Market Insights

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Emerging Markets Go Micro: EM Investing Amid Inflation and Margin Issues

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Executive Summary

Despite recent political instability in North Africa and the Middle East and the uncertainty about its ultimate impact on global markets, we remain long-term bulls on both emerging and frontier markets. However, we cannot overlook the major differences in the current market cycle relative to previous cycles, and the strong possibility that we are entering a more discriminating investment climate. First and foremost, many key emerging markets are exhibiting mid-cycle characteristics; while more tepid, developed market recoveries continue to show early-cycle behavior. This dichotomy is highly unusual, although not necessarily unexpected, given the dislocations that resulted from the financial crisis. Although emerging markets enjoyed massive fund flows in 2009 and 2010, they had lost their performance advantage by early 2011. In addition to recent events in one of the more volatile parts of the world, we see this trend as a direct result of cyclical issues in key emerging markets — specifically higher inflation, rising interest rates, vulnerable profit margins and a potential for price and capital controls.

We believe the risk trade of 2009 and 2010 has given way to a more selective approach in emerging market equities. As we have seen, good economic growth does not necessarily correspond to a good stock market; consider the strong growth but relatively weaker stock returns in China and Brazil in 2010. In China, we believe this is somewhat related to the preponderance of state-owned companies that are at the behest of government officials, not minority shareholders. But we believe the disappointing performance of these markets also illustrates how emerging markets have gone from macro-driven to micro-driven, putting a premium on individual stock selection and a deep understanding of key differences within the asset class. Despite continued investment flows, the MSCI Emerging Markets Index outperformed the S&P 500 Index only modestly in 2010, while developed markets have strongly outperformed emerging markets in the first three months of 2011. Of course, three months does not constitute a trend, and it would be inappropriate at this juncture to speculate that emerging markets will necessarily underperform for the full year. However, it is clear to us that many emerging markets are experiencing distinct challenges that may have a strong impact on individual company performance.

Across many emerging countries, one of the most visible and potentially problematic issues is food inflation. Groceries represent about 8% of the average American's wages; in emerging and frontier countries, food can represent one-third of wages or more.

Inflation & Peak Margins: Food For Thought

Another year of 10%-plus economic growth in China in 2010[1] brought with it inflationary fears, tighter monetary policies and highly publicized wage disputes. Inflation in India surged to mid-teen levels, as drought conditions depleted food supplies and robust demand supported consumer real estate sales. In Brazil, enthusiasm about the 2016 Olympics was accompanied by wage, real estate and food inflation.

Across many emerging countries, one of the most visible and potentially problematic issues is food inflation. Groceries represent about 8% of the average American's wages; in emerging and frontier countries, food can represent one-third of wages or more. We believe food inflation may be playing a bigger role in the recent anti-government uprisings than the public or media may realize. From an economic perspective, many companies have come to rely on emerging market consumption in the wake of anemic developed market demand could be stifled if higher costs and interest rates curb the spending habits of the emerging consumer.

Margin Sustainability and Valuation: The Old Drivers Are Back

Relatively high profit margins and inflationary inputs have placed pressure on companies globally. However, the problem may be more severe in emerging markets, where valuations in some cases do not necessarily reflect these pressures. Another important difference between developed and emerging market economic policy is that governments in emerging markets have been known to take the sting out of inflation with price subsidies, export tariffs and, in extreme cases, price controls. We believe the inability to pass along the high cost of commodities and other inputs, with or without government involvement, will ultimately put a premium on margin sustainability.

This is where we believe individual stock selection may become increasingly important as we assess investment opportunities. While China, India and Brazil are struggling with inflation, the issue appears to be under control in Korea, Taiwan and South Africa. The latter group represents countries with well-developed economies and consumer classes, strong financial institutions, relative political stability and strong corporate governance in South Africa's case. Many of the country's biggest and best companies have multi-national operations, strong management teams, and attractive valuations.

1 International Monetary Fund.

We believe it is essential to understand that many frontier markets lack liquidity and very often have a limited number of stocks available for investment. The frontier market asset class, as a whole, is highly concentrated in terms of countries and sectors, which increases their risk.

For us, the bottom line is to build a portfolio of the most compelling companies in emerging markets, not based on the macro cycle or latest trend. By contrast, we believe that simply buying an ETF, for instance, might expose investors to index concentration, whether in individual names or industries, and might eliminate a wealth of stocks more exposed to local country dynamics. Many of these stocks are issued by smaller, more nimble companies that are strategically positioned to tap the next phase of emerging market expansion, which we believe is tied to the developing middle class.

On the Frontier: We're Already There

As some emerging markets continue to "emerge" and some, on a relative basis, behave more like developed markets, we see investors in search of higher-risk and potentially higher returns drawn to "frontier" markets. Not surprisingly they want to find and profit from the "next" China, India or Brazil. MSCI has a Frontier Markets Index (see Exhibit 1). These markets stretch around the world, with both rich and poor constituents, including members of the Gulf Cooperation Council, Vietnam and Argentina. But as we learned during the Asian currency crisis in 1997, and during the fall of commodity prices in 2008 and its impact on oil-exporting nations, frontier markets do not always follow larger macro-economic trends. This lesson has been illustrated by MSCI Frontier Markets Index members such as Tunisia, Bahrain and other members of the Gulf Cooperation Council. The ultimate conclusion to their unrest will have a large impact on how frontier markets as a group progress.

Within frontier markets are companies that we believe are able to provide a degree of comfort regarding the risk/return tradeoff, and that can pass our tests for valuation, growth prospects, transparency, business forecasts and quality of management. We believe it is essential to understand that many frontier markets lack liquidity and very often have a limited number of stocks available for investment. The frontier market asset class, as a whole, is highly concentrated in terms of countries and sectors, which increases their risk. As a result, we believe that individual stock selection within a diversified global emerging markets strategy is the most prudent way to gain access to these markets.

We do not believe that value sacrifices growth. On the contrary, we believe long-term growth should have a more meaningful impact on value stock performance due to the base effect.

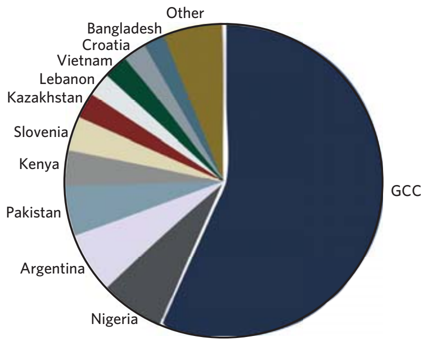
Exhibit 1 – Frontier Markets Index

The Geography of Frontier Markets

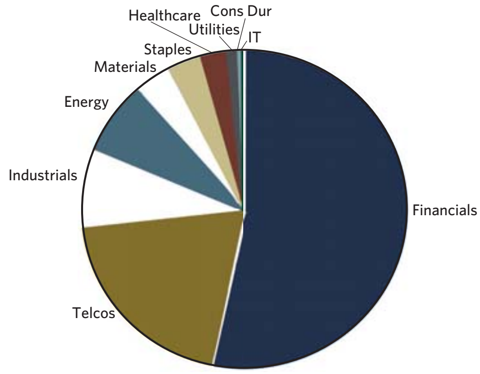
Argentina	Oman
Bahrain	Pakistan
Bangladesh	Qatar
Bulgaria	Romania
Croatia	Serbia
Estonia	Slovenia
Jordan	Sri Lanka
Kazakhstan	Trinidad and Tobago
Kenya	Tunisia
Kuwait	UAE
Lebanon	Ukraine
Lithuania	Vietnam
Mauritius	
Nigeria	

Source: Datastream, MSCI, UBS, as of March 2011

Country Weights in MSCI Frontier Index



Sector Weights in MSCI Frontier Index

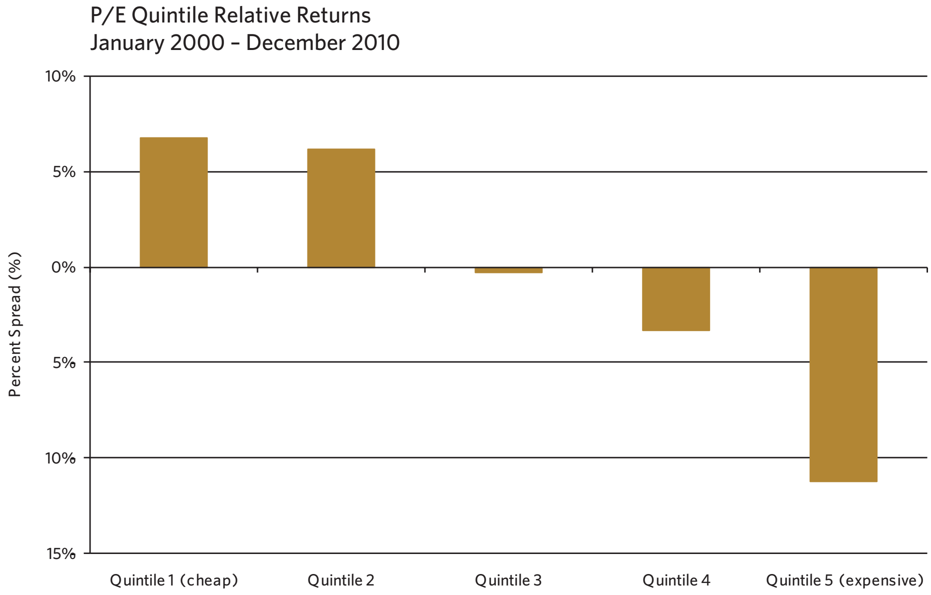


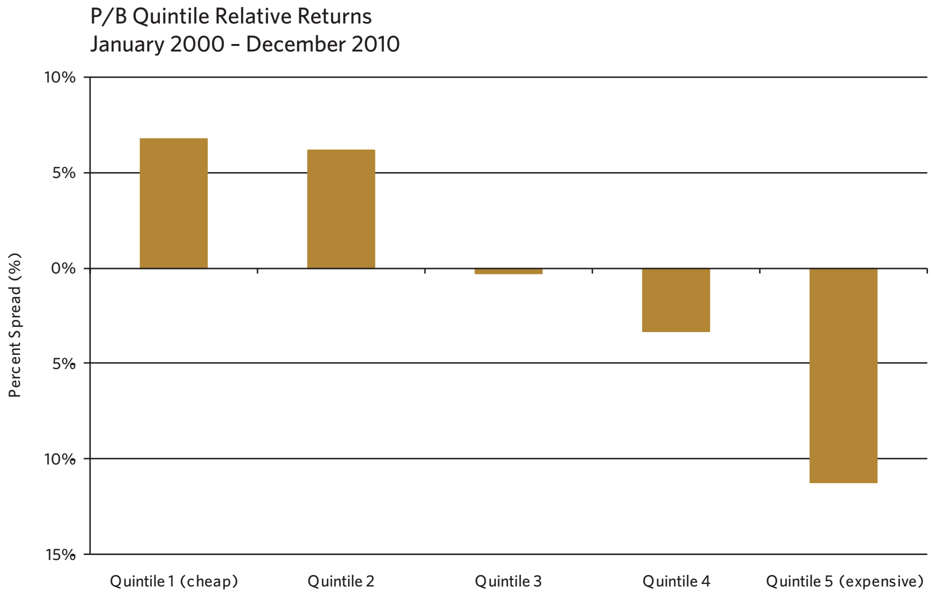
Source: Bloomberg, MSCI, UBS, as of March 2011

Why Value When Growth Is the Driver?

Investors sometimes ask, "Why be so focused on value in an asset class that's generally rewarded for growth?" We do not believe that value sacrifices growth. On the contrary, we believe long-term growth should have a more meaningful impact on value stock performance due to the base effect. As earnings and the stock prices begin to rebound, value stocks are generally starting from a low threshold. As profits and stock prices rebound, the stocks attract liquidity, which accelerates the turnaround process. Exhibit 2 illustrates the potential advantage of investing in companies with lower valuation multiples.

Exhibit 2: MSCI Emerging Markets — P/E & P/B Quintile Relative Returns (Annualized)





Source: Thomson Quantitative Analytics, TBCAM Research. Note: EM P/E & P/B Quintile Relative Returns (Annualized) measures the annualized return difference between each P/E & P/B quintile of the MSCI EM Index and the MSCI EM Index return from January 2000 – December 2010. The price-to-earnings ratio, or P/E ratio, of a stock is a measure of the price paid for a share relative to the annual net income earned by the firm per share. The price-to-book ratio, or P/B ratio, is used to compare a company's book value to its current market price.

Our research approach takes us well beyond the simplicity of low Price/Earnings or Price/Book investing. We use fundamental analysis to determine explicit price targets based on revenue and earnings expectations.

One can use fundamental analysis to determine explicit price targets based on revenue and earnings expectations, and build forecasts from analyzing product cycles, management strategy, the local country environment, and corporate governance. Valuation targets can help to uncover stocks that are often overlooked by momentum and index-based investors.

We believe that 2011 is lining up well for investors who do their due diligence with regard to individual companies and focus on fundamentals that include margin sustainability, management quality, and product resiliency.

We believe that focusing on populating a portfolio with undiscovered value opportunities can make you an "early" investor. In our opinion, investors who focus on valuation are more likely to persevere, and stay invested, throughout the full market cycle. We believe that 2011 is lining up well for investors who do their due diligence with regard to individual companies and focus on fundamentals that include margin sustainability, management quality, and product resiliency. We believe this is a good way to identify companies that are able to handle the pressures of inflation, growing competition, and evolving country dynamics.

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Andrea is a Senior International Research Analyst on The Boston Company's Non-US Value Team. Andrea is responsible for researching European companies. Prior to joining The Boston Company, Andrea was a Vice President with Standish Mellon Asset Management, where she was responsible for equity product management, development and positioning. Previous to that, Andrea was a Vice President of Institutional Product Management at Pioneer Investment Management, Inc. During her career, Andrea also worked for Putnam Investments in several business groups including Portfolio Analysis and Marketing. Andrea received a BS and an MBA from Suffolk University. She holds the Chartered Financial Analyst designation and is a member of the CFA Institute and the Boston Security Analysts Society.

Index Definitions

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market-value-weighted index (stock price times number of shares outstanding), with each stock's weight in the index proportionate to its value. The index is one of the most widely used benchmarks of U.S. equity performance.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The MSCI Frontier Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets. As of June 2009 the MSCI Frontier Markets Index consisted of the following 26 frontier market country indices: Argentina, Bahrain, Bangladesh, Bulgaria, Croatia, Estonia, Jordan, Kenya, Kuwait, Lebanon, Lithuania, Kazakhstan, Mauritius, Nigeria, Oman, Pakistan, Qatar, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Trinidad & Tobago, Ukraine, United Arab Emirates, and Vietnam.

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