



## DISCOVERING LOST WORLDS IN EMERGING MARKETS

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Incessant investor demand for exposure to new economy sectors – such as tech and healthcare – has driven valuations of many of the emerging world’s high growth companies to historical highs. Investors have ignored traditional value sectors – such as banks, insurance companies and industrials – despite rapidly improving free cash flow. The divergence of valuations between new and old economy stocks is now at the widest levels in the last 20 years.

In some sense, this demand is not surprising, since emerging markets (EM) tend to be associated with high growth. Yet, for Value investors, this has created many areas that are being overlooked or forgotten.

Emerging markets represent more than half the world’s population, accounting for over half of global economic growth since the 2008 financial crisis. Investors have been broadly sceptical of emerging markets, however, and have tended to concentrate their exposure within a limited group of high-quality growth companies. This has left a large part of the EM opportunity set ignored. Importantly, many of these companies continue to deliver decent growth, and valuations have remained relatively inexpensive. Against this backdrop, I believe a disciplined, bottom-up framework, aimed at identifying “forgotten” stocks or those that have been overlooked by investors, but which are fundamentally sound and have potential rerating catalysts, should be applied.

I remain constructive on EM as they are still only in the early to middle stages of the recovery cycle since the trough of 2016. Improving macro conditions and better corporate fundamentals, supported by more reasonable valuations, should help to boost market levels. The improved capital discipline of governments and companies in these markets only reinforces my view. After years of reckless spending, EM companies have shown restraint and shifted their focus to better capital allocation and cash flow generation.

### **DIFFERENT RULES FOR EMERGING MARKETS**

Simply buying cheap stocks and waiting for mean reversion is a flawed approach in EM. EM stocks can stay cheap for a protracted period. Without a deep understanding of a company’s execution track record and the resources to identify catalysts that could cause a stock to rerate, it is easy to be lured into these names. In EM, opaque ownership structures, weaker governance, and a prevalence of family- and government-owned companies, are all factors that can conspire to keep cheap stocks cheap for an inordinate amount of time.

Liquidity is also an important parameter in selecting “forgotten” stocks that are poised for fundamental change, hence, we focus more on liquid mid-cap stocks and avoid very small-cap stocks where the lack of liquidity poses a challenge and a potential risk.

## POSITIVE OUTLOOK FOR CHINA

Within Asia, China's economic transformation story remains a key positive. The government has put in place tangible reforms, and the continuation of policy credibility is positive for China in the near term. China will forge ahead with reforms while seeking to expand the economy at more sustainable levels. Although investors tend to have a negative view of state-owned enterprises (SOEs), these businesses represent good opportunities, especially those with successful reform stories.

The protracted trade dispute between China and the US, the increase in US interest rates and the strength of the US dollar have weakened sentiment but have not retracted most emerging markets from their recovery path.

As many investors continue to focus on high growth stocks and neglect the many misunderstood and undervalued companies, I believe emerging markets offer exceptional value investment opportunities.

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