the art of boring™

EP 170 | China in Focus: Traversing the Emerging Markets Landscape

[00:00:00] Rob Campbell: On this week's Art of Boring, Peter Lampert joins to talk emerging markets as the latest developments and rally in China are top of mind. While there are no easy fixes to China's economy, Peter talks through a probabilistic view of what this may imply with respect to the likelihood of lefthand tail risks, what it means for discount rates and why Tencent is such a terrific business. Peter explains what he means by stealth performers in the portfolio and why Turkey's Bim is one of them.

[00:00:32] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:00:49] Rob Campbell: Peter, welcome back.

[00:00:50] Peter Lampert: Thanks. Great to be back, Rob.

[00:00:52] Rob Campbell: I'm glad to have you, because listeners should know that we're recording this podcast on October 1, which is the start of Golden Week in China. I think for most investors, it was actually this past week that was the Golden Week for Chinese equities, because stocks are up something like 20% over the past few days on the back of a raft of stimulus measures announced by the Chinese government, pretty clearly aimed at driving consumption, supporting the housing market and the stock market, too. Peter, I know that we are bottom-up investors, but I do want you to put your macro hat on to start. Can you zoom out and just over the past few years, give us some broader context around this most recent stimulus and why now?

[00:01:34] Peter Lampert: Like you said, this was a very significant series of stimulus measures that came out of China over the last week of September, and like you said, supporting the areas that had been particularly weak in the property market, stock market, and household consumption. In aggregate, we estimated about 3% of GDP, and they said they're willing to do more.

The backdrop, like you said, was a very weak economy for the last couple of years. The government had taken a number of actions that was further stifling economic activity, depressing sentiments, depressing business activity, trying to achieve non-economic goals. I think they realize perhaps they've gone too far, and it's time to reverse course a bit. That certainly seems to be the message. We'll see if this is continued.

But why now? A big part of it is with the Fed easing now, the Fed starting their cutting cycle, it gives room for China to also be easing and injecting liquidity without having to worry too much about a major depreciation of their currency, which would have its own disruptions for the economy.

[00:02:39] Rob Campbell: You started with just some of the longer-term headwinds that are facing China versus the stimulus, which obviously, in the very short term, has had a pretty big impulse. How do you weigh those two things? I can imagine there's a case on both sides.

[00:02:51] Peter Lampert: Definitely. We shouldn't underestimate the stimulus though. Despite the challenges that the economy faces, we may look back at this and think of it as a “whatever-it-takes” moment, when Mario Draghi said that to put a line under the European sovereign debt crisis back in 2012. It also reminds me of the

COVID approach in China. As you know, they had a very strict zero COVID approach for three years and when it wasn't working, one day they just very abruptly opened up.

It seems that could be the case here, but like you said, it doesn't solve everything. There are still significant long-term challenges, but we think it probably helps mitigate three of the big challenges that we see. The first of those is the weak sentiment among consumers and investors, and that can lead to a reinforcing downward spiral where the negative sentiment drives negative economic activity, etc. If they can put a line under that, boost some confidence and boost some spending, that would help.

The second one being the regulatory interference in business. When we talk to people doing business in China, this is their number one complaint—dealing with regulations that change frequently, that are not enforced consistently. It's just a very difficult environment in which to do business. If the government is in fact more focused on driving economic growth, they know that business and markets are an important part of that, and they do understand that. If they take more business-friendly policies, that would be a significant shift.

Then the third big headwind facing China are the geopolitical risks. Now certainly those don't entirely go away. A lot of the trade tensions, the trade war, economic war that we see between China and the West are continuing around semiconductors, around tariffs. The stimulus does not address that. But, if the government is more focused on economic growth, we think the odds of a significant worst-case scenario for the economy (which would be an invasion of Taiwan) is reduced or at least pushed much further out into the future while the government focuses on economic growth. So again, it doesn't solve all of the underlying issues, but it moves the needle probably on three of those big risks.

[00:05:01] Rob Campbell: That last one is most fascinating. Can you help me connect these perspectives? It does sound like you think the stimulus is quite significant, not just a shorter-term impulse. How does that macro lens enter into the work that you and the team does in managing the emerging markets portfolio? Listeners would know that over the last couple of years, we had been reducing our position in Chinese companies. I'm just wondering if you can tie just how much of that was macro-driven or risk-driven versus the bottom up or are they quite intertwined?

[00:05:34] Peter Lampert: They are very intertwined from our view. We are bottom-up investors, and as part of that bottom-up fundamental analysis that we do, the macro awareness is very important. When we analyze and incorporate macro risks into our company-specific analysis, that shows up in our DCF models, in the projected growth rates, in the discount rates. When our perception of those risks shifts, our assumptions or the ranges we use around those variables shifts as well.

As you said, this approach has led to our perception of heightened risk in the last few years and a reduction in our Chinese holdings. But we were also increasing our positions on the day the stimulus was announced in late September, as we think the odds have shifted. Incorporating some of those macro views into the bottom-up analysis and reflecting that risk-reward assessment in the portfolio decisions.

[00:06:27] Rob Campbell: Can you make it a bit more real in the sense that can we talk about a specific company or set of companies and just how that bottom up actually works in the context of a risk framework?

[00:06:37] Peter Lampert: When we assess that the risks are higher, we apply a higher discount rate in China, essentially requiring a higher hurdle, a higher rate of return to compensate us for those risks. That's across the board for all of our investments in China. Therefore, the ones in the portfolio are the ones where valuations are most attractive and where they meet that higher hurdle rate.

The second issue is on the growth rates for those companies, which we deem are more economically sensitive in

a very weak macro environment. We've brought down some of those projected growth rates—companies like Milkyway Chemical or Great River Logistics, which are in more cyclical industries, chemicals distribution tied to industrial activity—we brought down our long-term expected growth rates there, given the structural challenges in the Chinese economy, not looking at quarter to quarter, but over a five-, 10-year view. We think the outlook had weakened. When we think about the ranges, the possible rates of growth that those companies could achieve over the long term, those came down and the valuations were no longer attractive enough with that combination of the lower growth rates and the higher hurdle rates to be in the portfolio.

Those were some of the examples of the stocks that we exited. On the flip side, there are other companies, and we're specifically emphasizing the ones that we think have independent growth drivers, independent of the overall economy. No company is entirely independent, but ones with less reliance—companies that can continue to do well in an environment where yes, there are headwinds, but we think the Chinese economy is more likely to look like a stone rolling down a hill rather than that risk of just really falling off a cliff. In that environment, there are a lot of companies that have their own growth initiatives that can do well, even in a weaker backdrop.

[00:08:25] Rob Campbell: Do you have a couple of examples of those?

[00:08:27] Peter Lampert: Certainly Tencent is a great one to highlight. They have a very prudent management team, very world-class, and they're focused on providing the best experience to their customers in their apps. As a result, they've been able to achieve and maintain a very dominant position with their WeChat app. But along the way, they've been very conservative on monetization because they want to protect that consumer experience. Now they have an opportunity to pull some of those levers to increase monetization, to improve their ad revenue and continuing to grow profits. Even if the overall advertising spending is weak and the overall economy is weak, they have their own monetization levers that they can pull. We think the valuation is still very attractive despite being a huge well-known company because of all of the pessimism toward China.

Another example is Tencent Music. This is the Spotify of China. It's a listed subsidiary of Tencent, so it shares that great DNA, great management culture. Similarly, they've been focused on achieving the dominant market position in online music streaming. They have not pulled those monetization levers as much as they could have, so now there's an opportunity for them to do that going forward with more advertising and higher pricing.

[00:09:37] Rob Campbell: We've talked a lot about the impacts of the stimulus in China specifically. I wonder within the broader emerging markets universe, whether there are ripple effects associated with this, or is this really primarily focused domestically? As an example, I'm thinking about Indian companies, which may have benefited over the last couple years as the West has sought to diversify supply chains. Might that reverse off these latest stimulus measures?

[00:10:00] Peter Lampert: Because of the long-term structural issues that China still faces, I don't think it changes the decisions that companies will be making around diversifying supply chains. Vietnam, for example, is a big beneficiary. You can see more in the short term from an investor fund flows perspective where investors may have been selling Chinese stocks and buying Indian ones, and that could reverse. But for us as fundamental long-term investors, I don't think it dramatically changes the outlook for most other countries and companies outside of China.

[00:10:28] Rob Campbell: Shifting gears, your portfolio—the emerging markets portfolio—has had a pretty great year so far. How come? What's been going well?

[00:10:35] Peter Lampert: Performance has been driven by stock selection this year. We talk about macro awareness, but ultimately our goal is to find great companies that can create shareholder value and investing in

those companies for the long term. Some of the biggest contributors to the portfolio this year have been FPT, which is a Vietnamese IT company; IGS, which is a Taiwanese mobile games company; and Aegis Logistics, which does logistics for LPG Fuel in India. The common theme here is, I call them stealth performers. They're not household names, but they're just excellent businesses, run by great management teams, somewhat flying under the radar. Every day they are creating value for shareholders, day in and day out.

[00:11:15] Rob Campbell: I know you're quite a fan, Peter, of ensuring that you have the ability to add stealth performers to your portfolio. What I mean by that is, yours is a genuinely all-cap portfolio with meaningful representation from the small- and mid-cap segments. Anything that you found there that you've added to the portfolio over the last year that you think is worth sharing?

[00:11:34] Peter Lampert: One to highlight would be Bim in Turkey. This is a discount retailer. Again, that go-anywhere approach, looking at all market caps, all geographies. Turkey's been an unloved, overlooked market for many years, including by us, because the economic risks were so high, inflation was so high, the discount rates that we use in our DCF models are so high that it was very difficult for any company to meet that hurdle. But Wen [Quan Cheong] on our team took a visit to Turkey last year, he met with a number of companies, including the management of Bim, did some store visits. This is a food retailer; they focus on discount retail.

The backdrop has also markedly improved because Turkey, although they still have economic challenges and very high inflation rates, they've shifted to a more orthodox, conventional approach focused on helping the economy and bringing inflation down. The outlook is much better than the tough period that they've had over the last seven or eight years.

With Bim in particular, one of the insights we had there was as a hard discounter, it's a very efficient model. They're very good operators. They have extremely low prices because of their model and effective management. While many of their competitors, other food retailers, have been struggling in this tough economic environment with high inflation, Bim has actually been gaining market share because they're able to offer that value proposition, the low prices to consumers. They've been growing and doing very well, even in a tough period. So as the environment normalizes, as the economic outlook improves in Turkey, Bim is coming at it from a position of strength, and we see a very positive long-term outlook for that company.

[00:13:12] Rob Campbell: Speaking of Turkey inflation, you mentioned it, it's something that comes to mind and this maybe goes back to an earlier part of the conversation just about how the bottom-up work that we do marries with some of the risk assessment. How does that lira devaluation enter into the consideration with Bim?

[00:13:29] Peter Lampert: One thing that's very important in our analysis of any company—and especially in these companies operating in high inflationary environments—is their pricing power. With Bim, they have been able to fully pass through inflation. We're talking inflation rates as high as 40, 50, up to 70 percent some months annual inflation. Bim has been able to pass those on in the form of higher food prices and still take share. When we look at their revenues and profits in U.S. dollar terms to strip out that lira depreciation, they continue to grow at very healthy rates, generate good profitability, thanks to their pricing power and that strong position that they have.

[00:14:10] Rob Campbell: Fantastic. Peter, thank you for the tour, mainly China-focused, but we did manage to get to other parts of the world. I appreciate your thoughts and all the work that you and the team do on the emerging markets portfolio. Thank you.

[00:14:22] Peter Lampert: Thanks for having me.

[00:14:23] Rob Campbell: Hi, everyone. Rob here again. To subscribe to the Art of Boring podcast, go to

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