Michael Kass: Why EM and International Equities Are Ready for the Spotlight

This is an edited version of an October 27, 2021, Q&A with Michael Kass, portfolio manager of Baron Emerging Markets Fund, Baron International Growth Fund, and Baron New Asia Fund, with additional commentary from members of the EM/International research team. To access the recording, please dial (800) 633-8284, passcode #21997855.

Key Discussion Points

- Drivers of market performance in the third quarter
- Why we think the post-pandemic "new normal" bodes well for EM and international equities
- Investing in China in light of recent events
- A sampling of our top investment ideas across the globe

Review of Third Quarter 2021 Market Conditions

To start, could you please give us a brief recap of the quarter?

Michael Kass: We had solid relative performance in the third quarter, in a difficult period for emerging markets (EM) in particular as well as international equities. The International Growth strategy is substantially ahead of its benchmark [MSCI ACWI ex USA Index] and the MSCI ACWI ex USA IMI Growth Index year to date. The Emerging Markets strategy is well ahead of the MSCI EM IMI Growth Index but slightly trailing its benchmark [MSCI EM Index] year to date.

The main market driver in the quarter was a return to concerns around inflation and central bank tightening. While COVID-related disruptions and supply constraints continued, Delta variant infections and hospitalizations peaked in most jurisdictions during the quarter, which is a positive. For the short term, however, the subsiding numbers of COVID cases is probably adding fuel to the fire of the supply/demand imbalance and the upsurge in inflation. We continue to believe this period of mid-cycle moderation is likely necessary to allow some of the supply chain, inventory, labor, and commodity supply shortages to cure.

The question is, will that happen naturally? Will we go through a period of financial tightening by central banks led by the Fed? How quickly can we regain balance and resume global economic and earnings expansion?

Michael Kass: Let me put the historical backdrop and forward-looking outlook into context. As we've been saying for the last couple of years, EM and international equities have underperformed for at least a decade. Now, these performance cycles are very long term, with extended periods of underperformance or outperformance. And over the very long term, they tend to mean revert. So, we are confident that we are due for a reversal. We think that fundamentals in the current setup suggests this is likely, notwithstanding the weak performance of EM and international equities relative to the U.S. year-to-date.

International and EM equities tend to outperform in periods of stronger global growth and trade. The period after the initial COVID crisis through the end of last year was a good example. A period of a weakening U.S. dollar was another correlation with strong relative performance for international and EM. Most of the last decade has been characterized by the opposite of those conditions. We had substandard global growth and inflation; we missed on policy goals on all measures for growth and inflation. That presented an elevated risk of disinflation, if not deflation and debt crises, and a persistently strong dollar. We're exiting that environment.

If we look at the COVID crisis and how the world reacted to it, particularly in the U.S. and Europe, we see major changes in policy initiatives. COVID was the greatest exogenous shock that we've seen in our investment lifetimes -- a near total global economic shutdown -- and the global policy reaction was of equal magnitude to offset the collapse in demand. We saw a massive fiscal expansion supported by central banks. Previously, central banks kind of ran with one oar in the water. Now, the levers of policy stimulus have shifted to politicians and elected officials through major fiscal expansion plans.

In short, we have transitioned to a whole new world. We need to be open to the likelihood that potential GDP growth and inflation and the potential for interest rates and yield curves in the decade ahead will exceed current expectations rather than lag them as they did in the past decade. That has significant implications for equity market leadership. It will most likely trigger capital flows out of bonds and into equities. It will likely trigger a much weaker dollar, as a lot of the fiscal expansion is coming from the U.S.

We think this new world points to enhanced earnings potential. It will favor inflation- and interest rate-sensitive companies and countries, owners of real assets, and companies with industrial pricing power. Banks will have greater pricing power or higher spreads. The EM and international markets tend to be much more weighted towards these industries. We think EM and international countries will also see a major improvement in sovereign credit and capital flows, which will be stimulative and reinforce their own domestic growth potential.

We've seen some big changes in China over the last few months. How concerned are you about the developments there?

Michael Kass: Developments in China have been the predominant driver of the widening of the discount, particularly for EM versus U.S. or global equities. While there is cause for concern around China as the largest EM component and the largest weight in an EM index, we believe the correction is very well advanced.

What we see today is the manifestation of China's credit and regulatory tightening that began in November 2020. Since 2015 or 2016, when China de-pegged its currency from the dollar, the government achieved an ability to conduct asynchronous monetary and credit policy. And they have been doing exactly that. In fact, I would say, knowing that we were moving towards COVID reopening and a major recovery of global economic activity and trade at the start of this year, they accelerated and pulled forward their credit and regulatory tightening to coincide with that.

Can you put what we are seeing in context?

I look at what's happening in the context of President Xi's political objectives. The Communist Party has laid out three major priorities: 1) lift hundreds of millions of people out of poverty into the middle class; 2) dramatically improve China's environmental trajectory; and 3) enhance the social, political, economic, and financial stability of China. These goals are the precursors for the party to maintain stability and longevity. From Xi's perspective, these goals are the precursors to achieve a third term.

Within China, Xi gets good marks on the first two objectives -- lifting out of poverty and changing the vector of the environmental trajectory. The U.S. financial or U.S. media may not present it that way, but within his own country, he gets high marks. But on enhanced stability, the reviews are mixed. Some would say that he's backtracked and that the country has not advanced enhanced stability. Regulatory measures, credit tightening, and property deleveraging are tied to this third goal of achieving passing grades on stability and discipline.

It starts with social stability, which extends directly to education, housing, health care, and the wealth gap, which are the key concerns of the middle class. This drive towards what China calls common prosperity is the policy response to the middle class feeling stressed in these areas of uncertainty.

Internet platforms are one of the key mediums to deliver common prosperity. China now views these companies as leveraging their market or pricing power and their data to advance their own corporate self-interest. That may sound familiar because it's the same concern that exists around the world with titans of digitization and platforms such as Amazon, Facebook, Google, and others. The way China addresses this issue is much more abrupt and one-sided. They hand down mandates and the companies respond. This approach created a major correction in these companies, along with concerns over uncertainty, the lack of transparency about where these regulatory changes are going to settle, and how significant an impact they will have on the business models and future earnings growth of these companies. In the aftermath of the initial shock, these companies traded down to a level well below intrinsic value. We think that intrinsic value is going to grow slower in the next decade than it did in the last, so we've been underweight those companies. We believe they represent good value right now, but they will not grow in value as quickly as they did in the past.

On the other side of this divide are companies seen as solving some of China's issues and challenges. These are companies that can enhance the country's stability by advancing the government's goal of self-sufficiency in the key intellectual capital-based industries. This is our China value-added theme, where we have been accumulating exposure in recent years. We have taken profits in digitization in China since late last year, with much of that capital going into themes such as semiconductors, software, SaaS, electric vehicles, renewables, biotech, pharmaceuticals, automation, and robotics. We believe these industries and companies are going to grow and prosper at the expense of the western multinationals that have historically dominated profits in these markets for the last 15 or 20 years.

There's going to be some rebalancing ahead, but we do not believe it's the end of private sector in China. It's not the end of China's kind of commitment to capitalism. The government knows they must have a functioning private sector to achieve their long-term goals. But there is going to be some modification and some rebalancing.

Can you talk about the Evergrande credit crisis? This was another big component of the China selloff.

The first thing we want to say is that this is an intentional crisis. It is a signal that the government is going to guard against moral hazard. They're addressing excessive leverage and property price inflation or speculation. Homeownership is one of the key issues for the middle class in China. We believe the government is looking to provide support to pricing while they drive and instill discipline on the most aggressive actors in the property development sector and perhaps firms in the financial sector that are lending to these entities. They are preventing broad contagion and they are going to do everything they can to prevent material decline in property prices.

Are you comfortable Evergrande is not going to become a much bigger problem?

We look at, number one, offshore traded RMB, which is the market proxy for the world's view of the RMB as a currency and China as a sovereign credit. Only a handful of currencies are up more than 2% against the U.S. dollar year-to-date: China, Canada, Russia, and Norway. If insiders in China felt the

Evergrande crisis had a high likelihood of becoming a much bigger issue, they would be looking to reduce their RMB exposure. They are not.

There's no question that there's lots of concern, but we think it is contained within the developer community and even there the concern is at the lower end of the quality spectrum. There’s also no question that there will be some equity write-downs and bond haircuts, which are intentional. That is how you send the message of discipline. But the crisis is not transferring into sovereign credit, sovereign spreads, or other broader credit markets in China outside the property sector at this time.

In any event, we're not exposed directly to the property sector. We've never owned a property developer in China. We have almost never had exposure to SOE banks. We own no steel manufacturers tied to construction and development. We've also been underweight China tech and digitization. We sold our position in [Chinese tutoring company] **TAL Education Group** long before these new mandates. So we feel very good about how we've been navigating our bottom-up thematic and stock selection in China. Year-to-date, our relative performance in China is positive.

Let’s hear from the EM and international research analysts about their top ideas, starting with Anuj.

Anuj Aggarwal: We are really excited about the investment opportunities in India, from a macro standpoint, a reform agenda standpoint, and a bottom-up perspective. India is positioned to be the fastest growing economy this decade. We expect GDP growth to be anywhere from 6% to 8% CAGR. It's got a strong and growing middle class of over 300 million people. Most importantly, the economic reforms implemented over the past three to five years have put the country on a structurally high growth trajectory.

We see significant value creation across multiple themes, but we are most excited about what's happening in digitization, which is just getting started in India. I would say India's digital/tech ecosystem is about 15 to 20 years behind China, so we are very early in terms of opportunity. Access to cheap mobile data is empowering over 600 million people in India to get onto mobile data and the internet for the first time. We expect this number to reach a billion-plus in the next three to five years. Think of the opportunities in ed-tech, food-tech, fin-tech, and e-commerce.

In terms of a particular stock, we are really excited about **Reliance Industries Limited,** which is the bedrock of the digitization theme in India. Reliance is a truly disruptive company, transforming mobile services from 2G and 3G, onto 4G -- really creating the digital ecosystem. Reliance also is the largest organized retailer in India, with over 12,000 outlets, spanning fashion, electronics, and other related merchandisers. It’s also transforming its legacy oil and gas business into green energy and has pledged to invest heavily in renewable energy and become carbon neutral by 2035.

Jose Barria: I cover the financial sector for the international and EM team. Building on the digitization theme, we are invested in a variety of fintech companies globally. One stock I would like to highlight is **TCS Group LLC**, which we own both in the EM and International Growth strategies. TCS Group is the owner and operator of Tinkoff Bank, the largest digital bank in Russia.

TSC Group is a pioneer in digital banking with over 10 years of experience. It is highly profitable with returns on equity of 30% or 40%, which we believe are sustainable. It has an intense focus on the consumer experience, which has helped it build a strong brand. Lastly, it is exposed to some attractive verticals, including digital brokerage and online payment processing, which are growing rapidly due to digitization trends that were turbocharged by the COVID pandemic. It's been a strong performer this year for both strategies.

Chingiz Gadimov: I would like to talk about our sustainability theme – in particular, two cyclical names benefiting from tighter environmental policies in both developed and emerging markets.

One is **China Conch Venture Holdings Ltd.,** an emerging leader in hazardous waste treatment and cement coal processing in China. The business has 70% plus margins and 40% plus project-level IRRs due to less capital intensity versus competing methods, and, as a result, much better pricing power. We expect this business to compound growth 30% per year and its value to more than triple over the next five years.

Another interesting environmental services company is **Befesa S.A.,** which we have held in our International Growth strategy for over a year. It's a leading German recycler of hazardous steel dust waste in E.U. and has a 50% market share there. Befesa collects steel dust wastes for a fee from customers and in the process amasses valuable byproducts. It generates high returns on capital -- more than 35% on a project level -- due to its scale, technological advantage, and customer captivity within geography. It has a first mover advantage and virtually no competition right now in China, which is tightening environmental regulations on methods for collecting steel dust,.

Eric Guzman: I cover the consumer and e-commerce space for the team. I would like to highlight **Ozon Holdings PLC**, which plays into the digitization theme. It's the second largest e-commerce marketplace in the Russian Federation. Like most other emerging markets, Russia is under-penetrated in e-commerce. E-commerce is about 10% of Russian retail spend, similar to levels we see in Brazil, Southeast Asia and some of the Mediterranean countries, versus well over 20% in the U.S. and the U.K. and over 40% in China. We think Ozon is an attractively valued, quality asset that can be one of the fastest growing e-commerce businesses in the world over the next five years.

Any closing thoughts?

Michael Kass: We strongly believe the fundamentals that will favor EM and international equities are falling into place. We see a lot of opportunities. Many investors tend to focus, particularly on the EM side, on the higher growth aspects of those countries. In contrast, we emphasize productivity gains and reforms. We're also excited about themes that transcend borders -- areas like offshoring and supply chain diversification. Fintech is a global phenomenon. Sustainability and decarbonization are probably the largest thematic increase in our weighting over the last 12 to 15 months. We are excited for what lies ahead.

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Baron Emerging Market Fund's annualized returns for the Institutional Shares as of September 30, 2021: 1-year, 17.95%; 5-years, 9.61%; 10-years, 8.90%. Annual expense ratio for the Institutional Shares as of December 31, 2020 was 1.09%.

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Portfolio holdings as a percentage of net assets as of September 30, 2021 for securities mentioned are as follows: Reliance Industries Limited – Baron International Growth Fund (1.1%), Baron Emerging Markets Fund (2.5%); **TCS Group LLC** – Baron International Growth Fund (1.8%), Baron Emerging Markets Fund (0.9%); **China Conch Venture Holdings Ltd.** – Baron International Growth Fund (0.7%), Baron Emerging Markets Fund (1.6%); **Befesa S.A. -** Baron International Growth Fund (1.5%); **Ozon Holdings PLC** – Baron Emerging Markets Fund (0.7%).

As of September 30, 2021, neither Fund held shares of **TAL Education Group**.

Top 10 holdings as of September 30, 2021

Baron International Growth Fund

Holding	% Assets
Future plc	3.0
S4 Capital plc	2.7
BNP Paribas S.A.	2.3
Keyence Corporation	2.0
Bajaj Finance Limited	1.9
TCS Group Holding PLC	1.8
Endava plc	1.8
argenx SE	1.8
Eurofins Scientific SE	1.6
Linde plc	1.6
Total	20.5

Baron Emerging Markets Fund

Holding	% Assets
Taiwan Semiconductor Manufacturing Company Ltd.	3.6
Bajaj Finance Limited	3.1
Tencent Holdings Limited	3.0
Samsung Electronics Co., Ltd.	2.9
Reliance Industries Limited	2.5
Alibaba Group Holding Limited	2.4
Novatek PJSC	2.1
Sberbank of Russia PJSC	2.1
Glencore PLC	1.7
Korea Shipbuilding & Offshore Engineering Co., Ltd.	1.7
Total	25.1

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

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