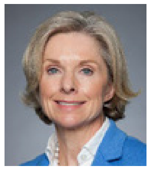
Global Emerging Market Equities

The true opportunity in emerging markets



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While emerging-market (EM) stock performance has been volatile in 2018, long-term demographic and economic changes across EM continue to create fertile opportunities for well-managed businesses capable of sustainable growth. An increasing number of EM companies have learned how to compete with their developed-counterparts, in many cases adopting new technologies and processes at lower cost than their more established rivals.

Joint Senior Portfolio Managers Kathryn Langridge and Philip Ehrmann answer investors' questions on the latest challenges and opportunities faced by EM investors.

1. 2018 has been a challenging year for EM investors. Do you believe the correction is over?

Macroeconomic and geopolitical challenges have been the dominant influences over EM in 2018, and it follows that if the correction is over, it will be macro driven.

Based on our valuations, we believe that much is priced in already. We see signs of stabilization, and there are important elements that could move more decisively to support EM at this stage. For example, we believe that any signs of the US rate cycle moderating will be critical. We'd also need to see signs of President Xi easing fiscal and monetary policy, being more supportive of the private sector and to see some relaxation in regulations in relation to China's new economy companies, where the correlation has been one of the tightest of all in EM in 2018. Finally, a breakthrough on trade would certainly be viewed positively.

Valuations are at the trough of their historic ranges but we recognise this is not in itself a catalyst for recovery. However, at the individual stock level, many of our highest conviction companies are pricing in low growth assumptions which appears to us to factor in considerable business cycle risks. EM in general and China in particular are at a much earlier stage of the business cycle than we see in the US.

2. What is your view of the implications of rising trade friction?

We see Asia as the most exposed region now that an agreement has been reached with Mexico. China and the small open economies of ASEAN (Association of South East Asian Nations) are perceived to compete with US labor and to benefit from asymmetric tariffs – and this is where some form of agreement may be possible. Chinese exports to the US are less than 20% of their total exports*, and net exports to GDP are significantly less compared with a decade ago, showing the extent to which China has already rebalanced its economy in favour of domestic drivers of growth. We also see that in the longer term, however, the issues between the US and China go deeper than a conventional trade spat and are likely to persist for years to come. This is more a struggle for global technology leadership, intellectual property and national security, with China viewed by the US administration as a long-term threat.

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>
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However, there may also be opportunities in the response that China will adopt. The unintended consequences are that China will be pushed further to reform, to move up the value-added chain, increase automation and diversify its supply base to lower cost countries, as well as to develop new trading relationships.

3. What to you are the most important elements for a successful EM investment strategy in an era of disruption and structural change?

We strongly believe that an approach focused on the best quality companies who have proven business models and strategic management skill can lead to strong returns over the long term, because these companies are capable of delivering persistent and superior returns on invested capital. These are companies that are able to exploit the structural growth opportunity while minimising business risks by demonstrating healthy engagement with ESG (Environmental, Social and Governance) issues. In addition, we believe experience in EM is a critical factor. These are complex and volatile markets and experience gives perspective to look beyond the noise of short term data, to understand the cycle and corporate behavior and acquire the discipline to apply proven investment principles. And patience, as well, to exploit the volatility of EM and invest dispassionately.

4. Is governance and transparency in EM improving?

We believe that the best quality companies in EM have long understood that conforming to high international standards of governance enables them to access capital markets more efficiently and at lower cost, and this has led over time, and particularly since the Asian fiscal crisis, to improvements in governance. Accounting standards have improved, as has the availability of data. At the same time, governments, Central Banks and regulators across EM have fostered institutional reforms which are gradually building stronger foundations for capital markets, which is all part of a process of deepening, liberalising and maturing which will characterize progress over years to come.

5. How do you think about E, S and G in your investment process?

All these elements are extremely important to us, as they have a critical impact on a company's potential value creation for shareholders. EM companies can offer compelling growth, but complex risks, and we believe that companies with strong engagement with ESG factors tend to be good quality companies. Equally, adverse governance can destroy an investment thesis, so removing high risk companies improves returns. We embed the analysis of ESG factors at every stage of our investment process. Our processes seek to ensure robust screening and transparency of ESG factors. We are not prohibited from investing in any given company or sector due only to ESG factors. Rather, we seek to engage with such companies to better understand their ESG strategy and, through constructive engagement, to improve their ESG performance metrics over time.

*IMF World Economic Outlook Database as at 13 November, 2018

6. What are the main risks that EM investors need to consider, and how do you mitigate them?

Macro factors including ongoing trade-tensions, the US interest rate cycle, the strength of the US Dollar and the price of oil have all had a negative influence throughout 2018, as has the direction of global growth and Chinese growth, in particular. The coincidence of these factors occurring together in 2018 has depressed valuations, which, in our opinion, creates an opportunity for long term investors. However, these macro risks are not going to disperse easily and will continue to give rise to volatility.

We mitigate these risks in a number of ways. We recognize that rapidly changing and growing emerging markets present inherent forecasting risks. We aim to minimize these risks by running diversified portfolios at the country, thematic and stock level. We also focus our research from the bottom up, identifying the best quality, high return companies. We believe that putting an emphasis on business sustainability, balance sheet strength and governance at the stock level, and paying a reasonable valuation based on our analysis, is also a critical factor in managing risk.

7. EM equities have suffered significant outflows in 2018. What will bring capital back?

In our view, until there is greater clarity around the challenging cyclical factors, market volatility is likely to continue and a long-term view for EM should be taken. However, the convergence of demographics, government reform and innovative technology is leading to strong and more resilient domestic EM economies in which a dynamic private sector is playing an increasingly significant competitive role. We believe these trends, coupled with EM equities trading at close to a 10-year discount to developed markets on a price-to-earnings and price-to-book basis, can offer compelling investment opportunities.

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