Fidelity Emerging Markets

FEML's truly active approach and go-anywhere mandate differentiate it from peers in the sector…

Update
27 December 2023

Overview

Fidelity Emerging Markets Limited (FEML) benefits from the experience of portfolio managers Nick Price and Chris Tennant, who have been investing in emerging markets for most of their respective careers. Through the FEML portfolio they take a go-anywhere approach within the emerging markets space, looking for on- and off-benchmark stocks across each sector, market cap and geography, including frontier markets - these are all fair game. They can also use derivatives to go long or short.

Nick and Chris point out that emerging-market businesses are currently sitting at attractive valuations versus history, as well as relative to their developed market counterparts. At present the managers argue there are opportunities across emerging markets, including Mexico, which is set to benefit from nearshoring, and in China, where many high-quality stocks have disproportionately derated (see **Portfolio section**). In 2023 the managers have been building higher conviction positions, given the valuations and the opportunity set they see, remaining disciplined in their process while doing so. They continue to identify, in their view, best-in-class emerging-market businesses, as well as make use of a broad set of tools, such as the ability to take out short positions, to help generate multiple sources of returns.

At the time of writing, FEML trades at a discount of 11.7% and the board has unveiled a package of measures aimed at narrowing it (see **Discount**).

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Analyst's View

We think FEML is a good way to access emerging markets and is well suited to provide diversification to a broader portfolio focused on developed markets. Its flexibility to take out both short and long positions is unmatched in the AIC Emerging Markets sector, making FEML a highly differentiated proposition versus others. The experienced managers who are well versed in the complexities of emerging markets, along with a team of emerging market analysts, gives it an edge when it comes to stock selection, in our opinion (see **Management section**). Given FEML's **Discount**, we think it may be at an attractive entry point for long-term investors who want exposure to emerging markets. The board is active in its efforts to narrow the discount, which, if coupled with good performance, could generate powerful returns for investors.

The managers think that emerging markets are currently full of opportunities, propelled by long-term structural drivers and historically low valuations. They see opportunities in multiple regions, including in Latin America, given the proactivity of many governments when raising interest rates to combat inflation, and also the potential benefits of 'nearshoring' for economies like Mexico. Smaller, less well-covered regions are also throwing up opportunities in the small- and mid-cap space, including in Vietnam and emerging eastern Europe.

BULL
Deep resources and an on-the-ground research team is an advantage with stock selection
An attractive discount versus history and peers, with the board active in seeking to narrow it
Extensive resources on the long and short side, including highly experienced managers

BEAR
Poor economic news could lead to weaker appetite for emerging market equities and could weigh on the discount in the near term
Political risks remain high in many key emerging markets, such as China
A highly active approach can lead to underperformance when positions don't work

Portfolio

Nick Price and Chris Tennant are the managers of Fidelity Emerging Markets Limited (FEML) and aim to deliver long term growth to shareholders by investing in companies across emerging markets. The managers think that many emerging market businesses hold the potential to sustain high levels of economic growth for years to come, which, when coupled with current attractive valuations, means both retail and professional investors alike should consider having at least some exposure to the asset class. With rates starting to come down in some parts of the emerging market universe – such as Brazil – the backdrop is increasingly positive. As a result, they have been buying a number of stocks that they think offer up attractive quality characteristics at record cheap valuations.

The challenge for investors, particularly in an area like emerging markets, is identifying the right companies, trying to understand how each company ticks and combing through the market noise and information that's thrown their way. After all, having to look through 24 emerging markets, which contain almost 1500 companies collectively, is an overwhelming prospect. FEML, in our opinion, is a good way to access these markets and would add a layer of diversification to an investor's portfolio. As Nick and Chris have spent most of their careers investing in emerging markets, they are intimately familiar with how the companies in the investment universe operate and with the management teams that run them. They can also utilise the experience of an effective team of emerging markets analysts, around 50, for help with idea generation and further analysis. The team are embedded around the world, working to a consistent approach, and have built a strong local presence, which, we think, brings regular access to company management teams, as well as a greater understanding of the companies in their investment universe. Over time the managers have cultivated a process whereby they can utilise a broad range of tools in order to generate alpha, something we think is unrivalled in FEML's peer group, meaning they are well equipped for the job at hand. They employ a strategy that genuinely embodies the notion of 'active management'.

Let's start with the heart of the proposition, the long book. Nick and Chris aim to invest in high-quality businesses that can generate superior and more sustainable returns over time. To consider something high quality, the managers need to see consistency of returns, and businesses that are well capitalised and capable of achieving superior returns, and also have healthy finances, including strong free cash flow generation which can be used to fund future growth or returns in the form of dividends or share buybacks. Furthermore, they want to target businesses that are dominant in their respective industries, whereby they can maintain superior levels of growth, as well as a sustainable competitive advantage. To help illustrate what we mean by this in practice, we've included some of the key characteristics for the long book below (the numbers are 2024 estimates by Fidelity analysts, and the benchmark numbers consensus).

Long Book Characteristics, 2024 Estimates

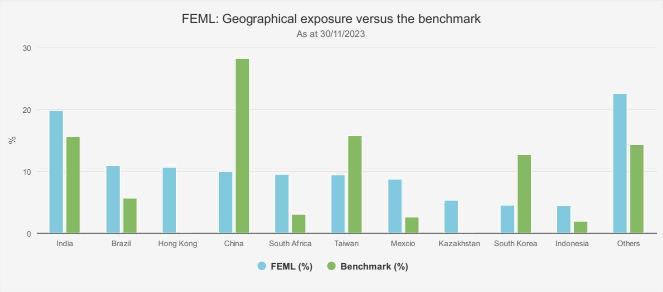
FIDELITY EMERGING MARKETS LIMITED GROWTH	PORTFOLIO	BENCHMARK
Sales Growth (%)	14.8	7.7
Net income growth (%)	23.8	17.6
VALUATION		
P/E Underlying (x)	11.4	12.8
EV / EBITDA (x)	6.4	7.6
MARGIN & RETURNS		
EBITDA Margin (%)	22.3	16.9
ROE (%)	18.2	13.1

Source: Fidelity International as at 20/12/2023. Aggregate data for the portfolio is based on Fidelity analyst estimates and for the benchmark is based on IBES estimates. Data refers to the long book only.

It's clear that the growth and margin numbers are markedly superior to the benchmark, while the portfolio also trades on a modest discount to the index on a P/E basis. The latter point highlights how valuations are crucial to the process. Given the inflationary and higher-rate environment, the managers have cautiously and deliberately looked to introduce a measure of value to the portfolio - while remaining laser focused on ensuring these companies still fit the quality criteria that they look for. Key examples would be high-quality names within the financials sector, where the exposure is to a diverse set of companies including HDFC Bank in India, Greece's National Bank of Greece and TBC Bank based in Georgia. The managers are overweight financials versus the benchmark at present, but are mindful of interest rates, so have looked to limit exposure to banks reliant on higher interest rates, instead targeting those likely to benefit from structural drivers. In the first half of 2023 they initiated a position in Gentera, Mexican microfinance lender to female entrepreneur clubs, which is steadily penetrating an uncontested market and should help improve its long-term growth potential. BTG Pactual, Brazil's largest local investment bank, was also added, which is a bank shifting from more volatile business segments to those with more stable revenues. Core holding Kaspi, the ecommerce and payments platform based in Kazakhstan, remains in the portfolio, although it was trimmed to manage position size following a good run of performance.

Naturally any changes to the portfolio will impact both the geographical and sector positioning, but this positioning is a residual of bottom-up stock picking rather than the managers targeting specific allocations. That said, we've included a chart below that highlights the portfolio's net country exposure (the long exposure minus the short exposure) relative to the MSCI Emerging Markets Index. Given the managers have a go-anywhere mandate, it helps showcase exposures to less-common parts of the market, including some frontier markets like Kazakhstan.

Fig.1: Geographical Exposure



Source: Fidelity Emerging Markets

Immediately a few things stick out. Firstly, the managers are overweight to India, mainly through businesses in the financials sector, like Axis Bank and HDFC Bank. They believe it is a strong market with a promising long-term structural-growth story, with a couple of positive shorter-term trends added to the mix more recently, such as increased government spending in advance of the election in 2024. While the valuations in India are more elevated than other regions, the managers remain focused on targeting the cheaper part of the market, which includes a number of stocks in the financials sector.

The managers are underweight China, although less so than it initially appears, as the exposure to China must be considered along with the Hong Kong exposure and the investment in Naspers, a South African internet and multimedia holding company, which has a large stake in Tencent and is held as a cheaper proxy for that company. Given the continued macroeconomic weakness in China, the managers are happy with the underweight exposure, but do also see significant value in the market. While China has not seen the recovery this year that many expected, the managers do believe that there are many high-quality companies that are returning cash to shareholders, which has prompted them to add several new names this year. Current holdings include an interesting pair trade in China's property market, something we discuss later.

Latin America is another area of interest for the team, buoyed by the fact that central banks have been much more decisive in raising interest rates, which has brought inflation under control and allowed some central banks - namely Brazil's - to start cutting rates. The team are also keen on Mexico, which they have been adding to over the past year, and believe that the economy is set to benefit from the trend of nearshoring, as companies in the US look to bring their manufacturing closer to home. Railroad company Grupo Mexico Transportes and GCC, a cement company, were added to the portfolio in 2023, as Nick and Chris anticipate a potential increase in demand for these businesses.

Clearly there are plenty of opportunities for the long book to exploit, in keeping with the managers' go-anywhere mandate and highly active approach. But something that really differentiates FEML from peers is its ability to make use of the short book. The short book includes companies which the managers believe have significant downside, often thanks to weak balance sheets, structural weaknesses in their business models or industries, or poor management teams – the mirror image of the long positions. While active short positions cannot be disclosed, we recently spoke to the team, who noted that a good example of a now-closed short position is Lojas Americanas, the Brazilian retail chain. The managers had been very bearish on the stock for some time, viewing it as struggling to keep up with rivals such as MercadoLibre. In January 2023 the company announced it had detected "accounting inconsistencies", and shortly went bankrupt, delivering value to the portfolio. This is an extreme example, as not all shorts go to zero, but it does show how the short book can add significant value.

Another tool used is pair trades. The managers can take a long position in a company that has all the qualities we've mentioned above and a short position in a company that they view as a weak rival. One interesting pair trade is in the China property space. The managers have a much more favourable view of state-owned developers (SOEs), which have been steadily gaining share at the expense of private-owned developers, many of which are indebted and are at risk of bankruptcy. Given this view, the managers have a long position in the SOE China Resources Land and have paired it with several short positions in the private space that have elevated levels of debt. In our view, the ability to short companies offers a good source of alpha in the current environment, as those that benefited from near-zero interest rates for many years will struggle as the cost of debt increases.

Overall, we think that FEML provides broad and well-diversified exposure to emerging markets. Its flexibility to use both a long and a short book is unmatched in the AIC Emerging Markets sector and the number of additional levers it can pull to generate performance makes the investment company a highly differentiated proposition with high return potential. Given its wider-than-average discount, and the track record the managers have built on the open-ended side (see **Performance section**), we think it could be at an attractive entry point for long-term investors who want exposure to emerging markets.

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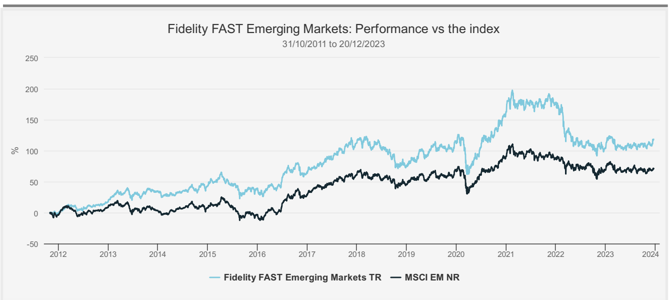
Gearing

FEML can borrow up to 10% of NAV but there is no facility currently arranged. However, effective gearing is taken through derivatives. Nick and Chris have flexibility in how they express their views on a company or a market. The gross market exposure can be up to 165% of NAV and the net market exposure up to 120% of NAV, and in normal market circumstances net market exposure would be expected to be between 100-110%. In our view, Nick and Chris have a good range of levers to pull, which is one of the key differentiating features of the investment company. We think that the number of different tools available to the managers and the flexibility they have regarding the use of gearing brings with it varying potential sources of returns and increases the potential for outperformance when multiple positions are working. However, gearing can increase risk when markets work against positions. At the end of November, the net market exposure was 98%.

Performance

FEML has only been managed under the current strategy for a little over two years. However, the portfolio mirrors that of Fidelity's open-ended FAST Emerging Markets fund, which has a longer track record that is useful and relevant to analyse. Nick Price has managed the fund since it launched in October 2011, and has delivered strong outperformance of the index. To 20/12/2023 the fund has delivered a total return of 118.5%, according to Morningstar data, which is comfortably ahead of the MSCI Emerging Market Index's return of 71.3%.

Fig.2: Performance Of Open-Ended Fund Since Launch



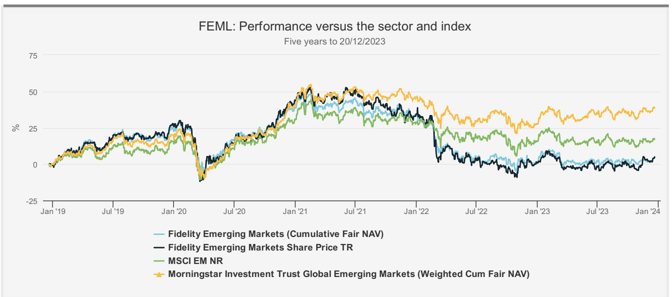
Source: Morningstar
Past performance is not a reliable indicator of future results.

Clearly long-term performance has been strong. There have been shorter-term bouts of underperformance, most recently in 2022, due to the impact of the Russian invasion of Ukraine, which had both first- and second-order effects on the portfolio (see our previous note for more detail). Towards the latter part of 2022, FEML's performance profile began to improve and relative performance year to date (to end November 2023) has been positive, with a number of different stocks contributing to performance. Kazakhstan's Kaspi holds the mantle for the top performer as of the end of November, and was trimmed following its strong run of performance. Perhaps unsurprisingly, TSMC and SK Hynix, a Taiwanese semiconductor manufacturer and South Korean memory-chip maker, performed well after indications the semiconductor downcycle was reaching a bottom, and also given the hype around artificial intelligence and indications this could boost demand for performance chips and other semiconductor components. A number of other investments in the portfolio performed well this year, including Nu Holdings, a digital challenger bank in Brazil that has continued to execute well and gain market share from incumbents.

Less positive was the performance of a number of Chinese holdings, including sportswear brand Li-Ning and auto dealer Zhongsheng, which have suffered from weak sentiment towards the China market. Disappointment following the economic reopening and property sector concerns have both contributed to weak sentiment and the decline has largely been due to multiple derating. The derating has been particularly significant in H shares, which have suffered from foreign investors exiting the region. In the managers' eyes, in an environment where growth is likely to be weaker than it has been historically, evidence that companies are returning capital to shareholders becomes even more vital. Positively, the managers note that they are seeing an increasingly shareholder-friendly attitude among companies in China. Many businesses that are currently trading on very cheap valuations have started to return capital to investors and are buying back shares.

Since Fidelity took over FEML in October 2021, the NAV total return has been -22.9% % compared to a return of -9.4% for the index. For the sake of completeness, we've also looked at FEML's NAV total return over five years in the chart below, although for the most part, it reflects the performance of the previous strategy.

Fig.3: Five-Year Performance



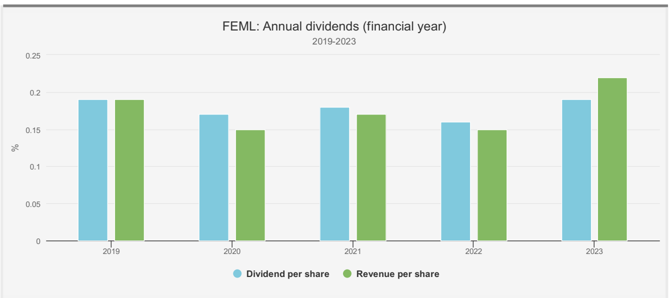
Source: Morningstar
Past performance is not a reliable indicator of future results.

Dividend

Nick and Chris aim to maximise capital growth over time using the investment process they've cultivated over the years, including the extensive toolkit available to them (see **Portfolio section**). Given this growth objective, the managers do not seek to deliver a particular level of income to shareholders, but given the nature of the process, and what the managers look for in each investment, they will have exposure to companies that generate some form of income. This means any dividend paid to shareholders is merely a by-product of the process. The stated dividend policy is to pay out substantially all of the net income received after expenses in a single dividend each year, which also means the dividend may vary, depending on the fortunes of the portfolio's underlying companies.

Over FEML's latest financial year, ending June 2023, the board declared a final dividend of 19 cents per share, due to be paid in December, matching the peak dividend FEML achieved in 2019. This represents a dividend yield of around 2.6%, which compares to 3.0% for the MSCI Emerging Markets Index, at the time of writing. Over the period, the revenue earnings have also increased, something we highlight in the chart below, though we do note the dividends are calculated in dollars, the company's functional currency in which its accounts are presented, but are paid to shareholders in sterling. FEML has substantial revenue reserves worth roughly 3.2x the last annual dividend, and the board can also distribute capital reserves by way of a dividend, if it wishes.

Fig.4: EPS & DPS



Source: Morningstar

Management

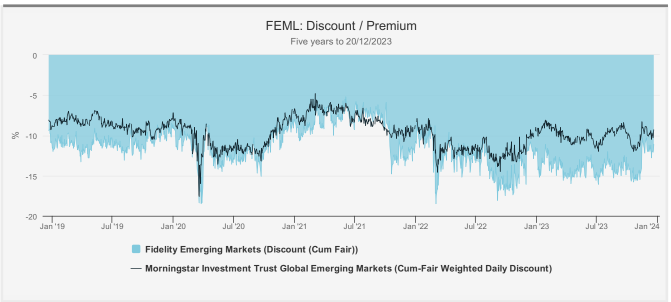
Nick Price is FEML's lead portfolio manager and boasts over two decades of investment experience. He led the development of Fidelity's Emerging EMEA group, launching the team's first portfolio in 2005. The investment process that was cultivated there has been used consistently by the team ever since, essentially forming the cornerstone of Fidelity's emerging market equity strategies. He has also employed the same strategy for the long/short Fidelity FAST Emerging Markets fund since 2011. Alongside Nick, both FEML and Fidelity's FAST Emerging Markets fund benefits from the expertise of Chris Tennant. He has been with Fidelity for over a decade, working closely with Nick from the outset, and has spent time as a metals and mining analyst as well as a shorting analyst. He was appointed assistant portfolio manager on the Fidelity FAST Emerging Markets fund in July 2019 and was then promoted to co-manager on this fund, as well as the investment company, in 2021.

One of the key strengths of FEML as a proposition is the experience of the managers and another is the significant resource available at Fidelity. Nick and Chris can draw on an extensive team of around 50 analysts, who are devoted to analysing emerging markets. There is a team in London, as well as analysts embedded on the ground across emerging markets. Having a local presence brings regular access to company managements, as well as a close connection with domestic markets and a greater understanding of the companies in their investment universe. After the restrictions imposed by COVID-19 lockdowns have been lifted, the team were able to resume their overseas trips in 2022, and this year visited Brazil, Mexico, and Saudi Arabia, among other places. On the ground research plays a vital role in the due diligence process and allows the team to assess all manner of opportunities and risks within in each company they visit.

Discount

FEML's discount is 11.7% at the time of writing. The discount has come in since the commencement of a share buy-back programme on 13/11/2023. This coincided with a rally in global markets following dovish noises from the Federal Reserve. As FEML has seen its shares rise further than the market it is possible the buyback decision has had an effect too. Although at the time of writing only a small number of shares relative to total issued share capital have been repurchased, the new policy is a signal the board is intent on narrowing the discount over time. Additionally, on 27/11/2023, the board announced it would undertake a tender offer for up to 15% of the issued share capital in Q1 2024 (subject to shareholder approval). The tender offer will see shareholders able to elect to receive NAV less costs of c. 2% on up to 15% of their investment. This is a hefty package of measures, which we think should support the rating in the near term, and signals that the board is committed to seeing the discount narrow on a sustainable basis. We think the double-digit discount is attractive as an entry point into an out-of-favour region even absent these measures.

Fig.5: Discount



Source: Morningstar

There is also a performance-conditional tender offer which will see up to 25% of the shares repurchased if the NAV does not outperform the benchmark between 1/10/2021 and 30/09/2026 and could see the discount narrow as the date approaches. Furthermore, it will offer shareholders the opportunity to sell some of their shares close to NAV, if the condition is not met. There is also a continuation vote to be held in 2026 and every five years thereafter.

Charges

When Fidelity was awarded the management contract in October 2021 they applied a temporary waiver of management fees, but estimated the OCF would be c. 0.8% on an ongoing basis, after the waiver was lifted. FEML's latest ongoing charges figure (OCF) is now 0.81% and remains one of the lowest in the AIC Global Emerging Markets sector, according to JPMorgan Cazenove. The management fee is 0.6% and is allocated 20% to revenue and 80% to capital. There is also no performance fee payable.

FEML's latest KID RIY of 6.2% must come with a health warning. It reflected the extraordinary costs following the change of manager and the turnover of the old portfolio. However, this does not reflect the ongoing costs to investors. Fidelity publishes their KID documents at the turn of each year, so we'd expect to see that figure fall when the new KID is updated in 2024.

ESG

At a firm level, Fidelity has a strong approach to integrating environmental, social and governance factors into the investment process. Across the business, ESG integration is carried out at the fundamental research analyst level within its investment teams, primarily through the implementation of the proprietary Fidelity sustainability rating, which considers not only the current practices of a company, but also its trajectory. Assessments consider the sector, country and company specifics of the stock in question, with it being scored on social, environmental and governance factors. Engagement with companies is another crucial part of the process, as is the implementation of quarterly sustainability reviews where the portfolio managers, along with the Sustainable Investing Team and relevant Head of Equities, will discuss ESG factors relating to the portfolio. Fidelity has a dedicated Sustainable Investing Team, which works closely with the investment teams, and which is responsible for consolidating Fidelity's approach to stewardship, engagement, ESG integration and the exercise of its votes at general meetings.

The open-ended version, FAST Emerging Markets, is an Article 8 fund under SFDR and FEML is a mirror of this strategy. Nick and Chris believe in the importance of ESG within an investment process, so have ensured its analysis is well embedded into FEML's strategy. Nick and Chris are not restricted from investing in poorer performers, but they do have to justify the ESG ratings and carbon footprint of their portfolios in the quarterly reviews mentioned above.

Morningstar marks FEML three out of five globes on its sustainability scoring system, which is scored across open- and closed-ended funds in the emerging markets space. In our view, FEML's integration of ESG is likely to satisfy investors who want ESG risks to be incorporated within the investment decision, but it may not meet the criteria for investors looking for more stringent ESG alignment, including specific restriction or exclusion policies.

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