# LGM Emerging Markets

## Risk: what really matters

Recent months have been unusually eventful, characterized by a swing in the global political landscape, U.S. dollar strength, geopolitical flash points, demonetization in India and military coups in Turkey (among many others), all feeding into general market nervousness and a significant rise in volatility. This was certainly the case in emerging markets. However, while volatility can be uncomfortable in the short term, what is ultimately more important for achieving long-term gains is having the discipline and patience to look beyond the short-term, and to understand what is noise and what is real change.

This mindset is central to how we think about risk when constructing a portfolio. "Risk" is a very broad topic and can mean different things depending on a particular viewpoint. Unfortunately, and all too often, risk has come to be synonymous with volatility (or standard deviation, beta, etc.). In our opinion, this is a misperception of an important topic. While it is very convenient to have risk boiled down to a single, understandable number like volatility, in our view, it does not reflect much (if anything) regarding the actual risk an investor takes. Volatility is simply a measure of variability of an asset price over time.

At LGM, we think of risk as the chance of permanent loss of capital — i.e., real, non-recoverable cash losses. We do not believe that the volatility of a stock's price in the market reflects this. To help us contextualize this, we focus on three key, broad areas:

- **Business risk:** the sustainability of the underlying business model, i.e., whether the business will be able to generate similar or higher cash flows 5-10 years from now and the visibility and predictability of that cash flow stream
- **Portfolio risk:** any risk including liquidity, concentration and macroeconomic risks
- **Valuation risk:** the risk of overpaying

### LGM Investments

**Rishikesh Patel**
Fund Manager

**Anders Heegaard**
Research Analyst

### Contact us

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Without downplaying the importance of valuation risk, we feel that business and then portfolio risk are the most important for the long-term investor. Ultimately, as long-term investors, we will always look at the quality of the business before we assess its value in our investment process. We believe that investing in quality business models over the long term translates into steadier, less volatile investment results by the compounding of consistent returns. This in turn has resulted in smoother, more consistent performance across all our core strategies, as evidenced by our strong risk/return metrics.

For the purpose of this discussion, we will focus more on business risk, given its relevance on our investment process. We have argued on several occasions that long-term returns are primarily driven by the development in cash flows. While the multiple an investor pays is clearly important, it pales in comparison to a company's ability to deliver earnings and cash flows. In the extreme short-term (one month), this multiple is the main driver of performance, explaining as much as 85% of a stock's returns. This number decreases to 55% on a 1-year basis, while over 5 years just 25% of the total return is explained by the multiple at which the stock was purchased. Seventy-five percent of the total return is driven by development in earnings and cash flows for investment horizons of 5 years or more; and that proportion increases over time. The primary risk focus of long-term investors therefore ought to be the long-term cash flow opportunity of the company with less emphasis on the multiple one pays for that.

While not subscribing to the "traditional" measure of risk (volatility, beta, etc.) in favor of actual risk to capital (business risk), a fair question to ask is: how do we assess risk tangibly? To that end, we spend a significant amount of time understanding, analyzing and meeting the companies in which we invest. This allows us to do two key things: 1) understand the company and how they have, and will, generate cash flows; and 2) build trust. This may seem straightforward, but it is complex and nuanced, as every company is different in emerging markets. Our investment process and definition of quality provide us with the framework to complete this analysis, as well as the discipline to ensure we do not compromise quality, particularly when something may look attractively priced but is not of high quality. We are always driven first by quality, then by value.

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By identifying quality companies that can: deliver a predictable and growing stream of cash flows, have a sustainable competitive advantage, operate with strong balance sheets, use debt/leverage prudently and have strong management teams; we believe we can reduce business risk within the portfolio, and as such, reduce the risk to invested capital. For us, the lowest business risk companies are found among dominant consumer, financial or services companies in the less developed parts of the market. We believe that not only are penetration rates low for many goods and services, thus providing a favorable long-term secular demand backdrop, but within emerging market economies there is also a high level of informality, which raises the entry barriers substantially, and results in a benign competitive environment, allowing the dominant companies (with a brand, distribution or scale advantage) to generate high returns and, as a result, strong free cash flow. This reduces business risk. We not only consider a business' competitive advantages: we try to assess the durability of those advantages. We find competitive advantages to be higher in sectors that are characterized by everyday goods, which are stable in nature and possess pricing power, thus allowing companies to pass on potential cost increases to consumers. Many of our holdings operate business models that date back decades, such as providing goods and services like banking, snack foods, infant milk, groceries, and more.

## Concluding Thoughts and Outlook:

Uncertainty seems to be the most used word in financial markets of late. We understand that many things are not just uncertain, but simply impossible to forecast. We therefore focus on what we can control and predict.

In our view, the structural case for emerging markets remains firmly in place. The UN expects that over the next 15 years, the growth in working-age populations in emerging markets ex-China will amount to approximately 700 million people, or the equivalent of an annual compounded growth rate of 2% of people entering the labor force. In addition, Boston Consulting Group estimates that between 2010 and 2030, the population in emerging market cities will expand by 1.3 billion, which alone is more than the total population of today's developed market cities. These secular drivers (demographics, urbanization, more women entering the labor markets, etc.) will continue to create the prerequisites for large and growing profit pools that can be tapped by our holdings which specialize in providing basic goods and services to this segment of society.

For example, the current credit penetration in Indonesia is 30%, with less than 20% of the population having access to a bank account, supporting the long-term investment case for our two Indonesian financials Bank Mandiri and Bank Rakyat. In the Philippines, the per capita consumption of Ready-to-Drink tea (RTD Tea) stands at 2.1 liters per annum compared to the Asian average of 15.3 liters, providing a very strong demand backdrop for our Philippine consumer holding URC, which dominates that category with a 74% market share. The central investment case for all these companies is that they benefit from the secular trends we see in emerging markets. But more importantly, they have all established strong competitive advantages (in the form of brands, distribution, innovation, etc.) that allow them to generate high margins and high returns with strong visibility as they compete in a rational and benign competitive environment. We believe the continued strength and dominance of these business models are the strategic reasons to invest in emerging market companies over the long term.

While recent months have been disruptive, in our view, not much has changed fundamentally. Donald Trump's policy decisions and the U.K.'s exit from the European Union will not determine whether consumers in Asia continue to brush their teeth, open bank accounts, eat snacks, drink tea or use hair oil. When we look back in 5-10 years' time, we doubt those events will be the determining factors of the portfolio's return.

To conclude, we are confident about the long-term prospects of our holdings, and recent political events have not changed that. The strategic investment case continues to look attractive for emerging markets generally, but even more so at a stock level. As we move through 2017, we remain optimistic. Whether the favorable secular growth drivers and encouraging bottom-up fundamentals will be reflected in the 2017 performance of emerging markets is anyone's guess, but we are confident it will result in solid returns on a 5-10 year investment horizon.



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