# M&G Global Emerging Markets Fund

## Opportunities in adversity

February 2014

Fund Manager – Matthew Vaight

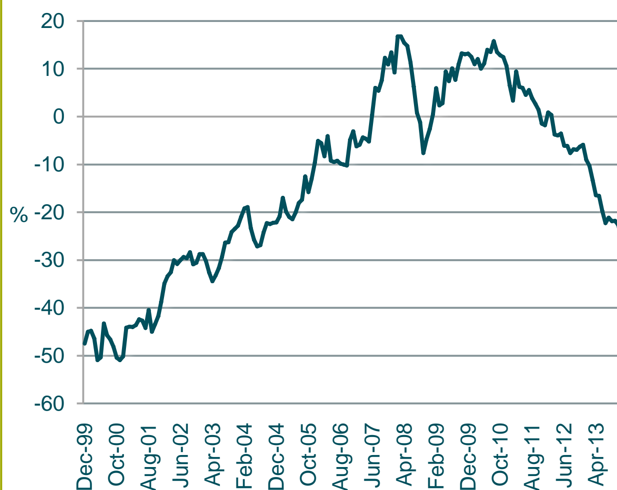
*Investor sentiment towards emerging markets is too pessimistic, argues Matthew Vaight. At a recent conference, he shared his thoughts on why despite the likely volatility ahead, for patient active investors there are still attractively valued opportunities to be found.*

Emerging market equities have fallen out of favour. Last year they trailed their developed market counterparts by 30%. However, a closer look at what drove the major equity regions reveals that performance was not always reflective of fundamentals. Take the US stockmarket, for example. Last year's performance was actually driven primarily by the expansion of multiples. It was a similar picture in Europe. Performance was not driven by earnings.

On the other hand, emerging market companies derated despite not dissimilar earnings. In Asia, earnings expectations actually rose and dividend payouts were also healthy. By focusing on the macroeconomic risks such as the slowdown in China, investors have arguably overlooked the good work many companies were doing for their shareholders.

Sentiment, rather than fundamentals, has been the primary force behind equity market moves recently. Emerging markets are now trading at a 30% discount to developed markets, the biggest discount since 2005 (see chart below). As contrarian value investors, this strikes us as an interesting situation.

**Valuations: Emerging markets relative to developed markets**




*Source: Citi Research, 31 December 2013*

However, we are pragmatic and realise that there is likely to be considerable market volatility ahead. For this reason, we try and construct a balanced portfolio with four different types of companies that should help the fund perform in different market conditions.

## Change for success

We believe two of the fund's four baskets – 'asset growth' and 'internal change' – will be particularly exciting areas to invest over the next few years. Emerging markets are changing: the old world of rapid growth is passing, rising labour costs have eroded companies' competitive advantage and margins are under pressure. We look for firms that have recognised the need to adapt. One of the ways that emerging market companies can maintain an edge in an increasingly competitive world is to embrace innovation and move up the value chain.

China and Korea are following a similar path to Japan. There is an increased focus on research and development, although in China it is growing from a low starting point. China now files more patents than the US and Japan. This investment in innovation and intellectual property is bearing fruit as world-class technology companies are starting to emerge. We consider Hollysys Automation Technologies to be a great example of this new breed of Chinese companies. Hollysys provides sophisticated control systems for nuclear plants and the high-speed railway network. Its advanced technology and the quality of its products mean it now competes with established multinational firms. Hollysys has been awarded the contracts to run the Hong Kong and Singapore metro systems, which we believe demonstrates the high level of confidence in its technology. There are not many of these sorts of cutting-edge companies in China at the moment, but the evidence suggests there will be more in future.

We are also seeing firms taking steps to improve their corporate performance, for instance, by changing their focus from growth to profitability. Korean carmaker Hyundai Motor has undergone a shift from being a

manufacturer of cheap vehicles to a quality car company with pricing power and a brand people want to own. It has improved operationally too and is now focused on utilisation, cashflows and profitability rather than market share. This is not to say that Hyundai is perfect; its corporate governance practices could be better. However, management is starting to talk about dividends and delivering returns to shareholders. We believe investors struggle to understand corporate change and the potential rewards it can deliver. In our view, they are underappreciating Hyundai's transformation and its share price should eventually reflect its fundamental value.

## Challenges for emerging markets

There are a number of headwinds facing emerging markets. One key issue is that the cost of capital is on the way up. In our view, the implied cost of capital in the ASEAN region is currently too low and there is a risk markets will derate as the cost of capital increases. In contrast, however, places like China, Korea and Russia are already pricing in a much higher cost of capital. In China, interest rates have to go up, which will make life difficult for the government and banks. Although Chinese banks appear cheap, we have concerns about them. They have grown their loan book and are highly levered. This situation means that a small amount of non-performing loans (NPLs) could hit profitability. We have learned that buying banks too early in the cycle can be painful; it is better to buy when NPLs are falling.

The current economic difficulties faced by many countries could well lead to reforms. Brazil, India and Turkey are all holding general elections this year, which could be catalysts for change. Typically when the economic environment is weak politicians will campaign on a pro-reform manifesto. These economies do need reforms. India's stockmarket has done very well lately in anticipation of a new government. If you look at Europe last year, investors did not need to see much improvement before they started buying shares again.

Although we consider valuations in emerging markets to be attractive, value does not necessarily mean markets will rerate this year. China is arguably the biggest tail risk. Investor sentiment is so negative about its prospects that if we see some reforms and market-friendly policies, the stockmarket could well perform.

## Valuation perspectives

As to which particular regions look attractive, we find emerging Europe tricky as there are not many listed companies. Russia is starting to look interesting though. It is a two-tier market with state-owned companies that are typically much cheaper than other stocks. Recently though, cyclical businesses such as oil companies have done well, while the more expensive consumer-related retailers and media companies have derated slightly. As valuations of non-state owned firms fall, our enthusiasm for the market increases. Turkey is having a difficult time, economically and politically, and we are waiting to see what opportunities arise.

In our view, investors frequently overreact to geopolitical risks such as the recent tension between China and Japan. However, in the long term, we do not think that they have much effect. Last year, we established a position in Dongfeng Motor, a Chinese car maker which has joint ventures with Honda and Nissan. It was out of favour as demand for Japanese cars in China had declined. We invested in Dongfeng as it is a profitable company and its shares were very cheap – they have subsequently recovered. Human psychology tends to look at the downside risks and over-discount them. As long-term investors, we are able to take advantage of these opportunities.

## Be active

While the headlines about emerging markets are full of gloom, our current view is that emerging market companies offer considerable value. The huge dispersion of valuations across sectors and markets presents abundant opportunities for careful, active stockpickers. Given the potential headwinds, what matters is having a disciplined process that can withstand volatility and perform in different market conditions. We believe our active, value-focused approach should be able to identify numerous attractively valued companies across the investment universe.

**M&G**
**February 2014**

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