A long view of the east

Qian Zhang, Investment Specialist

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Annual past performance (%) to 30 September each year

	2019	**2020**	**2021**	**2022**	**2023**
Asia ex Japan Composite	6.8	43.0	27.9	-20.9	-0.9
MSCI AC Asia ex Japan	2.5	12.6	10.0	-13.6	1.8

Annualised returns to 30 September 2023 (%)

	1 year	**5 years**	**10 years**
	1 Year	5 Years	10 Years
Asia ex Japan Composite	-0.9	8.9	11.6
MSCI AC Asia ex Japan	1.8	2.2	6.8

Source: Baillie Gifford & Co and MSCI. Share price, total return, sterling.

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A long view of the east

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In 2024, Baillie Gifford's Asia ex-Japan equities strategy marks its 35th anniversary. Of the approximately 140 investment managers currently offering such a strategy, only a handful can claim to have been doing so for this long.

That length of tenure matters because of the monumental changes over this period, and the lessons we have learnt from investing through them.

Turning time to our advantage

We have seen the region's economies collectively emerge as the world's new majority, with their growth engines upgrading from exports to domestic consumption, manufacturing to services, and industrialisation to digitalisation.

Since its inception in 1989, the strategy has delivered a 1,589 per cent cumulative return. With a 2.6 per cent net-of-fee excess return per annum, it has outperformed the reference index by 944 per cent over this period.

But we do not take this for granted. Looking ahead, we must apply what our three-decade experience of investing in Asia ex-Japan has taught us to continue generating excellent returns our clients.

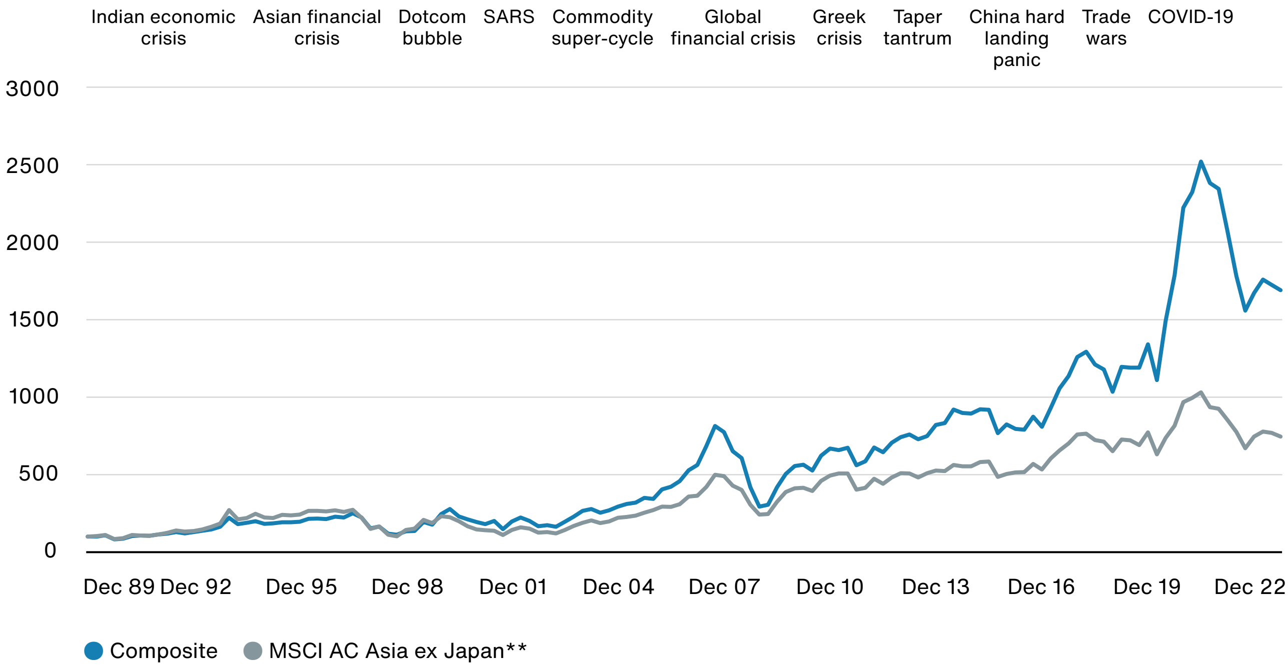
The first thing that sets us apart from many others investing in this region is time – both in terms of the longstanding nature of our investment philosophy and our long investment time horizon.

Since we began running dedicated Asian portfolios in 1989, the philosophy underpinning what we do hasn't changed. We've always been active, focused on growth and never allowed ourselves to get bogged down in short-term earnings estimates or price targets.

We've endured the Asian Financial Crisis, the dot-com bust, the 2008 financial crisis and the Covid-19 pandemic. We can truly say this is a tried and tested approach over many different environments.

While investors are attracted to Asia by its long-term growth, the news flow in the region can be ferocious, and market sentiment changes weekly. Such frequent fluctuations make it

Asia ex Japan and MSCI since inception*



Source: Revolution, MSCI. Rebased to 100. Net of fees, US dollars.

*31 December 1989 to 30 September 2023.

**MSCI AC Far East ex Japan until 31 January 2011.

difficult to remember that growth investing only works over sensible timeframes. Over short periods, share prices bear little relation to earnings. However, there is a real correlation between earnings growth and returns over five years or more.

That is why we devote all our efforts to creating a structure that facilitates patient, long-term investing. In our view, taking a long view is one of the most effective approaches to uncovering the nascent growth opportunities a company can avail.

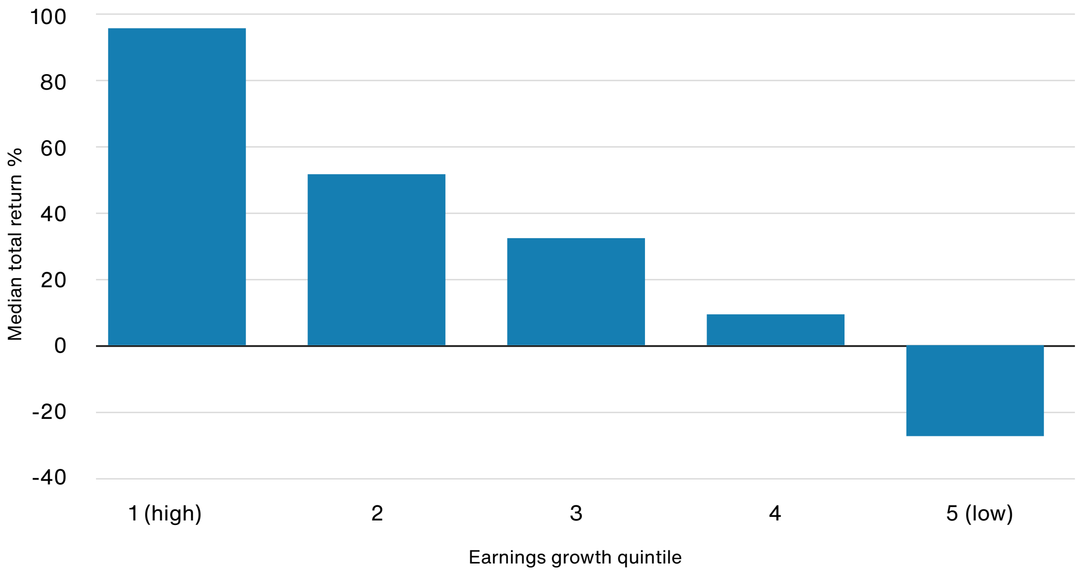
Take Reliance Industries, India's first listed company in 1977, for example. Having begun as a textile business in the 1960s, it has evolved into the country's largest petrochemical refiner, largest retailer, operator of its largest mobile network, and is potentially its leading online consumer platform. Growth of this magnitude doesn't occur overnight, nor can it be assessed from quarterly earnings reports. We first invested in Reliance in the early 2000s, and it is one of our largest holdings today.

We believe great companies are rare. As we aim to hold a relatively concentrated portfolio of these companies out of a wide possible universe, we think it's only fitting that we set a high bar for investment: we must envisage a scenario where the company can at least double in total return terms in hard currency over five years.

Do we manage to find these big winners? It would be unrealistic to expect every company we invest in to provide such strong returns. However, it is hopefully informative that over 50 per cent of the stocks held in the portfolio for five years or more have delivered this doubling over the holding period (incidentally, close to 30 per cent have more than tripled).

Delivered median total returns by earnings growth quintile

Rolling five year horizons (1994-2022)



Source: Baillie Gifford & Co, Factset.

Median 5-year USD returns from Asia ex Japan stocks as of the end of December of each year between 1994 and 2022 and with a market capitalisation larger than time-adjusted US$1bn.

Embracing the power of 'growth in all its forms'

A key lesson from our 35-year journey is the importance of adopting a pragmatic approach to growth. This is particularly crucial in a rapidly expanding region such as Asia, where the investment landscape often undergoes significant shifts.

In the early 1990s, China barely registered as an investment opportunity; today, about a quarter of the Fortune 500 companies are in China. The types of companies that come with the growth heading also change: from Hong Kong financials in the 1990s, to Thailand shipping companies in the 2000s, Chinese ecommerce platforms in the 2010s and Korean battery and semiconductor makers in the 2020s.

Our pragmatic approach to growth allows us to cast the net wide and capture evolving opportunities that others may miss.

This leads to a portfolio that is often considerably different from the index and our peers. Some examples include:

- A substantial allocation to Vietnam, which reflects a genuine willingness to deviate from the index, supporting our conviction in one of Asia's best structural growth stories;
- Large-scale sector shifts demonstrate our ability to capitalise on the drastic changes in Asia's opportunity set. For instance, our information technology (IT) and communication sector allocation rose from 25 per cent in 2013 to more than 50 per cent in 2017, before decreasing to 30 per cent in 2023. This move was primarily driven by active decisions rather than index changes, where IT and communication sector weights have hovered between 20–30 per cent over the same timeframe;
- Curiosity about the 'hidden gems' and the 'overlooked growth' in Asia: this ranges from niche suppliers in the semiconductor ecosystem, to upstream metal producers that are essential enablers for the green-transition, or traditional energy companies that are significantly discounted by the market but vital in meeting the growing energy demand in emerging Asia;
- While not targeting a specific market cap, our keenness to analyse the chains of events and their beneficiaries has resulted in around 40 per cent of our portfolio invested in companies with a market cap of less than $10bn, compared to the 20 per cent in the index; along with 20 per cent allocation to energy and materials, which are our current largest sector overweights.

A recent market intelligence report highlights that nearly two-thirds of our portfolio is invested in 'lightly owned' stocks – those held by less than 30 per cent of the peer funds. While our primary mission is to deliver long-term excess returns to our clients rather than simply 'being different', we are ready to depart from the investment crowd whenever and wherever we hold a differentiated view. We believe this is what our clients expect from us as an active manager.

Top five country and sector contributors to excess returns, 10 years to Oct 2023[6]

	Portfolio Average Weight (%)	Index Average Weight (%)	Total Attribution (%)
China	33.5	34.4	21.3
Singapore	3.3	4.3	7.8
India	17.9	11.0	5.3
South Korea	17.8	16.1	4.4
Indonesia	2.7	2.5	3.0
Vietnam	6.2	0.0	2.9
Consumer discretionary	16.6	12.3	17.2
Communication services	4.8	8.4	12.9
Information technology	34.6	23.5	7.4
Real estate	1.7	3.6	5.8
Materials	6.0	4.8	5.1
Energy	5.0	4.2	3.3

Appreciating the underappreciated

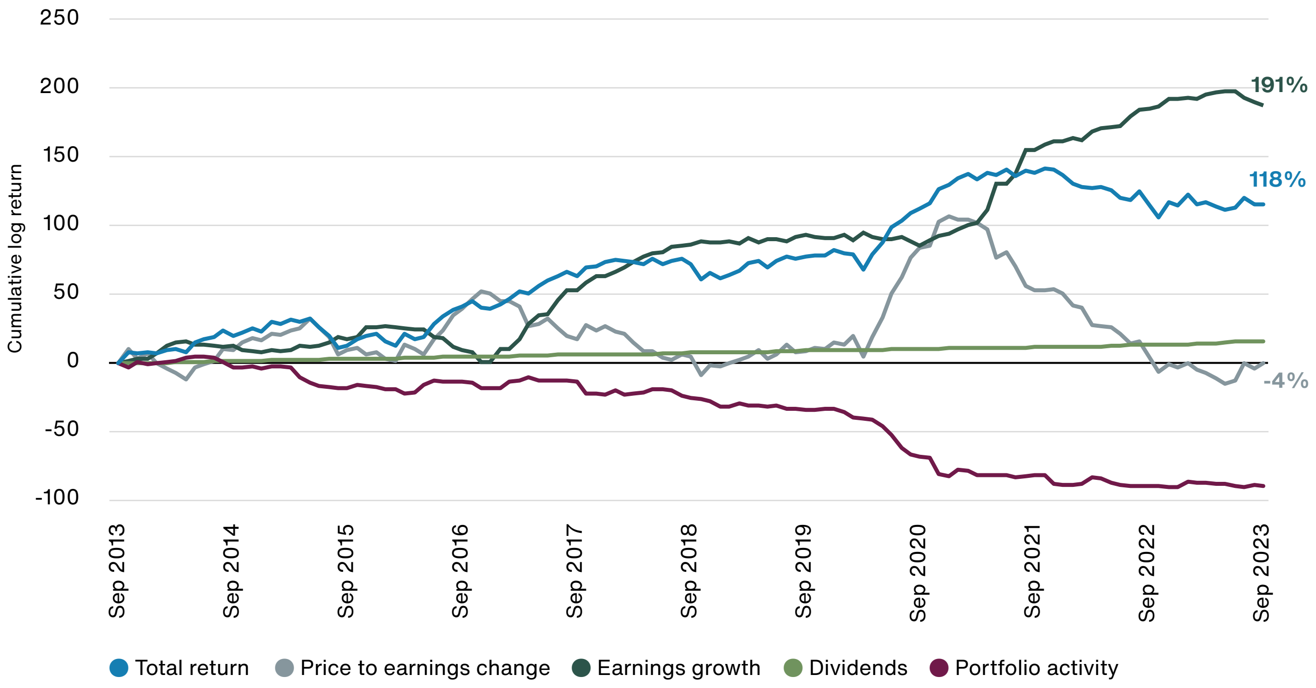
We think of growth as what drives long-term returns, not 'rapidly rising revenue with above-average valuations as a result', as lazy definitions of growth investing may suggest. By deliberately targeting diverse growth types, we construct a portfolio with various potential routes to achieve the doubling we are looking for. We look for companies that can grow over longer periods than expected, at faster rates than expected, or will surprise – growing when no growth is expected.

Much of this process relies on the interplay of data, experience, educated creativity and probability. This does not necessarily lend itself to a division of the investible universe into 'value' and 'growth'.

In fact, over the past ten years, about one-third of our portfolio's new purchases were bought at a price-to-earnings (P/E) ratio below that of the index at the time. The portfolio's current P/E ratio is slightly lower than not only the index, but also some of our 'value' peers. While this may not be typical compared to history, we view it as a natural outcome of our pragmatic approach to growth, the current market environment, and a keen awareness of valuation.

Based on our internal analysis of historical performance, it is evident that the primary driver of long-term returns for our portfolio has been operational progress, measured by earnings growth. In contrast, the contribution from re-rating, measured by price-to-earnings change, has been roughly flat. This aligns with our expectations.

10-year return decomposition: Baillie Gifford Asia ex Japan portfolio



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Staying the course

We know that the types of companies that can deliver the sorts of returns we're looking for will often fall in and out of favour with the market. This means that at the portfolio level, we should expect short-term drawdowns.

What's important to us, however, is that the companies stick to their long-term growth objectives, even when the market demands short-term share price returns. In fact, most of our top performance contributors have experienced multiple drawdowns on the way to great long-term returns.

We would also gently challenge the actual benefit of relying on drawdown as a risk measure for active managers in Asia. Asian markets are inherently volatile, where absolute drawdowns could be extreme, ranging from -20 to -40 per cent during past cycles and up to -60 per cent during global and Asian financial crises. That said, relative underperformance during drawdowns has generally been modest for our strategy, as during turbulent times, the market tends to sell off indiscriminately. When examining the 10 largest drawdowns of our portfolio, it outperformed the index during the same period on four out of the 10 occasions. When it didn't, average underperformance was a modest -2 to -3 per cent behind the index, with strong rebounds occurring shortly after the troughs.

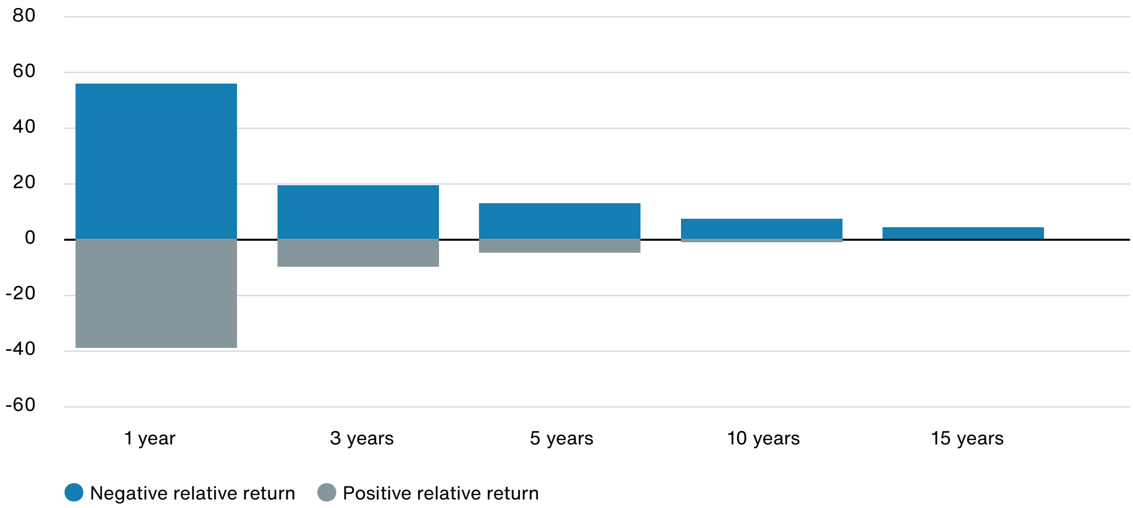
In a fast-growing market dominated by retail and changeable sentiment, short-term volatility and drawdowns can be inherent costs in pursuing great long-term returns. Avoiding them may hinder the potential for future rewards. We believe that, while patient optimism can be uncomfortable at times, over longer periods, it should be rewarded.

Top 10 relative performance contributors over the last 10 years

Stock	Largest drawdown during 10 year period	Number of drawdowns over 20% in 10 year period
SEA	-90.4	6
Tencent	-73.2	5
Accton Technology	-44.2	4
Alibaba	-80.1	4
Li Ning	-77.2	6
Kingdee Intl Software	-77.1	6
Geely Automobile	-74.8	5
Samsung SDI	-61.9	5
Tata Motors	-36.0	3
Meituan	-76.8	4

Source: Factset, Baillie Gifford & Co, MSCI. Not all stocks held for the full 10 year period. Data calculated 10 years to end September 2023. Index: MSCI Asia ex Japan. Based on representative Baillie Gifford Asia ex Japan portfolio, in USD.

Relative returns over rolling periods (net)



Source: Revolution, MSCI. US dollars. Index: MSCI AC Asia ex Japan Index. As at 30 September 2023.

The figures above show results after analysing annualised returns over each monthly time period for the Asia ex Japan Composite vs MSCI AC Asia ex Japan Index (MSCI AC Far East prior to 31/01/11).

Summing up

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Asia's growth story is well known. While the chance of strong absolute returns from Asia is significant on a long-term view, many debate about the most appropriate approach to take advantage of it. Ensuring adequate and smart exposure to Asia may be the most critical decision for many of us in the investment world for the next decade and beyond.

Baillie Gifford has been managing Asia ex-Japan portfolios for over three decades and is grateful to be entrusted by a range of clients worldwide. Our clients can be confident that in the future, we will still work to the same tried and tested principles that have guided us since 1989. We will continue actively seeking Asia's substantial growth opportunities in all their various forms, with the conviction that our clients will be duly rewarded over the long term.

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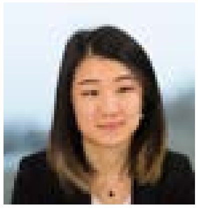
Author biography



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Qian Zhang joined Baillie Gifford in 2021 as an investment specialist and client service director in the Emerging Markets Client Team. Previously, Qian worked as a senior client portfolio manager covering emerging markets strategies at Pictet Asset Management and JPMorgan Asset Management. She began her career at Merrill Lynch in 2008. Qian graduated MSc in Mathematical Risk Management from Georgia State University and BSc in Economics and Statistics from Peking University. Qian is a native mandarin speaker and a CFA Charterholder.

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