GUARDCAP

19 January 2024

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. 2023 marks the seventh 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.

2023 in review

Emerging market equities began 2023 on a wave of optimism about the reopening of China, following three years of strict lockdowns. This optimism faded as it became evident that the recovery of the world's second largest economy was going to be slower-than-expected. While pessimism about China's economic prospects became more entrenched, falling US Treasury yields triggered a sharp improvement in most other equity markets in the last two months of the year.

For 2023, the MSCI Emerging Markets Index (the 'Index') returned +9.8%, boosted by the performance of the bigger markets outside of China such as Taiwan (+30.4%), India (+20.8%), Korea (+23.2%) and Brazil (+32.7%). The MSCI China Index returned -11.2%. China was the worst performing equity market of the 24 countries included in the emerging markets universe.

From the perspective of official economic data, China has performed reasonably well. GDP growth of 5.2% has been confirmed for 2023, an improvement compared to 3% in 2022, although it is difficult to reconcile 2023's GDP growth rate with what was reported by many of the companies operating in China. India's economy has barely missed a beat since COVID with GDP growth of 7% forecast for 2023, following 7.2% in 2022 and 9.1% in 2021. Brazil's GDP is expected to have grown 3% in 2023, similar to 2022, while Taiwan and Korea are expected to have grown at developed economy-like rates of between 1-1.5%.

For the twelve months to 31 December 2023, the GuardCap Emerging Markets Equity Fund USD I Share Class returned +4.8% on a net of fees basis. Since its inception on 19 December 2016, the USD I Share Class of the Fund has produced a return of +32.1% net of fees compared to an Index return of +42.7%. This equates to a 4.0% annualised return to investors since inception compared to an Index return of 5.2%.

From an absolute return perspective, it was the best year for the Fund since 2020 but also the third consecutive year of relative underperformance. As we have written before, emerging markets indices are very different to our portfolio, with more than 1400 constituents included in MSCI's version as of the end of 2023. This is more than 50 times the number in the Fund, which ended the year with investments in 27 different companies. As a result, the annual returns from the Fund will inevitably follow a different pattern from those of the Index, depending on the annual progress of earnings at

our companies and whatever happens to be in favour - or out of favour - at any point in time. Over the course of many years, however, we expect the earnings of our companies - in aggregate – to comfortably outgrow the average and deliver better investment returns than the Index.

The portfolio analytics that we use show that most of the portfolio's forecast risk is a result of stock specific exposure. Factor exposures are generally smaller but can still be impactful. The common factor that we would highlight for the Fund's relative underperformance in recent times is exposure to companies doing business in China, where economic growth and corporate profit growth has been weaker-than-expected for many different reasons. We address this exposure in the following section and later in the context of the Fund's holdings in Alibaba and NetEase.

Why bother with emerging markets?

From the perspective of absolute and relative returns, it has been a tough time in emerging markets for almost three years now. Although the market bottomed in October of 2022, there has not been a sustained recovery. The asset class has not bounced back like it did after the global financial crisis - when the Index doubled from its trough level in less than a year - or after COVID - when the Index almost doubled from its trough level within twelve months.

By the end of 2023, the Index had recovered by 25% from its October 2022 low and was still well below its February 2021 peak. It has returned an annualised -5.1% over a three-year period. The MSCI World Index for comparison reached a new high in December 2023, almost 40% above its low point in 2022 and has returned an annualised +7.3% since the end of 2020.

Another year of underperformance of emerging markets' equities has led many investors to question if they should be invested in the asset class at all, given the higher risk and lower return profile that dates to the early part of the last decade.

Part 1: The case for long-term growth

At times like this, when sentiment is depressed, we find it useful to remind ourselves of the investment case for emerging markets. While there are many arguments for and against, we have found it helpful to distil the positive case into two simple propositions: emerging economies are where most of the world's population live and are where most of the world's economic growth is generated.

To illustrate the demographic point, more than one-third of the people on the planet live in just two countries - China and India. The UN estimates that developing economies account for more than 80% of the world population. These people are, on average, getting wealthier over time because of economic development. According to the IMF, the compound annual growth rate of real GDP in emerging market and developing economies has been more than 2x the pace of growth in advanced economies since 1988. Thanks to the wonders of compounding, this means that emerging and developing countries have increased the size of their economies by five times over the period to 2022 compared to a doubling in size of advanced economies. The 2x rate of growth in emerging and developing countries is forecast to continue for at least the next five years[1].

The scale of the economic growth is huge. Chinese GDP, for example, was approximately 18 trillion US dollars in 2022. Assuming 3.5% annual growth in Chinese GDP, that is an incremental 600 billion US dollars of economic growth each year. For comparison, the UK's total GDP was 3 trillion US dollars in 2022. This means that China could potentially add an economy the size of the UK every five years.

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[1] IMF, World Economic Outlook, 2023

With growth in emerging markets on this scale, we believe it is inevitable that the asset class will offer many attractive investment opportunities over time. Of course, China has been a big source of capital losses in recent times and is the reason for much of the negative sentiment. The risks of geopolitics, regulation and the property market dominate the headlines. While recognising these and other potential pitfalls - and acknowledging that the economic growth rate in China will necessarily be slower than in the past - our expectation is that resolute policymaking efforts combined with entrepreneurial ambition and the sheer weight of numbers, will mean that China remains an important part of the global investment universe in the years to come.

In the meantime, the Fund is invested in what we consider to be some excellent company-specific opportunities. These include Chinese businesses that are led by founder-owners or executives who remain committed to investing for growth and generating long-term value. A number have increased cash returns to shareholders in response to fewer near-term growth opportunities and low equity valuations. In fact, for most of our Chinese investments, valuations are near an all-time low but positive earnings momentum has largely been absent. We continue to wait patiently for it to return.

Part 2: Sustainable growth businesses in emerging markets

Another helpful reminder of why we dedicate our research efforts to emerging markets comes from a closer examination of the companies that we are invested in.

As in previous years, we take this opportunity to share more details on the some of the companies the Fund invests in. This time we cover one from India, two from China and one from Mexico.

HDFC Bank

We have always been cautious when it comes to investing in banks. Warren Buffett put it best when he said: *"Banking doesn't have to be a bad business, but it often is. Bankers don't have to do stupid things, but they often do".*

In the developed markets, if you manage a bank and you want to grow faster than GDP, then you probably need to take on extra leverage or riskier loans.

In certain emerging economies, on the other hand, there is a natural growth of the banking market as the middle class grows and new parts of the population get access to financial services for the first time. But you still need to be highly selective given the risks involved.

The Indian banking market remains amongst the most attractive in the world from a long-term perspective, driven by a combination of sustainably high economic growth and relatively low banking penetration.

For example, India's retail loan-to-GDP ratio stands at approximately 15%, whereas in the US it is more than 75%. And public sector banks still dominate in India, controlling about 70% of total assets.

HDFC is a best-in-class private sector bank in India. By this, we mean that it has delivered consistent growth in revenues and earnings, while remaining suitably conservative in its approach.

It has a conservative balance sheet, supported by a strong deposit base. The management are conservative in terms of their lending practices and their provisioning policies and have a strong track record over the course of many cycles.

We consider HDFC to be one of the best banks in the world, operating in a country where it is possible for a bank to grow sustainably. The Fund has owned the shares since 2018.

2023 was a year of transition as the bank completed a merger with its parent company, the housing finance business HDFC Ltd. The merger was announced in April 2022 and completed almost 15 months later in July 2023. HDFC Bank's shares did not make much progress in the intervening period, while the broader Indian equity market continued to rise.

The merger helps HDFC Bank to become a full-service bank. The two entities were separate in the first place because of legacy regulatory constraints for private banks (it was only in 1993 that regulations permitted private sector banks in India). The deal includes the parent company's shareholdings in HDFC Group businesses in wealth management, life insurance and general insurance. Moreover, it gives HDFC Bank the ability to distribute mortgages directly and to access HDFC Ltd's branch network. This is in keeping with the bank's strategy of growing its retail loan book. Mortgages are long duration products that help to extend the bank's retail asset duration and to foster the development of long-term relationships with their customers.

With the merger now having completed, we'd expect to begin to see more evidence of the fruits of the transaction, which we believe could bring meaningful benefits to shareholders over time.

Alibaba

We return to Alibaba, which has been held in the Fund since 2019, and was discussed in last year's letter. Reflecting on recent performance, we think of the company as a microcosm of the broader Chinese economy and equity market. In 2023, for example, its ADRs returned -10.8% (inclusive of the recently instituted dividend), almost identical to the return from the MSCI China, of which it is the second largest constituent. The shares ended 2023 more than 20% above their October 2022 low but are far below their 2020 peak and at $78 per ADR were less than $10 higher than the 2014 IPO price.

At the beginning of 2023, Alibaba's share price had risen by almost 100% in the three months after the Chinese authorities announced an abrupt end to the country's policy of strict lockdowns. However, like much of the rest of the Chinese economy, the speed and scale of the business recovery at Alibaba proved disappointing relative to initial expectations. Consumer confidence and spending power did not rebound like they did in the US and Europe after COVID, where generous government support schemes had helped to soften the impact of lockdowns on employment and household savings. Problems in China's housing market also weighed on consumer sentiment and spending.

Whereas sectors such as travel and eating out benefited from pent-up consumer demand, e-commerce, especially larger ticket purchases, were slower to recover. Given the huge scale of Alibaba's business and the relatively high rates of penetration of digital services in China, it has been difficult for Alibaba's core e-commerce business to grow much faster than growth in consumer spending, especially as these consumers were free to shop offline more easily after COVID.

The June quarter saw a return to revenue growth in customer management revenues at Taobao and Tmall, benefiting from easier comparisons and growth coming from investments in "value for money" offerings. Sales growth fed through to better profits, helped by the cost reductions made in the previous two years. However, there was a setback in the following quarter as the core domestic business struggled for growth amidst a tepid economic recovery. With less growth to go around in the e-commerce sector, the competitive environment had become more intense, with some of the newer entrants - notably Pinduoduo and Douyin - taking market share. We have seen similar dynamics reflected in other sectors of China's economy – competition intensifies when industry growth slows. Alibaba's growth in its international e-commerce business, on the other hand, exceeded expectations as the company took steps to improve product selection and quality and worked to reduce delivery times, helping it to win market share.

Regulations in China are undoubtedly tighter than they were three years earlier, but the regulatory environment has normalised after the upheavals in 2020 and 2021. There has been change in top management at Alibaba during 2023 as the partnership and the board tries to effect positive change, with a new Chairman and a new CEO taking over during the year, albeit both with long experience in the business. There have also been several changes at senior executive level, as the new leadership puts its stamp on the management team.

In March, under the previous Chairman and CEO, Alibaba announced an extensive corporate reorganisation - forming a holding company for its six business groups - but has subsequently struggled to implement plans for IPOs of two business units because of weak capital markets. In November, it cancelled the planned spin-off of its cloud division, citing restrictions on the availability of AI chips because of geopolitical disputes with the US. The future of the original restructuring plan is uncertain.

Many of Alibaba's challenges reflect the broader challenges that Chinese equities have faced in recent times. Despite the headwinds, the company is likely to grow both its revenues and profits during calendar year 2023. Management has committed to improving ROIC in its operating businesses and will review all its existing businesses with a view to determining which are core and seeking ways to monetise those deemed to be non-core. We agree that this a worthwhile exercise even if it means undoing strategic errors that were made under previous management.

Cash generation remains exceptional. The company reported free cash flow of $27bn in the 12 months to the end of September 2023. It has returned almost $30bn through buybacks since the start of 2021, while retaining a net cash position on its balance sheet. This included $9.5bn of repurchases in 2023, supplemented by its first annual dividend worth $2.5bn. On a year-end market capitalisation of about $200bn, the combined figure of $12bn represents a shareholder return yield of 6%.

Alibaba is now in a more mature phase of its development, and we consider it to be a quality business with prospects for sustainable growth in both revenues and earnings. There are ongoing risks and challenges, but the valuation ended the year close to an all-time low, at less than 10x P/E on our estimates. The ongoing corporate reorganisation and strategic review may help to unlock some of the valuation discount. A sustained economic recovery in China, enabling stronger revenue and earnings growth at Alibaba, would be a more powerful catalyst.

NetEase

We first wrote about the gaming company NetEase in the 2020 letter, having acquired the shares earlier that year. It is unique amongst our Chinese holdings, insofar as its share price almost recovered to its previous peak level during 2023. This has not been the case for our other Chinese holdings, most of which are well below their previous high. There was a setback for the stock in late December when new draft regulations for gaming companies were announced but subsequent news has indicated that the impact will likely be more benign than initially expected.

NetEase's recovery is a reminder of what is possible. After a challenging period when new game approvals were suspended, the regulatory approach normalised in the second half of 2022 and through 2023. Since game approvals restarted, NetEase has delivered growth in its new and existing game franchises, benefiting from both pent-up supply and demand following the regulatory delays.

NetEase's in-game items tend to be small-ticket purchases, which suits a cautious consumer environment, and it has taken some share from other gaming companies. As a result, earnings momentum has been relatively strong in a challenging economic environment and the valuation has recovered somewhat, with the price-earnings ratio approaching the long-run average. The annual

dividend was raised by 16% in 2023 and the company has continued to repurchase shares, with a total cash return of about $9bn over 4 years on a current market capitalisation of approximately $60bn. Earnings per share will also have grown by about 100% over the same period, making for a nice combination of growth and returns.

NetEase operates in a growing industry and the company have developed a very strong operating model that has helped them to sustain their growth, even against strong competition. The founder William Ding summarised the company's approach on the Q3 earnings call, explaining that "*innovation through content production continues to be the cornerstone of NetEase and will be what propels our future growth.*"

With the wind behind it, it is encouraging to see what one of our companies in China can deliver. We expect that others will innovate and adapt and find ways to grow, despite the challenges.

Becle

Becle has a rich Mexican heritage. It traces its roots back to the 1750s when King Ferdinand VI of Spain granted land to Don Jose Antonio de Cuervo in the town of Tequila, Jalisco. Here the family founded a farm to cultivate the blue agave plant, distilled to create tequila. In 1795, Don Jose's son Jose Antonio de Cuervo was granted a licence to produce and distribute tequila, following a period of prohibition. The La Rojena distillery was established in 1812. In 1873, the first barrels of tequila were exported across the border and in 1880 Cuervo became the first company to bottle tequila, later establishing the brand of Jose Cuervo.

The management of the company has been the responsibility of the Beckmann family and their ancestors for more than 200 years. It came to the public markets for the first time in early 2017 and we bought shares soon after the IPO. Post-IPO, the family owned 85% of shares outstanding and the Chairman and CEO roles were split between father and son. The father has since retired, and his son Juan Domingo is now Chairman and CEO.

Warren Buffett said, in 1999, of Berkshire Hathaway's operating companies: "*We simply ask our managers to run their companies as if these are the sole asset of their families and will remain so for the next century."* We would argue that this has long been the case at Becle and remains much the same today, even after its public listing.

Over the course of many years, the team at Becle has developed a highly profitable, growing business with more than $2bn in sales and EBITDA margins of 20%, establishing it as the leading tequila company in the world.

It has the sustainable growth and quality profile that we look for. It is a business that is unique to Mexico – tequila can only be produced in the appellation of origin – but its sales are becoming increasingly global as the company expands its international reach and its product portfolio.

There are good opportunities for ongoing organic growth in the tequila business, which is one of the fastest growing spirits categories in the world. The category has been undergoing a premiumisation shift, with premium 100% agave tequilas gaining share at the expense of cheaper 51% agave blends. In addition, the company has had some success diversifying outside of tequila, most notably with the Bushmills Irish whiskey brand that it acquired from Diageo in 2015.

After a period of strong performance Becle's shares have struggled since 2022, hindered by a slowdown in the growth of the global spirits market as well as high earnings volatility from one quarter to the next. The appreciation of the Mexican peso against the US dollar has been a headwind to

earnings growth because the majority of the company's revenues are in dollars and most of its cost base is in pesos. On the other hand, the price of agave appears to have peaked, and this should be supportive for future profitability. The shares fell by about 20% in 2023. From our analysis, we conclude that Becle's business still has a long runway for profitable growth and the recent valuation is close to its lowest level since the IPO.

A small number of investments benefiting from the emerging markets opportunity

HDFC Bank, Alibaba, Netease and Becle are 4 of the 27 investments that the Fund owned at the end of 2023. All four of them are exposed to secular growth trends, operate in higher return industries and we believe can deliver sustained growth in shareholder returns. Together those companies accounted for approximately 15% of NAV at year-end.

Managing a concentrated portfolio means taking a very different approach from more diversified portfolios and broad market indices. 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. Our conviction in the Fund's potential to generate superior long-term returns remains high, not least because we enter 2024 with lower-than-average valuations and depressed earnings for many of our portfolio companies, which we think still offer a strong combination of quality and future growth.

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