The Power of High-Quality Growth Investing in Emerging Markets

polen capital

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Our Approach

At Polen Capital, our Global Emerging Markets Growth Strategy follows a clear philosophy. We invest in concentrated portfolios of high-quality businesses that we believe can compound earnings and cash flows at high rates of return. In addition, we see ourselves as business owners, seeking to invest with a long-term horizon and independent mindset.

Our strategy follows the same time-tested approach as other Polen Capital strategies. This approach has historically generated positive returns, as shown by the 33-year track record of our flagship Focus Growth strategy.

As seen below, we have been able to deliver favorable performance results under diverse market conditions and environments by adhering to our philosophy since our firm's founding.

This paper explains why we believe that applying a similar philosophy can also yield attractive long-term returns for our emerging markets clients. The following sections take a closer look at each of the four key tenets of our philosophy and explain why we view them as highly applicable to some of the fastest-growing countries in the world.

Consistency Through Varying Markets: A Look at Polen Focus Growth

Rolling 5-Year Net Returns Since Inception (12-31-1988)

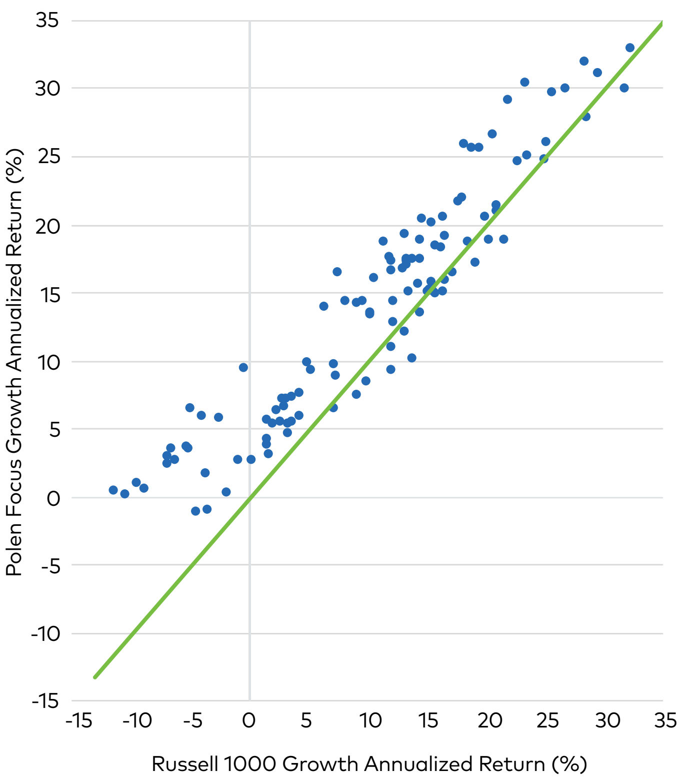

Figure 1: Source: Archer. As of 12-31-2021. Supplemental information to the fully compliant composite performance which accompanies this presentation.

Market Environment

Bear Markets (<0% return)	
Polen Focus Growth	2.64%
Russell 1000 Growth Index	-5.33%
Relative Performance	7.97%

Normal Up Markets (0-15% return)	
Polen Focus Growth	11.36%
Russell 1000 Growth Index	8.56%
Relative Performance	2.80%

Speculative Up Markets (>15% Return)	
Polen Focus Growth	22.44%
Russell 1000 Growth Index	20.78%
Relative Performance	1.67%

All Markets	
Periods Outperformed	90
Periods Underperformed	22
Total Periods	112
Overall Batting Average	80%

Tenet 1: High-Quality Growth Companies

At the heart of our investment philosophy is the principle that we only invest in what we consider to be the highest-quality growth companies in the market. Not only should these businesses be capable of compounding their cash flows (and hence shareholder returns) over time, but their sustainable and financially robust business models should also lead to better downside protection under periods of turbulence or stress. The latter is particularly important in emerging markets which are often associated with being higher risk and more volatile than their developed counterparts.

However, the term "high-quality growth" tends to be loosely defined and, in our opinion, frequently used without any consistency in meaning. For us, the definition of a high-quality growth company is straightforward and consists of four main elements:

1. **Competitively advantaged businesses:** We look for companies with attractive business models and value propositions that have the potential to generate high levels of return on investment and free cash flow. However, such attributes usually attract competition that, without any barrier, can erode margins and returns. Therefore, we focus on identifying companies we believe possess substantial and durable competitive advantages that enable them to generate high returns today and for many more years into the future.

2. **Structural growth opportunities:** We also look for companies with attractive growth potential, which we believe is a critical component of shareholder value creation. Just because a company earns a high return on capital, it does not also mean it can compound earnings or cash flows at high rates of return. For that to happen, we want to see structural growth opportunities that enable our companies to continuously reinvest their cash flows, driving the long-term growth flywheel. The chart to the right illustrates the impact of increasing return on invested capital (ROIC) and growth on a company's valuation and the synergetic power of combining the two.

3. **Trustworthy stewards of our client's capital:** We look for businesses that we believe are run by great leaders who are strategic in their approach and have a clear long-term vision. We also value companies that have embraced a culture of excellence, humility, and trust. A key element of our analysis of management capability is its track record on capital allocation, which is often the most crucial decision management and the board of directors can make.

The Impact of Return on Invested Capital & Growth on Equity Valuations

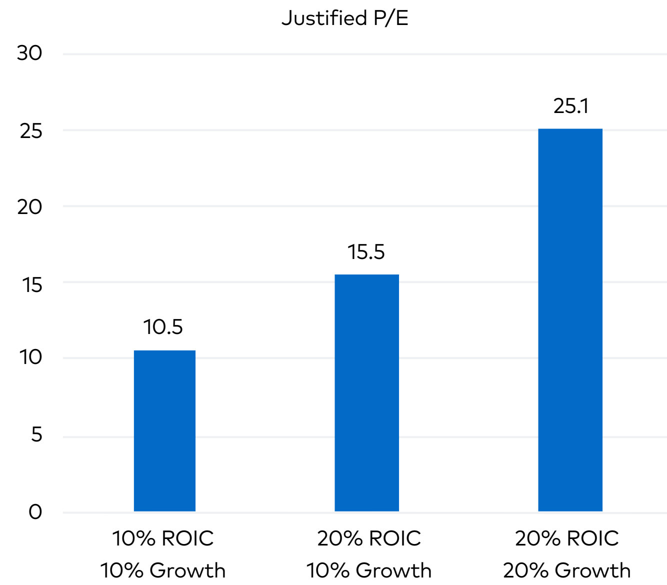

Figure 2: Source: Polen Capital. For illustrative purposes only.

4. **Self-financed growth and robust balance sheets:** We expect our companies to generate attractive cash flows and not rely on external sources of capital to fund their growth. In our opinion, the less a business depends on debt or equity markets for funding, the more durable its operations will be through times of market stress.

One way to understand the historical attractiveness of quality in emerging markets is by looking at the returns generated by the MSCI Emerging Markets Quality Index. This index has outperformed its mainstream sister index over the last 15 years, delivering returns of 6.8% vs. 4.5% per annum, as shown below. Additionally, it has achieved this performance with less volatility, with a standard deviation of 20.0% vs. 21.4%, as seen in Figure 3.

MSCI EM Quality Index vs. MSCI EM Index

Index	Annualized Returns			Standard Deviation		
	5 Years	10 Years	15 Years	5 Years	10 Years	15 Years
MSCI EM Quality	11.70%	6.78%	6.80%	15.46%	14.71%	20.03%
MSCI EM	9.86%	5.48%	4.45%	16.62%	16.37%	21.38%

Figure 3: Source: Bloomberg, MSCI. As of 12-31-2021.

In composing its quality index, MSCI selects the top (currently about 15%) of companies from the general universe based on return on equity (ROE), debt/equity, and earnings variability. While not comprehensive, these are some key characteristics we would look for in our definition of quality growth companies (notably attractive returns and low leverage). Taking a closer look, we analyzed the importance of these two quality characteristics individually based on historical performance.

First, we analyzed the performance of companies in the MSCI Emerging Markets Index, broken down by quintile of ROE over the last 15 years. As seen in Figure 4, companies in the highest ROE rank outperformed those in the lower quintile, particularly over a longer time horizon.

MSCI EM Index by ROE Rank

MSCI Emerging Markets Index annualized return (%) by ROE rank	5 Years	10 Years	15 Years
Top Quintile	12.11%	8.15%	10.69%
Middle Quintile	10.09%	7.94%	8.87%
Bottom Quintile	11.32%	5.11%	5.68%

Figure 4: Source: Bloomberg. Annualized returns by quintile were calculated using the MSCI Emerging Markets Index constituents, split equally by ROE. As of 12-31-2021.

Next, we looked at these index constituents over the same periods, but this time, by leverage. Again, we found similar results indicating that companies with lower leverage outperformed their more leveraged counterparts.

MSCI EM Index by Leverage Rank (Debt/Equity Ratio)

MSCI Emerging Markets Index annualized return (%) by lowest leverage rank	5 Years	10 Years	15 Years
Top Quintile	11.77%	8.07%	9.32%
Middle Quintile	10.96%	6.42%	7.49%
Bottom Quintile	10.65%	6.88%	8.18%

Figure 5: Source: Bloomberg. Annualized returns by quintile were calculated using the MSCI Emerging Markets Index constituents, split equally by Debt to Equity. As of 12-31-2021. Top Quintile represents lowest leverage, bottom quintile represents highest leverage.

Tenet 2: Concentrated Portfolios

Our second tenet is building concentrated portfolios consisting of only what we believe are the best businesses we can find. There are two reasons for this. First, it allows each of our investments to have a material impact on portfolio performance. Second, we do not believe that adding more companies is necessary for diversification. We would argue that more companies may even increase risk by diluting the quality of the portfolio. Warren Buffett illustrated this concept by stating that "diversification is protection against ignorance."

A seminal study by researchers John Evans and Stephen Archer suggests that a portfolio of only 10-15 stocks can achieve sufficient diversification.[1] Using the Evans-Archer methodology, we conducted an internal simulation[2] which assessed the threshold for adequate diversification in emerging markets by examining the number of companies required to produce lower volatility than the MSCI Emerging Markets Index. As shown in Figure 6, we found that about 18 companies are needed to achieve this result, and using a subset of higher-quality companies reduced that number closer to 12.

[1] Evans, John L., and Stephen H. Archer, 1968. Diversification and the Reduction of Dispersion: An Empirical Analysis. The Journal of Finance 23(5): 761–767.

[2] 50,000 total simulations (1,000 at each holding level from 1-50) based on the MSCI Emerging Markets Index (the "Index"). We screened the Index constituents for quality based on the following criteria: ND/EBITDA<4, ROE>5%, EPS>0%, average 3-year EPS Growth > 0%. The results presented are hypothetical.

Standard Deviation of Returns by Portfolio Size

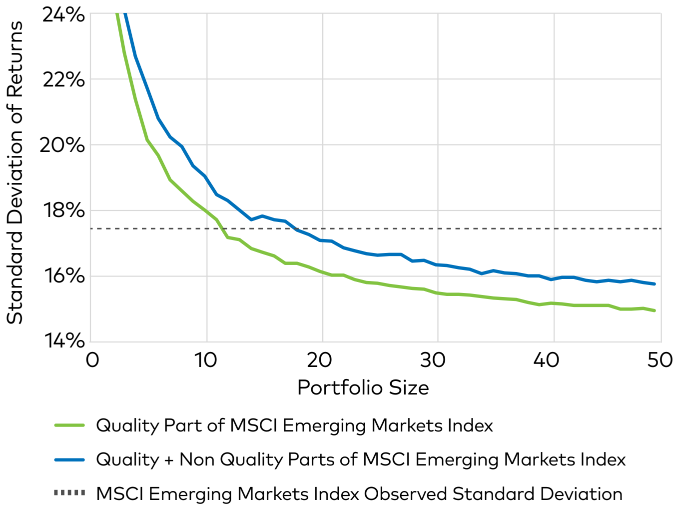

Figure 6: Source: Polen Capital, Bloomberg. As of 11-30-2021.

A Sharpe Ratio simulation arrived at a similar conclusion, as seen in Figure 7. The analysis indicated that only 13 concentrated quality holdings are needed to yield comparable levels of risk-adjusted returns as a portfolio consisting of 50 quality and non-quality securities.[3]

Sharpe Ratios by Portfolio Size

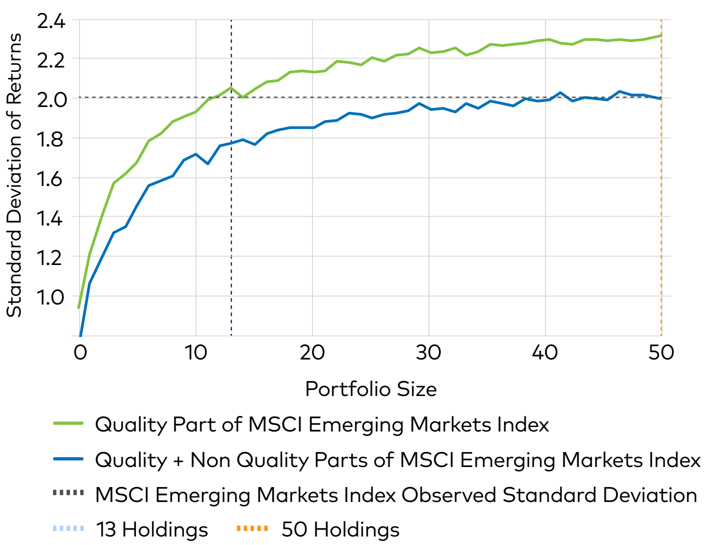

Figure 7: Source: Polen Capital, Bloomberg. As of 11-30-2021.

A further 2021 study examined the concentration of shareholder wealth creation in various markets at a company level. As illustrated in Figure 8, the data showed that over 30 years (1990-2020), the top-performing 0.5% of firms in emerging markets accounted for over 60% of the stock market wealth creation. This underscores why we focus on finding those companies that we believe will be able to compound returns for our clients over time and avoid diluting the return potential of our portfolio through unnecessary diversification.

Concentration of Net Stock Market Wealth Creation by Firms (1990-2020)

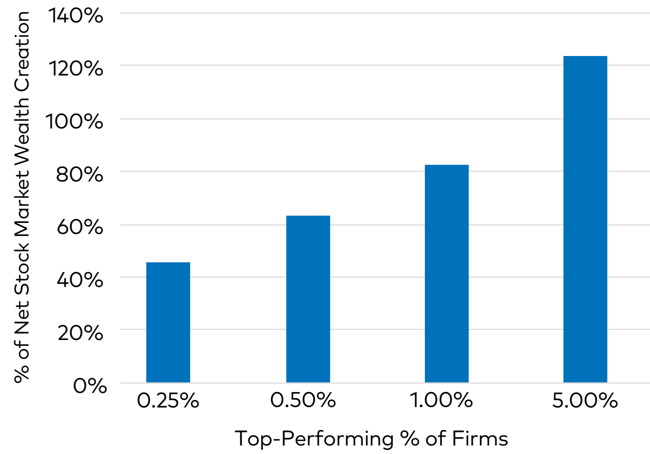

Figure 8: Source: Bessembinder, Hendrik (Hank) and Chen, Te-Feng and Choi, Goeun and Wei, Kuo-Chiang (John), Long-Term Shareholder Returns: Evidence from 64,000 Global Stocks (08-27-2021).

Tenet 3: Long-Term Investment Horizon

The third pillar of our investment philosophy is maintaining a long-term business owner's mindset. Given the power of compounding over time, we believe that once we invest in great businesses, the best path we can take is to stay the course through a long-term approach. This is why we aim to hold our companies for five years or more.

As investors, we focus our attention on long-term fundamentals rather than short-term market noise. This is especially true in emerging markets, where risks arise from time to time that can create bumps in the road. These headwinds are often difficult to predict in both timing and scale, so we strive to focus on long-term structural themes that have the potential to prevail regardless of short-term uncertainties.

[3] Averaging the three-year standard deviation and returns of the simulated portfolios and calculating the Sharpe Ratio.

Figure 9 shows the percentage chance of making a positive return by investing in the MSCI Emerging Markets Index for different holding periods, based on Bloomberg data collected from 1999 to March 2021. The data indicate that the chance of making a positive return on any day over the last 22 years in the MSCI Emerging Markets Index was just about 55%. The probability only increased to a maximum of 60% for any month. However, if an investor held for a more extended period, the chance of positive returns dramatically increased. For a five-year holding period, the likelihood of a positive return was closer to 89%. And for a 10-year holding period and above, the chance of a positive return was even higher.

Theoretical Probability of a Positive Return for the MSCI EM Index

Period invested in the MSCI Emerging Markets Index	Percentage chance of a positive return
1 day	54.7%
1 month (21 business days)	59.6%
1 year (262 business days)	65.7%
5 years	88.8%
10 years	99.9%
20 years	100.0%

Figure 9: Source: Polen Capital, Bloomberg.

Over this 22-year time horizon, the index's total U.S. dollar return was 648%. However, if an investor participated in every day of this period except for the five best days, they would have seen dramatically reduced returns of just 396%. Of course, knowing when these days will come is nearly impossible. For this reason, we do not believe in attempting to time the market. Instead, we believe in letting the power of long-term compounding do its work over time.

Tenet 4: Independent Mindset

The final key tenet of our philosophy is that we employ a benchmark-agnostic, bottom-up approach to investing. Hence, we pay close attention to absolute and not relative returns. When constructing portfolios of high-quality businesses, we do so with no consideration of the benchmark's allocation. Our portfolio construction starts with a blank piece of paper and one clear goal in mind: to maximize the risk-adjusted returns for our clients. Words such as "underweight" or "overweight" are not part of our lexicon.

Given their exposure and leverage to economic growth, one might have thought that a passive index of emerging markets equities would grow at rates well above economic growth. However, over the past 20 years, the MSCI Emerging Markets Index has failed to keep pace with nominal gross domestic product (GDP) growth as seen in Figure 10.

MSCI EM vs. EM GDP (Rebased to 100, 1999 =100)

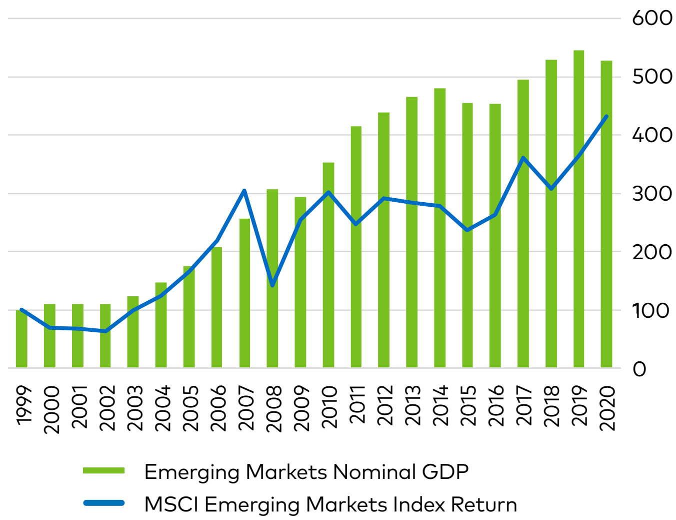

Figure 10: Source: Polen Capital, IMF World Economic Database, Bloomberg. As of 12-30-2020.

In our view, the discrepancy between economic growth and the benchmark's performance in emerging markets—and supporting reasons for an active management approach—can be explained by the following three factors:

- **Indices weighted by market capitalization tend to be backward-looking.** We believe the nature of index construction creates a lagged representation of the highest-performing companies, which means that investors may miss out on the most attractive growth opportunities. Over the past 10 years, information technology and consumer discretionary sectors have been key beneficiaries of economic growth in emerging markets. While they now account for a larger share of the benchmark, passive investors would have failed to benefit from their growth earlier due to their delayed representation. An independent mindset allows us to look for companies we believe will be successful tomorrow and not yesterday.

- **Benchmarks pay no consideration to business quality.** Historically, the emerging market benchmark has been heavily weighted towards more cyclical and commoditized sectors—which accounted for about half of the benchmark over the last 10 years. We think companies with distinct competitive advantages are harder to find within these industries, and their economic cyclicality can result in more volatile returns for investors. Figure 11 shows that non-commoditized industries have historically demonstrated both higher annual returns and Sharpe Ratios compared to those in commoditized industries. The benchmark also still contains many state-owned enterprises (SOEs) where, in many cases, corporate governance is lower and priorities are poorly aligned with those of minority investors.

- **Emerging market benchmarks do not fully capture the investment opportunity set.** As active managers, we have the flexibility to invest across the entire market cap spectrum and geographical landscape. The more extensive universe should, in theory, provide better opportunities to capture the leaders of tomorrow before the benchmarks reflect them. For example, China A-shares are only starting to feature in major indices, and Vietnam is still classified as a frontier country by most index providers. We believe that both offer attractive long-term growth opportunities to emerging market investors.

These factors support our conviction that a rising tide does not lift all boats when investing in emerging markets. Instead, we believe that an active approach is merited, particularly one designed to identify the highest-quality growth businesses.

MSCI Emerging Market Composites
10-Year Average Annual Returns Statistics (Calendar Years 2010 - 2020)

Composite[4]	Annualized Returns	Sharpe Ratio	Max 52 Week Drawdown	Drawdown Year
MSCI Emerging Markets Index	3.99%	0.30	-33.95%	2016
MSCI EM "Non-Commoditized" Industries	9.32%	0.63	-29.37%	2018
MSCI EM "Commoditized" Industries	-0.07%	0.05	-39.65%	2020

Figure 11: Source: Bloomberg, MSCI.

[4] Commoditized sectors are defined as the following GICS sectors: Energy, Financials, Industrials, Materials, Real Estate, and Utilities. Non-commoditized sectors are defined as the following GICS sectors: Consumer Discretionary, Consumer Staples, Health Care, Information Technology, and Communication Services.

Polen Capital Global Emerging Markets Growth Strategy

As discussed in this paper, our philosophy is to invest in a concentrated portfolio of high-quality growth companies with a long-term and independent mindset. We believe the outcome of this philosophy will be visible in several ways.

First, from a portfolio characteristics perspective, we expect the portfolio to exhibit high returns (ROE), low leverage (net debt/ EBITDA), and favorable earnings growth (earnings per share). Furthermore, we expect to see high levels of concentration, a low level of turnover, and a high active share.[5]

Second, we expect the portfolio to be differentiated from the average emerging market fund. The most significant differentiator when compared with our peers being the portfolio's high level of concentration and active share relative to the benchmark, as shown below.

Polen Global EM Growth Strategy Active Share and Number of Holdings vs. Peers

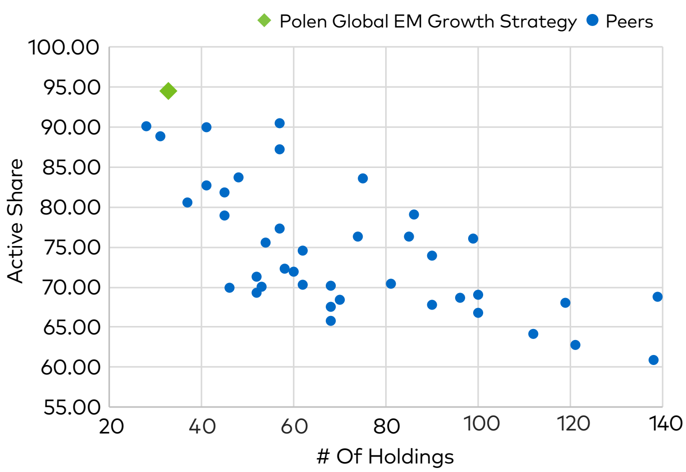

Figure 12: Source: Morningstar, Polen Capital. As of 12-2021.

Given our long-term horizon, we also anticipate the portfolio's turnover to remain at about 20%, sitting significantly below the average emerging market fund turnover of just over 50%.[6]

Finally, over time, we believe that the portfolio's performance will track the fundamentals of our underlying holdings—even if, in the near term, the two could become temporarily dislocated. We expect our companies to deliver mid to high teens earnings growth on an annualized basis, and given our focus on high-quality companies, we also anticipate the portfolio to exhibit a robust downside capture ratio over time. Indeed, when we look over our Focus Growth strategy's history, the downside capture ratio over the last 30 years has been near 60%.

Just as our flagship strategy has delivered favorable returns for clients over the last 30 years, we feel confident that a disciplined and intelligent application of our investment approach and a willingness to be different have the potential to yield positive results for clients in our emerging markets strategy as well.

[5] Active Share: Active share is a measure of the percentage of stock holdings in a portfolio that differ from the benchmark index.

[6] Morningstar. Morningstar's average emerging market fund turnover is calculated using the diversified emerging markets category and its median dollar value turnover. As of 12-2021.

Authors

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Portfolio Manager & Analyst

Dafydd joined Polen Capital in 2021. Dafydd is co-portfolio manager of the firm's Global Emerging Markets Growth strategy. Prior to joining Polen Capital, Dafydd was an Emerging Market Portfolio Manager at LGM Investments, overseeing the firm's Frontier Markets strategy and being a member of the Investment Leadership team. Dafydd began his career at HSBC in 2003 and has been involved in Emerging Markets investing since 2005. He earned a BSc in Economics (Hons) from the University of Bath. Dafydd is a CFA® charterholder.

Damian Bird
Head of Team, Portfolio Manager & Analyst

Damian joined Polen Capital in 2019. Damian heads the Emerging Markets Growth Team and is the lead portfolio manager of the firm's Global Emerging Markets Growth strategy. Prior to joining Polen Capital, Damian was an Emerging Market Portfolio Manager at LGM Investments. Damian began his career at Arisaig Partners as an Investment Analyst, primarily focusing on consumer companies in the developing world. Damian received a B.A. in History & Economics from the University of Oxford and has lived and worked in Singapore, Dubai, and South Africa. Damian is a CFA® charterholder.

Going Beyond with Polen Capital

Polen Capital is a team of experienced investment industry professionals who share an unwavering commitment to our clients, investors, community, and each other. We have been dedicated to serving investors by providing concentrated portfolios of the highest-quality companies for more than three decades. At Polen Capital, we have built a culture of results, and in this, an inherent belief in going beyond what's expected for the people and communities we serve.

We believe that an important part of growing our clients' assets also includes preserving it. To ensure this, we adhere to a time-tested process of researching and analyzing the highest-quality companies around the globe—selecting only the best to build highly concentrated portfolios. Then, we invest for the long haul and with a business owner's mindset—giving these companies time to grow.

Connect with Us

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Past performance is not indicative of future results. There can be no assurances that any portfolio characteristics depicted herein shall be replicated in the future.

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Past performance is not indicative of future results. Current performance may be lower or higher.

Returns are presented gross and net of management fees and have been calculated after the deduction of all transaction costs and commissions and include the reinvestment of all income. Net of fee performance was calculated using actual management fees.

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This information has been prepared based on assumptions believed to be reasonable; however, there is no guarantee that any forecasts made will come to pass. There may be several unexpected developments and market factors which may affect these scenarios, potentially adversely. There are certain inherent limitations. No representation is being made that any investment will or is likely to achieve future results similar to those shown.

Additional information regarding the analyses presented on this page is available upon request.

Simulated performance results have certain inherent limitations. Unlike an actual performance record, simulated results do not represent actual trading. Also, since such trades have not been executed, the results may have under-or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve future profits or losses similar to those shown. Presentation of simulated results does not reflect the deduction of advisory fees, brokerage, or other commissions and any other expenses a client would have paid or actually paid.

The volatility and other material characteristics of the indices referenced may be materially different from the performance achieved by an individual investor. In addition, an investor's holdings may be materially different from those within the index. Indices are unmanaged, and one cannot invest directly in an index.

The **MSCI Emerging Markets Index** is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world and captures large and mid-cap representation across 27 Emerging Markets countries. The MSCI Emerging Markets Total Return Index is maintained by Morgan Stanley Capital International.

The **MSCI Emerging Markets Quality Index** is based on the MSCI Emerging Markets Index, its parent index, which includes large and mid-cap stocks across 27 Emerging Markets (EM) countries. The index aims to capture the performance of quality growth stocks by identifying stocks with high-quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth, and low financial leverage.

Sharpe Ratio: a ratio of the return on an investment relative to its risk.

Standard Deviation: measurement of the dispersion or volatility of investment returns relative to its mean or average.

Active Share: Active share is a measure of the percentage of stock holdings in a manager's portfolio that differ from the benchmark index.

Chart Methodologies

Fig 2: Created using a simulated discounted cash flow model to illustrate the potential impact of different growth levels and ROIC on the value of a company and its implied P/E. In this model we have used a 10-year forecast and a terminal growth rate of 5%, ROIC of 10%, and a WACC of 10%. The results presented are hypothetical.

Fig 9: Using the MSCI Emerging Markets Index. Period: January 1999 to March 2021, reflecting the longest available period for data. The probability of positive returns is defined as the count of cumulative returns that were positive for any consecutive periods of that length, divided by the number of possible consecutive holding periods.

Fig 10: Generated by taking the MSCI Emerging Markets Index from Bloomberg and indexing it to the end of the year 1999 and taking the IMF's figures for emerging and developing markets nominal GDP and similarly indexing it to the same date.

Fig 12: Blue dots consist of peers. Peers were generated using the Morningstar "Diversified Emerging Markets" category consisting of 220 funds in total. Chart only includes funds where active data share was available at the time of this analysis. For accurate comparison purposes, we have included only those funds with active share under 97%, which are more representative of the emerging markets universe. Those funds excluded from the chart with active share above 97% are all EM small-caps, SMID, or Frontier funds, and therefore do not represent a direct comparison. For illustrative purposes, we have also limited the number of holdings to 140.