Q4 2023 - Emerging Markets Quarterly Update

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Hi, I'm Akhil Subramanian. I'm one of the portfolio managers on our Emerging Markets team, and I'm here to give you an update on the fourth quarter of 2023.

So it was an interesting quarter where we had a down month in October and then two up months in November and December, primarily on the back of increased optimism around the possibility of rate cuts, inflation peaking, and so all of that positive sentiment was quite good for EM. Uh, and both indices—the MSCI Emerging Markets and the MSCI Emerging Markets Value Index—were up about 8% in the quarter.

The notable exception to the performance in EM was in China. Um, there was continued fear around particular sector government crackdowns and the weak macro environment, and so against this backdrop, you know, most of our detractors were actually Chinese companies. Ironically, some of them had improving fundamentals. Um, if I look through the list of detractors, there were some companies that did quite well actually in the fourth quarter, but just their stock prices have not done that well on the back of increasing fears around what's going on in the country.

You know, against this backdrop, uh, you know, clients must be aware that we have been increasing our weight to China in the last couple of years. And so, coming into COVID, we were possibly 20 points below the index, and now our weight in China is a couple of points above where the index is. And so it's been a shift for our portfolio over the last couple of years, primarily because, you know, we're so valuation-focused, and we found so many interesting incremental investment opportunities in China. That was not that different in the fourth quarter.

So in the fourth quarter, we added four names: two of them were in China, one was in India, and one was in Brazil. So if I just walk you through them:

In India, we added HDFC Bank, which is one of the largest private banks in the country. It's an extremely well-run franchise, um, that's been taking market share and being pretty immune to economic downturns in the country. Um, we had the opportunity to acquire HDFC because the company is currently going through a merger with one of its sister companies, um, and just that merger is creating a lot of noise in the sense of the company holding elevated capital levels as they try to harmonize credit standards and other operating metrics across the companies. And so we had an opportunity to invest in a company that's undergoing a little bit of noise in the financials, and we feel like, coming out of the whole merger, once things settle down, the company will sort of get back to its cadence of optimizing its capital structure and really growing deposit market share.

Another company we added during the quarter was Vale, which is a Brazilian mining company. You know, in terms of the assets that Vale has, um, Vale has really high-quality iron ore deposits in Brazil, and there have just been concerns over, uh, demand and global demand for steel, and that's sort of been weighing on the company. But, you know, as you know, at Pzena, we're very focused on

normalized earnings—what are normalized levels of demand, what are normalized levels of iron ore—and we just felt like we had the opportunity in the quarter to acquire Vale at a very attractive price relative to its normalized mid-cycle earnings. And so that was another addition to the portfolio.
Now, in terms of the two Chinese companies that we added to the portfolio: one is a company that we've owned in the past called Man Wah. So Man Wah is the dominant manufacturer of sofa recliners in China—they have about 60% market share. We bought it once and did quite well just on the back of people buying sofas during COVID, um, and we're currently going through the post-COVID hangover where there's been a pull-forward of demand during the COVID years, and so sofa demand is coming back down, probably undershooting what the normalized trend should be. Um, but we see a path to recovery. Um, and also there's been a little bit of pain on the raw material side. So, you know, we've had a chance to acquire this company again. We feel like it still has a lot of room to grow. It's still a dominant manufacturer and has a good, um, plan to continue the increased penetration of recliners in China.

And then the last company that we added to the portfolio was a company called Beijing Oriental Yuhong. Um, this is a very interesting company—they make waterproofing materials for buildings. And so their customers include people doing fixed-asset infrastructure-type development but also the residential property sector. So the buildings are both commercial and residential. As you can imagine, the China property sector is going through a downturn, so they certainly are feeling pain there. They're also feeling elevated pain from raw material costs they hope to pass on. But this is a very good company, um, in an industry where players are exiting because demand fundamentals are challenging. And we think the market underappreciates a potential change to the building codes that is going to start to be implemented, where over the next couple of years the number of waterproofing coats that new buildings need to add is going to go up. And so that fundamental change in the building code is going to lead to increased volumes and revenue thus for Beijing Oriental Yuhong. So we're excited to own a company that has good structural tailwinds in sort of a demand air pocket as we're seeing weakness in the property sector.

So that, broadly speaking, is the summary of the, uh, environment and some of the actions that we've taken in the Emerging Market portfolio in Q4. I think the team is still energized by the fact that we're finding very cheap company valuations when comparing them against fundamentals, and we look forward to updating you next quarter on what we've done.