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EP30 | Emerging Markets

00:42	**Cameron Webster**	Welcome back to the podcast everyone! Today we're going to focus on emerging markets with Peter Lampert. Peter, welcome back.
00:49	**Peter Lampert**	Thanks Cam.
00:49	**Cameron Webster**	Thanks for spending time with us. So, focusing on emerging markets. We've just rolled through two years on the performance side of things; you've been running the fund for two years—why don't we start there. Just give [us] a sense over the two-year period [since] you started the fund some [of the] challenges [and] changes to the team.
01:08	**Peter Lampert**	Yeah, it's been a lot of fun. We past the two-year mark on January 31st of this year. I think the number one thing for us is, it's more of the same: what we do across our other funds at Mawer. Following the same investment philosophy but applying it directly and focused on emerging markets. It's a lot fun focusing on places like China, India, Brazil. There's a lot of excitement, a lot to learn. ... I think from [a] team perspective, the number one thing we've done is to continue to grow the team and to support our research efforts as we broaden our capabilities. We have about 30 people on the research team now, including two new analysts we hired in 2017 in Singapore. (They're based in our Singapore office.) And they give us a lot of help covering, especially, Asian companies; getting out there; meeting with management teams; travelling...that's been a huge help to our process.
01:54	**Cameron Webster**	Was the intent in hiring people in Singapore—was that distinctly designed to beef up emerging markets? What was the intent of the Firm behind that?
02:03	**Peter Lampert**	Broadly, they're analysts on the team like the rest of us. We're generalists. They don't focus exclusively on Asia, but certainly they spend a lot of their time looking at Asian companies. And that supports—definitely—our Emerging Markets Fund, but also our International Equity and Global Equity Funds and Global Small Cap, too.

Asia's becoming a bigger and bigger part of the global investment universe and we've dedicated more resources to looking at those companies.

02:26	**Cameron Webster**	Singapore is exciting—in terms of having a full office there and two dedicated analysts. Can you give us a sense of number of trips we've done? We have "boots on the ground," that's a big thing for our process.
02:40	**Peter Lampert**	Meeting with companies and assessing the management teams has always been a big part of our process and we all do a lot of travel from Calgary—we continue to do that. But having two more analysts in Singapore that can travel around Asia is helpful. I think across the team we've probably done about 10 trips to different countries in Asia over the last two years, including our colleagues in Singapore and colleagues from Calgary making the trip over.
03:00	**Cameron Webster**	Thanks for that overview Peter! We do call this [episode] "playing the plan" ... so let's get into "the plan" and some specifics within emerging markets.
03:10	**Cameron Webster**	One curious thing I observed in the portfolio is the presence of emerging market banks. There are two in the top 10: one's Brazilian and one is Indian. Why don't we just get into the thesis behind having emerging market banks in there and give people some sense of why these are attractive companies.
03:27	**Peter Lampert**	For us, it always comes back to our investment philosophy. And the first pillar of that is looking for wealth creating companies; the second one, excellent management teams; and the third, at a discount to their intrinsic value.
03:37	**Peter Lampert**	We don't have any kind of preconceived notions that a bank is a "good" business or a "bad" business, it just comes down to finding companies that fit those criteria. And these happen to be two companies that fit that criteria very well. HDFC Bank in India, Itaú Unibanco in Brazil. Both highly wealth creating companies. Because of some of the nuances in those markets and in the businesses and the ways that the management teams have run the companies, [that has] resulted in very good returns.
04:00	**Cameron Webster**	Why is it wealth creating? Why are you particularly picking HDFC Bank?

04:05 **Peter Lampert**

They've been able to grow much faster than the general economy. Their earnings have grown about 20% a year pretty consistently. Compare that to Indian GDP growth, [which] is less than half of that.

The reason they've done such a good job is because they have such a strong management team that run the bank so well. They have a good customer base, which allows them to have good low-cost deposits, and they take those deposits and lend them to customers—but with very prudent underwriting—managing the risk well.

I think one of the advantages they have in India is [that] many of the other competitors are state-owned or government-run banks. And those are typically less efficiently run [and] less focused on finding the best customers. That allows HDFC Bank to really carve out that niche focused on the high-quality customers where they can take less risk but earn high returns. And that's what has really resulted in good returns for the business and for shareholders.

04:56 **Cameron Webster**

Let's talk quickly about the Brazilian market. Is it similar? Is the Brazilian market full of state-owned banks and finance companies? Or is it an entirely different market?

05:07 **Peter Lampert**

There are a lot of parallels. The investment thesis is actually pretty similar for Itaú as HDFC Bank. Again, it's an excellent management team. In this case it's still owned by the original founding families; they still control the business. They want to make sure the business is around for the next generation, so they've been conservative and prudent. And similar to HDFC Bank, they have identified good customers, have a good deposit base, and make prudent loans. And yes, they also compete against some less efficient government-run banks which again, gives them a nice competitive edge.

05:39 **Cameron Webster**

Okay, those are similar qualities across two entirely different emerging markets. Peter, obviously you're involved in the international equity team—there are no European banks in that model. You're probably best-placed to say, “well yeah, two of my holdings in emerging markets are banks, two of the top 10 holdings.” Why not in Europe? What are the distinctions that you're noticing between the marketplaces?

06:01	Peter Lampert	The biggest distinction is that many, or almost all, European banks just don't meet our criteria on that first piece of our investment philosophy: being a wealth creating company. Most European banks earn very low returns on equities—mid to low single digit ROEs—and they're just not beating their cost of equity. They're not delivering returns for shareholders. And that's due to a variety of reasons. It's just a much tougher banking environment in Europe; it's much more competitive; the regulators are tougher. And management teams, by and large, haven't been able to navigate this difficult environment. Again, we don't take a view that banks are a "good" or "bad" business, but in Europe, it's pretty tough to have a wealth-creating company that happens to be a bank.
06:37	Cameron Webster	And how does your experience in international equity help inform your emerging market, or vice versa? [There are] probably interesting discussions when you flip between the two strategies.
06:50	Peter Lampert	I work on our emerging markets and our international equity funds but we take a very global perspective. We work closely with all of our colleagues across the research team, whether they're looking at Canadian equities or U.S. equities and I think that's really helpful. We've found great banks in Canada and the U.S. too, and just...seeing what works, what doesn't work, comparing regulatory environments, comparing competitive environments. [It] really brings that perspective and helps us to focus [on] what we're looking for in finding a wealth creating company—regardless where it is the world.
07:17	Cameron Webster	The stock market in China didn't do so well in 2018. Can you give us a little perspective on why you think that is the case? And then more specifically [around] the portfolio—what are you doing about it?
07:28	Peter Lampert	The Chinese stock market was the worst performing major market in 2018. And some of the underlying factors—well emerging markets in general sold off—and a lot of that is [to do] with interest rates, the U.S. dollar, (the Fed

looking to increase interest rates in 2018). That's a headwind and results in capital outflows from emerging markets.

We've seen that bounce back in 2019 with the Fed shifting their stance. Maybe we'll have rates lower for longer. China's been the best performing market so far year to date in 2019.

07:56 **Peter Lampert** But also, the other big factor in 2018 was the Chinese government itself reducing liquidity in the economy. There has been a lot of credit, a lot of lending in the economy. And they're concerned—they need to manage some of these risks that have been building. A lot of the lending has been happening outside of the formal banking sector: in shadow banking, and popping up in different ways, which is tough to regulate, tough to control. And could lead to a lot of risks and unintended consequences.

08:22 **Cameron Webster** Peter, you mentioned "shadow banking," can you just explain to listeners what we mean by that?

08:27 **Peter Lampert** They call them "wealth management products" which is really just a euphemism for corporates packaging up and borrowing money from the end retail investors. The end retail investors are buying these products and getting guaranteed high rates of return, but they're actually quite risky products, and in many cases backed with long-term liabilities and short-term assets. There's a mismatch there and it's fairly risky.

So the government's really been cracking down on that, trying to reduce that; taking liquidity out of the system, which has resulted in lower strains on the economy in the financial markets in 2018.

08:58 **Cameron Webster** Let's go drill into the portfolio in terms of, when markets go down. Maybe there are opportunities. Was China in 2018 sending any valuation signals to you that, actually, valuations are pretty attractive?

09:09 **Peter Lampert** As bottom-up investors we're looking to invest in great companies that we can hold for the long-term, so we try to look through a lot of volatility and when we could find great companies. In this case, some of the companies that were on our watchlist, prices came down to more attractive valuations.

We did add two new companies to the portfolio that happen to be based in China and sold off with the broader market.

09:28 **Peter Lampert** The first one is Yili, the number one dairy company with 20% share of the milk market. It's a huge market. Consumption's not quite as high as Western countries, but kids are drinking milk. What's important in China is that it's unlike say, Canada. The brands are very important. There've been serious quality issues in the past, so Yili has that strong brand that people trust and that's a strong competitive advantage—in addition to their distribution network and great management team that operates the business well.

The issue for us was that the stock had been expensive in the past. With a more attractive valuation we saw that as an attractive entry point.

09:58 **Peter Lampert** The second one is the Shanghai International Airport. They own and operate the Pudong Airport. If anyone's flown to Shanghai, they've gone through that airport. And what's great about this business is, they have the major international airport but with passengers coming in and out...there's a huge shopping mall inside. They generate most of their revenue and profits from the duty-free sales; from renting out those stores and generating those retail sales from that captive traveller.

10:21 **Cameron Webster** Just curious [about] what the revenue model is. Is it your standard real estate model where, here's your square footage, you put a store in there [and] you pay a lease? Or is it in addition, they're taking a percentage of sales?

10:32 **Peter Lampert** That's right. They typically take a percentage of sales in the lease. There are minimums involved but most of the stores are well above those minimums in paying a percentage of sales. What's great is that the leases just came up for renewal and Shanghai International Airport doubled its take on those rents. They had been undercharging in the past and so now it's going to be even more profitable going forward.

10:52 **Cameron Webster** It's a catch up...are they going to double it every period?

10:56 **Peter Lampert** [laughs] This is probably the sustainable level going forward.

10:59	**Cameron Webster**	Okay. So, you can expect regular inflation related increases in the lease. Is there any one retailer that's prominent across airports globally? I'm just thinking if it's percentage of sales then you want the best-selling products to be in your airport. I'm just trying to think of it from management. Do you have a sense of that from Shanghai to Hong Kong? What are the differences?
11:22	**Peter Lampert**	In this case, they enter into the lease with the duty-free operator who in turn attracts the end brands—like the Pradas and Guccis—but certainly there's a very high portion of those luxury products that generate those big revenues.
11:34	**Cameron Webster**	To me it sounds like it's basically shopping a mall without taxes.
11:40	**Peter Lampert**	That's a great description.
11:40	**Cameron Webster**	Is that kind of how you look at it? That's a global business. Would be there be other emerging markets where you're actually looking for that type of business?
11:46	**Peter Lampert**	Yeah, there are other listed airport companies around the world. Oftentimes they're not listed, or they're owned by governments. But certainly it can be a great business, and we've taken a look at most of the listed ones. In many cases, the valuations are quite high, but with the pullback we saw in China—I think Shanghai Airport was trading at quite a reasonable valuation, which is one of the big differences. In addition to the growth runway that they have, with more and more traffic coming through Shanghai (they're expanding the airport) and getting more passengers, [that] should result in more retail sales [as well].
12:14	**Cameron Webster**	Let's shift gears a little bit Peter. What I want to give listeners a sense of, is, when things done go quite according to plan. In 2018, Samsung was a holding that didn't perform that well for the portfolio. But what about that is not meeting your expectations? And how do you manage the risk in the portfolio?
12:30	**Peter Lampert**	Samsung Electronics was one of the worst performers for us in 2018. When most people think of the company, they're familiar with, probably, their phones or maybe some of their other consumer electronics. But really, the key for our investment thesis is their semiconductor business. They're the largest

makers of memory: DRAM and NAND memory chips which go into pretty much every electronic. Whether it's your phone, your computer—any electronics [that] use a memory chip. They're the largest maker. They have great economies of scale, they're incredibly well run and operationally efficient, which has allowed them to earn the highest margins in the industry. It's a consolidated industry with really only two or three major competitors in addition to Samsung. So that's really the cash cow and been a great a business for them.

13:12 **Peter Lampert** It is, however, a very cyclical business. Memory is pretty much a commodity. And when new supply comes on, prices come down. What we've seen is, there has been new supply. Samsung itself has been bringing on new fabs to build more memory and expanding their capacity. Meanwhile, demand growth had been very strong and that's starting to slow. We've seen a slowdown in smartphone sales, which is one of the big end markets, a potential slowdown in autos, and pretty much anything that uses electronics.

13:41 **Peter Lampert** With that slowdown—demand coming down but supply has come online...this is pretty typical in a cyclical industry where profits could be expected to come down. They haven't yet; they started to only last quarter. Prior to that they were still earning record profit levels. And the cycle might go on a bit further and profits come down a bit more.

13:58 **Peter Lampert** For us as long-term investors, we're willing to see through those cycles and ride out that volatility. On a 10-year view, even in the worst down cycles, when Samsung's competitors are losing money—it's always been, still, profitable. We expect that to happen again this time. And given the valuation, we think it's very attractive on a long-term view. We're more than willing to ride out those cycles.

14:21 **Cameron Webster** I'm hearing "willing to ride out" but are you willing to "add" to the position? How do you feel about the position size here?

14:27 **Peter Lampert** I think our position's reasonable right now. It's about 2.5% weight in the emerging markets portfolio. And given the risk/return, we do have some concerns with the business. But given the risk/return and that attractive valuation—that's a pretty good weight for us today.

14:40	**Cameron Webster**	Thanks for giving us that detail and for talking about a stock that's not quite performing up to expectations. Let's shift gears a little bit and talk about a current holding, but take those three tenets of our philosophy and just cover the reasons "why." Maybe I'll introduce the name of the [stock]. It might "nice" to have this in your portfolio. It's a Korean stock, and it's allcaps, so we don't know if you pronounce it "nice" or N-I-C-E but it's Nice Information Service. Over to you Peter.
15:09	**Peter Lampert**	Nice Information Service has been a stock in the portfolio for about two years. They operate a credit bureau in Korea. Many people will be familiar with similar businesses [like] Equifax, Experian in other markets. They're one of two credit bureaus in Korea.
15:22	**Cameron Webster**	Why is it a wealth creating business?
15:23	**Peter Lampert**	It's a great wealth creating business. It has historically earned high returns on capital. And the reason is that strong competitive advantage they have in the[ir] database. They have a database with the credit information on nearly every person in South Korea; they're only one of two companies that do this, and they have only one of two companies that have the government license to do this. There are a number of barriers in there. First is having the government license, second is having the database. The value in the data is that it's broad—it covers the whole population—and it's long. They've been doing this for 30 years. When banks and financial customers want to write a loan they'll pay NICE to check the credit bureau. Having that information is a small cost but high value to their customers.
16:01	**Cameron Webster**	Second tenet: management?
16:02	**Peter Lampert**	Management's run the business very well. They focus on the core business of the credit bureau and they've acquired one of their smaller competitors (there previously had been three competitors) to consolidate that market and really strengthen their market position. In addition to that though, management also has a growth focus. Many

companies with such a strong core business—many companies we see would just rest on their laurels, harvest those nice cash flows, and call it a day. What management's done in this case, is continue to find new ways to grow. [Like] use their position to try to add adjacent products, add more products for their customers—and use that data in new ways.

16:39	**Peter Lampert**	And that ties into the third piece—you didn't ask yet, but—about valuation. We think that we're getting some free options here, which we love to find. If we can pay a fair price for a great business and get some free options, [like] with some of these new growth opportunities com[ing] out [of what] management's working on, if they're successful. We don't think we're paying for that and that would be some nice upside to the stock.
17:00	**Cameron Webster**	Okay, good! ... What I want to conclude on, is, where do you feel the portfolio is right now? Are you looking to add more names over time? Are you comfortable with how many names [are] in the portfolio? Where do you want to take the portfolio going forward Peter?
17:16	**Peter Lampert**	Today there are about 45 stocks in the portfolio. We're comfortable with that, we think it's a well-diversified portfolio but still concentrated enough to have higher weights in some of our best ideas. In terms of the positioning, our goal is always to have a resilient portfolio of good companies that meet our investment philosophy and that we can hold for the long-term. Emerging markets can really get whipped around, especially on the changes in interest rates and Fed policy. But for the long-term investor, we think holding wealth creating companies run by excellent management teams [and] buying them at discounts of intrinsic value—over time this should result in good returns.
17:50	**Cameron Webster**	Awesome. Thanks for the playing the plan on emerging markets Peter.
17:54	**Peter Lampert**	Thanks Cam.