GMO

Arjun Divecha and Warren Chiang sat down to introduce Emerging Markets investing at GMO and discuss what makes our particular strategy so compelling to equity investors. The following is an abridged transcript, which is available in full here.

Why did you launch an emerging markets strategy two decades ago?

Arjun: **Investing in emerging markets is quite different from investing in developed markets.** I've spent a lot of time thinking about what it is that makes some countries rich while others remain poor. At the end of the day**,** I've found that countries that become rich do so because of their institutions. Indeed, developed countries have institutions that can survive long periods of bad government – and this is not the case in emerging markets. **Emerging market countries are dependent on the government of the day**, and should not necessarily be thought of as long-term investments. As I like to say, **those investing in emerging market countries must not fall in love – they should only date**, **moving money from country to country as they become more and less attractive.**

What makes our approach unique versus other managers?

Arjun: There are three basic things that differentiate us:

1. **A top-down approach (that is, getting the countries and sectors right) is the most important thing.** We devote 60-70% of our risk units to picking countries and sectors.

That's because we don't believe it's wise to buy a country and hold it for 10 years.

2. **We are value investors.** We prefer to buy assets that are both cheaply priced and attractive *today*, as opposed to assets that are expensive and looking forward to future growth.

3. **We mix quantitative and fundamental strategies**. We use about 70-80% quantitative and 20% fundamental inputs in our emerging markets portfolio.

Why Emerging Markets today?

Warren: The timing questions are always difficult. But what I look for is a degree of present-day safety. For instance, **right now, the value side of emerging market equity is extremely cheap. I equate that with a high degree of safety**. By definition, value always looks cheaper than the rest of the markets, but that spread varies over time. And over the last decade, it has gotten progressively wider. Actually, 2020 has been the worst year of them all, making value very, very cheap versus growth. **The nice thing is this underperformance has been almost exclusively due to multiple expansion.** Fundamentals, earnings, and dividends for value stocks have still done very well. Looking back 25-30 years, I used to say that value has only been cheaper during the internet bubble – but that statement is no longer true. **Value is cheaper now than it was during internet bubble times.** That should give you an idea of why we think **it's a great time to invest in emerging markets value.**

How is GMO Emerging Markets different from passive EM?

Warren: The single biggest difference is our country dimension. **The emerging market value index or, as I like to call it, "simple value," does not take country bets.** Rather, its country weights are equivalent to those of the core benchmark. But Arjun identified a huge country-level opportunity from the start as spreads across countries were so wide. We took the time to learn and understand how countries worked. Whether a country was cheap enough wasn't our only consideration. We sought characteristics that signaled strength at the financial and government levels (for example, perhaps a country doesn't have an institutional quality bank, but the current administration is very strong). This is what we've been developing over the last 25 years and **we've consistently added value from the country dimension – it's both our number-one contributor to alpha and our number-one differentiator relative to simple value.**

We benefitted from this dimension even in 2020, which has been a terrible year for value. **But you must be willing to take large positions.** For instance, we recently held 10+% positions in both Taiwan and China while effectively holding no positions in Brazil. Ultimately, to take advantage of the information, one must be willing to make the big bet. At GMO, that has been a huge value-add beyond traditional value.

Drilling down to individual stocks, simple value, almost by definition, buys cheap companies. The issue with that is that **what's indiscriminately cheap often tends to be junk** (i.e., they're cheap, but also exhibit low profitability and high debt levels). This is a problem. So we look at both the country and the stock level, and because we do that, we have more choices and can be selective in what we buy. As a result, GMO's portfolio is as cheap as the MSCI EM Value Index with profitability and debt levels that are more reminiscent of the core MSCI EM Index. **In other words, we tend purchase much higher quality assets at the same EM value prices.**

I also cannot overstate the value of our **19-person fundamental team, which allows us to examine every big position we take.** Taking a 10-15% position at the country level has a layer of safety because we can work with our fundamental analysts to determine how strong and robust the position is and incorporate better insights into our models. As Arjun has said time and again, **quantitative processes work great when history repeats itself. The problem in emerging markets is the likelihood of an occasional, but significant reset, such as a change in** administration or a large devaluation of currency. There could be a war or a coup, among other destabilizing factors to consider – all giant resets that won't be repeated. Having boots on the ground allows us to say, "Hey look, maybe the quant process is not going to work this time – should we do something different?" And that is a huge value-add to our process.

How has the strategy evolved over the last 25 years?

Warren: At a high level, nothing has changed. **The major tenets have been there since the very beginning – working with the fundamental team to determine countries first, then value.** It's something we've always believed in and that has always been a part of our process. Drilling down, you'll see we've applied hundreds of changes over time to incorporate better measures of value and quality, among other insights. For example, five years ago, we were buying highly liquid small cap names with high expected alpha. We wanted the small cap premium as well as the liquidity because it is so expensive to trade in emerging markets. When we noticed we weren't buying any high-alpha names from a group of less-liquid stocks, we did the research and found that was a mistake that led to a sub-optimal outcome for the portfolio. **So, we began separating the universe into**

liquid stocks and illiquid stocks. We'd run them separately and then put the portfolio back together, which not only increased the value of the portfolio, but also the amount of liquidity premium we achieved within it, making it a better portfolio.

Can you share with us one or two lessons learned over time?

Arjun: My favorite lesson is that **when governments decide to screw you, you're most likely screwed.** In short, you have to be cognizant of what governments are doing – whether they're going to take away your assets or do something to impair them in a permanent way. That's what makes the fundamental team so important. If you invest in an ETF, you may end up with a lot of money in a country when something goes wrong. Value, in itself, is subject to value traps – **it's because we blend quality and momentum factors into our value signals that we're able to avoid such traps and achieve a better outcome.**

Warren: In order to make money at the country level, you have to avoid some of the chatter. It's typical for value investors to buy unpopular positions, and such positions can be large. For example, in 2019, we went to a 15% positive bet in Russia. We may have gotten a lot of grief for it at the time due to the political environment there, but it was nevertheless the top-performing country of 2019. But placing such a bet requires conviction, and that's the lesson here – **one must be willing to stomach large positions and a substantial amount of risk**. And that is where everything we've talked about comes into play; integrating value *and* quality considerations, our largely top-down approach, and robust fundamental resources makes those bets a little less risky.

What are you most excited about in the portfolio today?

Warren: In the **short-to-medium term, I'm most excited about the valuation spread**. So far in 2020, value has underperformed growth by 30%. **An opportunity like this comes once or twice in a lifetime, and we've never seen a dislocation of this magnitude.** The timing might not be perfect, but it will surely be a long, long time before we see another opportunity this size.

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Longer term, I think about how emerging markets are going to change. EM has evolved a lot over the years, and is now more of an East Asian bet in China, Korea, and Taiwan. Most people say "Oh, this seems very risky; these things are always changing." **Our mentality is that every time there's a change, there's an opportunity.** We're facing that now with China, which already accounts for 40% of the index and will likely reach 50% once all the A-shares open up. Investors have to ask themselves the question, "**How do I run my portfolio - China only? EM ex-China? Such questions come naturally for us because we already consider country first.** We're excited about the changing composition of the index and expect to see more alpha because of it.

Closing remarks

The GMO Emerging Markets Strategy is a compelling opportunity for our investing partners. If you are interested in learning more about GMO's emerging markets equity products and capabilities, please contact us.

BIOGRAPHIES

Arjun Divecha

Mr. Divecha is the head and founder of GMO's Emerging Markets Equity team. He is also a member of the GMO Board of Directors. Prior to joining GMO in 1993, he spent 12 years at BARRA directing software development, marketing, client service and emerging markets research and development. Mr. Divecha holds a Bachelor of Technology in Aeronautical Engineering from the Indian Institute of Technology, Bombay and an M.B.A. in Finance from Cornell University.

Warren Chiang

Mr. Chiang is a portfolio manager for GMO's Emerging Markets Equity team and oversees quantitative research. Prior to joining GMO in 2015, he worked at Mellon Capital Management as a Managing Director of Active Equity Strategies. Previously, he worked at the Federal Reserve Bank of San Francisco as a research associate. Mr. Chiang earned his B.A. in Economics and his MBA from the University of California Berkeley. He is a CFA charterholder

Risks

Risks associated with an investment in the Strategy may include Market Risk – Equities, Non-U.S. Investment Risk, Currency Risk, Management and Operational Risk, and Illiquidity Risk.

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