NEDGROUP INVESTMENTS

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# Nedgroup Investments Global Emerging Markets Equity Fund

Quarter Four, 2021

## Nedgroup Investments Global Emerging Markets Equity Fund

### Portfolio strategy

Emerging equity markets continued to underperform developed markets in Q4 held back again by a rising Chinese political risk premium. The MSCI Emerging Markets index fell 0.84% in local currency terms and 1.24% in US dollars. IT was the strongest sector with a 7.5% gain, while healthcare was the weakest, falling 15.3%. Egypt was the best performing market, rising 18.4% while Turkey was the worst with a loss of 11.1% in US dollars as the lira collapsed. Turkish President Erdogan continues his campaign to re-write economic orthodoxy in the face of stiff opposition from the currency markets.

Changes to our country ratings this quarter include an upgrade to China based on cyclical liquidity and a downgrade to Russia centred on deteriorating politics. Our expectations are for a slowing global economy and a negative global liquidity backdrop meaning we favour defensive markets. We do currently like ASEAN countries such as Vietnam, Thailand, Philippines and Indonesia. Taiwan has been upgraded to a 2 rating and we plan to add, while Malaysia has been downgraded to 4 due partly to a poor earnings outlook. Our positive 2 rating on Greece is under review.

The portfolio remains underweight energy. The oil price was virtually unchanged as measured by Brent but stocks have seen positive revisions especially those with gas exposure, with prices soaring in Q3 although they have fallen back recently. Gazprom is a direct beneficiary of the shortage of gas in Europe although the company remains a policy tool of the Kremlin. OPEC+ supply discipline and drilling restraint by US shale operators has sustained the rally in crude prices after the vaccine led surge in demand earlier in 2021. The sector has delivered huge profits but has resisted the temptation to spend on production growth focusing instead on capital discipline and shareholder returns. Higher prices should tempt shale producers and OPEC+ to pump more while the gas shortage in Europe should abate, although the timing will depend on winter weather. Global inventories are unlikely to return to longer term average levels until 2023.

We also remain underweight materials although there are tentative signs that the Chinese economy is bottoming which is supportive for base metal demand. Changes within the Chinese economy away from investment in housing towards 'energy transition' infrastructure should lead to a shift from steel, iron ore and coal to copper, nickel and aluminum. We own agricultural chemical company Quimica Y Minera in Chile, which also produces lithium - the metal's price has surged due to growing electric vehicle penetration. The stock was hit by the left-wing presidential victory but there is no majority in Congress for major policy changes. There may be higher royalties but a reduction in licences / lower volumes leading to higher pricing. The global shift to net zero and ESG targets will also be a key driver in building materials as 'green building' will drive growth across commercial/industrial end markets and regulation in residential construction will lead to further green renovation of the housing stock.

We are overweight industrials with efficiency, sustainability, digitisation and decarbonisation all supportive trends for some stocks in the group and the backdrop for corporate capex and infrastructure spending remaining favourable. Airlines have been hit again by the omicron variant and restrictions on travel but we are hopeful that severe disease and deaths will be much lower this time, resulting in governments reversing the recent tightening of rules, helping re-opening plays across the entertainment, travel and hospitality industries. We continue to favour low cost operator Spring Airlines, Wizz Air Holdings operating from Eastern Europe and Airports of Thailand. In consumer discretionary, shortages of semiconductors are still impacting the auto industry as are higher raw material costs but pricing power is strong and the industry is looking forward to a recovery in sales in 2022, reflecting pent up demand. We like Geely Auto in China, which has some hybrid technologies and an exciting new product line, and is targeting 24% sales growth in 2022. We also like re-opening plays in this sector such as Indian hotelier Lemon Tree and Thai leisure group Minor International. In staples companies are trying to push through price increases to protect margins but some cost inflation is moderating due to supply chain issues easing. We like Bud APAC listed in Hong Kong but selling across emerging Asia. Beer companies have de-rated versus spirit companies as beer is consumed in public places, which have been impacted more by COVID. Lockdowns are temporary and beer consumption should recover as the world reopens again in 2022.

We remain underweight in healthcare although the quality defensive nature of the group may mean that profit progression is relatively attractive in the first half when we believe global growth will be slowing. Medical devices and services should benefit from a recovery in standard hospital activity as eventually enough people will either be vaccinated or have had exposure to the virus to reduce the burden on health services, allowing the number of hospital procedures to return to normal. We like Indian hospital operator Max Healthcare, which is growing its number of beds and is improving margins. In IT demand for semiconductors remains solid but there are signs that supply tightness is easing slightly. Inventory is uneven with some bottlenecks but stocks of other chips at high levels. Demand has stabilised but there may be order cuts where inventories are high just as supply comes into the market in late 2022.

In software and IT services digital transformation continues to grow rapidly boosted by the pandemic although valuations are near relative highs. Key themes include automation, cloud and the move to subscription models. The rise in political risk in China has hit IT, communication services and parts of the consumer sector hard. The companies that drove EM in the 2019/20 period are still exciting with superior quality and growth businesses but investors remain wary of the next regulatory announcement from Beijing. Accepting that this background is challenging to navigate we currently favour the likes of Tencent and chip makers such as Samsung and TSMC. We prefer companies that will work with the Chinese government to help them meet their economic and social goals.

## Performance Attribution and Commentary

| 3 Months to December 31, 2021 | Allocation (%) | Stock Selection (%) | Net Impact (%) |
|---|---|---|---|
| Total | 0.11 | -0.30 | -0.19 |
| Emerging Market Asia | 0.85 | 0.16 | 1.01 |
| China | 0.41 | -0.51 | -0.11 |
| Hong Kong | -0.02 | 0.00 | -0.02 |
| India | 0.02 | 0.43 | 0.44 |
| Indonesia | 0.00 | -0.13 | -0.13 |
| Malaysia | 0.00 | -0.01 | -0.01 |
| Philippines | 0.09 | -0.42 | -0.33 |
| South Korea | 0.14 | -0.01 | 0.13 |
| Taiwan | 0.06 | 0.93 | 0.99 |
| Thailand | 0.16 | -0.12 | 0.04 |
| Emerging Market Europe, Middle East and Africa | -0.53 | -0.29 | -0.82 |
| Greece | -0.05 | -0.01 | -0.06 |
| Gulf Markets (Saudi Arabia, Qatar, UAE, Kuwait) | -0.16 | 0.00 | -0.16 |
| Hungary | -0.02 | -0.01 | -0.04 |
| Poland | 0.01 | -0.05 | -0.04 |
| Russian Federation | -0.04 | -0.23 | -0.27 |
| South Africa | -0.03 | 0.00 | -0.03 |
| Emerging Market Latin America | -0.15 | -0.17 | -0.32 |
| Brazil | 0.03 | -0.09 | -0.06 |
| Chile | -0.02 | -0.08 | -0.10 |
| Mexico | -0.14 | 0.00 | -0.14 |
| Frontier Markets | 0.12 | 0.00 | 0.12 |
| Cash | 0.17 | 0.00 | 0.17 |
| Other | -0.35 | 0.00 | -0.35 |

Source: NS Partners Ltd

In a lacklustre end to a weak year the MSCI Emerging Markets benchmark declined by 0.84% in local currency terms and 1.24% in US dollars for a 2021 annual return of +0.14% in local currency and -2.22% in USD. The fund had a disappointing quarter. Security selection was the biggest detractor from relative performance in Q4 with country selection a small negative and sector selection positive.

The best performing sector was IT (+7.37%) with healthcare the weakest (-15.36%). The strongest market in Q4 was Egypt (+18.36%) with Turkey the weakest (- 11.13%). Among the larger markets, China declined 6.18% whilst Taiwan gained 8.48% The fund's underweight position in China was positive for relative performance as was the underweight in Korea (-1.48%) but this was offset by the underweights in Mexico (+6.37%) and the Gulf markets of UAE (+10.33%), Qatar (+2.56%) and Kuwait (+2.25%). Positive sector selection was a result of the fund's overweight in IT (+7.37%) and underweights in materials (-2.88%) and healthcare (-15.36%).

There was negative security selection in financials across several markets. In Latin America, our Brazilian banks Itau (-12.8%) and Bradesco (-8.4%) lagged the broader market, which was led by energy giant Petrobras. In Chile Banco Santander (-19.6%) fell sharply following the election victory of left wing presidential candidate Gabriel Boric in November's second round. In India our long term holding in mortgage leader HDFC (-6.23%)

was a drag. UK listed but Asia focused insurer Prudential PLC (-12%) reacted negatively to Chinese lockdowns, which weaken its Hong Kong sales to Chinese nationals.

In India, Devyani International and Max Health Care Institute drove positive overall security selection. Recently listed Devyani (+42.3%) is an operator of KFC and Pizza Hut and the largest Yum brands franchisee in India. The business is emerging from COVID related headwinds to its QSR (Quick Serve Restaurant) and has strong store growth plans. The formal food services industry is continuing to gain share in India. Max Health Care Institute (+23%) is an operator of private sector hospitals in and around the Delhi metropolitan area and continued strong demand is maintaining high occupancy rates in its chain along with an improving payor mix, as the share of government employee insurance scheme patients falls. The metropolitan footprint is key to the group's high occupancy and market-leading margins.

Security selection in consumer staples was negative for relative performance over the quarter. After a strong contribution to performance earlier in the year, Monde Nissin in the Philippines corrected 13.8% in Q4. A modest downgrade of its sales growth target from mid-single digit to low or mid-single digit was the driver, with the meat alternative business in the UK disappointing. Atacadoa Distribuicao (-13.8%) in Brazil also contributed negatively as a proposed deal with rival Assai involving acquisition of potentially 71 stores for conversion to the cash and carry format was viewed as increasing competition in the space even as hoped-for inflation arrives.

Security selection was positive in Taiwan where a number of our IT related holdings delivered strong returns. Unimicron (+76.2%) was particularly strong, with analysts predicting continued shortages for its high ABF products as more complexity in semiconductor design results in higher requirements for these substrates. Aspeed (+54.4%) was boosted by continuing strong demand from data centre expansions and increased capex plans of large customers like Meta. Aspeed has been able to secure capacity from global foundries for its server management semiconductor products while passing on increased costs to maintain its margins. Mediatek (+32.4%), the leading fabless semiconductor design competitor to Qualcomm, delivered strong results with positive demand guidance for 2022.

## Portfolio activity

### Top Purchases

| Country | Security | Sector | % |
|---|---|---|---|
| **China** | Tencent Holdings Ltd | Communication Services | 2.51 |
| **South Korea** | Daum Kakao Corp | Communication Services | 1.43 |
| **China** | Wuliangye Yibin Co Ltd-A | Consumer Staples | 1.36 |
| **South Korea** | Sk Hynix Inc | Information Technology | 1.27 |
| **Indonesia** | Bank Rakyat Indonesia (Persero) Tbk | Financials | 1.24 |
| **China** | Wuxi Biologics Cayman Inc | Health Care | 1.01 |
| **Taiwan** | Mediatek Inc | Information Technology | 0.98 |
| **Taiwan** | Cathay Financial Holding Co | Financials | 0.90 |
| **South Korea** | NAVER Corp | Communication Services | 0.65 |
| **China** | Shenzhou International Group | Consumer Discretionary | 0.62 |

Source: NS Partners Ltd

### Top Sales

| Country | Security | Sector | % |
|---|---|---|---|
| **China** | JD.com Inc-Adr | Consumer Discretionary | 1.61 |
| **Taiwan** | Realtek Semiconductor Corp | Information Technology | 1.30 |
| **India** | Godrej Properties Ltd | Real Estate | 1.08 |
| **China** | Longi Green Energy Technol-A | Information Technology | 1.05 |
| **Russian Federation** | Yandex NV-A | Communication Services | 0.98 |
| **India** | Hindustan Unilever Ltd | Consumer Staples | 0.93 |
| **Thailand** | Scg Packaging Pcl | Materials | 0.92 |
| **China** | Glodon Co Ltd-A | Information Technology | 0.81 |
| **Russian Federation** | Sberbank | Financials | 0.75 |
| **Taiwan** | China Steel Corp | Materials | 0.70 |

Source: NS Partners Ltd

Transactions over the quarter reduced the underweight in China. We have upgraded our assessment of the market based partly on improving cyclical liquidity. In staples, liquor manufacturer Wuliangye Yibin has been introduced on the expectation that the premium baijiu market will continue growing as household consumption rises with employment and consumer confidence. Domestic re-opening should help as business entertaining and dining-out re-commence. The company enjoys relatively strong pricing power so can pass on rising input costs to a greater extent than other staples companies. The sector as a whole has been making strides in improving corporate governance and there have been positive management changes at Wuliangye.

We have also introduced Wuxi Biologics, a leading biologics drug outsourcing company. It is the local hero (and 4th largest globally) in the fast growing CDMO (Contract Development and Manufacturing Organisation) industry, which has minimum exposure to healthcare regulatory risks. It enjoys cheaper labour costs (vs western peers) and has demonstrated a proven track record of superior project execution and quality. Originating in the upstream drug R&D market more than 10 years ago, the company previously focused on early-stage integration with its customers' supply chain. Its "follow-the-molecule" strategy now enables it to benefit from the whole drug R&D value chain by gradually increasing revenue per customer (due to stickiness in biologics R&D) as projects move to later stages yielding higher volume and more milestone and royalty revenues. The company is expected to deliver significantly above-average top-line growth (~30% above global peers and 10% above Chinese peers over next 2 years), with stable margins expected ex-COVID tailwinds.

In IT we have added to media, music and e-commerce giant Tencent, which, in common with many Chinese tech giants, has seen its share price decline from a peak last February as a result of tighter regulation by the local authorities. The company has been divesting assets including a US$16bn stake in JD.com, which will overhang the shares and led us to sell our position in the online marketplace company. Tencent, however, retains ownership of a number of fast growing exciting assets, including in gaming where new launches will drive sales, while its social network business remains resilient. Other outright sales in China include electrical power equipment maker Shanghai Liangxin Electrical, which may be impacted by Evergrande fall-out among other property developers. We are additionally concerned that the company will be unable to pass on raw material price rises to customers. We have also reduced solar panel manufacturer Longi Green Energy with the buy case less appealing after the extension of US trade protection policies to the industry due to manufacturing in the Xinjiang region.

Elsewhere in Asia we have bought internet portal company Kakao Corp, a company focused on building capabilities for the forthcoming age of the Metaverse. Management is putting in place strategies to become a distribution platform domestically through Kakao TV and Kakao Page while also looking to expand its media business globally. Sales momentum remains strong and there is upside to margins given that many of its businesses are in the early stage of monetisation. The stock was weak as Korean regulators focused on anti-competitive issues in the internet space, with Korean internet companies' shares responding in a similar manner to their Chinese peers. We have also added to similarly impacted Naver in the same industry. The company is aggressively diversifying its business mix with next-generation platforms for global markets, offering Webtoons, virtual worlds and B2B solutions. We have also re-introduced semiconductor manufacturer SK Hynix, which should benefit from expected memory market DRAM growth of 40% in 2022. There is strong demand in smartphones and SSD / enterprise segments and inventory levels at the DRAM makers and the major OEMs are lower than in H2 2018, which was the last upcycle in the previous cycle. PC DRAM inventories are now at 8-10 weeks, higher than previous cycle. Capex is likely to be strong but supply discipline remains intact. Hynix's underperformance should make it a better recovery play.

In Taiwan we have introduced life insurance company Cathay Financial as we like the low valuation and sensitivity to a steepening yield curve with earnings geared to higher longer rates. We have also added to semi maker Mediatek, which is benefiting from rising 5G penetration on smartphones. The company reported strong Q3 numbers with sales up 35% and raised guidance on margins. Management are shifting the product portfolio towards the high-end chips to raise the blended average selling price. The purchase was funded from Realtek Semiconductor as we want to focus our holdings and Mediatek is also an integrated circuit design house. We additionally sold China Steel where an expected Q3 recovery in steel prices did not play out. In Indonesia we have bought Bank Rakyat Indonesia which trades at a price to book discount to others in the sector but is focusing on ESG-complied loans and implementing an ESG lending policy. The company is also supporting the government's drive for financial inclusion through its recently established Ultra-Micro ecosystem. We have reduced India with the sales of Godrej Properties in real estate and Hindustan Unilever in staples. We have also exited Scg Packaging in Thailand. In Europe we downgraded Russia on politics and relatively weak money trends, which led to the reduction in internet search engine operator Yandex and Sberbank. We have also reduced Brazil with the reduction of Banco Bradesco.

## Country and Sector allocation

| Region | Portfolio (%) | MSCI EM (%) | Deviation (%) |
|---|---|---|---|
| **Emerging Markets Asia** | 83.88 | 78.99 | 4.89 |
| China | 25.81 | 32.40 | -6.59 |
| Hong Kong | 2.37 | 0.00 | 2.37 |
| India | 15.67 | 12.46 | 3.21 |
| Indonesia | 2.20 | 1.45 | 0.75 |
| Philippines | 2.83 | 0.71 | 2.12 |
| South Korea | 12.02 | 12.82 | -0.80 |
| Taiwan | 16.38 | 16.10 | 0.28 |
| Thailand | 5.14 | 1.68 | 3.46 |
| **Emerging Market Europe, Middle East & Africa** | 5.61 | 14.24 | -8.64 |
| Greece | 1.80 | 0.21 | 1.59 |
| Gulf Markets (Saudi Arabia, Qatar, UAE, Kuwait) | 0.00 | 5.84 | -5.84 |
| Russian Federation | 2.21 | 3.58 | -1.37 |
| South Africa | 0.00 | 3.17 | -3.17 |
| **Emerging Markets Latin America** | 2.64 | 6.77 | -4.13 |
| Brazil | 1.34 | 3.99 | -2.65 |
| Chile | 1.30 | 0.37 | 0.93 |
| Mexico | 0.00 | 2.05 | -2.05 |
| **Frontier Markets** | 1.48 | 0.00 | 1.48 |
| **Other** | 2.03 | 0.00 | 2.03 |
| **Cash** | 4.36 | 0.00 | 4.36 |

Source: NS Partners Ltd

| Sector | Portfolio (%) | MSCI EM (%) | Deviation (%) |
|---|---|---|---|
| Energy | 3.46 | 5.56 | -2.10 |
| Materials | 0.50 | 8.60 | -8.11 |
| Industrials | 7.08 | 5.07 | 2.01 |
| Consumer Discretionary | 12.87 | 13.54 | -0.67 |
| Consumer Staples | 7.07 | 5.87 | 1.20 |
| Health Care | 2.88 | 4.24 | -1.36 |
| Financials | 19.26 | 19.40 | -0.14 |
| Information Technology | 30.44 | 22.67 | 7.77 |
| Communication Services | 9.20 | 10.72 | -1.52 |
| Utilities | 0.63 | 2.37 | -1.74 |
| Real Estate | 2.26 | 1.95 | 0.30 |
| Cash | 4.36 | 0.00 | 4.36 |

Source: NS Partners Ltd

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