EMERGING MARKET INVESTING – WHY DO WE DO WHAT WE DO?

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Baillie Gifford started running dedicated emerging markets (EM) portfolios in 1994. Over that time, the philosophy underpinning what we do hasn't changed. We've always been active, always focused on growth and never allowed ourselves to get bogged down in short-term earnings estimates or price targets. Here, we revisit the evidence backing our investment philosophy as we ask ourselves, why do we invest in EM equities in the way that we do?

BEING SELECTIVE

Active investment may be out of favour, but we would strongly suggest that EM equity is an asset class where active management works best and where having a dedicated EM manager makes sense.

Being selective is critical, particularly now we are long past the China fuelled pan-EM boom. While investing in EM means you are gaining exposure to the world's fastest growth economies, GDP growth doesn't always lead to high stock market returns. Take Malaysia, for example, which has grown its GDP at an impressive 5.3% p.a. in US dollar terms over the last 20 years, and yet its stock market has contracted by 1.5% p.a.

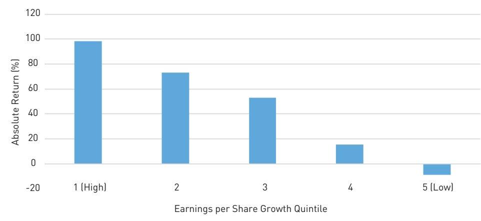
It's true that emerging markets have a higher proportion of entrepreneur-controlled companies versus developed markets, but State Owned Enterprises (SOEs) have served to drag down the absolute returns achieved through investing in EM. SOEs still account for 27% of the EM index by weight and today, we see large swathes of the market under threat. All the more reason to be selective.

For those still unconvinced that active management is vital, look at the make up of the index and its incumbents today. A number of long-term threats are apparent. Will internet finance displace traditional banks? Can online networks (both social and professional) leapfrog telcos? Will electric vehicle specialists and battery producers outdo traditional car companies?

RAISON D'ÊTRE

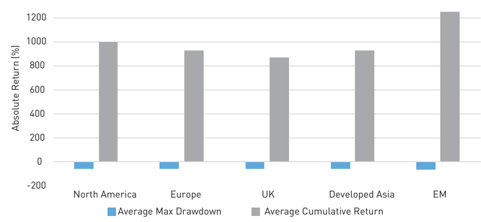
The whole raison d'être of EM investment is to capture the growth premium relative to developed markets. Underpinning our commitment to growth investing is the belief that, ultimately, those companies which can sustainably grow their earnings will be rewarded by the market. Having looked at different quintiles of earnings growth, in US dollars, over five-year periods, we discovered that in the last 20 years, the best quintile of earnings growers were rewarded,

Median Absolute Return by 5 Year EPS Growth Quintile



Source: Baillie Gifford & Co, Factset, Worldscope, and relevant underlying index provider(s). Data to end December 2016. Based on equities defined as Emerging Markets by MSCI or FTSE.

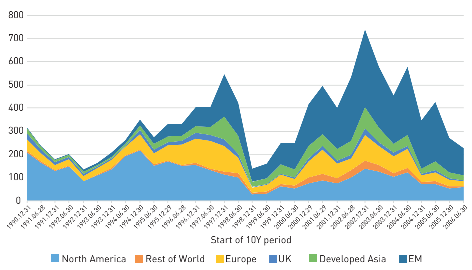
Asymmetry of Returns for Big Winners (10 Years)



Source: Baillie Gifford & Co, Factset, Worldscope, Datastream and relevant underlying index provider(s). Data from 31 December 1990 – 31 December 2016. Based on universe of global equities with market cap greater than $500m (historically adjusted) at start of period.

Upside = total return; Downside = share price return

10 Year Big Winners by Region



Source: Baillie Gifford & Co, Factset, Worldscope, and relevant underlying index provider(s). Based on universe of global equities with market cap greater than $500m (historically adjusted) at start of period.

on a median basis, with a near doubling in share price. This underlines the importance of having a process with an unwavering focus on finding companies that can grow their earnings over the long-term at double digit rates.

But it won't be a smooth ride. For the long-term EM investor focused primarily on individual companies, an active approach and resultant skewed portfolio, will lead to periods of pain. We all know, over short time periods (three years or less) share prices can detach themselves from operating fundamentals. In 2016, for example, 86% of Brazilian companies outperformed the EM index, as did 77% of Russian companies. It didn't matter which company you were invested in: these markets weren't driven by earnings; they were driven by economic and political factors.

STAYING THE COURSE

If we look at the 'big winners' in EM – companies which have delivered 20% p.a. total return in US dollar terms over a ten-year horizon – we find that these companies were subject to rocky price trajectories, suffering an average maximum drawdown of 69% during the ten-year window, the most significant globally. This gives some indication of the tolerance required of investors: short-term discomfort comes with the territory.

Perhaps this begs the question, why EM? Can we access the same big returns elsewhere without having to tolerate such unease along the way? To provide context, the 69% drawdown figure seems more palatable when you consider the average cumulative returns of big winners over ten-year periods is more than 1,000%. This too is, by some way, the largest on a regional basis.

CONCLUSION

In today's return environment, the need for equities to do the heavy portfolio lifting is as high as ever. EM equities look very attractive, as long as the correct focus is maintained when investing in them. That's why we will continue to invest in EM, we will be active, and we will seek to identify substantial growth opportunities with confidence that our investment philosophy will be rewarded over the long term.

We believe the chance of strong absolute returns from EM is significant on a long-term view, thanks to a number of strong businesses and improving macroeconomics for many countries. This is about more than high GDP growth, favourable demographics and rising middle class incomes. Many companies are displacing established peers and monopolising new industries, whilst growing at rates well in excess of the broader market. EM investors are being given the opportunity to invest in companies that we believe will dominate in years to come, not just in their home markets but globally, and in the process, generate world-class returns.

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