

DIAMOND HILL

INVESTED IN THE LONG RUN

Emerging Markets: A Selective Approach

Nov 2022

From an investment perspective, emerging markets can pose higher risks than those in developed markets, but they can also offer great long-term potential. Diamond Hill's International strategy uses a highly selective, company-by-company approach within emerging markets. We recently sat down with our international portfolio manager and analysts to ask their thoughts on investing in emerging markets today.

How does your team think about and invest in emerging markets?

Krishna Mohanraj, CFA: To start, using the phrase "emerging markets" paints a very broad picture. In the MSCI Emerging Markets Index, for example, there are 24 countries, and each country is so different. You have countries like Taiwan and South Korea with high per-capita incomes. You also have countries like Peru, Colombia and Turkey, which are in no way comparable to the former. So, we don't think about exposure to emerging markets as a broad group. Also, as bottom-up investors, we invest in companies, not countries. That said, we do pay attention to where companies operate and the risks associated with those geographies. In emerging markets, we pay a lot of attention to the political and social environments where a particular company's assets are held. That makes us extremely selective in certain geographies.

Today, within emerging markets, we have investments in a variety of places such as Poland, Peru, China, India, Taiwan and South Korea. We have also been spending quite a bit of time researching opportunities in Latin America – Mexico and Brazil, in particular, but also Chile, Columbia and Peru. We believe the outlook in the region over the next five years is relatively attractive. The region has some solid businesses with long histories, often trading at cheap prices. There are a lot of consumer companies in Latin America, and while it's not a high-end consumer base, it's one that is exposed to and used to inflation, even periods of hyperinflation. For example, London-based multinational consumer goods company Unilever has been able to increase prices and still retain volumes in the region because Latin American consumers are more used to inflationary periods versus developed regions like Europe where this is perhaps the first time many people are experiencing high inflation.



Yiting Liu, CFA
International Research Analyst



Krishna Mohanraj, CFA
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Chris Piel, CFA
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Chendhore Veerappan,
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Headlines in Latin America tend to get negative from time to time, and that creates opportunities for us. We are not just interested in winning markets. We also want to know what we are paying for in these markets. Depending on the opportunity and the valuations, we think Latin America could be an interesting place over the next five years.

In other countries, the political and social environments are simply too risky to get involved. Russia is a great example. Over the years, we've found some great businesses in Russia at good prices. But we've never invested because the regulatory risks seemed too high. As an example, Sberbank is the largest bank in Russia. It's well managed and has a strong deposit franchise. I used to be a banking analyst, and I've always been attracted to businesses with that kind of deposit franchise. But the political risk and the potential of what could happen over the course of a five-year period has deterred us. If we think the risk of cash flows disappearing over that five-year period is too high, we don't like to invest. In hindsight, it's been a good decision because it helped us avoid direct exposure to Russia in today's environment.

To summarize, emerging markets are always a mixed bag. There are a lot of great companies and a lot of opportunity. But country by country, we are always mindful of the political and social landscape. And we are highly selective on what price we would pay for some of these businesses, because as valuation-disciplined investors, price is a big part of our investment process.

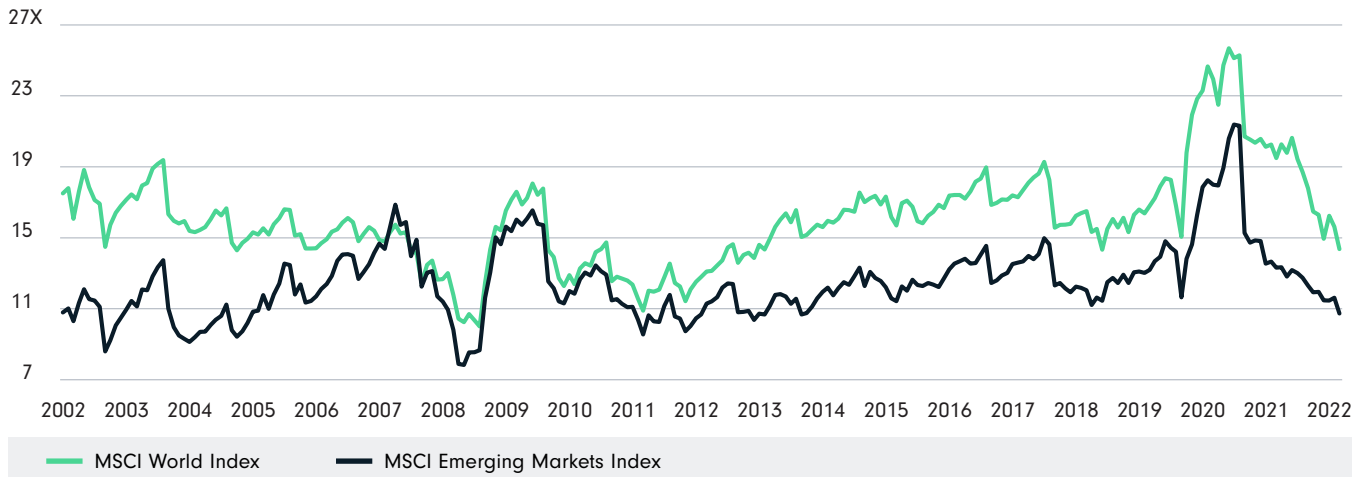
Chris Piel, CFA: There are benefits and risks to investing in emerging markets just like there are in any other market. Krishna mentioned some risks within emerging markets; in addition to those, you also have liquidity concerns, regulatory, political and corporate governance risks, as well as certain risks regarding minority shareholder rights in general in these markets. On the positive side, emerging markets have a lot of strong demographic tailwinds ahead of them, especially relative to some of the more developed markets. And the friction for foreign investors involved in allocating to these markets seems to be generally trending in a positive direction overall. Some markets also tend to be followed less closely by institutional investors whether due to size or liquidity constraints, or some other factor, which can result in attractive mispricing from time to time.

Overall, our goal is to identify businesses that we believe are high quality and trade at attractive prices relative to our estimates of intrinsic value regardless of where they are domiciled. We try to identify and price the potential risks of any investment effectively and then evaluate the potential reward relative to the risk. One of the ways we account for the heightened risks and uncertainties inherent in emerging markets is to require a wider margin of safety in order to consider an investment.

Where do you see opportunities within emerging markets today?

Yiting Liu, CFA: If you look at emerging markets as a whole, the asset class is trading at a meaningful discount from an equity valuation perspective compared to developed markets (Exhibit 1). So, from a purely statistical perspective, there are likely to be some interesting opportunities for valuation-disciplined investors like us within emerging markets.

Exhibit 1 — Price to Earnings FY1



Source: FactSet.

As bottom-up investors, we analyze the attractiveness of an individual company, not the country in which it is domiciled or headquartered. As long as the margin of safety is wide enough and we appropriately account for all the risks of a particular investment, then we would consider that company for a long-term investment. When looking for new investment ideas, we are market agnostic.

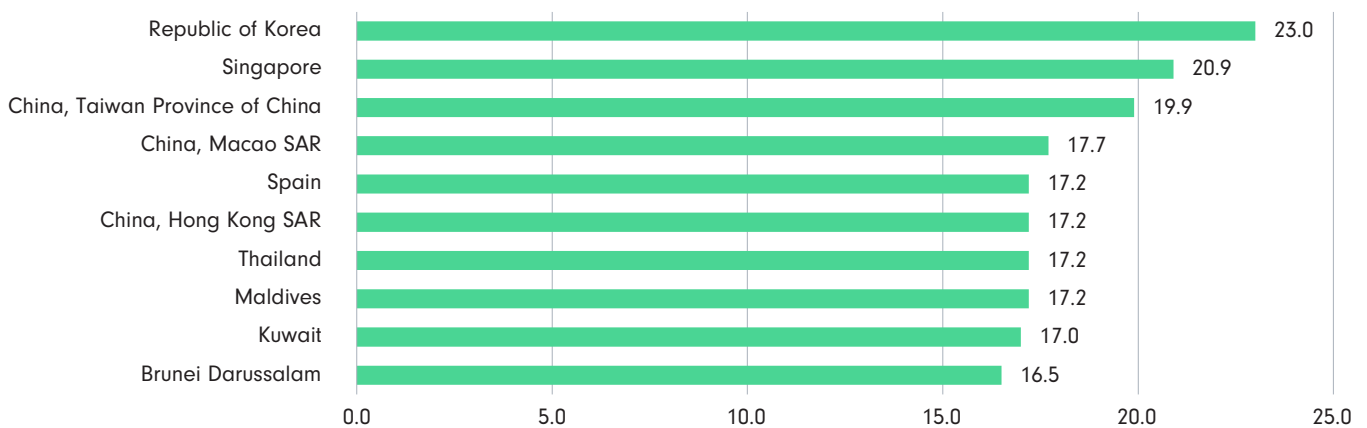
Chendhore Veerappan, PhD, CFA: Certainly, there can be pockets of overvaluation and undervaluation across the globe and in different markets and sectors. But the thing that excites me is the growth potential of a given end market. When I look at health care, for example, the ultimate need is enormous. Half the world’s population does not have access to health care services. The number of people who are going to be 65 years old and above is going to double in the next 25 to 30 years (Exhibit 2), and the countries with the largest expected increases are primarily emerging markets (Exhibit 3). This means emerging markets will need a lot more long-term and chronic care. You see a lot of these demographic shifts happening in emerging markets; meanwhile, they’re also getting wealthier. Now, the question is, are they going to be stuck in the middle-income trap, or are they going to continue to grow?

Exhibit 2 – Global Population Aged 65 Years or Over (MM)



Source: United Nations, *World Population Ageing 2019*.

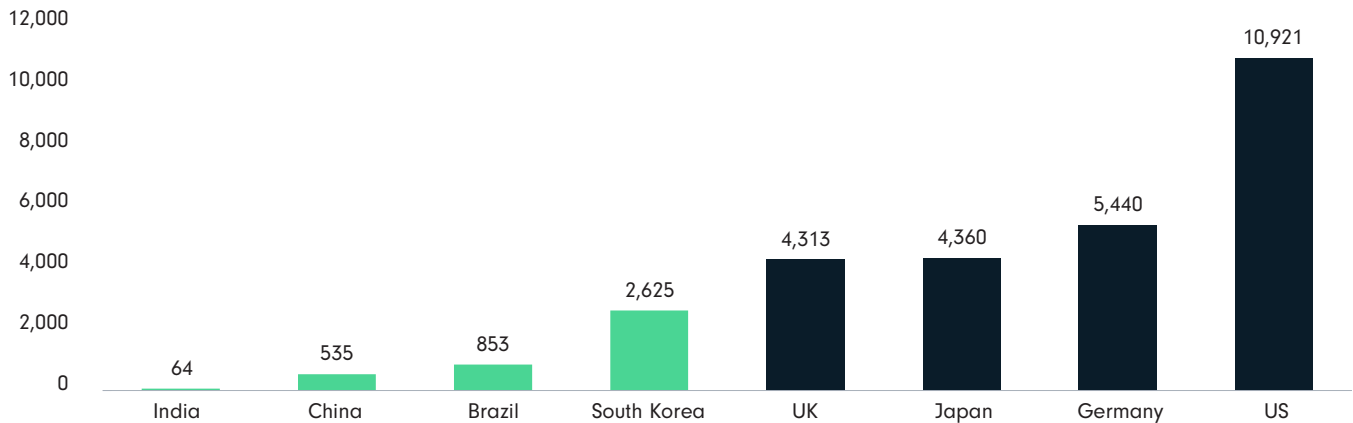
Exhibit 3 – Countries/Areas with Largest Percentage Increase in Share of Persons Aged 65 years or over between 2019 and 2050 (%)



Source: United Nations, *World Population Ageing 2019*.

Regardless, there is still so much unmet need that the end market growth, in my mind, in several emerging markets countries is very attractive. For example, China is currently the second largest health care market in the world. It's worth roughly \$1 trillion. To put that in perspective, the US health care market is approximately \$3.8 trillion, and the global market is over \$10 trillion. While China accounts for about 10% of the market today, with over a billion people, the country spent less than \$600 per patient per year in 2019. In the US, we spent over \$10,000. In Germany, they spent around \$5,000. In the UK and Japan, it's a little over \$4,000 (Exhibit 4). These expenditures have only intensified since the emergence of the COVID-19 pandemic and heightened awareness and utilization for health care services across the world.

Exhibit 4 – Health Care Expenditure Per Capita (USD)



Source: World Health Organization, data as of 2019.

So there remains a large difference in dollar terms of what is being spent on health care around the world. China's health care market is growing about mid- to high-single digits. But you also have stronger double-digit growth in countries like Brazil, India and Indonesia. There's tremendous opportunity to invest in quality companies that have the right technology and the right management that can allocate capital efficiently and grow with these markets over a long period of time.

I think in that regard, there are many opportunities in emerging markets. All we have to do is look at these companies from a bottom-up perspective, understanding the potential they have to grow into a much larger market over a period of time. In the US, we often think of health care as a mature, slower growth market. On the other side of the coin, some of these emerging markets are experiencing robust growth and demanding more health care services. Global health care companies are starting to look at emerging markets and invest in them as long-term growth opportunities.

Krishna Mohanraj, CFA: China is another super interesting situation because today the market offers an unusual combination of good companies and cheap prices, which we like. But we are also very mindful about political and regulatory risks. At the end of the day, there might be a great business in China, but we can't forget that it operates in an emerging market run by an autocratic government with no democratic input. So, when the operating environment changes, it can change fast without warning and the rug can get pulled out from underneath you too quickly for comfort. We've seen this over the years in China and that's why there's so much volatility in the market.

Right now, the Chinese economy is facing a lot of challenges. Growth has slowed down. Its zero-COVID policies are not helping. For the last two years, the Chinese government seems to be at war with businesses, forcing down regulations without warning. And looking ahead, geopolitics seems more complicated than it has been in the past.

Put that all together and it's no surprise that investor and consumer confidence is poor and that the Chinese equity market is in a pretty big bear market. Over the long run we are asking ourselves one question: Is Chinese domestic consumption going to be okay? From what we can see thus far, the answer is yes. But it's hard to say how long the debt recovery will take. Recent sales data from the large ecommerce players showed some resilience, but it's still a difficult environment in the short to medium term. We'll see what the future brings. There are a lot of negatives, but we also balance that with the fact that we are finding some dominant consumer franchises selling at rock bottom prices. We've been patient in our investments here and we're going to continue to be patient and always evaluate the changes in that market.

As of 30 September 2022, Diamond Hill owned shares of Unilever PLC.

MSCI Emerging Markets Index measures the performance of large- and mid-cap stocks across 24 emerging markets countries. **MSCI World Index** measures the performance of large- and mid-cap stocks across 23 developed markets countries. The indexes are unmanaged, market capitalization weighted, include net reinvested dividends, do not reflect fees or expenses (which would lower the return) and are not available for direct investment. Index data source: MSCI, Inc. See diamond-hill.com/disclosures for a full copy of the disclaimer.

Margin of safety is a principle of investing in which an investor only purchases securities when their market price is significantly below their intrinsic value. In other words, when the market price of a security is significantly below your estimation of its intrinsic value, the difference is the margin of safety.

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