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THE CASE FOR

A selective approach
to Emerging Market Equities

For professional investors only

The case for a selective approach to emerging market equities

Emerging market equities provide attractive opportunities for long-term investment returns. The asset class also, however, carries significant risks. The Henderson Emerging Market Equities Team believes the opportunities therefore need to be approached in an extremely selective and risk-aware manner.

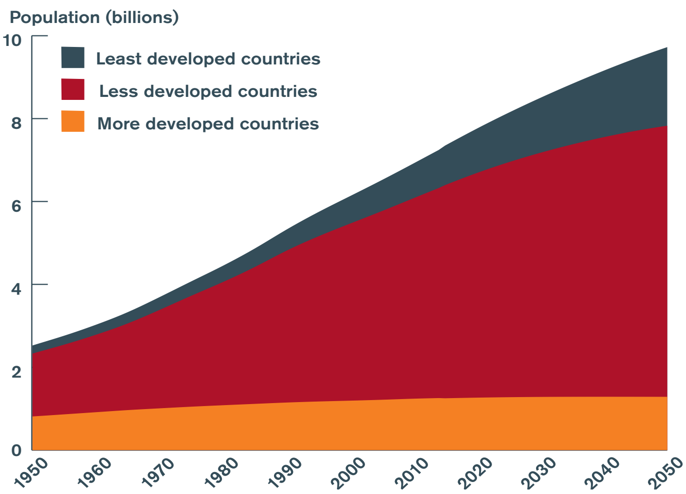
EM – risks and opportunities

Emerging markets (EM) can be a risky place for investors. Immature legal and political systems often mean inadequate levels of minority shareholder protection and economic volatility.

The opportunities for investment, however, are significant and well documented. Supportive demographic trends, such as population growth and a rise of the middle income consumer, are driving demand for a broad range of products and services that those of us in the developed world take for granted.

In approximate terms, of the world's seven billion people, six billion live in less developed countries. As the population rises towards its forecast nine billion by 2030, the vast majority of these additional inhabitants will live in countries that are considered to be 'emerging' (see chart below).

Most population growth will come from less developed countries



Source: United Nations Population Division, World Population Prospects: The 2012 Revision, Total Population, both sexes, using median fertility

Population growth on its own does not signify economic growth, but the demographic make-up of many emerging markets does. Rising standards of living and emerging middle classes bring with them commerce and consumerism, while the younger profile and increasingly educated nature of the EM workforce supports the development of dynamic and entrepreneurial businesses. Companies that are selling goods and services into these long-term secular trends look set to benefit.

In the developing world, penetration of financial products such as mortgages and insurance are often a fraction of developed world levels. Per capita consumption of everyday products such as shampoo, toothpaste, soap and washing detergents are much lower and are sold at much lower price points. A growing number of companies - both good and low quality - that generate the majority of their revenues from operating in emerging market countries are well placed to benefit from these trends.

Source: Unilever

The need for selectivity

When investing in EM it is essential to focus on high-quality companies. The Henderson Emerging Market Equities Team believes this is best achieved using a bottom-up, risk-aware approach and focusing more on what can go wrong than what might go right. Understanding the people behind the business is considered key, and company history a meaningful guide.

The team believes there are a number of important considerations when assessing EM opportunities:

i) Long term

Taking a long-term view when investing in EM can help to dial out the short-term 'market noise'. The asset class consists of a diverse collection of countries, each of which can fall in and out of favour at one time or another. A long-term approach means it is possible to take advantage of unpopular periods, through buying good-quality companies that may have become reasonably valued.

ii) People

Investing in companies is about investing in people. When investing in EM it is wise to question who owns the company and why they own it. It is important to understand the motivations of both the owners and managers of a business. What other businesses does the controlling shareholder own and does he or she have more at stake in those? Are management incentivised to invest for the long term? Building a successful business requires a willingness to invest against the tide. Cutting marketing investments or research and development expenditure may advantage a more long-term thinking competitor.

iii) State influence

The role of the state in EM corporate ownership and its control of capital markets should be a significant consideration. State-owned enterprises (SOEs) make up a substantial proportion of many emerging equity markets. This can introduce issues around whose best interests these companies are being managed in. While privately owned companies may put shareholders first, there is the risk that a company controlled by a government will make decisions aimed at stimulating that country's economy, with complete disregard for profitability.

iv) Controlling shareholders

In contrast, long-term owners whose wealth is invested in the same equity as that available to minority shareholders provide comfort that interests are aligned. Across EM, this type of controlling shareholder is often a family group, which tends to increase the ability of management teams to take far-sighted, sometimes contrarian, decisions that a professional management team more focused on short-term results and stock market pressure might not.

v) Track record

A selective approach to EM equities allows investors to target companies that have demonstrated resilience during tough times. It is important to understand whether a company has a history of risk taking. Conservatism is not just about today's balance sheet – what did it look like during previous crises? A management team that is willing to take risk when times are good can end up in trouble when the inevitable downturn follows. As such, it is important to look for companies and management teams that have weathered previous periods in which operating conditions were challenging.

vi) Inflation protection

One risk common to emerging market economies is that of inflation. Immature economies can face difficulties in managing the supply of a variety of goods in line with demand growth and also suffer occasional periods of currency weakness, leading to bouts of high inflation. In order to combat this companies in turn need to pass on higher costs to their consumers. Those companies that invest in innovation and in building a brand give their customers a reason to keep coming back for more, and themselves the ability to earn inflation-protected returns.

vii) Non-financial risks

Importance should also be placed on how a company has treated minority shareholders in the past and how they respond to environmental and social challenges. The market tends to underestimate how often non-financial risks become real financial losses, particularly in economies with immature legal and political systems. Companies may try to cut corners through loose environmental standards or mistreating their workforce. These behaviours are not likely to be sustainable and may result in the company being forced to adhere to stricter standards, having an expensive accident, or having its reputation tarnished, leading to customers voting with their feet.

viii) Endorsements

One way the Henderson Emerging Market Equities Team has found to become comfortable with the quality of an emerging market company is through endorsements from other reputable and established firms that are willing to do business with that company. This feedback can be based on formal relationships such as a joint venture or other high level business partnerships. It may also come in the softer form of customers, suppliers or competitors speaking of their admiration and respect for that company. The implied due diligence that will likely have been undertaken in order for that relationship to have formed can sometimes be taken as a seal of approval that investors can gain confidence from.

Expanding opportunities

The universe of EM investable companies is expanding. More businesses listed in the developed world are growing their exposure to emerging economies and more frontier market companies within the next generation of emerging economies are looking to the stock market as a means to raise capital for investment and growth.

Taking a global, benchmark agnostic approach allows for investment in good-quality companies, wherever they are listed, that are building businesses in emerging markets. Blurred lines between EM companies and global companies means it is sometimes possible to gain exposure to EM through developed market (DM) listed companies.

Some DM-listed companies have good corporate governance and a portion of stable cash flows from the developed world. If their growth is being led by revenues from EM, this may be a lower risk way of providing exposure to developing economies. Another method is to invest in the EM subsidiary of a developed market multinational, which will be directly exposed to EM consumer growth trends and which should also benefit from the corporate oversight of its parent company.

Summary - maximising EM opportunities

While certain risks are undoubtedly higher in EM than DM, the EM asset class offers attractive investment opportunities when approached in the right way. By following a process that incorporates a distinct set of checks and balances and remains true to a clear philosophy on how to invest in the asset class it is possible to maximise these opportunities.

The Henderson Emerging Market Equities Team follows a differentiated process that is shaped by this view and leads to the identification of companies they want to hold for the long term. The strategy is constructed without reference to an index, meaning their unconstrained approach to EM constantly weighs up the risk of losing money in 'absolute' terms rather than underperforming an index. This process has been shaped by years of investing in the asset class and properly balancing the opportunities against the significant risks. Indeed, the team believes "long-term performance is defined as much by what you don't own as what you do".

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