INVESTMENT
INSIGHTS

Searching for Sustainable Cash Flows in Emerging Markets

Kim Catechis
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Kim Catechis, Head of Global Emerging Markets at Martin Currie explains how bottom-up stock picking and careful portfolio construction creates value for clients

P&I: *Can you describe your team's investment philosophy?*

Kim Catechis: We identify mispriced emerging markets equities via fundamental research and exploit this through high-conviction stock-focused portfolios.

Our primary belief for emerging markets companies is that sustainable cash flows and the effective allocation of capital are the main determinants of share-price movement over the long term so we seek to identify companies that can sustain cash-flow growth and generate returns in excess of their cost of capital.

We look for business models that can resist competitive pressures for longer than the market expectations; this is the key market inefficiency that we seek to exploit.

P&I: *How does this translate into an investment process?*

Kim Catechis: We are 100% unapologetic bottom-up stockpickers because we think this is where we can add value.

There are two key parts to our process. First, through our fundamental research we identify what we believe to be the fair value of companies in our approved research list. For these 100–120 companies we have done sufficient due diligence and have satisfied ourselves that they are high-quality, strong businesses. This is our gene pool. Secondly, we construct and deliver these undervalued names in a balanced portfolio.

Each of the stocks on the approved list comes with its own baggage, its own factor risk. The way we put them together is like a jigsaw puzzle. We are always aware that the portfolio we are building may have inherent factor risk that we did not intend. The end result is that our highest-conviction companies drive the portfolio.

A key aspect of our process is that we are patient, long-term investors with a three-to-five year investment horizon. That means we attempt to minimize investment turnover, so as my father used to say when doing DIY, we want to measure twice and cut once. In choosing any company to include in a portfolio, we consider three things: our view on the company's ability to reach our expected target, our conviction as to its business model and finally what role the shares of that company will play in the portfolio.

P&I: *What quantitative and qualitative measures do you consider when choosing stocks?*

Kim Catechis: Any stockpicker worth their salt gathers all the quantitative information they can for fundamental research. For us that means looking at the operating metrics of how a company has behaved during a natural business cycle and projecting these into the future. This can be translated into a standard P&L, balance sheet and cash-flow statement looking forward five years. In order to do that we need to know the company well and understand the drivers of the company model very well. When it comes to valuation, we have an explicit focus on cash flows, because we believe that profits are a matter of opinion. Cash flow is fact.

Qualitative analysis is more interesting but also more difficult. It's tough because you have to allow for subjectivity, but as objectively as possible. As an analyst, you need to be aware of a whole range of elements that are not easily quantified but can have a significant impact on cash flows and hence the valuation of the company. We put this together under the notion of sustainability, not in the idealistic sense, but in the simplest meaning of the word. Businesses that have processes and policies in place to deal with the unexpected and undesirable have a better chance of survival over time. Companies that have clearly articulated policies guarding against environmental damage or losing human capital or potential changes to legislation tend to be better-run companies with better governance. And guess what? They tend to be survivors.

P&I: *Are these qualitative issues harder to assess or quantify in emerging market companies than in developed market businesses?*

Kim Catechis: They are not inherently more difficult in emerging markets companies. Qualitative factors are becoming increasingly relevant for companies operating in emerging markets, where growing demographic and resource challenges demand a more sustainable approach to both business and economic development. In China for instance, many companies get bad press, sometimes deservedly. Certainly they have only recently begun to consider the impact of the deterioration of the environment. But they are concerned now and as a result, China has some of the most stringent environmental controls in the world in certain sectors. Over the next ten years, we expect to see significant improvements in the quality of air and water in China.

There are also many examples of developed market companies that did not demonstrate resilience in the face of the unexpected or undesirable. The experience of BP in the Gulf of Mexico, where 45% of the company's market cap evaporated over a short period of time is an example. Companies in extractive industries do have real-world risks associated with their normal operations. They can take preventative steps to minimize these risks.

P&I: *What insight does this focus on sustainability bring to your investment process?*

Kim Catechis: We focus on three areas of sustainability: environmental, social and governance (ESG). We believe that an assessment of these factors can help identify business models that are most likely to sustain high returns and resist competitive pressures. ESG factors can have a material impact on a company's financial position, reputation and – ultimately – corporate value.

Our approach requires direct engagement with the management of the companies in which we invest. Extensive contact with management enhances our ability to understand both the financial and strategic characteristics of a business. We seek assurance and therefore we have built a strong franchise with emerging market managements as a thoughtful, long-term provider of equity capital. They are used to us asking far-reaching questions about strategy and policy, things that are unrelated to last quarter's results.

P&I: *Is sustainability more important to you because of the relative length of your investment time horizon?*

Kim Catechis: Yes. A lot of investors won't bother considering these issues because their time horizon is so short. If you're investing in a company for six months to a year, you can afford not to bother. We're looking out three-to-five years and assessing the ability of a business to generate future returns and successfully allocate their capital for the long term. This is where our engagement with management comes in again by allowing us to take a strategic view of a company.

P&I: *Why do you focus on sectors rather than countries?*

Kim Catechis: For our research we divide the world by sector because we think there is more commonality between companies operating within sectors than those operating in a single country. Take energy companies, for instance, regardless of where they are physically and geographically based. Local tax regulations will vary, but the actual operation of drilling, exploring and developing is fairly standard. Best practice travels fast. While each portfolio manager has a low intensity sector specialization, because that's practical, we make sure that there is no overdependence on a single person. We all have to be up to date with developments across the portfolio because we are fundamentally bottom-up stockpickers.

P&I: *How do you quantify the relative risk of investing in one country versus another in this type of portfolio?*

Kim Catechis: We identify a particular cost of equity for every country by considering the bond markets, which are more efficient in the short run at quantifying these kinds of risk. We look at the long bond local currency yield, long bond US dollar yield, macroeconomic research and political risk. With this information we can take an educated view of the likely impact on cash flow for any company.

P&I: *How is this calculation used in choosing a particular company to include in the portfolio?*

Kim Catechis: It is used to arrive at a fair common currency value for a company. As such it impacts our view of the cost of equity that is relevant to that country. The outcome is the upside that we expect to receive, given the riskiness of the country.

P&I: *When would you sell a stock?*

Kim Catechis: First, when it has hit our fair value target. Second, if we've lost conviction in the investment case. That can sometimes be as subtle as a brick in the face. For example, if there's a legislative change that makes it impossible for the business case to be realized, then it's gone and we sell. The third case can occur without anything much happening. The stock is delivering as expected, but now it's the least attractive one in the portfolio. Another idea is simply more compelling.

P&I: *Why do your portfolios operate with a high active share?*

Kim Catechis: It is purely a consequence of backing our best ideas with conviction. What may be more revealing is to look at our high active share with our low relative R-squared. The two in combination are evidence that we are not benchmark-hugging and that it's minimal factor risk that is driving the portfolio. ❖

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$10,107
Total AUM ($Millions)

$2,242
Total Emerging Markets AUM ($Millions)

$1,380
Dedicated Emerging Markets portfolios - AUM ($Millions)

As of 31 August 2014. Source: Martin Currie Investment Management Limited ('MCIM')

Strategy Spotlight

Firm Overview

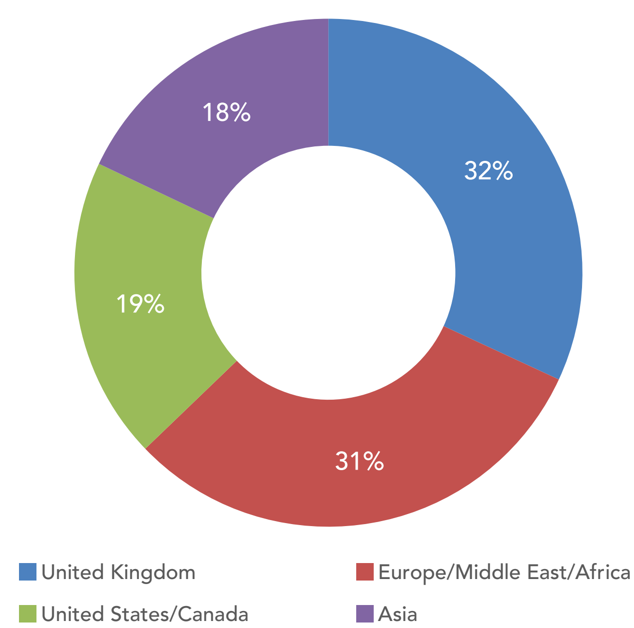
Founded **1881**

Edinburgh London
Singapore **6 Locations** New York
Zurich Melbourne

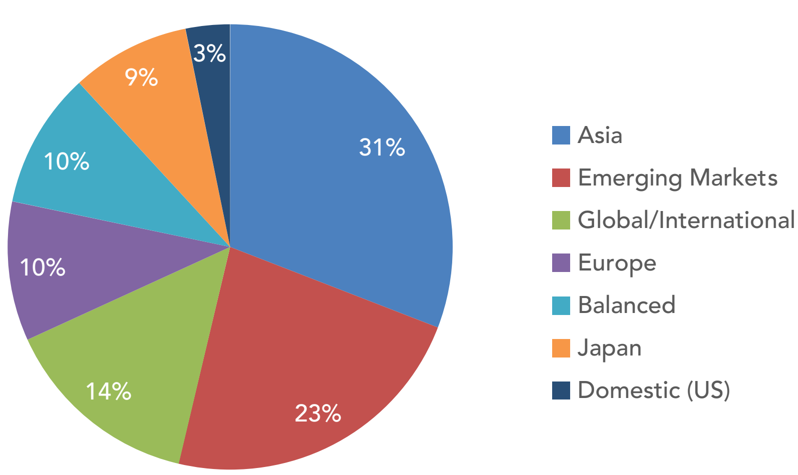
190 employees **45** investment professionals

17 years Investment professional average years experience

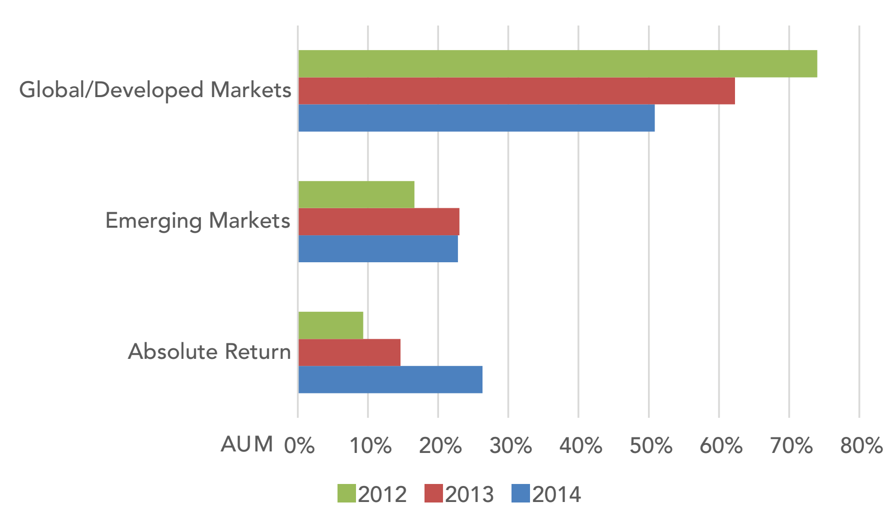
Firm Assets by Client Location



Firm Assets by Investment Strategy



Firm Assets by Asset Class



This information is issued and approved by Martin Currie Investment Management Limited ('MCIM') as at 31 August 2014.

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