FSSA Investment Managers

October 2023

Quarterly Manager Views

FSSA Global Emerging Markets Equities Focus

Balance and behavioural biases

Our investment process is designed to identify long-term buy and hold opportunities and to reduce risk. We seek value, but are wary of value traps. We seek growth, but not at any valuation. We seek great management teams, but they also need to be running decent businesses. We think about how big the business can be in 10 years, but we worry about what could cause it to deteriorate this year. We like to think counter-cyclically, but not just for the sake of it... Ultimately, we seek to invest in businesses that have great management teams, structural competitive advantages and attractive growth runways... it's all about balance.

One question that we frequently get relates to a common behavioural bias for quality investors: how do we balance admiration for a company without becoming too complacent? As investors focused on quality, one can easily "fall in love" with an investment and be too forgiving in certain situations, potentially missing important warning signs or sell signals. It can be even worse if you fall in love with the people behind a business. Over the years, we have certainly made our fair share of mistakes from these biases and as a result we have attempted to institutionalise ways to mitigate these risks.

Firstly, we strive to guard against behavioural biases by encouraging a team culture of openness, continual learning, and respectful debate. There is no "house view" that every team member must agree on. We encourage diversity of thought and different perspectives, which allow us to reflect on our investment decisions. We also make it a point to discuss mistakes and ruminate on the lessons learned — we hold specific meetings for this exercise every year, where each of us shares our latest mistakes. We believe that reminding ourselves of past mistakes and learning from the experience of others helps us become better investors as it builds and compounds wisdom amongst the team. For instance, in previous letters we discussed how our investment in the Argentine bank, Banco Galicia, ended up being a costly error. This prompted us to reflect on the macroeconomic risks when we look at companies and how they might swamp even the best investment case.

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Secondly, our generalist model entails that different team members will write meeting notes and conduct research on the same company, with no individual becoming "the authority" on a holding. While expertise is great, we also believe that one of the drawbacks from too much specialisation can be stale views and limited ability to "think outside the box". Robust discussions and debates on each company is paramount to our process — one way to ensure this happens is to let the research rotate and have different team members "attacking" the investment case from multiple angles. Over the last five years for instance, nine team members have met HDFC Bank and have written research on the company. It is this variety of research on the management team and the investment case that has helped us gain conviction over the years, explaining why HDFC Bank is one of the largest holdings in the strategy.

Thirdly, we try to practice second-derivative thinking as much as possible — but not for the sake of being deliberately contrarian. To us, this means inverting what is known and always asking what could go wrong. We ask ourselves: if a business imploded over the next 10 years, what might have been the main reasons? What would it take to start a business today, offering the same product or service? Can the current position be rivalled by a competitor or start-up with deep pockets? Why will the business not meet the same destiny as Nokia or eBay? These are all questions that require us to take a step back and challenge our fundamental views and understanding. A particularly useful exercise is the "pre-mortem review" where each team member reviews an existing holding, resulting in many thought-provoking views and healthy debates.

Finally, we have adopted various checks and balances in our investment process, and try to play "devil's advocate" on our holdings. We also carry out fund reviews that focus specifically on the risks to portfolio holdings and areas for improvement, and are carried out by team members other than the lead portfolio manager. We don't always get it right, but these kinds of discussions prompt us to revisit our core holdings and review our assumptions on a regular basis.

Werner Heisenberg, a founder of quantum theory, described an expert as "someone who knows the worst mistakes that can be made in their subject, and how to avoid them."[1] In the field of investing, we think the best way to accumulate expertise is by reflecting on the natural biases and tendencies we all have and putting effort into counteracting them. Our review exercises, open discussions, rigorous debates and the emphasis on nurturing different perspectives are critical in trying to avoid the worst mistakes.

Because of these conscious efforts, we will never be the most nimble of teams when it comes to changing our views, but that is partly by design. We could be more dynamic, but that would likely make us more at risk of over-activity and over-diversification — other major biases in the investments industry that often don't result in great outcomes. Instead, our approach, which is to buy and hold businesses for the long term, requires us to make sure we have invested in the right companies in the first place (by conducting in-depth due-diligence), and then giving ourselves the best chance of benefitting from the effects of compounding (by being patient). Once again, like most things in life, it all comes back to balance.

A brief comment on China

Eight months into the year, it is clear that the recovery in China has been weak. After Covid restrictions were lifted, expectations were high for robust consumption growth in 2023. The first quarter looked promising, but growth slowed from the second quarter onwards. Recent data have consistently fallen below expectations and over the summer Country Garden (one of the largest private property developers in the country) was "allowed" to default. These combined events have raised investor concerns, sparking a new wave of sell-offs since early August.

While we don't hold strong views on the near-term macroeconomic outlook, we are not overly concerned about the property sector, or on its implications for our holdings. To begin with, we do not have any investments in Chinese financials or the property sector. The liquidity issues we have seen in Country Garden, Evergrande and others seem more related to tight financing conditions for private property developers rather than being a systemic issue. The weakness has primarily resulted in declining sales for private developers (with state-owned enterprises gaining market share), rather than causing steep price drops across the board. This is not to say that there are no problems at all, but if one compares the current value of the Chinese real estate market (at about 240% of GDP) to Australia today or Japan in the 1980s (at 300% and 560% respectively),[2] the current value of the Chinese property market seems manageable especially when also considering the closed capital account.

[1] *Der Teil und das Ganze* (1969) ch. 17 (translated by A. J. Pomerans as *Physics and Beyond*, 1971).
[2] Source: Morgan Stanley Research.

However, the main issue we are focused on is the surprisingly sluggish consumer spending. Last quarter, despite "benefitting" from a low base effect, seasonally-adjusted retail sales growth stayed below 0.4% per month. This trend suggests that China's nominal retail sales may only grow by around 3-4% for the year, a significant decline from pre-Covid growth rates. Notably, consumers seem to be opting for more affordable goods and services, leading to lower per capita consumption and lacklustre sales of high-value items. For example, during the Labour Day holiday, the total number of tourists increased to 119% of pre-Covid levels (in 2019), but tourism expenditure per capita reached just 90% of 2019's level, indicating a strong trend of down-trading. Additionally, consumers are still reducing their debt and preferring to save. Since 2020, Chinese consumers have been deleveraging; and this trend has not reversed in 2023 despite the easing of Covid restrictions. In fact, the net increase in household deposits reached 20% of GDP in the first half of 2023, significantly higher than pre-pandemic levels, when it had rarely exceeded 5%. To us, this suggests that household balance sheets are not a limiting factor, but rather, confidence is. Recent government initiatives, such as supporting the private sector and maintaining a productive dialogue with the US, are positive steps towards boosting domestic confidence. However, it is clear that we need to be more patient than we initially anticipated.

Changes to the portfolio

Since our last update, we have added one new holding to the portfolio. We took advantage of weak market sentiment towards Chinese consumer companies to initiate a position in Chongqing Brewery. Following its merger with Carlsberg China in 2020, Chongqing Brewery became Carlsberg's sole subsidiary in China and its key profit contributor. Today, Chongqing Brewery is the fourth-largest beer company in China by revenue. It owns a diverse portfolio of both international and domestic beer brands, catering to a wide range of price points from economy to super-premium. The company's international brand portfolio includes renowned names such as Carlsberg, 1664, Tuborg, and Somersby, while its domestic brand portfolio comprises Wusu, Chongqing, Dali and Feng Hua Xue Yue, among others.

Despite Chinese beer consumption per capita reaching its peak in the early 2010s, leading market players have continued to achieve steady revenue growth through industry consolidation and premiumisation of their product portfolios. With less than 10% market share, Chongqing Brewery is still a small fish in the world's largest beer market. In executing its "Big City Plan", the company has successfully extended its regional coverage and gained market share in the past. By leveraging effective social marketing strategies, Chongqing Brewery transformed Wusu from a local beer brand, consumed solely in the Xinjiang region, into a nationally-recognised beer brand within a few short years. For the coming years, we believe that Chongqing Brewery can continue to grow its market share and drive superior volume growth.

The average price for beer in China, currently at around RMB 3 per litre, lags significantly behind average beer prices seen in the US (RMB 8 per litre) and Japan (RMB 10 per litre). Average selling prices (ASP) across China's beer industry have been increasing by low-to-mid single-digits per annum in the past few years. As Chinese consumers grow more sophisticated and their consumption power increases, we believe that premiumisation will continue to drive ASP and profit growth among leading Chinese beer companies – and for Chongqing Brewery in particular, which has one of the most premium beer portfolios among peers.

Lastly, we have been impressed by Carlsberg's governance as well as local management's strong execution and prudent capital allocation track record. We are also pleased to see that Chongqing Brewery places strong emphasis on sustainability, particularly in terms of water efficiency, and has set ambitious goals for achieving net-zero emissions. Overall, we think that Chongqing Brewery is a company that we are happy to hold for the long run.

Outlook

We continue to invest in businesses that we believe have proven management teams and competitive advantages that allow them to capitalise on the long-term secular trends that exist across emerging markets. Whether it is the formalisation of the Indian economy, the continued financialisation of the South African population or the growing adoption of enterprise resource planning (ERP) software by small-to-medium-sized Brazilian companies, we believe the investment opportunities are plenty. Yet, these kinds of businesses are often not well represented in broader indices and thus we believe a bottom-up active investment approach has much value to add.

While China is currently going through a challenging period, we are confident in our holdings' ability to navigate the situation, as they have done in the past. Competitive advantages in the form of strong brands, distribution advantages, cost leadership or simply providing a service/product that customers cannot live without, are the main traits that characterise our companies. We believe the current correction in share prices presents an excellent opportunity for long-term investors like us to accumulate leading franchises at attractive prices.

As 2023 progresses, we believe our holdings continue to offer long-term attractive compounding opportunities and our analysis suggests that they can grow earnings at around 20% CAGR on a weighted average basis over the medium term. For this kind of growth, the portfolio's aggregate valuations, at around 5% free cash flow yield or a 22x price-to-earnings ratio (PER) seem reasonable (and sustainable) to us. This makes us optimistic from both an absolute and a relative perspective.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. China macroeconomic data from JP Morgan and National Bureau of Statistics of China. As at 30 September 2023 or otherwise noted.

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