Emerging Markets: Finding opportunity in uncertainty

Fundamental analysis and bottom-up investing are keys to success

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Amid continuing volatility on the back of one of the biggest selloffs in emerging markets this year, active managers are finding hope in the long-term outperformers for their EM portfolios. The negative global macro-environment has, in fact, separated the bad from the good and has forced some EM companies and countries to be more self-reliant. A panel of emerging market experts that includes Maria Negrete-Gruson, managing director and portfolio manager at Artisan Partners; Ricardo Adrogué, head of emerging markets debt at Barings; and Claire Franklin, portfolio manager at BMO Global Asset Management discuss the macro-environment, share company and country specifics, and offer insights on where to look past the headlines.

Pensions & Investments: Given where we are in this challenging macro-economic environment, how do you see the impact of Federal Reserve rate increases playing out in the emerging markets?

CLAIRE FRANKLIN: The era of free money chasing yield via risky assets is over. Last year, Argentina issued a 100-year bond that was oversubscribed, and that's an issuer that has blown up seven times in the last century. Yields in many assets had become detached from what is sustainable long term. In emerging markets like Turkey and Argentina, the effect of tightening liquidity unfolds very quickly. Many countries and companies have benefited from that wall of money, and it's quite difficult to pinpoint how quickly that will unravel.

However, a lot of other countries in emerging markets are in much better positions today than they were in previous crises. Our view is that investing in emerging markets equity is for the long term. We try to find companies that have strong business models, don't need much capital to grow and are not leveraged, and I think that this will be key over the next five or 10 years. When things start to get tough, you see which companies have that resilient business model, selling a good or a service that people should still be demanding in tougher environments, combined with a strong balance sheet. We'd expect those companies to be in a far better position.

MARIA NEGRETE-GRUSON: The current concerns about this broad macro-environment are certainly valid in terms of difficulty accessing capital. In the past, it was expected that a favorable global liquidity environment was necessary for emerging markets to do well. But that may not necessarily be the case in the future.

We see that this tight liquidity environment in emerging markets has forced better behavior by companies. These companies don't expect a favorable global backdrop, and they don't expect this wall of money that Claire referenced to bail them out. These companies are focused on what they can do to fix their profitability: how they can deleverage, how they can achieve sustainable profitability for the long term. And we see such behavior because of a negative macro-environment, which has affected emerging markets companies in a very favorable way.

RICARDO ADROGUÉ: From an interest rate perspective, the environment has become more challenging for emerging markets due to increases in the U.S. rates by the Federal Reserve, as well as across the full yield curve. The U.S. curve has actually started to widen recently, including 10- and 30-year bonds whose yields have risen over the last few months.

In previous cycles, when the Fed was hiking rates, it was because U.S. economic growth was strong, which also translated into strong global growth, led by the U.S. This time around, thanks to U.S. trade policies that are more focused on fostering U.S.

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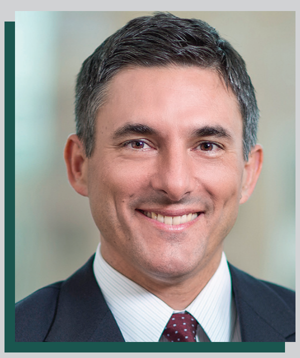

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growth, it is not translating into or leading growth across the rest of the world. Not only emerging markets, but China, Japan and Europe are also not growing as fast as might otherwise be expected, so that tends to create a negative environment characterized by high interest rates without the positive backdrop of stronger global growth. But that is precisely the type of environment in which fundamental investors who understand the macro challenges, do their homework, and analyze countries and corporations deeply should be able to succeed.

> We believe investing in emerging markets is about the long term, and our clients share that belief.
>
> — **CLAIRE FRANKLIN,** ***BMO Global Asset Management***

P&I: How should EM investors be interpreting the ongoing volatile trade situation between the U.S. and China?

ADROGUÉ: President Trump is using his presidential power to basically play hardball with those countries that he wants to squeeze more out of in terms of bilateral trade. Until the Trump presidency, the U.S. was more willing to engage on a multilateral basis and to take a broader global view with respect to trade. That has changed, and the U.S. is now seeking to capture a larger share of the global pie. President Trump has realized that dealing with one country at a time gives the U.S. significantly more leverage than dealing with all countries at once. Specifically with China, Trump is in the early stages of ongoing trade negotiations. Besides wanting a bigger slice of the global pie, he has political goals in mind with regard to human rights. That makes the trade situation with China that much more complicated and acrimonious.

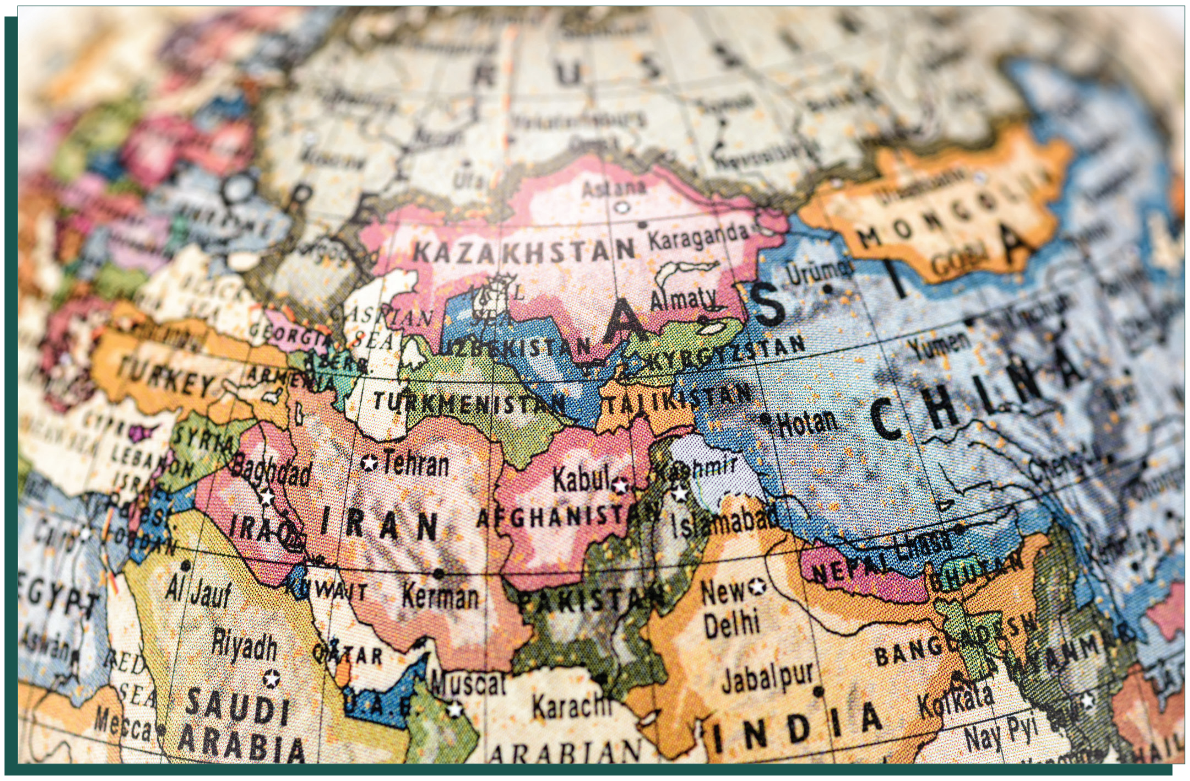
NEGRETE-GRUSON: There have traditionally been a couple of requirements for emerging markets to do well: The Fed had to be accommodative and the global trade situation had to be favorable because EM companies have historically succeeded by exporting their way out of trouble. That scenario is changing on both fronts. Again, from our perspective, it forces companies to look inward in terms of what they can do to better position themselves going forward.

FRANKLIN: China is seeing a correction for a number of reasons, not just because of the trade issue. Valuations have become detached with reality in some cases, and there is a lot of leverage in some of those corporates. Refinancing has become an issue, and we are firm believers that excessive leverage is not sustainable in the long term.

Headlines on trade wars can often lead to an overreaction, which can create some interesting opportunities. One of the best times to invest can be when everyone is running for the hills and everything looks terrible.

P&I: Given the volatility in emerging markets this year, should investors wait on the sidelines or look more opportunistically at their EM portfolio allocations?

NEGRETE-GRUSON: In the last several years, we have seen this shift toward passive investing, which can be dangerous in a negative macro-environment because you have to be more selective to find investing



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opportunities. If you attach your investments to an EM index that is very concentrated from a sector standpoint and geographically tilted toward China, you lose your flexibility. I think that has given some institutional investors pause, and they are seemingly noticing that the index is not particularly representative of the tremendous opportunities in emerging markets.

FRANKLIN: Sentiment drives short-term volatility, not returns. It's always a bit ironic, when markets are up 40%, there's very little mention of being wary or waiting on the sidelines, but there is when they're down 20%. We are very mindful of herd mentality. As Maria pointed out, money has poured into index funds where there is a high degree of concentration in the top five stocks. Those stocks drove a lot of the performance last year. It could well be a case of 'up by the stairs and down by the elevator.' We are cash-flow driven, bottom-up stock pickers. An index is very much backward looking, which is not a good indication of where to allocate capital for the future.

We think it is important to be transparent with our clients. Last year we communicated that some of the companies we owned, especially in India, where we had allocated a significant amount of capital, were looking richly valued and capital should be reallocated. The pullback in China has presented us with some attractively valued high-quality business models, where we are comfortable about our alignment of interest with the majority shareholders, find strong management and minimal or no leverage.

ADROGUÉ: Not every corporation or every country has the same types of 'pressure points,' so to speak; they can be very open to global trade or not so open, they can trade more or less with the U.S., they can be commodity exporters or manufacturing exporters, and so on. In this new world, where the U.S. wants a bigger share of global trade and is raising interest rates, not all emerging markets have the same level of need for financing. Accordingly, investors need to scrutinize each country and each corporation one at a time, on a case-by-case basis.

An increasing number of emerging markets, particularly in Asia, are actually exporters of capital and have accumulated savings that far exceed their financing needs. So higher U.S. interest rates eventually should benefit those countries, because their assets will then provide larger and larger amounts of income. But by the same token, countries in Asia that are more export-driven and more open to global trade may initially experience a more negative impact. These differences among countries and companies highlight the need for rigorous fundamental analysis on individual sovereigns and corporates. In our view, that is a critical requirement for successful investing in today's emerging markets landscape.

P&I: As institutional investors continue to invest in EM in their search for alpha, are you seeing a shift in their overall outlook?

FRANKLIN: We haven't seen any change in behavior from our investors. We believe investing in emerging markets is about the long term, and our clients share that belief. As I said before, we are transparent about where we see potential issues in emerging markets and look to deliver absolute hard-currency returns.

It's important to realize the long-term structural case for emerging markets hasn't changed. In 10 years, it's highly unlikely we'll be referring to trade wars or President Trump when we're discussing consumption of toothpaste in India or Indonesians opening bank accounts. Over the longer term, these sort of events are likely to pale in significance.

ADROGUÉ: We find that institutional investors in general are not seeing the need to reallocate their portfolios away from emerging markets at this time. For many, their biggest concern is whether or not there will be a global emerging markets crisis. Based on our latest analysis, we think that's very unlikely any time in the foreseeable future. That's not to say that individual countries may not encounter — or already have — very serious problems of their own. But for emerging markets overall, it's very difficult to see a major crisis unfolding.

With that perspective, the evaluation of emerging markets relative to other asset classes is helping most investors maintain their existing EM allocations. Recent outflows from the asset class have been significantly smaller than they were during the 2013 taper tantrum. And based on our experience, investors are increasingly recognizing the value of fundamental investing in emerging markets.

NEGRETE-GRUSON: Certainly geopolitics are a concern for investors, and what they see, both in the developed and emerging markets, is a new world. I don't think that's a concern exclusive to EM investing. But investors are also noticing the significant valuation gap that is growing between developed and emerging markets, and that should give investors some comfort. We have today valuation levels that compare very well historically to developed markets. We have an asset class that most likely will continue to experience volatility, but we need to look at discounted valuations and whether they will persist, or whether companies will underperform and destroy value. As investors, we need to find the pockets of emerging markets where we see a higher probability that profitability is sustainable, and

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we need to do that on a differentiated basis.

P&I: Could you highlight a couple of emerging markets that are positioned well for growth, and others that face continuing pressures in the current global macro-environment?

NEGRETE-GRUSON: Brazil has been in a deep, prolonged crisis for some time and has faced all the issues plaguing emerging markets — from leverage and poor growth to bad governance. But we see a market in Brazil that offers valuation support in a diverse range of opportunities. Of course, you have to discount future risks and the uncertainties surrounding potential structural reforms from Brazil's new administration. Even fully discounting those macro uncertainties, though, we find opportunity on a selective stock-picking basis going forward. We have been cautiously overweighting Brazil year-to-date, selecting securities one by one, and have generally been rewarded by that approach: year-to-date, EM overall is down significantly more than Brazil.

One area to look at is [Brazil's] state-owned or heavily regulated sectors like utilities and energy, which have been adversely affected by regulation but possibly face an inflection point as the new administration has a very different outlook from the last. Another area is private companies in education and discretionary areas like travel that have suffered from a negative growth environment and depressed consumer bases but also have significant capacity for big inflections resulting from any positive economic movement.

Our two large underweights are China and Mexico. That is not to say that we find China altogether unattractive by any means. Rather, it's reflective of our belief that China is heavily overrepresented in the index. In Mexico's case, we have been quite cautious on the appropriate way to discount political risks. While [President Andrés Manuel López Obrador] may do the right things, valuations are not particularly compelling. Mexico has been strangled by monopolies. Companies today are practically the same ones you invested in a decade or two ago. It's not a market that has had the dynamism and opportunities for investors across different sectors.

FRANKLIN: We believe India still holds tremendous potential, with some extremely strong companies with good governance. The importance is not overpaying. We had a very high allocation to India that we brought down due to the excessive valuations of some of our portfolio companies — valuations that simply couldn't be justified despite growth potential. However, in the

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small- and mid-cap space, there's been more of a correction, and valuations are looking more attractive, so we've added there.

We can also find good companies in countries where the macro-environment is challenging but still they do well. In South Africa, the macro-environment has been poor for a while, but we found some great companies generating fantastic free cash flow, growing at 15% a year and trading below intrinsic value.

ADROGUÉ: I believe a country like Poland is particularly well positioned and has been very well run by different governments, at least from an economic standpoint. It's very competitive economically and has sound fundamentals, along with low inflation and a robust 4.5% GDP growth rate for a population that hasn't really grown much in the last decade. In addition, its external accounts have continued to improve over the last 10-plus years. While the country may not be immune to the potential for a broader slowdown in Europe, Poland looks very strong overall, in our view.

As another example, one country that has been tested recently, but which could be an interesting investment opportunity, is Mexico. The market seems to perceive the presidency of López Obrador, who took office on Dec. 1, as potentially disruptive to some of the country's current macroeconomic policies. Granted, those policies have not resulted in much improvement in economic outcomes; growth has been slow over the past six years, and oil production has been on a deteriorating trend. The president has been calling attention to some of these obvious shortcomings of the Mexican economy. The risk is that he may basically try to reverse economic reforms and policies that could ultimately benefit the economy, but which haven't had a chance to fully play out yet.

Other countries are clearly more challenged in this global environment — an obvious example being Turkey, where governance has taken a huge step backwards. Turkey used to be a democracy. The country still has elections, but power is now effectively concentrated in the hands of the president. Another example is South Africa, which has had trouble adjusting its fiscal accounts. The latest financial report by the Central Bank of South Africa is sobering. The country's external accounts have improved somewhat on the back of higher metal prices and lower oil prices, but both of those tailwinds appear to be dissipating lately.

P&I: Could you highlight a couple of specific opportunities in emerging markets equity or debt?

FRANKLIN: India is still in the early part of the S-curve, which provides a great runway for growth. The key is finding opportunities at the right price. HDFC Bank is one company that we believe will benefit. It is a simple utility bank that is known to be conservative, with excellent asset quality that is proven across multiple economic cycles. It has less than 10% market share in a sector that is dominated by state-owned enterprise banks with 70% market share, asset-quality issues and capital constraints. This gives HDFC Bank the ability to compound at 20% or more by gaining market share while benefiting from increased financial penetration in the economy.

ADROGUÉ: What I find interesting are cases in which the overall sovereign view is not very constructive, but where there may be value in some specific names. Take South Africa, for example, where we don't have a very constructive view for the near term. But FirstRand is a very strong South African bank that is primarily exposed to domestic South African businesses. It doesn't have a lot of crossover lending, nor does it have a large nonperforming loan portfolio. And because it is generally not exposed to the potential dangers of the broader South African story, particularly depreciation of the currency, we believe the company can weather low economic growth in South Africa for a long time.

Not surprisingly, it is easier to find investment opportunities in sovereigns where we have a very constructive overall view; so, for example, we see good value in some Russian names. Then there are other companies that may be attractive because they're fully owned by strong governments, such as Israel Electric. Although its debt-to-profits ratio is high relative to other similarly-rated companies, it matters that Israel Electric belongs to a solid sovereign nation; indeed, some would say Israel is really more of a developed market story. Slightly weaker, but still strong, corporate credits are PT Pertamina and PLN, both of which are fully owned by the state of Indonesia.

NEGRETE-GRUSON: We see plenty of opportunities, and some are in the more controversial areas of emerging markets: Russia, Turkey, Argentina. Of course, we invest with eyes wide open in terms of governance and the potential effects of country risk. For instance, we own Pampa Energia S.A. in Argentina and TSKB in Turkey. We understand how they behave in this macro-environment from past cycles, their business models and how their earnings power can withstand a more prolonged crisis situation in the countries in which they operate.

P&I: What is your overall EM investment philosophy and approach?

ADROGUÉ: We believe that having a well-resourced team dedicated solely to emerging markets is key. That's why our EM debt team consists of around 20 talented, experienced investment professionals. Our model for bottom-up corporate research includes detailed analyses of financials, interests of participants, [environmental, social and governance] indicators and other factors. We also have a common set of measures that allows us to compare countries, based not just on macro parameters but also on institutional strength, transparency and so on. In addition, our team members make frequent country visits to cross-check our analysis against the reality of what is actually taking place on the ground.

FRANKLIN: We are bottom-up stock pickers. We look for companies that generate solid free cash flows from a sustainable business model, selling goods or services that you can see people wanting in 10 years. We take a long-term approach. It is key to have strong management and alignment of interests with majority shareholders. We spend a lot of time understanding how the business generates free cash flow and its sustainability. We run concentrated portfolios with around 40 stocks and a high concentration in the top 10. All our funds invest in the same way, with the same philosophy and process.

NEGRETE-GRUSON: Our process is oriented to identify companies that are undervalued relative to their sustainable earnings. We define sustainable earnings as normalized [return on equity]. We also look at bottom-up stock-selection risk related to earnings and governance. We have a strict internal scoring system that penalizes companies that come out weaker on these stock-specific risk considerations. In looking for the appropriate valuation, country risk is a very important determinant of the outcome in emerging markets. We use our deep model for applying top-down country risk that looks at a range of country-specific factors and historical averages.

P&I: What's your key takeaway for institutional investors as they navigate this challenging macro-environment for emerging markets?

NEGRETE-GRUSON: This negative macro-environment, which is undeniable, is creating a better mindset among EM companies. It is helping improve ROEs for the overall EM asset class. Further, we are seeing company 'self-help stories' whereby they are relying on themselves to succeed and be profitable — for example, by divesting noncore businesses. It's all about sustainable profitability in emerging markets.

We are also seeing empirically how critical this reality is across emerging markets. And we are optimistic about emerging markets, not because we expect the trade wars to end, not because we expect interest rates to become very accommodative, but rather, we are optimistic because of the steps EM companies are taking to better position themselves against this challenging backdrop.

FRANKLIN: We all know emerging markets swing in and out of favor. However, we view emerging markets as an allocation for the long term, and the long-term fundamentals have not changed. In 10 years' time, demand for goods and services in emerging markets will be significantly higher than they are now, and as long as we find the right companies to partner up with — that can generate that cash flow over the next 10 years, deploy it wisely, and in which we can invest at the right price — then it's still an allocation that should be made. Where things overreact on both the upside and the downside can create fantastic opportunities for a long-term investor.

ADROGUÉ: As investment managers, it is imperative that we earn and maintain the complete confidence of investors. Most investors don't have infinite patience. For example, they will not stay with us, or any manager, for 10 years if we're consistently underperforming, but most will be patient and continue to trust our process if we have a difficult quarter, month or even year from time to time. At the end of the day, investors basically want us to do our homework and execute on what we say we do well, which is bottom-up fundamental analysis. That's not to say we don't make mistakes in our analysis every now and then, but over the long term, if we are diligent in our analysis, we believe we will be successful with our investments many more times than not. Historically, that has largely been our experience as an investment manager. ■

Maria Negrete-Gruson is portfolio manager for Artisan Emerging Markets Fund. This article represents the views of the respective portfolio managers as of the date of publication and those views and opinions presented are their own. Artisan Partners is not responsible for and cannot guarantee the accuracy or completeness of any statement in the discussion. This material does not constitute investment advice or a solicitation of any specific investment product or service. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation. Prospective investors should consult their financial and tax adviser before making investments in order to determine whether an investment will be suitable for them.

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