JPMorgan Emerging Markets

Update
21 December 2018

Summary

JPMorgan Emerging Markets (JMG) aims to maximise total returns by investing in emerging market equities with a long-term, low turnover approach.

The manager, Austin Forey, has been in place since 1994 and so has vast experience in the region. His portfolio is concentrated in consumer names, financials and technology, selected on a bottom-up basis rather than for sector or country reasons.

The trust has been a consistent outperformer in rising and falling markets, beating its benchmark index in NAV total return terms in seven of the past ten years.

It has also generated steady dividend growth and aims to grow its dividend each year in lie with earnings; the yield is 1.5%.

The trust's shares are trading around 12% below NAV, and the board has been active in buying back shares to try and bring this below 10%.

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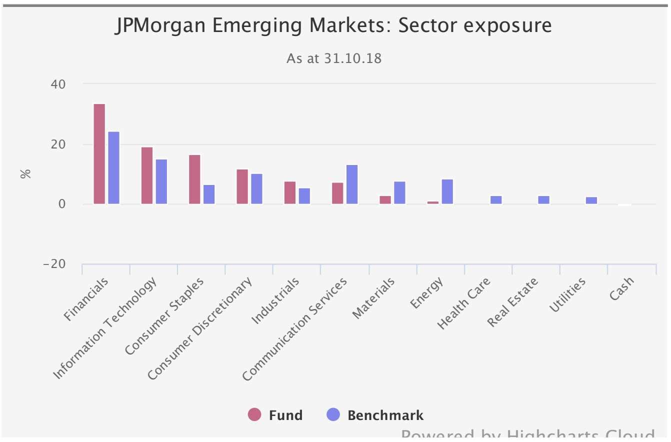
Portfolio

JPMorgan Emerging Markets aims to maximise total returns by investing in emerging market equities. The manager, Austin Forey, has managed this trust since 1994, and has refined his approach through multiple market cycles. He aims to pick well-governed companies with good competitive positions and hold them for the long run. According to Morningstar data, the turnover of the portfolio over the past three completed years (to end 2017) averaged just 10%, consistent with a holding period of 10 years.

Fig.1: Sector Allocation



Source: Morningstar

The portfolio, currently at the lower end of its three-year range of 60 to 70 stocks, has come to be concentrated in three areas: consumer stocks, financials and technology. The data shows us that all three areas are overweights versus the benchmark at the present time, but Austin tells us this is a long-term bias that has developed due to the shape of the market and where he sees the best opportunities over a multi-year view.

Austin and the team of close to 100 investment professionals, including nearly 40 sector analysts spread around the globe, aim to find businesses which can consistently grow their market share over time, which might be of a new market they are developing. For example, the trust has held TSMC for twenty years. This company entered a marketplace in which chips were manufactured by the users but has grown to become a global titan in production of chips for external customers.

Another top ten holding is HK insurer AIA, which the trust has owned since it IPO-ed in 2010. This stock illustrates how Austin looks at price and momentum well. The stock has made strong returns since launch, but justified those gains with earnings growth, therefore the manager has held on to it even when it has seen depreciations. Over five years, the share price has grown by 11% a year but the earnings per share has grown by 15% a year.

The aim is to hold companies for as long as their competitive advantages persist and not be swayed by short-term stock price movements, even if these are severe. For example, the manager has held on to Chinese tech titans Alibaba and Tencent this year after they sold off significantly. Both should be little affected by trade wars, which is the spark to have set the region's markets on a slide this year.

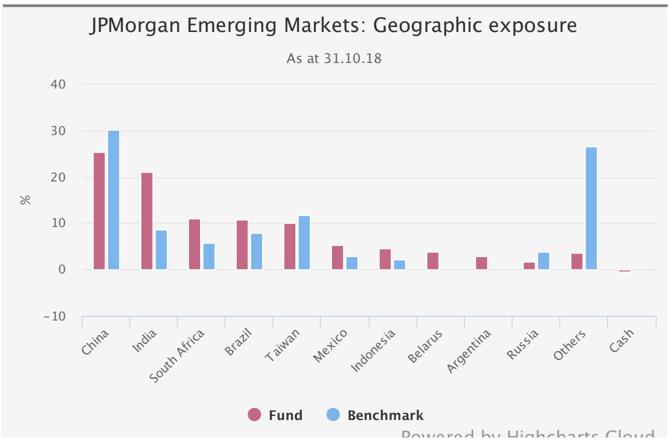
In fact, volatile markets like the current ones at end 2018 are advantageous for investors with a long-term view, in Austin's opinion, as they shake out the weak competitors from industries. Those that survive the tough times tend to be the strongest companies and they are in a better position to earn an even larger market share in the coming expansion. Austin believes that he cannot predict macro-economic events but he can make a decent fist of predicting company growth rates and which will be the winners.

Another advantage of taking a low turnover style is it reduces the insidious erosion of returns from trading costs which can have a serious effect on long-term returns.

The trust has had a significant overweight to India for many years. This reflects the quality of the individual companies rather than any view on the country, except insofar as some of the holdings are beneficiaries of a demographic tailwind, such as ITC and Supreme Industries.

Austin also has a significant position in the private banks, a sector which he has watched develop since the 1990s. In the '70s, India nationalised the banking system. Then, in the 1990s, the sector was liberalised, with new banks allowed to set up. These banks have brought modern practises to an archaic industry, and thus proven adept at growing market share. Austin holds Housing Development Finance and IndusInd Bank. They also have significant advantages over their state-dominated peers in bringing new technology to the sector. This story is similar for the largest holding in Brazil, Itau Unibanco.

Fig.2: Geographic Allocation



Source: JPMorgan

Given the focus on company fundamentals rather than macro-economics, the current political instability in India is not likely to lead to any changes in the portfolio. Although Modi's grip on power is weakening, Austin believes that his companies' multi-year prospects are little-changed. In fact, the weakening of the rupee this year has been a beneficiary for the tech offshoring companies the trust owns – Tata Consultancy Services and Infosys.

The trust has tended to be underweight China, although it has highly significant single stock positions. Tencent, Alibaba, AIA and Ping An are all top ten holdings. Austin says the opening-up of the China A-Shares market could offer some interesting opportunities in the fullness of time, but that market is currently too expensive following a strong period of growth.

Although the focus is on growth, valuation is important when it comes to taking up a position. This is not a value fund, so the trust will take up positions if the price is only "reasonable" rather than insisting on a bargain, if the business is exceptional. There is more leeway given to valuations once a position has been taken up as Austin does not aim to trade in and out of positions. As long as the company can continue to compound the value in the business and has a competitive advantage, the bias is to run the winners, which gives rise to an exposure to the momentum factor. This translates into a tendency to underperform when market directionality changes, although outperformance has been consistent on an annual basis thanks to steady relative gains in trending markets.

Given the focus on long-termism and low turnover, it is rare for the trust to pick up new stocks. Austin and the team may follow a company for years before pulling the trigger if the valuation is not acceptable to them or the time otherwise not right. In recent years, the trust has made two new acquisitions in the IT space: Globant in Argentina and EPAM in Belarus, both below $10bn in market cap, which puts them in the smaller end of the universe. Both do more cutting-edge software development than the Indian outsourcers with more of a focus on consumer experience through apps and in new technologies such as driverless cars. As such, they could be the mega-caps of tomorrow on their current trajectory.

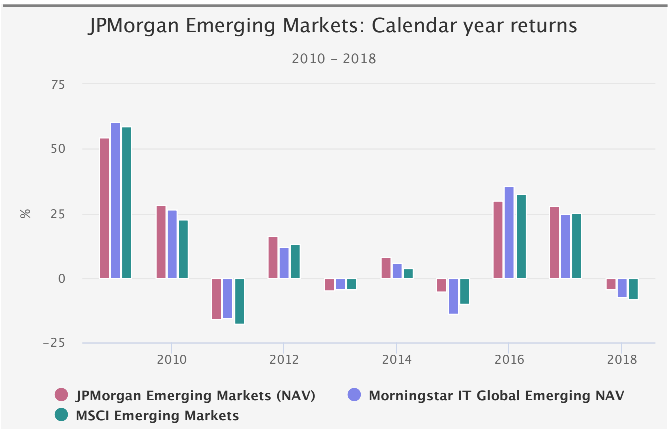
Gearing

In theory, the trust can borrow up to 20% of NAV, although in practice it has not used gearing for many years.

Returns

The performance of this trust has been remarkably consistent over the past decade. It has outperformed in NAV TR terms in seven out of the past ten years. Two of the years of underperformance were 2009 and 2016, when the region saw sharp, indiscriminate rallies. The trust beat the market in the up-years of 2010, 2012, 2014 and 2917, as well as outperforming in the down years of 2011, 2015 and 2018.

Fig.3: Returns

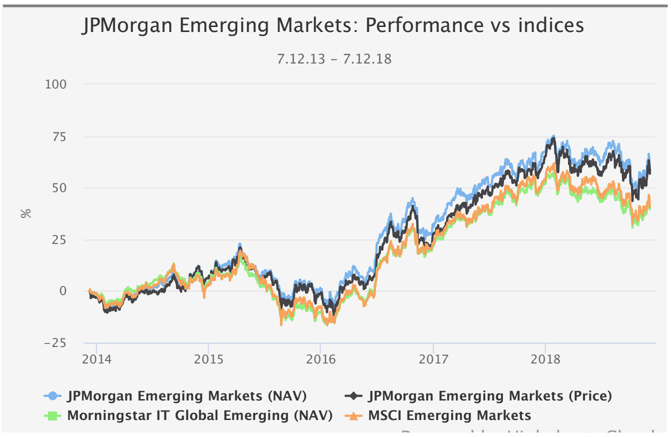


Source: Morningstar

Over the past five years this has resulted in performance of 60.4% compared to just 40.6% for the MSCI Emerging Markets index and 41.2% for the peer group.

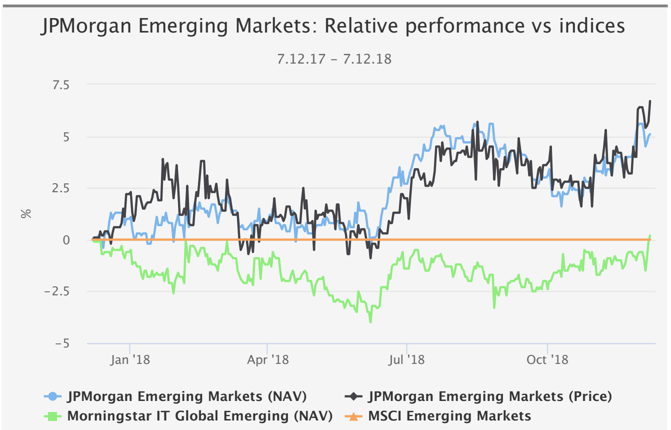
The trust is up versus the index and peers over the past 12 months thanks to outperforming in the sell-off since the summer. It is stock selection that has been driving relative returns, with TSMC, EPAM and Infosys particularly significant contributors, all in the technology sector. In the graph below, an upward sloping graph illustrates periods of outperformance, and downward represents underperforming periods.

Fig.4: Five-Year Relative Performance



Source: Morningstar

Fig.5: One-Year Relative Performance

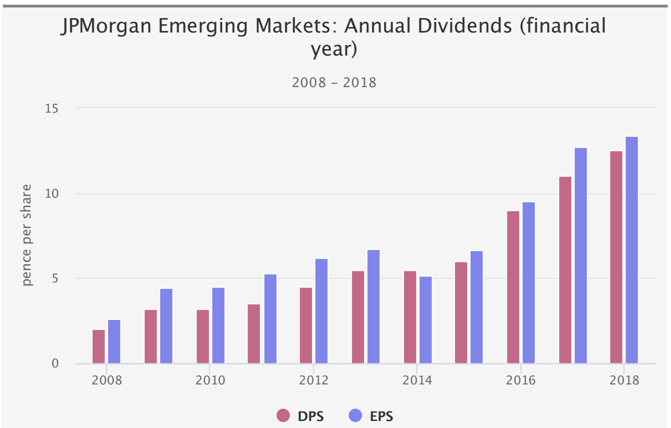


Source: Morningstar

Dividend

The trust has a progressive dividend policy, aiming to increase the payout in line with earnings over time. Dividends have grown at a healthy rate of 16% per annum over the past decade, while earnings have risen 13% a

Fig.6: Dividends



Source: JPMorgan

year. The payout has been covered in nine of the past ten years, and the trust has reserves equal to 89% of the 2018 dividend. The current yield is 1.5%.

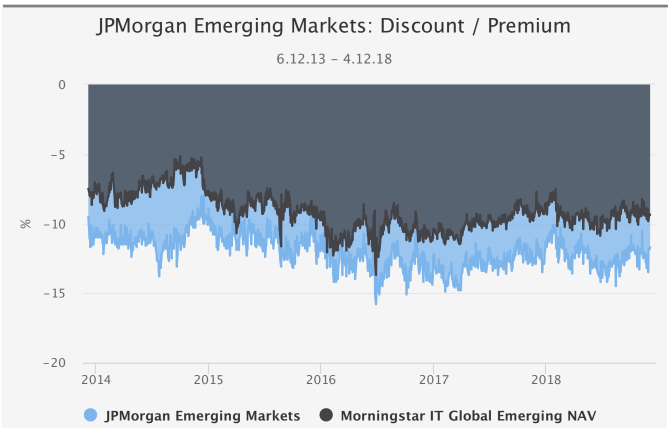
Management

Austin Forey has managed this trust since 1994, giving him a rare level of experience in the region. Austin has managed the portfolio through multiple market cycles and crises, including the Mexican crisis of late 1994, the Asian crisis of 1997 and the 2008 financial crisis. Austin tells us this has made him sceptical about the wilder claims that are often made about emerging markets, both optimistic and pessimistic. Investors often forget to respect the cycle in emerging markets, he warns. Austin has also learned to be wary of leverage in potential investments, as crises in the region almost always stem from excess leverage and a lack of cash. These insights may explain the remarkable steadiness of returns on the trust in recent years: in NAV terms it has outperformed in seven of the past ten years. Two of the three years of underperformance came in the sharpest rallies, which rewarded more highly leveraged and less cautious managers. Austin can draw on an extensive analyst team based on the ground in Emerging Markets which gives him a competitive advantage over many of his peers.

Discount

The trust has tended to trade on a discount between 10% and 14% over the past five years; it is currently in the middle of that range at around 12%. Board policy is to use the repurchase authority it possesses to prevent the discount being above 10% for extended periods of time – but only if this is out of line with the peer group and market conditions are orderly. In November 2018, the board began a buyback programme and has been active in the market daily, buying even when the discount comes in close to 10%.

Fig.7: Discount



Source: Morningstar

Charges

The OCF is 1.02% which compares favourably to the sector average of 1.3%. The management fee is 1% on the first £800m and 0.75% thereafter, which at the current size means it is roughly 0.93% and the operational costs therefore a mere 0.09% on a forward-looking basis. This would put it in the thriftiest decile should historic patterns be repeated, according to **our recent research**.

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