Fidelity Emerging Markets

FEML's go-anywhere mandate and ability to short companies differentiate it from peers in the sector...

Update
23 August 2024

Overview

Managed by Nick Price and Chris Tennant, both seasoned emerging market investors, Fidelity Emerging Markets Limited (FEML) benefits from their extensive experience and intimate knowledge of the companies and management teams within the sector. The managers are afforded a full set of tools with which to create a highly active investment proposition with high alpha-generating potential. They employ a go-anywhere approach within emerging markets, and can also invest into frontier markets and make use of derivatives in multiple ways, most importantly to take up short positions in companies (see **Portfolio**).

Over the last 12 months to the end of July, the managers' stock selection within FEML's short book has been a key driver of performance. Notable contributions came from shorts in an Asian utility company and an Asian battery maker. On the long book side, a variety of different stocks have also contributed to returns, including Kazakhstan's Kaspi, which has a very strong market position across a number of categories including e-commerce and payments. TSMC's share price climbed due to rising demand for semiconductor chips, and MakeMyTrip.com, an Indian online travel agency, rallied due to the recovery in international travel (see **Performance**).

FEML's **Discount** has narrowed over the last 12 months, thanks to proactive measures by the board, including a robust buyback programme and a completed tender offer, along with improved performance. At the time of writing, FEML trades at a 11.8% discount, in line with its five-year average.

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Analyst's View

FEML's managers believe emerging markets are currently ripe with opportunities, propelled by long-term structural drivers and historically low valuations. They see opportunities across the sector, optimistic about countries like Poland, which they visited earlier this year, and Vietnam and Mexico, which they see as beneficiaries from the 'friendshoring and nearshoring' trend as businesses seek alternatives to China.

Whilst rates will likely remain structurally higher than they have done historically, the likelihood that rates have peaked mean they own a well-diversified list of financials companies that are not rate sensitive, for example those in the fintech space, as well as those poised to rally from falling rates, such as OTP Bank in Hungary.

A key strength of FEML, in our opinion, is its differentiated strategy, particularly its flexibility to take out both short and long positions, something that's unmatched in the AIC Emerging Markets sector. We think this flexibility is particularly valuable in the current environment, where higher rates and therefore the higher debt costs are likely to increase pressure on weaker companies. By shorting these vulnerable companies, FEML can generate genuinely differentiated sources of alpha, making it less dependent on market direction for returns.

Overall, FEML presents a highly differentiated investment proposition. Whilst it has faced some challenges, notably in 2022, the experience of its seasoned managers and the proven success of the managers' strategy over the long run make it a compelling option for investors seeking emerging market exposure. Even with a **Discount** in line with its five-year average, FEML remains attractive, in our view, particularly if its performance remains strong and the board continues its proactive approach, which could see the discount narrow further.

BULL
Extensive resources on the long and short side, including highly experienced managers
A well established, on-the-ground research team is an advantage with stock selection
Emerging market valuations look attractive versus developed markets

BEAR
Political risks remain present in many key emerging markets, such as China
A highly active approach can lead to underperformance when positions don't work
Poor economic news could lead to weaker appetite for emerging market equities

Portfolio

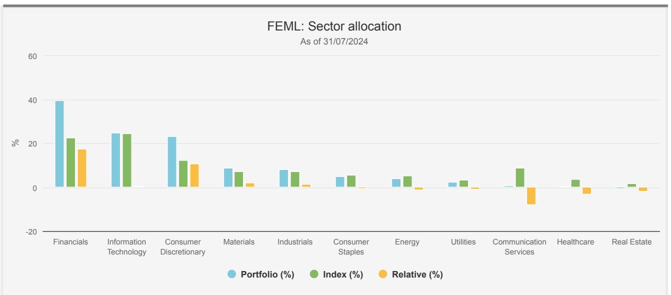
Emerging Asian countries, particularly China, India, and Taiwan are key components of emerging markets indices, but they also include fast-growing minnows outside of Asia that call Latin America or Europe home. Successfully navigating this vast universe requires a deep regional expertise, which, in our view, is where Fidelity Emerging Markets Limited (FEML) stands out.

Managed by Nick Price and Chris Tennant, both seasoned emerging market investors, FEML benefits from their extensive experience and intimate knowledge of the companies and management teams within the sector. FEML also has a large team of dedicated analysts on the ground, an advantage with stock selection, in our opinion. Having on-the-ground presence enhances their ability to maintain strong local connections, with regular access to company management teams, and a deeper understanding of the investment universe. Furthermore, the managers employ a truly active strategy, with a flexible, go-anywhere approach within emerging markets, seeking on- and off-benchmark stocks across each sector, market cap and geography, including frontier markets. They can also use derivatives to go long or short.

In the long book, the managers focus on investing in high quality companies that offer consistent returns and trade at compelling valuations. They are particularly interested in businesses with dominant franchises that are well positioned to capitalise on structural growth trends in developing markets. This is evident in their largest sector overweight, financials, although their stock selection is driven by individual company potential rather than a top-down allocation to countries or sectors.

The managers anticipate rates will come down from peak levels, informing their positioning in the financials sector, with holdings either not rate sensitive, for example fintech companies, or beneficiaries of falling rates, for example a bank held in Hungary, or an exchange in Brazil. They also invest in strong structural stories like Indian small-cap names such as Five Star Business Finance, which targets lower-income customers and benefits from a lack of competition. Another key position benefitting from structural drivers is National Bank of Greece, which is benefitting from improving asset quality in the Greek banking sector, but still trades on a very cheap valuation.

Fig.1: Sector Allocations

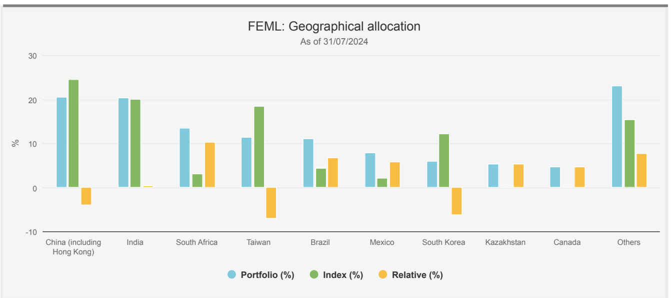


Source: Fidelity

Earlier this year, the team visited Poland, meeting with a number of companies to gain deeper insight into both new opportunities and existing holdings. This included a small-cap auto-parts distribution company, Auto Partner, an existing position in the portfolio. The managers believe it is an undiscovered gem within emerging markets, given only a few analysts cover the stock on the sell-side. It has grown steadily over time and is expanding its logistics footprint, aiming to grow in Western Europe.

The managers' extended toolkit also allows them to tap into structural growth drivers in smaller frontier markets like Vietnam. For instance, they hold a position in FPT, an IT services company benefitting from Vietnam's highly skilled, low-cost labour force. They also see Vietnam as a key beneficiary, over the next five years, from a diversification of supply chains away from China to some of the lower-cost regions in South East Asia. Similarly, the managers believe that Mexico is another economy set to benefit from the nearshoring trend. As companies in the US look to bring their manufacturing closer to home, they anticipate the shift could increase the demand for some of the portfolio's Mexican investments, including Grupo Aeroportuario del Pacifico.

Fig.2: Geographical Allocation



Source: Fidelity

Whilst remaining cautious, the managers are also seeing some green shoots in China. They note, for example, that the government has consciously shifted from deleveraging the property market to reflating it this year. They have actively adjusted their China exposure this year, adding positions like Anta Sports, to help diversify their exposure within the sportswear market. One of the ways they have increased exposure to China is by using the investment company's options book, which is a cost-effective way to take out insurance against a rally in the China market. Whilst the portfolio appears underweight to China, this must be viewed in the context of its Hong Kong holdings, which we've combined in the above chart, and also its investment in Naspers, a South African internet company, which has a large stake in Tencent and is held as a proxy for that company.

The managers also play China through FEML's short book, an aspect that we feel is unmatched in the emerging market sector. The short book includes companies that the managers believe have significant downside, often thanks to weak balance sheets, structural weaknesses in their business models or industries, or poor management teams – essentially the mirror image of their long positions. The managers have several short positions in Chinese EV makers, which they believe face challenges such as overcapacity, weak product cycles and fierce competition.

Whilst active short positions cannot be disclosed, the team highlight a good example of a now-closed short position in Microvast, a US-listed battery company with operations in China. The managers had a negative view on its battery-tech capabilities as well as observing its balance sheet was inappropriately structured and that it had too much leverage, with no way to refinance that debt. This inability to refinance its debt led to a significant drop in its share price.

In our view, FEML is well positioned to capitalise on the abundant structural growth trends in emerging markets. The managers' deep expertise and flexible go-anywhere approach, combined with the ability to short underperforming companies, provides a robust strategy that could deliver strong alpha in the current market environment.

Gearing

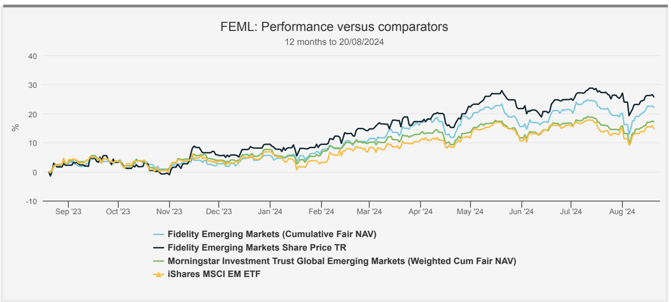
FEML can borrow up to 10% of NAV, though it currently has no arranged facility. Instead, effective gearing is taken through derivatives. Nick and Chris draw on the derivatives to express their views on a company or market, whether that be to gain additional market exposure or to seek a positive return from falling asset prices. The gross market exposure can be up to 165% of NAV and the net market exposure up to 120% of NAV, although, in normal market circumstances, it's expected that the managers will maintain net market exposure around 100%.

One of the key attractions of FEML, in our view, is the extended toolkit available to its managers. Being able to use derivatives in this way provides multiple potential sources of returns and can increase the potential for outperformance when multiple positions are working. That said, it can also increase risk when markets work against positions. As of the latest factsheet, FEML's net market exposure was 103.1%.

Performance

Over the 12 months to 20/08/2024, FEML performed strongly, with a NAV total return of 22.1%, significantly outperforming the MSCI Emerging Markets Index, which returned 14.7%. An ETF tracking the MSCI Emerging Market Index is shown below for comparison.

Fig.3: One-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

Overall, the last 12 months has been a very strong period for the trust, although China presented a headwind over 2023. Most of the portfolio's weakest performers over the period are Chinese positions, driven by weak consumption following its lacklustre economic reopening and property market pressures. Chinese consumer stocks like Li-Ning and China Mengniu Dairy were among the largest detractors over the period.

On the positive side, the managers' stock selection within FEML's short book has been a key driver of performance. Notable contributions came from shorts in an Asian utility company and an Asian battery maker. The managers were able to capitalise on specific weaknesses from each business – the former pivoting into an unrelated market in which it had no experience and the latter suffering from oversupply – validating the effectiveness of the strategy.

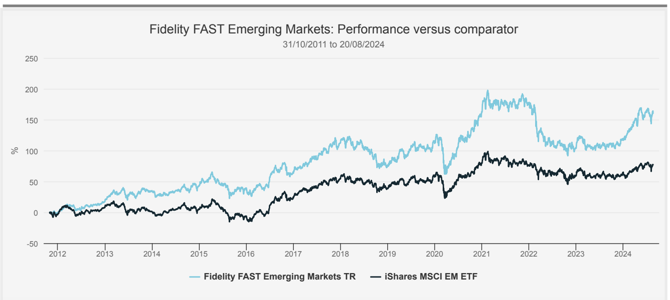
In the long book, several positions have performed well so far this year. Kazakhstan's Kaspi, which offers ecommerce, payments and fintech services, sits among the strongest performers. Its growing user base and its rapidly expanding e-grocery business have added to its impressive revenue growth since it launched in 2017.

Indian online travel agency MakeMyTrip.com was another strong performer, benefitting from a recovery in international travel. The team believe that the travel industry in India has huge scope for growth, and that MakeMyTrip, as the dominant operator in the market, should be a direct beneficiary of this. TSMC, a Taiwanese semiconductor manufacturer, has also continued to showcase strength this year, largely down to the increase in sales driven by rising demand for semiconductor chips. In the mid-cap space, Turkish airport operator TAV Havalimanlari also performed well, driven by improving sentiment towards the Turkish market. There was also a contribution from two Russian positions, where the managers took steps to reduce exposure when liquidity was available.

Conversely, there were a few positions outside of China that detracted from performance. Indian listed HDFC Bank saw its share price fall due to short-term concerns surrounding its recent merger. Additionally, Brazilian bank BTG Pactual declined due to weakness in the Brazilian market as expectations for the pace of rate cuts were pared back.

The strategy applied to FEML has been successful over the longer term. FEML's portfolio mirrors that of the open-ended Fidelity FAST Emerging Markets fund, managed by Nick since its launch in October 2011. From then to 20/08/2024, the fund has comfortably outperformed its benchmark, delivering a total return of 160.3% versus the 77.1% return from the MSCI Emerging Market Index. An ETF tracking the MSCI Emerging Market Index is shown below for comparison.

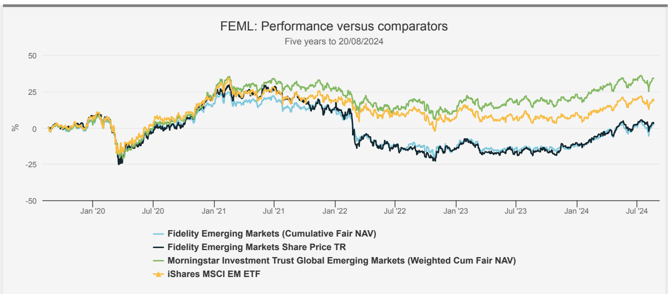
Fig.4: Performance Of Open-Ended Fund Since Launch



Source: Morningstar
Past performance is not a reliable indicator of future results.

Whilst FEML has demonstrated strong performance over the long term and has done well in the last 12 months, it has faced periods of underperformance, particularly in 2022. We've covered this in depth in previous notes, so we don't think there is too much to gain from covering old ground, but in short, underperformance was largely driven by the impact of the Russian invasion of Ukraine. At the time of the invasion, FEML was overweight Russia, which was compounded by the trust having an underweight exposure to the Middle East, which outperformed subsequent to the invasion.

Fig.5: Five-Year Performance



Source: Morningstar
Past performance is not a reliable indicator of future results.

Since Fidelity took over FEML in October 2021, the NAV total return has been -10.2% compared to a return of -0.6% for the index, impacted greatly by its underperformance in 2022. For completeness, we've included FEML's five-year performance below, although we note the period reflects an element of the performance of the previous strategy.

Dividend

FEML's stated dividend policy is to pay out substantially all of the net income received after expenses in a single dividend each year, meaning the dividend may vary, depending on the fortunes of the portfolio's underlying companies. Whilst some of the companies in the portfolio do generate some form of income, the managers, Nick and Chris, do not seek to achieve a particular level of income from the portfolio. Instead, their primary aim is to maximise capital growth over time using the investment process they've cultivated over the years, leveraging the extensive toolkit available to them. This means any dividend paid to shareholders is merely a by-product of the process.

In FEML's most recent half-year results, covering the six months to December 2023, the board announced a final dividend of 19 cents per share, an increase from the 16 cents announced at the end of 2022. This represents a dividend yield of around 2.2%, compared to 2.7% for the MSCI Emerging Markets Index, according to JPMorgan Cazenove. During the same period, revenue earnings per share decreased slightly from 9 cents to 6 cents.

FEML has substantial revenue reserves, roughly 2.5x the amount of the last annual dividend, and the board can also distribute capital reserves by way of a dividend, if it wishes. It's important to note that whilst the dividends are calculated in dollars, the company's functional currency in which its accounts are presented, they are paid to shareholders in sterling.

Management

Nick Price is FEML's lead portfolio manager and boasts over two decades of investment experience. He led the development of Fidelity's Emerging EMEA group, launching the team's first portfolio in 2005. The investment process that was cultivated there has been used consistently by the team ever since, forming the cornerstone of Fidelity's emerging market equity strategies. Nick has also employed the same strategy for the long/short Fidelity FAST Emerging Markets fund since 2011.

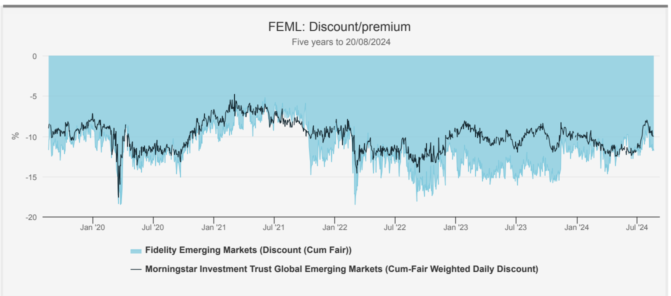
Alongside Nick, both FEML and Fidelity's FAST Emerging Markets fund benefit from the expertise of Chris Tennant. He has been with Fidelity for over a decade, working closely with Nick from the outset, and has spent time as a metals and mining analyst as well as a shorting analyst. He was appointed assistant portfolio manager on the Fidelity FAST Emerging Markets fund in July 2019 and was then promoted to co-manager on this fund, as well as the investment company, in 2021.

In our view, one of the key strengths of FEML as a proposition is the experience of the managers but also the significant resource available at Fidelity. Nick and Chris can draw on an effective team of around 50 analysts, who are devoted to analysing emerging markets. There is a team in London, as well as analysts embedded on the ground across emerging markets. Having a local presence brings regular access to company managements, as well as a close connection with domestic markets and a greater understanding of the companies in their investment universe. The team continue to value their trips overseas, with the latest occurring in April this year as they visited Poland and met with 16 companies. They believe these visits are crucial in capturing unique insights on the ground and allow them to assess all manner of opportunities and risks within each company they visit.

Discount

The chart below highlights the movements in FEML's discount over the last five years compared to the weighted average of the Morningstar Investment Trust Global Emerging Markets sector. From late 2021 to 2023, FEML's discount traded fairly consistently in the realm of mid-teens, peaking at 18.5% in March 2022, which was unusually high relative to its history. In our view, the widening of the discount can largely be attributed to the fallout from the Russian invasion of Ukraine, which led to a challenging performance period in 2022, and also reflects the general trend of widening discounts across the broader investment trust sector.

Fig.: Discount



Source: Morningstar

However, since that peak FEML's discount has narrowed materially, trading at 11.8% at the time of writing, in line with its five-year average. This marked reduction from its peak discount of 18.5% can be attributed to two main factors, in our opinion, starting with the proactive measures taken by FEML's board. On 13/11/2023 the board announced a share buyback programme, a decision we think has helped reduce FEML's discount, given shares have since risen more than the market.

In addition to this, two weeks later the board announced it would undertake a tender offer for up to 15% of the issued share capital, giving shareholders the option to receive NAV less costs of approximately 2% on up to 15% of their investment. The tender offer was approved and completed on 22/02/2024, with the board repurchasing 13,531,881 participating redeemable preference shares at a price of £7.4030 per share (NAV less 2%). The settlement of the tender offer occurred on 27/03/2024 and was distributed to shareholders who validly tendered shares shortly after.

The second reason behind the narrowing discount is FEML's strong recent relative performance, outperforming its benchmark by 7.3 percentage points over the last 12 months. Despite facing some challenges presented from their exposure to China (see **Performance**), several stocks in the portfolio have performed well, which we think highlights the managers' effective stock selection across the sector and the strength of FEML's differentiated strategy (see **Portfolio**). In turn, this has contributed to the discount narrowing back to its five-year average, at the time of writing.

We think a combination of this hefty package of measures and recent strong performance should support the rating in the near term and these actions signal that the board is committed to seeing the discount narrow on a sustainable basis. Since the tender offer, it has continued to buy back shares, repurchasing an additional 3,567,727 shares, or 4.9% of the issued share capital, up to 20/08/2024.

Charges

FEML's latest ongoing charges figure (OCF) of 0.81% is the lowest in the AIC Global Emerging Markets sector, well below the 1.04% weighted average. This includes an annual management fee of 0.6%, allocated 20% to revenue and 80% to capital. We think that an OCF of 0.81% is very attractive and given its differentiated strategy (see **Portfolio**) and strong long-term **Performance** profile, makes FEML a compelling option for investors seeking emerging market exposure. There is also no performance fee payable.

The latest KID RIY is 2.85%, higher than the sector's weighted average of 1.45%, according to JPMorgan Cazenove. However, we would caution that calculation methodologies can vary.

ESG

Environmental, social and governance (ESG) integration is carried out at the fundamental research analyst level within each investment team. This is primarily through the implementation of the proprietary Fidelity sustainability rating, which considers not only the current practices of a company, but also its trajectory. Assessments consider the sector, country and company specifics of the stock in question, with it being scored on ESG factors. In addition to Fidelity's sustainability ratings, the firm draws on its proprietary climate rating, assessing which companies are in the best position to transition to net zero, or have a positive trajectory towards transition.

Engagement with companies is another crucial part of the process. Fidelity has a dedicated Sustainable Investing Team, who work closely with the investment teams, and who are responsible for consolidating Fidelity's approach to stewardship, engagement, ESG integration and the exercise of its votes at general meetings.

Morningstar scores FEML two out of five globes for sustainability, considering both open- and closed-ended funds in the Global Emerging Markets equity sector.

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