

The Skerryvore Global Emerging Markets Equity Strategies

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Transcript

Introduction

Hello there, I'm Glen Finegan, a founding partner at Skerryvore Asset Management.

Skerryvore Asset Management is an independent investment management boutique, based here in Edinburgh, and it specialises in global emerging market equities.

Why Skerryvore?

It's called Skerryvore because we named it after the tallest lighthouse off the west coast of Scotland and we quite like the image of a lighthouse which helps you navigate safely in treacherous waters – our investment philosophy has been pretty good at that if you accept the premise that emerging markets can be treacherous waters.

Our investment philosophy has been pretty good at navigating and generating better longer term returns from the asset class than perhaps the wider peer group or index suggests would have been possible.

Why invest in the emerging world?

Emerging markets, whilst not having been a great investment for people over really quite a long period, probably over a decade now, do provide a very interesting and very broad and varied opportunity set for investors – I think there are two things to set out:

We'll start with the positives – most of the people in the world live in emerging markets – there are some very interesting, positive demographic stories, whether it's Indian subcontinent, or Africa, Latin America, there are some very interesting, strong demographic tailwinds that exist in emerging markets. Of course, there are other parts of the emerging markets where demographics are a big challenge such as China, as we all know it has an aging population – but I think if one is very selective then emerging markets present a very interesting opportunity set, a very broad, varied opportunity set for investors to look at thousands of companies and narrow down a universe of names that might enable you to generate decent long-term returns.

I think on the negative side – the emerging markets have been a challenging place – certainly if you look at the index or what have you – it's been a challenging place to generate good absolute returns. To my mind, or to our mind anyway, that's largely been a governance issue that relates to the challenge that comes with investing in emerging markets which is, in many cases, relatively 'weak or emerging rule of law' situations and poor governance ultimately that comes from that. If you think about a pretty obvious recent example – a total loss in Russia – where I think investors owning equities they were turning a blind eye to quite open poor governance and a lack of alignment between themselves as a minority shareholder and the underlying people in control of the companies and have paid the price. Correcting the exciting emerging market universe for poor governance is a very important part of how one goes about generating decent long-term returns from the asset class.

What is your investment philosophy?

Our investment philosophy hinges on the belief that compromising on alignment in emerging markets is extremely foolhardy. Therefore, we put this at the forefront of everything that we do. Well governed, well-aligned management teams with strong franchises i.e. high-quality businesses form the absolute core of our investment universe, and we try to bring this into a portfolio by applying a very strict absolute return valuation discipline – some people might call this *Quality At A Reasonable Price*.

Why does alignment matter?

Getting the alignment piece of any investment decision right is absolutely crucial – there is a very large portion of the emerging markets universe that ultimately doesn't exist to generate returns for us, and what are we, we are foreign minority shareholders with limited ability to take or to demand legal recourse if things don't work out so there is a very large portion of the universe that is simply un-investable from an alignment perspective – whether that's the governance challenges in Russia or listed ministries ultimately in things like State controlled oil companies in Brazil or State controlled banks in China – these are extensions of government which simply don't exist to generate returns for you or us as foreign minority shareholders.

Why is the index a poor guide to returns?

So, the emerging market index has failed to provide acceptable returns to investors for over at least a decade now, perhaps a bit longer. Why is this – I think it is mostly because the index is a very poor representation of the genuine opportunity set that exists in emerging markets. The index is hijacked by very large companies many of which exhibit poor standards of alignment – many of these are state controlled enterprise, many of these are very politically connected type groups where one might have concerns about standards of governance and certainly alignment with you as a minority shareholder. So, I think for one to set out to make acceptable returns from the asset class one needs to disregard the index all together and look bottom up for the best quality companies run by the most aligned individuals.

How do you find emerging market leaders?

So, we have spent over 20 years travelling around, really 25 years now, travelling around the emerging markets universe, or the developing countries in the world, trying to build a watchlist or an investment universe of companies where we don't feel you are going to be exposed to any possible risk of a governance failure and therefore some sort of total capital loss. What are we looking for? Generally speaking, long histories of acting in the interests of all stakeholders, so all of our work on any new idea, it always starts with who are the people behind the business, and ultimately studying history more than maybe thinking about the future and trying to forecast the future – it's looking for evidence of acting in the interests of all stakeholders and by doing that you do manage to exclude many of the businesses which both have in the past and are probably are maybe likely in the future to be a problem from a governance perspective.

How do you find new companies?

We travel a lot around the emerging markets. We meet hundreds of companies every year and we also obviously have this bank of businesses that we have identified over a long period of time, and we regularly look to them for endorsements on new ideas so if an existing business that we admire is forming a joint venture with a new one that we haven't heard of before then we'll go and look at it. Or

if they talk in glowing terms of a supplier in China, we'll go and look at it. So, we do quite often take a steer from companies that we have already built a lot of respect in.

Describe the investment process – what are the four lines of defence?

Thinking about the investment process – it is very much about trying to filter what is a very large universe down into a manageable investment universe and then into a portfolio that we believe can meet our absolute required returns. We are really trying to answer two questions – is it a quality business? And then is it available at a reasonable price? So, in order to build our watchlist, or our investment universe, where we believe we currently have around 350 companies that we have identified over many years travelling around emerging markets, we try to protect our watchlist using 4 lines of defence.

The first line of defence is about people and governance and the study of history – trying to establish integrity – and if you can't get to a satisfactory conclusion then an idea finishes there it doesn't get through that line of defence.

The second line of defence is around franchise strength and the sort of inflation protective nature of the business – can it grow in real terms? Because obviously we are hard currency investors so buying regulated utilities when you don't believe the government will let them put prices up if inflation picks up – that doesn't make sense for us. We are looking for companies in control of their own pricing power. Where there is evidence that they have been able to beat inflation in previous devaluations. So, franchise strength is the second line of defence. So, we come across lots of well-governed businesses where ultimately, we just don't have confidence in their pricing power, and they fall down at that second line of defence.

The third line of defence is really about the risk appetite of the people behind the company. Honest people can still be very risky just because they have a high-risk appetite, and we sort of talk about that more in terms of balance sheet. So we want companies that are run by people who won't risk the balance sheet and therefore a large number of the companies that we invest in actually have no debt because they don't need to juice up their returns using debt because they think more like longer term owners and they have a risk appetite more in line with our own – so that third line of defence is around sort of balance sheet strength and cash flow generation.

And then finally we think about – is the business behaving sustainably. And where we come across businesses where there is evidence of environmental arbitrage, labour arbitrage, those types of companies – it almost comes full circle, it comes back to you questioning the integrity of the people who you would be invested alongside in the first place.

So for a business to move from an idea into our watchlist it needs to move through these 4 clear lines of defence and we have a very experienced team who are involved in challenging one another on each of those pieces of any new idea.

How does a business on the watchlist make it into the portfolio?

Well really that's about valuations and it's about our mandate or what we set out to do which is to generate absolute returns from the asset class and we have always, well for over nearly two decades now, we've sort of set ourselves an absolute return hurdle of 10-12% in hard currency terms, in US dollar terms.

What businesses do you like to invest in?

What businesses do we like to invest in – we are looking for businesses that are beneficiaries of the exciting longer term structural demographic tail winds that exist in some emerging markets, so we do own a number of branded consumer goods type businesses, such as soft drinks bottling operations in countries where consumption per capita remains low and populations are growing quickly; convenience retail operators who are able to roll out stores into very underpenetrated markets – things like that. What do we like about those sorts of businesses? Well not only have they got a nice long term demographic tailwind behind them that means you can believe they will grow, they also have strong pricing power, and I think that's a key part – obviously we put alignment and integrity of the people behind the businesses first but the second thing we are considering is whether or not a franchise has pricing power.

We also like businesses that generate intellectual property - inventing things, investing in R&D is another way of maintaining pricing power and you know whether you are a global leading microchip manufacturing business or a leading business out of Brazil that manufactures electric motors - what would give us confidence to own companies like that would be their continuous reinvestment in research and development. That gives you confidence that they have pricing power.

Finally, or a final piece when it comes to picking individual companies for us, it is also about balance sheet strength. You know EM economies have been somewhat crisis prone – and why add to a risky environment by owning risky balance sheets?

What companies do you avoid?

Thinking about businesses that we avoid – clear examples of misalignment or kind of wrongdoing. So, whether that's businesses that built openly on bribing politicians in order to win government contracts – there's plenty of those around emerging markets – we are just not interested in those types of business models. State controlled enterprise where the government is ultimately directing capital allocation. We are here to generate returns for our clients and emerging market governments have a completely different sort of set of priorities and they tend not to be aligned with one another, so we'd steer clear of those normally. In terms of business franchises that we tend to avoid, it would be those that lack pricing power. Beating inflation is an important part of generating decent returns from emerging markets and businesses that are not in control of their own price setting or essentially in control of their own destiny would not be of interest to us.

What can investors expect from the strategies?

This valuation discipline and focus on quality means that the returns have been delivered in quite a different way to the general asset class in that we have quite often underperformed frothy markets where valuation becomes less important, momentum is the main driver, we tend to underperform. We are exiting businesses where we think valuations are too high and we are maybe moving into less popular parts of the market and similarly and more positively perhaps, when markets have experienced big selloffs, we've tended to do very well. And it's been that downside protection, long term compounding approach that has enabled us to deliver superior returns to the asset class.

What is the most valuable lesson you've learned in over 20 years of investing?

It's about not compromising – being willing to take the pain, in the sense that, there have been periods over my career where you know momentum rules and the riskier the business then more in favour it is with investors – and you just have to be prepared to underperform and explain to clients why you are doing what you are doing and why you think it is their best long term interests.

Thank you

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