Rocaton

INSIGHTS

Emerging Markets: *Compelling Long-Term Value or Value Trap?*

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EXECUTIVE SUMMARY

* Emerging market asset classes, primarily equities and local currency debt, have declined significantly in 2015 and have struggled to keep pace with developed market assets for much of the last five years.
* Almost all investors have exposure to emerging markets either directly or indirectly. Many companies are global multinationals that derive an increasing percentage of their revenues and earnings from emerging economies.
* There are significant risks and opportunities in emerging markets resulting in the potential for a wide range of outcomes.
* Attractive valuations in portions of emerging equity markets are somewhat dampened by a challenging macro backdrop. In particular, the global economy is slowing and political and economic reforms have been slow to arrive in many countries.
* The likely change in U.S. interest rate policy presents additional challenges for emerging markets over the near term.
* Declining emerging markets currencies are largely responsible for the poor performance in emerging markets. Weaker currencies should improve competitiveness for many emerging market entities, but may also create an asset/liability mismatch.
* Recent commodity price declines are a significant positive for a majority (based on market capitalization) of emerging economies which are net commodity importers, but falling commodity prices are a significant drag for countries such as Brazil, Russia, Indonesia and South Africa.
* We believe investors need to take a long-term view in order to initiate or maintain an existing investment in emerging market equity or local currency debt. An investor's decision to have dedicated exposures to emerging markets should be conditioned on the investor's ability to tolerate the associated volatility of the allocation.
* We believe that actively managed strategies are the best way to invest in emerging markets as benchmarks in these asset classes are often flawed. Further, inefficient information flow, capital controls, and dispersion across the individual markets provide a robust opportunity set for skilled active managers to add value.
* Sizing of emerging allocations is a critical consideration given the level of volatility these markets can experience.
* For investors with an appropriate long-term outlook, now may be an appealing time to allocate to emerging markets.

Introduction

During a strong bull market in which nearly all asset classes have risen in price, there has been one noticeable outlier: emerging markets. Following the global financial crisis, emerging markets appeared to be an attractive investment as these countries were, by many measures, in better fiscal health relative to the developed world. However, the experience for investors allocating to emerging markets, particularly equities and local currency debt, has been anything but satisfying and the recent sell-off has created even more questions. Many investors are now struggling with determining whether the recent sell-off represents a buying opportunity or if it is a sign that further declines are in store for emerging markets. The balance of this paper will attempt to address this issue by presenting the case for and against emerging markets.

Background on emerging markets

As we have noted, performance for emerging markets for much of the last five years has been underwhelming. Emerging market equities, in U.S. dollar terms, are down 2.5% annualized over the recent five-year period, driven in part by a 14% decline over the trailing 12 months. The selloff in emerging market equities has been driven by expectations for slower growth by emerging economies and by currency declines relative to the U.S. dollar. Notably, local share prices are slightly positive over the same five-year time period. This also explains why performance for local currency emerging debt has been similarly weak as the J.P. Morgan GBI-EM Index is down 3% annualized over the past five years. A bright spot in emerging markets has been hard currency emerging market debt, which has benefited from falling U.S. interest rates and investors' search for yield.

Figure 1: Performance of Emerging Markets as of October 31, 2015

Market	Index	Month	YTD	1 Year	2 Year	3 Year	5 Year
Hard Currency (U.S.$)	J.P. Morgan EMBI-GD	2.7%	2.7%	0.4%	4.4%	2.1%	4.9%
Local Currency Bonds	J.P. Morgan GBI-EM	4.5%	-11.1%	-17.4%	-10.4%	-7.5%	-2.9%
Corporate Bonds	J.P. Morgan CEMBI	3.1%	3.4%	-0.1%	3.4%	2.1%	4.6%
Equities (USD)	MSCI Emerging Markets	7.1%	-9.2%	-14.2%	-6.9%	-2.5%	-2.5%
Equities (Local Currency)	MSCI Emerging Markets	5.4%	-1.8%	-3.1%	1.3%	4.4%	2.7%
Developed Equities	MSCI World	8.0%	1.9%	2.3%	5.7%	12.2%	9.8%
U.S. Equities	S&P 500	8.4%	2.7%	5.2%	11.1%	16.2%	14.3%

Source: Bloomberg; Rocaton.

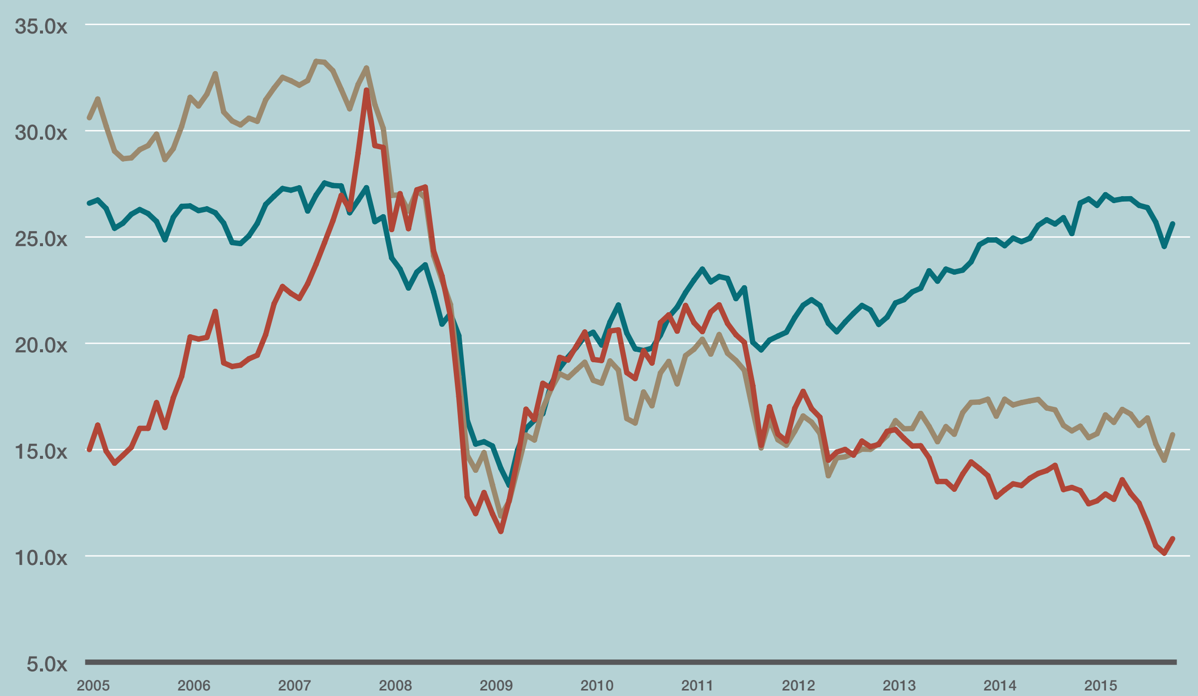
Performance for periods greater than one year is annualized.

Unfortunately, poor performance has impacted many investors as allocations to emerging markets have become a larger portion of investors' portfolios in recent years. Emerging equity and debt mutual fund assets increased to $313 billion at the end of September 2015, up from $117 billion at the start of 2007. More broadly, developed market companies are deriving a growing portion of revenues and earnings from emerging markets and are more exposed to economic activity and market volatility in the developing world. Especially in light of the greater role emerging markets have on portfolios today, we believe it is prudent for investors to review the role of emerging market allocations within their portfolio.

The case for emerging markets

Following recent price declines for emerging market asset classes, valuations might seem more attractive. Based on a cyclically adjusted price/earnings ("CAPE") measure, emerging markets are trading at 10.8x, below the median level of 17x and close to the lowest level on record dating back to the inception of the data series in 2005 (See Figure 2 below). To be fair, the data series' short history was recorded during the recent commodity super-cycle, which provided a meaningful tailwind to natural resource-intense emerging market countries. With that qualifier, the current valuation remains cheap relative to its own history and compared to developed markets counterparts.

Figure 2:
Cyclically Adjusted Price/Earnings Ratios since 2005



Legend:

- Emerging (MSCI EM)
- Non-U.S. Developed (MSCI EAFE)
- U.S. (S&P 500)

Sources: Rocaton; Standard & Poors.

Based on monthly observations through October 31, 2015.

On a long-term basis, many investors would argue that the primary reason for investing in emerging markets is the superior long-term growth expectations relative to developed economies. However, strong economic growth is not necessarily correlated with higher stock market returns[1], rather it is economies that grow faster than expectations that generally outpace those that grow slower than expectations. Investors who are bullish on emerging markets should invest on the basis that emerging market economies will grow faster than their current expectations. Beyond the growth story, there are a number of reasons to be bullish on emerging markets.

1 Numerous studies have shown that there is in fact a negative correlation between economic growth and equity market returns. A recent and often-cited study by Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School draws similar conclusions.

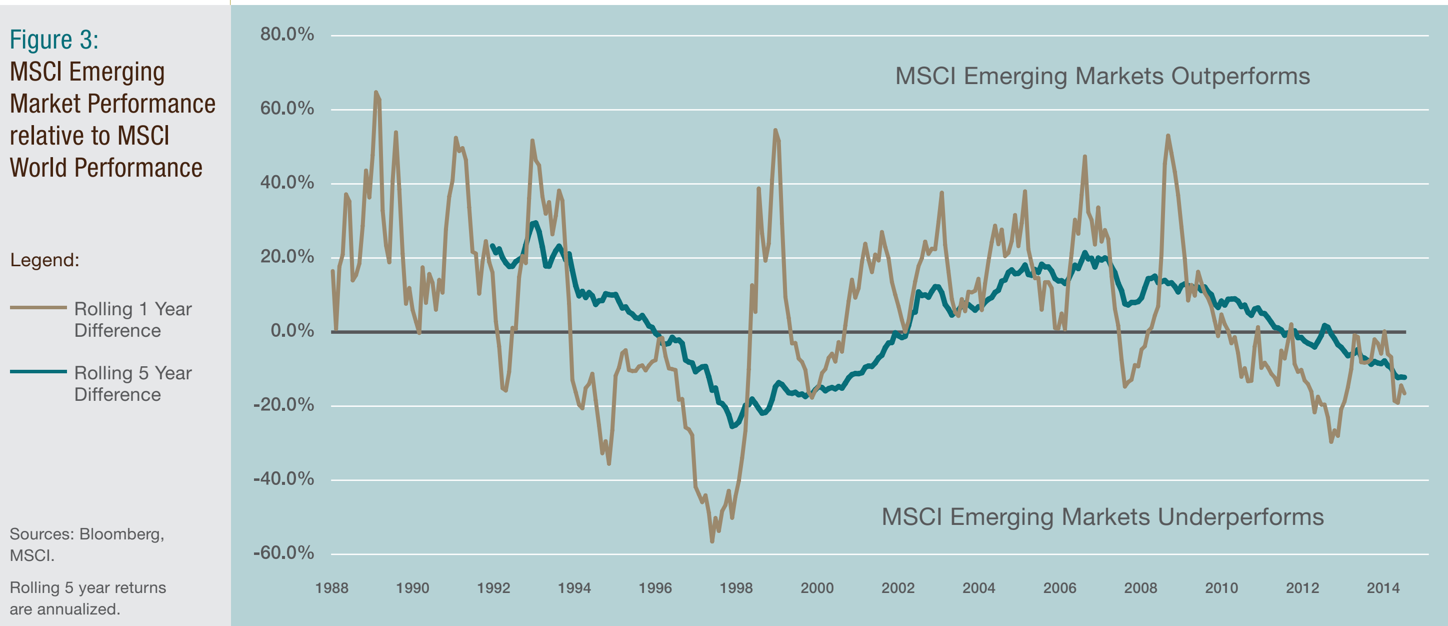
Falling currencies, which have been an enormous drag on emerging market performance, should ultimately help in the long run. Currency devaluations should be self-correcting as countries with falling currencies become more competitive; conversely, those with appreciating currencies should become less competitive. Note that further currency depreciation is possible as the Federal Reserve prepares to raise interest rates and many emerging market countries continue to ease monetary policy. However, it is hard to imagine that the divergence between the U.S. and other countries will continue indefinitely, particularly as U.S. companies increasingly rely on emerging markets to drive revenue and earnings growth. For investors in the emerging markets, it is difficult to know which catalysts will potentially unlock the value. Factors that could spark a turnaround include stronger export growth which should be aided by weaker emerging currencies, a continued recovery in Europe and Japan, structural reforms, stability in Chinese economic growth and improved investor sentiment.

On an individual country basis, there are several countries with more positive fundamental backdrops, including Mexico and India, although market expectations may have already priced-in a better fundamental backdrop for these countries. Mexico has become more competitive relative to the rest of the world due to a combination of a weaker currency and lower wage growth rates. Low natural gas prices also provide an advantage because Mexico has the ability to import cheap U.S. natural gas and the ability to develop its own shale reserves. This should create an additional layer of competitiveness for Mexican manufacturing businesses as energy costs should be lower relative to other parts of the world. The country has also made a number of reforms, including opening up the nation's energy industry to private capital. In India, the labor force remains extremely competitive, the private sector has low levels of indebtedness and the currency has become cheaper. Lower commodity prices are also a benefit to India, given it is a net importer of oil and other commodities, and the Indian government is working on broad-based reforms that are designed to eliminate barriers to growth and promote investment.

The case against emerging markets

Although we have highlighted a number of reasons to be bullish on emerging markets, there are a similar number of reasons why investors might take a more cautious view. Perhaps the principal reasons why investors might want to avoid emerging markets are the uncertainty and volatility, which arguably have always been part of the equation for emerging markets. Emerging market equity indexes have experienced a number of significant corrections in the last two decades including a 56% decline during the Asian debt crisis, a 52% decline during the bursting of the U.S. tech bubble and a 65% decline during the global financial crisis. The recent 27% decline from April 28th to August 24th looks relatively modest compared to prior crisis periods. Aside from absolute declines, emerging markets can underperform developed markets for long periods of time, as they have done more recently. The figure on the next page displays the return differential between emerging and developed equity markets over rolling one- and five-year time periods. On a rolling five-year basis, emerging market equities underperformed developed equities for more than six years in the late 1990's and early 2000's. More recently, emerging equities have underperformed developed equities on a rolling five-year basis for less than two years.

Figure 3:
MSCI Emerging Market Performance relative to MSCI World Performance



Sources: Bloomberg, MSCI.

Rolling 5 year returns are annualized.

While improved competitiveness may be a benefit of falling currencies, an offsetting drawback is the fact that many emerging market companies and countries have borrowed in U.S. dollars, yet their revenues are denominated in local currencies[2]. This might compromise the ability of certain borrowers to service their U.S. dollar-denominated debt and could pose a significant challenge for many emerging market entities. Hard currency debt outstanding, for example, has risen meaningfully in the last decade at the corporate level. The International Monetary Fund estimates that corporate emerging market debt has increased to $18 trillion in 2014, up from $4 trillion in 2004. To be fair, the asset/liability mismatch we describe may not be as dire for some emerging market companies as part of the risk has probably been hedged. Beyond currency issues, there are a number of additional challenges for emerging markets including continued volatility from China, an interest rate hike from the Federal Reserve, global political uncertainty and further social unrest in the Middle East. Although some of these risks apply to emerging markets broadly, there is clearly a lack of homogeneity across developing countries.

As we have pointed out, there are a number of bright spots in the emerging markets, but there are also a number of countries with significant structural and fiscal challenges. Brazil tops the list of countries with fundamental challenges. Among the list of issues for Brazil is a rapidly weakening labor market, high levels of inventory in key industrial sectors, high domestic real interest rates, higher public tariffs and taxes, high levels of household indebtedness, soft commodity prices, political uncertainty, and depressed consumer and business confidence.

2 In the case of emerging market countries, revenues are primarily in the form of taxes.

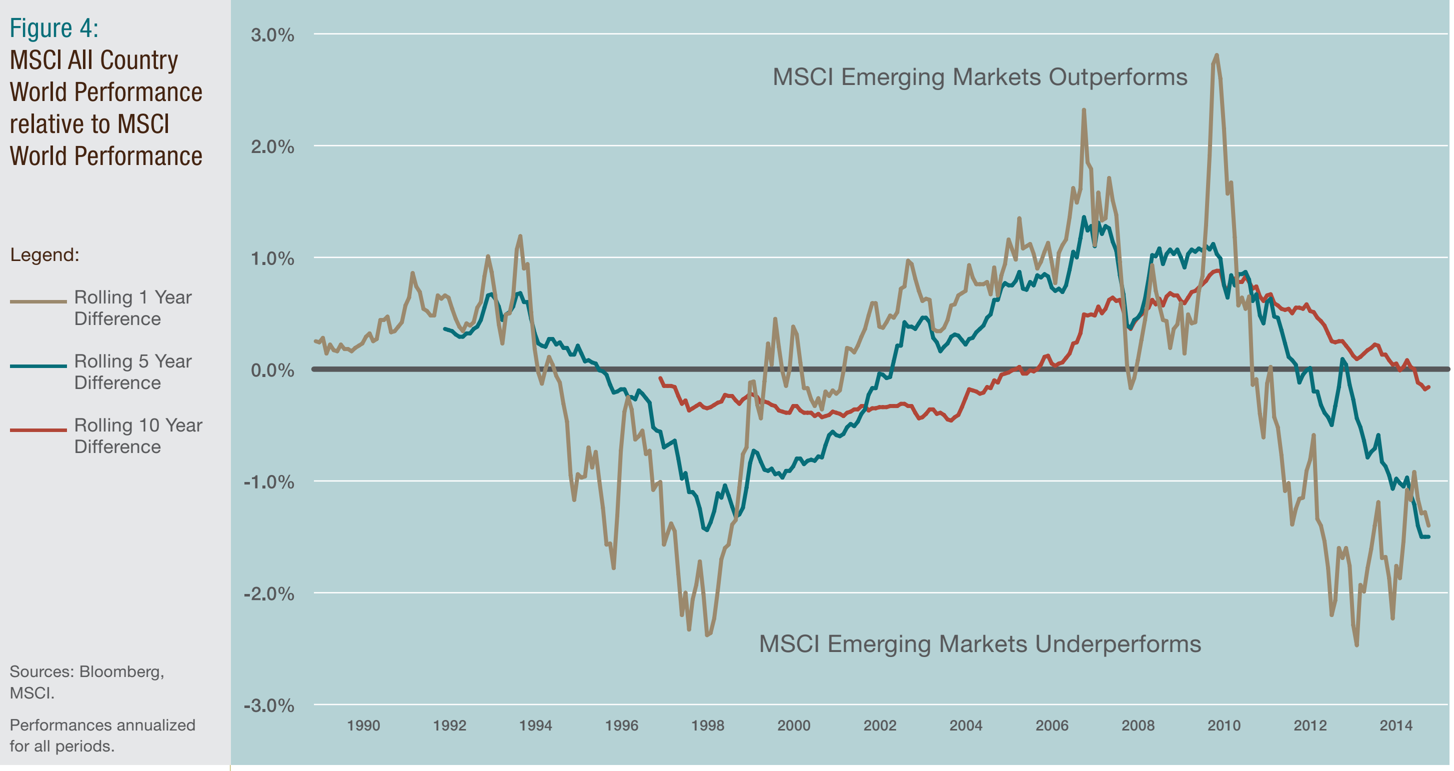
The country's currency appears to reflect many of these issues as the Brazilian real recently fell more than 35% to an all-time low relative to the U.S. dollar. Other emerging markets with a difficult outlook include Turkey, Russia, and Venezuela, of which the last two have been significantly impacted by falling oil prices. In the case of Russia, valuations may already reflect the current issues as the country's CAPE ratio was recently 5x. However, the Russian equity market is largely comprised of state-owned enterprises ("SOEs"). The government ownership component of an SOE can negatively impact the operational aspects of a company as government-owned companies might be influenced by a broader set of interests, beyond generating value for shareholders. The issues associated with government ownership typically lead to discounted valuations for SOEs relative to the rest of the publicly traded universe.

How should investors allocate to emerging markets?

As we have outlined, the outlook for emerging markets is far from certain. We believe that the decision to allocate to emerging markets today should be driven by an investor's timeframe and sensitivity to market volatility. Appropriate sizing of emerging market allocations is critical for those investors who determine that they want an allocation to emerging markets. For investors who are able to tolerate volatility and uncertainty, we believe now may be an attractive time to make a long-term investment in emerging markets.

Figure 4 demonstrates the need to take a long-term view when allocating to emerging markets. The chart shows that, over longer time horizons, the return differences between public equity exposures with and without emerging markets equity (e.g. MSCI ACWI and MSCI World) are much narrower than short time periods.

Figure 4:
MSCI All Country World Performance relative to MSCI World Performance



Sources: Bloomberg, MSCI.

Performances annualized for all periods.

If an investor chooses to maintain a dedicated exposure to emerging markets, we believe strategic allocations are appropriate for some investors given the difficulty of tactically allocating to emerging equity and debt strategies. We would, however, suggest investors review their emerging market allocations on a regular basis. Sizing the allocation appropriately is important in order for emerging allocations to have the desired return and risk impact at the total portfolio level. Investors who want some exposure to emerging markets without a dedicated exposure could consider global or broad non-U.S. strategies that include modest exposures to the emerging markets. Some ways for investors to get exposure other than dedicated broad-based strategies include:

1. *Emerging equity exposure through global or non-U.S. strategies:* Currently, approximately 21% of the MSCI ACWI ex U.S. Index is represented by emerging market countries.
2. *Emerging debt exposure from opportunistic fixed income strategies:* A number of opportunistic and/or unconstrained strategies have the latitude to invest in emerging markets, although investors should be aware that exposures can vary meaningfully among strategies and managers.
3. *Regionally based strategies:* While we have suggested that some regions and countries in the emerging markets are more attractive (e.g. Mexico, India), there are relatively few regionally based strategies available to institutional investors.

Global exposure to emerging equity and debt appears to be the most appropriate solution. Should regionally-based (e.g. Latin America, Asia, Europe) or other viable emerging market strategies gain traction, we would likely revisit the potential for allocating to emerging markets in a more targeted way.

Importantly, we believe that actively managed strategies across both debt and equity are the best way to invest in emerging markets which often have inefficient information flow, capital controls and dispersion across the individual markets. These dynamics provide a robust opportunity set for skilled active managers to add value. In the case of fixed income, passive exposure is generally not an option for investors. Flaws with emerging market benchmarks also contribute to the case for active management. In the equity arena, the MSCI Emerging Markets Index has a 69% weight in the top five countries, including a 24% weight to China. The broad emerging equity index also has an approximately 30% allocation to SOEs which, as we described earlier, may not always operate in the best interest of shareholders. Emerging market debt indices are faced with similar issues. The J.P. Morgan EMBI Global Index may appear to be diversified with exposure to 63 emerging market countries, but 38 of those countries have a less than 1% weight in the index and the top 5 countries represent 40%. Local currency emerging market debt, as proxied by the J.P. Morgan GBI-EM Global Index, is no different as the index is comprised of just 16 countries and a 63% weight to the top five countries. Finally, beyond implementing via a dedicated, actively managed exposure, investors should rebalance these allocations with some regularity (either quarterly or semi-annually, at a minimum).

Figure 5:
How Should Investors Allocate to Emerging Markets?

Approach	Rocaton View	Rationale
Investor Objective	**Growth** / Capital Preservation	Emerging markets may not be appropriate for capital preservation investors given the potential for volatility
Time Horizon	**Long-term** / Short-term	Emerging market investors must have a long time horizon given the potential for long periods of underperformance
Allocation	**Strategic** / Tactical	Tactically allocating to emerging markets is difficult to do and there are few consistent records of success
Location	**Broad** / Regional	There is limited product availability of regionally based strategies
Manager Style	**Active** / Passive	A number of inefficiencies exist in the emerging markets, including flaws in benchmark construction

Conclusion

The experience for any investor with an allocation to emerging markets has been disappointing over the last five years. Despite valuations that are at record low levels, it is difficult to know if and when prices will rebound. If economic growth does not rebound in emerging markets, and market fundamentals worsen, today's valuations may not prove to be cheap. This uncertainty creates a challenge for investors who do not have a long-term time horizon or who cannot tolerate the volatility inherent in emerging markets. However, for investors with an appropriate long-term outlook, now may be an appealing time to allocate to emerging markets. In an environment where bond yields are close to all-time lows and developed equity market valuations are at elevated levels, we believe emerging markets stand out as an attractive asset class.

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