NEWTON

Investment Management

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THEMATIC INVESTING IN AN EMERGING-MARKET CONTEXT

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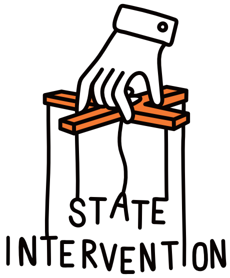
Against a diverse emerging-market backdrop, we use themes to identify globally important, observable forces of long-term change that we believe can influence our investible universe.

In this article, we focus on four themes – *state intervention*, *Earth matters*, *financialization* and *net effects* – that currently play a key role in helping us to select our emerging-market investments.

- In a world of ever-increasing volume and velocity of information, we find it helps to have such a thematic framework to maintain focus on the true long-term drivers behind businesses, be they more macro in nature (credit cycles, demographics, policy and geopolitics) or structural (technology disruption, health-care demand, climate change, etc.).
- Our themes help to identify the beneficiaries of such change while also highlighting areas of risk, as we seek to focus on the investment 'signal' while ignoring the 'noise'. They help to keep our attention on a five-to-ten year horizon while most of the market looks towards a much shorter time horizon, and help to provide more context and conviction when we create our valuation case for buying companies.
- Themes do not produce all the answers, but provide context to our focus on stock selection. Companies, sectors and countries on the right side of these long-term changes can benefit from a tailwind from an investment perspective.
- Thematic considerations may have a very material impact on the ability of even a good company to generate attractive long-term returns. This is particularly the case in less developed markets with potentially less stable politics, institutions and economies.
- Our thematic approach is not a 'tick-box' exercize, nor a basket approach. Instead, we need to assess the impacts of a theme at the country, sub-sector and stock level, where the implications can vary significantly. The same theme can be positive for one industry or company at the same time as being negative for another.
- Technology-related themes such as *net effects* and *smart revolution* are cases in point, with there being both winners and losers from the rise of cloud computing, internet usage, artificial intelligence and automation.
- Often the conclusions are not obvious. Many market participants saw telecommunications companies as beneficiaries of the data explosion, but this was manifestly not the case for most as they lacked the ability to monetize data growth into cash flows and returns, highlighting that a far more considered approach is required.



In more developed markets, concern over *state intervention* centres around central bank policymaking. While that is of course highly relevant across emerging markets too, there is in fact an even larger state-led consideration when investing in these markets: the fact that c.23% of the MSCI Emerging Markets index is comprised of state-owned enterprises (SOEs).

The majority of these companies are not run with profit-maximising or shareholder value-maximising intentions. They tend to be strategic state assets such as banks, or utility and resources companies, with heavy capital-expenditure burdens. In our view, this tends to make them poor stock investments over the long term, though a major commodity bull market can change the optics temporarily. We think return on equity (ROE) is usually less important than other strategic desires of the state in capital-allocation decisions.

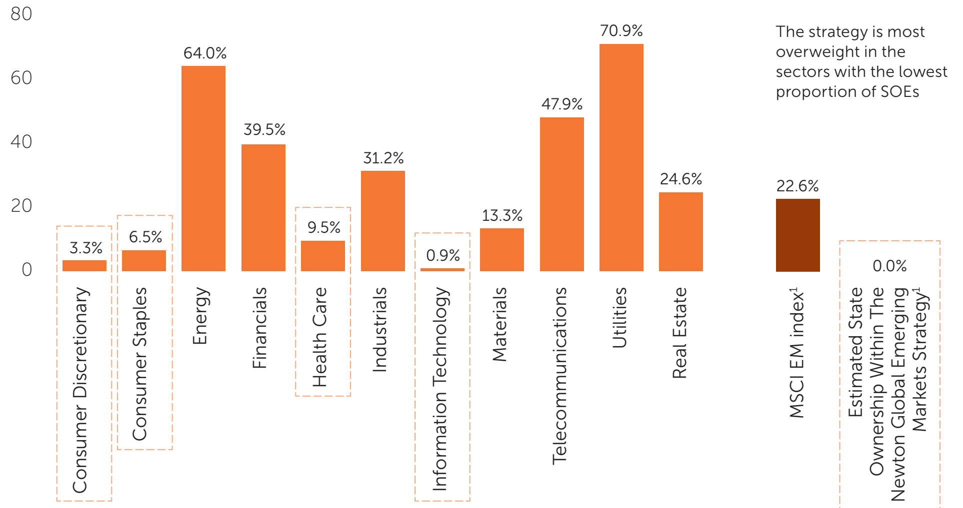
State ownership can provide stability, but this may involve significant shareholder value dilution, as minority investors tend to be a low priority in stressed situations or in capital-allocation decisions. Interestingly, we saw such dilution with many Western banks following the global financial crisis, and emerging-market companies are perhaps even less likely to focus on shareholder value in such situations.

> "We believe our active approach which allows us to currently take zero exposure to SOEs is a big advantage."

Of the larger emerging markets, the proportion of state ownership is highest in Russia at c.55% and China at c.40%, though the Middle Eastern countries United Arab Emirates (UAE) and Qatar have the highest rates overall at 96% and 81% respectively.[1]

History teaches us that the interests of a Russian oligarch or the Chinese politburo are rarely aligned with those of minority investors, and we therefore believe our active approach which allows us to

Exhibit 1: MSCI Emerging Markets Sectors – Estimated State Control (%)



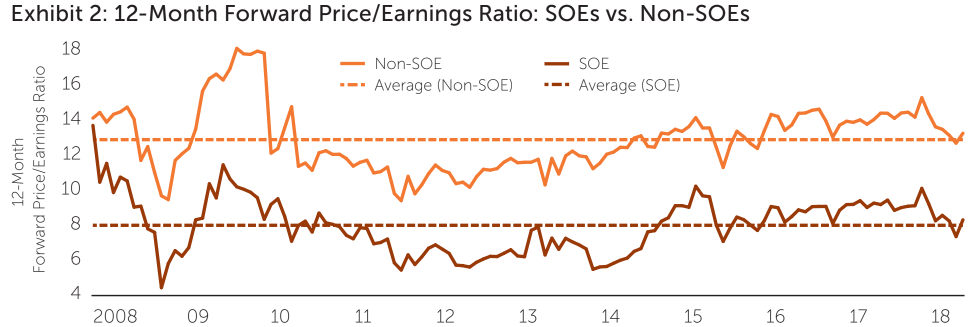
Source: Newton, CLSA, May 31, 2018. For illustrative purposes only.

[1] Estimate for the proportion of state-controlled companies in the whole MSCI EM index is calculated by defining each constituent in the index as state or privately-controlled (a very small proportion as 'unclassified' or 'majority foreign ownership') – then summed the index weights for all of the constituents considered to be state-controlled. Total GEM (Global Emerging Markets) is a weighted average.

currently take zero exposure to SOEs is a big advantage. SOEs have significantly underperformed non-SOE companies over both the long term and more recent periods (11.5% vs. 22% over the 12 months to end May 2018),[2] despite trading at a wide valuation discount. This, we believe, is owing to them, in aggregate, being perennial value destroyers on a through-the-cycle basis. Exhibit 3 shows that there is a long-term ROE gap (11.05% vs. 13% and widening) between the two types of companies owing to the lower quality of SOEs, which tend to have more indebted balance sheets, lower growth rates and higher capital-expenditure burdens, leading to lower cash flows and returns.

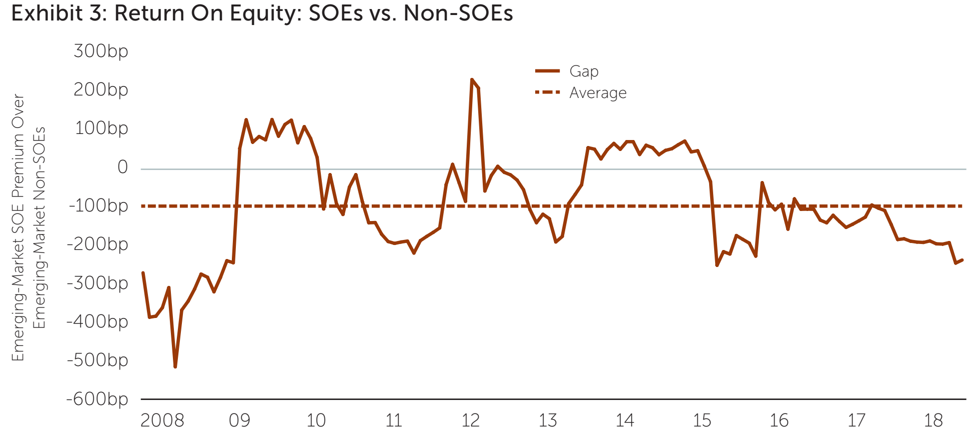
Conversely, the technology, consumer and health-care sectors are relatively free from state control and are where we find the most interesting investment opportunities.

Exhibit 2: 12-Month Forward Price/Earnings Ratio: SOEs vs. Non-SOEs



Source: MSCI, Datastream, UBS, July 31, 2018.

Exhibit 3: Return On Equity: SOEs vs. Non-SOEs



Source: MSCI, Datastream, UBS, July 31, 2018.

1 Source: CLSA, May 31 2018.
2 Source: MSCI, Datastream, UBS, July 31, 2018.

Earth matters has been a core theme at Newton for many years owing to our recognition that rapidly increasingly levels of economic activity across the globe have created significant stress on the world's environmental resources, and we have sought to evaluate the resulting investment opportunities and risks. Currently, there seems to have been something of a convergence of both pressure and intent across individuals, businesses and governments to ignite action in this area.

This theme covers a wide scope of environmental threats, including climate change, pollution and resource depletion, while considering the development of clean technologies and innovation across a range of industries to help build the necessary safeguards. It also analyses cost and affordability constraints, even with rapid technological advances, as well as the rising risks of non-compliance with laws in both financial and reputational terms.

The biggest investment opportunity we see across this space from an emerging-market, and possibly global, perspective is driven by the nascent electric-vehicle (EV) revolution. The automobile industry globally is currently being affected by policies on fuel economy, climate change, and air pollution. EVs look well placed for dramatic growth, but costs will have to fall as subsidies are removed. We expect EVs to reach cost parity with combustion vehicles by 2021, as battery pack costs decrease to \$100 per kilowatt hour (kWh), from \$1,000 per kwh in 2010. This should create an inflection in demand, such as has been witnessed historically in the adoption trends of many compelling consumer technologies, which scale their penetration faster than is anticipated.

The market remains far more cautious about this demand outlook and provides us with a point of differentiation. We believe demand is supported not only by policy and pricing, but by the fact that EVs are ultimately better products. Tesla has done a lot for the credibility of EVs in consumer perception, but EVs also have higher instant torque, are more reliable, and safer, and have lower maintenance costs and no engine noise! We believe that both battery manufacturers and

lithium producers are very well positioned to create value from what is set to be a long-term trend.

In 2017, the number of EVs globally increased from 740,000 to 1.3 million. Pure EVs grew at 61%, while hybrids grew at 36%.[3] We expect EV penetration to rise from 2% to 10% of new car sales by 2025. In our view, the market is currently erroneously over-focused on near-term supply, when the key issue is long-term demand. It is instructive to see that incumbent auto original equipment manufacturers (OEMs) are all now on board, launching products into the market by 2020, and securing their lithium supplies.

The European Union (EU) has announced that steep fines will be imposed on those not meeting their 2020 targets to reduce carbon emissions to 95 grams per kilometre.[4] To achieve this, almost all manufacturers need to improve their emissions by 20 grams per kilometre and more. That is almost impossible with conventional power trains.

We know that this is still very much a nascent industry, with a number of ongoing challenges, such as insufficient charging infrastructure, mass-market models still subject to 'range anxiety' and affordability. Further technological advancement of batteries is coming and costs will fall as battery capacity increases. We do not expect straight-line progress, as the early-stage industry scales to multiples of its current size, but we are excited about identifying the right investments to capture the value of this high multi-year growth opportunity.

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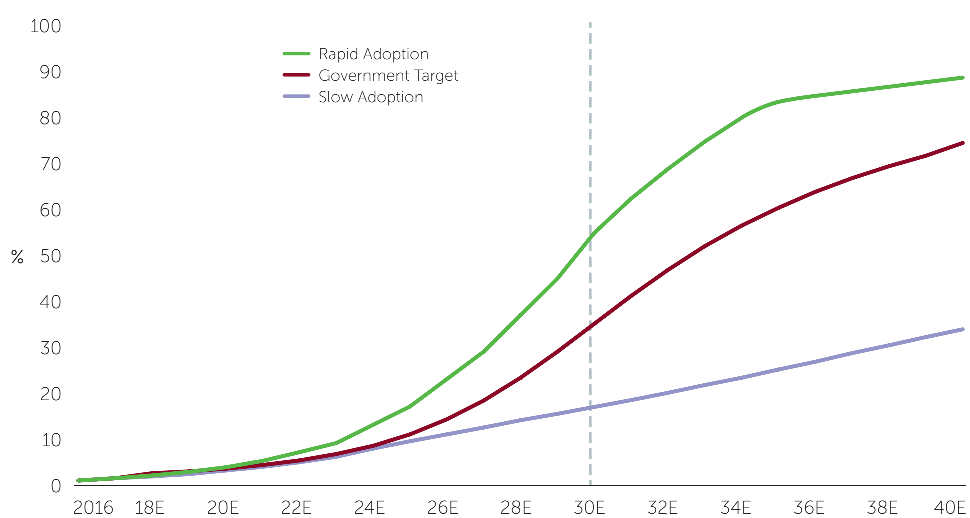
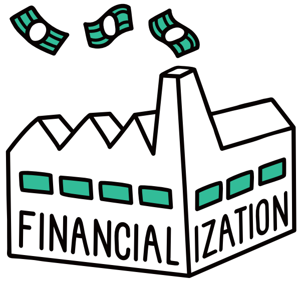
Exhibit 4: Three potential rates for battery electric vehicle (BEV) and plug-in hybrid electric vehicle (PHEV) adoption as a percentage of car shipments globally: by 2030 we project 55% for rapid adoption, 35% for government target scenario and 17% for slow adoption



Source: SNE Research and Bernstein estimates and analysis, December 2017. For illustrative purposes only.

3 Source: SNE Research and Bernstein analysis, December 2017.
4 Source: www.transportenvironment.org, 2017.



Growing real wages and buoyant growth in many emerging markets have resulted in significant wealth creation. This has supported a positive consumption environment, but it also has meaningful repercussions for the evolution of savings behavior and the development of the financial system.

As larger numbers of households begin to cross higher-income thresholds, this leads to a significant step change in the need for protection and long-term savings products from these newly affluent consumers, which are increasingly akin to the needs of developed-market consumers: in Guangdong in China, average income per capita in 2017 approached $13,000 per capita, whereas in Jiangsu it was close to $16,000.[5] Consumers of these income brackets are a relatively new phenomenon within China and emerging markets as a whole and have different financial requirements.

Changing financial needs are shaped further by demographic trends such as increased longevity, which requires greater provision of health care and places a growing burden on state pensions.

We anticipate that insurance and investment products will therefore play an increasingly critical role in addressing the shortfall in protection cover needed to safeguard populations against early mortality, disability and growing out-of-pocket medical costs. Policy initiatives in many emerging markets (e.g. demonetization in India) have sought to promote a shift in savings behavior, with individuals encouraged to move savings out of traditional, physical savings vehicles, such as gold and property, into the financial system. Such approaches are intended both to mobilize savings more effectively for economic growth, and also to encourage consumers to take more responsibility for their own retirement needs.

In this context, however, the MSCI Emerging Markets index's financial weighting remains dominated by banking institutions,[6] reflecting earlier stages of economic development and lower income levels. Awareness of the opportunities presented by the financialization of savings of emerging-market consumers suggests significant growth potential within asset-management and insurance-focused business models.

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At Newton, we retain a cautious stance towards the banking sector globally on account of growing regulatory capital requirements and balance-sheet risks. However, we are much more constructive on the savings-related financial businesses, which can offer higher returns and reduced regulatory risks relative to those seen in the banking sector. These businesses also offer significant growth potential on account of very low penetration.

Exhibit 5: Mutual Funds' Penetration In Emerging Markets Is Way Below The Global Average

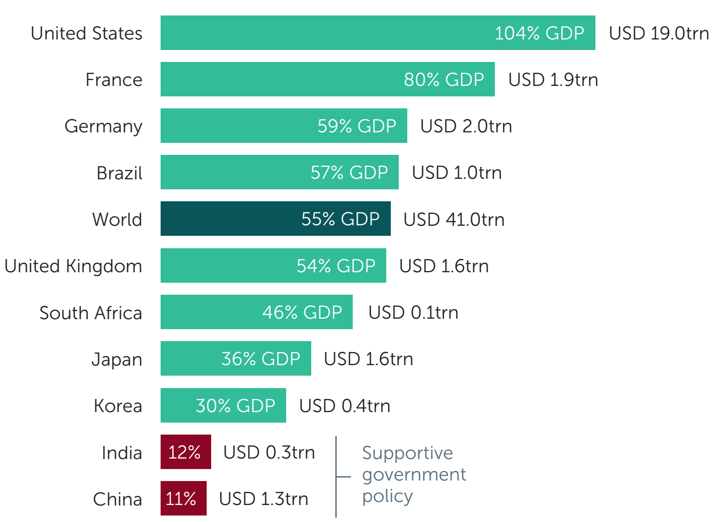
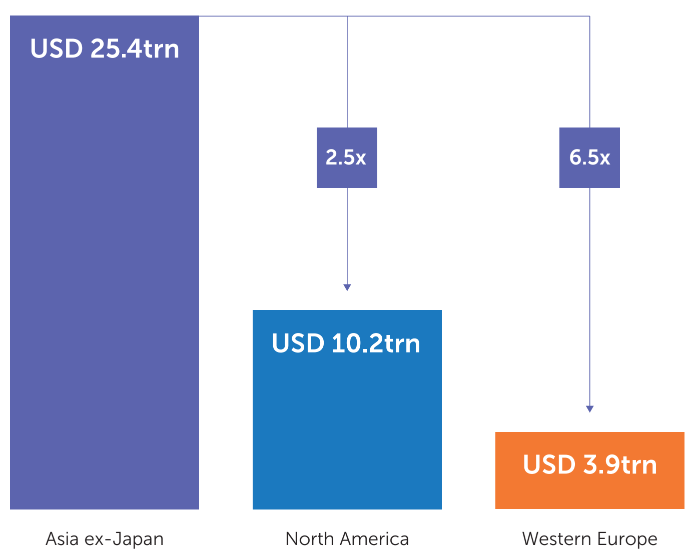
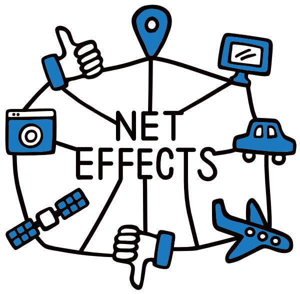


Exhibit 6: Significant Wealth Creation
2015-2025 New personal financial assets creation (estimate)



Source: AIA 2017 annual results presentation, February 27, 2018, McKinsey, Brookings Institution, EIU, World Bank, BCG Global Wealth 2017 Report. For illustrative purposes only.

5 Source: CLSA, May 2018.
6 Source: Bloomberg, October 2018.



The *net effects* theme, and indeed its predecessor, *networked world*, have been a long standing influence on Newton's Global Emerging Markets strategy. Currently over 30% of the strategy comprises stocks that seek to harness this long-term theme.

One reason for the large exposure is the scale of opportunities we see relating to the theme in a broad range of sectors, not simply traditional 'tech', although we are selective within this. For example, the most attractively placed companies in our view are often asset-light and first movers rather than telecommunications or device manufacturers.

These types of companies range from e-commerce to social networking, but also online recruitment and travel companies. The theme also extends to leaders in the semiconductor area. Many sub-industries have consolidated to oligopoly or duopoly markets, and as new technologies like artificial intelligence create increased demand for semiconductors (e.g. memory chips), these leading companies are gaining pricing power to an extent they have never had before.

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We regard Asia as a very exciting place to find beneficiaries of the *net effects* theme. This stems from a few factors: *population dynamics* and rising income levels mean there is still a long 'runway' for growth. In India, for example, mobile internet penetration is only 32% (see Exhibit 7).

Another reason is the use of technology to leapfrog traditional bricks and mortar infrastructure and grow digitally from the start. This can happen in developing economies where the formalisation of many industries is still in its infancy. Many of our investments in this area are Chinese companies because they are publicly traded. This is in stark contrast to India, where the e-commerce landscape is controlled by the private company Flipkart (now 77% owned by Walmart) and Amazon. In Indonesia, the leading players Tokopedia and Lazada are unlisted and in fact are backed by China's biggest e-commerce firm.

The way the Chinese landscape has evolved perhaps epitomizes the *net effects* theme. Thanks to internet business Tencent's social networks, called QQ and Weixin (also known as WeChat), and the availability of cheap handsets and affordable data, virtually the entire population is connected to one ecosystem through which almost every aspect of daily life is conducted and livelihood is created. Grocery shopping, food deliveries, bill payments, money transfers, video and gaming entertainment, e-commerce, social interaction, travel, business interaction… the list goes on. This is a 'super app' which connects users to other third-party websites or 'mini programs'. As the chief commercial officer of one luxury online fashion retailer was quoted saying, "practically everything in China happens on WeChat".

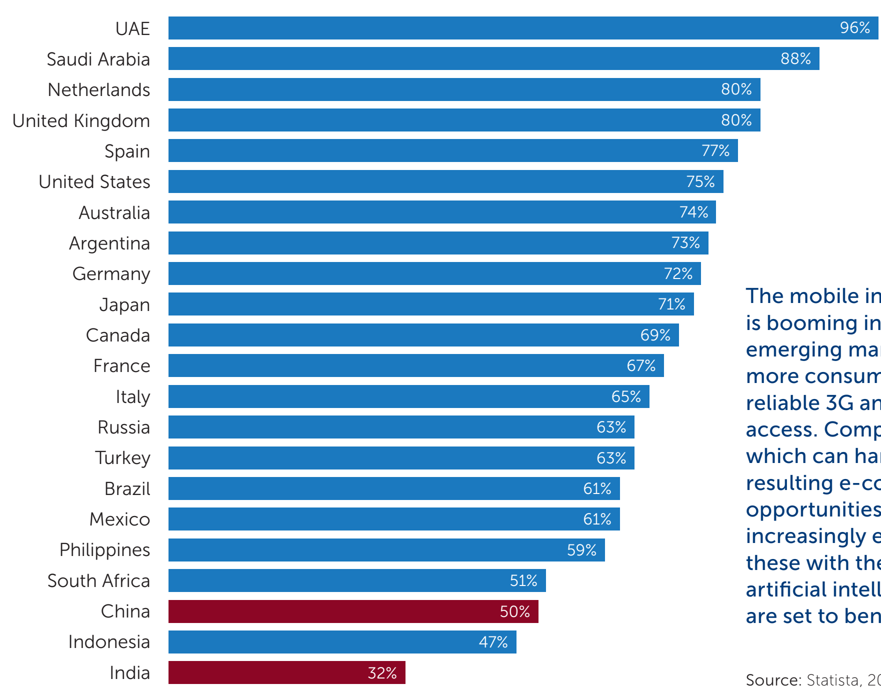
The *net effects* theme can be seen in action as companies spring up on the back of Tencent's infrastructure. One example is a social e-commerce company with a unique 'team-buying' concept. It was launched in 2015, but already has almost 300 million users thanks to the way referrals to friends and family happen via QQ and WeChat.

A start-up coffee chain is another example – launched in November 2017, it already has 525 cashless stores, over half of which are solely for fulfilment of delivery orders. While the collectively known 'BAT' (search engine Baidu, together with Alibaba and Tencent) are now quite well known in the Western world, there is another rising tier known as 'TMD' which have created their own niches: these are in areas such as newsfeed/short video, service e-commerce and smart transportation. These companies are already at multi-billion dollar valuations based on their latest private-equity funding rounds and have ambitions to list publicly.

As *net effects* are happening in every industry, the upshots of this theme are growing. They are perhaps most visible in retail, where online leaders are now taking control of their offline counterparts in what is popularly called OMO (online merged with offline), but also in finance and health care for example.

As this wave of disruption rolls on, regulation catches up and this introduces risks to the theme. We have recently seen the People's Bank of China crack down on online finance platforms. And the idea of data privacy – now well known in the U.S. and Europe – is rapidly evolving in China and other emerging markets too. This means we remain very selective in our investment approach. We note in particular that private-equity capital continues to pour into this space, resulting in a vast number of IPOs as the private-equity firms look for an exit, and we see a potential bubble in the making. However, we believe there could be attractive opportunities over time for long-term investors.

Exhibit 7: Mobile Internet Penetration By Country Q3 2017



The mobile internet is booming in many emerging markets as more consumers get reliable 3G and 4G access. Companies which can harness the resulting e-commerce opportunities, and increasingly enhance these with the use of artificial intelligence, are set to benefit.

Source: Statista, 2018.

For More Information

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Newton Global Emerging Markets Strategy – Key Investment Risks

- **Past performance is not a guide to future performance.**
- **Your capital may be at risk. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested. There is no guarantee that the strategy will achieve its objective.**
- This strategy invests in international markets which means it is exposed to changes in currency rates which could affect the value of the strategy.
- A fall in global emerging markets may have a significant impact on the value of the strategy because it primarily invests in these markets.
- The strategy may use derivatives to generate returns as well as to reduce costs and/or the overall risk of the strategy. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.
- The strategy invests in emerging markets. These markets have additional risks due to less developed market practices.
- A fall in the value of a single investment may have a significant impact on the value of the strategy because it typically invests in a limited number of investments.
- The strategy may invest in small companies which may be riskier and less liquid (i.e. harder to sell) than large companies. This means that their share prices may have greater fluctuations.

Important Information