THE LONG VIEW

Navigating the Emerging Market Opportunity

'A smooth sea never made a skilled sailor'

Thomas Jefferson (attributed)

On a foggy night in October 1707, five British warships were making their way home from skirmishes with French forces near Gibraltar. The weather made it difficult to navigate so the admiral called together his navigators, who reached a consensus view that they were west of Île d'Ouessant in safe waters. One dissenter, an unnamed seaman, came forward to disagree. At the time it was forbidden for 'inferiors' to engage in subversive navigation and the admiral ordered the man hanged. Unfortunately, his warning turned out to be prophetic, as the Scilly Isles, just off the tip of southwest England, loomed out of the fog and four of the five ships went down, with all but two hands – one of the worst naval disasters in history. How could the boats have been so badly lost?

Emerging markets[1] represent 50% of the global economy and 66% of global GDP growth in the past 10 years (2012 to 2022) and are home to 4.3 billion people[2]. They make up only 13% of total global stock market capitalisation[3], however, providing an attractive and broad set of environments in which to find businesses, invest in them and generate long-term absolute returns. The challenge, though, is that there are many hazards. In the past 12 months alone, we have witnessed the tragic war in Ukraine, alleged Indian corporate governance failures, accounting irregularities in Brazil and the disregard of foreign holders of Chinese debt. These events have each caused a permanent, or likely permanent, loss of capital for international investors. As a business named after a lighthouse built to keep mariners safe, we find ourselves thinking a lot about how best to avoid treacherous rocks.

OUR NORTH STAR

Dava Sobel's excellent book, Longitude, talks about the race to find a way to determine longitude at sea, without which sailors could become hopelessly lost and at risk of shipwreck. Discovering ways to accurately navigate also allowed sailors to abandon the narrow corridor used previously for transatlantic passages and instead sail their own course.

Equity markets like oceans are vast, deep and subject to rapidly changing conditions. A storm may pass through, leading to roiling seas, imperilling those on the water. At other times clear skies and light wind result in smooth, glassy seas and easy sailing. We believe that an investment philosophy and the set of principles that underlie it act like the navigation principles and tools developed by ancient mariners to keep themselves safe. What matters, then, is believing in those principles and following them irrespective of what the weather throws at you. The course others sail matters less than staying true to your principles and steering clear of hidden dangers.

In this regard it is clear that the index offers little in terms of useful advice on how to chart a course. The ability of these rudderless benchmarks to impact global capital flows has, however, not been lost on governments. The Wall Street Journal reported in 2019 that China had pressured MSCI to increase the weight of Chinese equities within the benchmark, a decision that sent $125 billion into Chinese stocks. It was also reported that 'MSCI's decision was driven by concern that Beijing would stymie its effort to expand in China'[4]. The rising tension between China and the United States led to the White House in 2021 issuing an executive order[5] that resulted in benchmark providers deleting certain Chinese businesses which are believed to support the Chinese military. This suggests not only that indexes are a poor navigational aid but also that these 'passive' indexes are subject to influences that make them more active than they might seem. The outcome of these influences is not about generating returns for minority investors.

THE IMPORTANCE OF INTEGRITY

Our philosophy is built on four lines of defence against mistakes – people, franchise, financials and sustainable behaviour. We have discussed some of these areas in other articles but wanted here to focus on people and specifically the importance of integrity. A business that exploits its stakeholders for the sake of improving short-term returns is likely to be caught out when customers or the government respond, resulting in profound damage to the long-term economics of the business and the potential for a permanent loss of capital. Even if this does not happen, a management team that is prepared to mistreat one set of stakeholders is more likely in our experience to exploit us as minority investors, too. Our interests are not aligned. In essence, we are looking to invest in businesses that act with integrity – those 'doing the right thing when you don't have to – when no one else is looking'[6].

This assessment is helped because we can look through the glossy annual report using a lens that considers actions rather than words. For example, considering how a business was started or acquired, how it gained its licence to operate or how a business owner has treated business partners can give clear indicators of the level of integrity of the business and its owners. The plethora of sustainability data published by businesses gives us additional opportunities to assess integrity in terms of how seriously the management team take this responsibility. Are the targets they set specific, challenging and material to the business, or just selected because they can be easily achieved? Is there an attempt to distract or divert attention away from the real challenges? Where does ultimate responsibility for sustainability lie – the marketing department or the boardroom?

Recently, we found an example of a business that would fail our integrity test. We met a company in India in an office that we realised doubled up as the family home, occupying most of a 37-storey building. Lavishly appointed, our meeting room had a sumptuous marble table the length of a good-sized bus, an elevator adorned with leather and an army of people seemingly hugely underemployed. The owner of this listed business seemed comfortable demonstrating a willingness to use company and shareholder funds to live in lavish surroundings, at the expense of minority shareholders. It swiftly became obvious this business was one we would not be comfortable investing in.

YOU CAN PUT A PRICE ON INTEGRITY

It is a common refrain that you can't put a price on integrity. Although it may be difficult to place a specific price on such a thing, however, it is possible to see where certain choices must only lead to a fall in reputational value. Again, a set of principles that hold people to account for showing a lack of integrity can avoid calamitous outcomes.

Equally where we believe integrity is compromised in existing holdings we will choose to sell our shares rather than hope for the best. It was in this vein that we decided to sell our holding in Commercial International Bank (CIB) in 2020. We believed CIB to be one of the better banks in our investment universe because of the quality of its management, their attitude towards risk and their independence from the government. In October 2020, however, it was announced without further explanation that the bank's long-standing chairman of over 20 years would be abruptly leaving after an audit by the central bank and was to be replaced by a government-approved individual. This looked like a change in control and was something we had seen before. We chose to sell the same day.

Within a year CIB had announced[7] a joint venture with a less-than-reputable group, which underlined that the lending department was less focused on risk-adjusted returns and more on supporting the government and individuals it would not have lent capital to before. A company presentation[8] shows that since the change in chairman the return on equity is down by about a third, loans have almost doubled and the share price is down by more than 50% in US dollars. Alignment and integrity really do matter.

PREPARE, DON'T PREDICT

Successful sailors prepare for tougher conditions ahead – they don't predict. The weather forecast is a guide but predicting the future is a difficult business. We follow the same principle. We didn't predict that the Chinese education business TAL Education would see its shares lose over 85% of their value from their peak because of the changes in government policy. We did recognise, though, the inherent fragility within the variable interest entity business structure, listed offshore to get around Chinese government rules about ownership of sensitive industries.

Last year we owned no Russian companies, not because we had the foresight to spot the impending tragic invasion of the Ukraine, but because we could not find a business that passed our strict principle of integrity. The last Russian company left the team's previous watchlist in 2018 after we saw the founder Sergey Galitsky sell most of the business[9] to the second-largest state-owned bank VTB, which then sold the majority of its stake[10] to the son-in-law of Sergey Lavrov, the current minister of foreign affairs for Russia. This made it clear that no business was beyond the influence of the government and the damage that could potentially wreak on any investment.

CONCLUSION – A SHIP IN HARBOUR IS SAFE, BUT THAT'S NOT WHAT SHIPS ARE BUILT FOR[11]

The safest option in emerging markets is never to set sail, but we think that would be to miss the opportunity that these markets present and to ignore the resilience of the best businesses we find. However, the lack of an ability to navigate overcast skies led to the tragic fate of the four ships mentioned at the start of this article. We know from experience that having a way to navigate that is based on sound principles, such as the integrity of the people behind a business, helps to avoid the destruction of wealth. Ultimately having a guide by which to navigate allows you to ignore the decisions of others and have the confidence that the course you follow is a sensible one.

SOURCES

[1] As defined by the MSCI Emerging Markets Index

[2] www.worldeconomics.com/Regions/Emerging-Markets

[3] MSCI

[4] www.ft.com/content/bbe7b2c2-45ca-11e9-b168-96a37d002cd3

[5] www.whitehouse.gov/briefing-room/presidential-actions/2021/06/03/executive-order-on-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china

[6] Charles Marshall, Shattering the Glass Slipper, 2003

[7] https://enterprise.press/stories/2021/05/27/cib-tmg-set-up-real-estate-spv-for-commercial-properties-41982

[8] https://ir.cibeg.com/en/financial-highlights

[9] www.reuters.com/article/us-russia-magnit-vtb-idUSKCN1G00FS

[10] www.marketscreener.com/quote/stock/MAGNIT-6498973/news/Magnit-Russia-s-VTB-sells-part-of-stake-in-retail-chain-Magnit-for-1-billion-26646006

[11] A quote from John A Shedd, 1928

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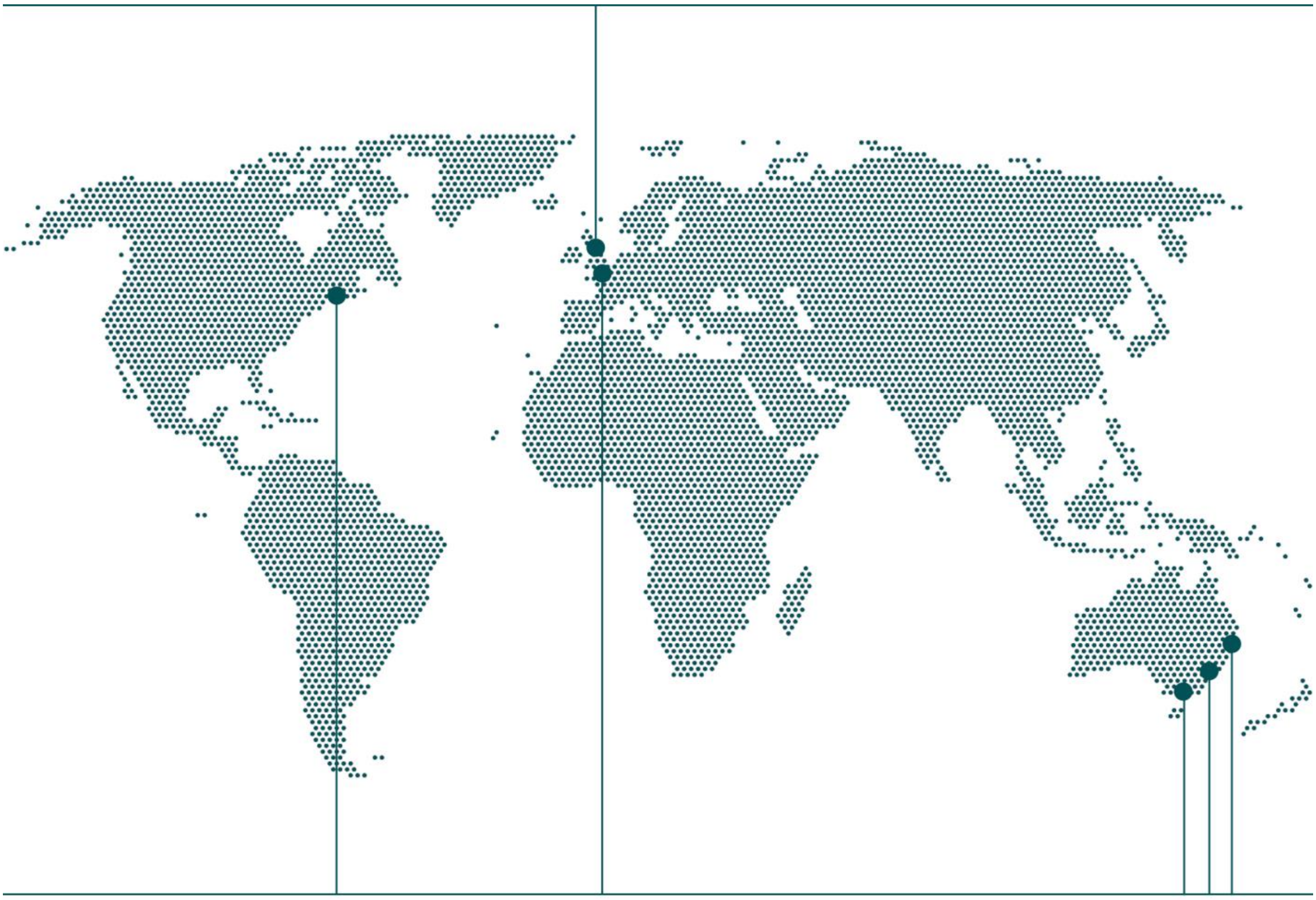

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