

A Different View on Emerging Markets

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Emerging markets were relatively poor performers in 2018 with Turkey, Argentina and China suffering relatively large declines. Successfully investing in emerging markets requires a strong filter because of the multitude of risks that plague these markets. Only a select few ideas are strong enough to make it through our investment filters at Tacit.

These markets though do have certain advantages which aren't available elsewhere. In popular media, much of the focus is on GDP growth and the rapidly increasing middle class. While important this tends to paint only part of the picture.

Two structural advantages are usually left out. These are what we term 'coming late to the party' and 'minimum efficient scale.'

Coming Late to the Party

Imagine you were tasked with building an interstellar spaceship to transport humans to the nearest solar system as quickly as possible. You have two options. Build the spaceship now using the available technology and begin transporting humans as soon as possible. Or, wait for a hundred years until space travel technology has significantly improved.

If you choose the first option, you are at risk of spending a lot of money trying to build a spaceship that may be lapped by a more advanced one built in the next 100 years. The optimal time to start building is somewhere between now and the next 100 years and depends on the rate of improvement in space travel technology. The point of this example is to show that starting later can have its advantages, especially if the rate of technological improvement is rapid.

Bringing things back down to earth, most emerging markets have [skipped landlines](#) and have gone straight to mobile phones simply because they were slow adopters of landlines. The reason for the slow adoption is largely structural. Landlines require roads which were often non-existent in rural parts of emerging markets. Landlines also require long stretches of telephone wires making them more expensive to build. Mobile phones on the other hand require minimal infrastructure because they operate using radio signals.

By skipping landlines and going straight to mobile, some companies operating in emerging markets were able to very quickly capture the market without making significant capital investment required for landlines. Coming late to the party does have its advantages.

Minimum Efficient Scale

This is mainly applicable to smaller emerging market countries. These are often so small they can only support one or two companies in a given industry. This discourages foreign multinationals from entering and competing. Also, local companies have the benefit of understanding local tastes. For example, Burger King and McDonalds have tried and failed to gain a foothold in Vietnam because they couldn't adapt to local tastes.

At Tacit, we are always looking for new ideas. The recent decline in emerging markets has created opportunities through lower valuations and using our strong investment filter, we are, as usual, searching for value where few are currently looking.

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