the art of boring™

EP 155 | Fishing in Less Crowded Ponds: Identifying opportunities in Emerging Markets

[00:00:00] Rob Campbell: An Art of Boring debut today for Portfolio Manager Wen Cheong – we talk semiconductors, misconceptions investors have with the emerging markets (EM) universe, and what working smart and hard looks like for our EM team.

[00:00:17] 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.

[00:00:34] Rob Campbell: It's not often that we have one of our colleagues from Singapore joining us on the podcast, which I think says more about my willingness to either stay up late or get up early, but this is a real treat. Wen, we're here to talk about the emerging markets portfolio, but before we do that, I wonder if we could just spend a moment to introduce you, given it's your first time on the podcast. What was your journey investing-wise, and how did you come to Mawer?

[00:00:58] Wen Cheong: I started exploring investing at 17. At that time, I built up a $1.2 million portfolio and had an unaudited eight-year track record of up 20%, all this was as a student. I did lots of small-cap stuff then. At that time, I set up what seemed like a business facade to interact with company management teams, who were most of the time taken aback, having seen me in person – especially around 17 and 18 with a very youthful face – and it was actually quite funny. This early experience actually sparked my passion, curiosity, perseverance, and lifelong ambition to want to become one of the world's best investors.

[00:01:41] Rob Campbell: Wen, you still look quite youthful – credit to you. What about Mawer? How did we cross your path?

[00:01:49] Wen Cheong: I have very generous friends, and one of my generous friends saw the posting on the CFO website. Immediately, he sent me a text message saying it's a wonderful company. And then I did my own homework, basically looking at two things: investment philosophy and that aligned like a glove with what I do. And the second is culture. I did Glassdoor checks; I spoke to employees at the firm. Upon these two criteria, I applied. I'm blessed to have been able to join this company, and I think turning this passion I have into my career, I find immense joy and have lots of energy at work. I think I'm experiencing what Buffett coined as tap dancing to work. Awesome experience.

[00:02:36] Rob Campbell: Fantastic. We feel that too, Wen. We're certainly glad that you joined us.
You talked about when you were running your own portfolio at the age of 17 or 18, you were finding lots of opportunities in smaller-cap companies. As listeners may know, our emerging market strategy is one that is genuinely all-cap. In other words, we are looking for companies that meet our philosophy, regardless of their size and where they are in the world, but there is meaningful exposure to small caps in the portfolio. I'm wondering just

how much of that is your influence, given your background. And why do you think that's so important in constructing a great emerging markets portfolio?

[00:03:15] Wen Cheong: I think the key thing about small-cap companies is that it's just a pond where there are just fewer rocks. It's not intellectually stimulating, but you find opportunities from time to time. It's hard work; you have to work through and turn over stones. But that being said, the beauty about it is that there are investment opportunities everywhere. Large companies are good, steady-eddy businesses with established competitive advantages. And then you have these small- and mid-cap companies where you can juice up returns for the portfolio, as well.

[00:03:53] Rob Campbell: I hope we have a chance to speak to one or two of those companies a little bit later, but can I start just on a topic that's been quite influential, both at markets at large but certainly for emerging markets investors? And that's semiconductors. Certainly a wild ride with respect to stock prices over the last couple of years, with geopolitics playing a role in some of those tensions. Can you summarize what's been happening, both in terms of the fundamentals in the industry as well as the stock prices?

[00:04:21] Wen Cheong: I believe the slump in 2023 was driven mostly by post-pandemic demand normalizing and macro challenges leading to inventory de-stocking cycle.

So what changed since then? I would sum it up in four key buckets. The first one is that we have industry capital and operational discipline actually playing out, given that the industry has actually consolidated very much over the decades. The second bucket will be real demand acceleration caused by increasing artificial intelligence (AI) applications in the market. And I think it's arguable that this may actually usher in a new era for semiconductors.

The third bucket will be an intensifying geopolitical landscape, which you rightly pointed out, driving the diversification of the supply chain, hence more equipment demand or overstocking by China. And lastly, the three factors combined, I believe, radically led to a change in investor sentiment, especially from a year ago when everything was looking bad.

[00:05:30] Rob Campbell: In terms of the portfolio, TSMC is obviously the top weight, and I think hits a lot of what you just talked about in terms of really being one of the drivers of the beneficiaries and that consolidation, with others not being able to keep up. But what other exposure do we have across the portfolio?

[00:05:46] Wen Cheong: Yes, several direct or indirect exposures. We have companies like Leeno in Korea that offer test pins and sockets that are actually essential consumable items used in the research and development (R&D) stage of mobile chip testing. We have Samsung; I don't have to elaborate much about that well-known company. We have Kinik. This is a rather new initiation. It's a Taiwanese semiconductor consumable player. We also have FPT Corporation. It's a Vietnamese conglomerate with a rapidly growing low-cost IT services business with a focus on newer age, digital transformation projects.

[00:06:29] Rob Campbell: Can you talk a little bit more about Kinik? Because I think it is one of the more recent additions to the portfolio. How did you come across it? What kind of work did you do? Presumably, they work closely with existing holdings like TSMC. How did that inform your analysis?

[00:06:43] Wen Cheong: Let me just take a step back and talk about the three avenues where I usually find ideas. The first one would be more brute force screening when I go through company after company, reading their cash sheets and respective business models. Secondly, just reading trade journals, attending conferences, speaking to great sell-side analysts, or other creative channels. And the third one is speaking to other good buy-side investors.

For Kinik, I wish I could claim all the credit for myself in finding this, but this company was actually brought up by my trusted friend. After I completed a very deep dive analysis of the company, we decided to add this to the portfolio. The most interesting thing about Kinik is its dominance in a consumable use in chip manufacturing called diamond disc conditioners. And that's quite technical. I don't want to bore you with the technicalities.

But the key thing to take away is that as process technology gets more and more complex, the consumable actually benefits from higher pricing because of the customization that's required, more frequent usage, and a quicker replacement cycle. So they do benefit from the current trend toward leading technologies.

And the beauty is that Kinik, in the past, it used to have 30-40% market share, but in the leading-edge technologies, in the three-nanometer process nodes and two nanometers, they have anywhere from 70-80% market share. We believe that this advantage is sustainable given patterns, technical barriers, very importantly, very close and trusted customer working relationships, especially during the R&D process.

Another important factor is that it's a very low-cost product, but this will cost the company a lot more if they switch it up for a slightly cheaper product. And that's the reason why we're doing this. Just not worth the risk.

[00:08:39] Rob Campbell: Great to see the trusted friend or generous friend network strike again there with respect to helping you out with that investment idea.

Shifting gears, perhaps this played a role with Kinik, but one of the questions we often get from clients, just with respect to the emerging markets space specifically, is, “We get that you're a bottom-up manager looking company by company, but surely macro considerations must play a role, or a more heavy role, in the emerging market space?” Can you speak to what that looks like in terms of managing or putting together this portfolio?

[00:09:11] Wen Cheong: Yes, we do have a slight macro overlay, but the key essence here is that we make decisions for the entire portfolio entirely on a bottom-up basis, and then we just have a slight macro overlay. But I think I would like to speak with regard to one more important topic of macro, which is geopolitics.

I think that makes investing a lot trickier in my opinion, especially because I believe this risk has binary probabilities and outcomes. But our stance is to prepare not predict and not swing to the extreme end, like having 100% weight in China or excluding China/Taiwan. But take a more middle ground approach while having a higher hurdle rate in terms of business quality, management teams, and valuations.

Kinik is actually a great example of that because I think it fits all three buckets really well, and valuations looked attractive at the time we purchased it; therefore we didn't exclude it just because it was in a region where the risk of geopolitics is high. So, we are constantly open on the mind, on the hunt for great opportunities, and we do see great companies, well run companies at good prices. So stay tuned.

[00:10:31] Rob Campbell: On that subject of great companies at great prices, the portfolio has done remarkably well over the last 18 months or so. Can you talk a little bit about what's been driving that?

[00:10:38] Wen Cheong: I always believe that to achieve differentiated results, we have to be different, and many times the intangible aspects are often overlooked. I'll just spend a little bit of time talking about intangibles, which are team culture and candour. That allows us to operate a nimble, high-trusted, and high-performing team. I think candour is important when voicing dissenting opinions. We actually provide a safe space to admit mistakes when things don't go according to plan. We accept errors from time to time, and this safe environment actually gives everyone the courage to act on good ideas. I think that's really important.

Secondly, on process, we run a relatively more concentrated strategy. Today, we have about 40 names, and the top 10 names account for about 40%. So this means we have fewer resources spent monitoring and doing update reports. This gives us actually more time to look for new ideas. Even for update reports, we prioritize very concise analysis of key insights only and that frees up more time to hunt for new ideas and to build out an inventory list. Therefore, our team spends a lot more time turning over stones globally. And more importantly, I think we earlier discussed choosing to fish in ponds where there are fewer rocks.

Today we have about 84-85% of the portfolio in non-index names. So that's on the more intangible front and on the more tangible front, looking at portfolio attribution, I think we did find very well-run, super-quality businesses with very attractive valuations.

For example, Kaspi in Kazakhstan, Salik in the UAE, BCG in the Baltics, and Dino Benefit Systems in Poland. At the time, these wonderful companies were priced attractively given the geopolitical uncertainty in the region and, to a smaller extent, in Latin and Asia. So we do have stocks that did really well, like FPT in Vietnam, XP and GPS in Brazil, and PetroRio in Brazil as well, but I would just add a caveat that this geographical mix isn't planned and deliberate. We make our decisions on pure bottom-up analysis, and these stocks were added into the portfolio.

[00:13:04] Rob Campbell: Well, I was going to say, it sounds like the contributions to the portfolio's performance over the last little while have been quite broad and quite company specific as well, which is what we want to see, given the way that we approach investing.

Wen, before I let you go and before I let you go to bed, what misconceptions do you think North American investors might have about emerging markets or that we might underappreciate about the opportunities in the space?

[00:13:27] Wen Cheong: Several misconceptions. I think the first general one is that the EM space is a difficult market. And yes, it is a difficult market, but that is where we make money by working hard and working smart. A lot of it has to do with EM as a whole having a bad rep for corporate governance. So investors might treat the entire emerging markets as a monolithic entity, but in reality, the EM space is actually very diverse. There's wide inequality, and just by identifying great management teams, you can make good money. Some of these EM markets, they are just as professional as in the developed market space. And what makes it better is that there are better management incentives because most of the companies in EM tend to be more founder-run companies. So from what I can think of, such markets tend to be in Taiwan, Poland, Brazil, etc.

Another misconception is that EM business quality is generally poor, and that is true to some extent because in the EM space, a large percentage of companies are commodity companies, banks, agriculture companies, and those low-value manufacturers. So what I'll say here similarly is that it's really diverse. So if you spend time to dig, there are really interesting companies, quality businesses as well. So I think all in all, it's a great space to be in with lots of opportunities.

[00:14:55] Rob Campbell: It sounds like you are perfectly placed, given your passion for the hunt. Thank you so much for joining the podcast. Hope to have you on again soon.

[00:15:07] Wen Cheong: Thanks Rob. And thanks everyone listening.

[00:15:10] Rob Campbell: Hi everyone. Rob here again. To subscribe to the Art of Boring Podcast, go to Mawer.com. That's M A W E R dot com forward slash podcast. Or wherever you download your podcasts. If you enjoyed this episode, please leave a review on iTunes, which will help more people discover the “be boring, make money” philosophy. Thanks for listening.