Emerging market equities

Opportunities remain for the intrepid explorer

In conversation:

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Opportunities remain for the intrepid explorer

Despite the disappointing performance of emerging markets (EMs) since 2011, many investors remain hopeful that over the long term they will recover to higher growth rates than their developed counterparts.

Hiccups in performance are part and parcel of investing in EMs, as illustrated by the shockwaves felt by global markets following China's equity market crash and currency tinkering in the late summer. Many view the downturn as a symptom of the cycle rather than a structural flaw and where there is volatility, there is an opportunity to stock pick.

Using an active unconstrained approach is particularly valid when considering EMs are home to 85% of the world's population and more than 50% of its global GDP growth, yet represent only 12% of global equity market capitalisation. Many argue therefore, using global indices does not capture the market nuances the way an active manager can.

While certain EM countries such as Brazil are facing significant challenges over inflation and economic growth, there are opportunities to be found elsewhere. China's 'new normal' economic growth might be muted, but its stock market shows promise having been liberalised through the Hong Kong-Shanghai Connect, paving the way for greater investment into the region, particularly in the tourism, insurance, environment and healthcare sectors.

Elsewhere, India has overtaken China, the US and the UK as the world's number one destination for foreign direct investment and its stocks and bonds have been among the best performing markets globally and a strengthening rupee has led to additional returns for investors. Mexico and the Philippines have also been seen as reformers in this space.

Even issues around corporate governance, which has long been an obstacle to accessing EMs, are being addressed throughout the emerging and frontier world. In China, president Xi Jinping has taken steps to clamp down on internal corruption and improve returns at state-owned companies. Elsewhere in the frontier markets space, the Romanian government has taken a particular stance against corruption among government, parliamentary and local government officials, amid a raft of other political changes.

Furthermore, a recent survey found EM companies have increasingly disclosed more environmental, social and governance (ESG) information over the last five years as a means of attracting foreign investment with the greatest improvements in the energy and financial services sectors.

This roundtable sees a panel of asset managers and consultants discuss investing in EM equities from the impact of recent volatility in the market through to the obstacles for investors and how to best access the opportunities.

Sebastian Cheek
deputy editor, *portfolio institutional*

John Malloy

"Many of our institutional clients are underweight emerging markets because they never rebalanced over the years. We've had a big correction, but I don't think investors were badly hurt by it." John Malloy

How have the recent events in emerging markets (EMs), including the Chinese equity market crash and the currency devaluation, affected equity investors with emerging market exposure?

Simon Hill: The crash in Chinese equities did come to the attention of a lot of trustees and woke them up to what had been going on in emerging markets, but it's unfortunate everything has been focused on China, because we've known that Chinese growth was going to slow for some time.

What's happened to equity markets is due to three overlapping issues. The first clearly is the China slowdown affecting those who supply China – not just the slowing rate but the composition of that growth is changing. Russia – and all the economies around it also have their own problems. The second is around commodity exporters generally, whether it's oil, steel, wheat or other commodities, they've all suffered significant falls in price. The third is the way in which longer term expectations of growth have been seen to be deteriorating in emerging markets. So this is not just cyclical, but may be longer term.

Nick Samuels: Investors also got spooked by what happened in the third quarter of 2015 when outflows were as bad as those in the last quarter of 2008. Many of the issues that emerging markets are struggling with are priced into the equity market. That's why it's an awful lot cheaper than developed markets, but the currency devaluation was the surprise.

John Malloy: Many of our institutional clients are underweight EM because they never rebalanced over the years. So EM equities have been in a bear market for almost five or six years. We've had a big correction, but I don't think investors were badly hurt by it.

A lot of hedge fund money, which shows up in ETF outflows as well as others, has come out of the market pretty quickly and much of it went short during this period. But there are quite a few markets where domestic investors are coming back, such as India, where foreign investors are selling and local money is coming back. The other headwind in EM has been rates, so it's hard to compete against equities in Brazil for instance, with 14% interest rates. Once rates start to fall, you should see market flow back into the equity market.

Sophia Whitbread: China definitely grabbed the headlines, but it's both an opportunity as well as a problem in that emerging markets are often tarred with the same brush. There is a good degree of heterogeneity in terms of conditions and we can show some positive examples of reformers among the emerging markets, such as India, but also perhaps Mexico and the Philippines. Conditions there are very different than in more challenged economies such as Brazil and other economies where the terms of trade environment is changing very rapidly as the profile of Chinese growth changes.

Sophia Whitbread

"There is a good degree of heterogeneity in terms of conditions and we can show some positive examples of reformers among the emerging markets, such as India, but also perhaps Mexico and the Philippines." *Sophia Whitbread*

So it's been a tough year, but it's not all doom and gloom?

Samuels: If you buy emerging markets at these sorts of valuation levels, you tend to do well. There is potentially money to be made – certainly relative. The difference between emerging market and the US equity market is enormous, so on a forward-looking view, EM is quite attractive.

Hill: There is little doubt that the valuations of course are attractive. But is the capital outflow also as-


Nick Samuels

sociated with a reduction in the capital attractiveness of emerging markets generally? If so, and we have seen signs of lower productivity growth, then these markets may be attractive – but not as attractive as they look – if your long-term expected rate of return is gradually shifting down.

Malloy: The debate is really: is it a secular or a cyclical slow down? Many emerging markets have been going through rate-hiking cycles when you've had easy monetary policy in US, Europe and Japan. But India has had a pretty tight monetary policy and just started cutting rates. Chinese monetary policy has also been tight, so as rates come down, you should start to see that impact on the economy. The other factor is that margins, whether operating margins or any type of profitability, have been squeezed in emerging markets, which is a sign of a cyclical slow down.

Whitbread: In terms of how we access emerging markets going forward, there has been an increasing awareness that to do well in future, we will have to be increasingly active. Some of the more exciting opportunities in emerging markets where you have structural growth that's not reliant on economic growth is not reflected in the index. For example, healthcare which has less than a 3% weighting in the index is a very exciting growth story. We can also look at parts of the consumer as you can get very concerned about some of the state-owned enterprises and how they're used as tools for government policy. But there is also some good news there, which is not being reflected at all.

Hill: That's is a really insightful comment, and I agree that a lot of securities that are invested in as part EM are actually global companies, which happen to be domiciled in emerging markets and trade in international commodities. The original rationale for strategic investment in emerging markets was all to do with development in areas like healthcare, education, growth and population.

We need to distinguish – and a lot of managers do – between the very large cap stocks that could be anywhere and those which actually reflect the reason why you might regard emerging markets as a class apart from developed markets, for reasons of long-term development, higher growth rates, but more importantly higher rates of return on capital.

Samuels: You have to go down the cap scale to access those, and that brings with it a liquidity risk. That also means the type of manager you choose is very important and it's probably not the guys that are running large amounts of money in emerging markets because they are capacity constrained and the better opportunities are in smaller-capped stocks.

Whitbread: Not all the good opportunities are necessarily that far down the cap scale. Some of the e-commerce IPOs in China are huge and do represent a very exciting and relatively new area of structural growth. Those opportunities are available for the larger managers.

I would agree it's a very good time to be a smaller investor in emerging markets, particularly as some of the larger investors have shown how difficult it is when your AUM gets high you cannot be nimble.

Malloy: Then there's indexation. Some use ETFs or derivatives, but this year it's been difficult as there have been high correlations among markets. Even with mega caps you have dispersion, so the question is not only about large managers, but indexation, as there is a cost to indexing.

Hill: That's a good point. The problem is, if you've got a medium-sized fund with a relatively small allocation, the expense of going out to look for a good, active emerging market managers is quite tricky.

Only two or three years ago, many of the best had reached full capacity and were closed to new money. So a lot of investors were almost forced to go down the passive route.

There are lots of good reasons why passive doesn't make sense in emerging markets, but was often the only option available.

You could say all the problems with market cap weighted indices are writ large in emerging markets and concentration is more intense in many individual countries. You get these distortions like state-owned enterprises or one or two really big, global companies that dominate an individual index, which makes this a good time to be an active manager.

But the big story is whether what is really going on is a perfectly legitimate reappraisal of how rapidly the productive capacity of these economies will be growing.

John Malloy and Nick Samuels

The the problem with economics is it takes a long time to sort the wheat from the chaff to see what is really going on under the bonnet to mix a few metaphors, but that's the problem. It's difficult to see just how cheap emerging markets are. But if the perception around all developed markets is they are going down, then that still gives emerging markets a margin, but we just don't know how those differentials are going to play out over the next decade or two.

Whitbread: We would agree that global growth is slowing down and that emerging markets are part of that, but there are some very compelling long-term thematic drivers, which look to support emerging market growth ahead of developed market growth. Population market dynamics are a very powerful strand within that, as are the debt burdens that seem very prominent in developed economies. Certain emerging markets have become far more penetrated with debt; Brazil, China would be among them. But on the whole, we can see that debt ratios are lower, and I think that is very helpful for emerging markets.

Is it a cyclical or a structural, long-term systemic problem?

Samuels: I personally think it's cyclical and most of the bad news is priced into that. That's why the valuations are at an extreme.

Malloy: Four months ago we were all worried about Greece taking down the world for the fourth time and they were having their fifth or sixth election? Greece is an emerging market now, believe it or not. 10-year bonds in Greece got to over 20% but now they are sub 8%. So 7.5% on 10-year Greek bonds. On a price basis, that's probably a 30 point increase on the price, but that's not on the front page of the FT.

Unfortunately, we have a one or two month attention span in the markets.

Hill: It's not a disaster case, it's a two-month story at best. The problem is it will just take a long time to tease all these things out and see what's really been going on underneath.

What will be the effect of US, and perhaps UK, rate rises on emerging markets?

Whitbread: We believe the US rise is further away than some would suggest. We don't expect anything until next year. But although a stronger US dollar and higher rates does make it very difficult for those countries, with deficit positions – Turkey in particular looks very challenged – a stronger US dollar and a stronger US consumer associated with a higher rate environment in the US does not mean bad news for all emerging markets, particularly manufacturing EM.

Samuels: I think a lot of it is in the price. The dollar has strengthened a lot and emerging markets have sold off a lot in anticipation of this happening. When it does happen, I think we'll be surprised that the reaction is quite muted.

Malloy: We are already seeing shifts in the current accounts, so India started earlier just because of other reasons, but its current account deficit has gone from over 5%, to approaching 1%. Brazil, which had a very overvalued exchange rate for a long time, now you could start to see some fair value in that currency.

The time to worry about the strong dollar was probably two or three years ago or when people started worrying about the first taper tantrum.

When you start to see interest rates coming down with the cheap currency, again, you won't find many industrial stocks to buy, because while there are some big companies that will start to take advantage of it, a lot of that whole sector of the economy has been crushed.

Hill: What is worrying me is whether the rise in the dollar is actually indicating this portfolio shift and this view and whether it may be just a risk aversion thing. But I suspect it may be that some of that capital movement, some of that weakening in currencies, is about a shift in portfolio preference away from emerging markets, in terms of not just portfolio investment, but long-term capital investment.

How does this feed through to pension fund trustees' portfolios?

Samuels: My understanding, talking to other managers, is that they are starting to see a bit of activity in

Simon Hill and Sophia Whitbread

"Even if the returns are really super, it's sure going to be a bumpy ride and that's quite a challenge for pension scheme trustees." Simon Hill

emerging market searches, which sounds like there are some contrarian institutional investors out there, which would possibly be a first. But hopefully that is true; you could start to see people allocate and be brave.

Hill: You do get more pushback from trustees and among my braver trustees. That question must be put in a much wider context around pension schemes and the push to reduce risk generally as there is a gradual shift towards fixed income assets. A lot of pension schemes that have had valuations within the last six months are going back to sponsors asking for yet more money. In some cases this is the third round of triennial discussions that they've had with lower bond yields or bond yields that haven't gone

"The spread in valuation is very wide and so pockets of EMs are incredibly expensive. Healthcare and consumer are at record valuations and in some cases more expensive than their developed market counterparts." Nick Samuels

up and the deficits are at least as bad, despite the money that has gone in. So they won't be looking at something that everybody agrees is a higher risk.

Even if the returns are really super, it's sure going to be a bumpy ride and that's quite a challenge for pension scheme trustees.

Malloy: Many people aren't going to come in right now, but they will come in. We had a 10% month already and if you have a 20% or 30% month, then they start to rethink it. The risk/reward on investing in emerging markets is good. Obviously you don't want to have too much and you don't want to be a hero.

Whitbread: How nervous are people sitting on zero weight emerging markets? It's been a great position for us. We have very strong performance since our start up and we are definitely picking up a lot of interest in emerging markets as people look for new areas and managers.

How can investors best access emerging market equities?

Samuels: The spread in valuation is very wide and pockets of EMs are incredibly expensive. Healthcare and consumer are at record valuations as well and in some cases more expensive than their developed market counterparts.

The managers that have done very well have typically been in quality stocks. Quality has re-rated to levels that we saw in the financial crisis and the Asian crisis. So those spreads will normalise and that tends to be a better environment for a value-oriented manager in emerging – well in any equity market. You need a

valuation element to outperform the market – a quality-at-any-price focused manager will underperform.

Whitbread: Valuation is important, but I caveat very heavily a value-driven approach in emerging markets, because the cheaper stocks in emerging markets tend to be that 28% of the index, which is state-owned. There are good reasons why they are more expensive than their developed market counterparts in the growth profile they have. Healthcare in many markets is very poorly provided by the state, so there is huge demand and it's also subject to lower regulatory burdens.

Malloy: You definitely need to look at the growth, because that usually gets you out of the problems. But then you have to look at the valuation. So again, it goes back to being a stock picker within the sector, within the different industries or different countries.

To what extent are boundaries between emerging and frontier markets becoming more blurred?

Malloy: Frontier markets really is an asset class that was made up by Wall Street. Brazil was a frontier market 20 years ago. Argentina went from being a developed market 100 years ago, to an emerging markets and is now a frontier market. It's really just a story about finding countries that are developing at high growth rates and putting the right policies within their reform process. Some are moving in the right direction in terms of opening the capital markets and as an emerging market investor, you can really take advantage of those.

Whitbread: It's clearly very subjective, what gets termed developed and what gets termed emerging, but the approach remains very much the same, and you see very many of the same thematic drivers in investment cases. Population dynamics are just as positive for frontier markets as they are for emerging markets. It's not necessarily that helpful to draw too much of a distinction.

Governance has always been a bit of a barrier to emerging markets. How has this improved?

Whitbread: It depends very much on the market. Over the last couple of years, we've actually seen a

John Malloy and Nick Samuels

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very clear emphasis on improving returns at state-owned companies led by the Chinese premier. There have been examples of consolidation in some sectors and changes to remuneration schemes in some state-owned enterprises.

But we remain very wary as you have to understand how that company will be used to pursue any government agenda, such as banks. Brazil's state-owned banking sector used to dish out cheap credit to try and shore up growth within the Brazilian economy.

You want companies that are going to be run in the interests of all shareholders, minority shareholders included. It's clearly a very, very prominent issue within emerging market investing. It definitely can't be ignored.

Malloy: We've developed an internal ESG model which is more of a checklist – do they have independent board members, shareholder stock options for management? Do they have a sustainability policy? We recently took on an account to manage socially responsible funds, strictly restricting certain industries across the board. So there is more of that even within emerging markets.

Whitbread: One area we have a specific focus is on equity income and dividend policies within emerging markets with regard to attitude towards shareholders. Russia and Korea do not pay out very many dividends and it gives you a good idea, perhaps, how important their shareholders are to them.

But in some emerging markets where you have large local pension investors – Latin America has several examples of these – you can see very good corporate governance particularly in South Africa which leads the field within emerging markets for sound governance and the proper treatment of shareholders. South Africa has other issues, too, some markets take it really seriously.

Hill: I first started investing in emerging markets 25 years ago and it's improved beyond recognition in that time. Back then, even major companies just didn't recognise the concept of governance. It's so much better now and though there are still problems, people need to remember that the developed markets haven't covered themselves in glory in terms of governance either.

Trustees worry about transparency, but a good active manager will be able to get that information one way or another, and if they can't, they wouldn't invest in those stocks.

How do you see the EM equity sector developing?

Samuels: In five years' time, I imagine the market will be trading on a higher valuation than it is now and some investors will have joined that party later than others. That's just how markets work – simple behavioural biases bring people in at different times, and the market will re-rate over time. We might have another wobble over something else, but I'm pretty confident that emerging markets will trade higher.

Malloy: You haven't made money in emerging markets for seven years, really. We peaked in '07, '08, and then we went down a lot and up a lot, but we're still below that level. Whereas London real estate, real estate globally, European stocks, other asset classes, have had very strong returns. So at some point we will start to move higher and you'll see a recovering of markets. It's hard to say what the catalyst will be.

Hill: What you've just said is actually one of the great defences. The big worry for emerging markets has been whether it was US quantitative easing that's pumped emerging markets up and now it is reversing, is that the end of the story? The fact that other asset classes have done much better out of that process suggests it isn't all quantitative easing. Something more subtle and longer term is going on. In five years we may be trading at higher multiples than now, but it's just possible the multiple may correct somewhat because the earnings side won't go quite as well. I'm absolutely convinced and advising all my clients that the long-term structural case for having an allocation to emerging markets still stands.

Sophia Whitbread

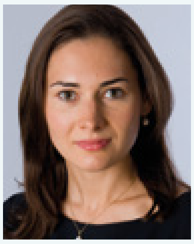
Whitbread: I would also emphasise the importance of being active in emerging markets, because the outlook is significantly differentiated and I believe more differentiated than it has been. Parts of the commodity-reliant emerging markets have lost the big support over the decade, but other areas do look more interesting and relative to certain developed markets that are more saddled with debt, the long-term picture from emerging markets I believe is very strong.

Hill: The commodity-related issue is part of the big problem with emerging markets. 20 years ago, nobody thought in terms of investing in emerging markets for commodity reasons. The money that has gone in in the last 20 years or so has been around commodity cycles and now it's perhaps coming out for that reason. That is clouding the real reason for investing. Emerging markets happen to be to a higher degree than elsewhere, commodity producers and commodity exporters. That is part of the problem. Once that washes out, people will be investing in the right companies and the right markets for the right reason, which is this long-term structural development point.

Whitbread: This is why it's so important to be active, because of course the index does reflect where people have been looking for the last 20 years.

Finding true value in your emerging-market investments

By Sophia Whitbread, portfolio manager, emerging and Asian equity team, Newton Investment Management



Compared to more established economies, the value of investments in emerging markets may be subject to greater volatility owing to differences in generally accepted accounting principles or from economic or political instability.

In recent months, emerging-market economies have been increasingly characterised by diverging performances at regional, industrial sector and company levels, not least owing to sharp changes 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, we explain why we believe being active in managing emerging-market investments may help you find real value.

The 'great moderation' of the 1980s and 1990s 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.

Emerging-market indices (and indeed global indices) may be uninspiring over the next year. 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. 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 US-dollar terms through currency devaluation and reduced demand for global manufacturing.

With recent falls in commodity prices, the pressure on the US Federal Reserve to increase interest rates has weakened, as annual consumer price index (CPI) inflation is likely to move lower. Our expectation is therefore that US rates should only rise gradually, which should not cause an indiscriminate rush of capital from emerging markets.

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 is compelled to buy more of those areas which have already performed well. Conversely, truly active managers can seek to take advantage of favoured country, industry and company characteristics.

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 over 2.8% of the MSCI Emerging Markets index[1]), but which we think offers highly 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 health-care 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 2.8%). 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 significant 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.

We believe that the most important risk to 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.

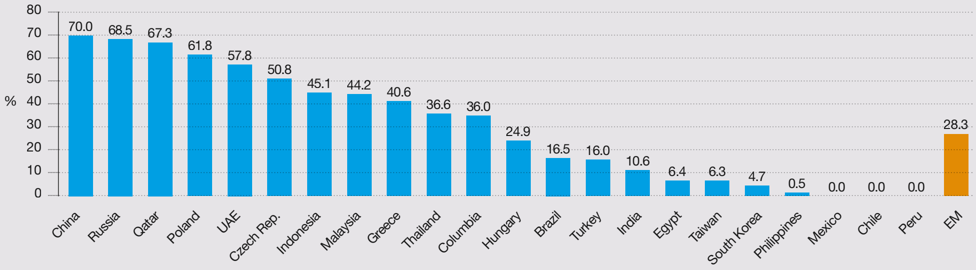
In tracking an index, passive investors may embrace significant sectoral biases, irrespective of their views about the sectors. An investor with a negative view of the financials sector, for example, would be unwise to track the MSCI Emerging Markets index given the dominance of this sector, which comprises 28.6% of the index[2]. Similarly, from a country perspective, the MSCI Emerging Markets index is weighted heavily to certain countries: notably China (23.4%), South Korea (15.5%) and Taiwan (12.5%)[3]. We believe a more absolute-style, fundamental approach can avoid unintended biases, particularly if a long-term perspective is applied.

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.

The chart below 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 six countries, including China and Russia.

MSCI Emerging Market countries – % state control



For illustrative purposes only. Source: CLSA, FactSet, Bloomberg, March 2015. Current MSCI Emerging Markets constituents are used to calculate the government control per country. % state control is calculated by aggregating MSCI weight of companies in the respective country with effective government control. Total EM (Emerging Markets) is a weighted average.

Within the overall picture, some sectors are more state-controlled than others. Utilities, energy and telecommunications companies, for example, have a high degree of state control. By contrast, the information technology, consumer, and health-care sectors are relatively free from state ownership[4].

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 assert that population dynamics are key drivers of GDP growth and asset prices, but they vary significantly between different emerging markets. Such dynamics may create favourable investment opportunities, for example where they are associated with strong working-age population growth, 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. Post-financial-crisis policy responses differed, leading to credit explosion in some countries (e.g. Hungary), but credit shrinkage in others (e.g. the Philippines). Where debt burdens are high, GDP growth is likely to be impeded, and vice versa. An active manager can try to exploit this.

Many of the points we make in this article 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.

[1] Source: MSCI, 30 September 2015 | [2] Ibid | [3] Ibid | [4] Source: MSCI, Deutsche Bank, February 2015.

Responsible investment: a respectable history, but a whole lot more to come

By John Malloy, emerging markets equities portfolio manager, RWC

On New Year's Day 2015 as most investors were recovering from the festive season, they had little idea what was in store for emerging markets. To say that the year has been interesting is an understatement. But the real story is that there continues to be wide dispersion of performance even within the once over-hyped BRIC complex. One would have thought maybe India with a strong economic reform programme led by their colourful leader, Modi, should have been the clear winner as we moved into the New Year. Clearly, Russia, the rogue nation, led by their very confident leader, Putin, would continue to be under pressure and trade poorly.

Far from the truth, by the end of the 3rd quarter, Russia was up 9.4% while India held up ok down -1.5% compared to China down -11.3%, but nothing compared to the disaster happening in Brazil with the market down -39.3%. This phenomenon is not only in large emerging markets. Two countries located in the same post code could have very different performance such as Hungary up +32.5% while Poland was down -7.2%.

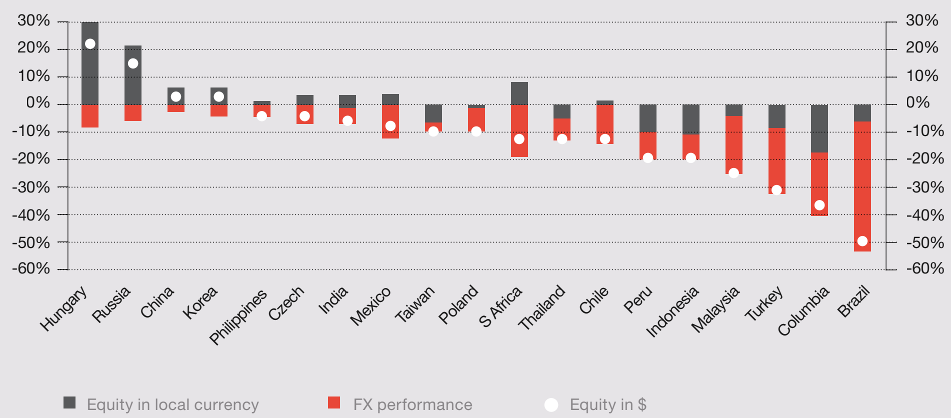
Top-down, macro-economic analysis does matter when investing in emerging as well as frontier markets. With the RWC emerging markets and frontier investment team, we've incorporated a macro framework to guide our team of analysts to look for ideas in countries where we think the direction is positive and avoid deteriorating situations. This combined with bottom-up stock picking increases the probability of finding winning stocks.

For an investor, this represents a big opportunity.

Two of the outperforming countries and the stocks within them couldn't get much different in comparison – Philippines and Russia.

Jan 2015 – Oct 25 2015

Source: Bloomberg, as at 27 October 2015



The Philippines, with its 100 million population and an average age of 24 with a GDP per capita at $2,840, offers investors a very good investment backdrop. Economic growth has tracked 6.8% over the last three years and is expected to expand at a 6% rate over the next few years, making it one of the fastest growing countries in the world today. With over 10 million foreign workers, the current account in surplus continues its secular rise in workers' remittances. Remittances support consumption and also justify a relatively stronger peso since these inflows are permanent. Despite massive inflows they have been able to keep inflation low by sterilizing through building reserves. With household spending at 72% in the Philippines there are very good consumer-focused investment opportunities.

As a result, companies with exposure to the growing domestic consumption have done extremely well and continue to grow as the population's discretionary income increases. Universal Robina Corporation, which is one of the largest consumer food and beverage producers, has its sight set on ASEAN with its expansion plans into Vietnam, Cambodia and Myanmar, alongside growth in Thailand and Indonesia. So instead of focusing on a 100 million population opportunity, it is targeting a much larger population of greater than 600 million. According to estimates by the McKinsey Asia Consumer Insights Centre, ASEAN middle class households are estimated to grow from 65 million from 2014 to 125 million by 2025. As a result, URC has performed strongly this year up 8.6% in a difficult market.

In Russia, where most investors have had a negative view on the economy and currency, there continues to be profitable investment opportunities.

Interestingly, Russia's policy response has been very credible to low oil and sanctions. The ruble has been left to float, absorbing the shock from oil and now trades at very competitive levels. The central bank's policy of establishing inflation targets and minimizing intervention during times of intense pressure has been very effective. They have been able to smooth FX volatility while not intervening to change the depreciation trend. In addition, the central bank provided FX liquidity to banks to allow corporates to pay off debt and, as a result, concerns have decreased substantially, as big rollovers are behind with massive external debt delivering.

The buffers are strong and the slowdown in the economy led to import compression, which allowed them to maintain a healthy current account surplus. We believe that the economy is near bottom with recent high frequency data pointing to a trough. As a result we expect to see the capital expenditure cycle kick in in a quarter or so. The bottom line is we have been getting closer to the inflection point we have been looking for.

In such a weak economic situation with high volatility, one would be surprised to find Russian steel producers as star-performing stocks.

Given the devaluation in the ruble, these companies are the world's lowest cost producers. They had cost optimisation programmes ongoing to become more efficient and have reduced cost per ton even further. Given that the companies are vertically integrated with iron ore and coal assets, so the devaluation affected both mining and steel-making labour, and much of the maintenance capex costs. Approximately 80% of steel-making costs are denominated in ruble as are 90% of mining costs. This has made Russian steels "best of breed" and it shows in the capacity utilization rates above 95% compared 68% globally. They have reduced capital expenditure and leverage and, therefore, significantly increased free cash flow.

At what looks like a low point in the cycle, Russian steels are making mid to upper cycle-type returns and instead of buying them at very high P/E multiples, as you usually do with cyclical companies at or near the bottom of the cycle, they are trading on 7-8x P/E. With high dividend pay-outs and dramatically improved corporate governance, Russian steel companies have become shareholder friendly.

As an example, Severstal is making a 31% fully integrated EBITDA margin in Q3, has a dividend yield over 7% and despite a 20% rally year to date, the stock only trades at 7x earnings. Their strong corporate governance recently translated into their selling a US-based asset and paying out the proceeds to shareholders.

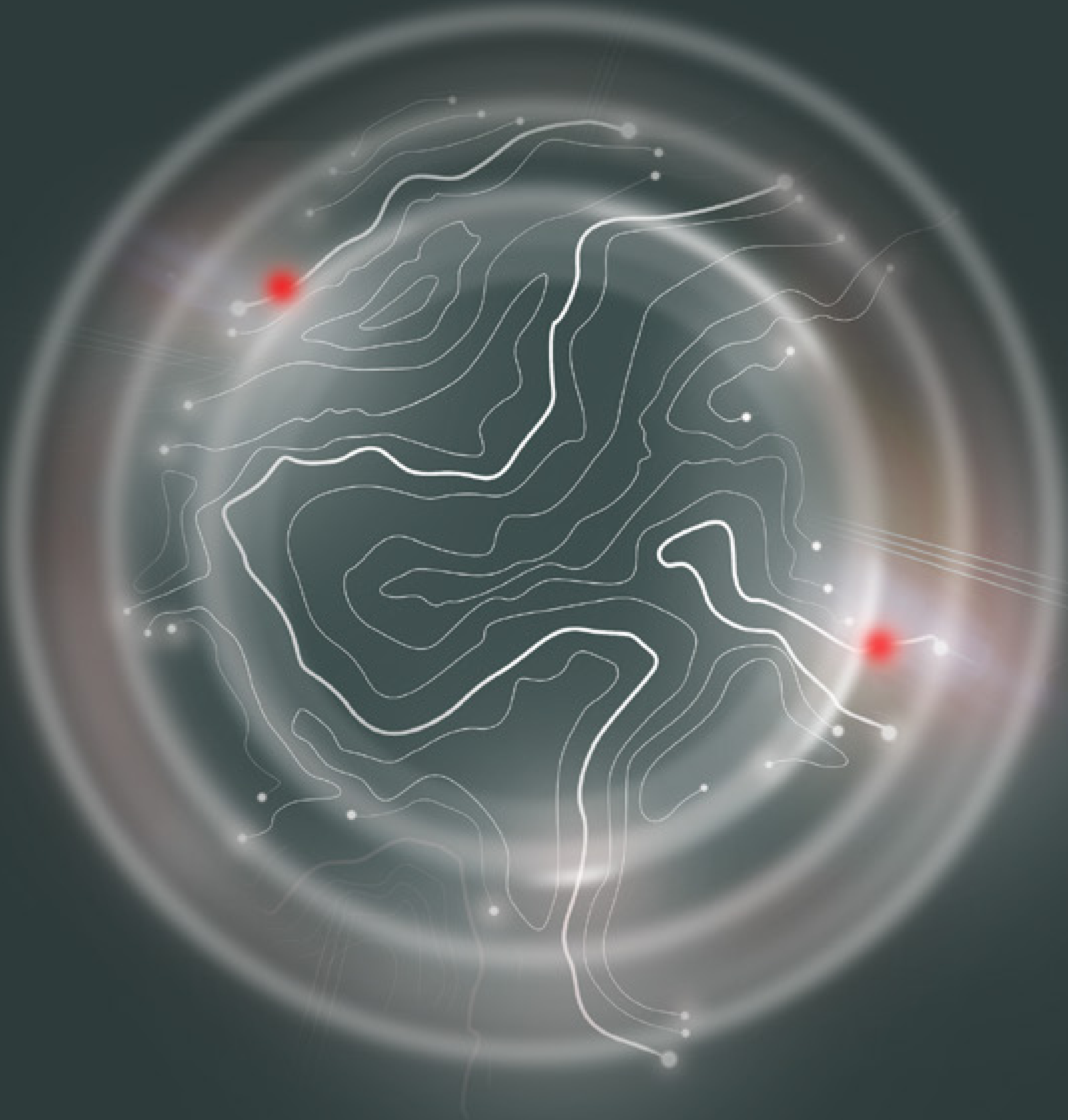
There continues to be a wide dispersion among countries, sectors and stocks. The key to increasing the probability of winning trades is to combine top-down research with solid fundamental company analysis. As we have seen in the examples above, investors can find great ideas in less obvious countries like Russia and Philippines as well as in very different sectors like steel, basic food and beverage companies.

Taking an index-agnostic approach leading to a high active share should continue to create alpha for investors. When you have the occasional market correction - as we are currently experiencing - correlations spike. But as volatility declines, dispersion of returns should create even more opportunities in the years ahead.

We believe an opportunistic and flexible approach is key to generating alpha in emerging and frontier markets.

RWC

These are the opinions of John Malloy, portfolio manager of a number of RWC's emerging market equity strategies
Source: all data related to market movement taken from Bloomberg on 27 October 2015.



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