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Finding Tomorrow's Opportunities in Emerging Markets

By Andrew Dalrymple, Director and Investment Manager, Aubrey Capital Management

Emerging markets have undergone a remarkable change in leadership over the past two years. Artificial intelligence, data centre investment and surging demand for memory chips have propelled Taiwan and South Korea to the forefront of the asset class, while a relatively small number of technology companies now account for an unusually large share of index returns.

The obvious question is whether this is simply another technology bubble. The answer is more complicated than recent share price performance might suggest, and hinges on distinguishing between businesses where structurally higher earnings justify a higher index weight, and businesses simply carried higher by the flow of passive capital.

There are certainly signs of excess. Leveraged ETFs tracking Samsung and SK Hynix have sprung up in Korea, and hot money has clearly piled into the same stocks. However, earnings tell a different story. Samsung Electronics is trading at around six times earnings for this year and approximately four times next year, with SK Hynix on similar multiples. Earnings are growing fast on surging memory demand and staying strong because new capacity is so expensive and slow to build that supply can't easily catch up.

The current cycle may also prove longer than previous memory cycles. Historically, demand was heavily influenced by products such as PCs, mobile phones and games consoles, which produced relatively short booms followed by sharp declines as each product cycle matured. AI infrastructure is different. Building new fabrication capacity takes years and requires enormous capital, giving the leading semiconductor manufacturers a degree of protection that wasn't always present in previous cycles.

That does not mean recent rates of return can continue indefinitely. Markets tend to anticipate changes long before they become visible in company earnings, and some of the heat already appears to be coming out of technology stocks. A period of consolidation would hardly be surprising after such exceptional performance.

The more interesting question is what happens to that crowded capital if leadership starts to broaden. We don't know precisely when, or how quickly, that broadening will happen, but markets which have fallen out of favour rarely stay there once the earnings case reasserts itself.

India's longer-term structural development is continuing regardless of what foreign investors have been doing. There are now around 900 million smartphones in circulation, while digital payments, logistics and internet connectivity are laying the groundwork for much wider adoption of e-commerce and financial services. China went through a similar transformation during the previous decade, creating opportunities not only among online retailers but across payments, logistics and the wider digital ecosystem.

This is one reason why emerging markets should not always be viewed as a single asset class. Taiwan and Korea offer world-leading semiconductor businesses. India remains one of the fastest-growing major economies in the world. China has developed sophisticated technology and service industries, while markets across Latin America and the rest of Asia offer very different combinations of growth, valuation and structural change.

The opportunities, therefore, are much broader than whichever part of the index happens to be leading at a given moment.

There are also signs of change within South Korea beyond semiconductors. Korean companies have historically suffered from weak profitability, low returns on equity and poor treatment of minority shareholders. Recent efforts to improve corporate governance, influenced by reforms seen in Japan, have begun encouraging companies to distribute profits more effectively and pay greater attention to shareholder returns. Combined with the semiconductor boom, this has contributed to a dramatic re-rating of the Korean market.

The challenge for investors is separating temporary momentum from sustainable earnings growth. Technology has earned much of its recent leadership, but exceptional performance inevitably changes the balance of risk and reward. Conversely, markets that have fallen out of favour can become increasingly attractive even when their underlying fundamentals remain intact.

That is particularly relevant today. Taiwan and South Korea combined have risen from around 29% to 48% of the MSCI Emerging Markets Index in little over a year, while valuations elsewhere have become more reasonable. India, still growing at 7-8% in real terms, is the clearest example, but it is unlikely to be the only one.

The next five years of emerging market returns are unlikely to look exactly like the last two. AI infrastructure and semiconductors will remain important, but market leadership will evolve as valuations, earnings and capital flows change. Some of tomorrow's strongest opportunities may come from today's winners continuing to compound, while others may emerge from areas that investors have temporarily overlooked.

Finding those opportunities will depend less on predicting the next fashionable theme and more on identifying where sustainable earnings growth, strong financial returns and attractive valuations come together.

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Biography

Andrew Dalrymple | Director and Investment Manager

Andrew is Founder, Director and CIO at Aubrey, as well as being lead Investment Manager of the Global Emerging Markets and Global Equity strategies.

A graduate of Cambridge University, he began his career at Cazenove & Co then joined James Capel in 1987 and was transferred to James Capel (Far East) in Hong Kong in 1991. He continued in his role as an Asian specialist working with UBS Warburg from 1992-1998 in Hong Kong.

Andrew joined Stewart Ivory in 1998. In 1999 he established the First State Global Opportunities Fund, which remained his signature fund throughout his tenure at First State Investments. Since inception (August 1999) through June 2006 the fund rose 112.2% compared to a rise of 3.8% in the MSCI World Index. The Fund was top quartile over 1, 2, 3, 4, 5 years and since inception.

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