Evaluating Opportunities in Emerging Markets

Spring 2014

Why Emerging Markets Matter to the US Investor

Merriam-Webster defines "emerge" as "to become known or apparent". This definition understates the significance of the markets that have been defined as "emerging" by investors.

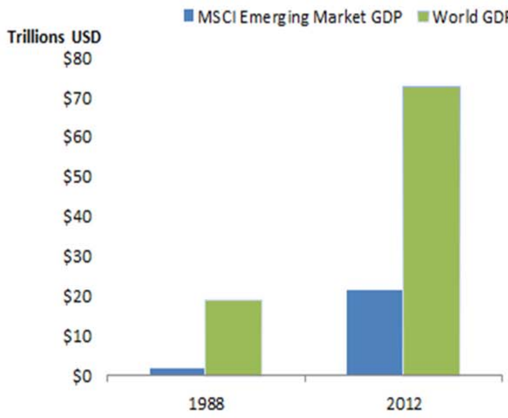
Emerging markets (EM) are increasingly relevant whether measured as a percentage of world GDP or by total market capitalization. Today, there are 800 listed companies in the 21 markets that are considered emerging by MSCI. When small-cap companies are included, the figure increases to 2,600. EM represents nearly 30% of global GDP, compared to 10% in 1988. As a result of this growth, emerging markets' market capitalization as a percentage of the world is now 13% versus just 1% in 1988, underscoring the relative growth differential and investment opportunities as compared to developed markets.

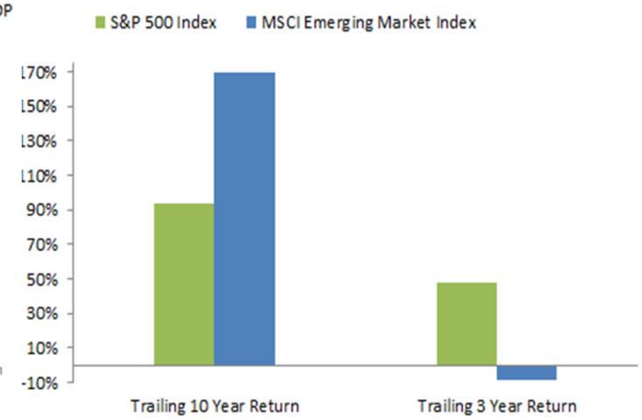
As emerging markets continue to develop their capital markets, foreign capital available for investment and economic growth has significantly increased. According to the World Bank, global capital flows fluctuated between 2-6% of world GDP from 1980-95. By 2006, global capital flows represented 15% of GDP, or $7.2 trillion.

EM economic and corporate profit growth resulted in tremendous return for EM equity market investors. Over the last three years, however, the S&P 500 outperformed EM by 57% (cumulative). As a result, the market capitalization of various EM indexes as a percentage of GDP (a favorite data point of Warren Buffett) remains at a significant current discount to the US.

On the following pages, we examine EM growth potential as well as the challenges facing EM investors today and evaluate the opportunities to profit from recent market weakness. We believe there are opportunities for US investors to invest in select emerging market companies which are leveraged to strong economic and corporate profit growth. However, there is great disparity within EM, and we must be mindful of benefits and risks as globalization has introduced greater interconnectivity and more rapid capital flows.

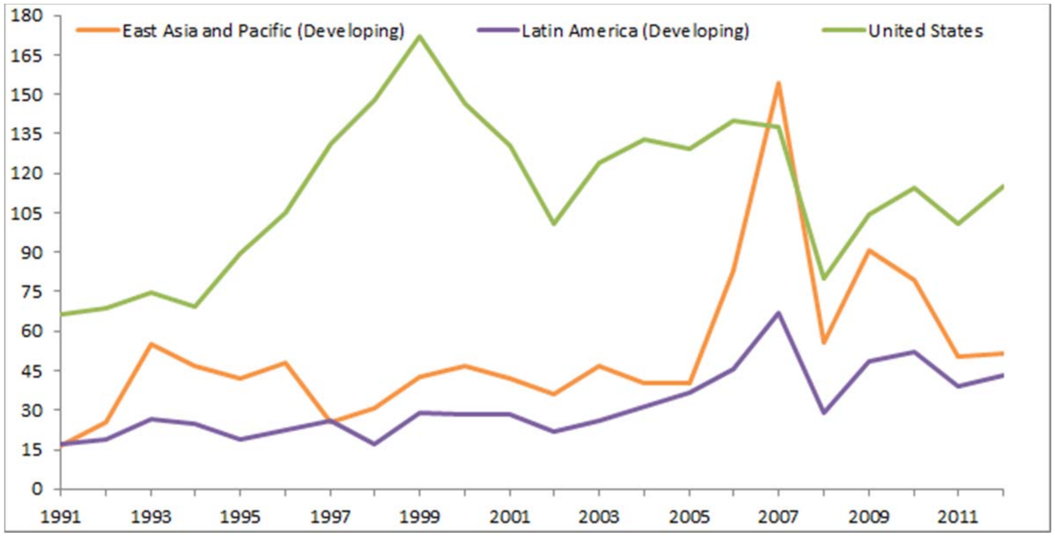
Tremendous EM Growth Drove Long Term Outperformance Until Recently





Source: World Bank, Bloomberg

Market Cap to GDP Ratio Shows Value in Emerging Geographies



Source: World Bank

Stark Differences Across What is Defined as "Emerging"

What comprises the "emerging markets" is arguable and varies dramatically by organization (MSCI/S&P/Dow Jones/FTSE/World Bank).

MSCI, a leading company in international index construction, identifies 21 countries as meeting their emerging market classification qualities based on economic size, liquidity and market accessibility. The MSCI EM Index invests across all 21 markets but is heavily weighted towards larger countries and companies– the top 10 countries represent 88% of the index. The result is high concentrations in financials, energy, and mining. These 3 sectors represent nearly 50% of the index.

The table to the right highlights some of the variances across countries that are included in the index. For example, it is debatable whether South Korea (GDP per capita of $22k) should be classified together with Peru (GDP capital of $6k). South Korea designs, manufacturers, and exports global brands such as Samsung and Hyundai while Peru's main exports are commodities such as gold and copper. The world's second largest economy, China, is included in the same index as the world's 39th largest economy, Philippines.

The past few decades have fostered significant change across emerging markets. The commodity super-cycle along with the emergence of global trade and outsourced manufacturing have resulted in dramatic shifts across these regions. There are meaningful divergences across leadership regimes, economic composition, education, quality of life, and debt levels that have positive and negative implications for investors. Similar to MSCI, investors (and the media) continue to assign a very broad label to very distinct countries creating both risk and opportunity in emerging market investing.

MSCI Emerging Markets

Americas	Europe, Middle East, Africa	Asia
Brazil	Czech Republic	China
Chile	Egypt	India
Colombia	Greece	Indonesia
Mexico	Hungary	Korea
Peru	Poland	Malaysia
	Russia	Philippines
	South Africa	Taiwan
	Turkey	Thailand

Source: MSCI

The fallacy of index construction is the application of a broad label to often distinct countries.

Wide Dispersion of Living Standards and Consumption

	GDP per Capita (Current USD)*	Private Consumption, as % of GDP*	Exports, as % of GDP*	Health Spending, as % of GDP **
United States	$51,749	69	14	18
Euro Area	$36,527	57	45	11
South Korea	$22,590	54	57	7
Argentina	$11,573	59	20	8
Brazil	$11,340	62	13	9
Mexico	$9,749	67	33	6
Colombia	$7,748	62	18	6
Peru	$6,796	60	26	5
China	$6,091	35	27	5
Thailand	$5,480	56	75	4
Indonesia	$3,557	57	24	3
Philippines	$2,587	74	31	4
India	$1,489	60	24	4

*2012 Data Sourced from the World Bank
**2011 Data Sourced from the World Bank

EM Outflows Drive Recent Currency and Market Weakness

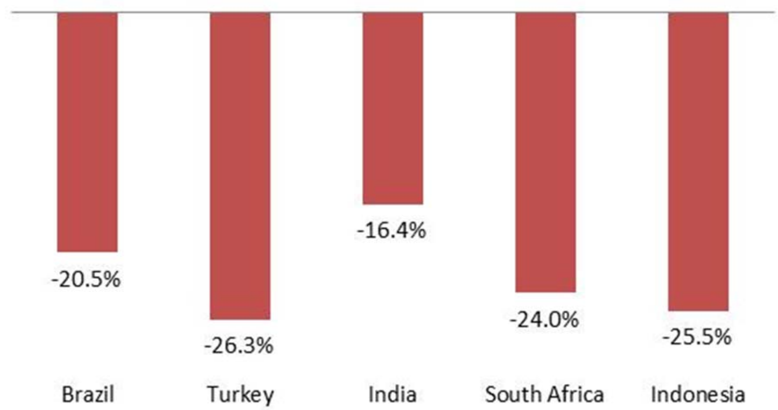
Through the summer of 2013, investors' demand for yield pushed US interest rates to historically low levels. In May, the US 10-year Treasury reached 1.6%. Record low yields in developed markets resulted in greater willingness to invest in higher yielding bond markets around the world. Emerging market bonds were a direct beneficiary of this trend as investors looked past some of the issues impacting many countries such as slowing growth and widening current account deficits.

In May of 2013, improving US (and European) economic data brought the potential of Fed tapering to the foreground instead of the far-away event investors had become accustomed to. The downward trend in US rates reversed, and yields nearly doubled during the second half of 2013. The increase in rates and subsequent stronger US dollar caused global investors to reassess yield and risk opportunities, resulting in outflows from emerging market currencies, bonds, and equities.

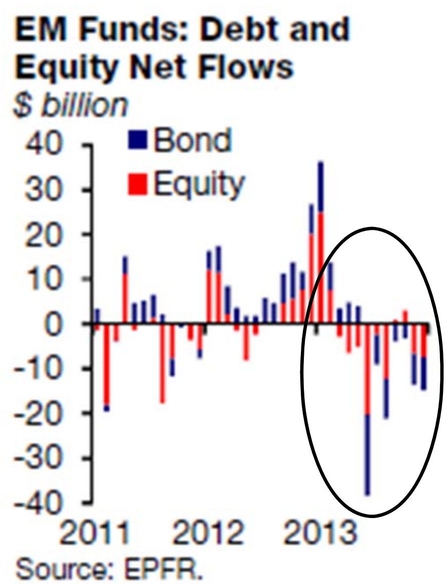
A handful of emerging market countries, dubbed the "Fragile 5", have been especially penalized by investor outflows, sending bond yields higher and pushing currencies to multi-year lows. Since May 1st, the currencies of the Fragile 5 have depreciated between 16% (India) and 26% (Turkey) versus the US dollar. The currency depreciation has also shined a spotlight on some of the underlying problems facing the Fragile 5, including slowing growth, widening account deficits, and the increased difficulty of honoring obligations on US dollar debt. To add context to the magnitude of depreciation, the Brazil Real, the South African Rand, and the Indonesian Rupiah have depreciated to levels last seen during the financial crisis in the Fall of 2008.

Not all emerging market currencies are weakening with the Fragile 5. Some currencies such as the Hong Kong dollar that are pegged to the US dollar and others that have sufficient foreign currency reserves have remained relatively stable. In addition, other emerging Asia currencies (Malaysia, Singapore, Taiwan) which are not facing the same economic issues as the Fragile 5 have also remained stable.

Fragile 5 FX depreciation since May 1st (versus USD)



Source: Bloomberg



Investor concerns have resulted in significant EM outflows

What Has Changed Since the Asian Crisis

It is important to raise awareness of some of the changes that have occurred in emerging markets, specifically Asia, since the late 1990's crisis. The most relevant to today's concerns is the change in currency policies. Since the Asian crisis, more countries have adopted free-floating currency policies. At the same time, foreign currency reserves have been strengthened. Most importantly, however, the amount of outstanding debt that is denominated in foreign currency is approximately one-half the level of the late 1990s.

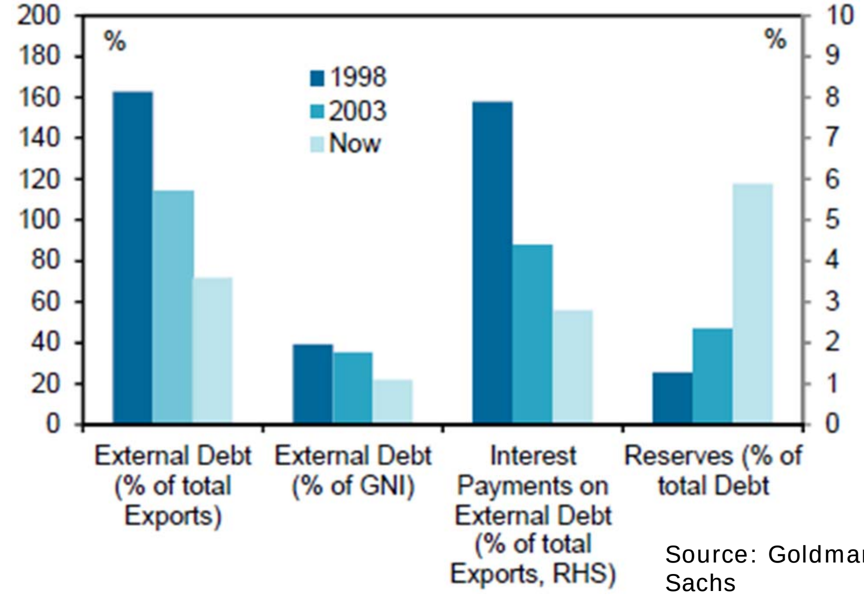
The above factors dramatically reduce the probability of a repeat of the 1998 Asian crisis. At that time, many Asian countries in poor fiscal health tried to maintain unrealistic pegs to the US dollar. Once the peg was broken, the country often suffered an overnight haircut in the value of its currency that left it unable to pay its debt denominated in foreign currency. Default became inevitable, and contagion spread.

Today's flexible currency policies act as a relief valve. Currencies can be allowed to weaken, which over time makes their economies more competitive, reviving growth. Again, this process is less painful and more likely to succeed when a country limits its amount of external debt.

Not all countries have been as successful in improving their economic health. Turkey is one of the most threatened countries within the Fragile 5. Turkey has maintained a wider than average current account deficit for several years (most recent statistics indicate a deficit of above 7%) which requires a healthy level of external financing to maintain. This combination is not a problem when capital is plentiful and yields attractive. However, it leaves the country exposed when investors pull their capital.

Our research supports the view that emerging markets are unlikely to suffer widespread contagion, but countries such as Turkey, Indonesia, and South Africa are likely to remain under duress. We advocate that investors focus on other emerging countries that are stronger financially, benefit from trade to the improving developed economies, and have vibrant and growing middle class to support the economy.

Less External Debt, Higher Reserves…



Source: Goldman Sachs

Improvement Looks Different Among Select Asian Countries

Source: Wall Street Journal

Identify and Invest in Future Growth

Looking forward, we believe that best future investment opportunities are in companies selling goods and services to the emerging middle class, not in companies dependent on another investment-driven commodity super cycle.

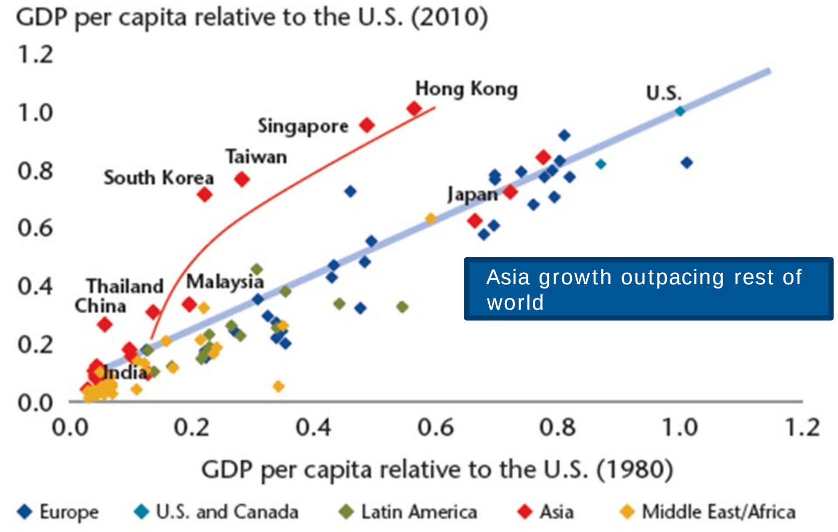
We have been advocates of the emerging consumer for several years. Economic growth has slowed modestly in key regions such as Asia ex-Japan, but we believe this slowdown is a precursor to a more sustainable growth trajectory. Over the long run, the consumer thesis will continue to reward investors. Data provided by McKinsey & Company suggest that the wealth effect in China is only beginning. By 2020, they expect 187mm households will have household income greater than $16K, an increase of 10x from 2010 (18mm households met this criteria then). Despite the improvement, the absolute level of wealth is relatively low compared with the developed market.

Although the above statistics focus on China, the rising middle class phenomenon is occurring throughout broader Asia in places such as India, Indonesia, and Vietnam. KPMG estimates that by 2020, China's middle class will be the world's top consumer, followed by India at #3 and Indonesia at #8.

Growth in consumer expenditures within emerging markets continues to outpace that in developed markets. The direction of GDP per capita wage growth, and education attainment across emerging markets should enable this trend to persist. At the same time, capital markets are expanding across Asia, providing funding for local companies to grow and creating investment opportunities.

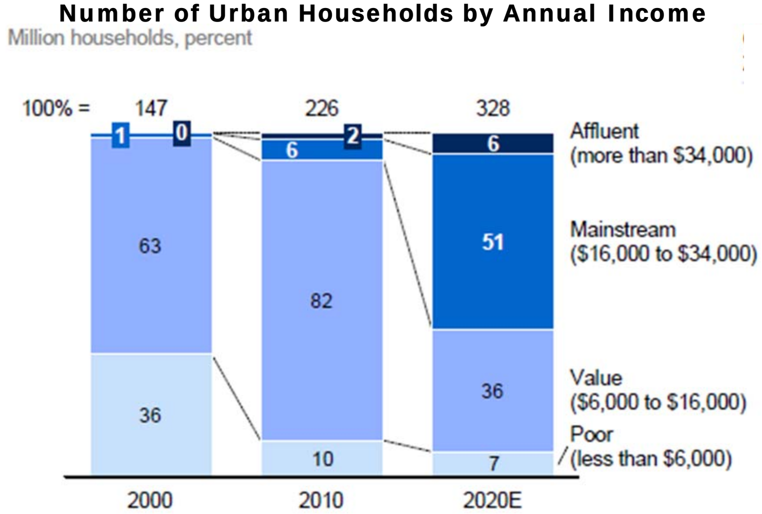
Many of the beneficiaries of this shift in growth are not well-represented in emerging market indexes. Attractive sectors such as consumer discretionary and staples, technology, and healthcare are under-represented in the MSCI Emerging Markets and the MSCI Asia ex-Japan indexes. The ability to identify value and growth opportunities in companies and countries that are "off benchmark" will be critical to long-term performance.

Rising Standards of Living from 1980 to 2010
Asia Countries GDP Per Capita Relative to US



Source: Matthews Funds

Growth of China Middle Class Consumer
Number of Urban Households by Annual Income



Source: McKinsey Global

Recognizing that “emerging markets” encompass 21 countries around the globe that have little in common except that their economic systems are not deemed to have reached “developed” status, we feel that investors must be deliberate in their emerging market allocation.

We believe that the most attractive sector within emerging markets is Asia ex-Japan. This index has reached historically low levels in terms of price/earnings ratio. As sentiment improves, and asset flows turn positive for EM, we think it is likely that there could be an initial rally at the index level. However, for long-term investors, there are three significant factors that lead us to avoid broad emerging market index investments:

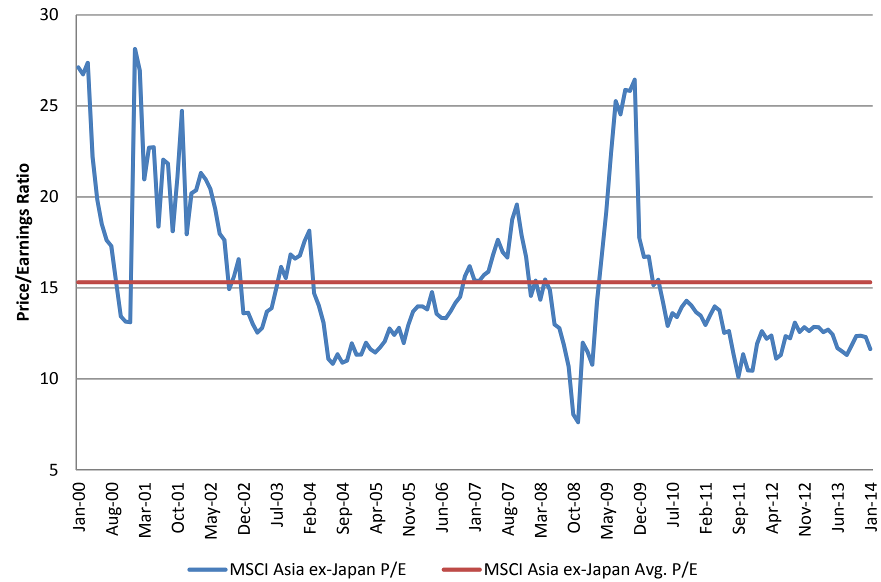
- State-owned Enterprises- broadly speaking, these are bloated, poorly-run, and low-growth companies.
- Commodity/materials exposure- these companies are reliant on another commodity super-cycle which we don’t think is on the horizon.
- Exposure to countries with significant macro-economic headwinds and/or political instability.

The disparity across regions, countries, sectors, and companies results in a good environment for active portfolio management as well as targeted regional exposure.

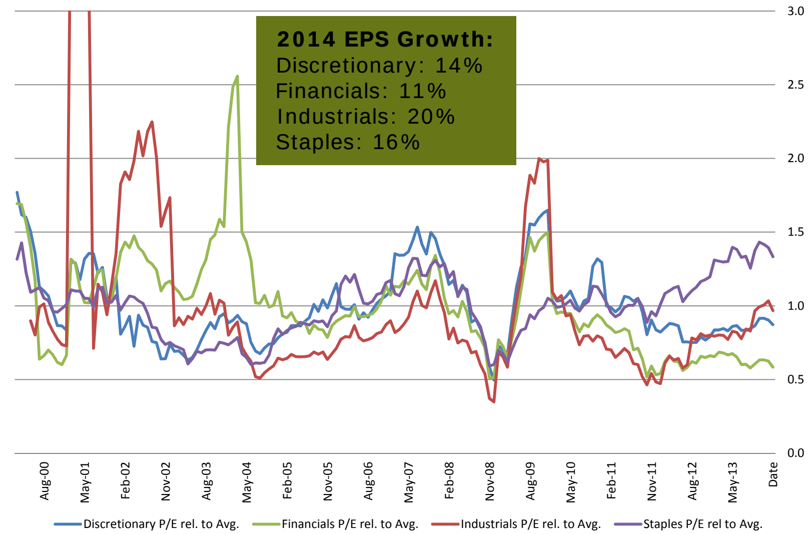
Actively-managed portfolios will not trade at as large a valuation discount as the broad EM indexes. <u>However, there are still attractive subsets of EM- particularly Asia ex-Japan (including China)- where valuations are inexpensive relative to their historical levels and compared to the US. At the same time, 2014 corporate EPS growth is expected to be strong. We believe that this region possesses the best combination of fiscal health, valuation, and strong growth (led by consumption, not infrastructure).</u>

By investing in actively managed portfolios, our clients are able to gain exposure to attractive companies and markets while also maintaining a quality bias in their portfolios. Emerging markets, and Asia ex-Japan specifically, have been an area where active portfolio management has added value.

Long-Term P/E Ratio: Asia ex-Japan



Sector Valuation Relative to History



Source: Bloomberg

Success of Active Portfolio Management

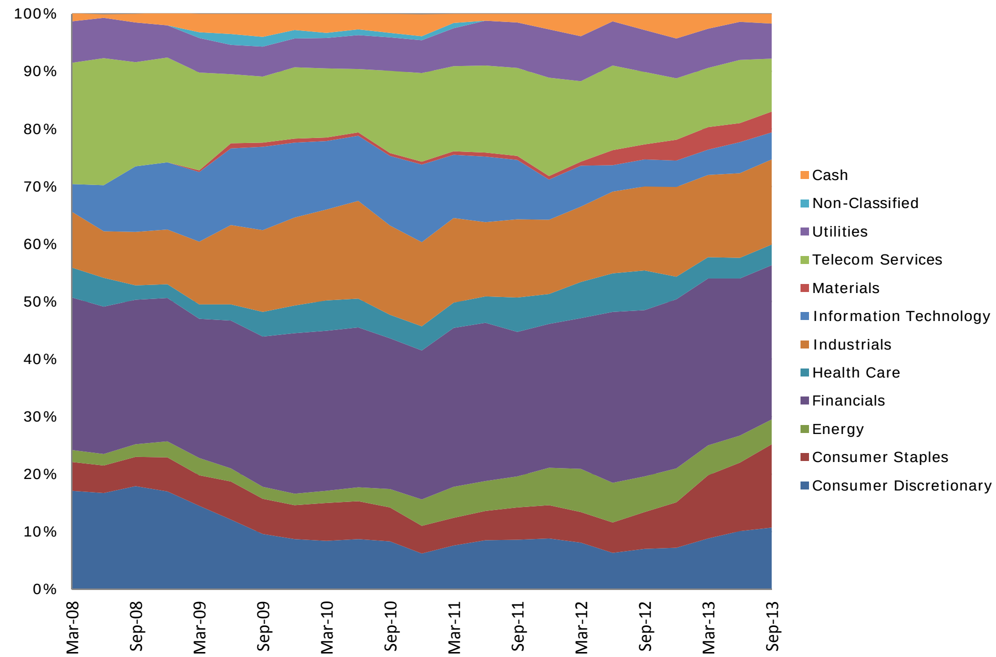
The intent of active management is to outperform with less risk by allocating capital to the most attractive companies and sectors within a market. The graph to the right illustrates the rotation across sectors in search of value over time.

While there are sectors, such as financials, which have maintained relatively high allocations, others have grown or contracted based on their fundamental value and outlook. Consumer-related (both staples and discretionary) and industrials have grown in recent years, while less attractive sectors such as telecom and utilities have smaller allocations. <u>These portfolio shifts reflect the changing nature of Asia's economies and sources of growth.</u>

The success of active management is judged by performance as well as risk. Over the last three years, Matthews Asia Growth & Income and Pacific Tiger have outperformed both Asia ex-Japan as well as broad EM, while taking meaningfully less risk. Over a longer ten year time frame, the results are similar.

While we prefer to look forward vs. backward, we continue to believe that active portfolio management is required in emerging markets. Investor sentiment is negative, and EM currencies and equity markets have been subject to outflows. We believe that these concerns (at least in our preferred markets) are overdone. <u>Recent price weakness and underperformance relative to developed market equities have created the opportunity to own a high-quality companies at attractive valuations that is positioned to benefit from continued economic transition and consumption within Asia.</u>

Matthews Asia Growth & Income- Historical Sector Exposure



Source: Matthews Asia Funds

Success of Active Portfolio Management

	Trailing 10 Years			Trailing 3 Years		
	Return	Volatility	Sharpe	Return	Volatility	Sharpe
Growth & Income	10.4%	14.3%	0.6	5.0%	12.2%	0.4
Pacific Tiger	11.7%	22.1%	0.5	3.8%	16.7%	0.2
MSCI Asia ex-Japan	9.4%	22.7%	0.4	0.0%	18.7%	0.0
MSCI Emerging Markets	10.1%	24.0%	0.4	-3.4%	19.6%	-0.2

Source: Bloomberg

EDGE Capital Partners

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