Even for those investors who have been allocating to emerging markets (EM) for decades, it can seem a daunting prospect to reinvest after a period of choppy returns.

Now investors are starting to reassess their developed market exposure in an increasingly volatile environment, while considering the growth potential of emerging market economies.

For Ralph Jaeger, managing director and portfolio manager of emerging markets private equity at Siguler Guff, certain developing markets are now presenting attractive entry points.

He says private equity used to be thought of as more of a beta play and the opportunity set was concentrated to just a few large markets, namely China, India and Brazil, but adds: “It has evolved over the past 10 years and become far more sophisticated across numerous markets with various investment strategies and different sector focuses.”

Jaeger notes EM publicly listed equities can be skewed towards just a few sectors — energy, utilities, financial services and materials — because they make up a large portion of indices. Conversely, investors’ exposure to healthcare, consumer or tech sectors can be limited, for the opposite reason. Yet the latter are the high-growth sectors he believes are among the most attractive in emerging market economies.

“In addition to the better breadth we believe private equity exposure can provide, valuations are generally lower than comparable publicly listed companies,” he adds.

It is this lower average valuation for EM private equity, compared with publicly listed counterparts, Jaeger believes is a big source of alpha versus listed equities right now.

Although there tends to be a valuation lag between public and private markets, Jaeger stresses that is not to say they are uncorrelated. He also admits private equity is unlikely to be the first asset class on investors’ radar when they think about allocating to EM, particularly if they have no allocation to private equity in developed markets.

But, in his view generally EM private equity investments can be complementary to
public equity investments because of the relative ease and value in accessing index outliers such as health care, consumer and tech companies.

He adds investors need to “demand to get compensated for investing in private equity” where investments are typically held for much longer time periods. Jaeger suggests investors look for a premium of at least 500 basis points (bps) above the MSCI Emerging Markets index and at least 300bps over private equity returns in Europe and the U.S.

DIGGING DEEP
Selectivity and a fine-tooth comb are tools Rob Marshall-Lee, leader of Newton’s Asian and emerging equity team also believes are a prerequisite for public equity investing in the asset class. Marshall-Lee says there has been a great divergence in emerging market economies over the past few years and there are no signs of reversal.

“This is great news for fundamental, active investors but not so much for those who analyze emerging markets from a relative index perspective,” he says.

Marshall-Lee agrees with Jaeger on the diagnosis of emerging market equity indices in terms of their large weightings to commodity-exposed economies such as Russia, Brazil and South Africa but says investors willing to dig deeper and deviate from those benchmarks can benefit from far greater diversification.

Like Jaeger, he prefers consumer-related sectors and those where growth is predicated on growing middle classes with higher disposable incomes — sectors such as healthcare and technology.

“When you have investment flows based on the shifting sentiment towards commodities, and related economies, it can impact the valuations of all equities in emerging markets — even those that are inherently attractive underlying investments.”

DISCERNING VALUE
Much of 2016 has been characterized by the countries and sectors that performed badly in 2015 witnessing a reversal of fortunes. But Marshall-Lee does not believe those pro-cyclical areas are necessarily sustainable long-term investments. “Even though high beta, lower quality stocks are bouncing first and fastest, we believe valuations look more attractive in opportunities where we see sustained strong profit growth.”

Emerging markets as a whole appear to have de-rated substantially as evidenced by the Shiller P/E ratio but Marshall-Lee

SHILLER P/E RATIO: INSTITUTIONAL BROKERS’ ESTIMATE SYSTEM (IBES) MSCI EM vs. IBES MSCI WORLD

Sources: Newton, Thomson Reuters Datastream. As of April 30, 2016.
content this measure of value is flawed as it is backward-looking and the future will not necessarily be a repeat of the past.

Over the next five years, he still believes India will be the best-performing market in hard currency terms. As a commodity importer with pent-up demand following a slowdown, he says the country is emerging from a painful credit cycle and has undertaken positive economic reforms. It is also a country with attractive demographics, hosts businesses with entrepreneurial spirit and features a relatively low level of government interference in listed equities.

When looking at China, he divorces headline rates of growth from company analysis. “China is rebalancing. While we are cautious on headline GDP growth, consumer wealth is growing consistently in high-single-digit to double-digit levels. So you have to look for good companies with strong brands or business franchises in the highest growth areas.

“Chinese credit overhang, which many commentators are concerned by, is very heavily slanted towards state-owned enterprises (SOEs) because banks have been lending mainly to them at the prompting of the state. You see a lot of capital misallocation in the Chinese government and SOEs but investing in independent companies that are self-funded through cash flows does hold some appeal.”

Jaeger believes China and certain countries in Latin America look attractive from a private equity point of view. In China, a transition towards a ‘new normal’ economy hinges on innovation, which he believes creates opportunities for venture capital investors.

Whether looking towards private equity or publicly listed companies in emerging markets, the message from both Jaeger and Marshall-Lee is consistent: developing economies can no longer be treated as a homogeneous group, if indeed they ever should have been.

A repeat of the mid-2000s boom is not expected but the managers see the potential for solid returns from specific parts of emerging markets over the next 5 to 10 years.

**WEIGHING THE COMPETITION**

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<tr>
<th>EMERGING MARKETS</th>
<th>Pros</th>
<th>Cons</th>
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<tbody>
<tr>
<td>Growing middle classes and attractive demographics.</td>
<td>Low penetration of credit in some countries means scope for growth in consumer spending.</td>
<td>Corporate social responsibility can be lacking and state interference in some markets is high.</td>
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<tr>
<td>Low penetration of credit in some countries means scope for growth in consumer spending.</td>
<td>If exposure is index-based or ‘closet tracker,’ then commodity-linked sectors and economies can dominate allocations.</td>
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<td>EM may leapfrog developed markets through adopting new technologies without ever having to build the infrastructure for older iterations.</td>
<td>Infrastructure spend can be piecemeal or ill-thought out by governments eager to provide a boost to their economy.</td>
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<tr>
<th>DEVELOPED MARKETS</th>
<th>Pros</th>
<th>Cons</th>
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<td>An overall depth and breadth to the market through virtue of greater competition and a general commitment to capitalism.</td>
<td>Aging populations and less attractive demographics from a working-age population standpoint.</td>
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<td>Home to multinational businesses well positioned to resist volatility due to diversified revenues.</td>
<td>So-called ‘zombie’ companies considered to be propped up by central bank and government intervention since the global financial crisis.</td>
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<td>In many sectors and markets, there is a strong culture of paying dividends to shareholders.</td>
<td>Mature companies, which could be considered ex-growth, can still make up a large part of the index due to their overall market capitalization.</td>
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**KEY POINTS**

- Emerging markets cannot be treated as a homogeneous group.
- Consumer-related areas look appealing versus more commodity-skewed sectors.
- Thorough research and maintaining realistic risk/reward expectations remain important EM considerations.
IMPORTANT INFORMATION

Main risks: 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 great with emerging market countries. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees.

The cyclically adjusted price-to-earnings ratio (CAPE), commonly known as Shiller P/E is a valuation measure usually applied to the U.S. S&P 500 equity market. It is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation. As such, it is principally used to assess likely future returns from equities over timescales of 10 to 20 years, with higher than average CAPE values implying lower than average long-term annual average returns. It is not intended as an indicator of impending market crashes, although high CAPE values have been associated with such events.

The MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) designed to measure equity market performance in global emerging markets.

The MSCI World is a stock market index of 1,643 'world' stocks. It is maintained by MSCI Inc., formerly Morgan Stanley Capital International, and is used as a common benchmark for 'world' or 'global' stock funds. The index includes a collection of stocks of all the developed markets in the world, as defined by MSCI.

The Institutional Brokers' Estimate System (I/B/E/S) is a service. I/B/E/S began collecting earnings estimates for U.S. companies around 1976 and used the raw data to calculate statistical time series for each company. The data subsequently was used as the basis for articles in academic finance journals attempting to demonstrate that changes in consensus earnings estimates could identify opportunities to capture excess returns in subsequent periods. An investor cannot invest directly in any index.

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