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FINDING "UNLOVED" VALUE IN EMERGING MARKETS

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The rally in emerging market (EM) equities over the past two years has been largely concentrated in a select group of new economy[1] stocks, mainly within the technology/internet and healthcare areas, as well as China A-share companies. Old economy stocks[2], however, have lagged the rally in emerging markets over the past two years.

Today we believe that there is real opportunity to be found in looking more closely at some of these forgotten old economy stocks that appear cheap relative to history and which have solid potential for a re-rating, or an expansion in valuations.

THE RETURN OF CAPEX?

Evidence of stronger management discipline is one factor underpinning our positive outlook. EM companies are generating substantially more free cash flow compared with previous years as management teams have begun paying more attention to spending and other capital allocation decisions. Profit margins have subsequently improved, giving us confidence that EM companies are positioned to deliver better earnings growth and shareholder returns.

Significantly, capital spending as a percentage of sales for EM companies has dropped to the lowest level in at least a decade (Figure 1). We believe that a resumption of capital spending after many lean years could spur job creation, loan growth, and wage increases in select emerging markets, which could drive valuations higher. Last year, 2017, saw a return of capital spending among new economy businesses. We believe that old economy companies will soon follow suit in 2018.

Consequently, one area that we like today is financials, where valuations are significantly below long-term average levels. Banks, for example, stand to benefit considerably from an expected upturn in borrowing/loan growth. A number of EM economies have undergone painful adjustments in recent years but we believe that the worst of the bad loans/bad credit cycle is now behind us.

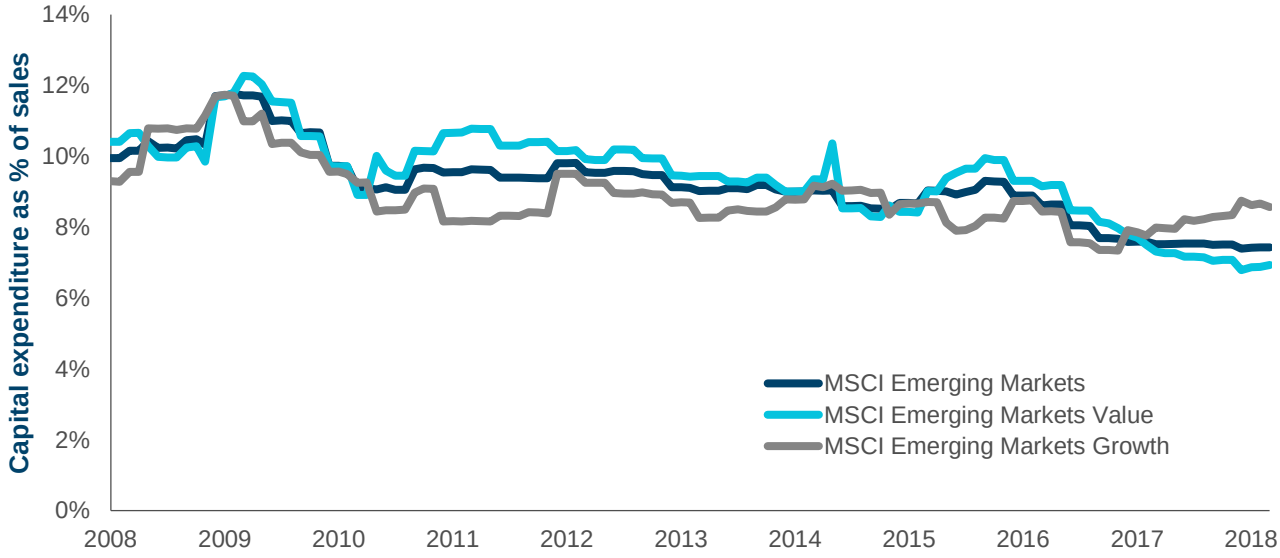
Within our portfolio, we own select South African financials, including Nedbank, the country's fourth largest lender, and financial services company Barclays Africa. We bought these companies in early 2017 when most investors were shunning South Africa. Both companies have strong balance sheets, both have made significant efforts to

[1] New Economy: Consumer Services, Auto, Internet, Tech Hardware, Pharma, Consumer Durable, Healthcare, Semiconductors.

[2] Old Economy: Real Estate, Construction Materials, Coal, Metal & Mining, Insurance, Household & Personal Products, Transport, Utilities, Conglomerates, Banks, Machinery, Food Beverage & Tobacco, Chemicals, Electrical Equipment, Diversified Finance, Construction & Engineering, Telecom, Oil & Gas..

Figure 1: **EM capital spending at lowest levels in more than a decade**

As at 31 March 2018



Source: FactSet.

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clean up bad debts and both pay a handsome dividend. The companies are leveraged to the country's macro recovery cycle, and have healthy exposure to continental Africa, a part of the world much neglected by investors, but a region where we see signs of solid recovery.

THE MUCH MALIGNED STATE-OWNED ENTERPRISES

Many of the state-owned enterprises (SOEs) in EM countries also represent good opportunities in our view. Generally speaking, global investors have a very negative view of these businesses, which we believe is perhaps coloured by a small group of bad companies. However, it is possible to uncover a number of good quality, but unloved, SOEs trading at cheap valuations.

In Russia, for example, Sberbank, owned by the Russian central bank, is widely regarded as one of the highest quality banks in the EM universe. The company has fallen out of favour with investors as several rounds of U.S. sanctions have weighed on Russia's headline GDP growth. However, domestic economic activity is stable and Russian companies' are paying healthier dividend yields thanks to a newfound focus on minority shareholders. In terms of the quality of the business and standards of governance, we believe it is every bit as well run and progressive as any other publically-owned business.

Brazil's state-owned oil giant Petrobras is another example. Having become embroiled in a major corruption scandal in 2014, the replacement interim government has since implemented wide ranging reforms, transforming it into a better run, more efficient and more accountable company. After a decade of consistently negative cash generation, Petrobras has generated positive free cash flows each year since 2015, irrespective of the movement in oil prices.

Meanwhile, it is perhaps among the Chinese SOEs that we are seeing the greatest change. Not only has Beijing cut excess industrial output, boosting profits for many SOE's, significant efforts are also being made to become more shareholder friendly, something that the majority of investors still do not seem to fully appreciate.

Emerging market equities experienced a trough in late 2015/early 2016, so we are roughly only two years into the market cycle. As a result, emerging market valuations remain generally reasonable, both compared to history and relative to developed markets.

Over recent years, we have seen an increasing number of large SOEs paying out special dividends, something very rarely seen in the past. Significantly, a number of Chinese SOEs are also reintroducing stock option incentive programs for management, having largely removed such incentives in 2009, and this is a positive moving forward.

LEVERAGED TO A RECOVERY IN REAL ECONOMIES

Given the economically sensitive nature of most value sector companies, a sustained recovery is often necessary to spark a turnaround in their prospects. While EM equities have performed strongly in the past two years, we have not seen a similar major recovery in the real economy of many EM countries. For example, Russia and Brazil experienced a deep recession in 2015 and 2016, and growth in both countries has remained in low single digits in recent years. Accordingly, building and construction activity in these countries, as well as India and South Africa remains very low versus history.

Even among the South East Asia (ASEAN) nations, considered the higher growth economies of Asia, construction remains depressed. Pre-sale volume of houses, for example, has declined for the past four years. We expect this situation to soon start to reverse and those areas leveraged to the recovery in these economies – and unloved by the wider investment community – offer exciting opportunities in our view. Accordingly, we currently own Posco Steel in Korea, Anhui Conch Cement in China, and Lafarge Holcim, the largest cement company in the world (which is listed in Switzerland but does most of its business is in Asia).

We believe that improved macro conditions, better corporate fundamentals and constructive valuations are likely to support the potential for EM outperformance in 2018. EM remains a fertile hunting ground for value opportunities, particularly as many investors continue to focus on quality-growth names and neglect the many misunderstood and undervalued companies in the EM space.

Key Risks - The following risks are materially relevant to the strategy highlighted in this material:

Transactions in securities denominated in foreign currencies are subject to fluctuations in exchange rates which may affect the value of an investment. Returns can be more volatile than other, more developed, markets due to changes in market, political and economic conditions. Investments are less liquid than those which trade on more established markets. The strategy has increased risk due to its ability to employ both growth and value approaches in pursuit of long-term capital appreciation.

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