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## Preparing for Launch and Emerging Market Outlook



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Founder & Portfolio Manager

I've always loved the adage "the best time to fortify a ship is before you set sail from harbor, not when the storm is raging". And that is exactly what we've been busy doing at Ethos Investment Management - fortifying the team, investment portfolio, operations, and our long-term mission & values prior to launch. We strive to build both a portfolio and a firm strong enough to endure for decades to come. I'm truly thrilled with how things are coming together and for so many incredible partners that have joined me for this journey!

### Investment Philosophy

We believe that investing in high-quality businesses with sustainable growth prospects, led by excellent management teams that are purchased at reasonable prices, will achieve excess returns over a complete market cycle. We take a long-term, business-owners, approach to investing and invest only in our highest conviction 30-50 ideas.

We also care about the impact of our investment decisions. ESG is integrated into our process and using our proprietary ESG Scorecard we aim to identify businesses that rank highly on Governance, Social, and Environmental factors, and engage with companies to enhance shareholder returns.

In short, *we seek great returns through business that do good.*

### Why now?

The first questions to answer are: Why am I launching an emerging markets (EM) fund? And why am I focusing on EM small and mid-cap stocks (SMID)? The short answer is that over my 17-year career in investing, I have found this opportunity set of EM SMID to be the most attractive and inefficient (i.e. opportunistic for alpha) in terms of finding excellent structural growth companies trading at attractive valuations. Emerging markets is home to **85% of the world's population**, now accounts for over **59% of the world's GDP**, yet comprise only **12% of global market cap** and less than **6% of global institutional investors' allocations**.<sup>1</sup> Over time, I expect these numbers to continue to converge in favor of EM. As structural growth trends continue of a rising EM middle class, growth in innovation sectors, and access to capital, EM seems poised to continue its growth trajectory. What is especially exciting to see is that while developed markets have seen the total number of companies listed on exchanges decline over the past decades as fewer companies go public and more delist, EM has seen the number of companies listed in Consumer, Technology, and Healthcare sectors more than triple over the past decade (from 455 in 2010 to 1,622 in 2020). What this gives us a much bigger opportunity set of attractive business models to invest in.

So far 2021 has been a tumultuous yet opportunistic year for emerging markets. Year to date through 30 November, the Emerging Markets Large Cap Index is **down -4.6% in USD**. Encouragingly, the Emerging Markets SMID Cap Index where we focus has outperformed substantially and is **up 10.1% in USD**. However, these both are lagging the MSCI ACWI World Index which is **up 15.9% YTD** and the S&P 500 which is up **25.6% YTD**.



It's important to zoom out from the short-term trends and see the big picture as well. We are, after all, long-term investors. Interestingly, over the past 20 years, starting Nov 2001 to Nov 2021, all Indices, both EM and DM have delivered nearly identical annualized USD returns. (EM has delivered **9.85% IRR** since 2001, EM SMID has delivered **9.81%**, compared to S&P500 at **9.31% IRR**, in USD). This is despite the recent underperformance in EM.

In terms of valuations, EM is currently trading at historical record discounts now to their counterparts in US and Europe, trading at over 60% discount on a P/E basis (see chart below).

I feel that we are getting a great entry point into emerging markets right now and expect we can buy some high-quality businesses with long-term structural growth at good valuations which equates to better than average expected future returns. Of course, there are risks. Rising inflation, heightened regulatory, and geopolitical risks in China and other countries, the ongoing COVID-19 pandemic, and global supply chain shortages are all key risks that we need to weigh in the balance when underwriting any investment into the portfolio.

Fig 2: Long-term price earnings ratio



Source: Ashmore, Bloomberg. Daily data as at 20 November 2020.



## Country Outlook

We are bottom-up, fundamental long-term investors. We don't seek to speculate on what markets will outperform over the next 6 to 12 months and we take a benchmark-agnostic approach to how we construct the portfolio. We simply seek to assemble our highest-conviction portfolio of high-quality businesses with best-in-class ESG practices to achieve the highest expected USD returns possible for partners.

That being said, we are commonly asked what countries our financial models, ESG risk models, quality scores, and 5Y expected returns are indicating the highest expected returns are at any given point of time in EM.

Currently, the underlying dynamics are leading us to have higher exposure than the EM Index in China, Taiwan, and Brazil. And leading us to have lower than market exposure in Southeast Asia, slightly lower in India and lower in Eastern Europe. Below I have highlighted China and India.

**China**, is expected to be our second largest market in the portfolio, behind Taiwan. While 2021 has been a tumultuous year for many listed Chinese equities, with heightened regulatory risks in sectors such as education, e-Commerce, and health care being negatively impacted, the long-term trends in China remain promising. We find that many great, high-quality businesses with low regulatory risks and high pricing power are now trading at attractive valuations in China. I've personally been travelling to and investing in China for nearly two decades and having lived in Hong Kong for the past five years, I've seen both bull and bear cycles over the period, including the bear markets of 2008, 2015, and 2018 in China. Despite the cycles, China has remained undaunted in its structural growth, rising urbanization trends, investment in innovation and access to capital benefitting from a large consumer market, high domestic savings rates, and low external debt levels. Many are surprised to know that since the year 2000, China has created more unicorns than any other country in the world, including the US.<sup>2</sup>

It has been an imperative that companies are aligned with President Xi's "common prosperity" goals. As part of our ESG and Quality Scorecards, we do deep dives into the regulatory risks, pricing power, and societal risks of all the businesses that we analyze. This has helped us avoid many of the problematic sectors that were exposed in 2021 such as property and education, where we had no exposure. In the end, China and President Xi have been clear in their statements and 5-Year plans that that will continue to encourage economic growth, but they want businesses and regulators to promote:

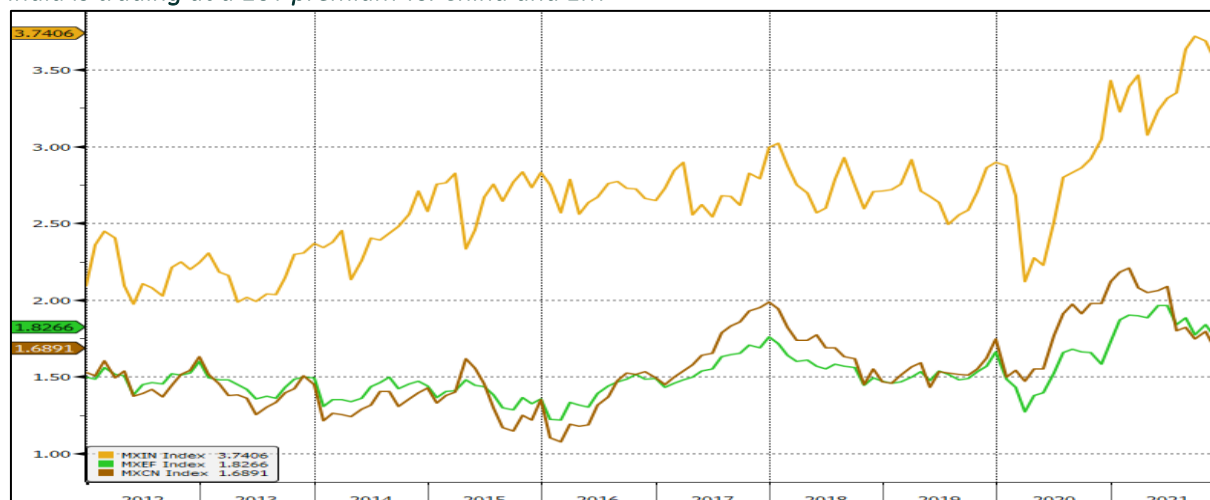
- Fairer competition
- Reducing income inequality
- Social well-being
- Data Protection

In my opinion, these are not absurd goals. In fact, Charlie Munger was recently questioned at the Sohn Australia Conference about China's crackdown on speculation and corruption, and he said "China is right to step out, step hard on booms and to not let them go too far. The extent that my country doesn't do that, we're inferior to China. They're acting in a more adult fashion".<sup>2</sup>

Whether "adult" or not, what we can't dispute is China has undergone incredible economic growth over the past two decades, and we still see a market full of innovation, access to capital, and long-term strategic thinking. There are high-quality businesses in China that succeed in meeting all of Xi's priorities and that we believe benefit from long-term structural growth trends in the market. And currently, many of them are trading at quite attractive valuations, due to the recent selloff.

**India**, on the other hand, has had an exceptionally strong run in 2021, as YTD through 30 November, the India SMID Cap Index is **up +41.7% in USD**. We believe India has a lot of attractive long-term characteristics: a large and entrepreneurial population, a rising middle class, ongoing structural reforms led by Prime Minister Modi, and global leadership in sectors such as pharma, technology, and healthcare. We find numerous businesses in India that we think are exceptionally high quality led by great managements with long-term growth potential. We expect our exposure to be slightly underweight India relative to the Index due to heightened valuation levels (India is 15% of the Index). The graph below shows that MSCI India now trades at a 10 year high relative to MSCI China and MSCI EM on a P/Book basis.

*India is trading at a 10Y premium vs. China and EM*



## Operational Updates

**Tim Zhang** has joined as our first investment analyst. Tim has five years of buy-side experience, is a graduate of Columbia Business School’s prestigious Value Investing Program, is a CFA Charterholder and a CPA and is a native Cantonese and Mandarin speaker. We are currently interviewing for our second analyst on the team and have many interesting candidates. We also have two interns working for Ethos, one from Columbia Business School, **Joanna (Jiao) Zhou**, and one from BYU Business School, **Madhavan Padmanabhan**. It’s exciting to see the research team take shape, to build on the best practices that I’ve learned from my career of how to build a robust and successful investment team and process.

In addition to the fund construction, we have been hard at work building a first-class operational setup at Ethos. I’m thrilled that our operations will be led by **Dana Witkin**, who was hired as Partner and COO of Ethos Investment Management. As many of you have known and have interacted with Dana, you can attest to her high attention to detail and industry knowledge. She has over 20 years of experience as a Managing Director of Operations and Investor Relations with numerous funds including Red Cedar Asset Management, Glade Brook Capital, Icahn Capital, and Blackstone.

In setting up the operations, we focused on using the best Tier-1 service providers as we built the organization. **JP Morgan** will be our global custodian and administrator, and they have been hard at work getting country registrations ready for January for our 18 countries. **Morgan Lewis** as our onshore legal counsel and **Walkers** is our offshore legal counsel. We have selected **Ernst & Young** as our fund auditor. We have selected **Optima** for our outsourced compliance, and they will be assisting us with registration. We will be using **Agio** as our IT service provider and cybersecurity partner. For our CFO, after discussing whether to

bring in a CFO in-house or outsource the position, we concluded that outsourcing to the industry's largest outsourced CFO organization for hedge funds, **Agile**, would offer clients the most robust solution, and Dana has worked with the Agile team with success in the past. Overall, it's a fantastic structure of best-in-class service providers that I believe will service the Ethos portfolios incredibly well.

## Launch

We're thrilled to announce that Ethos EM SMID Master Fund LP will launch on January 3<sup>rd</sup> with over \$60M, plus additional follow-on commitments which will bring the fund to \$100M AUM from our seed investors. We've been so fortunate to attract renowned family offices from the US, Hong Kong, Japan, and Australia, who believe in our mission and our long-term vision. I am humbled and honored to invest money on behalf of so many great investors, and I promise to work my heart out for you. We are currently raising capital for our Founders Class open, and we are having a number of productive conversations with potential investors.

The past few months have been unforgettable as we built the foundation of Ethos Investment Management. We aim is to create an investment company focused on exceptional returns and best-in-class ESG integration and offer a portfolio that our clients are proud to own. We continue to find many high quality, innovative businesses at attractive prices in EM SMID cap. In fact, I am looking forward to investing more than half of my personal liquid net worth alongside our clients in the fund. I sincerely believe that we have the investment philosophy, process and people which will allow us to generate long-term value for investors and create a legacy in the asset management industry.

We look forward to embarking on this journey with you.

Sincerely,



James Fletcher  
Founder and Chief Investment Officer

1. Data is obtained from FactSet, MSCI and eVestment, as of December 2020.
2. <https://fortune.com/2019/10/22/china-us-unicorns-beijing-silicon-valley/>
3. <https://cryptonews10.com/warren-buffetts-right-hand-man-charlie-munger-hates-crypto-thinks-millennials-are-peculiar/>



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