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Our funds generally maintained their positive momentum in Q3. The Asia and Global Funds were both up 17%. Conditions remain tougher in Latam, where our Fund was down 1%. Our new impact fund, the Next Generation Fund, is freshly open for subscriptions.

Day-to-day work for us remains exclusively screen-based. At the time of writing, the prospects of company visits or a return to the office before the end of this year seem remote. Nonetheless, we have been positively surprised by the access we have maintained both to company management and to independent experts throughout the work-from-home pandemic. We have certainly extracted maximum value from our Zoom and Microsoft Teams accounts, and are lucky to have invested significant effort in upgrading our cloud-based infrastructure in 2019, which has helped make our global move to remote working mercifully seamless. And the lack of travel has afforded us additional time for introspection in our relentless pursuit of research excellence. We hope this is reflected in some of the research material available to investors in the coming weeks.

Q3 Performance: Digital and China

Though China has so far avoided a second wave, for the most part there is little sign of major emerging markets closing the book on the COVID crisis. India and Brazil are global infection hotspots; Mexico and Argentina are underreported disasters; Indonesia and Pakistan are moving in the wrong direction. Most ASEAN and African nations have emerged with credit, but overall, there is little reason for optimism from a top-down pan-EM perspective pending the successful development of a vaccine.

We commented last quarter that our year-to-date performance was benefitting from our earlier decision to embrace the structural shift of consumer attention and spending into digital channels. Smartphone ownership, now at 60% of the population in China and already 37% in India (that’s a combined 1.4 billion people), makes people consume different products through different channels. We have endeavoured not to jump at every ‘shiny new thing’ in the digital space, and have taken our time to reflect this structural shift in consumption, but much of our trading activity in recent years has resulted in us increasing the size of our digital exposure at the ‘head’ of the portfolio while cutting companies at the ‘tail’ which are lagging in adapting to digital marketing and selling channels.

Our increased exposure to digital names continued to pay dividends in Q3 and this is the best rationalisation we can conjure for the fact that our portfolios appear to be tracking infection rates more closely than overall spending growth. JD.com, SEA, MercadoLibre and Yandex, among others, have all been notable strong performers, each capturing the digital channel shift in a different way in their respective regions. Through COVID, there has been an undeniable acceleration here of this pre-existing trend: the four businesses named above, for example, experienced average top line growth of 49% in Q2. Since we have very little exposure to the worst affected industries (e.g. travel) our portfolios have remained relatively well insulated from direct COVID impacts.

Our Chinese names, most of which are still plain old consumer staples businesses, were the other major contributor to performance. The Arisaig ‘basket’ of Chinese stocks (a sample size of eight) was up a simple average of 35% over the quarter. Part of this reflects buoyant domestic investor sentiment, largely retail-driven; part the international influx into a market which is both increasingly rich in quality, and likely to be the first major global market to shake off the COVID shackles on earnings.
The Importance of Alignment of Interest

Our increased exposure to China in recent months (it now represents 34% of our Asia Fund exposure and 28% for our Global Fund, having bottomed out around 20%) is a reflection of our growing ability to fulfil the ‘alignment’ criteria of our due diligence process in the local market. Growth has never been hard to find; quality perhaps a little more so, given the difficulty of establishing durable competitive advantage in a country in which capital is rarely in short supply.

Adequate protection of the interests of minority shareholders, however, was always the toughest test for Chinese companies to pass, given the persistent prevalence of state interests in the running of nominally private enterprises. Many would also comment at this point that even non-SOEs tend to demonstrate inferior governance by international standards. This might be true, but it does also appear to us that the high profile, large scale and international listings of bad actors such as GSX and Sino-Forest, along with an imposing language barrier, have possibly inflated perceptions as to the universality of fraud and lack of financial controls across corporate China. Taking the number of forced de-listings as a crude proxy for frauds, we note that the numbers fell from 123 between 2000 and 2010 to 41 between 2010 and 2020. Though this sounds like a high absolute number, in truth it’s not significantly larger on a ‘per listed company’ basis than most countries.

Nonetheless, we have historically struggled to identify corporate structures which placed us, as foreign minority shareholders, on the same page as the people running the business. Where the state is not involved, even wholly private enterprises are often prone to messy conglomerate structures rife with opaque related party transactions. In these situations, we simply cannot be sure that capital allocation decisions will be taken in the interests of all shareholders.

This is why a company like Foshan Haitian, the condiments business which is more than 85% owned by employees, represents such a valuable exception. Haitian has been a cornerstone of our Chinese allocation in recent years, and remains our largest individual holding at the firm level. The distance it has still to travel in terms of consolidation and premiumisation leave us confident holding on to it for some time to come. As consumption patterns evolve, and businesses founded post-Deng Xiaoping’s ‘Southern Tour’ mature, more and more genuinely shareholder-friendly companies are beginning to appear on Chinese exchanges, helped also by the rush of liquidity brought about by the HK-Shanghai connect.

Yihai and Haidilao, which we view as a ‘compound holding’ addressing both the at-home and dine-out hotpot markets, both represent similarly strong examples of management incentives pointing in the direction of positive shareholder outcomes. Cofounders Zhang Yong and Shi Yonghong have designed a system of partnership, commissions and stock options which reward consistent long-term execution and thus the interests of all business owners (with no obligations to unlisted affiliates or arms of government).

‘New economy’ names in China, particularly in the digital space, have also for the most part represented a welcome break from dated, unsatisfactory governance structures. The likes of JD are far from perfect given their concentration of voting power in the hands of founders (a disease which also afflicts the US tech sector), but there are signs of growing maturity here. Alibaba, we believe, has handled its succession from Jack Ma and the development of a partnership scheme in exemplary fashion.

Arguably we have historically been too dogmatic on the question of alignment. There will always be businesses which plough on regardless and which end up looking like painful misses. Kweichou Moutai, for example, is very much our kind of business in most other respects – the strength of its
brands is unparalleled globally within the spirits category. We have avoided it because it has the fingerprints of the state all over it, but even its frequent resultant governance missteps have thus far proven insufficient to offset its immense pricing power and growth.

Still, we place a huge degree of emphasis on alignment because we are ultimately merely intermediaries in a series of capital allocation decisions. We believe we add value through our ability to match far-sighted institutional investors to genuinely pioneering, long-term minded emerging market businesses, via the quality and depth of our research. The model doesn’t work effectively if any link in this chain is chasing distinct goals or time horizons.

**Next Generation Fund**

This emphasis on alignment holds resolutely true in the case of our new fund, which has now opened for subscriptions. The key difference is that this strategy is intended to serve investors who wish to generate positive impact alongside financial returns. We seek to build a portfolio of businesses which is providing solutions to some of the developing world’s most pressing problems: such as poor standards of, and access to, essential health services; lack of formal employment options; endemic gender inequality; and both chronic and acute physical climate change risk (more on this below).

Because they operate in hugely underserved markets, these companies have naturally strong growth profiles. Because of the essential nature of the goods and services they provide, they are naturally comparatively resilient to economic shocks (of which COVID has recently provided unwelcome confirmation).

There is a mildly tedious debate still raging within pockets of the investment world about the need for end company ‘intentionality’ in order it to be classed as a genuine impact investment. This intention clearly exists for us and for our investors and is reinforced by our engagement strategy. In contrast, we are confident that most of our businesses don’t particularly care about the UN Sustainable Development Goals. But they care a lot about their customers; about the quality of the services they are offering; and about continuing to drive affordability and reach so as to address the huge untapped market at the base of the pyramid in their target geographies. In order to do so successfully at scale, they need to operate profitable, high growth business models which can continue to reinvest in their own growth (and thus also reward shareholders along the way).

Our holdings tend to demonstrate a neat alignment between the sustainable scaling of their positive impact and the long-term interests of shareholders. They are generally using their unique business models, often enhanced by a technological advantage, to profitably address the previously neglected portion of the market for the first time. Africa’s mobile money businesses are an excellent example of this – the provision of essential financial services through even basic mobile handsets has allowed populations to leapfrog past the establishment of a widespread formal ‘high street’ banking infrastructure, straight into a more efficient, fintech-dominated industry landscape.

Other impact innovations can be more prosaic. Hapvida in Brazil, for example, is a vertically integrated, affordable private healthcare business operating in an industry currently split between a weak and underfunded public system on the one hand, and a fragmented, profiteering private health industry on the other. Most Brazilian private treatment is addressed by different businesses at each level of the value chain, creating a need for margins at each level, and incentivising over-prescription and over-treatment which results in worse healthcare outcomes.

By collapsing the various levels of the healthcare chain, Hapvida generates significant efficiency relative to its competitor base, ensures a greater emphasis on prevention over treatment, and is able
to pass on significant cost savings to its customers with entry-level pricing. Oversight over all stages of the value chain enables it to score consistently highly on independent assessments in terms of service quality, demonstrating that its cost leadership does not result in compromises in terms of treatment outcomes. Unsurprisingly, cost-efficient, high quality service at industry-leading prices achieves good financial results, and the company is therefore growing much faster (with higher margins) than its peers in the Brazilian health system.

Navigating the Climate Crisis

With much of the world focused on testing, tracking, social distancing and vaccine research, several major natural disasters have occurred over the last few months. The most widely covered of these was the worst bout of seasonal forest fires on record in California. To date, they have destroyed almost 4% of the state’s land, almost 8,000 structures and taken 25 lives.

Less well covered, but equally worrisome, were the record wildfires recorded in Siberia and shocking flooding in Bangladesh. Nearly a third of the country was submerged, which alongside Cyclone Amphan in May and COVID, is creating a major humanitarian crisis. What all of these have in common in the eyes of a growing consensus of the world’s leading scientists¹, is a link to rising global surface temperatures, in turn linked to anthropogenic greenhouse gas (GHG) emissions.

Putting climate change in context

More frequent and more intense weather-related events is a multi-decade trend, as recorded by the International Disaster Database (see chart below). Indeed, our deep-dive research on physical climate risk (available on request) found that these events are now causing over USD200bn in economic losses each year; a figure that still massively understates the total societal costs of climate change (in particular in emerging markets where most losses are uninsured).

¹ E.g. see https://sciencebrief.org/topics/climate-change-science/wildfires/explorer; or https://sciencebrief.org/topics/climate-change-science/floods-and-climate-change
As GHG emissions continue to surge\(^3\), this is anticipated to worsen in the future - indeed, the World Economic Forum has identified ‘Extreme Weather Events’ as the most likely major global risk over the next ten years\(^4\).

With this in mind, climate change has profound consequences to us as long-term investors. As readers may be aware, we model the cash flows of our companies on a 20-year horizon, all as part of a desire to hold them for at least as long. Where other investors may be able to bury this issue in the ‘too difficult’ pile – perhaps understandable when one considers that the average holding period of equities in emerging markets is less than one year – we must confront it head on.

We have been upping our efforts here both in terms of better understanding the risks that climate change poses to our portfolios, but also in the shape of opportunities might emerge to mitigate climate risk or benefit from climate change transition, that could be attractive investments under the ‘environment’ pillar of our Next Generation Fund (please ask if you’d like to see our work on the solar industry). To support these efforts, we are pleased to announce the arrival of Tianyue (Joy) Wu, who joins us from Carbon Trust and will support our team on both climate and broader sustainability research.

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\(^2\) Refers to drought, extreme temperature, extreme weather, flood, landslide, mass movement and wildfire

\(^3\) Even in the face of COVID disruptions, GHG emissions are expected to fall by only 4-6% in 2020 according to the International Energy Agency - https://www.iea.org/reports/global-energy-review-2020/global-energy-and-co2-emissions-in-2020

\(^4\) The Global Risks Report 2020, 15th Edition, World Economic Forum – it is notable that pandemics were not cited in the top five risks
**Portfolio findings on physical climate risk**

The research we have conducted thus far does not paint a rosy picture for emerging markets. Evidence suggests that many of these countries find themselves at the epicentre, both due to their geographic positioning (weather events are not distributed uniformly and tend to concentrate between the Tropics) as well as their economic vulnerability. Several of our markets – including Bangladesh, Pakistan, Egypt, Philippines and India – were identified as being particularly exposed to this ‘physical climate risk’ and are already experiencing the consequences of more volatile weather.

This was validated by a third-party portfolio risk assessment conducted by South Pole, which highlighted the companies across our portfolios which could be most at risk (helped by a geotagging exercise we commissioned of our holdings’ key facilities). We then applied an internally developed risk exposure questionnaire to these companies, which assessed in more detail the risk level across the value chain: through the supply chain, direct operations and downstream demand.

We engaged with the companies that were identified as being high risk through our internal assessment, in order to understand what they were doing to manage this risk. Our discussions with management of these companies pointed to decent awareness of this issue and various efforts underway to manage it, including an identification of alternate suppliers, adapted factories and hazard insurance. In fact, we learnt that one of our company’s products is on the list of supplies recommended by the government to prepare for flooding – it is deemed to provide an important nutritional solution during times of population displacement (sales have grown every year since 2005, despite a series of major climate-related events).

**Responding to the low-carbon transition**

Against this backdrop of growing volatility (both risk and reward), we see it as our fiduciary duty to carefully integrate climate risk into portfolio decision-making and active ownership approaches. This is very much consistent with our investment thesis of backing high quality companies that steward their capital efficiently and sustainably for the long-term. It is also aligned with our desire to be constructive shareholders and help companies to focus on issues which might manifest themselves most materially beyond the tenure of current management.

We are currently looking at ways in which we as investors can align ourselves and our portfolios with a sustainable climate outcome - which is currently defined as a ‘net zero’ emissions world by 2050⁵ - and are working with a group of like-minded investors to draw up a collective strategy. We see our most powerful tool in achieving this as active engagement and awareness building with our holdings. This in part reflects the low starting point for many emerging market management teams (particularly true given the limited immediate transition risk in the sectors we focus on) but also the potential for shared value creation through constructive dialogue and an ‘ownership mentality’.

We are in the process of developing a framework that will identify high-risk companies, track their progress in managing climate transition risk and help us draft up engagement plans for the laggards. Progress (or indeed lack thereof) will be reported in our annual ESG Review.

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⁵ According to the 2018 IPCC Special Report on 1.5°C (SR15), global net human CO₂ emissions must decline by about 45% from 2010 levels by 2030 and reach net zero around 2050 for global surface temperatures to remain within 1.5°C of pre-industrial levels.
Playing our role as a business

Regarding climate change, alignment is once again firmly on our agenda, and so this year we have redoubled our efforts to hold ourselves to the same environmental standards we ask of our holdings. Though we have been carbon neutral since 2010 through offsetting, we have also set ourselves the target of reducing emissions per employee 38% by 2030 versus a 2019 base\(^6\) (please request our Climate Risk Policy for more details on this). This is part of our broader certification process as a ‘B Corporation’ (our application has just gone in), which forces us to formally integrate the values we have long lived by into our governance structures. We welcome feedback from readers on their own journeys in this direction.

\(^6\) We adopted the SBTi’s recommendation of 4.2% annual linear reduction rate to be aligned with limiting global warming to 1.5°C. See https://sciencebasedtargets.org/wp-content/uploads/2017/04/SBTi-manual.pdf
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