INVESTMENT
INSIGHTS

Robert Marshall-Lee
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Applying Thematic Insights in EM

Robert Marshall-Lee, investment leader of the Emerging Markets team at Newton Capital Management, helps investors sort potential winners from losers across emerging markets.

P&I: Though index returns have been disappointing the past few years, you believe emerging market equities offer tremendous potential — where are you finding opportunities?

Robert Marshall-Lee: Emerging markets are now highly differentiated, which is very different compared to 10 years ago. In our view, there is still plenty of growth but only if you find the right stocks. That means being selective and keeping a long-term view. We're looking for companies with superior growth on a five-year view and attractive returns on capital. We believe that is where investors may earn a compounded return that dramatically drives up earnings over time, and ultimately drives capital appreciation.

P&I: How does a thematic approach lend itself to finding such companies?

Robert Marshall-Lee: The first thing to understand is that we don't believe in a "tick-the-box" type of thematic approach. Not every company exposed to a theme will benefit. Long-term themes help focus fundamental stock research, which is critical to determining which companies may truly benefit from the trend. For example, the mobile internet is booming in many emerging markets as more consumers get reliable 3G and 4G access, which has only happened over the past few years. We call this theme "Net Effects," but we don't buy just any company exposed to the mobile internet.

We don't hold any handset companies, for example. We believe established players will have a very tough time competing against emerging Chinese handset companies. We think many of the telcos will see declining returns on capital, because even though they are seeing data growth, they are putting more capex into the ground to support it, while losing voice revenue at the same time.

But many internet companies are piggybacking on that and actually benefiting. Likewise, some of the component companies that sell into the handset value chain are capturing the value of that mobile internet growth. Many of these companies have high profitability with high growth, and that's where investors may see really good earnings growth and capital returns.

So we're looking for companies that meet these strong thematic criteria that also sit well in the value chain and competitive landscapes and have strong fundamentals. We want superior management teams and strong balance sheets, and companies that won't be forced into a capital raising at an inopportune time. We want high barriers to entry, good brands and good cash generation. We're very holistic in how we interpret financial statements and understand what's driving them. Finally, we still need attractive valuations to justify our investment. We need to have significant upside potential. If possible, we try to buy at contrarian moments.

P&I: And what's your view on valuations in EM equities, currently?

Robert Marshall-Lee: In terms of relative value, we think a lot of emerging markets are now very attractive at the currency level, as well as at the stock level. For example, India has done well recently, and if you look at valuation on a through-cycle basis, Indian companies might have high PEs, but that is on low margins, coming out of the bottom of a cycle and poised for growth. In U.S. equities, by contrast, you find high multiples on high margins. That is a rather less comfortable position in terms of future capital appreciation.

We like having cheap stocks in cheap currencies, with significant growth potential, because that is much more attractive in terms of the scope for future capital appreciation in hard-currency terms. Overall, we look for stocks with upside potential of 50% or more, over a five-year time horizon — a 10% anomaly here and there is not really enough to get our attention. But we're very, very selective. There are more than 800 stocks in the index and many more off the index that we can invest in. We've got just under 60 in the portfolio, currently — combining high conviction with a long-term view, focusing on what we believe are the best companies to generate proper value at the fundamental level from this theme-driven growth.

P&I: You mentioned not owning any handset companies — is it common for you to be zero weight, or have large underweights in key benchmark sectors?

Robert Marshall-Lee: We use the benchmark as a performance barometer, but not as a starting point for constructing a portfolio. We don't believe that the index, as a whole, is very attractive. You can find some interesting growth areas, but we think there are also some horrible places where you can destroy value. We think indices are also not very good reflections of fundamental risk, and we're very focused on fundamental risk. We want investors to make attractive returns but with appropriate risk protection.

For example, why hold onto stocks in Korea if you think their growth prospects are relatively weak and those stocks will decline? Why be just 5% underweight, why not just be zero weight? In China, we don't own any banks. That may mean in a given quarter, or six months, we might lag a big rally in Chinese banks. But just because they're rallying over a few months, why would we own them if we still think they're unattractive investments? We have less than 2% of the portfolio in state-owned companies, compared to 29% in the index, because such companies rarely prioritize the interests of minority investors.

So, again, emerging markets are highly differentiated, and if you want attractive risk characteristics with attractive long-term growth, all in the same package, that may require significant deviations from the benchmark in terms of overweights and underweights. But I would add here that even where we maintain large overweights, we take great care to try to keep the portfolio well diversified. We are currently 20% overweight to India, but it's only 27% of the portfolio, and with no more than 5% held in any one individual company. We believe it's critically important to employ strict risk management discipline, including position limits, even as we pursue high-conviction opportunities.

P&I: The word "long-term" comes up quite often — how does that factor into the thematic process?

Robert Marshall-Lee: The themes we have identified are fairly observable and widely understood, but what investors may lack is the conviction to stick with those themes and let them pan out through growth and profitability. Our overweights to India and the Philippines, for example, have been building over many years. With a long-term view, you can invest in fundamentals and sit and wait, as opposed to second-guessing the market over the next two or three months, as many market participants may have to do.

"Healthy Demand," for example, is a theme we find absolutely fascinating, as it has different interpretations in different parts of the world. In the western world, it's very much about an aging population and a strained health-care system, whereas, in the emerging world, you find a fast-growing middle class with high aspirations and increasing disposable income. They like to spend money on health care and education, and governments tend to be behind the curve in serving those aspirations. That leaves a big private-sector opportunity, and we like investing in those areas for that very reason.

We identify lots of interesting companies with high returns on capital; very good cash-flow metrics, very good organically driven growth, and we feel that's going to be the case for decades to come. We believe investors can find strong business models at reasonable valuations. They don't have to dig around for rock-bottom valuations. They can take a buy-and-hold strategy and aim for steady annual growth year in and year out, almost irrespective of the ups and downs of the asset class. We love those kinds of stocks. They may help investors sleep easier at night.

P&I: And are you still bullish on the long-term strategic case for EM?

Robert Marshall-Lee: When we factor in the superior long-term growth potential of emerging markets, with a lower level of indebtedness and superior demographics, together with some catch-up productivity gains, we are very excited about the long-term potential in a large number of the places that we invest.

Now, we believe the global realignment and rebalancing of growth and trade will cause big problems for certain parts of the EM index, while providing a tailwind for other parts. Our themes help us highlight potentially attractive areas and steer us away from areas we deem unattractive. But ultimately, we are looking at the fundamental risk-reward of each stock — we believe that the most important component of any equity strategy is to get the fundamental analysis right. If investors can get this right, we believe there are attractive returns to be made in emerging markets. ❖

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- Currently manage over **$3.7** billion in emerging market securities across the firm
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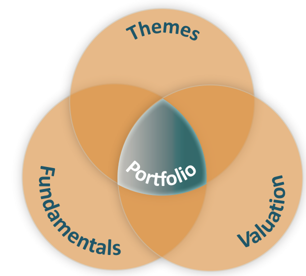
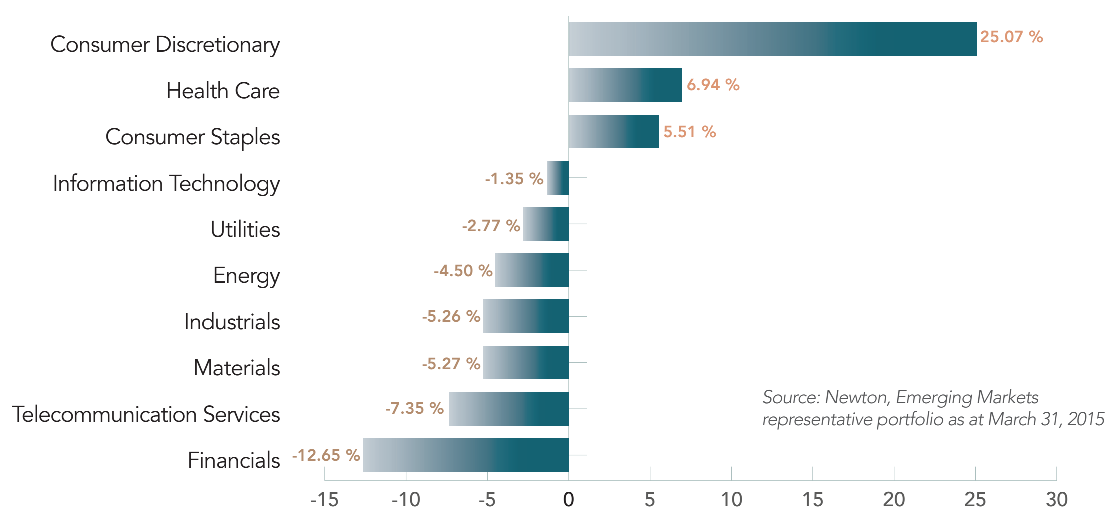
  - Quality
  - Return on capital employed
  - Governance



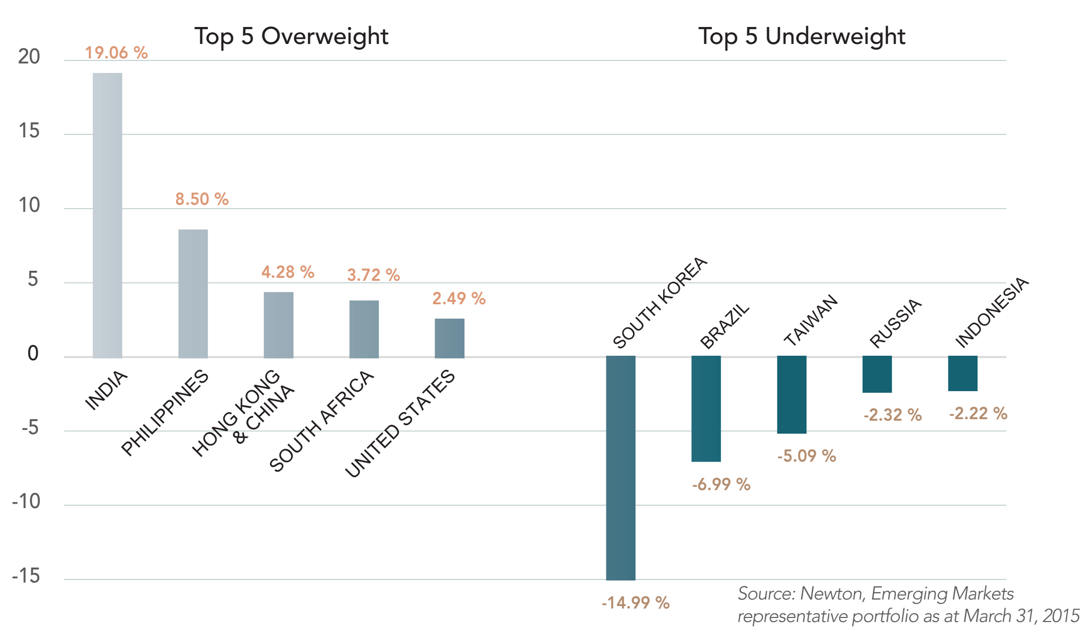
Emerging Markets Investment team

Name	Role	Years' Investment Experience
Rob Marshall – Lee	Investment leader	19
Sophia Whitbread	Portfolio Manager	9
Zoe Kan	Portfolio Manager	14
Naomi Waistell	Portfolio Manager	7
Douglas Reed	Global strategist	8

Sector Diversification - *Relative to MSCI Emerging Markets*



Country allocation - *Relative to MSCI Emerging Markets*



Top 10 Holdings (% of total portfolio)

Naspers Ltd	4.99
Taiwan Semiconductor Manufacturing	4.66
Tata Motors Ltd	4.57
Baidu Inc	4.52
Hero MotoCorp Ltd	4.15
AIA Group Ltd	4.08
ITC Ltd	3.63
Vipshop Holdings Ltd	3.35
Alibaba Group Holding Ltd	3.24
Universal Robina Corp	3.19
TOTAL	**40.38**

Source: Newton, Emerging Markets representative portfolio as at March 31, 2015

Vehicles Offered

MUTUAL FUND[1]
SEPARATE ACCOUNTS
POOLED FUNDS

[1]*Offered through The Dreyfus Corporation.*

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