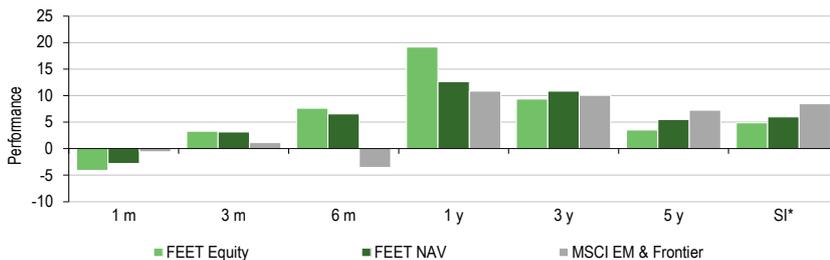


# Fundsmith Emerging Equities Trust

## Stepping forward

Fundsmith Emerging Equities Trust (FEET) has evolved from an emerging markets (EM) consumer-driven growth story since launch in 2014. Its strategy remains to own high-quality companies, but a number of changes in emphasis have been made. The managers have made the portfolio more focused by number of holdings (38 at end-September 2021) and the weighting in technology and healthcare has increased. The team stresses that the fund suits investors with a long-term time horizon, as the underlying strong portfolio fundamentals lead to it owning businesses with superior operating performance, regardless of short-term market momentum. A combination of the recent robust performance of FEET's holdings and a lengthy correction in China's equity market (where FEET at c 15% is underweight the benchmark at c 19pp) has resulted in a strengthening of the fund's absolute and relative performance.

### FEET's performance since launch



Source: Refinitiv, Edison Investment Research. Note: \*SI – since launch in 2014.

## Why invest in FEET now?

FEET's portfolio appears well placed (as it was prior to the COVID-19 outbreak) to mitigate both the short-term challenges and benefit from the long-term opportunities associated with the pandemic. The managers decided to avoid making any specific investment decisions based on the impact of the pandemic and this has helped FEET outperform the benchmark.

FEET's approach to ESG continues to differentiate the trust from peers. The majority of the businesses FEET owns are brand owners that value their long-term responsibilities. This makes them more conscious about their ESG responsibilities than more cyclical businesses, which FEET typically shuns (for more details see our [initiation note](#)).

## The analyst's view

EM has been a 'mixed bag' in terms of performance in the past few years, with big divergences between countries. The differentiated approach and the high Indian exposure (c 46%, overweight the benchmark by 34pp, which is an outcome rather than a policy) have started to pay off, as performance has strengthened. The increased portfolio concentration of 25–40 stocks (from 35–55), following the investment policy amendment (made in 2021, see page 3), allows the managers to focus on the highest conviction stocks, while managing risk prudently.

**NOT INTENDED FOR PERSONS IN THE EEA**

## Investment trusts Emerging markets equities

17 November 2021

**Price** 1,460.0p

**Market cap** £383.8m

**AUM** £426.4m

NAV\* 1,600.4p

Discount to NAV 8.8%

\*Including income. At 16 November 2021.

Yield 0.1%

Ordinary shares in issue 26.3m

Code FEET

Primary exchange LSE

AIC sector Global Emerging Markets

Benchmark MSCI EM + Frontier Markets Index

52-week high/low 1,510.0p 1,255.0p

NAV\* high/low 1,600.4p 1,365.0p

\*Including income.

### Gearing

Gearing at 31 October 2021 nil

### Fund objective

Fundsmith Emerging Equities Trust's investment objective is to provide shareholders with an attractive return by investing in a portfolio of listed companies that operate in or sell into developing economies, providing exposure to the growing proportion of middle-class consumers in these countries or to the broader social and/or economic development of those countries.

### Bull points

- Differentiated return potential from a highly-concentrated (target 25–40 stocks) long-only portfolio.
- A long-term portfolio of companies with superior margins, consistent cash conversion and faster cash flow growth relative to the benchmark.
- FEET has strongly outperformed in 2021, after 2020 performance strengthened, following portfolio changes in 2019.

### Bear points

- Investors may shun active EM funds and continue buying trackers or allocate money elsewhere.
- The fund can be geographically concentrated.
- Performance might lag during periods when stocks and sectors, underrepresented in FEET (such as Chinese tech), rally.

### Analysts

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**Fundsmith Emerging Equities Trust is a research client of Edison Investment Research Limited.**

## The manager's view

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### China: An interpretation of the current policies

Portfolio manager Michael O'Brien continues to have a limited exposure to China (c 15% portfolio weight versus c 34% in the benchmark). He believes the recent regulatory reforms taken by Chinese regulators over the past 12 months are an integral part of Chinese government policies. He highlights three major motives for the recent heightened scrutiny measures around private enterprises: economic, political and social. He believes the government imposed the embargo on the high-profile \$34bn Ant Group's IPO and a \$2.8bn fine on its parent company Alibaba in November 2020 to maintain economic stability and exert control over the financial system. We believe, similar large-scale regulatory actions, moving to other commercial sectors, might have served two key purposes. Firstly, limiting the economic and market power of, arguably, the largest private enterprises, by imposing direct restrictions. Secondly, this widely publicised process is to act as the showcase for other companies, so they would willingly comply with the new regulatory measures. The regulatory measures were introduced and applied to a number of industries, including technology, property, education and gaming. This implies that new regulations can be applied to all enterprises, big and small, across all industries. On this basis, O'Brien believes the hard-line policies of President Xi Jinping and the party could make further corporate interventions affecting the economy.

The manager says that, politically, he sees the Chinese president Xi Jinping to be an interventionist, who wants to gain further support and popularity ahead of the October 2022 plenum. Xi is motivated to demonstrate that anti-monopolistic and anti-corruption measures will benefit ordinary Chinese citizens, and strengthen their support for the party and its increasingly interventionist policies.

Socially, the manager believes that China will promote greater equality, under its 'common prosperity' agenda, as it has done historically. This may suppress and limit the influence of highly entrepreneurial and wealthier individuals. O'Brien notes that gambling, which is engrained in Chinese culture, does not align well with the ideology of the Chinese Communist party. Another area that the government tackled recently was education. The manager believes that private educational institutions had too much influence with an education sector, which is subject to the party's control of the curriculum.

### China versus India

FEET is overweight India versus China, as a result of the team finding a wider range of high-quality Indian businesses in which to invest. Historically and since launch FEET has had a relatively high exposure to India (c 46% at end-September 2021; for details see the portfolio section). This relatively high exposure is an outcome, rather than a policy, explains O'Brien. The fund's policy is to find and own what it perceives to be the best companies, with high returns and strong growth prospects, and a number of Indian consumer-oriented companies fit this criteria.

The consumer staples sector is still the largest sector within the fund (44.4% at end-September 2021), and the manager points out that in the EM, India, arguably, has the largest concentration of high-quality and fast-growing FMCG companies. FEET's portfolio managers also regard certain local healthcare and consumer technology businesses highly and include them in the portfolio.

In contrast, China has been a market where the managers see less fit for their investment criteria. Governance, capital allocation, regulation, ownership and transparency are reasons that investments in China do not pay off.

Furthermore, the managers are much more upbeat on demographic trends in India versus China. India's overall population growth and lower urbanisation rates allow FEET's investee companies in India to grow at rates ahead of comparable companies in China.

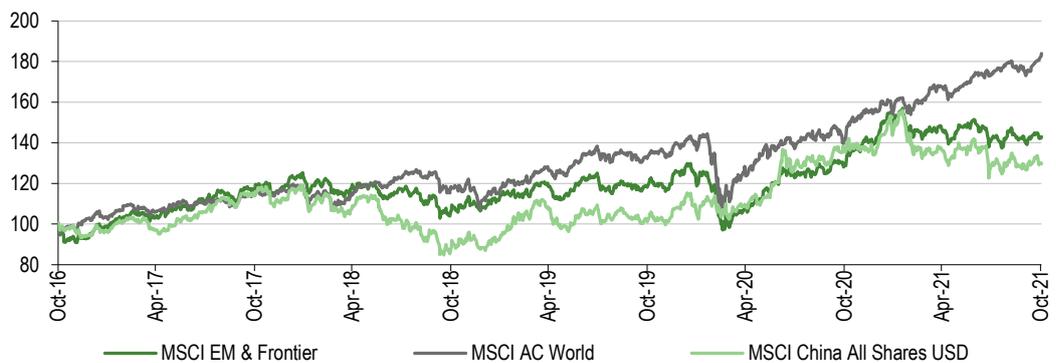
## The EM market performance and valuations

International investor concerns over regulatory scrutiny across a number of sectors in China have resulted in the MSCI China Index falling 4.9%, compared to the MSCI World rising by 8.3% over the past six months to end-October, on a total return basis in pounds sterling. The fall in the China component has been exacerbated by Evergrande Group's situation, fears over economic growth and high levels of debt in the Chinese economy. Evergrande Group is the second largest property developer in China with RMB2.3tn (£260bn) of debt and is on the brink of bankruptcy.

The publication of draft anti-monopoly regulations by the Chinese financial regulator at the end of 2020 and the suspension of Ant Group's IPO in November last year sent Chinese equities markets into a downward trend. Exhibit 1 illustrates that the Chinese market, having returned -4.9% and -3.8% over the past six and 12 months, respectively, is still trending down, pulling the EM index downwards as well, albeit to a lesser extent. China is c 34% of the MSCI EM Index (at end-September 2021), and major moves in the Chinese equity market greatly affect the performance of the EM indices. Exhibit 1 also shows the divergence between Chinese and global equities during 2021.

Geopolitical tensions also continue to weigh on EM equities performance. The US-China relationship remains an ongoing issue, with tensions around the origins of the COVID-19 outbreak, human rights and trade. There are also issues around Hong Kong-China relations and the situation around Taiwan. Political protests (exacerbated by local governments' measures to tackle the pandemic) have taken place in a number of countries where FEET invests, including Brazil, Bangladesh and South Africa. Brazil and the Philippines both face elections in 2022.

**Exhibit 1: Equity markets' performance**



Source: Refinitiv, Edison Investment Research

Global developed markets currently trade at 17.4x forward PE, and are more expensive than EMs at 13x, making EMs more attractive from the valuation point of view. Whilst China valuations have come down from their 2020 highs (China A-shares reached 17.4x forward PE then) and currently trade at 13.9x, they are still more expensive than their five years average at 12.6x. We highlight P/E ratios here to show relative and historical comparisons between and within markets. FEET's management team does not use P/E ratios in its investment process when picking portfolio stocks.

## Investment objective and policy amendments

FEET's investment objective was broadened in May 2021. The previous objective was to: "invest in shares issued by listed or traded companies which have the majority of their operations in, or

revenue derived from, developing economies and which provide direct exposure to the rise of the consumer classes in those countries”. The amended objective adds “or to the broader social and/or economic development of those countries”.

The portfolio managers believe that adopting this change will result in the short term in an increase in the investable universe by around half a dozen stocks. The board believes that this amendment provides the portfolio managers with a broader range of potential investments over time as countries and their economic infrastructures develop.

Another change was the decision to make the portfolio more concentrated, with the reduction of the portfolio stocks to a range of 25 to 40, from 35 to 55 stocks previously.

According to the FEET team, the recent amendments to the investment objective and policy do not represent a revolutionary change, but a natural response to the development of the EM economies and capital markets since launch in 2014. The managers continue to focus on those investment opportunities available for investment in high-quality businesses offering meaningful growth opportunities and sustainable returns.

## Portfolio

At 30 September 2021 FEET’s portfolio had 38 holdings. The top 10 FEET holdings, presented in Exhibit 2, illustrate the portfolio’s differentiation from the benchmark, where the top 10 are dominated by Chinese companies. FEET has one Chinese and eight Indian companies among its top 10 holdings. Its top 10 concentration at 48.3% is higher than that of the benchmark (30.9%).

**Exhibit 2: Top 10 holdings versus the benchmark**

Company	Country	Industry (GICS)	Portfolio weight % 31-Sept-21	Top 10 benchmark* constituents	Country	Industry (GICS)	Index weight % 31-Sept-21
Mercadolibre	USA (Argentina)	Consumer discretionary	7.4	Alibaba	China	Consumer discretionary	8.5
Info Edge	India	Communication services	6.0	Tencent	China	Communication services	5.8
Foshan Haitian Flavouring	China	Consumer staples	5.6	TSMC	Taiwan	Information technology	5.7
Asian Paints	India	Materials	5.5	Samsung Electronics	South Korea	Information technology	3.7
Havells	India	Industrials	5.4	Meituan Dianping	China	Consumer discretionary	1.7
Avenue Supermarkets	India	Consumer discretionary	4.8	Reliance Industries	India	Energy	1.3
Nestlé India	India	Consumer staples	3.6	Naspers	South Africa	Communication services	1.2
Marico	India	Consumer staples	3.6	JD.com	China	Consumer discretionary	1.0
Hindustan Unilever	India	Consumer staples	3.5	China Construction Bank	China	Financials	1.0
Godrej Consumer Products	India	Consumer staples	3.0	Ping An Insurance	China	Financials	0.9
<b>Top 10 (% of holdings)</b>			<b>48.3</b>				<b>30.9</b>

Source: Fundsmith Emerging Equities, MSCI, Edison Investment Research. Note: \*MSCI EFM Index.

While FEET’s investment strategy disregards index composition (see Exhibit 3), with the largest overweights in consumer staples and healthcare, the proportion of the fund invested in consumer staples has fallen by 8.7pp compared to the end of 2020. This was the largest sector shift, aided by the change in the investment policy, allowing the managers to look at a wider range of stocks. The information technology and communication services sectors have increased by 5.9pp and 3.7pp, respectively.

The additions to the information technology sector included two business process outsourcing (BPO) companies: Genpact (G US, c \$9bn market cap) and WNS Holdings (WNS US, c \$4bn market cap). Genpact designs and manages business operations to manage risk and compliance. The company started as an India-based process services unit of GE Capital and has become a global business. Genpact has operations in 13 countries; the majority of its revenue is provided from operations in India. Genpact works with more than 400 global clients in such industries as banking and finance, healthcare, insurance, manufacturing and transportation. GE continues to

account for a large portion of Genpact's revenue. The business has attractive returns, and operates in an industry with high barriers to entry and high levels of customer loyalty.

WNS is the second largest standalone BPO company in the world and has its headquarters in Mumbai. Over the five years to March 2020 the business reported double-digit compound revenue growth and considerable margin expansion. Indian BPO businesses have consistently gained market share in a growing market over the past two decades. According to the managers, WNS's competitive advantages include a strong brand, client relationships, consistency of service delivery, technology expertise, labour availability, scale and delivery cost.

### Exhibit 3: FEET sector split versus the MSCI Emerging + Frontier Markets (EFM) Index

	Portfolio weight	Portfolio weight		Benchmark*	
GICS Sector	31-Sept-2021	31-Dec-2020	Change	31-Sept-2021	Active weight vs benchmark
Consumer staples	44.4	51.8	(7.4)	6.0	38.5
Healthcare	15.2	15.1	0.1	5.0	10.2
Communication services	10.7	6.9	3.8	10.4	0.3
Consumer discretionary	9.2	10.3	(1.1)	14.5	(5.3)
Information technology	8.1	2.4	5.7	20.7	(12.6)
Materials	5.1	4.8	0.3	8.7	(3.6)
Industrials	5.1	3.7	1.4	4.9	0.2
Financials	1.8	1.9	(0.1)	19.7	(17.9)
Energy	0.0	0.0	0.0	5.9	(5.9)
Utilities	0.0	0.0	0.0	2.3	(2.3)
Real estate	0.0	0.0	0.0	2.2	(2.2)
Cash	0.4	3.1	(2.7)	0.0	0.4
<b>Total including cash</b>	<b>100.0</b>	<b>100.0</b>	<b>N/A</b>	<b>100.0</b>	<b>N/A</b>

Source: Fundsmith Emerging Equities, MSCI, Edison Investment Research. Note: \*MSCI EFM index.

Despite the risks highlighted earlier, FEET's team has found a handful of Chinese companies, compatible within its investment process, to include in the portfolio. There are six Chinese holdings currently in the fund, including three technology companies.

The latest addition in the technology space is a Chinese company Medlive Technology (2192 HK, c HK\$26.5bn market cap). It operates as an online professional physician platform, providing medical information, clinical guidelines, medical conferences, case readings, diagnosis and treatment knowledge base, and other medical information. It is backed by M3 Inc, a Nikkei 225 company, incorporated in Japan in 2000, which provides a multiple of global services centred around its physician platform, such as m3.com.

Two other recent Chinese additions to the portfolio were Yihai (1579 HK and NetEase (9999 HK). Yihai is a condiment and ready to eat food manufacturer listed in Hong Kong and based in mainland China. It is the second largest supplier of hot pot condiments in China with a market share of c 7% and a 35% share of the mid-to-premium end hotpot segment. The portfolio managers believe that the group's strong market position, brand and premium offerings provide potential for market share and distribution network growth. The business has exhibited strong revenue growth over recent years and has an attractive margin profile.

NetEase is one of China's largest internet technology businesses and is the second largest mobile gaming company in the world, a segment that accounts for around 80% of its revenues. The managers note that NetEase is not heavily exposed to products designed for children (relative to other gaming companies), an area that the Chinese regulators have been restricting. The group's gaming business benefited from the increased consumer usage during lockdowns and also has structural growth drivers. These include the rising spending power of Chinese consumers, increasing mobile internet penetration, which will be supported by 5G launches, and the shift to mobile gaming from desktop gaming. Outside of its gaming businesses, the group has a large installed user base. NetEase has over one billion email users and 800 million NetEase Cloud registered users, and Youdao (its education business) has over 100 million average users. The managers believe that the large user bases add further value and growth potential to Net Ease.

Recent portfolio exits included Prodia, on capital allocation concerns, as the business had one of the lowest returns on invested capital among the portfolio holdings. The team also sold the position in Dali Foods, as growth of the business disappointed, and the company had been slow to execute on the roll-out of its products. FEET also exited East African Breweries and Britannia Industries.

## Performance

Exhibit 4 shows that in the six months to 16 November, FEET's net asset value (NAV) increased by 13.8%, outperforming the MSCI Emerging Markets plus Frontier Markets Index (-0.6%) on a NAV total return basis by 14.4pp. The trust also moved to the top of the ranks of seven EM equities peers. FEET ranked fourth over one year, fifth over three years and sixth over five years, respectively. This turnaround in performance was due to a combination of strong performance from a large number of the portfolio holdings and its weighting in China, a market which has performed poorly over recent months.

**Exhibit 4: AIC Global Emerging Markets sector selected peer group as at 16 November 2021\***

% unless stated	Market cap (£m)	NAV TR 6 months	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
<b>Fundsmith Emerging Equities Trust</b>	<b>383.8</b>	<b>13.8</b>	<b>16.9</b>	<b>38.5</b>	<b>51.8</b>	<b>(8.8)</b>	<b>1.3</b>	<b>No</b>	<b>100</b>	<b>0.1</b>
Fidelity Emerging Markets	766.2	2.4	4.7	39.0	57.0	(12.8)	1.0	No	98	1.5
JPMorgan Emerging Markets	1,592.3	11.2	13.4	63.3	100.2	(7.7)	0.9	No	100	1.0
JPMorgan Global Emerg Mkts Income	436.9	9.5	18.8	44.8	67.9	(9.8)	1.0	No	106	3.5
Jupiter Emerging & Frontier Income	62.6	7.3	21.6	39.4	N/A	(8.2)	1.4	No	108	4.2
Templeton Emerging Mkts (TEMIT)	2,220.4	(0.5)	5.3	43.0	76.0	(9.8)	1.0	No	104	3.1
Utilico Emerging Markets	474.6	6.1	21.8	15.4	29.9	(12.3)	1.1	No	103	3.6
<b>Average</b>	<b>848.1</b>	<b>7.1</b>	<b>14.6</b>	<b>40.5</b>	<b>63.8</b>	<b>(9.9)</b>	<b>1.1</b>		<b>103</b>	<b>2.4</b>
<b>FEET Rank</b>	<b>6</b>	<b>1</b>	<b>4</b>	<b>6</b>	<b>5</b>	<b>3</b>	<b>2</b>		<b>5</b>	<b>7</b>
Count	7	7	7	7	6	7	7	0/7	7	7
MSCI EM + Frontier Markets Index		-0.6	1.0	3.1	16.7					

Source: Morningstar, Edison Investment Research. Note: \*Performance as at 16 November 2021. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

Among the top contributors to total return were five Indian stocks, which in combination have added c 4.5pp to FEET's NAV total return during H121. These included three healthcare businesses: Metropolis (METROHL, 3.9% of the portfolio at end-June 2021, the latest portfolio data), Dr Lal PathLabs (DLPL, 3.3%) and Thyrocare (THYROCAR, 2.5%). All three are medical diagnostics companies which saw growing demand for their products and services with the surge in COVID-19 cases witnessed in India during 2021. Two top 10 holdings, Marico and Avenue Supermarkets (DMart), reported very strong operating performances during 2021, and their share prices reflected this. Marico posted double-digit volume and revenue growth of over 30% in its Q1 trading statement, with the international businesses showing 20% plus revenue growth. DMart's share price performed strongly in anticipation of India exiting lockdown restrictions and strong growth in its e-commerce offer.

FEET's performance has strengthened without the use of gearing. As the trust follows a growth strategy, the dividend yield is 0.1%.

## Further discount narrowing potential

The trust currently trades at a 8.8% discount to its cum-income NAV, which is slightly wider than the three-year average of 7.5%, and wider than the five-year average of 4.1%. The average discount was close to 10% for about three months' time period, after the market corrected in March 2020, as the COVID-19 pandemic struck, but has narrowed since then. The team's consistent implementation of its strategy regardless of shorter-term market fluctuations has resulted in a

stronger performance over the past 12 months, which has created further potential for discount narrowing.

The board monitors the share price discount and has been addressing it principally through executing the company’s investor education strategy (eg fund manager interviews, podcasts, publications), rather than through active share buybacks. According to resolution 13 at the May 2021 AGM, the company can buy back up to 14.99% of the issued share capital. From 1 January to 15 October 2021, the company repurchased a total of 0.32m shares to be held in treasury at a total cost of £4.4m. It currently has 26.3m ordinary shares outstanding.

The company also has a discretionary continuation vote mechanism in place.

**Exhibit 5: One-year discount/premium to cum-fair NAV**



Source: Refinitiv, Edison Investment Research

## Board

Professor Heather McGregor CBE joined the board at the conclusion of the AGM held on 26 May 2021. Following that, the board consists of five non-executive directors who are independent of the manager, and is chaired by Martin Bralsford (appointed in 2014).

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