Reasons to still be optimistic on emerging markets

As we approached Q2 this year, we made some very optimistic calls on how emerging markets would cope during the coronavirus pandemic and where we would look to invest through this period. In his latest webcast, fund manager Jorry Nøddekær reviews these calls as well as explaining what his current outlook for emerging markets outlook is, with a specific look at the role technology will play in their recovery.

In April, we called a V-shaped recovery, referring to the 90% economy where we said with the exception of travel, hospitality and so on most industries would go into 2021 at more or less their nominal trend growth rate. We had plenty of comments saying we were too optimistic, so I am pleased to say that so far, six months later, I still feel relatively comfortable with the call across most of the key emerging markets.

North Asian economies in particular performed well given how they were able to deal with COVID-19 and keep the economy running at the same time. If you look at like export data or normal economic activity, we have seen a V-shaped recovery and the ASEAN region has also performed relatively well. Countries within ASEAN have performed differently, with our standout being Vietnam while Indonesia and Malaysia are a little trickier – we do not have much exposure here.

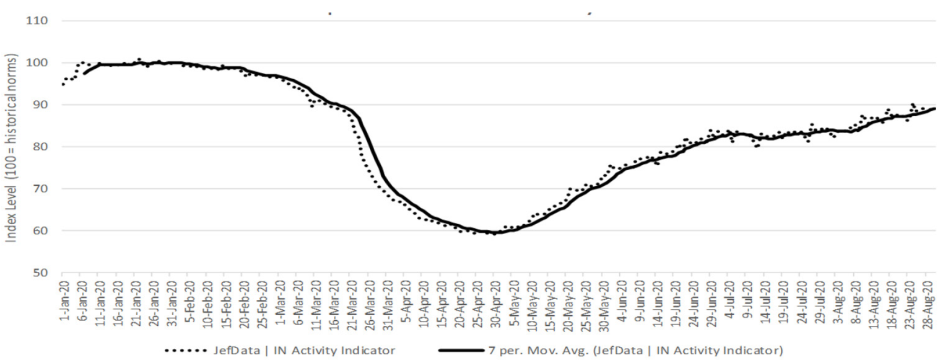
Jorry Nøddekær
Fund Manager
Jorry joined Polar Capital in June 2018 to set up the Polar Capital emerging markets growth franchise in July 2018.

CITYWIRE AAA

Source & Copyright: CITYWIRE. Jorry Nøddekær have been awarded a AAA rating by Citywire for his 3 year risk-adjusted performance for the period 31/07/2017 - 31/07/2020. Fund inception date: 29/06/2018.

India has captured many of the Asia headlines and short-term economic activity data indicators show it is close to a 90% recovery. If you look at some of the more complicated datasets like deaths per 100,000 people then the numbers are high, hardly surprising given its 1.4 billion population. India is still performing well on a relative basis – another call we made in April – as when you have a young population it will not be hit to the same degree as those countries with a more mature demographic. While India's equity market has lagged, our glass is still half full as sentiment is strong and the real economy is following the kind of path we were hoping it would.

JefData India Economic Activity Index



Source: Jefferies, September 2020.

Latin America has been problematic. It is more commodity-driven at a time when exports are pulling down the economy as a whole. On top of this there are specific issues with, for example, Brazil and President Jair Bolsonaro's policies that have left a lot to be desired. On the ground, however, we are seeing some of the country's technology companies – cable internet services and so on – coming through and performing extremely well in this environment.

Something else we highlighted in April was the comparison everybody had with the global financial crisis where, again, we stuck our neck out by saying this is actually slightly different from the global financial crisis. We think the supply-side disruption was significantly higher during the global financial crisis and this time the recovery will be faster.

Awards & ratings

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With the data we are seeing so far on G10 countries, or the global economy in aggregate, we are seeing a more V-shaped recovery that has definitely been faster than we saw during the global financial crisis. So, again, in terms of our call in April, we feel relatively comfortable with our analysis and how we view these developments.

"The developed world will be carrying their built-up debt for years to come which is something everybody should keep in mind when they allocate between developed and emerging markets"

Structurally, with monetary stimulus at least, we think emerging markets are behaving much more rationally than developed markets, Europe and the US in particular. There, we have seen aggressive policy measures that are giving the worst of both worlds. COVID-19 is not being fully managed and their economies have taken a big dive downwards, even though some industries are showing a V-shaped recovery.

One thing to highlight is, looking at US data, we are literally seeing the same response as World War II when, in my mind, there is a huge difference between COVID-19 and World War II.

Fiscal support has been the largest and fastest in peacetime

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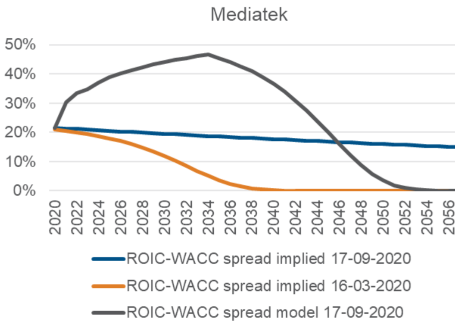
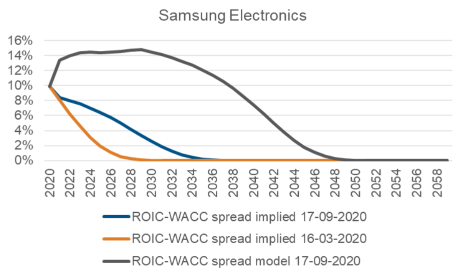
In Europe – and I know I am comparing apples with oranges but I think there are some shared underlying trends here – I think we are potentially creating large liabilities in developed markets with the current coronavirus policy response and the disease's impact on the economy. In this respect, emerging markets offer a lot more as they are better managing the pandemic and they will have a higher structural growth rate as a result. The developed world will be carrying their built-up debt for years to come which is something everybody should keep in mind when they allocate between developed and emerging markets.

Switching to sector or thematic trends, technology is not only important as a theme in itself but also because of the impact it is having on others, helping them develop that much faster. We still see it as a kind of 'creative destruction' across a number of industries and sectors, and generally see it as being in only the first phase of these development trends. There is a huge second technology cycle leg coming into 2021 and 2022.

While we will find greater agreement on the bigger thematic trends, what about their valuations?

Valuation Opportunities





Source: Polar Capital Emerging Markets and Asia Team, September 2020.

"When we talk growth versus value, we need to think about it at an industry level and those that will do well when we get a strong demand recovery"

To illustrate the point, we slightly reversed our EVA (economic value add) model, trying to show an implied growth rate from data we could get in the market and, while not an exact science, it gives a good indication. The orange line represents the implied EVA growth rate profile, clearly depressed during the lockdown which was generally the picture for many companies. The blue line is where the market is pricing these two companies now. There is a big spread between what is now implied in the market versus our valuation and we are still finding similarly attractive valuation cases across emerging markets. Many are in our portfolio, which makes us very comfortable about the return opportunities going forward.

Growth and value: not a binary choice

We are increasingly meeting investors who argue the case for value given how well and for how long growth stocks have performed. Obviously, we would still argue the case for our growth style but generally, when we talk growth versus value, we need to think about it at an industry level and those that will do well when we get a strong demand recovery. These more cyclical business models are beginning to appear and, where they have pricing power, they are likely to generate excess returns. This was the picture we saw for the couple of decades before the global financial crisis when what we have been seeing in the past few years has been growth doing better than value.

The way to explain it simplistically is we now have a demand curve sliding downwards and a supply curve shooting up, driven by technology that means you can now produce much more with a lot less, leading to that supply-side expansion. Instead, when we discuss growth versus value, we think about what is moving these two curves and where we get the imbalances between the two. Our process aims to take advantage of these imbalances.

Social demographic trends indicate consumers have a very different set of preferences, way of living and budget compared to the slightly older generation. As a result, demand curves across many industries are under significant pressure, a structural trend that will continue for years. At the same time, people have to ask whether some of technology-driven disruption is about to disappear or is only just starting. For example, the energy market is just starting to be disrupted so we think these old industries are suddenly getting pricing power back. I would even add that one of the issues we have seen during COVID-19 is a lot of the old capacity is still alive and well – it is not like the old style structure where when we have weakness, the weak players disappear, and the few surviving companies get the pricing power. Six times in the past few years we have seen value trying to make a comeback and we see swings in the market as a result. However, structurally, technology and disruption will impact more and more industries, which leaves us very comfortable with our investment process, looking for the imbalances between demand and supply.

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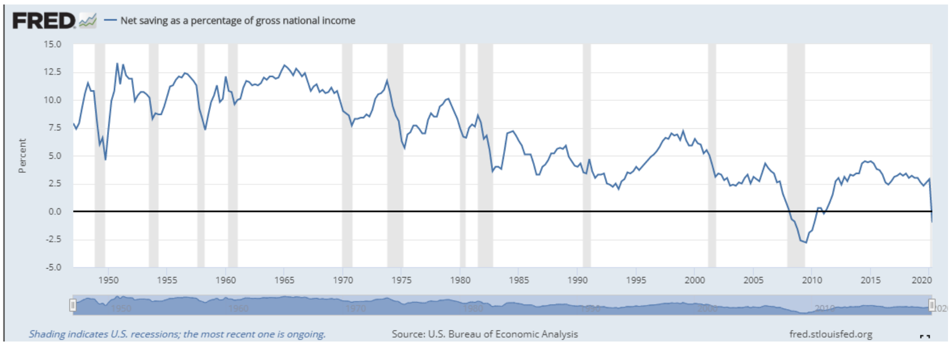
Net saving as a percentage of gross national income



Source: US Bureau of Economic Analysis and fred.stlouisfed.org, September 2020.

"In March...we felt our companies' fundamentals were stronger than the market was pricing them at and, so far, that call is pretty much right"

Many see a link between a weak dollar with strong reflation and an increase in nominal spending power in emerging markets. Looking at monetary policy in the US as well as physical spending shows savings rates are dropping, partly because of the budget deficit and partly because of the more hazardous environment to invest in the US. We could see a weaker dollar for a period of time, but we acknowledge we cannot forecast the dollar or any other currency. What we will say is that if you believe in a weak dollar, our portfolio will not be the one that benefits as a direct result.

Right now, we see a number of very weak emerging market economies, such as South Africa and Turkey. They may improve, but we still think they are too risky an investment to take on and a weak dollar may not reflate these economies. At best, maybe they will just about keep them afloat, but it is not something we think is attractive enough to identify underlying stocks that can be value creative. So, a weak dollar may be a tailwind but we are not overplaying it. We are not sure we will see the traditional impact of a weak dollar this time around in emerging markets.

Our approach is about finding an EVA spread that is being mispriced by the market. We have not only been making good returns from the technology companies in our portfolio, but also from, for example, a Canadian copper mining company; a South Korean manufacturer; an Indian insurance company; and an Indonesian micro lender specialising in the female market. We believe we have a great deal of balance and variation in our portfolio and we continue to invest productively in areas that are normally not perceived as high growth because of our ability to identify a company's EVA spread.

Fund Performance

In March, we made a call that the market was getting very, very cheap, particularly for the stocks in our portfolio. We felt our companies' fundamentals were stronger than the market was pricing them at and, so far, that call is pretty much right.

Even with the volatility in September, our Fund has beaten its benchmark, that is roughly flat, by around 20% year to date[1]. This has really been down to our stock-picking which is the core of what we try to do with our investment philosophy and process.

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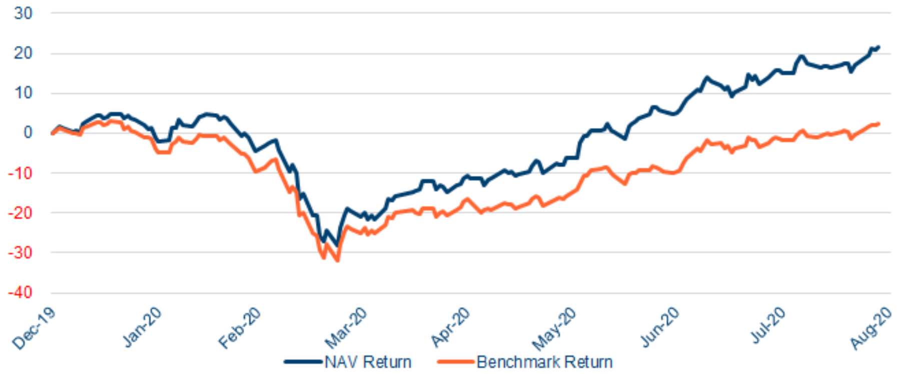
[1] Polar Capital; 21 Sept 2020.

Performance: Fund versus benchmark (%)



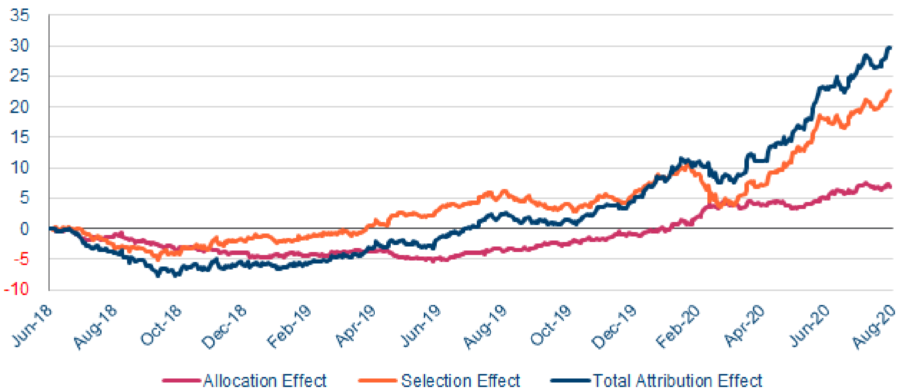
Source: Polar Capital; 28 August 2020. Benchmark is MSCI Emerging Market Net Total Return Index. Past performance is not indicative or a guarantee of future returns. All opinions and estimates constitute the best judgment of Polar Capital as of the date hereof, but are subject to change without notice, and do not necessarily represent the views of Polar Capital.

"For us, it is about finding companies that are truly able to navigate through the bad times as well as creating value, running a strong sustainablility profile"

The strong returns we have been able to generate since the end of March are down to the quality of our companies and their adaptability. COVID-19 has been the ultimate stress test for a portfolio, with massive disruption on the supply and demand side of the economy. Which companies have been able to control their stakeholder environment, still have customers who will pay for their services, with the balance sheet to navigate this environment and adapt to what has hit them? Generally, our companies have benefited from COVID-19 in terms of really showing how valuable their products and services can be. They have shown prudent management of their balance sheet – which has proven invaluable during this period – that has allowed them to take advantage of the situation, both in giving good service to customers and making sure they are positioning themselves for the next leg. I will come on to that later.

Over the longer term, it is consistent with the way we have implemented the strategy for the past nine years, where we have generated strong performance versus the benchmark. For us, it is about finding companies that are truly able to navigate through the bad times as well as creating value, running a strong sustainability profile.

Sector Breakdown: Bottom-up aggregation (%)



Source: Polar Capital, 28 August 2020. The Fund was launched on 29 June 2018. Performance contributions are quoted gross of fees. Totals may not sum due to rounding. Past performance is not indicative or a guarantee of future returns.

We feel our performance goes hand in hand with the strong sustainability profile of the companies in our portfolio. In fact, we would flip it around and believe our companies have actually been able to perform the way they have because of their strong sustainability profile, highlighting their quality and adaptability.

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"We firmly believe we are ready for any second leg of the COVID-19 pandemic and see attractive opportunities around technology alongside internet and healthcare services"

Fund activity

As mentioned earlier, we have seen a strong rebound since the bottom in March and our relative and absolute performance have been strong. We have been more active than usual, largely because the outside events and the fundamental changes in the market have been so profound. We have maintained our barbell approach, acknowledging there is still a lot of uncertainty combined with ongoing massive structural changes.

A decent portion of the portfolio will include high quality businesses, including some of the internet service-related companies. They are not dirt cheap, but they do show signs of strong growth, so we still find these companies attractive and think they offer good downside protection, with strong upside potential.

Furthermore, I still believe we are in front of the big 5G-led technology cycle that is just about to kick in, finding cheap companies with very strong fundamentals. We have been allocating/reallocating capital into these kinds of company so again we think we have been able to optimise the portfolio. We have also added new names into the portfolio, taking profit from some of the strongest performing names as they hit their target price. For instance, we have recently been buying Seoul Viosys, a micro LED and UVA lighting technology firm, as well as Agora, an exciting Chinese software company focusing on interactive live video communication – a Zoom 2.0.

What I want to highlight is we have not been standing still and have a number of attractive companies with attractive risk/reward profiles. We firmly believe we are ready for any second leg of the COVID-19 pandemic and see attractive opportunities around technology alongside internet and healthcare services.

Jorry Nøddekær, Fund Manager

Polar Capital Emerging Market Stars Fund

28 September 2020

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