GIB ASSET MANAGEMENT

GIB Asset Management Emerging Markets Active Engagement Fund

Quarterly Investment Letters

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GIB ASSET MANAGEMENT

Fourth Quarter 2023

"In the land of the blind, the one eyed man is King"

Dear Investors and Friends,

We are delighted to begin our series of "Quarterly Letters" on completion of our first full calendar year of running our investment strategy. We launched our UCITS fund on 29 July 2022. As 2023 ends, we are able to reflect on the previous seventeen months with a sense of achievement but perhaps more importantly, deeper purpose about what lies ahead. Our team remain unchanged and we retain commitment to focusing on a single strategy without wider distractions.

Executive summary

- 2023 was broadly a good year for emerging markets: EM ex China outperformed DM ex US;
- 2024 and beyond: i) EM is out of favour, with ii) immediate catalysts and iii) a corporate earnings recovery story – it's the confluence of these three factors that historically makes them attractive and a compelling entry point;
- Expect a continuation of high volatility and sharp market/ style rotations – the case for bottom up investing strengthens further;
- 2023 Fund performance was strong: relative outperformance was driven by stock selection across markets and sectors;
- Portfolio latency is high: pent up hidden value to be unlocked by our Process for Active Corporate Engagement (PACE™) approach – this represents a predictor of future returns.

Performance snapshot

	Dec 2023	3 months	YTD	Since Inception*
GIB AM Emerging Markets Active Engagement Fund	3.12	8.69	20.53	20.30
MSCI Emerging Markets	3.91	7.86	9.83	6.81
Relative Performance	-0.79	+0.83	+10.70	+13.49

No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Past performance is not indicative of future performance. *Inception Date: 29.07.2022

Authored by:

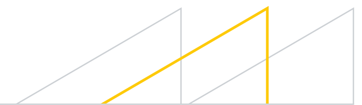
Kunal Desai, CFA

Portfolio Manager

"With valuation dispersion reaching extreme levels, the drum for bottom up stock pickers – like ourselves - beats louder.

It is in the afterglow of consequences that the once subtle risks become glaring beacons of oversight."

Performance data source: Dimension / MSCI. Returns data provided refers to Class I2 USD (C) Non Distributing only, and is based upon NAV net of fees. Class I 2 USD (C) of the Fund is reserved to institutional investors and is subject to an initial subscription of USD 500,000 or more (or the equivalent in another currency). The benchmark is MSCI Emerging Markets Index. The Sub-Fund is actively managed by reference to and seeks to outperform the MSCI Emerging Markets Net Total Return Index. The Sub-Fund is mainly exposed to the issuers of the benchmark, however, the management of the Sub-Fund is discretionary, and will be exposed to issuers not included in the benchmark. The Sub-Fund monitors risk exposure in relation to the benchmark however the extent of deviation from the benchmark is expected to be material.



Market review and outlook – what surprised us, what didn't & where next?

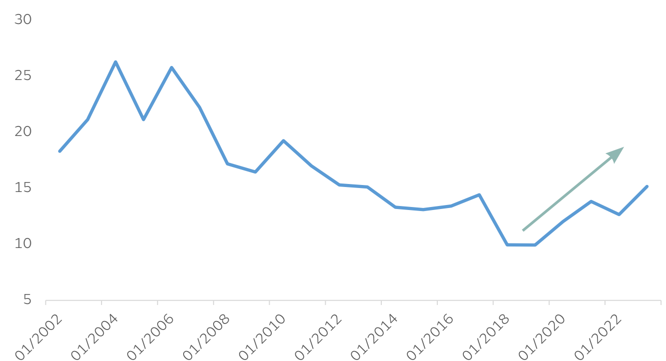
In truth, 2023 was a year of false starts and about turns. Forecasters struggled, as the early narrative of a synchronised global recession, rapid disinflation and a weaker USD lost momentum. Stickier inflation combined with a hawkish Fed pushed 10-year yields to 5%, intensifying the USD rally and overwhelming non-USD assets. But markets rotated frequently, and often violently. We experienced one of the deepest bond market collapses quickly followed by one of its sharpest ever rallies. Equities led – but its leadership rapidly switched in market and styles. By the end of the year, evidence of a significant fall in inflation raised hopes of a 'Fed Pivot' and the prospect of 'immaculate' disinflation. Markets changed direction once more, resulting in large gains for bonds, growth styles and Emerging Markets ex China. However, as the year drew to close, US equities were the standout performer – powered by the 'Magnificent 7[1]' whose business models Artificial Intelligence (AI) seemingly transformed. Conversely, China and fixed income underperformed.

Headline performance for Emerging Markets (EM) was reasonable with a 7% return (all in USD) following a -22% fall in 2022. In the context of strong US performance (+25.1%) though, this felt a little disappointing. It is rare for EM to lag Developed Markets (DM) in a rising market. Since 1991, there have been 17 years when both DM and EM have risen. In 14 of those years, EM gains have beaten DM returns. Of the three years when rising EM equities have lagged DM (which previously occurred in 2019), 2023 saw the biggest relative underperformance (-14.80ppt).

However, focusing on the headline numbers can be misleading. We can attribute the poor relative performance between EM and DM to the relative performance of its two largest constituents: China and the US respectively. Whilst the US (68% of MSCI DM at end 2022) performed remarkably, China (32.3% of MSCI EM at end 2022) was miserable, falling -13.3%. In other words, if we strip out the largest market from each index, EM ex China (+16.9%) actually beat DM ex US (+14.8%)! As in 2022, we saw significant divergence in performance from individual emerging markets through 2023. Latin America (Mexico, Peru and Brazil) thrived, whilst Taiwan, Korea and India led Asia. Hungary, Poland and Greece all delivered 40%+ returns over the year.

The composition of emerging markets looks very different today than it did end-2022, and certainly against end-2020. The competing interests and fortunes of India and China frame much of this. China's market performance much hobbled by its unique challenges to reignite growth – as the economy continues to suffer from disinflationary excess capacities, eroding growth and a geopolitical landscape that keeps risk premia high. Its trajectory can re-align – but this will require a believable paradigm policy shift. India, on the other hand, shines bright on the back of a rapid corporate Return on Equity (ROE) recovery story (Chart 1), a likely impending investment cycle and a deep and integrated domestic market with limited trade dependency. As a result, China's share of MSCI EM has fallen from 43% to under 28% in just three years. Meanwhile, India's weight against China's in the index has grown from 24% in 2020 to more than 55% - a significant achievement.

Chart 1: India's Return on Equity (ROE) revival – finances the next investment cycle[2]



A negative feedback loop emerged in China – weak consumer confidence and low business confidence led to deteriorating aggregate demand. Piecemeal stimulus failed to revive animal spirits. What's required to resuscitate the market? A comprehensive and forceful easing package alongside demand side focused stimulus. Confidence boosting policies targeting the private economy and a government backstop in housing and stock markets would help too. However, the policy response remains hesitant with concerns of renewed misallocation after a large buildup of historic unproductive debt – particularly in the property market.

The PBOC Governor Pan reminded markets in November

[1]Amazon, Apple, Alphabet, Meta, Microsoft, Nvidia and Tesla
[2]Bloomberg (2024)
Views, opinions, statements, forecasts and projections are as of date and subject to change without prior notice. There is no guarantee they will be met.

2023: *"China is experiencing a transition of its economic growth model. The traditional model of relying heavily on infrastructure and real estate might generate higher growth, but would also delay structural adjustment and undermine growth sustainability. The ongoing economic transformation will be a long and difficult journey, but it is a journey we must take."* Patience is required and the so-called 'Policy Put' might just be a little lower than where we are today.

Looking to 2024 and beyond, we expect volatility to continue. Rapid style rotations will likely continue as the 'top-down' landscape swings between fears of recession, hopes for recovery and the potential return to secular stagnation. Unpredictable geopolitical newsflow will continue whilst data-dependent Central Banks can stymie sustained style leadership. More than half the global population will vote in elections through the year.

There are reasons for optimism for the emerging markets story though. The last thirty years have shown that the time to buy emerging markets is when three things fall together. First, when the market is unloved and out of favour. Second, with the growing prospect of easier liquidity and a weaker USD. Third, with an improved relative corporate earnings cycle versus DM. For us, as the charts below illustrate, there is evidence that such tailwinds are now emerging.

EM now trades at a 45% discount to DM peers (Chart 2) – at the most discounted relative valuations since the 1997 Asian Financial Crisis. Ownership levels of EM from Global funds is at a multi-decade low. With global inflation peaking and likely rolling over, expectations are for easing liquidity and a weaker US dollar (Chart 3). This is historically supportive for EM given their correlation with commodities, the levels of dollar denominated debt and their risk-on nature. EM Central Banks, meanwhile, are ahead of the curve in solving their inflationary pressures (in part through a multi-year painful balance sheet repair process) and lead the rate cutting cycle (Chart 4). This will likely be positive for EM's relative growth impulse. Finally, a relative corporate earnings story is emerging. EM ex-China's expected ROE is rising at the fastest relative pace vs. DM in a decade, with earnings growth revisions leading global markets.

Chart 2: >45% price/book discount to DM[3]

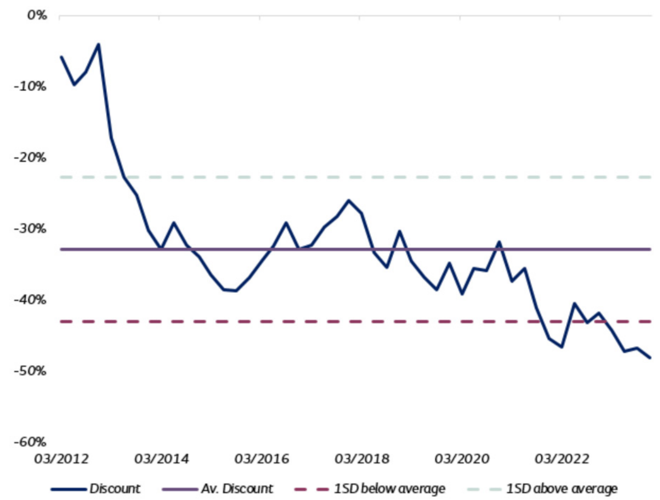
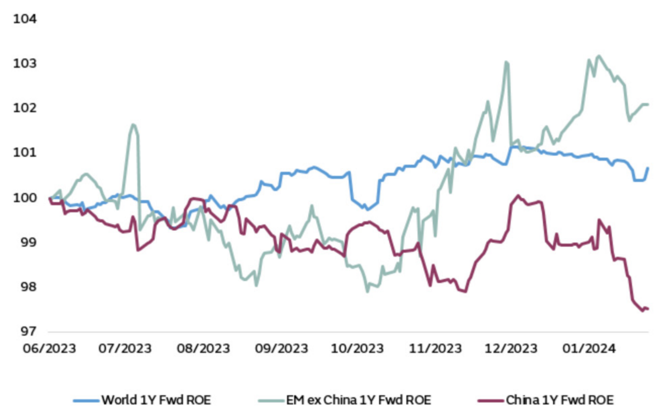


Chart 3: EM Central Banks ahead of the curve: lead the rate cutting cycle[4]

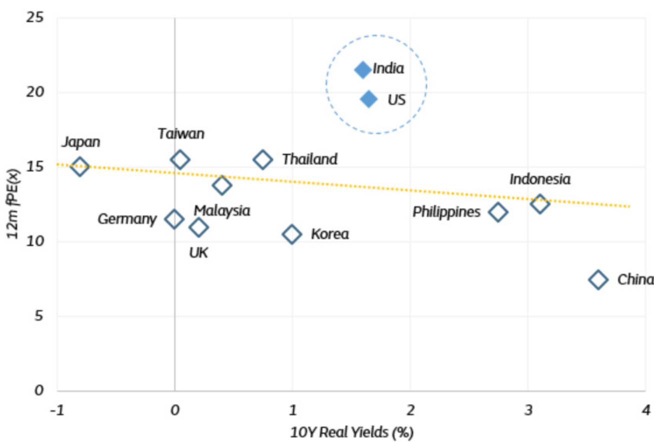
Chart 4: Beyond China, corporate fundamentals are inflecting[5]



[3]GIB AM, Bloomberg (2024)
[4]BAML, Bloomberg (2023)
[5]GIB AM, Bloomberg (2024)

This provides an asymmetric opportunity for investors. The relative valuation gap with DM implies that emerging markets (ex-India) are pricing in a very high risk premia. As the monetary easing cycle begins, we expect investment returns in EM to surprise positively – through both sharp earnings revisions and valuation multiples re-rating (Chart 5).

Chart 5: American and India 'Exceptionalism' – but what next for the rest of EM?[6]



Risks remain, of course. The advent of a Multipolar world[7] suggests block and spheres of influence rather than the multilateral rules based order which has been eroding for nearly two decades. Implications are for increased complexity, potential for greater geopolitical instability and higher volatility. But through this noise, the drum for bottom up stock pickers – like ourselves - beats louder.

The proverb "In the land of the blind, the one eyed man is King" can be a timely reminder. For us, re-affirming our focus on using such market volatility to identify strong franchises with valuations that underestimate their true compounding power. This approach builds on the foundation of employing our Process for Corporate Active Engagement (PACE) framework to unlock hidden value in partnership with our portfolio companies.

With valuation dispersion reaching such extreme levels, we are particularly excited about the year ahead and the opportunities we are working on.

How did we perform and why?

The Fund returned 20.53% (USD) over 2023. This outperformed the MSCI Emerging Market Index's return of 9.83% by 10.7ppt. Since inception, the Fund has delivered a net return of 20.30% against the Index's return of 6.81%. Outperformance over that period stretches to 15.46ppt. The good start places the Fund in the top decile against Emerging Market peers over the course of 2023 and since inception.

Perhaps more pleasing for us, is how those returns have been generated. Our bottom up process of investing has long pointed to relative returns generated predominantly by stock selection rather than asset allocation. This is an important feature for us – since it underlines an investment process that is both robust and repeatable. It further allows us to invest with conviction in a disciplined manner. The chart below illustrates this. Asset allocation judges the relative performance achieved by simply being under/over-weight a particular geography or sector. Stock selection instead appraises the relative attribution gained by selecting specific stocks that outperform its wider sector or geography. Since inception, stock selection has generated 87% of our relative returns on a sector basis. From a geographic perspective, the contribution sits at 67%.

Chart 6 & 7: Drivers of relative outperformance: stock selection[8]

Chart 6: Georgraphies

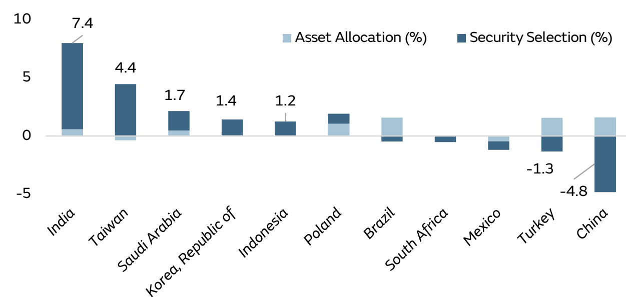
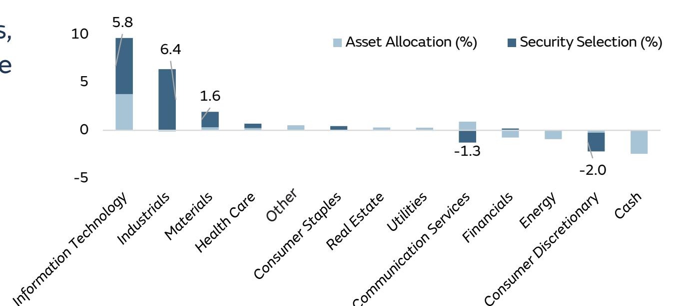


Chart 7: Sectors



[6] GIB AM, Bloomberg (2024)

[7] A world order in which power is distributed among multiple centers, as opposed to a unipolar world dominated by a single power or a bipolar world with two dominant powers.

[8] GIB AM, Bloomberg (2024). No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Past performance is not indicative of future performance.

India, Taiwan, Saudi Arabia, South Korea and Indonesia were important drivers of our strong absolute and relative gains. Meanwhile, Information Technology, Industrials and Materials contributed strongly from a sector perspective. Performance across these sectors and geographies was predominantly driven by strong stock picking and successful engagement outcomes.

China continued to detract from our absolute and relative returns, shaped through weaker stock selection. The depth and persistence of deflationary pressures surprised us. Over the last three years, we have witnessed a 61% drawdown, 30% fall in market cap, 56% de-rating in Index P/E, a 19% drop in cash turnover and a 58% slump in capital fund raising in Hong Kong and China.

Our allocation in China towards companies aligned with the domestic consumer hurt us. Some of this was due to the consumption cycle, some due to company specific issues and some more down to a Growth style out of favour for 2023. Growth tends to lead Value when the economy improves and financial conditions loosen, and vice versa. China has become a Value market – 25%/45% of index constituents now trade below book value/less than 10x PE. However such Value, and indeed strong 2023 performance, resided in sectors such as Banks, Developers, Utilities and Energy despite our belief of their longer term fundamentals being significantly challenged. As such, our allocation in higher ‘quality’ areas such as Discretionary Consumption, Technology and Industrials suffered relatively.

Of our top two contributors, one operates in India (Cyient) and the other in Korea (HPSP). Our biggest detractor was from China (Li Ning).

Cyient (India | Technology | +185.7%) is a market leader that provides outsourced Engineering and R&D services to a diversified base of 300 clients across eleven industries. Through recent strategic acquisitions, Cyient has positioned itself as a design, build, operate and maintain partner to cater to clients across the value chain. The company’s competitive advantages are derived from its cost structure, its scale economics that provide it a cash profile to finance faster inorganic growth, and the high switching costs embedded in its customer relationships. Its reinvestment runway is driven by growth of the ER&D market as global spending and outsourcing penetration increases. We would expect its total addressable market to double in the next four years from $30bn to $60bn as a result of increasing outsourced ER&D spend which are increasingly captured by Indian peers.

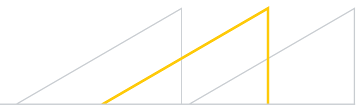
Our initial investment in the company was shaped by a belief that the implied expectations built into its starting valuations underappreciated its true franchise value. The business was trading at a steep discount to its peers in July 2022 despite robust fundamentals. Our Engagement Plan for the company sought to unlock value through tackling investor misconceptions through an improvement in Compounding Power and its market implied Cost of Capital. Our suggestions focused on initiatives to improve the business’s revenue run rate and earnings predictability; re-directing focus on the core business; addressing balance sheet inefficiency and wider concerns of capital misallocation and embedding Sustainability as a source of returns and competitive advantage. We were encouraged by the traction of Engagement Action Points and the resultant impact on share price performance.

HPSP (Korea | Technology | 120.6%) is a Korean semiconductor equipment supplier that specializes in high-pressure hydrogen annealing technology. This process corrects defects in the high-k materials that are adopted by the most advanced chipmakers. This gives it direct exposure to the growing trend of semiconductor miniaturization. HPSP is a monopolistic owner of the technology, which creates high barriers to entry and resultant strong pricing power.

The company has historically focused on the logic foundry market, although future growth aligns to the memory space where the adoption of high-k materials is low and expected to increase significantly. This, combined with the continued miniaturization of processes in the logic foundry market, provide significant runway for the company to grow with the market and compound its capital at high rates of return.

Our initial due diligence on the company began in late 2022. As our due diligence progressed, the strength of their IP and the quality of the management team impressed us increasingly. Discussions with several industry experts, customers and competitors confirmed our thesis regarding the uniqueness of the high-pressure hydrogen annealing technology, HPSP’s monopolistic position and the company’s economic moat.

Despite superior technology, high profitability and a



durable growth profile, the company was trading at a close to 50% discount to relevant global peers, which in our view was unjustified and primarily driven by the lack of business understanding among investors. Our Engagement Plan for the company centers on reducing their implied cost of capital (and valuation discount) by enhancing investor relations communication, corporate governance structure and introducing Sustainability and Net Zero frameworks. In Korea, companies with superior communication, transparency and best in class governance can be rewarded by premium valuations. HPSP's experience with Capital Markets is relatively short (since its IPO in 2H 2022), however we are very encouraged by the level of management receptiveness to ideas that can be value enhancing for the business.

Li Ning (China | Consumer Discretionary | - 68.7%) is the second largest domestic sportswear brand in China in terms of market share. The company's moat is derived from its strong brand equity, large investments in R&D and a digital transformation, which powers its operational efficiency relative to peers even further. Its improved brand equity implies it is well positioned to enjoy long-term market share gains with increased health awareness, sport participation and rising preference for athleisure products driving industry growth.

In light of the wider Chinese consumer malaise, Li Ning experienced a difficult period of execution in 3Q23. Amidst heightened competition, overly optimistic sales target, excess inventory and distributors selling on unauthorized channels, brand equity and market returns suffered materially. Shares de-rated further on a Capital Allocation misstep of purchasing of a building in Hong Kong for $280million to house their international expansion. In the context of their wider challenges, such a development was met with short shrift by the wider market.

Since our initial investment in 2022, our Engagement Plan for the company to unlock further value centers around strategic Capital Allocation, a review of incentive structures and an improved governance framework. Given the dramatic decline in their share price reaction following the 3Q23 results, which was later further exacerbated by the building purchase in December, Capital Allocation strategy and improvement in governance controls became even higher Engagement priorities. These Action Points aimed to reduce their market implied Cost of Capital.

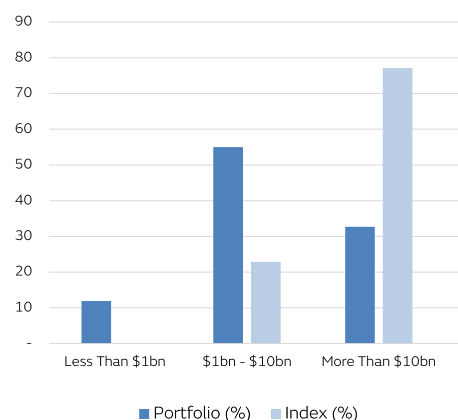
Suggestions included utilizing their balance sheet strength for a meaningful share buyback, enhancing disclosures, recalibrating communication methods, and organizing an Investor Day to address market concerns and restore confidence in the management team.

We are pleased to see our suggestions to enhance shareholder returns thoughtfully considered and subsequently implemented by the management with a HK$3bn share buyback programme announced in December. Current valuations sit at a two decade low. We believe this particularly attractive for one of the biggest domestic sportswear brands in China.

Chart 8: Our characteristics and exposure (Portfolio vs MSCI Emerging Markets Index) [9]

	Portfolio	Benchmark
Return on Invested Capital	14.77	10.6
Return on Equity	27.63%	16.61%
Return on Assets	11.25	7.11
Net Debt / EBITDA	-0.56	0.5
Net Income Growth	62.56	7.05
Free Cash Flow Yield	3.76	3.12
Dividend Yield	0.51	0.89
Forward P/E Ratio	19.49	11.53
Forward EV/EBITDA	12.68	8.02
Active Share	94.93	
Tracking Error	7.69%	
Volatility	19.65%	18.19%
Number of Securities	33	
Avg Market Cap (US$ bn)	25	108.5

Chart 9: Market cap spilts (Portfolio vs MSCI Emerging Markets Index) [10]



[9] GIB AM Dimension / MSCI (as at 31.12.2023)
[10] GIB AM Dimension / MSCI (as at 31.12.2023)

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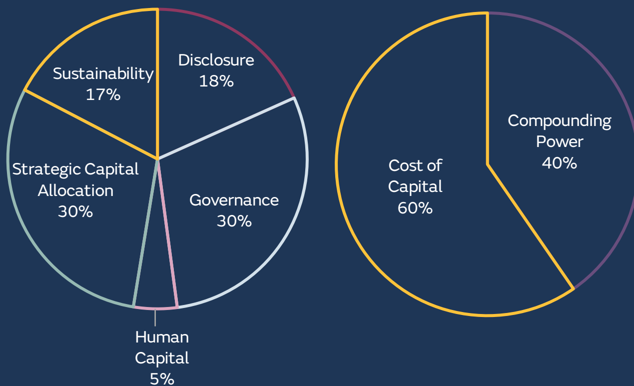
Portfolio latency - how engagement drives results

We are particularly excited about the inbuilt latency that exists in the portfolio today. We were successful with 44 Engagement Action Points in 2023 which each having an impact on improving the Compounding Power or reducing the market implied Cost of Capital for their respective business. Perhaps more importantly, there remain 167 outstanding Action Points across the portfolio, which we believe can help drive future incremental returns. Of these Action Points, 59% are focused on reducing the market implied Cost of Capital whilst 40% aim on improving the business' Compounding Power. 41% of our Action Points center on improving Governance; 30% on Strategic Capital Allocation; 17% on incorporating Sustainability as a source of returns and 18% on improved Disclosure.

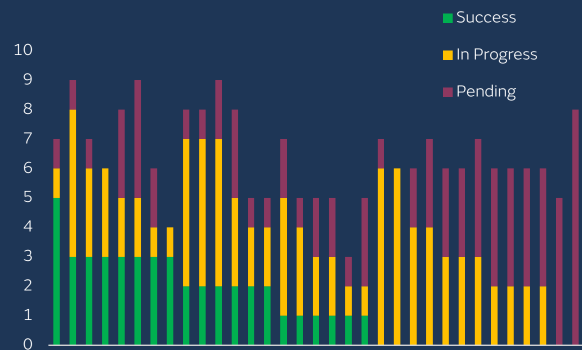
Chart 10: Engagement points[11]

239 Action Points raised since inception



The chart bellows illustrates the remaining Action Points we have for our 33 companies in the portfolio. 44 Action Points have been successfully resolved (shaded green) however, the yellow and purple shaded areas point to the outstanding unresolved Action Points that represent unaccounted inbuilt latency.

Chart 11: Engagement latency: outstanding suggestions in our current portfolio [12]



As these bars turn incrementally green over the subsequent months and years ahead, this can be a strong predictor of future shareholder returns to come.

With our very best wishes,

Greg Konieczny,

Kunal Desai (Author),

Marcin Lewczuk,

and

Megan Ie

[11] GIB AM Analysis (as at 31.12.2023)
[12] GIB AM Analysis (as at 31.12.2023)
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