Invesco

Quarterly Fund Update

Invesco Emerging Markets Equity Fund

Covering Q1 2024

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Investment Risks
For complete information on risks, refer to the legal documents.

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.

As a large portion of the fund is invested in less developed countries, you should be prepared to accept significantly large fluctuations in the value of the fund.

The fund may invest in certain securities listed in China which can involve significant regulatory constraints that may affect the liquidity and/or the investment performance of the fund.

This marketing communication is for professional investors and qualified clients/sophisticated investors only. Investors should read the legal documents prior to investing.

Executive summary

The Emerging Markets Equity Fund delivered a positive gain in Q1, outperforming the benchmark. Much of the focus has been on the market performance and economic prospects of both China and India, we provide an update on both here, as well updates on Korea's 'Corporate-value-up' programme and on AI, as we have exposure to both.

Performance

Past performance does not predict future returns

Cumulative returns (%)	3m	6m	1 yr	3 yrs	5 yrs	10 yrs
Invesco Emerging Markets Equity Fund[1]	2.7	10.1	9.9	-6.6	35.3	56.3
MSCI Emerging Markets[2]	2.4	10.4	8.2	-14.4	11.6	33.7
Out/underperformance	+0.3	-0.3	+1.7	+7.8	+23.7	+22.6
EAA Global Emerging Markets Equity[3]	2.5	10.4	8.0	-16.4	8.8	24.0
Quartile	2	2	2	1	1	1

Source: Invesco, as at 31 March 2024.

Q1 Attribution

- Being overweight 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 Fire & Marine** was a contributor, while holdings in **Hyundai Motor** and **KB Financial** also added value.
- It was another strong quarter for Asian tech stocks, particularly those in Nvidia's supply chain such as **TSMC**, although **Samsung Electronics** has underperformed amidst concerns – in our view misplaced - around the strength of its position in high-bandwidth memory (HBM).
- Stock selection in China was positive, with internet companies **Tencent Music**, **NetEase** and **Full Truck Alliance** all reporting better than expected earnings. Manufacturers **Gree Electrical** (air conditioners) and **China BlueChemical** (Fertilizers) also enjoyed a decent rally to start the year.
- However, Hong Kong has continued to prove contrarian as the domestic macro has disappointed. **AIA** was one of the bigger detractors, as it has exposure to real estate.
- ASEAN performance was mixed, with gains for **Sea Ltd**. partly offset by weakness in Astra. Stock selection in Indonesia and Thailand disappointed with detractors including **Astra**, **Telkom Indonesia** and **Kasikornbank**.
- While **Gujarat Pipavav Port** and **Shriram Finance** contributed significantly to performance, fellow Indian listing **HDFC Bank** was a notable detractor. Indian bank deposit growth has slowed, prompting a near-term focus on profitability and slower loan growth, potentially for the near to-medium term. We remain comfortable with our current position given the valuation opportunity and medium-term growth outlook.

Top attributors (% impact)	
Samsung Fire & Marine	0.5
Gujarat Pipavav	0.4
Tencent	0.4
TSMC	0.4
Hyundai Motor Company	0.4

Top detractors (% impact)	
Kasikornbank	-0.7
HDFC	-0.6
AIA	-0.5
Largan Precision	-0.3
Cosco Shipping	-0.3

Top sector overweight (%)	
Communication Services	3.7
Consumer Staples	2.0
Industrials	1.7

Top sector underweight (%)	
Information Technology	-2.9
Energy	-2.5
Materials	-2.4

Positioning

- Brazil is the fund's largest overweight position, our overweight position is 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 remains an 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.

- We continue to have a modest overweight position in Hong Kong & China, with a mix of large internet companies, life insurers, auto parts manufacturers, as well as selected consumer-related stocks.

- 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.

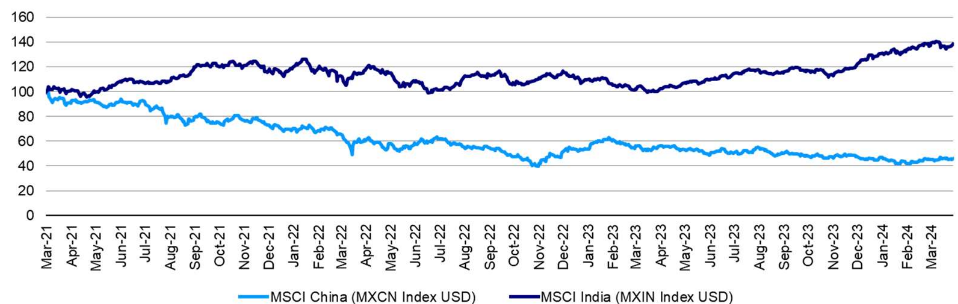
- In terms of fund activity, we introduced VIP Shop (Chinese discount retail) and we sold Ping An Insurance Group (Chinese financial services) and Telkom Indonesia (telecommunications). Please see end of document for full rationales.

Why China over India?

Every client meeting we have these days includes a discussion on why we are overweight China and underweight India. Given our contrarian approach, the positioning in itself is unsurprising. What is extraordinary is the degree of divergence in performance we've seen between these two countries, with China down 50% over the last 3 years and India up over 35%.

MSCI China Index (MXCN Index USD) vs MSCI India Index (MXIN Index USD), 3-year performance to 31.03.2024

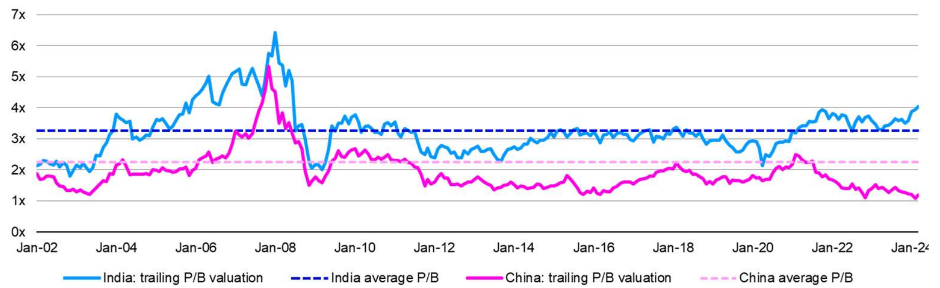
Past performance does not predict future returns



Source: Bloomberg as at 31 March 2024

This divergence of performance has led to an extreme valuation disparity. As can be seen in the chart below, at 4x P/B the valuation of MSCI India is as expensive as it has been at any point in the last 15 years or so, while at just 1x P/B China has rarely been this cheap in recent history. Meanwhile, in terms of forward price/earnings multiples, roughly a third of the MSCI India index constituents are trading above 30x, and two thirds above 20x, whereas for MSCI China almost 90% of the index is trading below 20x, and half below 10x.

China and India Valuations: MSCI China and MSCI India price to book valuation



Source: Invesco, LSEG as at 1st March 2024

Obviously, there are reasons why India has been outperforming China, and there are good reasons for Indian stocks to trade at higher multiples than Chinese ones. Not least the geopolitical situation between China and the US, and the weak Chinese economy.

But while the Indian economy may be performing better than the Chinese economy, it's not perfect by any means. Economic indicators for the consumer economy are less rosy than share prices of some consumer stocks might suggest. Passenger vehicle sales are -6.9% y-o-y and domestic air passenger numbers -4.7% y-o-y, with volumes of both still below 2019 levels, whereas plenty of the stocks in these sectors have been rallying strongly and are close to all-time highs.

What about China? Are there any green shoots? Many investors we speak with have yielded to the view that the risk of escalation in political tensions, persistent weak consumer sentiment, and a property market overhang cannot be overcome. And the recently announced 'moderate' stimulus measures failed to dispel that narrative, let alone invoke animal spirits. However, most state of affairs are impermanent and subject to change rapidly, as we discussed in depth in our Q2 report last year. Whilst indicators are mixed in China contributing to the sense of unease about what could turn the tide, we can point to some improvement. Sales of existing property in the secondary market grew by over 40% y/y last year compared to an 8% decline in new-home sales according to the Beike Research Institute. Suggesting that appetite for property in China hasn't vanished. While buyers are more cautious and less willing to pre-pay for new property two years in advance, some are being lured into the secondary market given the 20% drop in prices per square meter over the last couple of years. For context, disposable incomes per capita grew by 12% over that same period. So far in 2024, exports growth (+7.1% y/y), retail sales (+5.5% y/y), money supply M2 (+8.7% y/y), industrial production (+7% y/y), show mid-single digit growth – not a disaster by any means.

And although earnings resilience has been a lot better in India than in China over the last few years, it is not as though we are seeing constant earnings upgrades in India. Larsen and Toubro (L&T), one of the best performers in India – and held in our portfolios until last year – is now on 38x current year earnings. The lack of earnings upgrades contrasts with Tencent, the biggest index position in China, where earnings have been revised up in the last year, but the share price is down.

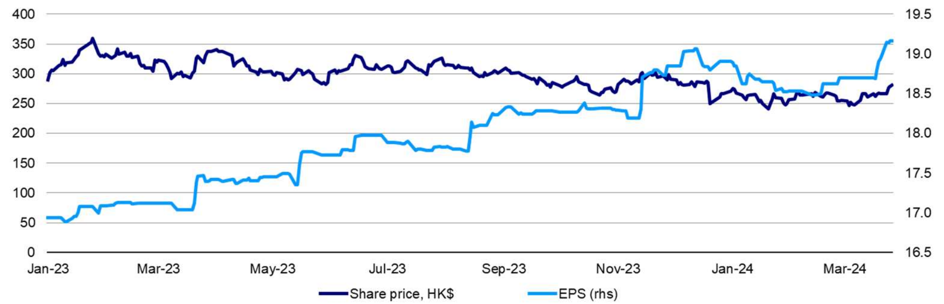
L&T: price and earnings per share

Past performance does not predict future returns

Source: Bloomberg as at 31 March 2024

Tencent: price and earnings per share

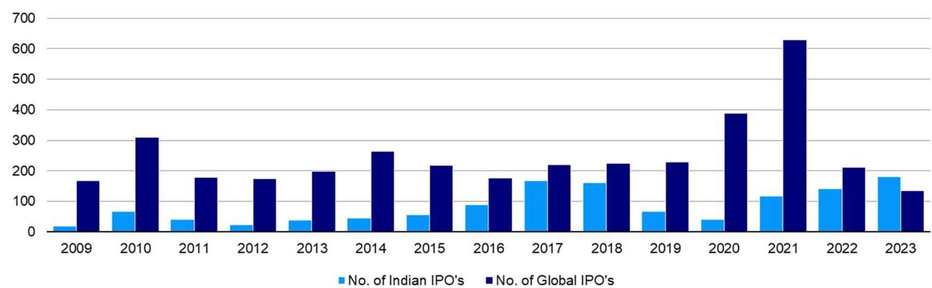
Past performance does not predict future returns



Source: Bloomberg as at 31 March 2024

We are also seeing signs in India typical of stock market exuberance: 2023 was a record year for IPOs in India against a backdrop of weak deals globally, whilst placements by insiders hit a 6-year high. For example, in 2022 we saw US$5 billion of insider sales, this has rose to over US$12 billion in 2023, topping the recent peak of US$10 billion in 2020. This may be an indicator of bearish sentiment creeping in.

Vintage Indian IPO Year: A record number of companies are going public in India, while Global IPOs in 2023 are set for worst year since financial crisis as companies and investors remain far apart on agreed valuations.



Source: Bloomberg as at 14 December 2023.

In the last two months of the quarter, China began to outperform India on no real news. Without suggesting that it is a harbinger of things to come we believe that when valuations become unhinged from fundamentals the odds of reversal increases.

We would also point out that our preference for China over India is by no means structural, rather dependent on the valuation opportunities we are finding. Indeed the strategy was approximately 5% overweight India in mid-2020 and approximately 5% underweight China. At that time, the market was worried about India's approach to covid and favouring the approach taken by China. How wrong that view turned out to be.

As ever, we believe the best opportunities are likely to lie where investors are fearful, whereas the biggest risk of capital loss is most likely where investors are most exuberant.

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.

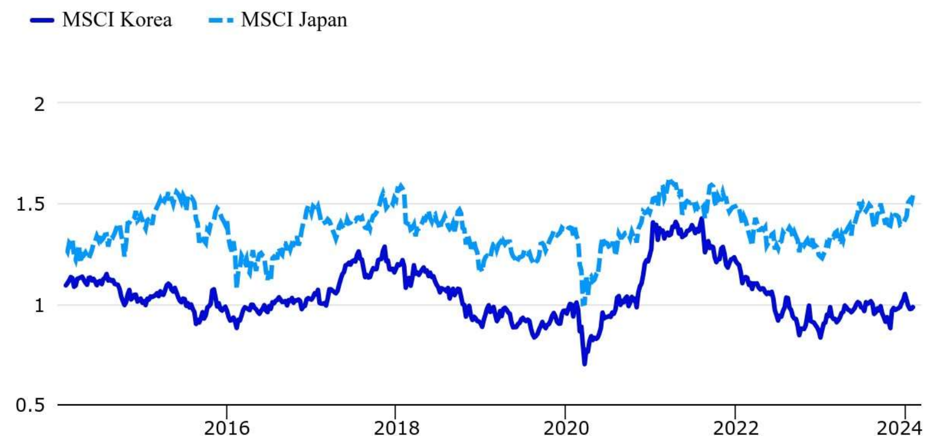
Is this time different?

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.

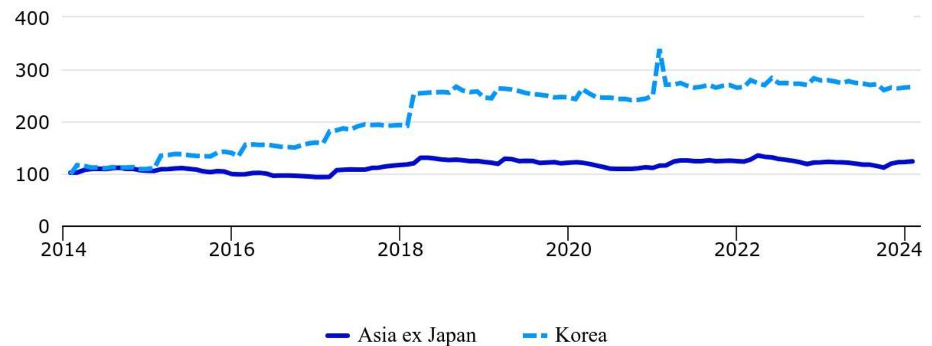
It's already happening!

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

Our overweight in Korea reflects the strength of the bottom-up opportunities that we can find in Korea rather than any top-down view or belief in catalysts.

Conclusion

We are contrarian investors. We believe in buying shares when they are out of favour. That's the way we do things and that's the way we will always do things. It is normal to feel uncomfortable going against the grain, but it tends to be very rewarding when markets revert back from extreme levels, as we saw during the pandemic with the rotation in markets between tech/internet and cyclicals.

We believe there is a great contrarian opportunity in being overweight China and underweight India. We are now max underweight India (by our 'rules of thumb', we don't like to be less than half the index weight in any large country). Market weakness in China has also tended to be broad-based and fairly indiscriminate, which has allowed us to increase the quality of the China portfolio (without necessarily increasing the overweight).

However – it is important to point out that we spend the large majority of our time focused on stock selection – country allocation is mainly a by-product of this. We do happen to have a strong view at the moment on what country weights we should have, but that is mainly driven from the bottom-up.

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 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 opened a new position in **VIP Shop**, an online discount retailer in China, mostly focused on apparel. The stock trades at 9x PE and 9% FCF yield. Additionally we take comfort that they have 40% of their market cap in cash and by the ongoing commitment to a significant share buyback programme.

We sold 2 positions in Q1:

We exited **Ping An Insurance Group** because our investment case hasn't worked. Simply put, new business volumes have not recovered as we expected and asset quality concerns continue to affect investment results. Whilst the shares appear cheap, we now foresee significantly weaker long-term earnings power from the business and so we have changed our estimate of fair value. We are also concerned that capital ratios look increasingly weak.

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. Given the fairly generous multiple of 15X PE, we felt the investment case has changed and so we decided to exit.

Standardised rolling 12-month performance (% growth)

Past performance does not predict future returns

Calendar Year Performance					
In %	**2019**	**2020**	**2021**	**2022**	**2023**
Fund[1]	17.81	25.58	1.93	-16.00	13.57
Benchmark[2]	18.44	18.31	-2.54	-20.09	9.83

	31.03.14 31.03.15	31.03.15 31.03.16	31.03.16 31.03.17	31.03.17 31.03.18	31.03.18 31.03.19	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 Equity Fund Z-AD Class[1]	0.1	-8.7	15.9	20.5	-9.5	-22.4	86.7	-12.9	-2.4	9.9
MSCI Emerging Markets NR[2]	0.4	-12.0	17.2	24.9	-7.4	-17.7	58.4	-11.4	-10.7	8.2
EAA Fund Global Emerging Markets Equity[3]	-0.9	-11.2	16.1	22.2	-8.8	-18.9	60.5	-13.4	-10.6	8.0

A discretionary cap on multiple components of the total costs is maintained. This discretionary cap may positively impact the performance of the Share Class.

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

The performance shown in the chart above up to 7 September 2018 relates to the performance of the Irish-domiciled fund, which was merged into the Luxembourg-domiciled fund on that date.

The performance data shown does not take account of the commissions and costs incurred on the issue and redemption of units. Returns may increase or decrease as a result of currency fluctuations. The investment concerns the acquisition of units in a fund and not in a given underlying asset.

[1] Fund performance figures are shown in US dollars, inclusive of gross reinvested income and net of the ongoing charges and portfolio transaction costs. The figures do not reflect the entry charge paid by individual investors. Performance figures for all share classes can be found in the relevant Key Investor Information Document/Key Information Documents

[2] The reference benchmark is the MSCI Emerging Markets Index. Reference index information source is Refinitiv, net total return, US dollar. As the Fund is actively managed, it is not intended that the performance of the Share Class will track the performance of MSCI Emerging Markets Index (Net Total Return) (the "Benchmark").

[3] Sector average performance is calculated on an equivalent basis to fund performance. The sector is EAA Fund Global Emerging Markets Equity. The sector is shown for performance comparison purposes only. The Fund does not track the sector.

All data is as at 31 March 2024, sourced from Invesco unless otherwise stated. Fund (Z-AD share class; as at 2 August 2021, this is now the Primary share class for this fund) and sector average performance source: Morningstar.

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