balance sheets and their economies look set for a period of low growth with the fiscal position leaving little room for manoeuvre. We sincerely hope for a better outcome than this and there is a possibility that the pandemic will prompt a shift in political attitudes in the West towards greater public investment and the need to tackle huge inequalities. However, this is more hope than expectation. It is likely that the coming years will see a growing divergence of fortunes between the countries that managed the pandemic well and those that did not.

Even before COVID-19 had taken hold globally, Charlie Munger commented that "*The strongest companies in the world are not in America. I think Chinese companies are stronger than ours and are growing faster." (*Daily Journal Corporation, Annual Meeting, February 2020*).* He began investing his family's money in China in the mid-2000s.

Many others have followed his lead. According to the UN, foreign direct investment in China in 2020 was larger than that in the US for the first time ever, totalling $163bn compared to $134bn. We observe a growing confidence amongst the leading companies in China. Encouraged by their government, many of the largest US-listed Chinese companies re-listed their shares in Hong Kong, raising huge amounts of new capital in the process. In addition, in recent years, many have invested heavily in R&D and provided venture capital to investee companies and are now seeing the fruits of these investments. For example, Meituan and Pinduoduo, who counted Tencent as an early investor, both saw their market capitalisations surpass $200bn during the year. And various businesses that have been incubated within large Chinese companies have gained separate listings in recent years, including JD Health from JD.com, Tencent Music Entertainment from Tencent and Lufax from PingAn, although Ant Group is a notable absentee from the list.

Looking beyond Asia

Even with the growth and quality of companies available in China and Asia, we still feel grateful that our investment mandate includes other emerging economies, especially those of Latin America. MercadoLibre, headquartered in Argentina and whose biggest market is Brazil, has been the largest contributor to returns for our UCITS portfolio since inception in 2016. Their CFO explains that the relatively slow development of e-commerce in Latin America, as compared to other markets, gives them the opportunity to learn from others and shape their business accordingly. The later development of their end-markets is a source of strength.

"We historically always try to understand very well what's happening in the global e-commerce landscape and if there are things that are applicable or things that are worth emulating, I think we've always been very adept at doing so and adapting it to whatever the local reality is. And our network is a case in point in that. We firmly believe that we are building out the most efficient network in the region across multiple geographies, not just in Brazil or just Mexico, and that obviously requires hiring the right people, investing aggressively but also learning what others are doing globally and replicating where applicable." (Pedro Arnt, CFO, MercadoLibre, November 2020).

2020 performance

For the twelve months to 31 December 2020, the GuardCap Emerging Markets (UCITS) Fund USD I Share Class returned 31.0%. This compares to a return of 18.3% for the MSCI Emerging Markets Index. Since inception, the USD I Share Class of the Fund has produced an annualised return of +15.7% compared to an index return of +13.5%.

2020 was the second consecutive year of high-teen percentage returns for the Index and the benchmark closed the year at a new high, having surpassed the previous peak of January 2018 during the fourth quarter. It was also the first year in three that returns from the MSCI Emerging Markets Index exceeded those of the MSCI World Index (+15.9%). 5-year annualised returns from the MSCI Emerging Markets Index (+12.8%) are now ahead of the equivalent returns from the MSCI World Index (+12.2%). During that 5-year period, China's weighting in the Emerging Markets benchmark has increased from approximately 25% to 40% as a consequence of relative performance, new issuance and the partial inclusion of A-shares. Over 10 years, the annualised returns from the MSCI World Index (+9.9%) are still well ahead of those of the MSCI Emerging Markets Index (+3.6%).

The emerging markets index is very different to our portfolio, with 1,397 constituents in MSCI's version at the end of 2020 compared to 26 equities in our portfolio. 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 65% was invested in companies that are represented in the MSCI Emerging Markets Index, 32% was in companies that are not represented in the index and 3% was in cash. Considering the portion invested in non-index companies, approximately 5% was invested in HDFC Bank, which is India's largest private sector bank and is domiciled in India but is not currently included in the Index. In addition, MSCI continues to categorise MercadoLibre - Latin America's largest e-commerce company and one of the largest positions in the Fund - as a developed market company.

A small number of investments benefiting from the emerging markets opportunity

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 will conclude by quoting William Ding's 2020 *Letter to Investors* again.

"So to the shareholders of NetEase, I wish to say that when NetEase first became public 20 years ago, our youthfulness was the biggest barrier to gaining trust from the investment community and the media. But as you have witnessed, it was exactly our youthfulness that fuelled our enthusiasm for hope and opportunity in the decades that followed."

Although we are not, unfortunately, as young as the NetEase team were when they went public in 2000, we recognise some of the sentiments in William's remarks. We hope that others will choose to invest alongside us.

Ed Wallace
Investment Manager