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[INTRODUCTION]
James Yardley (JY): Hello and welcome to the Investing on the go podcast. I'm James Yardley and today I'm joined by Rasmus Nemmoe, the fund manager of FSSA Global Emerging Markets Focus. Thank you very much for joining us today Rasmus.

Rasmus Nemmoe (RN): Thank you very much for inviting me today.

[INTERVIEW]
[0:18]

JY: Now Rasmus, it's quite a difficult decade for emerging markets. They've underperformed the UK and they substantially underperformed the US. So why is this? When all the growth in the world is supposed to be coming from emerging markets? And why should investors consider emerging markets today going forward?

RN: Now, that's a good question. Well, it's very true that emerging markets has underperformed over the past decade, but I think it's important to look at the starting point. Coming into the previous decade, we had 10 years where emerging markets absolutely crushed developed markets, but it was also a time where commodity prices were at record high. And so was growth expectations, which emerging markets ultimately failed to deliver on. Conversely, if one looked at developed markets back then, they were relatively cheap as earnings growth actually did a lot better, not least propelled by the rise of big tech. However, if we look at the markets today, I think we could be at one of those inflection points. This is not to say that developed markets will be a disaster, but I think there are some credible arguments to why the leadership between developed markets and emerging markets might change.

The primary argument has to do with the reversal of the broad-based slump in commodities and the rise of big tech in developed markets that we have seen over the past decade. If we start with the commodities, I'm not a massive bull on commodities, but I think the green transition and the investments in renewables will initially require significant investments in physical infrastructure, which should lift commodities. It's also a fact that we at least in the short term are facing some bottlenecks in fossil fuel development, which should keep a floor under oil prices for some time. Again, this is not to say that I expect commodity prices to rise forever, but I do think the decade-long slump has reversed. And the second order effects should keep many EM better off than in the previous decade.

And if we then look at developed markets, the rise that we have seen in recent years has very much been driven by an increasingly concentrated group of companies. I'm not suggesting any of them will implode, but maybe the tailwinds will not be as strong as they used to be. Especially if we are also starting to see regulatory headwinds occurring.

And if we look at emerging markets more specifically, I think several countries which have been laggards over the last decade, could start to do better. Peru and Chile, for instance, should benefit from higher copper prices. And South Africa should also benefit from increased platinum exports. Domestic developments in large countries, such as India and China, should also see some tailwinds materialising. In India for instance, we haven't had a proper credit cycle for many years, but we starting to see early signs that this is happening. And in China - this is admittedly a more tactical outlook - but we have seen quite a bit of tightening for some time now, which should be reversed ahead of the political events next year.

So in short, I think there are both some global factors, but also local factors that should be supportive for emerging markets relative to developed markets in the coming years.

[3:24]

JY: Rasmus, your fund has outperformed since launch, so how have you been able to achieve that?

RN: The portfolio is long-term oriented, seeking to invest in businesses that have structural competitive advantages, attractive reinvestment potentials, and are steward by great management teams. As a team, we are primarily bottom-up and work with an absolute return mindset and long-term thinking when selecting stocks. We have a high preference for quality companies with sustainable and predictable growth, which we then combine with strong valuation disciplines. Historically, we have focused on growing our client's wealth by protecting capital in down markets and not chasing strong liquidity-driven rallies that we see in emerging markets from time to time. That's how we have done over the long term.

Having said that, from a more recent perspective, I think it's fair to say that we were quite wrong-footed in the early stages of the pandemic, which challenged how we usually behave in down markets. The unprecedented lockdowns had a huge impact on many of our holdings, given our focus on service companies in less developed countries. For instance, one of our holdings, the Mexican restaurant operator Alsea had never experienced same-store sales declines of more than 4% prior to the pandemic. But during the second quarter of 2020 they saw sales declining, 60% to

70%. And equally for some of our travel related companies like airports, the decline was even greater at 9 5%.

However, after the lockdown occurred, we took a step back and did a deep dive on all our holdings. We had calls with management teams and reevaluated their businesses. Fortunately, this gave us great confidence in the longer-term trajectory of our holdings. The majority of our holdings are market leaders. And what we realised was that if they were struggling, competitors would be even worse off. By talking to the management teams, it became increasingly clear that coming out of the crisis, many of our holdings would have even greater market share and face less competition. And not only that: because they were cutting costs, like there was no tomorrow, for instance, by renegotiating rental agreements, supply contracts, focusing on efficiency, operational leverage should also result in margin expansion that in many cases would outstrip their pre-pandemic highs.

So even though we had a challenging period in the early stages of the pandemic, we tried to take advantage of the situation and found some very attractive bargains, especially among Indian private sector banks and Latin American consumer companies, which eventually worked out okay for us.

[5:57]

JY: And you have quite a concentrated portfolio, I believe there's about 40 companies within it. So how do you filter down this huge universe of stocks to get to just 40 holdings?

RN: We specifically focus on strong management teams in quality franchises with defensive characteristics, such as high returns and recurring cash flows. Often they can be found among the dominant consumer financial service companies and the less developed part of the market. Not only are penetration rates low for many goods and services, which provide a favorable long-term secular demand backdrop, but also high level of informality in many of these countries, raises the entry barrier substantially, which often facilitates a benign competitive environment that allows many of the dominant companies with brand distribution or a scale advantage to generate high margins and high returns, and as a result strong free cashflow.

A key feature however of our investment process is to assess not only the franchise strength of our holdings, but also the people running and controlling them. While the company's financial performance is in many cases more dependent on the quality of the industry than the quality of the management, a weak or misaligned management team, or a dishonest controlling shareholder can destroy any investment case.

The primary trait that we look for in management teams is therefore stewardship and more specifically management integrity and alignment. We spend a lot of time assessing this through multiple meetings. Secondly, we look for great capital allocators, independently minded thinkers whose approach is long term, and we need to counter cyclical. And finally, this is admittedly more intangible, but we also look for the right culture. Management teams which can attract and retain employees and have a good track record of recruiting internally for senior positions are some of the traits that we look for.

[7:46]

JY: And the fund has a bias towards consumer and financial stocks at the moment, so why is this, what do you like about those areas in particular?

RN: The simple reason is that they have done very well over the years and we believe they will continue to do very well in the future. Emerging markets have some strong secular tailwinds, like demographics, urbanisation trends and productivity gains, that will continue to facilitate demand for many goods and services, including credit.

We start with the consumer companies. Through brands, distribution and innovation advantages, consumer companies often have the ability to protect margins across the business cycle as most of them command strong pricing power. On top of that, the business model of many of our holdings tends to be cash based. They typically receive cash up front, but pay the suppliers with a lag giving these companies a significant cashflow advantage, which amplifies their returns. And if we look at the capital intensity for most of our consumer holdings, this is also something which is quite limited. Many are generating large sums of cash, which are typically being redeployed to facilitate further growth, which also limit the need for diluted capital raises. It's basically the pricing power and the asset light nature of these companies that make them great investments over the long term.

If we then moved on to financials, this one may be slightly more counterintuitive, but the banks that we have invested in are not the usual emerging market banks with mediocre earnings and return profile, instead they're all high quality, plain vanilla banks characterised by strong deposit franchises, consumer-oriented loan books, which generally generate high returns across the cycle. Equally important, they're known for their risk-aware counter cyclical management teams, which helps to ensure a lower levels of stress during downturns compared to peers. What is probably surprising for most is that our banks in aggregate has compounded book value per share at 16% in US dollar terms for the past one and a half decades, despite the global financial crisis and other major adverse events.

And coming out of this crisis, the structural investment case has actually improved for many of our holdings, led by a few things such as better capsitalisation ratios and lower stress levels. These are important advantages because when we can compare the problems raising funds in a crisis, well-capitalised banks have access to adequate capital and thus are able to lend when others cannot. This allows the stronger banks to cherry pick customers, expand their net interest margins, reduce asset quality risk and, last but not least, grow their loan book faster, which all leads to higher profitability levels. We saw this happening during the global financial crisis, and we believe it will repeat again in coming years.

[10:26]

JY: Now you also have a big bias in favour of Indian companies and also I believe a bias to Latin America as well. What is it about those areas in particular you like?

RN: Yeah, the first point I would say is that positioning is really the residual of where we find the best long-term opportunities. But what I would say in terms of India is that it's a very deep market with many excellent management teams and quality companies. So the pool of great businesses in India is just a lot bigger than in most other markets, as Charlie Munger would say, fish where the fish are.

In addition, you also have some great structural tailwinds that we discussed earlier, like the demographics, urbanisation and productivity catch-up, which makes it a lot easier from a buy and hold perspective. And lastly, we haven't had a proper credit cycle in India for close to a decade. Instead, most companies have been deleveraging following the boom in the 2000s, but we are now starting to see early signs of this turning. The first impact of a new credit cycle will be on the banks. But the second order impact will be much broader than that. A new credit cycle will drive activity, employment and wealth, which will intimidate the benefit demand for many goods and services. And while the valuation may currently be a bit on the high side, especially amongst small and mid-cap companies, it still looks very reasonable within private sector financials, industrial companies, and some of the more cyclical companies like Maruti Suzuki which we are currently invested in.

And with respect to Latin America, our exposure here is mainly within Mexico, where we have 10% of the portfolio invested. From a country perspective, Mexico should be a significant beneficiary of the current recovery we are seeing in the US, but our positioning here is driven more by company specific factors, such as our holding in Alsea which represent close to 50% of our Mexican exposure. And we discussed that earlier.

[12:17]

JY: And what about China? It's obviously a huge part of emerging markets, it has had a very difficult year so far. Is this an opportunity or a risk going forward?

RN: I think it's both. It's clearly not without risks as recent quarters have demonstrated, but I still believe you have many attractive investments in the country. Similar to India, China is a very deep market with lots of companies across various sectors. And on top of that, you have some of the most driven, hardworking entrepreneurs in this planet. But regulation and clumsy communication from the authorities will continue to be an issue. Admittedly, I do not have any particular insights of this, but I do not believe the authorities are anti-business or anti-private sector, as some have suggested. Most of the recent policies which have been introduced have actually been very sensible in my opinion and more company specific than outright anti-business.

If we look at the educational stocks, for instance, while the extension of the crackdown was a bit surprising, I don't think the crackdown itself was a surprise. At the end of the day, more than 90% of the tutoring customers are disappointed because they do not get accepted to the schools or universities that they have applied to. Instead of helping growing the pie in China, some would argue that the educational companies was exploiting and capsulizsng on the inherent bottlenecks in the system, which is a proposition I would personally have my reservations about. Similar, if we look at Meituan, the delivery company, I also think there is a good case to be made here that they have had some issues with their delivery staff by not paying them properly and not paying them insurance, et cetera. And in all of these cases, I actually think that the authorities have a fairly good case for stepping in and while it was maybe done in a clumsy way, I would still agree with the end result. And that's also why I wouldn't be too concerned about Chinese companies, for all the talk about over-building, a negative demographics, you still have a growing middle-class with large savings that they're looking to spend. Companies which are well positioned to take advantage of what the Chinese consumer will buy more often in the next 5 to 10 years should continue to do very well.

[14:26]

JY: And finally, what's the best performing stock in your portfolio this year and why?

RN: One of the best performers this year has been United Breweries in India. United Breweries is the Indian Heineken subsidiary and is India's leading brewery. It has a 55% volume market share - roughly twice that of its next largest competitor AB InBev. It has iconic brands in the portfolio such as Kingfisher, but also many strong regional brands. In addition, it has also started to launch Heineken and other international brands at the premium end making the portfolio very future-proof.

India is an attractive market for a couple of reasons. First of all, the market is highly concentrated with 80% of the market controlled by United Breweries and AB InBev, ensuring reasonable and rational competition. Secondly, if we look at the entry barriers, regulation for newcomers is a significant hurdle and you need specific approval to operate in each State. These are very hard to get suggesting that new competition isn't likely to emerge anytime soon. Thirdly, there is a long runway for growth, per capita consumption is very low at four litres per capita. This is low compared to most other countries such as China where consumption per capita stands at 33 litres, Brazil is more than 60 litres and most developed markets where it's even higher than that. Part of that is an affordability issue though. The consuming population in India is only about 300 million versus its total population of 1.3 billion people. However, this is a number that's estimated to at least double over the next decade, driven by increasing incomes, improving affordability, as well as the fact that another 200 million people will reach the legal drinking age over the next decade.

The fourth element is really on prime… premiumisation. The premium end of the market is today only 8%, which is roughly half of the premium portion in China and the 20%-30% that we're seeing in more developed markets. As the market grows, the premium end should expand, which is high-end margin. So not only should they benefit from strong volume growth, but also price increases due to premium growth, which should boost margins.

If we look at the performance of the past couple of years, United Breweries have had a tough 2020 because of lockdown and this year it has done well as the market has come back up. Maybe it has overshot a bit in the near term. If you look at something like PE or even current year free cashflow, but if you look three to four years out, the investment case still looks very attractive because of all the tailwinds I explained earlier, this is also why it remains a continued holding of ours, despite the reasons brought up.

JY: Rasmus, thank you very much for those insights, that's been absolutely fascinating.

RN: Thank you very much for having me on today.

JY: And if you'd like to learn more about the FSSA Global Emerging Markets Focus fund, please visit fundcalibre.com and please also remember to subscribe to the Investing on the go podcast.