GUARDCAP

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**GuardCap Emerging Markets Equity Fund**

To our investors,

The team at GuardCap has been managing emerging markets equities in a variety of investment vehicles for a number of years. 2021 marks the fifth full calendar year for the UCITS version of our emerging markets equity strategy. Since 2017, we have written to our unitholders and published this letter on our website for others who are interested.

**2021 in review**

While 2020 was a year of huge change, as the world embraced digital technologies to overcome the physical constraints of the pandemic, 2021 has demonstrated how the sudden restarting of physical activity creates considerable challenges of its own.

It was a year characterised by a huge cyclical upswing in demand amid significant supply-side bottlenecks. These bottlenecks have appeared throughout the global supply chain: shortages of container ships, shortages of semiconductors, shortages of long-distance lorry drivers and shortages of restaurant staff, to name a few. Given the inter-connected nature of the chain, one shortage typically begets another. The knock-on effects have rippled upstream and downstream. This has resulted in surging prices for many of the items that are in short supply, including the commodities that underpin the global economy such as oil, copper and corn.

In addition to this, we have seen a renewed regulatory focus on those businesses that benefited the most from the pandemic, especially in China. The leading Chinese digital companies all had a very good 2020, recording double-digit revenue growth (and in some cases triple-digit growth), at a time when China's GDP only grew by 2%. However, some of the Chinese government's recent regulatory actions can be seen as redressing the balance somewhat, now that the pandemic is passing.

Whereas the health crisis placed physical restrictions on activity and certain businesses were better placed than others to navigate these challenges, the recovery of 2021 has been a stark reminder of the resource and regulatory constraints that can limit growth at both the macroeconomic and company level. If 2020 offered a glimpse of what is possible, then 2021 was a reminder of what is practical.

**An unusual period in economic history**

It is important to remember that the last two years of economic activity have been extraordinary. The pendulum has swung from one extreme to the other, from a record global recession to an unprecedented global economic recovery. In the US, for example, the -3.4% annual real GDP contraction in 2020 was worse than the -2.6% contraction in 2009, during the global financial crisis. The recovery in 2021, expected to be 5.5%, is the highest US annual growth rate since 1984. The quarterly fluctuations in GDP over the period look even more unusual from a historical perspective.

In 2020, it was the asset light, digital-led companies that thrived during a lockdown when physical activity was limited. In 2021, some of the biggest beneficiaries were the owners of physical assets that were in short supply and have seen their prices rise as a consequence. How long this widespread commodity inflation will last is uncertain, but we doubt that it is sustainable. For most commodities, given time, either supply constraints will be resolved or demand will subside such that imbalances dissipate and prices correct.

**Sustainable growth businesses in emerging markets**

Our focus remains on those industries and companies that can sustain their growth through the cycle. This typically requires structural growth in demand for their goods and services.

***TSMC***

CC Wei, CEO of TSMC, the world's largest semiconductor manufacturer and a portfolio holding, explained how and why the underlying growth trends for semiconductors are structural in nature.

*"We are entering a period of higher structural growth. The multiyear mega trend of 5G and HPC related applications are expected to fuel massive requirement for computation power and prepare greater need of energy-efficient computing, which demand the use of leading edge technologies. This mega trend will not only spur unit growth, but also drive increasing semiconductor content in HPC, smartphone, automotive and IoT applications"* (CC Wei, CEO, TSMC, October 2021).

He also acknowledged that there are "*short-term imbalances due to interruptions in the supply chain brought about by COVID-19"* and there is a possibility of an inventory correction as the imbalances are ironed out. Yet any correction, should it occur, "*could be less volatile for TSMC than previous downturn[s]"* because of the underlying structural strength of demand.

TSMC's CFO, Wendell Huang, noted that the company needs to invest alongside its customers to "*capture the growth*". It is certainly doing this. TSMC spent $30bn on capital expenditures in 2021, increasing capital intensity from 38% of sales in 2020 to more than 50% in 2021, and have budgeted to spend upwards of $40bn in 2022. It innovates extensively, spending almost $5bn on R&D in 2021.

TSMC expects to be able to manufacture chips at 3 nanometer nodes in 2022, the first in the industry to start production at this node. In practical terms, their technology advances mean that TSMC's products support their customers' devices with faster speeds, greater processing power and lower power requirements.

All this investment widens TSMC's moat and reinforces their competitive position. It is difficult for others - with the exception of a few companies such as Samsung - to compete with such huge scale and technological skill.

***Tencent***

Tencent, which has been at the forefront of digital development in China and beyond, is another portfolio holding that has been investing and innovating at a terrific rate to broaden and strengthen its competitive advantages.

The company started out in 1998 as an instant messaging and gaming business on PCs. Thanks to relentless investment into its business over 20 years, along with an incredible ability to evolve and grow, it has morphed into a digital giant, with 1.2bn users of WeChat and $75bn+ in annual revenues. The company's President, Martin Lau, outlined their approach to innovation in a call last year:

*"With a focus on user experience, we pursue continuous innovation to enhance our platforms. We invest in incremental innovation to enrich existing product experiences and we also invested in transformative innovation and to create new products to certain new user needs. Many of these innovations have taken years of patient investment to yield results."* (Martin Lau, President, Tencent Holdings Ltd., March 2021).

Tencent's revenues have been growing at more than 20%, despite its huge scale, as it adds on more and more products and services for its sticky and loyal users and expands into new areas such as cloud and e-commerce. The pace of innovation at scale in China from companies such as Tencent, exceeds most of what we see elsewhere in the world. We think that is hugely positive for the future.

At the same time, Tencent management have invested the company's cash flows into a portfolio of public and private investments, estimated to be worth well in excess of $100bn. Lau has described their approach to investing, noting that they have built an *"ecosystem"* to support *"innovative companies via capital investment and business partnerships to better serve users and enterprises."*

*"Our investment principles are to invest in high-quality management teams and best-in-class companies which have deep industry know-how and core competence in their respective fields. We aim to support the investees' innovation while enabling them to grow and operate independently."* (Martin Lau, President, Tencent Holdings Ltd., March 2021).

It is difficult to argue with their approach and the success it has yielded. Tencent has innovated and invested to create long-term competitive advantages and this has helped to generate sustainable growth and profit potential.

**Regulation, regulation, regulation**

It is understandable that ongoing efforts such as these to innovate and invest can get overlooked amidst a barrage of news about new regulations in China. Leading companies, both inside and outside of China, need to navigate regulatory challenges in order to maintain and build their competitive strengths. This is not a new development; it has been the case for many years, especially so in China, but that is not to say that navigating these challenges is straightforward.

Regulatory intensity in China has increased markedly over the last 12 months. It is not unusual to see these periods of increased regulatory focus, often as regulators seek to catch up with innovation in the private sector. A similar episode occurred in China in 2018, albeit less extensive, with new regulations targeting sectors such as healthcare and online gaming.

The developments in 2021 were a reminder that China's regulatory decision-making framework is very different to that in most western countries. Policy decisions are not consulted upon widely and the methods of implementing policies vary. This can mean that policy changes are difficult to predict and sometimes the rationale for new policies can be unclear. The sweeping crackdown on privately-run, after-school tutoring services last year was one such example. Other recent policy actions have been more conventional, with the regulatory rationale seeming sensible. The decision to sanction Alibaba for anti-competitive practices or the decision to require Meituan and other online platforms to protect basic labour rights for their delivery riders are examples.

Ongoing geopolitical disputes between China and the US have also caused strains. The SEC has threatened to delist foreign companies that do not allow US regulators to scrutinise their accounts. Chinese regulators, who failed to block the US IPO of ride-hailing app Didi, have instructed the company to delist from the NYSE, with the company planning a Hong Kong listing. In this regard, all the US-listed Chinese companies owned by the Fund have established another listing in Hong Kong and the two lines of stock are fungible, making it relatively straightforward to switch between them.

There is no certainty as to how future regulations or political relations will develop, and these are some of the ongoing risks that investors have to manage. Through all of this, we are reminded that a company's practices need to stand up to scrutiny and should be consistent with the creation of long-term value in order for their growth to be sustainable, both in China and elsewhere in the world. If history is any guide, there will be a point in time when the regulatory headwinds recede and the focus returns to the underlying quality of businesses such as Tencent and Alibaba, along with the growth opportunities that lie ahead of them.

**2021 performance**

For the twelve months to 31 December 2021, the GuardCap Emerging Markets (UCITS) Fund USD I Share Class returned -11.0%. This compares to a return of -2.5% for the MSCI Emerging Markets Index. Since inception, the USD I Share Class of the Fund has produced an annualised return of +9.9%, compared to an index return of +10.2%.

Part of the Fund's underperformance in 2021 is a reversal of the outperformance in 2020. For the two years since the end of 2019, the Fund's return (+16.6%) is approximately in line with the Index return (+15.3%). As we have written before, the annual returns from the Fund will inevitably follow a different pattern from those of the Index, depending on the annual progress of earnings at our companies and whatever happens to be in fashion - or out of fashion - at any point in time. Over the course of many years, however, we expect the earnings of our companies - in aggregate - to march higher, comfortably outgrowing the average and affording better investment returns than the Index.

Returning to the indices, it is notable that the returns from the MSCI Emerging Markets Index (-2.5%) lagged those from the MSCI World Index (+21.8%) by almost 25 percentage points in 2021, the largest annual performance differential since 2013. Five-year annualised returns from the MSCI Emerging Markets Index (+9.9%) are now well behind the equivalent returns from the MSCI World Index (+15.0%), having been ahead at the end of 2020. The gap is even larger over 10 years, with the annualised returns from the MSCI World Index (+12.7%) far ahead of those from the MSCI Emerging Markets Index (+5.5%). If you go back 20 years to 2001, the last time that there was a deflating technology bubble in mature markets, the annualised returns from emerging markets (+9.6%) are ahead of those from developed markets (+8.1%).

Emerging markets indices are very different to our portfolio, with 1,420 constituents included in MSCI's version as of the end of 2021. This is more than 50 times the number in the Fund, which ended the year with investments in 26 different companies. We look for companies that enjoy above-average growth because they sell into emerging markets or have a competitive advantage because they are located in emerging markets, regardless of whether or not they are in an index.

Of the Fund's NAV at the end of the year, approximately 60% was invested in companies that are represented in the MSCI Emerging Markets Index, 38% was in companies that are not represented in the Index, with the remainder in cash. Considering the portion invested in non-index companies, approximately 5% was invested in HDFC Bank, which is India's largest private sector bank but is not included in the Index. In addition, MercadoLibre - Latin America's largest e-commerce company and one of the largest positions in the Fund – is classified as a developed market company.

**A small number of investments benefiting from the emerging markets opportunity**

Our experiences in 2021 remind us somewhat of 2018, which is the last time that the Fund had an extended period of negative returns and underperformance compared to the benchmark. Long-term performance is, however, what we focus on. The first five full calendar years for the UCITS fund have delivered annualised returns of 9.7% (in US dollar terms) for our investors.

We have learnt a lot over this five-year period and believe that we are better investors for it. We hold firm to the view that investing for the long term in a small number of excellent businesses is a sensible approach to the emerging markets opportunity. Buying the shares of these companies when they are out of favour is usually the right thing to do. We trust that time will prove us right.

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