

## Artisan Partners' Take on Emerging Markets

Lewis Kaufman, manager of Artisan Developing World, talks about his approach to emerging-markets investing.

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**Nick Watson:** Hi. With Morningstar, I'm Nick Watson. Today I'm joined by Artisan Partners' Lewis Kaufman, who runs the Artisan Developing World fund.

Lewis, thanks for joining us today.

**Lewis Kaufman:** Thanks for having me.

**Watson:** Lewis, one of the first questions I want to ask: You've been running emerging-markets money for 10 years now. In what ways has your approach evolved over the years?

**Kaufman:** Well, I guess I'd highlight a few different areas. First, domestic demand: We are a domestic demand fund, we were domestic demand fund, and we will be a domestic demand fund. And that's because low-penetration domestic demand in the emerging markets should engender better compounding outcomes. Now, as you've gone through different economic cycles, and as we've gone through the last 10 years, what we've seen is more and more low-penetration domestic demand opportunities in the emerging markets are running up against constraints. When we think about domestic demand in the emerging markets, increasingly, we're thinking about low-penetration domestic demand that can transcend those constraints. That's one big change for us, we see a constrained opportunity set in the emerging markets. We see a lot of countries that are no longer able to grow at the same growth rates that they were once capable of growing at. And we need businesses that can better transcend those constraints, which brings me to my second point, which is how we think about businesses.

In the old days, we would talk about financially sound, free cash flow generative companies as the way that we

pursued long-term capital appreciation in the emerging markets. We still think that's an important thing to do. But increasingly, I can see that as a risk management concept. What we're focused on more these days is scalable businesses, companies that have the scalability to transcend the constraints of emerging markets. A couple of examples of that would be companies like MercadoLibre in Latin America or Sea in Southeast Asia. So the way that we approach long-term capital appreciation in the emerging markets because of the constraints on emerging markets economies has changed.

The third point that I would bring up is our approach to managing risk. Risk management has always been at the core of what we do. I would make a simple observation that when you put yourself in a big hole, it's very difficult to compound your way out of that sort of result. So, we want an approach to managing risk that does a thoughtful job of capital preservation and also at the same time pursues long-term capital appreciation in the emerging markets. We think managing risk is a simple and important thing to do for intuitive reasons. I think we all wish to mitigate the volatility of returns; we all wish to have better risk-adjusted outcomes, and that's something we continue to emphasize. In fact, we've been able to add our most value in the down markets rather than the up markets. But I think that where we've had some evolution and thinking is, at the same time, we want to use our risk management framework, what I call our foundational approach to managing risk, to reinforce that compounding outcome. In other words, at the stock level, we're looking for companies that can compound business value and create disproportionate equity outcomes. And at the portfolio level, we want to use our risk management framework to really lean in to leverage the different correlations in our portfolio, whether that's between a

Chinese company listed in Hong Kong and a Chinese company listed in the mainland, or if it's between, say, a multinational company that is selling off because the global markets have become more attuned to coronavirus--which is exactly what's happening now-- whereas Chinese equities went through an earlier period of price discovery. We want to leverage these different correlations in our portfolio. We want to leverage our risk management framework to reinforce that compounding outcome. So the way that we use our risk management framework has evolved in that way.

**Watson:** Absolutely. As you mentioned, plenty of the risks in the space have been grabbing headlines recently. You named virus fears in China. There's also ongoing trade tension involving China and the U.S. How do you think about staying focused on the long term, paying attention to the growth story in China, for instance?

**Kaufman:** Ultimately, I think, first and foremost, we view volatility as our friend because it gives us a chance to reinforce that compounding outcome. Now, the way that we get there and we build this foundational approach to managing risk is really in three separate components. First, over the 10 years that I've done this, I've seen multinational companies be touched by the emerging markets in two sorts of different ways. Number one, China has become a lot bigger. Now we have very significant investments in companies like LVMH and Nvidia. Nvidia is not a company that you might have thought of as an emerging-markets company, but it has about a quarter of its business in China. And similarly, consumers are skipping entire generations of technology. For example, Netflix as a business has had a lot of success in the emerging markets, something I really wouldn't have conceived of five, 10 years ago, where the emerging-markets story through a multinational had a lot more to do with say, soap or toothpaste. And so, our opportunity set is opened up a lot there. And we do use multinationals to provide that different correlation experience that I just was speaking of. I think that has a couple of other benefits as well in terms of mitigating the volatility of the strategy. These are generally dollar- and euro-denominated assets, which tend to have less currency volatility than

emerging-markets assets as a whole. And also, these companies have higher on average corporate governance standards, and they're very well-run companies, and they're very large and liquid companies. I think the multinational component and what it provides is very useful and beneficial in an emerging-markets context.

The second thing we do is we identify countries and currencies that are less dependent on foreign capital. That's because countries that are dependent on foreign capital have to be financed with foreign stock and bond flows, and the market can give and take away those foreign stock and bond flows. That act of giving and taking away can cause currency volatility in the future. We're not averse to currency volatility, per se, but it's something we would like to mitigate. For countries like Egypt and Turkey, maybe Argentina these days, those are countries that by and large we would like to avoid. We don't really think that we can be compensated for risk or that we're interested in having that conversation. But for most emerging-markets countries, I think it's a matter of degree, and where we have a country like South Africa or India or Mexico where there's some degree of external vulnerability, we're okay with that. But we want to be compensated for risk in some sort of disproportionate way and increasingly, we're finding fewer opportunities that do that. So, I would say, in aggregate, the portfolio probably has less currency risk or less risk of currency volatility than it has had in the past.

The third thing we do is something I already mentioned, which is, we invest in financially sound, free cash flow generative companies with business models that have acceptable degrees of cyclicality. That's an extra dimension of risk management at the stock level. And I think those three things in aggregate provide that foundational approach to managing risk that puts us in a position to reinforce the compounding outcome.

**Watson:** Sure. Lewis, thank you for your time and insights today. For Morningstar, I'm Nick Watson. Thank you for watching.

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**Clarification:** Argentinian company Mercado Libre is held in the Developing World Fund as of 31 December 2019.

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