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EP 144 | Emerging Markets: Recent Rebound, China, and New Opportunities

[00:00:00] Andrew Johnson: Hi everyone, Andrew here. Today I sat down with Peter Lampert, lead manager of the emerging markets equity portfolios here at Mawer. There's been a strong rebound in performance from emerging markets compared to last year. And I wanted to get Peter's thoughts on the main drivers behind that. We also talked about China and the increasing risk profile of investing in companies there. Finally, Peter shared his thoughts more broadly on the state of emerging markets economies and what that may mean for the rest of the world. With that, here's my conversation with Peter.

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[00:00:48] Andrew Johnson: We are back, and today we have Peter Lampert joining us. Peter is the lead manager for our emerging markets equity portfolios here at Mawer. And as you might have guessed either from that statement or from the title of this episode, that's what we're going to talk about today. So, first of all, Peter, it's always good to see you. So, a big welcome back to the podcast.

[00:01:05] Peter Lampert: Yeah, thanks. It's been a while since we've done one together, so it's nice to be back.

[00:01:09] Andrew Johnson: As I was thinking about the portfolio ahead of this conversation, one thing that became very clear to me was that 2023 looks and feels very different from 2022 for this portfolio; there's been an incredible rebound from the downturn last year. So, why don't we start there and get your thoughts on what's been happening and what are the main drivers behind it?

[00:01:29] Peter Lampert: Yeah, it's been great to have the rebound that we've had in 2023. 2022 for this portfolio was a tough year. It was a tough year for markets generally, and we underperformed as well on a relative basis. But we're having a very strong 2023 on an absolute and relative basis, primarily due to stock selections. Many of our stocks last year were down more than 30%, and this year, many of those have fully recovered. A lot of those were in Eastern Europe. After the Russian war broke out in early 2022, investors sold off stocks across Eastern Europe. We have holdings in Kazakhstan, Poland, and Lithuania, and pretty much across the board, those underperformed last year.

As investors have gotten more comfortable and realized that the geopolitical risks are probably not any higher in those countries than they were before the war, those stocks have largely rebounded. So, that was a big driver of the negative performance last year, and that normalizing or mean reverting led to the positive performance this year. The other big area is Brazil. Brazil's been one of the best-performing markets this year, and as you know, we're not top-down investors, but our bottom-up philosophy had led us to avoid Brazil for a number of years. Valuations were just expensive, even though there are some high-quality companies there. And that started to change last year. We started turning over more stones, seeing more opportunities in Brazil as valuations were coming down. We added Petro Rio, a fantastic oil and gas producer in Brazil last year, and then GPS and XP, two other great Brazilian companies, into the portfolio this year.

[00:03:00] Peter Lampert: And all have done very well, starting from very attractive valuations as the businesses continue to do well and investors have become more comfortable there. Many of our stocks that were beaten up last year have rebounded nicely. The new stocks that we've added to the portfolio have also done well. So, it was a pretty strong performance across the board, which is really nice to see. I think we've been surprised by the volatility. It hasn't been a smooth ride, it was a bit bumpier than we would have expected.

As you know, our slogan is: Be Boring. Make Money.™ We typically invest in companies that are pretty resilient and have solid cash flows, and when we look at the companies in the portfolio on a fundamental basis, they've been performing as expected, but the market could have a mind of its own, and it could price stocks every morning. It can price stocks however it wants. We've seen a significant sell-off last year and a strong rebound this year.

[00:03:48] Andrew Johnson: Boring, for our listeners, [is] about the process, the philosophy, the businesses themselves from a fundamental [standpoint]. But as you said, the stock market is anything but boring.

So, another thing that I noted when looking at the portfolio has been a sizable reduction in the overall weight and exposure to China, at least from a direct holdings perspective. China and Hong Kong, as you know and many of our listeners know, play a really important role in the global economy, markets generally speaking, and even more acutely in your world, just given that they makeup, I think, about a third of the investable universe for emerging markets.

I should note for our listeners that the portfolio still has a fairly healthy weight there, but there has been a notable diversification away from China. And I think we can all understand those geopolitical risks that are out there, those tensions that are rising. And more recently from an economic standpoint, they're facing some headwinds as well. So, I wanted to ask you to help us understand how you and the team think about that and ultimately approach these types of decisions.

[00:04:46] Peter Lampert: You're right. We have significantly reduced our weight in Chinese companies from a peak in early 2022 of 36% of the portfolio down to 19% today, so nearly cut in half. That's been a significant move because we've seen big headwinds in China. You talked about the weakening macroeconomy. I mean, we've seen across the board that the economic data coming out of China this year has continued to disappoint investors, whether it's the property market coming down very significantly, weak consumer sentiment, high youth unemployment rates across the board; weak manufacturing, weak exporting, the decoupling with the west is happening. In 2022, we had a declining population for the first time in China.

It's incredible, the perfect storm, the number of headwinds they're having on the economic front. And then a lot of the government policies are also making business tougher.

[00:05:36] Peter Lampert: So, we saw more regulatory interference in business over the last couple of years. There were a few stocks that we had to exit completely. New Oriental and Alibaba are two examples where the government just made life very difficult for them with increased regulations. And there's a number of others that we've exited as well.

Then third piece, in addition to the weak economic activity and the weak domestic politics, is the geopolitical situation and the potential of an invasion, or at least more tension between China and Taiwan and between China and the U.S. What we see as a worst-case scenario in that capital flows could be cut off, like we saw with Russia, and we had to mark our investments down to zero. So, there's a lot of risks out there. For all of those reasons, we've reduced our weight in China.

[00:06:19] Peter Lampert: We've exited many of the Chinese stocks that we had in the portfolio previously, but we're still there. We still have 19% of the portfolio in China. We have ten different companies there that we think we've high graded. The companies that are still in the portfolio are there because they're fantastic companies. Valuations are extremely attractive. They're still very attractive for long-term investors, with that overlay that we want to manage the risk at a portfolio level. And the reason we've been able to significantly reduce our weight in China is because we found lots of opportunities elsewhere.

[00:06:49] Peter Lampert: China, as you pointed out, it is a third of the emerging markets universe. It's easy to find companies there, even though there are a lot of companies that don't meet our criteria. Just given the sheer volume of companies, we find a lot of great companies there. But we've been working hard, we've rolled up our sleeves, we've been traveling, we've been looking around the world in going to all corners to find investments all around emerging markets. So, some of the new portfolio companies we've added are Jumbo in Greece, a couple in Saudi Arabia, and a number in Latin America. In fact, six were in Latin America, five were in Asia, two in the Middle East, and two in Eastern Europe.

So we've really been covering the ground, covering the universe, and turning over stones. As a result, we think the portfolio now is much more resilient and better diversified. All of these companies meet our bottom-up criteria of being wealth-creating companies with strong, sustainable competitive advantages, excellent management teams, and attractive valuations, but with what we think is a stronger, more resilient portfolio.

[00:07:43] Andrew Johnson: Before we wrap up, emerging markets can sometimes be a bit of a prelude or a sign of things to come for the global economy. Peter, this is the typical crystal ball question that I'm going to fire at you: can investors take anything away from those economies and extrapolate it to the rest of the world?

[00:07:58] Peter Lampert: [In] China, clearly, we've been seeing very weak economic activity, as we've discussed throughout the last year or the last few years. That has the potential to drag down other economies with it, whether it's their regional trading partners like Korea and Taiwan or Germany, for example being a big exporter to China. We certainly expect China's weakness to spill over to the rest of the world.

At the same time, we're seeing globally earnings come in around the world, both EM (in emerging markets) and developed markets, with many companies pointing to weaker outlooks ahead, seeing signs of softening demand as higher interest rates make their way through the economy. So yes, we've seen the weakness already in many emerging markets led by China, and it seems to be the rest of the world is slowing as well.

For this portfolio, we do have some valuation support. It's trading at 13x earnings, which is pretty attractive for the quality of companies and the growth prospects that our companies have. So, as always, we remain focused on the long term. We have a portfolio of companies that we think can survive any downturn if it comes, but then have very attractive long-term outlooks and we're getting this portfolio, I think, at a very reasonable, more than reasonable, extremely attractive valuations today.

[00:09:11] Andrew Johnson: All right Peter, well, I always appreciate getting to chat with you and I'm sure our listeners do as well, so thanks very much for your time.

[00:9:18] Peter Lampert: Thanks very much.