INSIGHTS
INVESTMENT

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Emerging Market Equities Look Strong After 2017 Rally

As U.S. stocks grabbed financial headlines in 2017, emerging market equities, as measured by the MSCI Emerging Markets Index, were delivering even better performance, a welcome outcome after several years in which emerging markets lagged stocks in the U.S. and other developed markets. Can this outperformance continue? Dara White, global head of emerging market equities at Columbia Threadneedle Investments, discusses his 2018 outlook for the asset class, where he sees opportunity, and how he finds worthy emerging markets investments.

|Pensions & Investments| ***What has been driving the recent performance of emerging market equities?***

|Dara White| A number of things have happened. First, starting in mid-2016, we saw an end to a major earnings recession in emerging markets (EM). Second, from 2012 to 2016, we had a massive fall in commodity prices, which we believe is over. While we're not extremely bullish on commodities, not being bearish is an important starting point for this asset class. We saw a big bounce off the bottom of commodity prices in 2016 and now we think we are in a long, drawn-out move sideways.

The third thing I would point out is that valuations are attractive. They may be a tad above their historical mean, but we think emerging markets can trade at a significant premium, primarily due to changes in the composition of the universe. Ten years ago, the biggest names in this universe were companies like Gazprom, Petrobras, PetroChina and big, cyclical state-owned type companies. Today, the biggest names are Alibaba, Tencent and Samsung, which are much higher-quality companies delivering a higher return on invested capital (ROIC). These companies deserve a much higher multiple.

The final point I'll make on valuation is that the relative multiple is very attractive. We have seen developed market multiples climb a tremendous amount, and EM is trading at about a 30% discount to the S&P 500, for instance, so we don't have concerns on the multiple.

|P&I| ***In this context, then, do you expect emerging market equities to continue to rally?***

|White| Yes, we do. At the beginning of 2017, the expectation was for about 15% earnings growth for the universe, and it looks like it ended somewhere between 25% and 30% for the year. We expect a similar dynamic in 2018, where earnings are revised up throughout the year.

When we look at our bottom-up universe, we are excited about the earnings stories, and it is earnings that will drive markets over time. We feel that many investors are under-allocated to EM, which again points to a good starting position.

Global growth is also looking a lot better. There has been a broad-based expansion across the EM universe where we had a very significant slowdown over the last five years, and now we are finally starting to see loan growth tick back up.

|P&I| ***What's behind the earnings turnaround?***

|White| Improving economies are part of the story. Driving the big picture in EM is improvement in GDP per capita, and it's not only in China. It's in places starting from a much lower base like India, Indonesia and the Philippines – even Russia and Brazil.

We are also seeing much greater capital discipline from companies: cost-cutting, rightsizing of balance sheets, etc. Greater operating efficiency plus some pent-up demand in those economies is a big driver of the earnings story.

|P&I| ***What role do you think U.S. or global interest rates will play in EM performance?***

|White| Interest rates are going higher because the global economy is stronger, and that can be very positive for emerging markets. If you look at past interest-rate cycles, emerging markets have performed quite well in periods of rising rates if the underlying factor is a stronger global economy.

I think that there is a lot of fear in the markets around the impact of rates, perhaps because of the taper tantrum in 2013, when emerging markets significantly underperformed simply with the prospect of higher interest rates. But EM is in a much less vulnerable position today than in 2013.

We also think interest rates won't go too high in the U.S. given some of the debt dynamics and the leadership of this country.

|P&I| ***What impact or influence does China have on emerging markets, broadly speaking?***

|White| China is a huge portion of the universe. It takes up almost 30% of the MSCI Emerging Markets Index. It is also politically and economically the driving force behind much of the universe, in terms of things like commodity demand and Silk Road investments. It is a much more stable story, and a lot of that stability has been driven by supply-side reform. Previously, there were many industries — such as steel mills, cement makers and old industrial sectors — with overcapacity. They were losing money, and many banks had lent to these industries.

But with supply-side reform, the government forced capacity to be reduced, resulting in many companies with

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better cost structures and greater free cash flow. The government has instructed these companies on how to use this cash — to repair their balance sheets. That has taken some of the scary scenarios of the Chinese banking system off the table.

The other piece of the China story is the generational change that we are seeing. If you think about 25-year-olds today and what they make for a living, what kind of education level they have, and you compare it to their grandparents' generation, that dynamic shift is amazing. There is a very vibrant, entrepreneurial side to the Chinese economy driven by this younger generation that is often overlooked during macro discussions around China.

|P&I| ***With tech companies and stocks playing such an important role in emerging markets, how do you position your portfolio to take advantage of this opportunity?***

|White| In general, tech has been a very good performer for emerging markets, and internet companies, particularly in China, have been big drivers of that. Alibaba and Tencent have been two of our larger positions.

An overriding driver in emerging markets continues to be the emerging middle class and, in our view, internet and technology has become the most powerful way to leverage that dynamic, particularly in a place like China. These companies are amazingly well-run.

Tencent and Alibaba, for example, both throw off about $10 billion in free cash flow a year, and like many, are in the early days of their monetization models. Commission rates at Alibaba are less than half of what we see in U.S. counterparts. Advertising revenue opportunities at a company like Tencent, which has a user base of 800 million, are enormous, especially when you consider the capacity for growth vs. a company like Facebook. These companies are also diversifying, with cloud and financial businesses.

|P&I| ***How is your bottom-up approach valuable when investing in emerging markets?***

|White| The universe has changed significantly over the years. Fifteen or 20 years ago, investing in EM was very much about what country you wanted to be allocated to and then you only had a handful of liquid stocks, perhaps one in each of the big sectors. EM investing was essentially a call on interest rates, on inflation, or on whether you wanted to be in the one telecom stock or financial stock.

Today we have a very, very diverse set of business options when investing. What we look for is companies with proven business models and a high ROIC – companies that outperform their peers.

We think that a high ROIC is a signal of a well-run company. In addition to visiting stores and factories, when we meet with management teams we make sure that they understand how to invest shareholder capital – by building barriers to entry, and building longer-term shareholder return. We determine whether they are good stewards of capital.

These types of companies tend to see longer sustainability in growth, particularly in EM, where so many industries are still dominated by either state-owned enterprises or mom-and-pop shops. The opportunity for market share growth is significant.

One good example is the Indian banking sector. When I first started investing in private banks in India, 95% of the sector was dominated by state-owned banks. Today state-owned banks are 70% and the private sector has 30% of the market. We believe the split will eventually be 50-50 and then 30-70.

|P&I| ***With your bottom-up approach, how do you address portfolio construction?***

|White| We build it from the bottom up, but then we use various risk models to make sure that our sector and country weights make sense to us, and we have risk parameters around our sector weightings and our country weightings to make sure individual bets don't get too big.

We keep price targets at 12 to 18 months out, both on the upside and on the downside, which I believe is very important. I think a lot of people tend to get too focused on what they could make and not enough on what they could lose.

We do this for everything that we own, everything that we have identified that we would like to own, and for all positions in the benchmark with a weighting greater than 25 basis points, which helps us understand relative valuation as well.

This assessment becomes our map to allocate capital across the universe and makes volatility our friend. If we see stocks trading below our downside price target, it allows us to sit back and ask whether anything has changed fundamentally for this company, or whether there are just more sellers than buyers. If a stock goes above our price target, it's not an automatic sell. We can revise our targets, but if we don't, we will take advantage of upside volatility to achieve gains and reduce our weighting.

I think evaluating relative valuation keeps you intellectually honest. One of the faults that many investors have, and one I had earlier in my career, is a tendency to fall in love with what you already own; by forcing yourself to look at what you don't own, you have a better perspective on your portfolio.

From a portfolio construction perspective, companies with the best upside and downside ratios are sized accordingly. I think that the MSCI Emerging Markets Index is a poorly constructed benchmark, still dominated by many state-owned businesses, so there are a lot of opportunities for an active manager.

|P&I| ***Looking at 2018, are there areas that worry you?***

|White| There are always going to be areas that concern us. Geopolitics comes to mind, but it is very hard to predict how things will play out. North Korea adds unpredictability. Brazil may be very volatile this year because of its elections. You have two candidates — they are not official candidates — but they seem to be on the extreme ends of things. Also, the recovery that we are seeing in the Brazilian economy is fragile. Mexico is an area to watch as well; we need to see how Mexico-U.S. relations play out with the upcoming election and whether NAFTA is rewritten.

We are always worried about errors by global central bankers. Will they raise interest rates too high and kill the global growth story?

But even with these larger concerns, the EM market is diverse enough and robust enough for stock pickers to find opportunity, and the growth of local participation in EM equity markets is helping to dampen some of the worst volatility. If there are any temporary dislocations, you want to own the best companies that you can, though, and that's what we try to do in our portfolios. ■

Emerging Market Equities Have Considerable Upside Relative to Developed Market Stocks

Source: Columbia Threadneedle Investments and FactSet as of Dec. 31, 2017. Chart displays total return of indexes re-indexed to 0.

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