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EMERGING MARKET EQUITIES: LOOKING TO THE LONG-TERM

Kim Catechis
Portfolio Manager,
Head of Global Emerging Markets

- In our view, it would be limiting to confuse a temporary cyclical crisis with a permanent shift in the long-term trend
- Across emerging markets now, banking systems are much more solid than they have been in the past and authorities have made progress implementing reforms
- Demographic trends provide a young and growing workforce and debt levels at both a sovereign and household level are low
- We see a mismatch between the pessimism pervading emerging market sentiment in this current environment against the positive long-term view we have for the asset class

NOV 2015

Cyclical downturn, not structural decline

It's been a torrid time for investors in emerging markets,[1] who have seen 18% shaved off the MSCI Emerging Market Index[2] over the last six months. At the eye of the storm has been China, where faltering economic growth has been compounded by stock market routs. In August, Shanghai's benchmark index[3] fell by 8.5% in a single session, prompting Chinese policymakers to undertake a spate of interest-rate cuts to bolster the flagging economy. For its emerging market peers, China's decision to allow the yuan[4] to devalue over three days was especially significant, and watched with consternation. The move led to fears of competitive devaluations across Asia and broader emerging markets, an unwelcome development to exporters already feeling the pinch of falling commodity prices.

It's clear that growth concerns in China are causing unease elsewhere — central bankers in India and Taiwan have also opted to cut interest rates in recent months, while exporters of copper to China are braced for lower demand. Further afield, other markets are facing their own problems. In Latin America, for example, Brazil's credit rating was recently downgraded by Standard & Poor's[5] as its political and fiscal situation deteriorated. Taken in aggregate, investors' recent caution towards emerging markets is understandable. To our mind though, the recent downturn has exposed the gap in expectations between more bullish investors in emerging markets and the current equity returns. However, it's important to remember that the asset class was, is, and always will be, cyclical. This cyclicality, manifesting itself via the current downturn, seems to have overwhelmed the long-term structural growth story in the minds of some investors.

1 **Emerging markets** are nations with social or business activity in the process of rapid growth and industrialization. These nations are sometimes also referred to as developing or less developed countries.

2 The **MSCI Emerging Markets (EM)** Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

3 The **Shanghai Stock Exchange Composite Index** is a capitalization-weighted index. The index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange

4 The **renminbi (or yuan)** is the name of China's currency.

5 **Standard & Poor's (S&P)** is an American financial services company that publishes financial research and analysis on stocks and bonds and is also known for its stock market indices such as the U.S.-based S&P 500.

A long-term growth opportunity

Recently, we have often been asked if the current cyclical downturn has undermined the structural long-term opportunity. Our answer is no — while the extent of growth might be curtailed, emerging market equities still look appealing relative to other markets (and asset classes). In our view, it would be limiting to confuse a temporary cyclical crisis with a permanent shift in the long-term trend.

History teaches us that the rise of emerging markets is likely to be interrupted by crises such as the one we're experiencing. This is the 'baggage' that comes with investing in the asset class. That said, economies in Russia and Asia have weathered previous storms successfully, emerging at the other side with an improved quality of life and reduced poverty. India, for example, is making slow, but gradual progress following the election of its pro-reform prime minister, Narendra Modi in 2014. For investors, that throws up opportunities to capitalise on a thriving and growing corporate sector.

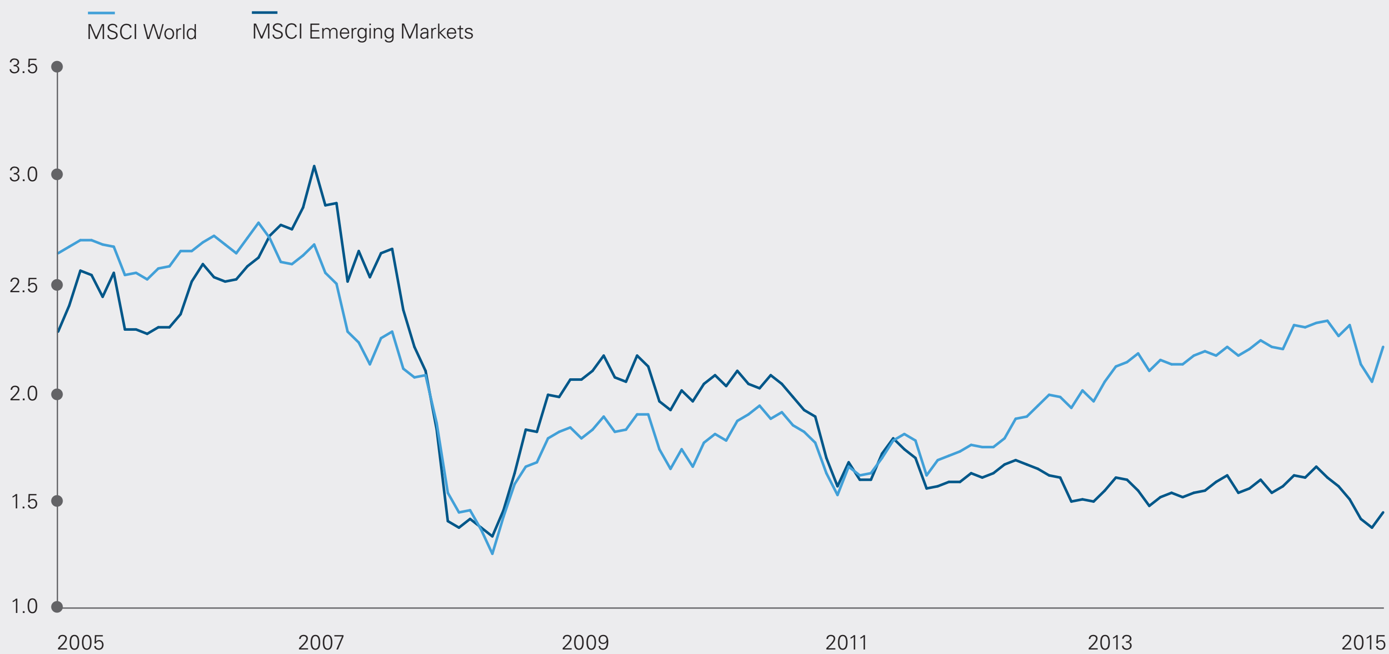
Taking stock

When drawing comparisons between the current situation in emerging markets and crises of the past, a few points stand out. Firstly, the situation today has unique characteristics compared with past crises. Currencies are typically floating versus fixed and there is much less public sector debt in the system — most of which is now denominated in local currency.

In addition, part of the reason behind the current market volatility lies with the 'text- book-altering' events resulting from the global financial crisis. The natural macro adjustments that should have followed in its wake have been deferred as developed economies[6] have pursued aggressive monetary agendas in attempts to 're-inflate' their indebted economies. This has led to inflated asset prices that are disconnected from underlying macro fundamentals. With a growing acknowledgement that this aggressive monetary stance can't last forever, markets are falling, due to significant redemptions, as investors become more risk averse.

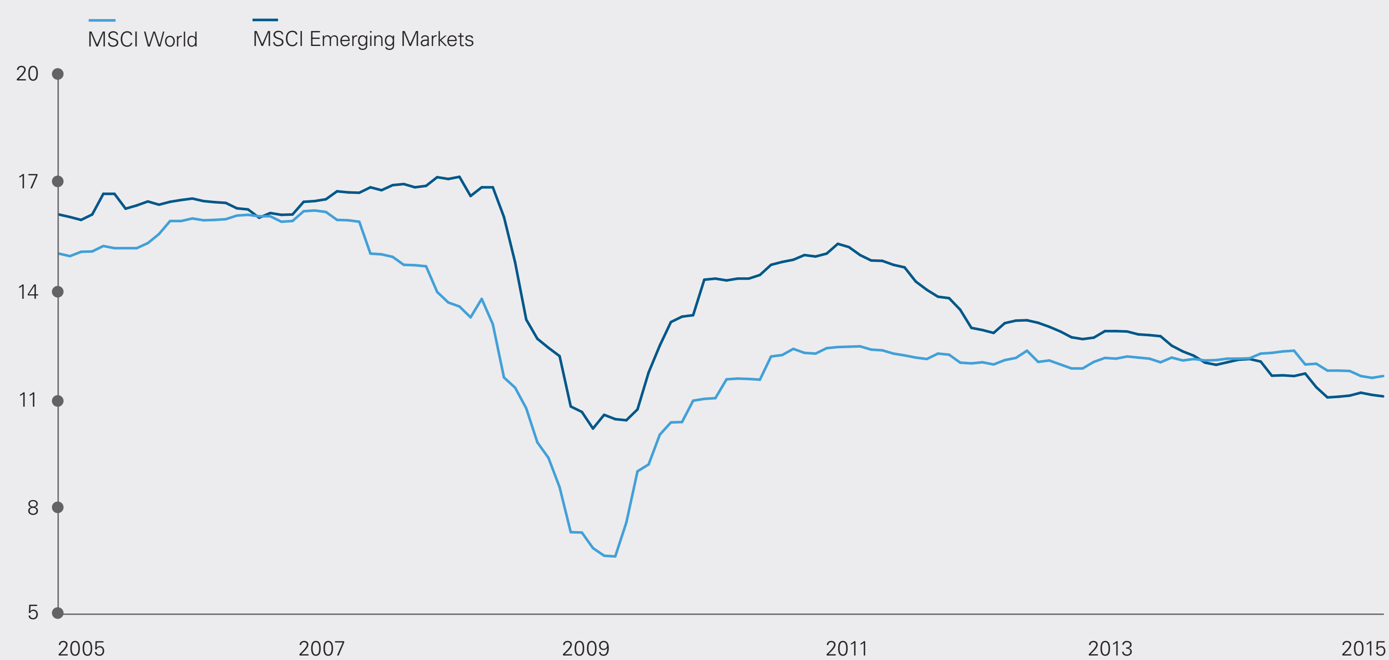
[6] **Developed** refers to countries that have sound, well-established economies and markets and are therefore thought to offer safer, more stable investment opportunities than developing markets.

Figure 1: Price to book Over 10 years



Source: FactSet, as of October 31, 2015. **Past performance is not a guide of future results.**

Figure 2: Return on equity (%) Over 10 years



Source: FactSet, as of October 31, 2015. **Past performance is not a guide of future results.**

Across emerging markets now, banking systems are much more solid than they have been in the past, thanks to improved capitalisation, supervision and regulation. Also, authorities have made progress implementing structural/institutional reforms — although the extent of this success varies markedly across the asset class.

Most importantly, investors shouldn't lose sight of the myriad factors underpinning emerging markets, which have been overshadowed by recent volatility. Demographic trends provide a young and growing workforce, where debt levels at both a sovereign and household level are low, especially compared to developed-market peers. Many countries are also at an advantage in terms of natural resources and technology benefits.

What this means is that we see a mismatch between the pessimism pervading emerging market sentiment in this current environment against the positive long- term view we have for the asset class. This is the kind of situation where valuations become very interesting. As in the charts on page 4, emerging market equities (as measured by the MSCI Emerging Market index) are considerably discounted compared with the MSCI World index,[7] while in our opinion, still offering a compelling long-term growth story.

[7] The **MSCI World Index** is an unmanaged index of common stocks of companies representative of the market structure of 22 developed market countries in North America, Europe, and the Asia/Pacific Region.

Looking beyond short-term drivers

We don't know when the cyclical downturn will end, nor how far US interest rates will rise (if they rise at all soon). We also don't claim to know where oil or iron ore prices will be in 12 months' time. Consequently, our investment strategy does not include big aggregate factor views on the direction of markets; any interpretation of markets or macro factors is carried out through the lens of individual business analysis. As such, the outcomes we do envisage are not significantly exposed to any individual country or sector. We believe in a patient, long-term approach driven typically by the sustainable compounding of corporate cash flows by competitively positioned and robust companies. Although these companies aren't immune to economic downturns, their market positioning shouldn't be compromised.

Our long-term fundamental focus (as opposed to a short-term, speculative approach) means that our strategy can, from time to time, face challenging periods of relative performance. However, we absolutely retain our conviction that the fundamental characteristics of the businesses we favor, allied with attractive valuations, will reward patience and produce compelling relative returns over the medium to long term.

In summary

- Despite short-to-medium-term global growth challenges, the structural story for global emerging markets is valid.

- Many emerging market countries are in a much better place than in the past. Authorities have made progress implementing structural/institutional reforms, banking systems are more robust, currencies are typically floating versus fixed and there is much less public sector debt in the system — most of which is now denominated in local currency.

- Historically, emerging market equities haven't been suitably rewarded for their return-on-equity[8] premia to developed markets. Now, they're being inordinately discounted relative to other asset classes. This presents compelling opportunities for discerning investors.

[8] **Return on Equity (ROE)** is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. ROE is expressed as a percentage and calculated as: Return on Equity = Net Income/Shareholder's Equity.

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* As of September 30, 2015.