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 several years. 2022 marks the sixth 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.

2022 in review

From the perspective of economic growth, 2022 was a relatively benign year compared with the prior two years. 2020's pandemic-induced recession was amongst the deepest recorded, swiftly followed in 2021 by a recovery that broke records for its speed and scale.

In 2022, US GDP growth and global GDP growth rates were approximately 2% and 3% respectively, much slower than the recovery of 2021 but similar to the average growth rates of the previous decade. Of the major economies, China's 2022 GDP growth rate of 3% was one of the furthest below its pre-pandemic trend rate, with annual GDP growth ranging between 6-7% from 2015-19. The primary reason for the slower growth was the country's zero-COVID policy leading to frequent lockdowns and disruption to both production and consumption. At the height of the lockdowns in major cities such as Shanghai and Beijing in Q222, China's year-over-year GDP growth rate was just 0.4%, the lowest for decades except for the most acute phase of the pandemic in 2020.

It was a tough year for equity market returns, with higher inflation and rising interest rates combining with the devastating impact of Russia's war on Ukraine and China's ongoing struggles with COVID-19. Together, these factors have led to a deceleration in GDP growth and increased the risk of a prolonged recession in 2023.

When the pandemic first broke out in early 2020, the MSCI Emerging Markets Index (the 'Index') declined by more than one-third in the space of three months before almost doubling over the course of the following year, as pessimism rapidly turned to optimism. The subsequent 40% decline from the Index peak in February 2021 to the recent trough in October 2022 was more protracted and returned the Index to a level below where it had traded before the pandemic.

While there is a myriad of company-specific and market-wide factors that can explain the performance of emerging market equities over the last three years, the general market direction – down, up and down again – can be understood in the context of an economic outlook that has shifted from negative as COVID took hold, to positive as the economy restarted, to negative again as the recovery faltered.

Risks and remedies

Although the slings and arrows of the last three years are interesting to consider, what matters is that the businesses we are invested in are well-placed to deal with the challenges and opportunities that they face.

The share prices of all companies will be buffeted by the ups and downs of the market, no matter the strength of their underlying businesses. It is our job, however, to look past periods of elevated volatility, identify those companies that can grow sustainably and buy their shares when they are attractively priced.

It's not straightforward of course. There are many factors involved, which add uncertainty to any analysis. In recent years, regulatory and political risks in emerging markets have returned to the forefront. Will regulators allow companies to pursue strategies that can sustain their growth? Might the actions of governments prevent companies from operating in certain markets or curtail their access to foreign capital? For foreign investors in Russia, the imposition of international sanctions following the invasion of Ukraine led to huge – and most likely permanent - capital losses almost overnight. The Fund was not invested in any Russian companies, primarily because we could not find any that met our criteria for quality, growth and valuation, not least because of their exposure to the risks of doing business in Russia.

We trust in our criteria and process to focus us on the highest-quality companies that can turn the economic advantages of emerging markets into sustained growth in shareholder value. For a number of our Chinese companies, the market began to price in the risk of China going the way of Russia. There are many reasons why we do not think this will be the case but share prices have reflected a more negative view in recent months and years. This has contributed to two consecutive years of negative returns for our investors.

2022 performance

For the twelve months to 31 December 2022, the GuardCap Emerging Markets Fund USD I Share Class returned -21.6% on a net of fees basis. This compares to a return of -20.1% for the MSCI Emerging Markets Index, representing the worst year of returns for the Index since 2008. In addition, since its inception on 19 December 2016, the USD I Share Class of the Fund has produced a return of +25.5% net of fees compared to an Index return of +30.0%. This equates to a 3.8% annualised return to investors since inception compared to an Index return of 4.4%.

The Fund underperformed the Index from the market peak in early 2021 through to an interim market trough in April 2022. In addition to stock-specific factors, other contributing factors responsible for this underperformance were the absence of exposure to commodity companies and relatively high exposure to growth companies, especially in China, both of which had contributed to the Fund's outperformance in earlier periods.

The Fund seeks to avoid exposure to commodity companies, which are typically capital-intensive and whose products are subject to fluctuations in global supply and demand. These companies are price takers, and their share prices typically perform well during times of rapidly rising inflation, like the period from 2021 through mid-2022. However, once the market assessed that sharply higher commodity prices would likely result in demand destruction, their share price performance waned.

China, on the other hand, experienced a huge bear market over 18-months, with the local indices declining by almost as much as they did during the global financial crisis. Stocks do not fall in a vacuum and there has been a laundry list of challenges for investors to contend with, including new regulations

for big tech, the crackdown on privately-run after-school tutoring companies, tensions with the US heightening the risk of de-listing for Chinese ADRs, component and energy shortages, ongoing problems in the real estate market, an unprecedented third term for President Xi and the longstanding enforcement of a zero-COVID policy. Even though the economy avoided a technical recession, we observed a large recession in corporate earnings, particularly in the first half of 2022. Some of these challenges appear to be easing, especially with the authorities providing additional policy support and with an abrupt end to zero-COVID. Earnings growth forecasts are, in aggregate, being upgraded again ahead of an anticipated recovery in sales growth.

Sustainable growth businesses in emerging markets

Not every company that we invest in will have an unblemished record of sales and profit growth, year in and year out. However, we try to identify those companies that can grow sustainably over the course of a cycle and are resilient and adaptable enough to emerge from an economic downturn in a stronger competitive position.

Looking at our portfolio and reflecting on company performance through the ups and downs of the last three years, some companies have expanded their sales and profits throughout the period, some have experienced a decline in either sales or profits, and others have seen a decline in both sales and profits. We look at an example of each in turn and consider what this means for their prospects.

MercadoLibre – both sales and profits higher than 2019

MercadoLibre's revenues have grown from $2bn in 2019 to around $10bn in 2022. Net income was negative in 2019 and is forecast to be approximately $500m in 2022.

This has been a period of supernormal growth for the company, despite a recession in its largest markets in 2020. The company was well-positioned for the rapid increase in the penetration of e-commerce during the pandemic. Penetration rates have receded somewhat since lockdowns ended but are much higher now than in 2019 because new shopping habits were established.

The company has also continued to expand further in payments and logistics. It has grown a highly profitable consumer and SME lending business in recent years, returning the overall business to profit after a period of losses that resulted from investing in growth initiatives. The credit business brings new risks given the high rates of non-performing loans, albeit loan sizes are relatively small and loan durations relatively short.

The share price quadrupled during 2020 and has more than halved since, ending 2022 about 40% higher than it was at the end of 2019. Evidently, the market struggles to place a consistent valuation on the shares, which is understandable given the very high rates of growth and the large swings in profitability in recent years. Given the relatively early stage of development of MercadoLibre's markets and management's track record of capitalising on new opportunities, we continue to see strong potential for growth in revenues and earnings over the coming years, albeit at lower rates and more dependent on the economic cycle than in previous years.

Alibaba – sales higher than in 2019, profits below 2020/21 peak

Alibaba is one of the more controversial portfolio holdings, for obvious reasons. Its revenues were RMB500bn in the fiscal year to March 2020 and are forecast to reach approximately RMB900bn in the current fiscal year. Some of this growth has been organic and some has come from acquisitions. Adjusted net income will be similar in March 2023 to what it was in March 2020 but much lower than its peak level in March 2021, despite revenues continuing to grow since then.

There are lots of moving parts but, in short, the most profitable parts of the business – Taobao and Tmall – have seen revenues decrease in the last year because of a weaker economy and ongoing competition. The faster-growing parts of the business such as services, cloud and logistics have continued to grow but at a slower pace and are much lower margin (or loss-making) businesses when compared to the core Chinese e-commerce operations.

Unlike in Latin America, where the secular tailwinds for digital services have remained strong, the penetration rates in China are already much higher. Combined with some tougher regulatory measures, it has been difficult for Alibaba's core business to grow much faster than GDP. Consensus earnings forecasts for the year to March 2023 more than halved, and the ADRs, which had gone up by approximately 50% in 2020 and peaked more than 3x above their 2014 IPO price, subsequently fell by 75%. Other controversies, including the last-minute cancellation of Ant Financial's IPO and the risk of ADR de-listing, led to a significant valuation de-rating.

In our view, Alibaba remains a quality business with prospects for sustainable growth in both revenues and earnings. We believe it is entering a more mature phase of its development, with a well-established, second-generation management team in place. Growth will be slower than before because the core markets it serves are growing more slowly, regulations are tighter, and competition remains intense, albeit some weaker players have exited. Management is investing in several interesting new businesses, but these are at earlier stages of development, and the future returns they can generate are less certain.

Returns on invested capital for the business overall are high, and cash generation is exceptional. Even in a tough year such as 2021, when profits fell sharply, the company generated more than $20bn in cash from operations. It has returned almost $20bn through buybacks since the start of 2021, while retaining a net cash position on its balance sheet. There are ongoing risks, especially around regulation, but the valuation has been close to record lows in recent times.

Yum China – system sales and profits both lower than 2019

Yum China's reported revenues will be higher in 2022 than in 2019 because of the acquisition and consolidation of some sizeable local KFC affiliates in the interim. However, total system sales are the best measure of the overall strength of its restaurant business, and these are forecast to be lower in 2022 than in 2019. Sales at Yum China's KFC and Pizza Hut restaurants were on course for recovery in 2021, but a resurgence of COVID cases and renewed lockdowns through 2022 caused a setback. Restaurant margins had also been recovering but ultimately sales are the most important driver of margins, and therefore profits will be lower in 2022 by 30% or so compared to 2019.

Yum China is an example of a company that has innovated and gained share during the downturn when smaller and less well-capitalised competitors have been forced to retrench. The company has invested extensively in growing its digital business, delivery services, and restaurant base. Over the last three years, the number of digital members has grown by about 50% to 400m, delivery revenues will be approximately 2.5x higher, and the number of restaurant units has increased by almost a third. The network effects of a denser store base are evident – the closer a restaurant is to a customer's home or workplace, the more convenient it is for them to walk a short distance to dine-in or pick up a takeaway. It is also quicker to deliver fried chicken or pizza to nearby addresses and thereby the better the quality of its product on arrival. This is a network effect that their competitors struggle to replicate at scale, even with access to third-party delivery drivers.

Management of the business has been good during the downturn. The company has avoided laying off frontline staff and has improved medical insurance coverage for restaurant managers and their families. It has generated $1bn+ in cash from operations annually even with a lower level of sales. This has given it scope to invest for growth and continue to return cash through dividends and buybacks. The share price recovered quickly from the initial phase of the pandemic before falling sharply as China struggled to contain the resurgence of COVID. The shares ended 2022 higher than they ended 2019, with optimism growing about a full re-opening of the economy. The valuation is not far from the long-term average, suggesting that there is a reasonably widespread conviction that Yum China can deliver sustainable growth over the long term. This is not surprising given the company's ability to weather the storm over the course of the last three years.

A selective approach to emerging markets

We use the MSCI Emerging Markets Index as our benchmark, but not all the equities that we invest in are included in the Index. 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. What is important to us is that they stand to benefit from the growth of emerging market economies and have the quality to provide certain protections to shareholders.

Of the Fund's NAV at the end of the year, approximately 56% was invested in companies that are represented in the MSCI Emerging Markets Index, 42% was in companies that are not represented in the Index, and the remainder was in cash. Considering the portion that is invested outside of the Index, a number of these companies are listed on emerging market exchanges. For example, approximately 7% of the NAV 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, other portfolio companies currently excluded from the Index include Mexican-listed tequila manufacturer Becle and Chinese-listed appliance manufacturer Midea. Similarly, MSCI continues to categorise MercadoLibre – Latin America's largest e-commerce company and the largest position in the Fund at year-end – as a developed market company.

A small number of investments benefiting from the emerging markets opportunity

The Fund owned 27 companies at the end of 2022 compared to 1377 constituents in the Index. We cast our net wide to identify those companies that have exposure to the emerging markets opportunity. Still, we focus our portfolio on a small number of equities that offer a combination of growth and quality and are available to purchase at an attractive valuation. It is our view that, over the long-term, a considered investment in a small number of companies will generate superior returns when compared to investing in a highly diversified index that includes many companies with poor economics and excludes a number of attractive investment opportunities in the region.

The returns from the Fund will inevitably follow a different pattern from those of the Index, which contains more than fifty times the number of companies. We expect the aggregate earnings of our companies to compound higher over the course of the economic cycle, comfortably outgrowing the average and delivering better investment returns than the Index.

Our conviction in the portfolio's ability to generate superior long-term returns is as high today as it has ever been, given the starting point of lower-than-average valuations and depressed earnings for many of our portfolio companies.

Ed Wallace, Joris Nathanson & Alice Yin
Investment Managers

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