Invesco

Quarterly Fund Update

Invesco Emerging Markets ex China Fund (UK)

Covering Q1 2024

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James McDermottroe

Fund Manager

Charles Bond

Fund Manager

Top contributors (% impact)	
Gujarat Pipavav	0.4
Samsung Fire & Marine	0.3
KB Financial	0.3
Sea Limited	0.3
Power Grid Corp of India	0.3

Top detractors (% impact)	
HDFC Bank	-0.6
Largan Precision	-0.5
Naver	-0.5
Kasikornbank	-0.4
LG Chem	-0.4

Top sector overweight (%)	
Information Technology	+2.3
Consumer Discretionary	+2.1
Healthcare	+1.2

Top sector underweight (%)	
Industrials	-3.3
Energy	-2.0
Materials	-1.5

Attribution figures are estimates and should be used for indicative purposes only. Data cleansing and retrospective information availability may cause changes.

Executive summary

The fund started 2024 with positive returns although slightly below the index for the quarter. Since inception (March 2022), the fund has delivered solid absolute and relative performance. In this report we provide updates on the ‘Corporate Value-Up’ programme in Korea and the excitement around AI.

Performance

Past performance does not predict future returns.

Cumulative returns (%)	3m	6m	1 year	Since Inception
Invesco EM ex China Fund (UK)*[1]	4.4	13.4	21.0	29.1
MSCI EM ex China 10/40 index[2]	4.9	13.5	17.8	8.7
Out/underperformance	-0.5	-0.1	+3.2	+20.4
IA Global Emerging Markets[3]	3.2	6.8	6.4	1.9
Quartile	2	1	1	1

Source: Invesco, as at 31 March 2024. *Invesco Emerging Markets ex China Fund (UK) Z Acc. Since inception figures are from 31 March 2022.

The 5-year rolling performance figures, can be found on the fifth page of the document.

Q1 Attribution

- In Korea, the fund’s exposure to selected stocks trading on low price/book multiples and paying decent dividends, contributed positively as a ‘corporate value-up’ programme was unveiled. Samsung Electronics was a strong contributor, while holdings in Hyundai Mobis and Samsung Fire & Marine also added value.
- It was another strong quarter for Asian tech stocks, particularly those in Nvidia’s supply chain such as TSMC. SK Hynix, the Korean semiconductor manufacturer, also climbed while MediaTek rallied on the back of growing sales figures.
- Stock selection in Brazil was positive, with miner Ero Copper benefiting from higher commodity prices and insurer Porto Seguro reporting better than expected earnings. These gains were marginally offset by PetroBras (Petroleo Brasileiro) where the share price fell, after the company decided against paying any extraordinary dividends for 2023.
- Stock selection in Indonesia proved a headwind to performance, as both Telekom Indonesia and Semen Indonesia dropped back after missing earnings estimates for FY2023. Performance elsewhere in ASEAN was mixed, with gains for Sea Ltd more than offset by weakness in Kasikornbank.
- HDFC Bank was a significant detractor as deposit growth slowed sector-wide in India, prompting a near-term focus on profitability and slower loan growth, potentially for the near to-medium term.

Positioning

- Brazil remains an overweight position. Our holdings are spread across energy, financial, consumer, and materials stocks. Broadly speaking we believe that valuations remain attractive, below historic averages, and with high dividend yields on offer.
- South Korea is the largest overweight position in the fund. Improvements in corporate governance and dividend pay-outs are being underappreciated by the market, which has provided opportunity to own operationally solid companies, with good balance sheets, as well as an ability and desire to improve shareholder returns over time.
- The fund continues to have significant exposure to dominant semiconductor companies in Taiwan and Korea. Excitement surrounding AI-related demand persists, but it seems to us that the level of semiconductor demand required to support the growth of AI has not been fully priced into some of the mega cap Asian tech stocks.
- In terms of fund activity, we introduced Laureate Education (Latin American education provider). We sold Aurobindo (Indian pharmaceutical), Saudi Telecom and Telkom Indonesia (Telecommunications). Please see end of document for full rationales.

Korea “Corporate Value-Up“

China and India are not the only areas of particular interest in our universe, Korea has also been the source of some interesting developments. Politicians and regulators – ahead of general elections in April – have been promising to narrow the ‘Korea discount’, by improving shareholder returns and corporate governance. This has prompted the start of a rally in some Korean stocks, particularly those trading on a ‘low P/B’ or paying decent dividends. Drawing inspiration from the success of a similar initiative in Japan, moves are underway to introduce co-ordinated measures to strongly encourage companies to boost share price returns and valuations.

This is music to our ears! Our Asian and Emerging markets portfolios are overweight Korea as we believe that gradual improvements in corporate governance are being underappreciated.

What’s particularly interesting is that some of the best performing stocks this quarter have been Korean financials - those that are already ‘showing the way’ – as it suggests that if regulators do eventually come up with meaningful measures, they’ll be pushing on an open door in some parts of the market.

What has happened so far?

Before the finance minister pledged to narrow the ‘Korea discount’, President Yoon discussed efforts to encourage Korean companies to seek higher stock market valuations at a Town Hall-style event. There have also been pledges to reform a tax system that has hindered stock market development. Inheritance tax, which is charged at 65% for those with assets more than KRW100bn (US$75m) is of particularly relevance for the *chaebol* (family-controlled conglomerates) who face large tax bills when it comes to inter-generational transfers. There has also been discussion around cutting corporate and dividend taxes.

The Financial Services Commission’s (FSC) ‘Corporate Value Up Program’, has zeroed in on companies with low P/B, suggesting that: management should be accountable for improving governance; boards should measure PB/ROE and explain actively to investors why they are underperforming; these metrics should be published on a relative basis vs industry/peers; and those succeeding should be included in a premium index tracked by ETFs. These measures are similar to Tokyo Stock Exchange’s ‘name and shame’ strategy, which continues to build momentum.

We’ve also seen the suggestion that treasury shares cancellations may be enforced, with potential rules excluding treasury shares from market cap calculations and preventing their use in M&A and other corporate actions.

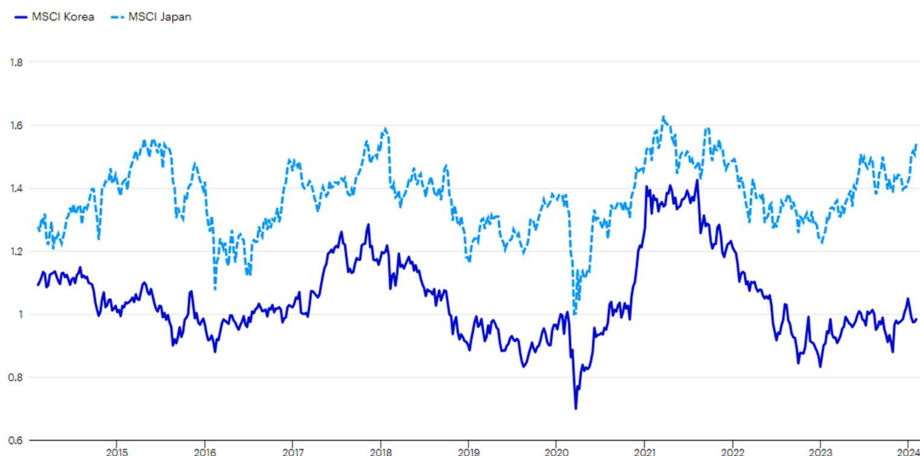
Is this time different?

This is the wrong question to be asking. Politicians and regulators have been co-ordinating on measures to improve corporate governance for years. Initiatives introduced in 2014 by President Moon Jae-in promised similar improvement, since then we’ve identified signs of gradual improvement, particularly in growth of dividends from Korean companies.

Culture changes slowly. We’d expect more announcements from government and regulators in the coming months, and that more Korean corporates will start making more of an effort to improve appearances when it comes to dividend pay-outs and balance sheets. We’re not saying that the experience in Korea will be the same as Japan, but we can’t argue with the direction of travel.

Furthermore, we believe improvements in corporate governance are likely to be irreversible. We won’t go into the myriad of reasons why Korean corporate governance standards are below par, but we believe as/when shareholder friendly reforms are introduced, they will be almost impossible to remove. We’re also working from a low base - the valuation of Korean stocks is low - so any such improvements are a bonus to the investment case. As can be seen in the chart below, the valuation of the Korean market in terms of price/book is just 0.9x, with over 50% of companies trading below book value.

Korea vs Japan P/B



Source: Bloomberg as at 1 February 2024.

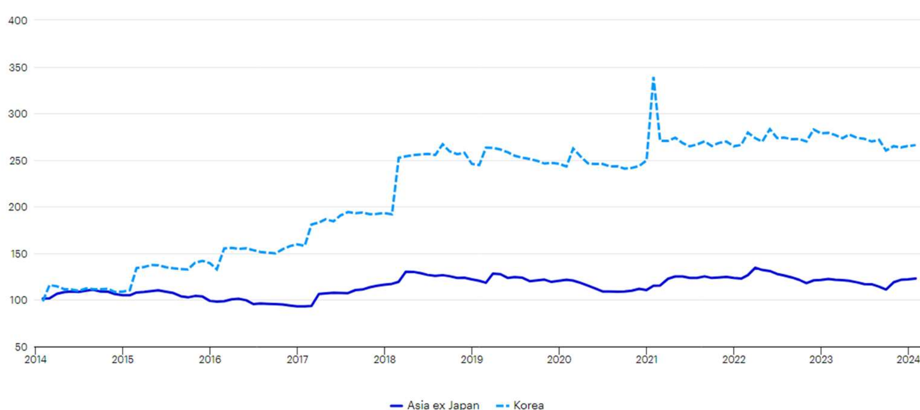
It's already happening!

The recent earnings season in Korea saw a number of positive surprises on buybacks, dividends and share cancellations, particularly in financials. It does seem the message is finally filtering through.

Samsung Fire & Marine (held across our portfolios) proposed a stronger than expected FY23 DPS of W16,000 (+16% y/y), with a progressive dividend policy from this year – the shares trade on 0.8x P/B and we believe the prospects for earnings growth remain very strong, whilst the capital ratio is very high. Other Korean financials and Samsung Group companies also surprised with buybacks, dividends and share cancellations, giving sceptics pause for thought. There is a strong chance that other banks and insurers will follow suit. Some of the portfolios also hold KB Financial (+30% year-to-date, but still trading at just 0.47x P/B, with a sustainable ROE of around 9%).

The payment of better dividends is not a new trend. As can be seen from the table and chart below, the Korean companies held in our portfolios offer attractive dividends, that have been growing over time.

Dividend per share: MSCI Korea index vs MSCI AC Asia ex Japan, Rebased to 100 at December 2013



Source: Bloomberg as at 1 February 2024.

We are overweight Korea, and it appears to be a differentiator given that it is a perennial underweight in the portfolios of many of our peers. Our positioning reflects the strength of the bottom-up opportunities that we can find in Korea, rather than any top-down view or belief in catalysts, but more positive news on this front could be the trigger for managers to close their underweight positions as the upside/downside asymmetry is now more visible.

An update on the AI frenzy

We also want to address the AI excitement that has continued in global equity markets. The frenzy has been driven by NVIDIA raising guidance on AI-related chip growth, unveiling new AI chips which are multiple times more powerful than the prior generation, and also the continued launch of new AI applications such as Sora from OpenAI.

As we highlighted in previous updates, Asian markets have also seen strong benefits from the proliferation of generative AI and the success of NVIDIA, with suppliers in or soon to be in NVIDIA's AI supply chain continuing to see their shares rally following the above new developments. This includes our holdings in TSMC and Samsung Electronics.

However, new since our last update, the stock-rallying effect of an association to generative AI has spread away from NVIDIA's supply chain and into to more nascent or niche adopters or beneficiaries. In this we would include our holding in Mediatek. Mediatek announced the launch of a new mobile chip in November 2023 which facilitates the use of generative AI on smartphones – a trend referred to as 'edge AI'. This chip has been adopted in a few high-end Android smartphones. Samsung Electronics also unveiled their first on-device AI smartphone in January 2024.

At this point, the contribution to earnings of these new AI components or devices is negligible, but the market has been placing higher multiples on these new earnings with the expectation that there is significant, structural growth from these products in future years.

Why are we still holders of these AI beneficiaries if they are clearly in-favour? Arguably the biggest change we have seen in the fundamentals of these holdings since our prior AI updates has been that the semi cycle, impacting the majority of the revenue and earnings of the holdings we mentioned, has improved. More specifically, excess inventory in the supply chain for PCs, mobiles, and servers has been reduced such that shipments are starting to grow again and margins improving. This should be the key driver for earnings growth in our investment case for these holdings, and we don't need to place high multiples on the AI parts of the businesses to get to our double-digit return estimates.

The most interesting case of this is the Korean memory chip stock holding, Samsung Electronics, which has seen the effects of the combination of a typical supply/demand cycle with new generative AI applications. We saw a severe downcycle in the memory market in 2023, which drove inventory levels to record highs, and prices and margins to record lows. In response, memory makers cut back their production levels significantly to protect against further losses. But at the same time a new demand segment for DRAM memory chips emerged. This is High Bandwidth Memory (HBM), the complex memory chips that are required to work with NVIDIA's new AI chips. The production of HBM requires stacking commodity DRAM chips on top of each other and then punching tiny holes between the layers to allow for the transmission of data. NVIDIA's demand for HBM has been soaring, which has taken away a significant amount of supply of DRAM chips from the memory market. Combining the impacts of memory maker's supply cuts with NVIDIA's high demand for HBM has resulted in a much tighter supply of DRAM than the market expected, leading to prices of DRAM recovering faster than expected.

As ever, we remain on guard for areas of exuberance, and whilst it is clear that the AI theme is having a buoying effect on our two largest holdings (TSMC and Samsung Electronics), we continue to believe that the earnings prospects for these businesses are well underpinned, which should ensure that prospective returns meet our hurdle rate.

Fund activity

We introduced **Laureate Education**, a private university owner and operator in Mexico and Peru, headquartered in the US. Laureate offers offline, online and hybrid degree courses with a reputation for offering affordable courses with a focus on employment outcomes. The company has good revenue visibility, and we like that there is the possibility for revenue growth and margin increase. The company has strong cash flow generation, low capital expenditure, and net working capital near zero. We also like the track record of management efficiently managing their business with a focus on shareholder returns.

We sold the following positions in Q1:

Aurobindo has been a strong performer for the fund, benefitting from the bull market in Indian mid-caps and excitement around rising company revenues, particularly in the US market. We exited as the stock now trades on historically high valuation multiple for a business subject to uncertainty due to regular FDA approvals.

We sold **Saudi Telecom** on share price strength after they bought a stake in another business, Telefonica, which lowered our conviction in the stock. We had concerns that that the company was prioritising building the size of the business over shareholder returns and we took the opportunity to exit.

Telkom Indonesia was sold after we lost conviction in the continued benefits of consolidation in the Indonesian telecommunications industry for Telkom. Consolidation has benefitted the industry as a whole but we have to weigh up the risk of Telkom losing market share, as the current number one player in the industry. We were also concerned that the company may decide to lower prices in order to regain market share, hurting margins and profits, so we decided to exit.

Standardised rolling 12-month performance (% growth)

	31.03.19 31.03.20	31.03.20 31.03.21	31.03.21 31.03.22	31.03.22 31.03.23	31.03.23 31.03.24
Invesco Emerging Markets ex China Fund (UK) Z Acc[1]	-	-	-	6.7	21.0
MSCI EM ex China 10/40 index[2]	-	-	-	-7.6	17.8
IA Global Emerging Markets NR[3]	-14.6	47.6	-7.1	-4.2	6.4

This information is updated on a calendar quarterly basis. Up-to-date information is available on our website www.invesco.com/uk.

Past performance does not predict future returns.

[1]Fund performance figures are based on the Z Accumulation share class. Fund performance figures are shown in sterling, inclusive of reinvested income and net of the ongoing charge and portfolio transaction costs. Performance figures for all share classes can be found in the relevant Key Investor Information Document.

[2]MSCI EM ex China 10/40 index information is sourced from Refinitiv, total return, Sterling. This is a comparator benchmark. Given its geographic focus the Fund's performance can be compared against the Benchmark. However, the Fund is actively managed and is not constrained by any benchmark.

[3]Sector average performance is calculated on an equivalent basis to Fund performance. Source: Lipper. The sector is IA Global Emerging Markets sector. This is a comparator benchmark. Given its geographic focus the Fund's performance can be compared against the Benchmark. However, the Fund is actively managed and is not constrained by any benchmark.

All data is as at 31 March 2024, sourced from Invesco unless otherwise stated.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested.

The fund invests in emerging and developing markets, where there is potential for a decrease in market liquidity, which may mean that it is not easy to buy or sell securities. There may also be difficulties in dealing and settlement, and custody problems could arise. The fund may use Stock Connect to access China A Shares traded in mainland China. This may result in additional liquidity risk and operational risks including settlement and default risks, regulatory risk and system failure risk.

The fund may use derivatives (complex instruments) in an attempt to reduce the overall risk of its investments, reduce the costs of investing and/or generate additional capital or income, although this may not be achieved. The use of such complex instruments may result in greater fluctuations of the value of the fund. The Manager, however, will ensure that the use of derivatives within the fund does not materially alter the overall risk profile of the fund.

Important information

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Views and opinions are based on current market conditions and are subject to change.

For the most up to date information on our funds, please refer to the relevant fund and share class-specific Key Investor Information Documents, the Supplementary Information Document, the financial reports and the Prospectus, which are available using the contact details shown.

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