M&G Global Emerging Markets Fund

Emerging market opportunities for selective investors

FUND MANAGER MATTHEW VAIGHT

With attractive valuations and improving corporate governance standards, Matthew Vaight, manager of the M&G Global Emerging Markets Fund, believes now is a good time to take a closer look at emerging markets.

Matthew Vaight

"Looking at current valuations within emerging markets, there is a broad dispersion across countries"

2014 saw a great deal of volatility in emerging markets. Optimism about elections and the prospect of reforms in some of the major emerging markets contrasted with concerns about the US Federal Reserve's 'tapering' of its stimulus efforts. Risk aversion rose as the oil price plunged and the crisis in Ukraine escalated. A rising US dollar also caused problems for countries that are vulnerable to capital outflows.

At the headline level, emerging markets had a difficult time. But this masks the huge variation between different countries and industries. Egypt was the best-performing market in 2014, closely followed by India, Indonesia and the Philippines, with gains of more than 20% in US dollar terms. On the other hand, Russia, Greece, and commodities-dependent Latin American nations, such as Colombia and Chile, experienced sharp declines.

A diverse opportunity set

Looking at current valuations within emerging markets, there is a broad dispersion across countries (see figure 1). We believe profitability, as measured by returns on equity (ROE), determines valuations. There are several examples of markets where the valuations seem excessive, given the levels of ROE. After impressive gains last year, driven by positive outcomes in elections, India and Indonesia appear very expensive to us. While Prime Minister Narendra Modi has started to implement changes to revive India's economy, we think the price we are being asked to pay for the potential benefits of these reforms is currently too high.

For some time, we have considered the smaller ASEAN markets to be too expensive. Investors have been drawn to countries such as Malaysia and the Philippines for their fast-growing economies. South Africa has some of the highest standards of corporate governance and levels of profitability in emerging markets. However, we struggle to find value among these well-managed companies.

In contrast, we think there is value today in North Asia, most notably in China and South Korea. These markets have relatively robust economic fundamentals, attractive valuations and the potential for improving corporate governance. Brazil and Russia are two of the cheapest markets currently and, in our view, we are being paid to take

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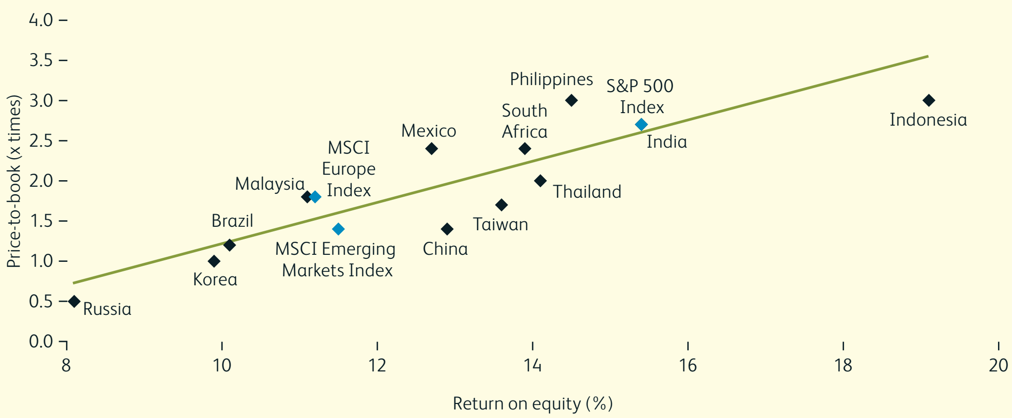
Figure 1. Emerging markets offering a diverse opportunity set



Source: Morgan Stanley, 31.03.15, based on 2014 consensus estimates.

some risk here. Despite concerns about the economy, Brazil is home to some of the best-run companies in emerging markets, with good capital discipline and a focus on shareholders. While there are undoubtedly some cheap markets now, as always in emerging markets, investors have to be selective to find the best opportunities.

At the sector level, there is a similar range of valuations (see figure 2). Consumer staples and healthcare stand out as by far the most expensive areas in the market. They have benefited from investors' search for perceived safety lately, as investors have paid up for their stable returns and high profitability. In our view, they now trade at a valuation premium.

The most attractive areas, in our opinion, are cyclical sectors, such as consumer discretionary and information technology. These have similar levels of profitability to consumer staples but trade at lower valuations. There is also value in utilities, where we have an above-index position. Energy is the cheapest area in the market as the recent decline in the oil price caused an indiscriminate sell-off of oil-related companies. We think there are opportunities to buy some of the better companies with resilient business models.

Following the value

We follow value, and over the past year, we have increased our exposure to China, South Korea and Taiwan. These markets have been out of favour on macroeconomic grounds, but we believe many interesting companies have been overlooked.

Investors are preoccupied with China's slowing economic growth but we believe this ignores the fact that there are exciting businesses in China that are striving to become globally competitive. Many firms are investing heavily in research and development to create sophisticated products and quality brands. Over time, we expect to see more Chinese firms become better run and emerge as 'global leaders'.

While there are value opportunities in China today, we are not prepared to sacrifice our corporate governance discipline. We are committed to finding companies we understand and trust to create value for minority shareholders. As a result, we have never owned a Chinese bank as we believe they are run for the benefit of the state not with the minority shareholder in mind.

Meanwhile in Korea, valuations are low and we see nascent signs of corporate governance reform which could lead to more shareholder-friendly policies, such as increased dividend payouts. Encouragingly, car maker Hyundai Motor and Samsung Electronics, a technology firm, both raised their dividends significantly in 2014.

We have been increasing our exposure to these companies and funding these purchases by taking profits from stocks that have performed well, most notably our Indian holdings. The Indian stockmarket has rallied on excitement about the government's economic reforms, but we are worried about valuations. Pessimism has been replaced by optimism and we think investors' expectations are too high. We also reduced our exposure to South Africa, another market that looks expensive.

In terms of sector positioning, we have added to our holdings in the consumer discretionary and information technology areas. Despite having concerns about the valuations of consumer staples companies generally, we have also been able to find individual

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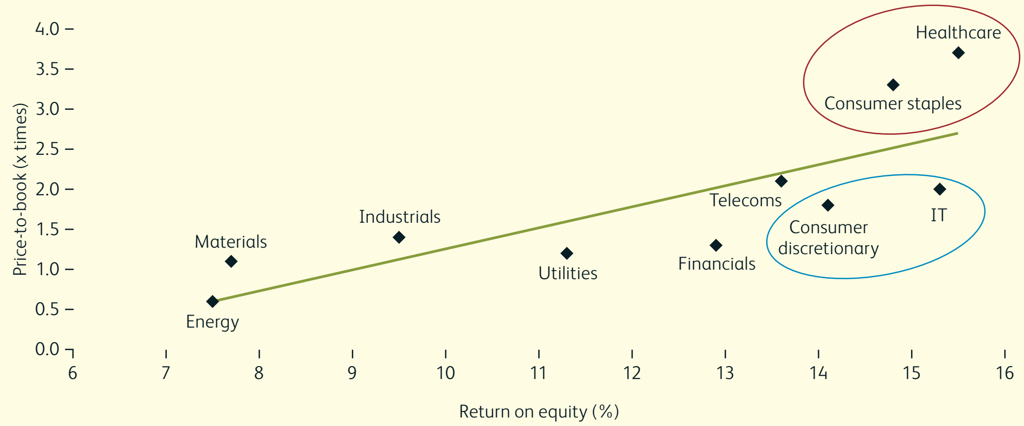
Figure 2. Consumer staples and healthcare look expensive



Source: Morgan Stanley, 31.03.15, based on 2014 consensus estimates. Sectors in MSCI Emerging Markets Index.

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opportunities in this area. We have bought stocks in Brazilian, Russian and South Korean businesses, which were written off, in our view, because of where they are based.

For instance, Ambev is a Brazilian drinks company that we think is one of the best-managed businesses in the emerging markets and yet it was trading at a significant discount to global peers. While we have concerns about corporate governance standards at large, state-owned Russian enterprises, there are some non-state owned businesses that are run for their shareholders. O'Key is a well-managed Russian retailer that had been dismissed because of general antipathy towards Russian companies.

In our view, this shows the benefit of a contrarian, bottom-up approach that looks beyond negative sentiment and focuses on finding undervalued companies wherever they may come from.

Attractive valuations

After several years of underperformance, emerging market equities are attractively valued on both absolute and relative perspectives (see figure 3). The question for investors is whether valuation is a strong signal to buy.

Emerging markets have been cheap for some time and this alone has not been the catalyst for a re-rating. The main reason for the recent underperformance, in our view, is the decline in profitability and earnings. However, we are starting to see signs that earnings are stabilising, particularly in Asia, where companies are benefiting from declining commodity/oil input costs. In addition, many Asian firms should be helped by the recovering US economy and a stronger US dollar, which should drive demand for their exports.

There will likely be more volatility ahead as the US raises interest rates. However, as long-term investors, we see volatility as an opportunity to take advantage of mispriced opportunities. From our point of view, as value-oriented investors, the preference for 'growth' stocks during recent periods of risk aversion has been challenging. We are confident though that, over the long term, a 'value' approach works in emerging markets. We remain focused on finding stocks on a bottom-up basis that will perform when investors start paying attention to fundamentals once again.

A real opportunity

We believe there is currently a real opportunity in emerging markets. They are the only asset class that has not re-rated over the past few years. Alongside the attractive valuations, we are excited about the multi-decade trend of improving corporate governance standards including the emergence of innovative, R&D-driven firms that are becoming globally competitive and companies that are implementing self-help measures to improve their performance. For selective, value-focused investors, we think now is an attractive time to take a closer look at emerging markets.

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Figure 3. Emerging markets look attractively valued

Source: Morgan Stanley, 31.03.15.

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