Finding True Value in Your Emerging Market Investments

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In recent months, emerging-market economies have been increasingly characterized by diverging performances at regional, industrial sector and company levels, not least owing to volatility in commodity markets. There are many companies and countries with exciting potential profit growth and hence capital return prospects, but also many areas to avoid. Against this backdrop, Robert Marshall-Lee, leader of our emerging and Asian equity team, explains why we believe being highly active in managing emerging-market investments may help you find real value.

The 'great moderation' of the 1980s and 1990s, which saw a period of decreased volatility, spawned the idea of 'market efficiency,' which holds that financial-asset prices take account of all known information that could influence them. It also saw an associated growth in index-based investing, with investors concerned not to miss out on market gains.

When markets are rising, there tends to be less differentiation between securities than when markets are falling or trading sideways; 'a rising tide lifts all boats.' In addition, we observe that emerging equity markets tend to be less efficient than developed markets and possibly subject to even greater short-termism, which may provide opportunities for those with a longer-term investment horizon.

We think emerging-market indices (and indeed global indices) may be volatile over the next 12 months. The continued unconventional actions of policymakers in the likes of Japan and the European Union may continue to distort the monetary backdrop and the prices of financial assets. In our view, such actions not only amount to little more than short-term sticking plasters, but also cause problems for global growth by affecting nominal growth in U.S.-dollar terms through currency devaluation and reduced demand for global manufacturing.

Our global thematic investment approach seeks to provide us with perspective and a forward-looking appreciation of the issues that may have an impact on equity markets. High debt levels around the world have been encapsulated in our debt burden theme; hence we never expected a 'normal' economic recovery following the global financial crisis. Consequently, we have been consistently more cautious than the market on the timing and extent of U.S. interest-rate rises. With December 2015's 'lift-off' rate hike

received broadly positively by markets, our outlook has since been for very modest and well-spaced additional rate rises in the U.S., given mixed economic data and the likely impact on growth and confidence of global factors such as the UK's vote to leave the European Union. Our expectation is therefore that U.S. rates should only rise gradually, which should not cause an indiscriminate rush of capital from emerging markets. Indeed Indonesia, among other emerging markets, was in a strong enough position in early 2016 to make three successive rate cuts, which were well received by the market. Had the country felt its currency was vulnerable, it would not have taken this action.

In a prospective environment of low, but unstable, returns, we think that aligning the composition of a portfolio with that of an equity index may have significant drawbacks. Indices are based on past trends, not future prospects. A passive investor may be compelled to buy more of those areas which have already performed well. In the context of emerging markets, this could be seen currently to include commodity-related stocks and Brazilian equities. But declines in commodity prices present terms-of-trade challenges that significantly affect the currencies, credit cycles and consumption within commodity-exporting countries, such as Brazil and Russia, in a very negative way. Conversely, this can be very positive for commodity-importing economies, like India and the Philippines. Truly active managers can seek to take advantage of favored country, industry and company characteristics.

As our mind the gaps theme highlights, we believe it will be critical in the years ahead to be selective, and to distinguish between the prospects of companies which are structurally challenged by the 'new normal' environment, those which can grow despite a difficult backdrop, and those with relatively stable earnings growth.

We see many of the higher-growth prospects for emerging-market investors being in sectors which have only modest weightings in indices. The health-care sector is an example of an area that is poorly represented in emerging-market indices (it comprises just 2.7% of the MSCI Emerging Markets Index*), but which we think offers attractive investment opportunities. Rising disposable incomes are driving changes in lifestyle and consumption patterns, meaning greater incidences of obesity. Increased affordability and insurance products also mean that healthcare services are seeing a greater share of consumer spending.

Active investors are able to harness such opportunities from the outset, irrespective of their weighting in an index. They could, for example, have very meaningful exposure to emerging-market health-care stocks (say, perhaps, a 10% weighting versus the index weighting of 2.7%). Passive investors, by contrast, are compelled to restrict their exposure to whatever the weighting in the index happens to be at a given point (which would currently mean allocating c.15% of their investments to the commodity-exposed energy and basic materials sectors).

RISK IS NOT WHAT IT WAS

Given our outlook for lower and more volatile returns from financial markets in a more nuanced world, we no longer see risk so much as in being 'out of the market,' but in being invested in the 'wrong' stocks. We see opportunities in select areas, such as Chinese internet stocks and consumer-facing areas more generally.

However, we think other parts of the market will shrink over time, for example commodity-exporting countries and companies whose terms of trade look set to worsen amid China's attempts to rebalance its economy away from export trade and capital investment towards its domestic consumer and services economy.

Our thematic work, notably our state intervention theme, leads us also to believe that the risk of policy-driven financial-market distortions has increased substantially in recent years. As active managers, we seek to steer our clients away from the distortions which we believe threaten the fulfilment of their objectives.

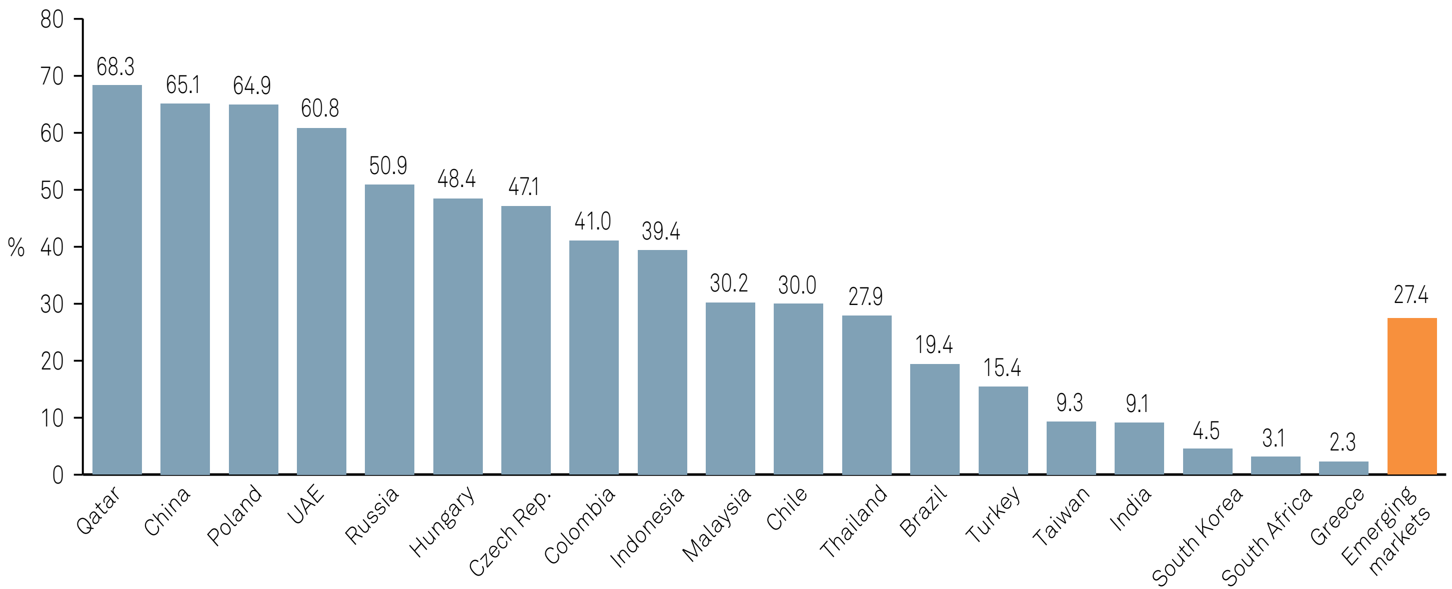
Brazil is a good case in point. The country needs its currency to adjust to the deterioration in terms of trade via depreciation. We did start to see this process, along with the knock-on negative impact on the Brazilian consumer, but more recently the currency has strengthened again which is unhelpful for the necessary fiscal consolidation. The government has filled the GDP growth gap with credit expansion and via expansionary socialist policies, but this has not led to the necessary productivity growth. We believe the economy has reached the limits of this policy backdrop, so now the painful adjustment is beginning and we think there are likely to be a tough few years ahead. The recent 'hope rally' predicated on President Dilma Rousseff's impeachment trial rather than anything fundamental does not change our view on this and has only served to inflate valuations of companies for which the earnings outlook is difficult.

We believe that the most important risk to passive investors is that their investments are inadequate in meeting their objectives. Proponents of passive investing argue that tracking an index allows investors to gain exposure without the risk of 'underperformance.' That implies, however, that 'neutral' performance is free from risk, and it overlooks a vital consideration: whether the index itself is fit for purpose.

In tracking an index, passive investors may embrace significant sectoral biases, irrespective of their views about the sectors. An investor with a negative view of the financials sector, for example, would be unwise to track the MSCI Emerging Markets index given the dominance of this sector, which comprises 26.1% of the index*. Similarly, from a country perspective, the MSCI Emerging Markets Index is weighted heavily to certain countries: notably China (25.8%), South Korea (14.6%) and Taiwan (12.1%)*. We believe a more absolute-style, fundamental approach can avoid unintended biases, particularly if a long-term perspective is applied.

*Source: MSCI, June 30, 2016

Exhibit 1: MSCI Emerging Market Countries - % State Control



Source: Newton, CLSA, January 2016. Estimate for the proportion of state-controlled companies in the whole MSCI Emerging Markets Index is calculated by defining each constituent in the index as state or privately controlled (a very small proportion as 'unclassified' or 'majority foreign ownership') – then summing the index weights for all the constituents considered to be state controlled. Total MSCI EM Index is a weighted average.

WHY WE THINK BEING ACTIVE CAN HELP FIND TRUE VALUE IN EMERGING MARKETS

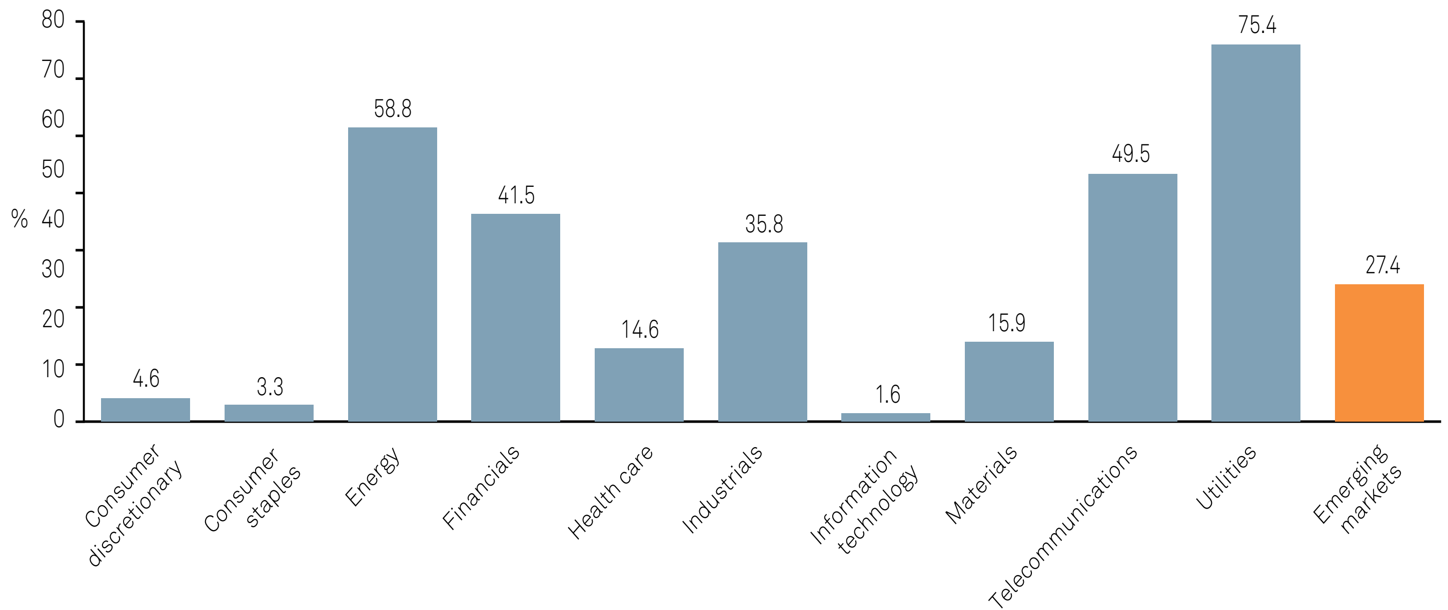
Emerging markets are not homogeneous. Investment prospects differ greatly between different emerging markets—more so, we suggest, than within developed counterparts, particularly in the aftermath of the global financial crisis. One specific characteristic we are concerned about in some emerging markets is the extent of state control, and its scope to distort the investment outlook and cut returns.

Exhibit 1 illustrates that, while almost 30% of all publicly listed emerging-market equities are in state hands, the state actually controls more than half of the stock market in five countries, including China and Russia.

Within the overall picture, some sectors are more state-controlled than others. As Exhibit 2 shows, utilities, energy and telecommunications companies, for example, have a high degree of state control. By contrast, the information technology, consumer, and healthcare sectors are relatively free from state ownership. And it is exactly in these sectors with the lowest state exposure that our strategy has its highest weightings.

The interests of the state or an oligarch are rarely aligned with those of minority investors, and we observe that the governance structures of the majority of emerging-market companies tend to be less clean than those of their developed-market counterparts. We contend that it should be a big advantage to be able to focus on those companies most aligned with minority shareholders, particularly given the threat of less stringent regulation around corporate governance in emerging markets. When constructing an emerging-market portfolio, we should be looking to capture the benefit of economic growth through capital appreciation and hence need to be particularly wary of the risk of value 'leakage' through misaligned incentives.

Exhibit 2: MSCI Emerging Market Sectors - % State Control



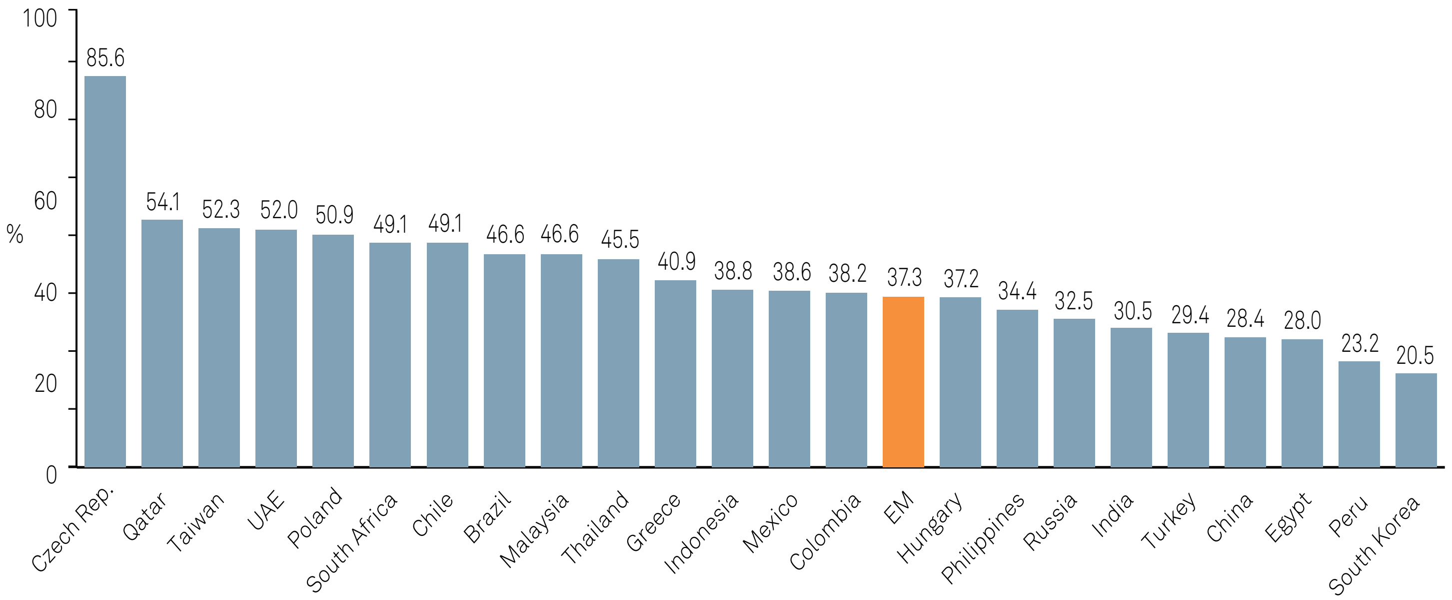
Source: Newton, CLSA, January 2016. Estimate for the proportion of state-controlled companies in the whole MSCI Emerging Markets Index is calculated by defining each constituent in the index as state or privately controlled (a very small proportion as 'unclassified' or 'majority foreign ownership')—then summing the index weights for all the constituents considered to be state controlled. Total MSCI EM Index is a weighted average.

Unfavorable ownership structures may promote poor capital discipline and can result in the approach to paying dividends running counter to the interests of shareholders. Policies on dividend payments vary enormously from one emerging market to another. As Exhibit 3 on the next page shows, companies in the Czech Republic, for example, are estimated to pay out an aggregate 85.6% of their earnings as dividends to shareholders. In South Korea, however, the payout ratio is only 20.5%. With income from dividends forming an important element of investors' long-term return from equities, it is important to understand the implications of these distinctions.

We assert that population dynamics are key drivers of GDP growth and asset prices, but they vary significantly among different emerging markets. Such dynamics may create favorable investment opportunities, for example, where they are associated with strong working-age population growth (see Exhibit 4), but they may also entail risks which reduce the appeal of some markets.

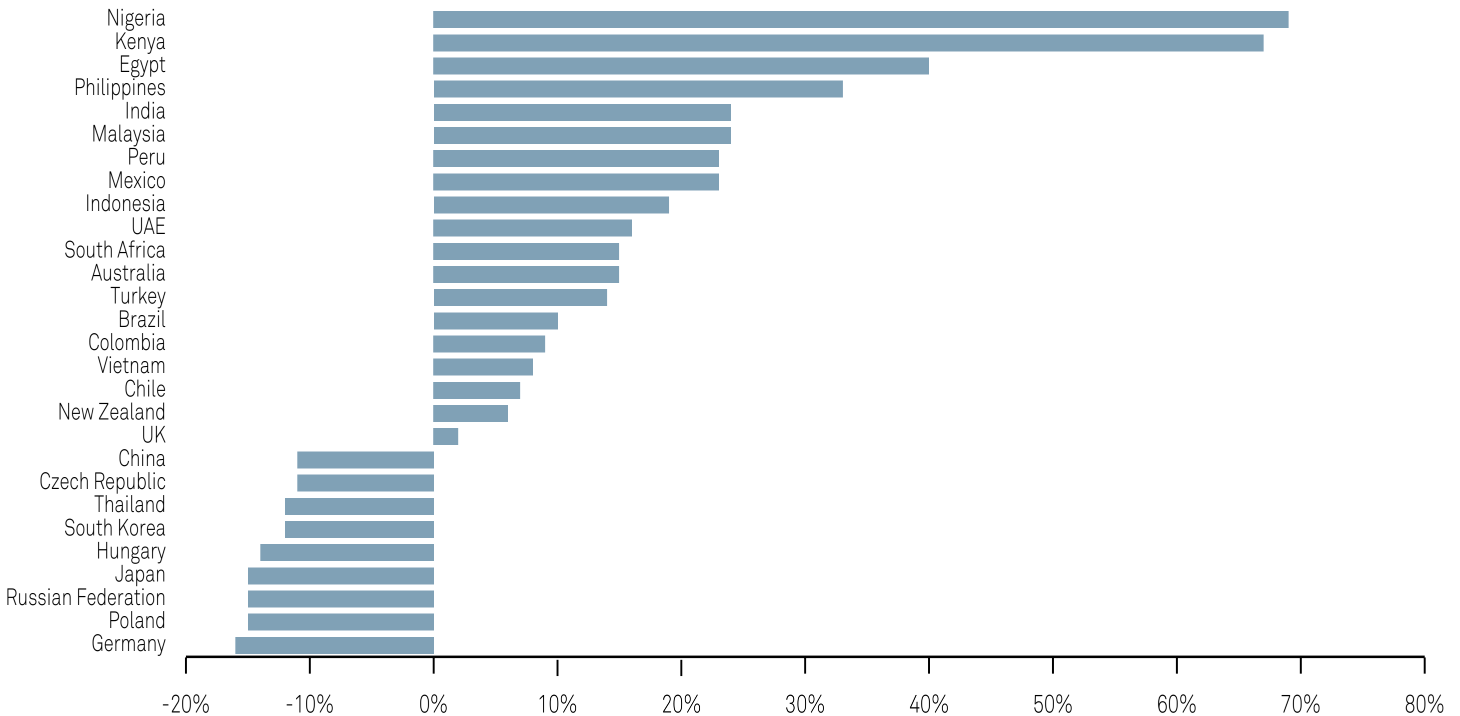
Similarly, public finances differ greatly between one emerging market and another, which shapes the opportunities and risks facing investors and points, we think, to the importance of active management. Exhibits 5 and 6 on page 7 show the current account balances and fiscal deficits of a range of countries. Put simply, some emerging markets are at different points in the credit 'cycle' from others. Post-financial-crisis policy responses differed, leading to credit explosion in some countries, but credit shrinkage in others. Where debt burdens are high, GDP growth is likely to be impeded, and vice versa. An active manager can try to exploit this.

Exhibit 3: 12-Month Forward Dividend Payout Ratio (%) of Constituents of MSCI Emerging Markets Index



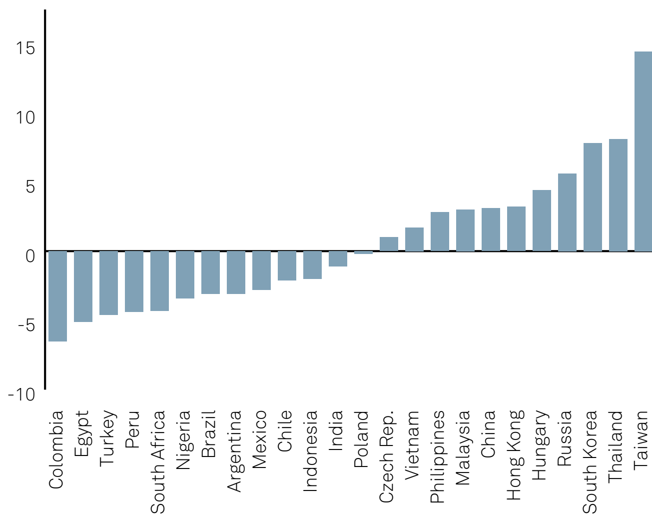
Source: Thomson Reuters Datastream, CLSA, June 2016.

Exhibit 4: Working Age Population Growth (2015-2035, UN Estimates)



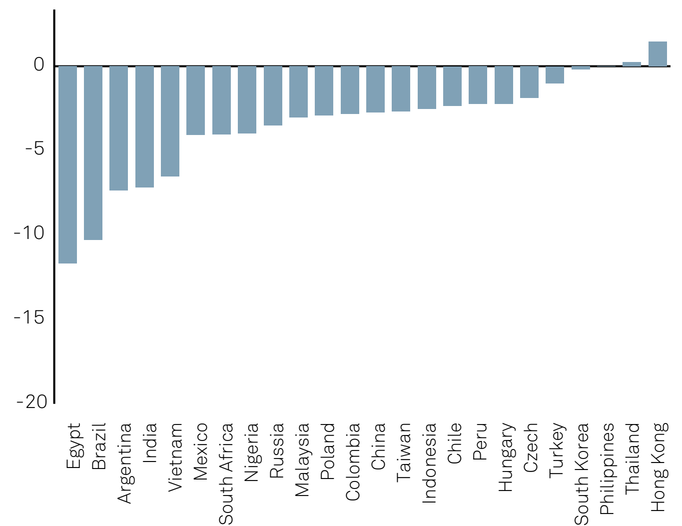
Source: Newton, UN Population Information Network - World Population Prospects: The 2015 Revision, April 2016.

Exhibit 5: Current Account Balance (% of GDP)



Source: Thomson Reuters DataStream, Newton, June 2016.

Exhibit 6: Government Fiscal Balance (% of GDP)



Source: Thomson Reuters DataStream, Newton, IMF World Economic Outlook, June 2016.

THE MATH OF PERFORMANCE MEASUREMENT

Studies have been published which aim to 'prove' that active investment management produces higher returns than passive management, or vice versa. In reality, we believe the debate is often flawed. Where a number of active managers are trying to beat an index-based return, it is unrealistic to expect them all to do so because, in aggregate, they equate to a major part of that market. In relation to 'peer group' benchmarks (where a median of a group of investors is usually taken as the benchmark return), it is a mathematical truth that one investor will generate the median return, half of the remaining investors will outperform the benchmark, and half will underperform.

As one study found, taking an arithmetic average of a universe of funds can be misrepresentative**. The study identified that 'weighted averages', which give larger funds a greater influence on a sector's average calculation (to reflect the true average return experienced by investors in that sector), generally exceed simple average returns.

We suggest that a particular phenomenon for investors to avoid is paying an 'active' fee for a product which is, in effect, passive in its composition. In relation to this, a measure such as 'active share,' which measures the share of a portfolio's holdings that differs from the composition of a benchmark index (i.e., how 'active' the portfolio is), may be a useful tool.

Many of the points we make in this paper apply, we believe, to investment across regions and asset classes. However, we think that active management works especially well in the context of emerging-market equities, particularly given our outlook for economies and financial markets over the coming years.

**Premier Asset Management, The State of the Universe, September 2013: https://www.premierfunds.co.uk/media/58078/state-of-the-universe-2013-areview-of-fund-management-in-the-uk.pdf; Premier Asset Management sourced their data from Morningstar's universe of funds sold in the UK.

Risks

All investments contain risk and may lose value. **Equities** are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. Small and midsized company stocks tend to be more volatile and less liquid than larger company stocks as these companies are less established and have more volatile earnings histories. **Investing in foreign denominated and/or domiciled** securities involves special risks, including changes in currency exchange rates, political, economic and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

The **MSCI Emerging Markets Index** is used as a comparative index for this strategy. The strategy does not aim to replicate either the composition or the performance of the comparative index. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging-market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Qatar, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

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