

THE HUB MARKET INSIGHTS

NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

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Emerging or submerging?

For investors, that is the question.

Key Takeaways

- The third-generation companies that are arising in emerging markets have had no antecedents in communist, socialist or colonial pasts and they are not imitating existing European or US models. Instead, they are innovative, pioneering businesses that are creating new societies for the 21st century in the emerging world that do not hark back to the West. These businesses have not converged towards historic standards, they have far surpassed them.
- The developed economies of Europe, US and Japan no longer have a monopoly on invention and progress. The New World is being built on a stage far, far away. The world is not just changing, it is being reinvented.

The world is not just changing, it is being reinvented. Shanghai perhaps, is the epitome of the transformation that we are witnessing. The Bund and its stunning art deco architecture are still there, but across the river, the old fishing village of Pudong has been turned into a forest of magnificent skyscrapers. It is China's hypermodern interpretation of a 21st century Manhattan. But, while there may be a new Manhattan, just as there was once a New Orleans and a New York, this analogy fails to do justice to the full extent of today's reality. The seismic shift that has occurred is even more dramatic than the move from the Old World to the New World at the start of the 20th century.

Emerging market investors have, rightly, often been wary of the first-generation of emerging market companies – the former state-owned entities sold off or floated on newly created markets in what used to be called the "Third World". The newly privatised companies were relics of a bygone era, impossible to reform and doomed to extinction as they dragged down the indices and hit the performances of emerging market funds. Instead, the focus of active managers has been on second-generation companies – the recently created businesses set up by local entrepreneurs replicating business models that worked in Western Europe and the US and introducing them successfully to the recently liberalised market economies.

Savvy emerging market investors have scanned markets worldwide to snap up recently created supermarkets,



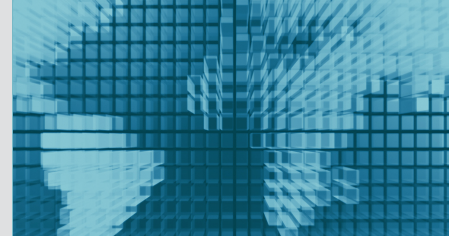
Jean-Louis Scandella,
Equity CIO,
Ostrum AM

cell-phone companies just floated on the stock market and newly licenced private television stations setting out to challenge the lumbering old state TV behemoths. These companies may have offered nothing new – they copied fashions that were sometimes ridiculous, but their swift growth was exhilarating, providing the real driver behind the expansion of the emerging markets until the mid-2000s. This was the period when emerging market investment truly meant riding the wave of convergence with the developed world.

Today, the real opportunities now lie beyond this emulation of Western models and this is where reinvention is occurring at a tremendous pace. The third-generation companies that are arising in emerging markets have had no antecedents in communist, socialist or colonial pasts and they are not imitating existing European or US models. Instead, they are innovative, pioneering businesses that are creating new societies for the 21st century in the emerging world that do not hark back to the West. These businesses have not converged towards historic standards, they have far surpassed them!

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Centre stage, not surprisingly, are the Chinese companies Alibaba and Tencent. Investors may be aware that Alibaba is better than Amazon and that Tencent's WeChat is better than Facebook, but few appreciate just how much better. In Shanghai or Beijing today, any coffee shop you visit gives a receipt with a bar code that customers scan with the Alipay app and the cost is directly debited from their accounts. This is the Google pay dream become reality, but it is also Ingenico's nightmare taking place right here and now. And with the same app, the Chinese middle classes can manage their cash online like professionals – the Alibaba money market fund has become the world's largest. Tencent of course, is up there with the best – members can exchange messages, photos and videos just like Facebook, but they can also play online games like "League of Legends" and "Clash of Clans", which have become to millennials what Hollywood films were for the older generations. An entire generation's perception, inner world and sense of aesthetic is being shaped by radically new approaches to social interaction created in China. From a cultural perspective, it is colonialism in reverse.

Tencent's influence is not just restricted to leisure activities, it also extends to all aspects of China's economic and financial life: Chinese traders can negotiate bond prices in real-time on the social medium's finance forum, turning the official market into little more than an entity for rubber-stamping transactions. London traders have

already made enquiries with their own regulator on ways to join these trading forums. The City – renowned for its historical leadership in financial innovation, has now become a follower.

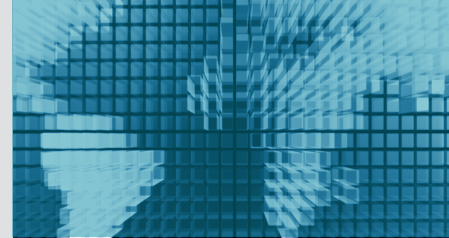
In the emerging world, China is not an exception that can be just attributed to the size of its economy. The New World of the 21st century is developing in places where we would least expect it. Malaysia is the world leader in outsourcing online public services. Citizens can already use a digital platform to renew their car registration document and their electronic driving license, regularise the legal status of their cleaning lady and start making social security contributions for her, while the more religious can pay their Islamic tax, Zakat, online. The platform has such a constant stream of imaginative innovations coming on-line that in a decade's time, Malaysia will have eliminated all tiresome bureaucracy creating a "state-free state".

It is not just the Asian emerging markets that are creating our 21st century. Kenya is the leader in mobile banking. Ten years ago, the Nairobi-based mobile phone leader, Safaricom, developed the largest mobile banking platform in the world starting from just two text messages. They developed a radically new banking model to fulfil a local need: young men in Kenya leave their provinces to work in the cities and regularly send money back to their families in their home villages. In the past, with no bank accounts and the need to transfer just a few tens of US

dollars per month, they would have sent an envelope of cash with the bus driver to take back home. But then Safaricom gave them the ability to buy units of telecom accounts (i.e. a deposit) and send the money transfer recipient a text message with a code. Safaricom would simultaneously send the same code by text message to the "banking" correspondent in the village, which could be a petrol station, store, small company, etc. The recipient then visits the correspondent, the codes are compared and if they match, the correspondent pays the money to the recipient. This money transfer service has evolved into a sophisticated digital banking environment. Users can receive their salary on Safaricom, pay bills and take out cash from an ATM. Its impact can be gauged by the fact that 50% of Kenya's annual GDP now passes through Safaricom.

The developed economies of Europe, US and Japan no longer have a monopoly on invention and progress. The New World is being built on a stage far, far away. The developed world is no longer in control, so who is really emerging and who, submerging? Exploiting the opportunities that are arising from this changing world is what we, at Ostrum Asset Management, are undertaking in our investment portfolios.

Written in September 2018



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