# Annual Commentary: Emerging Markets

**December 2014**

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| | 2014 | | | Annualised Returns | |
|---|---|---|---|---|---|
| **Index (Total Return) % change in US$** | **Dec** | **Q4** | **12 Months** | **3 Years** | **5 Years** |
| MSCI EM | (4.6) | (4.4) | (1.8) | 4.4 | 2.1 |
| MSCI EM Latin America | (9.1) | (13.4) | (12.0) | (5.9) | (5.0) |
| MSCI EM Asia | (1.8) | (0.2) | 5.3 | 9.3 | 5.2 |
| MSCI EM EMEA | (9.8) | (10.1) | (14.7) | (0.1) | (0.3) |
| MSCI World | (1.6) | 1.1 | 5.5 | 16.1 | 10.8 |

| Ten Year Government Bond Yields (%) | Dec 2014 | Sep 2014 | Dec 2013 | Dec 2012 | Dec 2011 | Dec 2010 | Dec 2009 | Dec 2008 |
|---|---|---|---|---|---|---|---|---|
| US$ | 2.17 | 2.49 | 3.03 | 1.76 | 1.88 | 3.30 | 3.84 | 2.21 |
| £ | 1.76 | 2.43 | 3.02 | 1.83 | 1.98 | 3.40 | 4.02 | 3.02 |
| Yen | 0.33 | 0.53 | 0.74 | 0.79 | 0.99 | 1.13 | 1.30 | 1.17 |
| € | 0.54 | 0.95 | 1.93 | 1.32 | 1.83 | 2.96 | 3.39 | 2.95 |
| JPM EM Bond Index Global | 6.15 | 5.76 | 6.10 | 4.50 | 6.08 | 6.13 | 6.71 | 9.25 |
| EMBI Global sovereign spread | 4.04 | 3.34 | 3.27 | 2.66 | 4.26 | 2.89 | 2.94 | 7.24 |
| Gold Price (US$/oz) | 1,185 | 1,208 | 1,206 | 1,675 | 1,564 | 1,421 | 1,097 | 882 |
| Oil Price (Brent blend – US$/barrel) | 55.76 | 93.17 | 110.82 | 111.94 | 107.58 | 94.30 | 77.20 | 41.76 |

Emerging market economic and stockmarket performance in 2014 disappointed even the low expectations held at the beginning of the year. Growth downgrades were broad-based, with Russia, China, and Brazil recording significant downward revisions. Forecasts were reduced due to poor performance of exports to developed economies, the drag on commodity exporters from lower prices, supply bottlenecks (such as in Brazil) and the withdrawal of monetary or fiscal stimulus. Many of our intrinsic value estimates for portfolio companies were reduced over the course of the year, with common themes being weaker demand, stronger competition (including from new disruptors), higher taxes and lower pricing, particularly in the commodity space.

Lower commodity prices appear, on average, negative for developing countries with many affected by an adverse terms of trade shock. The same dynamics that inflated the US dollar value of GDP growth in the good years for commodity exporters now work in the opposite direction – lower export prices reduce growth and cause currency depreciation in real terms. Russia is the key example – more on the situation there below. Currency appreciation in emerging markets has been a meaningful contributor to portfolio returns (as measured in US dollars) in the decade to end-2012 but this has reversed over the past two years. In industrial commodity markets, 2014 saw the impact of strong supply (a result of the mining investment boom), coupled with increasing demand concerns particularly as Chinese macroeconomic indicators turned down; factors expressed most vividly in iron ore. In energy, the year was dominated by the momentous decision by Opec in late November to maintain production quotas, effectively placing US shale oil as the swing production source to balance the global market. The impact on the energy sector was material, in share prices and in terms of our intrinsic value estimates, given the impact on near-term cashflows, although our long-term oil price assumption remains unchanged.

In the resources sectors, we like companies with low cost producing and development assets, good governance, diversity of opportunity and an ownership culture that supports the objective allocation of risk capital. It is currently fashionable for companies to sell assets and return cash to shareholders but that seems too short-termist at a time of depressed sentiment and prices. **Tullow Oil** exemplifies the attributes we seek but nonetheless experienced a significant share price decline during 2014. Tullow is hard at work developing a major second project in Ghana, which should be complete in 2016, meaning that, in 2015, leverage will remain elevated. The balance sheet was not as comfortable as we thought but further material oil price declines notwithstanding, we are confident in their ability to reach completion with existing funding. Similarly in mining, both **Anglo American** and **First Quantum** are investing to develop new projects, and should be well positioned with volume growth irrespective of any pickup in metal and mineral prices.

2014 marked the fifth successive year of slower growth in **China**. The property sector, where new housing doubled over the five years to 2012, is now suffering from over-supply, especially in smaller cities. New housing starts are likely to have declined by over 10% last year, and the property sector comprises 15% of GDP. Meanwhile, credit has also decelerated, driven mainly by the central bank's efforts to scale back nonbank lending. The economic slowdown and liquidity tightening has exposed lenders to a corporate sector whose combined debt is 150% of GDP. To the credit of policymakers, who have kept overall liquidity at a healthy level and used targeted policy relaxation to alleviate stress in the more affected areas such as property and SMEs, the hard landing feared by many (including us) did not materialise. In addition, banks, regulators and the government have been working together to restructure defaulted trust loans to avert a system-wide credit problem. As the slowdown increased, the government increased spending and the central bank cut its benchmark interest rate in November.

During the year, the Chinese Communist Party continued to build political support for economic reform. Since a high-level decision in late 2013, key fiscal and financial reforms have been pushed through. Fiscal reform that allows local government to raise debt will reduce the burden on banks. The central bank and financial regulators further pushed ahead with interest rate liberalisation and financial market opening, and even the latest interest rate cut was accompanied by a relaxation of the regulated deposit rate ceiling. Key missing elements, such as state-owned enterprise reform, have also been piloted. To create space, the government has become more tolerant of slower growth, trying to strike the right balance between short-term stability and long-term efficiency. So far it has not announced a growth target for 2015, although the whispers are for 7% or below. Together with reforms like fiscalisation of local government debt, this should strengthen the banking system, but China's high debt means the economy remains inherently unstable, and the job of the government to maintain the appropriate pace of economic growth is not easy.

Within the portfolio, holdings in cyclical sectors, such as **China Merchants Bank**, **Anhui Conch Cement** and **China Overseas Land and Investment**, are industry leaders that stand to become stronger in a tougher environment. The portfolio does not hold large state-owned banks, which may benefit from the government's help to reduce potential bad loans from their books, because their inherent captive relationship with the government still concerns us. Performance of certain consumer companies, like **China Resources Enterprise** and **Tingyi**, has been affected by weak consumption and company-specific issues. On the other hand, we have continued to make progress in investing in A-share listed companies where the diversified opportunity set and inefficient pricing presents new opportunities. Through both new investment quota and price performance, the A-share weighting in the portfolio has increased to over 2% across five holdings.

While the stockmarket in **Russia** was almost flat last year in local currency terms, it was down almost half in US dollar terms. The rouble had enjoyed substantial real appreciation against the US dollar in the decade to the end of 2013 as Russia's terms of trade improved markedly, but then gave back much of that in a dramatic few weeks in late 2014. The central bank has worked hard to bolster confidence, by raising interest rates and using various regulatory measures to patch up banks' capital. We do not expect controls to prevent repatriation of capital; in fact the recent trend has been towards financial liberalisation, for example in allowing the free float of the rouble.

Much of the currency weakness relates to the fall in the oil price. Russia spends rather than saves its resource revenues, and therefore commodity price declines must, to a large degree, be counterbalanced by rouble depreciation. But on top of the oil price fall, the continued conflict in Ukraine and the Western sanctions are isolating Russia financially. In light of these challenges, we are certainly cautious, but not quite pessimistic. Our view is that self-interest on all sides will allow for a 'muddle through' scenario in the coming years. Looking forward, the need to adjust to a lower oil price hopefully could catalyse much-needed reform. We have stress-tested portfolio holdings for potential balance sheet problems and found little cause for concern. If companies have US dollar debt it is either long term or has US dollar earnings to match it. **Sberbank** is well funded by domestic deposits, and will emerge from this relatively stronger versus other local banks, although the expected GDP contraction (for two years probably) will have a negative impact on loan growth and asset quality. **Novatek** may experience some project finance-related delays for its liquefied natural gas subsidiary, but we see no spill-over stress to the parent's balance sheet. From the rational perspective of today, both of these businesses now are more attractive – due to massive share price declines – for our clients to hold than they were previously.

The relationship between companies and the state – the heart of many emerging market inefficiencies – has been thrown into stark relief in **South Korea** in 2014, with an acceleration of the redefinition of the role of the *chaebol* in society. *Chaebol* led the Korean export miracle, but have left an uncomfortable legacy, accused of using their economic might and low costs of capital to smother competition in the domestic economy, retaining the fruits of productivity growth rather than sharing with workers and allowing owners to extract a disproportionate share of the companies' value creation. The government has enacted a series of laws to make them more transparent, reduce family control and introduce more protection for minority shareholders. The most visible example is the Samsung group restructuring. The exact path of restructuring, and thus the full implication for portfolio holdings **Samsung Electronics** and **Samsung Fire & Marine** stumps smarter brains than ours, but on the positive side, family control will become more straightforward, the need for capital-inefficient cross holdings will be eliminated, and the path for higher dividends cleared, despite the interests of family and minorities in some group companies not being clearly aligned during the restructuring process.

This time last year we wrote that in a number of developing countries citizens were expressing dissatisfaction with inept and corrupt politicians, and that there would be opportunities at the ballot box to make changes. This duly happened in both India and Indonesia, where outsiders from beyond the traditional political elite were elected, but not Brazil, South Africa or Turkey, where the incumbents held on. Following the elections, both India and Indonesia took advantage of lower oil prices to reduce the quantum of fuel subsidies, an important reform we were looking for. In **India**, the new government has looked to streamline processes to expedite approval of investment projects, although critics claim at the cost of short-changing long-term environmental and social impact assessments. Meanwhile, economic growth remains muted at an estimated 5.3% for the fiscal year ending March 2015. Investment, as a percentage of GDP, is at an all-time low, and the debt-fuelled spending binge by Indian companies a few years ago has saddled the banking sector with non-performing assets estimated to be as high as 15% of total loans.

With low inflation, still-tight monetary policy (with room to ease) and hopes for a growth recovery, investor expectations are high as reflected in stockmarket valuations in India. Portfolio holdings contain a mix of competitive exporters, branded consumer franchises and two of the leading banks. **Sun Pharmaceutical** and **Lupin** have invested in new drug development for the US market, including several complex products that have seen large price increases due to exclusivity or shortages in the market. Despite the slowdown in the domestic banking industry, **Axis Bank** has managed to outgrow its peers and diversify its portfolio by increasing the proportion of retail loans. **Kotak Mahindra Bank** continues to deploy capital efficiently, most recently announcing the acquisition of ING Vysya Bank, which will allow Kotak to expand its presence in southern India. Both are well positioned to grow ahead of their peers through well-capitalised balance sheets, low-cost liability franchises and increased distribution reach in one of the most underpenetrated banking markets in the world.

In contrast, the presidential election in **Brazil** resulted in a narrow victory for the incumbent Dilma Rousseff. Subsequent events, including the nomination of a market-friendly economic team, have been dominated by a major corruption scandal involving Petrobras, the state-owned oil producer which is alleged to have been the subject of substantial misappropriations stretching back many years. Combined with what was already a modest economic outlook for 2015 (the government expects GDP growth of 1%), this episode caps, in our view, a period of increasingly populist management of the economy and of gradual but persistent erosion of several key institutions. Policies including directed subsidised credit via state banks, control of fuel and electricity prices plus moral suasion applied to investors in infrastructure to accept lower returns, have introduced erroneous price signals which serve to suppress investment. A material improvement in the outlook requires a reform agenda which is currently notable by its absence.

Despite a reduction in **Santander Brasil** (see below) and the poor returns of both the Brazilian currency and stockmarket during 2014, the portfolio ended the year with a higher exposure to Brazil than it began. The broad decline in prices created an opportunity to initiate four new positions (**Hypermarcas**, **Gerdau**, **Linx** and **OdontoPrev**) and to add to existing holdings. Although in disparate industries (pharma, steel, technology and health care) the common threads of the new holdings are growth and quality.

Portfolio turnover was 20% in 2014, in line with the long-term average. The two largest individual purchases were both banks: **Credicorp** (Peru) and **KBank** (Thailand). Both are quality operators: Credicorp offers growth due to low banking penetration in Peru while KBank is attractive because of its potential fee growth and rising margins. Banks represent almost a quarter of the portfolio and the net effect of 2014's trading activity in the sector was a small increase. A tender offer from the parent company of **Santander Brasil** led to a large sale there. We were disappointed with this move, seeing it as opportunistic and highlighting a lack of commitment by Santander to minority investors in their overseas subsidiaries (their opinion of course differs – in that they have confidence in the business whereas the market did not). We see signs that the Santander Brasil franchise is gaining traction, as well as clear value, so have retained a meaningful position despite the lower trading liquidity implied in a reduced free float.

The overriding theme of portfolio activity during the year was profit-taking in India. Approximately 5% of the portfolio was sold from India, from various positions including the banks **Axis** and **Kotak Mahindra**, the pharmaceutical companies **Sun** and **Lupin**, **Infosys**, **Maruti Suzuki** and other smaller positions. This was partly offset by additions to Indian IT services firms, **Cognizant** and **TCS**. As well as Brazil, there were smaller net additions to Thailand, Peru, Turkey and Russia, the latter particularly towards the end of the year. Some assets were diverted away from Mexico through further sales of **América Móvil** and also Taiwan where **TSMC** was trimmed. We see a battle royal ahead in the semiconductor foundry business – Samsung Electronics and Intel are threatening TSMC's dominance but TSMC is confident that in a hyperactive digital appliances world, customers will focus on reliability and technology leadership from TSMC rather than price. The net result of trading in China was little overall change to exposure as sales in the technology companies **Baidu** and **Tencent**, along with **China Mobile** and **China Life Insurance**, helped fund a number of new holdings including **AIA** and **WH Group**, plus the A-share holdings of **Gree** and **Kweichow Moutai**.

Our composite client portfolio retreated by 1.4% in 2014, marginally ahead of the MSCI EM Index. Many of the successful markets in the EM universe were in Asia, with India, Indonesia and the Philippines each rising around 25% in US dollars, with Thailand close behind. After being one of the weakest markets in 2013, Turkey recovered, gaining 19%, but performance was gloomy elsewhere in eastern Europe led by the Russian weakness. Other notable underperforming markets this year were the Latin American duo of Brazil (down 14%) and Mexico (down 9%) while South Korea lost 11%. China, South Africa and Taiwan all posted positive single-digit returns.

Looking at the portfolio, India topped the list of country contributors to relative portfolio return for the second consecutive year. Most holdings outperformed the strong local market, supplementing the portfolio's overweight position. Seven of the ten largest contributors to the portfolio return came from India, with **Axis Bank**, **Kotak Mahindra**, **Sun Pharmaceutical** and **Lupin** leading the way. Other sizeable contributors included banks in Thailand (**KBank**, **Siam Commercial** and **TMB**) and Turkey (**Garanti** and **Yapi Kredi**), Saudi food producer **Almarai** and the largest holding in the portfolio, **TSMC**. Russian companies and those from the energy and mining sectors dominated the detractors, especially **Tullow Oil**, **Sberbank** and **Novatek**. A few Chinese consumer names also significantly underperformed including **China Resources Enterprise**, **Li Ning** and **Wumart Stores**. Value was added through stock performance in Brazil and South Korea whilst the portfolio's overweight position in the strong Thai market also contributed. Losses were incurred in China and Russia, both from stock performance and relative weighting, while the portfolio's Nigerian holdings suffered towards the end of the year following the oil price decline.

At year end, India had the largest portfolio exposure in country terms at 14%, growing 100 basis points during the year despite significant sales. Thailand's country weight increased by 200 basis points to 6%, while there were near 100 basis point increases in Brazil and Turkey. Among other large markets, China's portfolio weight remained at 14%, South Africa's fell from 12% to 11% and Mexico's from 5% to 4% but the largest downward shift was in Russia (8% to 5%). Sector weightings saw increases to the banks and consumer sectors (both to 22%), technology remained at 17%, while materials fell slightly to 15% and energy by 3% to 4%.

Some portions of the portfolio still seem relatively expensive (e.g. India, Thailand, health care and many consumer companies), but others are trading on much lower multiples, such as Russia, Nigeria and banks, with notable upside still present in the resources holdings. In July we described how we reduced the hurdle rate used in our models of companies' future cashflows to 8% real, from 10%. This was an attempt to adjust to what we saw as a new reality of lower levels of profitability in certain industries (due to factors like higher competition, taxes and regulatory pressure), higher penetration of basic goods and services than ten years ago and hence a slower demand environment, commodity prices which should in general fade to lower long-term equilibrium levels, and strong share price performance and hence rich valuations in certain industries, for example consumer staples. Much of this came to pass last year, often in dramatic and abrupt fashion. We are also very much alive to the threats and opportunities posed by new disruptive business models, especially after a year marked by the spectacular Alibaba IPO. We reiterate our confidence in the quality and integrity of the companies in client portfolios and at current prices the expected annual return of the portfolio remains in double digits in US dollar terms. We expect earnings growth this year to be approximately 10%, although if our readers give little credibility to our short-term forecasting, we completely understand, given that is precisely what we said last year and the likely result will be a small decline.



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