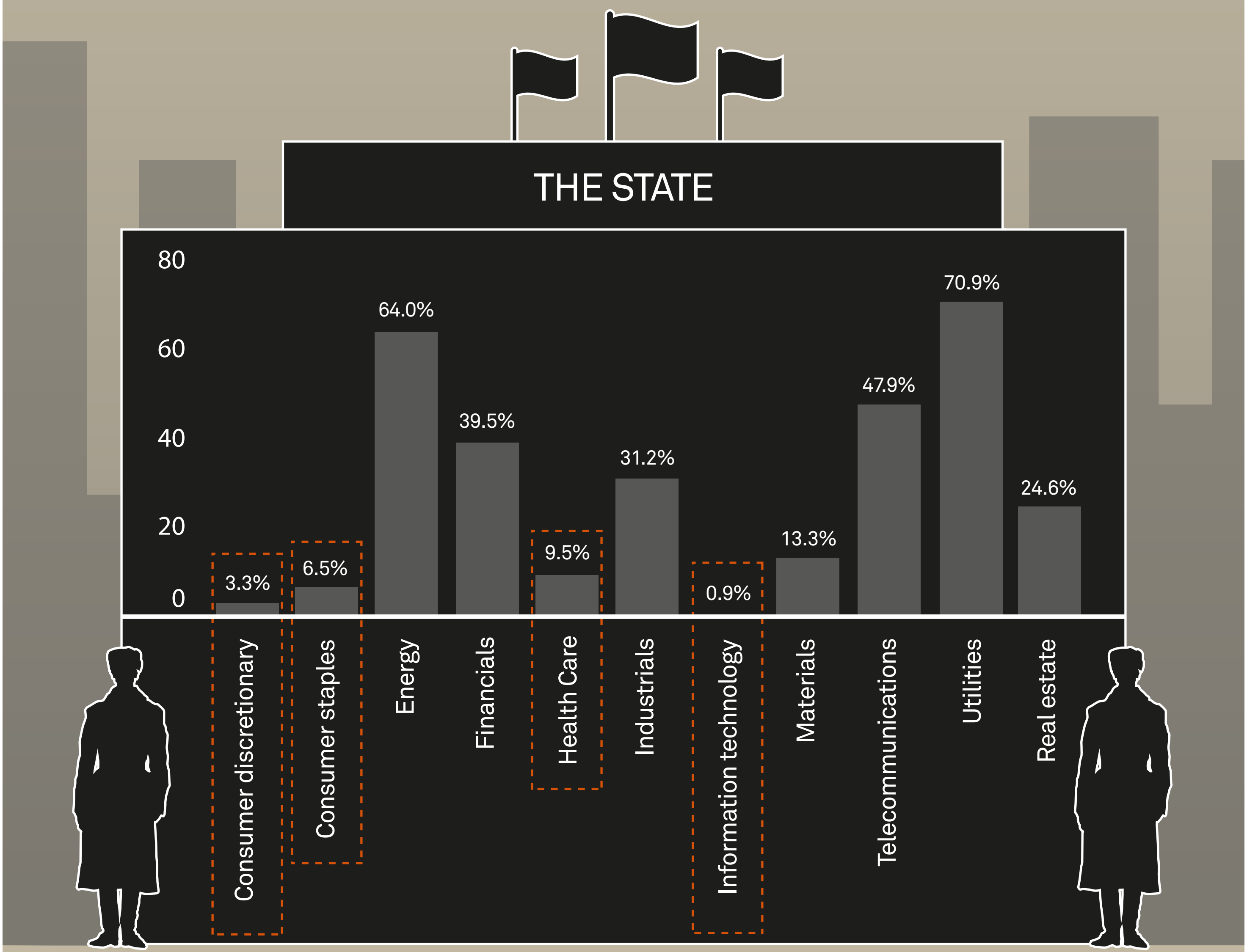
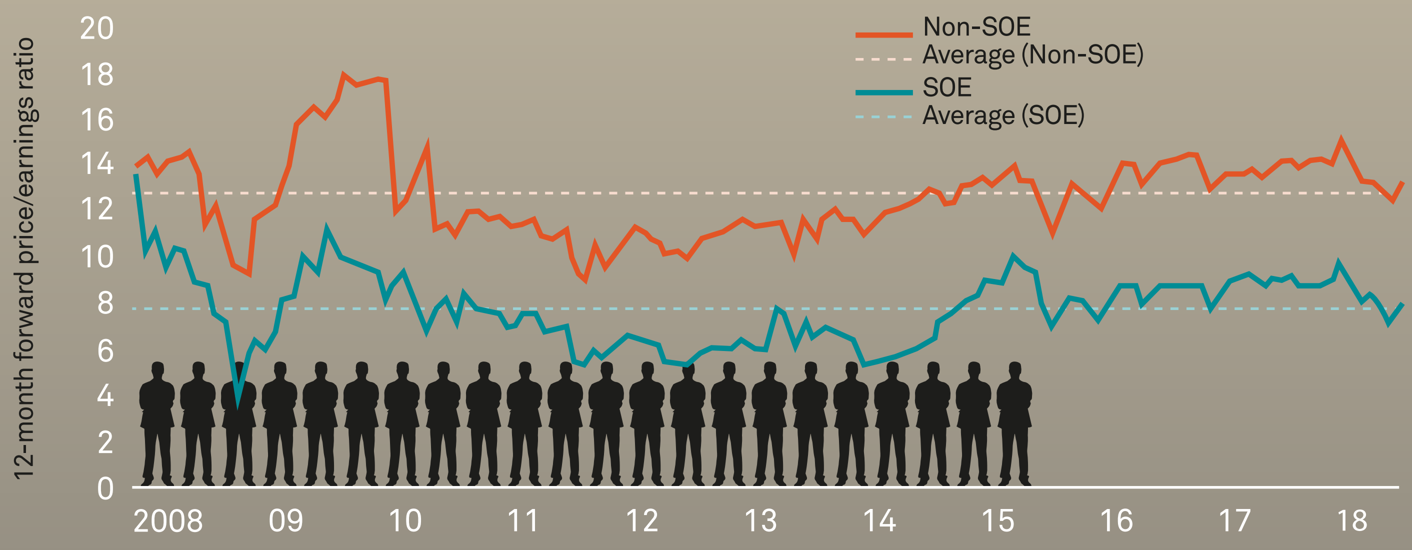
State control in emerging markets

MSCI Emerging markets sectors - estimated state control (%)



Source: Newton, CLSA. 31 May 2018 For illustrative purposes only.

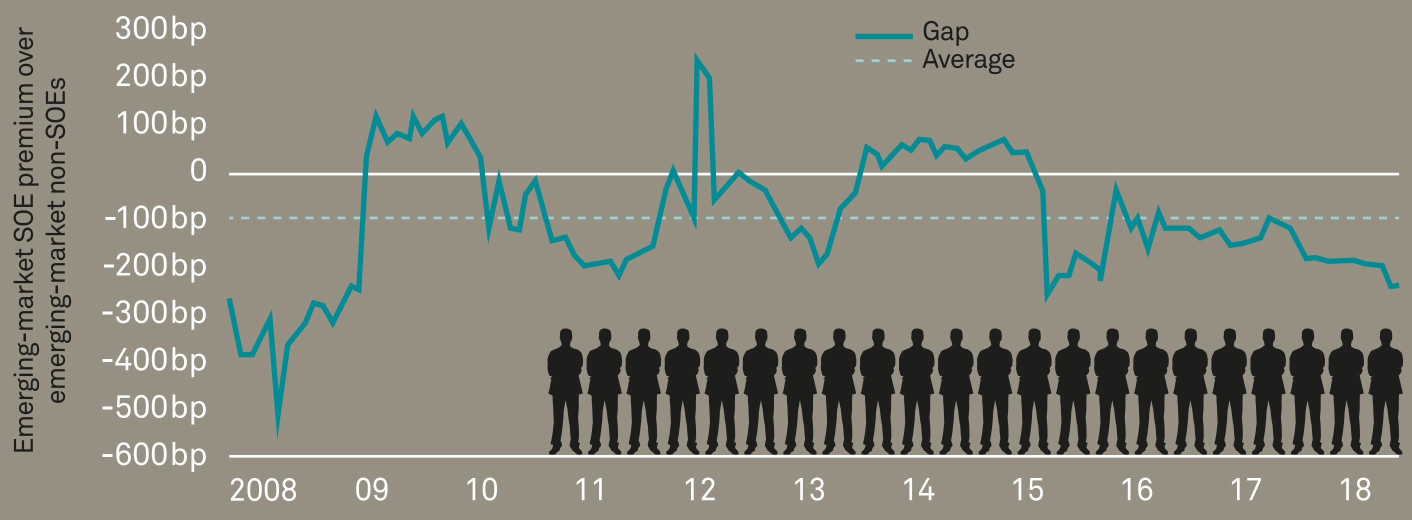
SOEs[1] have significantly underperformed non-SOE companies over both the long term and more recent periods...



Source: MSCI Emerging Markets Index, Datastream, UBS, 31 July 2018. Past performance does not guarantee future results. Index data does not depict the characteristics of a specific investment.

[1] SOE = State-owned enterprise.

Mind the gap... Return on equity: SOEs vs. non-SOEs



Source: MSCI Emerging Markets Index, Datastream, UBS, 31 July 2018. Past performance does not guarantee future results. Index data does not depict the characteristics of a specific investment.

In more developed markets, concern over state intervention largely centers around central bank policymaking. While that is of course highly relevant across emerging markets too, there is in fact an even larger state-led consideration when investing in these markets: the fact that around 23% of the MSCI Emerging Markets Index[2] is comprised of state-owned enterprises (SOEs), as of 31 July 2018 (Source: MSCI).

The majority of these companies are not run with profit-maximizing intentions, in our view. They tend to be strategic state assets such as banks, or utility and resources companies, with heavy capital-expenditure burdens. This tends to make them poor stock investments over the long term, although a major commodity bull market can potentially change the optics temporarily. Return on equity (ROE) is usually less important than other strategic desires of the state when it comes to these companies making capital-allocation decisions.

State ownership can provide a measure of stability, but this may involve significant shareholder value dilution, since minority investors tend to be a lower priority in stressed situations or in capital-allocation decisions. Interestingly, we saw such dilution with many Western banks following the global financial crisis, and emerging-market companies are perhaps even less likely to focus on shareholder value in such situations.

As such, when looking at Emerging Market equities, we very rarely take exposure to SOEs and tend to focus on the technology, consumer and health-care sectors as they are relatively free from state control. This is where we find the most interesting investment opportunities in Emerging Market equities.

Naomi Waistell, portfolio manager Emerging and Asian equity team. Newton Investment Management – part of BNY Mellon Investment Management

[2] The MSCI Emerging Markets Index (net of foreign withholding taxes) is a free float-adjusted market capitalization weighted index designed to measure the equity performance in the global emerging markets. The index consists of 23 MSCI emerging market national indices. Indices are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

All investments involve risk, including the possible loss of principal. Asset allocation and diversification cannot assure a profit or protect against loss.

Return on Equity (ROE) is a measure of quality that measures how much profit a company generates with the money shareholders have invested.

Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. 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.

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MARK-43990-2018-12-10