Emerging Markets Spotlight

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"China's Tencent surpasses Facebook in valuation a day after breaking $500 billion barrier."
CNBC, 21 November 2017

Over the long run, emerging market equities have delivered a total return of about 11.3% p.a. in US dollar terms (since the MSCI Emerging Markets Total Return index came into existence in 1988). This compares to an 8.0% annualised total return for developed market equities (based upon the MSCI World Total Return Index over the same time period).

For the year-to-date to 30 November, the MSCI Emerging Markets Total Return Index has returned 36.3%, far outstripping its long-term returns. More significant, though, is the make-up of those returns. The median stock in the index has returned only 21.6%, while 49 index constituents have returned more than 100% year-to-date. Of the 49 stocks to have more than doubled, 22 are in the information technology space, including Chinese internet heavyweights Tencent and Alibaba. Other mega-cap Asian technology names have also performed very strongly: Samsung Electronics +58.0%, Taiwan Semiconductor Manufacturing Company (TSMC) +41.6%. Naspers, a South African holding company with a 33.2% stake in Tencent, +76.5%.

Even with strong underlying growth in these companies, we feel it is paramount as investors to maintain valuation discipline at all times. We do not intend to cover all our research on these stocks in this investor letter, but would like to provide an update.

We feel that the Tencent business model is one of the strongest in the world. Whilst its total addressable market is smaller than Facebook's, its core business continues to grow revenues successfully without overly relying on advertising. Cloud and payments have beaten analysts' expectations, while the cost pressures in the video business seem to be abating. Against this, though, is the degree to which the share price has out-run earnings. Tencent is valued at 37.6x 2018 consensus earnings, which is near the 40x earnings which has historically formed the upper limit to the stock's valuation range. Even modelling for significant success in cloud, payment and video, we find it difficult to see great upside from here and do not hold Tencent directly. Rather, we hold a significant position in Naspers. Naspers trades at a deep discount to its underlying net asset value (in fact, Naspers trades at a discount to its stake in Tencent alone), and we see Naspers as undervalued, with an exciting portfolio of assets other than Tencent, as well as a cheap and defensive way to have exposure to Tencent. We retain a significant position in Naspers.

Alibaba is a stock which has delivered very strong results in the last two quarters, both from monetisation of the Chinese user base, and also growth in the international business. Again, this seems to have been significantly valued in by the recent share price rise, and we find limited value above the US$180 per share level (note that we initially bought Alibaba at US$64 about two years ago). We have been reducing the position into strength and are now significantly underweight relative to the index weight.

Similarly, in the semiconductor space, we find TSMC challenging at above 15x forward earnings and have been reducing into strength. There is no denying the company's edge in its sub-20nm products for high-performance chips, nor the strong return on capital seen in the last four quarters of results, but even pricing this in, we find reduced upside and prefer to allocate capital elsewhere. In contrast, and as previously detailed, we find the low valuation, strong operational performance and improved corporate governance at Samsung Electronics highly attractive and retain a substantial investment in the stock.

Large index constituents delivering strong returns can be challenging for portfolio managers. We have enjoyed strong returns from mega-cap Asian technology stocks, but our valuation process is now causing us to increasingly differentiate between them.

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