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Top performing PM: It's time to get real on EM

LONG READ: Lewis Kaufman, manager of the Artisan Developing World fund, explains why his fund has returned 71% over the past year in spite of a bleak outlook for emerging markets.

By **DANIELLE LEVY** / 14 DECEMBER, 2020

While 2021 should see some form of economic normalisation return to certain parts of the world, one leading fund manager doesn't believe this will necessarily spell a great year ahead for emerging markets.

Lewis Kaufman, manager of the top-performing Artisan Developing World fund, named several constraints which have been exacerbated by the pandemic.

Kaufman said the classic emerging market story has typically focused on the 'demographic dividend', combined with foreign capital formation, which results in strong productivity and an attractive output.

However, this hasn't been the case for the past few years. This is because a number of emerging markets have found themselves stuck in a 'middle income trap', having squandered gains from the commodities boom.

What's more, Kaufman said, investment in education has been lacking, which means there hasn't been a significant expansion of the skilled labour pool in some countries.

'Combined, you don't have skilled labour capability, you don't have foreign capital formation, so investment slows. When this happens, job creation slows, real income growth slows, consumption growth slows and ultimately potential output slows, which is what you are seeing across the emerging markets. A lot of those places have slowed to a crawl,' Kaufman told Citywire Selector.

'I am willing to think differently about the problem. I am willing to not invest there at all and to be creative about ways to tap into growth in emerging markets,' he added.

As developed markets have taken on a significant amount of debt to tackle the Covid-19 pandemic, Kaufman said investing in emerging markets will become less of a priority for them. This will slow down the impetus for reform which is needed to unlock the potential of emerging markets, not least the low penetration of domestic demand.

While China has done a good job of containing the Covid-19 outbreak, with an impressive economic rebound so far, Kaufman said this hasn't been the case for most emerging markets. This has left them with the unenviable choice of additional lockdowns. However, unlike the US and parts of Europe, EMs don't have the luxury of a 'fiscal bridge'.

'Political differentials [between emerging and developed markets] are the most unfavourable they have been for some time,' he said, adding the impetus for reform in emerging markets looks lacklustre.

Tapping into profit pools

That doesn't mean there aren't opportunities to make money in emerging markets. Kaufman (pictured) has done this by developing an approach that, in his opinion, transcends emerging markets' constraints. Put simply, he focuses on companies which are able to create and sustain business value.

The approach has paid off so far: the Artisan Developing World fund is up 71.1% over the 12 months ended 30 September 2020, which compares to a 10.5% return by the MSCI Emerging Markets Index over the same period.

In spite of his bleak outlook for emerging markets, Kaufman believes it is a unique point in time, as large profit pools are starting to become evident, which are aligned to disproportionate value creation. And his fund is seeking to tap into these.

One example is the Chinese domestic economy, which is able to produce very large companies over a short space of time. Kaufman highlighted food delivery company Meituan as a case in point, having grown from being a $70bn business a year ago to $210bn today.

'That amount of equity value creation in a short period of time is really something that China is uniquely situated to. Those are the types of value pools we want to be aligned to.'

Another profit pool relates to digital services, where Kaufman said companies are extracting value – even from economies that are constrained. Examples here include Southeast Asian ecommerce company Sea and MercadoLibre, which has been dubbed Latin America's equivalent to Alibaba.

Meanwhile, the third opportunity for 'disproportionate value creation' lies with so-called 'passporters'. These are multi-national companies with borderless capabilities, which means they can expand into new countries without having to build infrastructure. He cited payments business Visa as a prime example.

Forget about value vs growth

Kaufman's approach goes beyond the traditional value vs growth debate, as he said these types of "style boxes" aren't always helpful. While viable Covid-19 vaccines should bolster the prospects for an economic recovery, which could bode well for value stocks over the short-term, the fund manager urges investors to think longer term.

'When I think about value vs growth, do I think "value" stocks can continue to reflate as the economy normalises? Sure, but I think that is an approach with a ceiling and a finite duration. If you contrast that to the profit pools our fund is aligned to, I think the level of value creation over any medium-term time-horizon is going to dwarf any sort of cyclical recovery potential we might see.'

While President-elect Joe Biden has indicated he won't immediately remove the elevated tariffs imposed on China by Donald Trump's administration, Kaufman expects to see a continued period of competition between the two nations – albeit a friendlier one.

He expects China will remain focused on its domestic market looking ahead; the introduction of its dual circulation policy over the last few months is a testament to this.

'Even as relations perhaps do normalise under a Biden administration, China can't necessarily rely on the US for key technology inputs, in particular semiconductors. It can't necessarily rely on Western markets for demand creation in the same way it could in the past with a more export-oriented model.

'I think what we are going to see from China is further mobilisation of household savings. Savings in China are amongst the highest in the world. I think they are running at 44%, so there is room for savings rates to come down and to be mobilised by the government, put into both domestic capital formation and consumption. I think both of those things are supportive of a more vibrant domestic demand opportunity in China.'

This optimism on China, in contrast to other emerging markets, helps to explain why the country accounts for 38% of the portfolio. 'China was already the best economic story within the emerging markets, and I don't just mean in terms of its management of the pandemic, I mean the underlying structural trends.

'They have got a wide pool of skilled labour, they have got a capability for domestic capital formation and they essentially have the best and only durable productivity story in the emerging markets. I think that is conducive to the types of disproportionate equity outcomes we week, more so than any other emerging markets.'

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Investment Results as of 30 September 2020 (%) Artisan Developing World Fund	1YR	3YR	5YR	ITD	Expense Ratios Prospectus 30 Sep 2019
Investor Class: ARTYX	71.06	22.82	23.28	18.03	1.36%
Advisor Class: APDYX	71.28	23.02	23.52	18.24	1.18%
Institutional Class: APHYX	71.45	23.13	23.64	18.36	1.09%
MSCI Emerging Markets Index	10.54	2.42	8.97	4.79	
Morningstar Peer Group Percentile	1st	1st	1st	1st	

Source: Artisan Partners/MSCI/Morningstar. Fund inception: 29 Jun 2015.

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Carefully consider the Fund's investment objective, risks and charges and expenses. This and other important information is contained in the Fund's prospectus and summary prospectus, which can be obtained by visiting www.artisanfunds.com. Read carefully before investing.

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Portfolio country classifications are defined by the investment team and may differ substantially from MSCI classifications. For the portfolio's country and region breakdown according to MSCI methodology, refer to the Fund's most recent portfolio holdings at www.sec.gov.

The discussion of portfolio holdings does not constitute a recommendation of any individual security. These holdings comprise the following percentages of the Artisan Developing World Fund's total net assets as of 30 September 2020: Alibaba Group Holding Ltd 7.0%, Meituan 4.5%, MercadoLibre Inc 5.2%, Sea Ltd 5.2%, Visa Inc 6.9%. For the purpose of determining the Fund's holdings, securities of the same issuer are aggregated to determine the weight in the Fund. Securities named but not listed here are not held in the Fund as of the date noted. The portfolio holdings mentioned are subject to change and the Fund disclaims any obligation to advise investors of such changes.

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