

SPECIAL REPORT:

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EMERGING MARKETS



An expanding universe



BNY MELLON

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INTRODUCTION

The allure of emerging markets for investors, with their high growth and increasing bond opportunities, remains substantial. This despite the sell-off in 2013, increased volatility in some markets, worry over China and the perception of increased political risk in the wake of Ukraine/Russia tensions.

Over the five years to 31 July 2014 there has been more than US\$380bn in inflows across the 10 main Lipper global emerging market fund sectors, which include both fixed income and equity funds. By June 2014 funds across the 10 sectors had accumulated more than US\$2 trillion in assets.

Returns have had no small part in attracting such inflows. The MSCI Emerging Markets equity index has returned 218.91% over the past decade to 31 July 2014 compared to 114.85% from the S&P 500, both in US dollar terms. Even in the more difficult recent past emerging market equities have fared reasonably well, up 45.45% in dollar terms over the five years to the end of July.¹

Government bonds across emerging markets have also had positive returns over the longer term. The JP Morgan GBI-EM Global Diversified index has gained 35.29% in dollar terms over the past five years and 3.39% over the past year. While the latter may appear to be a small gain, by comparison the Bloomberg US Treasury index shows a return of 2.34% in local currency terms over the past 12 months.²

Indeed, emerging market debt (EMD) as an asset class continues to demonstrate strong growth. The investable universe of EMD at the end of the first quarter 2014 comprised more than US\$2 trillion in bonds³ while sales by emerging markets corporates and sovereigns reached US\$69.47bn in the first half of this year, a 54% increase on the first six months of 2013.⁴

Much of this growth and interest in emerging markets, which include a diverse range of countries and economies, has evolved from the compelling consumer story and the rise of the middle class. According to a paper from consultants Ernst & Young, since 1800 the world has seen two great middle class expansions – we are living through a third. “The 19th century industrial revolution created a substantial Western European and American middle class, which grew again after the Second World War – a spurt which this time included Japan. Today this is happening in the emerging markets (EMs).” The paper goes on to highlight that in Asia alone, 525 million people can already count themselves middle class – more than the European Union’s entire population. Over the next two decades, the global middle class is expected to expand by another three billion, coming almost exclusively from the emerging world, it reads. “By 2030, so many people will have escaped poverty that the balance of geopolitical power will have changed completely, and global trade patterns will also be unrecognisable.”⁵

At BNY Mellon, several of our boutiques feature emerging market expertise with managers specialising in equities as well as various aspects of EMD (local, hard, corporate and long/short). Here fund managers from Standish, Insight, Newton and The Boston Company look at the latest trends affecting emerging markets assets, their outlook for the months ahead and engage in a broader discussion on the impact of political risk and China.

“By 2030, so many people will have escaped poverty that the balance of geopolitical power will have changed completely, and global trade patterns will also be unrecognisable.”

1. Bloomberg as at 8 August 2014
 2. Bloomberg as at 8 August 2014
 3. JPMorgan, Bank of America Merrill Lynch, Standish as of March 31, 2014
 4. Consensus over debt market euphoria, FT 21/07/14
 5. Forecasting the next super - Middle class growth in emerging markets

POLITICAL RISK ASSESSMENT

Geopolitical risk is just one factor emerging market investors must consider. But, in a volatile world, investors must also weigh up market perceptions against the likely magnitude of events and performance impacts.

Conflicts, protests and coups are all part of the political risk landscape when investing in emerging markets. To some they are daunting attributes to these economies; yet emerging markets managers point out that in many ways such fears can be overblown and that political risks are everywhere.

Insight emerging markets debt manager Colm McDonagh notes: "In many developed markets, investors have discounted political risk yet events over the past few years have challenged that assumption. Indeed, such events have had a meaningful impact on bond and equity prices. But in emerging markets investors have always measured political risk and assume asset valuations can be affected by it. Indeed, it is a key component in understanding where you do or don't allocate money in emerging markets."

Urban Larson, Standish senior product specialist, emerging markets debt, points to a gradual decline in political risk in emerging markets over the past decade but also stresses the continued importance of its risk analysis.

"Emerging markets are a very diverse asset class but share the perception of political risk. For this reason, the analysis of political risk should be an integral part of any research process. The level of political risk varies greatly from one country to another. In some countries it can lead to considerable volatility while in others it is not noticeably higher than that seen in developed markets."

However, the problem with political risk is that it can spring up anywhere with little notice. So, how can managers assess investment opportunities in countries that could be affected by largely unpredictable events? McDonagh says: "I think the outcome of political events may be hard to ascertain but you can see warning signs, signs of a shift or unstable structures. If you think of

the Ukraine crisis, it started with a shift in policies that begot unrest and went on to create even more unrest, leading to a standoff with Russia. Could you foresee what would happen? No. But you could see that initial shift."

Gaurav Patankar, portfolio manager, emerging markets equity research at The Boston Company, agrees emerging markets can experience unexpected shifts in geopolitical risk, but he believes there are ways to watch out for this.

"In terms of volatility and guarding against the unexpected, the one thing you can do is manage your risk. As an emerging market investor you need to remain nimble and alert and know where your risks are in order to be able to switch in and out of positions," he says.

CURRENT EVENTS

Patankar believes market participants underestimated the influence of geopolitical events in early 2014 but are now pricing in recent events in the Ukraine, Iraq and other areas of unrest. In terms of specific geopolitical concerns, he sees the recent conflict between Russia and the Ukraine as a potential pivot point for the resolution of long-running disputes between Russia and the West and is hopeful recent events could ultimately lead to positive change.

"Given current market positioning, structure and investor sentiment, we are treating Russia as a trading market during this potentially transitory period. Value and geopolitical risks are neatly balanced, but there is potential for long-term multiple expansion, particularly if President Vladimir Putin either leaves office or becomes a catalyst for fundamental change himself. We expect this to be a choppy and arduous road in the near to medium term. But longer term, we believe this could be a structural

turning point for investing in Russia and can hopefully be resolved in a peaceful manner," he says.

While Larson acknowledges the local impact of ongoing conflicts in Russia and other markets such as the Middle East, he does not see these representing a major increase in the overall geopolitical risk associated with emerging markets.

"While these countries have been occupying the headlines in the past few months, India, Colombia and Indonesia have all held uneventful national elections in which hard-fought campaigns led to clear and credible victories by the more market friendly candidate, while Mexico has put the final touches on a major reform to its energy sector. Given this diversity it is crucial for investors to analyse each country separately and resist the temptation to tar the entire asset class with the same brush," he adds.

A QUESTION OF PERCEPTION

Some of the concerns regarding political risk are ones of historical bias. McDonagh says looking at the tussles

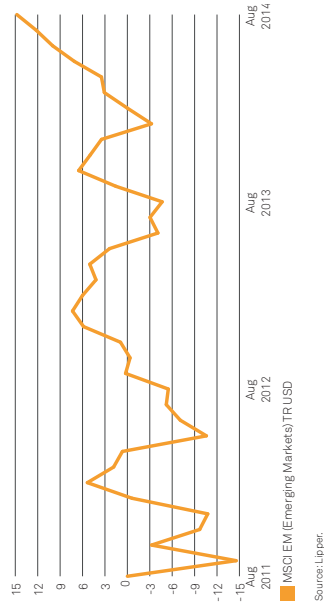
"It is not just the immediate economy impacted by a political event; globalisation means the effects can be felt in developed economies as well."

increasing regulation, politically acting central banks and initiatives to create supervisory bodies have been driving factors for developed markets.

"Generally, the trust in free markets where governments just set the framework has been massively eroded. This holds especially true for Western European countries, which rely increasingly on interventionary policies. Accordingly, managers have to take political risk and actions to take increasingly into account."

In addition, it is worth remembering that it is not just the immediate economy impacted by a political event; globalisation means the effects can be felt in developed economies as well.

MSCI EM equity index over three years to 31 August 2014



Typically when you speak to Western investors they worry about emerging market political risks yet ignore those in their own backyard."

Gunther Westen, head of asset allocation at Meriten, agrees political risk is certainly a factor which has re-entered the stage in the Western world with a vengeance. The onset of the financial crisis marked a turning point when political intervention prevented markets and economies from imploding after the Lehman's shock, he says. Since then intervention in the form of

Westen points out Western Europe is certainly the most affected region by political unrest in the Ukraine and the subsequent sanctions. "Moreover, Russia is most likely to move into a recession, thus creating more headwinds for an already lacklustre upswing in the eurozone. However, bar a sharp acceleration of events in the Ukraine, or Russia cutting energy supplies to Europe in a response to sanctions, the knock-on effects appear to be limited for the time being." Accordingly, he notes, spreads for high beta countries have not

budgeted much in reaction to recent political event risks. This probably indicates that the healing process in the eurozone has already entered an advanced stage and is not easily derailed, he comments, adding that as a result it would likely take a serious rollover in economic sentiment to see a reversal of that development.

Corporate governance is another element affected by Western perceptions. Yes, McDonagh admits emerging markets companies can collapse or default but is this any different than the large Western blow-ups such as Tyco and Enron – or indeed US or European banks?

McDonagh concludes: "The difference is you are not always paid for the risks in developed markets. We acknowledge the risks in emerging markets – you are most often compensated for them and they can also be a valuable source of investment opportunity."

ACROSS THE UNIVERSE

Growing issuance in the emerging market debt corporate universe is driving an ever wider range of choice and opportunity for global investors, increasing the need for careful investment selection, according to Insight.

The emerging market debt corporate universe is deepening, creating diversification benefits in the asset class. Insight emerging market portfolio manager Rodica Glavan comments. Noting there has been a huge influx of issuance in the corporate bond space recently, Glavan says this market has grown to more than US\$1.5 trillion with gross new issuance of around US\$300bn a year, approximately US\$180bn net; over the past few years the growth of new debt has been around 14-15% per annum. "Post 2008 the cost of capital - globally - has changed. The knock-on effect of this has been a transformation of balance sheets away from banks, encouraging companies to borrow through capital markets."

The ratings profile of the new issuance still favours the investment grade end of the market but as in Western economies there has also been a surge in high yield due to the cheap cost of capital, Glavan says. Approximately 70% of outstanding emerging market corporate debt is investment grade, she says, so questions why investors would want to look exclusively at this dominant end of the ratings spectrum. "Because emerging market corporates is becoming a deeper market with much more diversification in issuers and geography, an investor can choose what kind of exposure they want to have and be a bit more selective and carve out different risk/return experiences. You wouldn't have been able to do this as easily a few years ago."

Although the influx of issuance has come from across a range of economies, much of it has been in the more developed emerging markets. "When you have a clearly established government bond market, both external and local, then people are more comfortable with pricing corporate risk. How would you price a corporate bond in a country that does not have any outstanding government debt? You have to be able to make some assumptions."

MARKET CONSTRAINTS

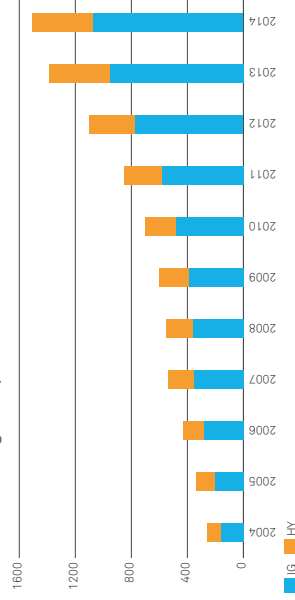
Glavan notes emerging market corporate bonds are like a second derivative of the government debt market as they are effectively a higher beta version of the sovereign. "If an economy is deteriorating, either politically or economically, then no matter how good the underlying corporate is they are always going to be constrained by what is happening at the government level. We saw this in peripheral Europe not too long ago," she comments. "Regardless of the underlying value of a good quality corporate, as an investor you have to be aware that the quality of the country itself can have a meaningful sway on valuations."

With around half of corporate bonds being issued from companies not yet publicly listed, the debt market may be the only way investors can access some good quality emerging market companies. However, this very point may also cause investors to wonder about the robustness of the debt issuance. However, Glavan argues as in other fixed income universes there is a spectrum of opportunity on offer. "Some very good quality companies may not have a listing but there are also more speculative offerings (those without a listing) so you have to make that distinction very carefully."

In addition defaults, again like those in Western markets, are exceptionally low at the moment and not forecast to go up much over the next 12 months, she adds. She cautions this with a note regarding interest rates, as if globally they rise there will likely be a corresponding jump up in defaults. The other issue is economic growth, which according to Glavan remains supportive for companies. In fact she notes growth in emerging market economies is doing better this year than last.

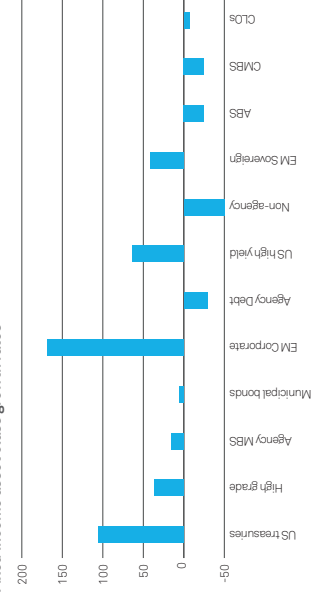
Another idiosyncratic part of emerging market corporate investments is currencies, with a multitude to examine. Unlike emerging market sovereigns, issued more in local currencies these days, the

Growth in outstanding EM corporates



Source: JPM EM Corporates Mid-Year Review from 21 July

Fixed income asset class growth rates



Source: JPM EM Corporates Mid-Year Review from 21 July

corporate universe remains largely US dollar based. "However, you have to be sure that whatever a company borrows in, it can be paid back in the event of a meaningful currency move. Are they matching their borrowings with their revenues? It is not as massive an issue as some have alluded to in recent months but it is something as an investor you have to keep an eye on." However, with a continuing deepening in debt markets, the problem of currency mis-matches is one that may diminish over time as more companies begin to issue in local currencies, she adds.

OUTLOOK

With respect to valuation a brought on by the recent issuance influx, Glavan notes yields, while compressed to 4.3% for investment grade, still offer a risk premium. Currently she does not see much value in Asia as spreads between investment grade issues and sovereigns are exceptionally

tight. There is much more of a risk if Treasury yields rise, she says, adding they may not sell off too much but they will sell off. She does see pockets of value in places like China but cautions investors have to be distinguishing in their choices. Glavan also sees some value in Indonesia but is less positive on South Korea and Taiwan. Calling Eastern Europe interesting with fluctuating dynamics, Glavan says there is not an appealing level of diversification available in these markets just yet. Turkey and Russia may have more issuance than Hungary or Poland but of course, she comments, you have to be cognisant of what is happening in these countries at a political level. Latin American issuance has risen in places like Mexico and Brazil but also in Chile, Columbia and Peru. As a result of a lot of good quality in Mexico it has become somewhat expensive whereas Insight does see some value in Brazil, which had a difficult year in 2013.

GREAT EXPECTATIONS

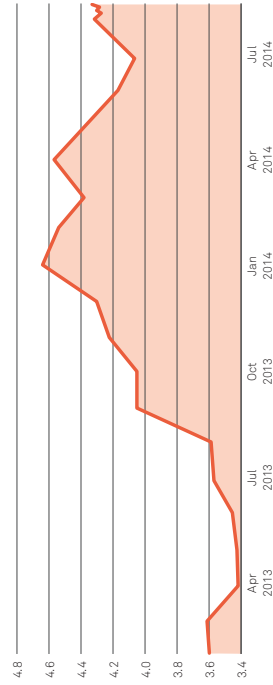
Regulatory restrictions and limited access make it hard for foreign institutions to invest in the local debt markets of the growing economic superpowers of China and India. But political and economic change could drive opportunities for both markets to open up to overseas investors, says Standish's Javier Murcio.

While the global appetite for emerging market debt continues to grow, two of the biggest areas of potential opportunity remain hard to access and lie outside the main local currency benchmark indices used by emerging market debt investors.

The debt markets of India, whose total domestic bond market size is estimated at US\$900bn and China, whose domestic market is about US\$4 trillion¹, are currently beyond the reach of most investors thanks to prohibitive local restrictions, regulations and capital controls restricting foreign investment.

Commenting, Standish's Javier Murcio, director of emerging markets, portfolio manager and senior sovereign analyst says: "China and India both strictly control foreign investment in local currency assets through either capital controls or quotas. In fact it is far from easy to invest in the debt of either country at a local currency level. While it is possible to take positions in the Indian rupee and the renminbi with currency forwards, investment in the local currency bonds of either China or India is really not feasible at the moment."

China Government Bond 10Y



Source: TradingEconomics.com/Ministry of Finance of the People's Republic of China, 13 August 2014.

CHINESE POTENTIAL

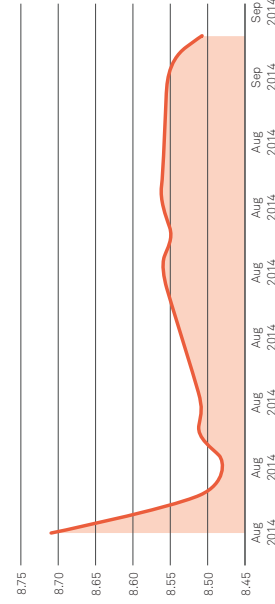
Despite efforts to promote overseas trading of the renminbi, and its huge potential, Murcio feels China is less likely to liberalise and promote foreign access to its domestic debt market in the short term. Nevertheless, analysts such as PwC point to China's need to deepen long term financing and develop transparent and efficient pricing of capital in markets and the need to attract longer term sources of funding² – a role that a number of foreign banks and global investors would find attractive if the Chinese debt market was liberalised and transparency increased.

Commenting on the likely benefits of future investment in Indian and Chinese debt, Murcio believes they would immediately bring greater market choice and diversification potential.

"In many ways Asia is underrepresented in existing emerging market debt benchmarks, so the addition of India and/or China would immediately inject more diversity and liquidity to the markets. Over the long term, these are bond markets with rich potential for both public and private sector issuance. Both markets are already ranked as investment grade so greater foreign access to them would be widely welcomed", he concludes.

"China and India both strictly control foreign investment in local currency assets through either capital controls or quotas. In fact it is far from easy to invest in the debt of either country at a local currency level"

India Government Bond 10Y



Source: TradingEconomics.com/Ministry of Finance, Government of India, 3 September 2014.

OUTLOOK

While Murcio is optimistic China and India may join benchmark local currency emerging market debt indices at some stage this is unlikely to happen soon or without significant changes to local market rules and regulations. While other emerging markets, such as Uruguay, have well developed local currency bond markets, in most cases they remain relatively small. The team at Standish therefore feels these smaller countries are unlikely to join established emerging market debt indices in the short to mid-term future.

1 Foreign investors face hurdles in China's bond market, Wall Street Journal, December 2013.
 2 An emerging market bond index public goods? Ashmore, May 21, 2014.
 3 October 28, 2013.
 4 Foreign banks plan to join global bond indices, March 11, 2014.
 5 Foreign banks in China 2013 forecast: rate liberalisation and development of the bond market, PwC Perspectives, January 2014.



MAKING IT PAY

Dividend pay-out ratios in emerging markets have risen steadily since 2010, supported by more robust economic growth than is the case in the developed world, and they look set to continue this rise, according to Sophia Whitbread, emerging market equity income manager at Newton.

As an indicator of financial health, dividend pay-out ratios are often overlooked. But combined with other indicators, they are an invaluable yardstick with which to measure the performance of a company or market and its success in managing its capital and growth, in particular when it comes to the less mature investment landscape of the developing world.

“Emerging markets boast a greater stability in dividend pay-out ratios than developed markets.”

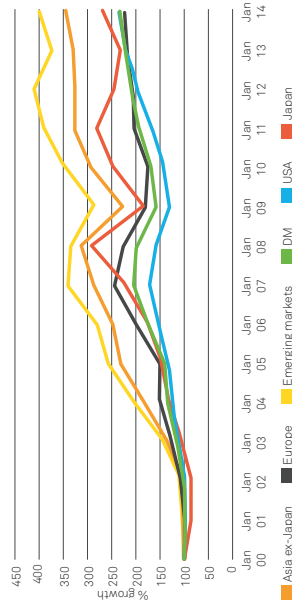
“For the past decade, emerging markets have been paying out in the 30% to 35% range but, with falling capital intensity and low levels of indebtedness, they are well set to increase and deliver higher yields on a sustainable basis over the long term,” she adds.

Emerging equities demonstrate stable dividend payout ratios



Source: Factset, CLSA Asia Pacific Markets. As at 31 December 2013

Emerging markets have seen highest growth in dividends



Source: Factset, CLSA Asia Pacific Markets. As at 31 December 2013

markets are generally less leveraged than developed markets, albeit with some exceptions, she notes. Importantly, dividends can also indicate a regard for shareholders and corporate governance generally, which cannot always be taken for granted in emerging markets.

“At the same time, once a company management team has committed to a regular pay-out ratio, managements may be less likely to fritter money away on areas shareholders may find less appealing, for example, on an aggressive M&A campaign.”

Meanwhile, there’s the attraction of emerging market dividend-paying stocks as defensive ‘bond proxies’. Although investors may be cognisant of the fact that in many developed markets, the dividend yields on offer are higher than that of the domestic 10-year government bond yield, many are oblivious to the similar trend in the developing world. Indeed, in 2012, 29% of MSCI emerging market stocks paid out a dividend yield higher than the country’s 10-year bond yield, according to research by CLSA.

But dividend culture differs hugely according to each market within emerging markets. Whitbread continues: “In certain markets, companies are increasingly encouraged, and in some cases required, to pay more dividends. For example, authorities in both Russia and China have spoken of mandatory pay-out ratios for state-owned companies, which make up 55% and 75% of their local equity markets, respectively. South Korea has most recently sought to increase dividend pay-outs from a very low base,

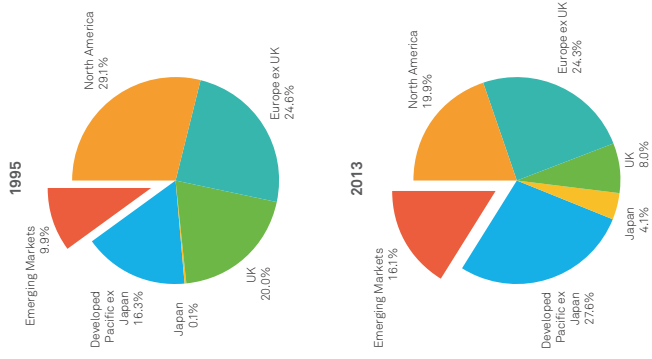
with its finance minister imposing penalties on companies with high cash reserves, thereby incentivising the payment of dividends.”

In many cases, governments are seeking to improve returns from their corporate assets. For example, in Brazil and Chile, companies are legally required to pay out dividends with a minimum pay-out ratio of 25% and 30%, respectively. “These developments can increase the universe of dividend-paying stocks but it is important to be actively selective when investing for income in emerging markets,” Whitbread tempers. “Minimum pay-out ratios can be harmful to companies which need to prioritise rebuilding balance sheets or capital expenditure. Both China and Russia have a large proportion of their respective indices made up of banks and commodity companies. These two sectors are facing more elevated capital and investment requirements in order to meet increased regulatory standards and greater capital expenditure objectives; commodity companies in general are having to spend increasing amounts to maintain the same level of production,” she adds.

“As such, in these sectors state-encouraged dividend payments could do more harm than good, highlighting once again the perils of state intervention: indeed, some 30% of the MSCI Emerging Market Index is owned by governments,” says Whitbread. “As an emerging market equity investor it is all-important to know your fellow shareholders and be wary of how you might be treated by a government as a controlling shareholder.”



Geographical split of FTSE World Index stocks yielding greater than 3%



Source: Factset, Datastream, 31 December 2013. Current yields are not indicative of future yields

OUTLOOK

Whitbread says: "We believe emerging markets have factored in most of the market impact from the US Federal Reserve's asset-purchase tapering. Monetary conditions in the West look set to remain relatively loose for some time, and there are signs of a recovery in the demand for emerging-market exports from key developed markets. Both these factors are likely to be supportive of valuations. We continue to see emerging markets as relatively well-positioned globally, as key developed markets continue their struggle with heavy debt burdens and ageing demographics. In view of this context, we find the current valuation of emerging markets compelling. We also believe that demand for

equities for income will continue to be supported by these ageing trends in developed markets. "Against an uncertain backdrop, with significant divergence in trajectories of countries in both developed and emerging markets, differentiation between markets and individual stocks will become increasingly important. Across emerging markets, we see rising inflation and related social unrest, along with state intervention, as key risks. In light of this, we continue to favour companies and markets boasting strong cash-generation potential, pricing power and competitive advantage, and to steer clear of areas we regard as vulnerable to government interference."

EASTERN PROMISE?

After averaging a world-beating 10% year-on-year growth rate for the past three decades China is starting to see its growth levels dwindle amid very high levels of investment. High growth levels had helped lift over 500 million people out of poverty, propelled national incomes to middle-income levels, boosted global commodity prices and contributed heavily to regional and global economic growth. But macroeconomic and financial imbalances have recently worsened, with slackening growth rates and the burgeoning scale of China's shadow banking sector causing concern for many global investors.

Against this backdrop we asked investment specialists at The Boston Company, Insight, Newton and Standish for their views on the Chinese market, its influence on various asset classes and the potential investment opportunities.



Jay Malkowski, portfolio manager, emerging markets equity strategy, The Boston Company



Paul Lambert, head of currency, Insight



Robert Simpson, emerging market debt, Insight



Robert Marshall-Lee, investment leader, emerging equity team, Newton



Aninda Mitra, senior sovereign analyst, Standish



WHAT ARE YOUR BIGGEST CONCERNS RIGHT NOW REGARDING CHINA AND ITS INFLUENCE?

Robert Simpson:

The size of China's economy, in excess of \$9 trillion, means that when it even splutters it reverberates across global markets through trade channels, commodity prices, and perhaps most acutely, sentiment in financial markets. It is a fast growing economy with some structural problems that it needs to address, some of which have become more pronounced as a result of the fiscal stimulus after the 2008 crisis. There have been concerns over shadow banking creating excess leverage in some asset classes, particularly property, but so far it does not appear systemic. If that changed it would be a severe exogenous shock for all financial markets.

Robert Marshall-Lee:

While Chinese equities seem to be in favour of the month due to a loosening of monetary conditions by the central bank and government, we would prefer them to have persevered with the more half-hearted approach that they appeared to have been adopting. The key issue here is that the credit intensity of Chinese growth has been outright concerning. Total social financing as a proportion of GDP has risen from about 125% to over 200% since the global financial crisis, when the Chinese government dipped into its deep pockets and re-stimulated the economy.

Much of the recent credit explosion has circumvented the more tightly controlled banking system, coming instead in the form of 'wealth management' products, such as trust funds, often administered by banks for a fee. The fear is that the underwriting and risk-monitoring of these is rather more lax than for loans on bank balance sheets and that this has increased risks of a negative credit cycle, not least as much of the money has probably helped finance speculative property development. This does not necessarily herald an imminent financial collapse, but does raise the risk profile of investing in China.

We would prefer the government to maintain tighter policy and accept lower growth in GDP, but with far higher quality of growth – i.e. not credit-propelled with a poor multiplier of credit into GDP. We would like to see continued reforms, not least of the SOEs (state-owned entities) to improve returns on capital and remove unproductive subsidies. One key risk is of a rebalancing of Chinese growth from a property slowdown, leading to reduced demand for hard commodities, which would be very painful to many mining and industrial companies around the world.

As well as particular global industry sectors, whole countries, such as Brazil, may be impacted where terms of trade have benefited from the commodity

demand up-cycle since the early 2000s. This could lead to currencies weakening, as well as economic slowdowns across entire effected economies – far more than we have seen to date.

Jay Matikowski:

Investors are rightly concerned about many risks in China and have become complacent that government stimulus measures will prop up the economy. While we are not anticipating a hard landing in China, we do believe the country is headed for a period of lower growth than in the past, disappointing investors who expect it to maintain its growth rate. This will create a challenging environment for many Chinese companies exposed to the cyclical economy as well as companies in other regions that sell cyclical equipment or materials to China.

Aninda Mitra:

The stock of Chinese credit has grown sharply in recent years – outpacing nominal GDP growth, and rising to around 200% of GDP. Much of the recent increase has come about from the rapid growth of off-balance sheet or shadow bank lending. Declining returns on the large stock of credit and investment imply that an adjustment cannot be put off much longer.

We do not think China's challenges will result in a financial crisis, or a very abrupt or large loss of economic output. Put simply, we do not expect a 'hard landing'. This is because the authorities still retain enough policy space, and the necessary tools, to avert a broader loss of confidence and, consequently, a deeper than expected slowdown; and the formal banking sector has sizable buffers to withstand a downturn – should it materialize.

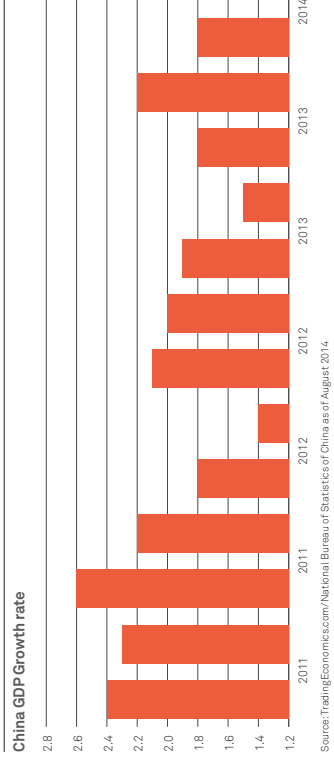
Nor do we think that ongoing economic headwinds are merely cyclical. Therefore, we do not expect any imminent rebound in growth – which is to say we are not in the 'soft landing' camp either. This is because the scale, and increasingly complex, nature of China's leverage and over-investment implies that any adjustments will not be fleeting. This also means China's increasingly mature economy will not be able to grow out of its problem anytime soon.

Our conclusion is that China will experience a 'long landing'. We think this will amount to a prolonged process of re-balancing and de-leveraging. But the authorities sustained commitment to reforms and an ability to manage a downshift in investment will limit macroeconomic volatility around a decelerating growth trend. With the passage of time, it will also lower the risk of widespread financial instability.

Paul Lambert:

The rate at which China's US\$4 trillion of foreign exchange (FX) reserves accumulate and how the Chinese recycle these into other currencies has a profound effect on currency movements across the globe. Concerns around the Chinese economy will find an echo in FX markets.

The spectacular development of the Chinese economy has been achieved by massive domestic investment and rapid credit growth. A shift to more



WHAT OPPORTUNITIES DO YOU FEEL ARE PRESENT (NOW OR IN THE FORESEEABLE FUTURE) EITHER IN OR FROM CHINA?

Robert Simpson:

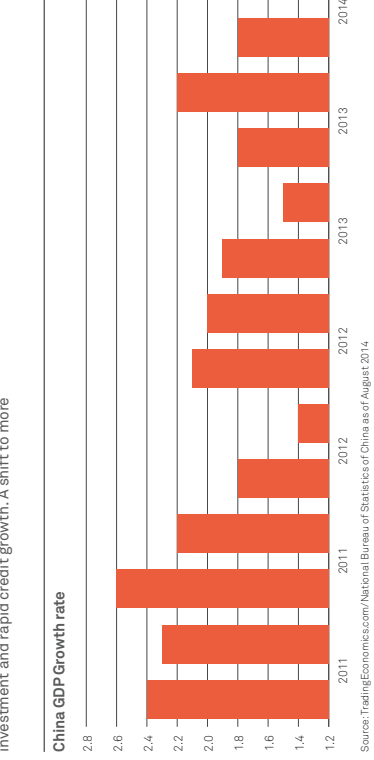
There has been huge growth in the Chinese offshore corporate bond market, predominantly issued in US dollars. Those issuers vary enormously in terms of quality. Some are attractive. Others should be given a very wide berth. We expect there will be increased access and liquidity in Chinese yuan (CNY) denominated bonds, and a development in the municipal sector. This would provide multiple avenues for expressing investment views, which is what all fund managers want. The continued progress toward CNY convertibility will also open new investment opportunities.

Robert Marshall-Lee:

If the proposed reform agenda is rigorously pursued by the Chinese leadership, improved returns on capital could propel the Chinese stock market much higher and reduce investment risks to boot.

Although generally wary of SOEs, we have to be mindful of such potentially transformational shifts in behaviour. Thankfully, there are already plenty of great investment opportunities in and around China, not least in structural growth areas such as those driven by rapid growth in internet penetration. Very useable android smartphones and tablets in the US\$50-100 price range,

balanced, consumption-led, growth appeared to be the new policy prescription. However, an economic slowdown in the first quarter of 2014 appears to have spooked the government and it is now backtracking. In the short term, that is good news for China and sentiment in markets. In the longer term, it makes it likely that the inevitable adjustment is more painful.



combined with greater broadband, 3G and 4G connectivity have opened up huge new swathes of consumers to e-commerce and social media.

Jay Matikowski:

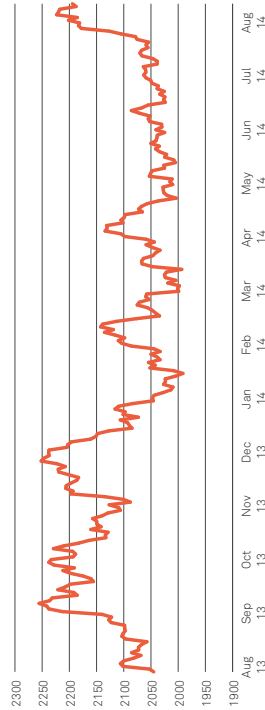
Although a slowing of the economy will be quite challenging for many companies, we see three themes that can prove beneficial. First, we see secular trends in many sectors, such as healthcare, that are less cyclical and where China's consumption is lower than developed-world standards. Second, several very large state-owned companies are inefficiently managed, but reforming them, which is a central goal of the new regime, could dramatically improve shareholder returns. Finally, as we believe others will begin to agree with our view on lower growth, attractive opportunities may emerge in distressed companies.

Aninda Mitra:

The authorities are enhancing the role of market forces to rebalance the economy away from investment and toward consumption, and this process is going to be sustained in an incremental fashion. This important aspect of Chinese reforms is underscored by the authorities' inclination to not tolerate the widespread occurrence of defaults,



China Shanghai index 12 months to 8 August 2014



Shanghai Stock Exchange Composite Index

Source: Bloomberg, 8 August 2014

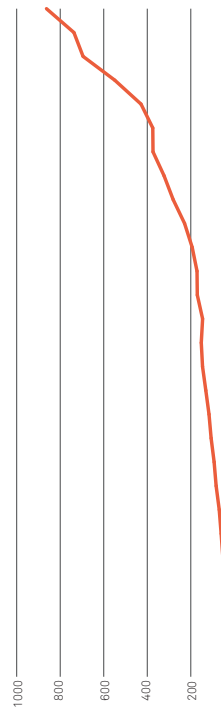
but also gradually liberalise interest and foreign exchange rate settings. The former underpins economic stability amid a delicate transition process, and the latter gradually enhances the role of a risk-based system of credit allocation.

Additionally, China's strong fundamentals also underpin its reform intent and policy capabilities. For instance, China's investment-driven leverage is almost entirely domestically financed. This is in stark contrast to the experience of all other Asian emerging markets which experienced investment booms in the 1980s and 1990s, but had to contend with domestic savings shortfalls that ultimately resulted in current account deficits and a dependence on foreign inflows. High domestic savings also highlight the financial repression which has facilitated China's investment growth to begin with. But alongside capital controls, low inflation and a stable currency, large domestic savings provide a formidable buffer, and more time, to absorb a write-down of bad loans – should a clean-up of the banking sector prove more costly than is currently thought possible.

A shift in any country's growth model is likely to prove stressful at the best of times. In China's case the shift comes in the aftermath of a significant build-up of leverage and over-investment. But China's macroeconomic and financial buffers and its policy space are fundamentally, and uniquely, well positioned to weather some of the evident stresses.

In this context, we think the breadth of China's recent reform policies, and its cautious implementation plan is credible and accords with overall macroeconomic stability. As such, we maintain a constructive investment outlook in the US dollar credit space. In particular, we think the intensity of economic activity will shift from investment-related sectors to consumption-oriented areas, and from large state-owned companies to smaller enterprises. These shifts will take time to materialise. But as the government establishes a track record of reforms with stability, we think investment opportunities will continue to arise in what we believe will remain one of the world's most dynamic economies.

China external debt – total in billions



Total Billions

Source: Bloomberg/National Bureau of Statistics of China

Paul Lambert:

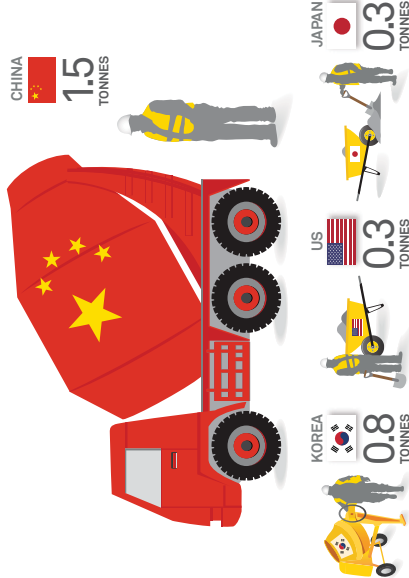
China's high levels of intervention and reserve portfolio rebalancing appear to be at least part of the explanation for the weaker dollar and stronger US treasuries in the first half of 2014. As Chinese reserve accumulation appears to be slowing we expect that exchange rates will have an opportunity

to move back in line with fundamentals. In particular, we believe the US dollar will have an opportunity to appreciate especially against currencies such as the euro and the Australian dollar that appear to us to have been supported by reserve manager purchases.

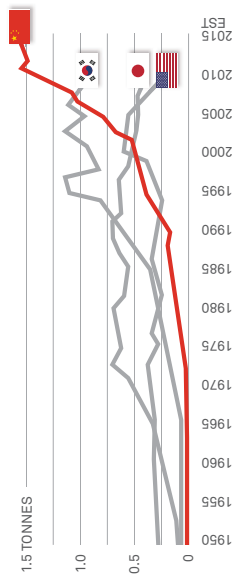
CHINA'S OVERCAPACITY PROBLEMS KEEP BUILDING

Cement sector supplying unprofitable infrastructure projects

CEMENT CONSUMPTION PER CAPITA 2011



PER CAPITA CONSUMPTION OF CEMENT SINCE 1950



Source: China Cement Association, Company data, Credit Suisse estimates.



MIXED FORTUNES

Despite record inflows of foreign direct investment (FDI) last year emerging markets have enjoyed mixed fortunes in 2014. Now investors must reassess their commitment and risk exposure to an increasingly complex range of market options.

Emerging markets saw a record share of FDI inflows in the first half of 2013, with China, Russia and the Asia region all benefiting strongly. The correlation between FDI inflows and the wider stock market performance of emerging markets, however, remains hard to quantify. In February 2014, just months after the United Nations Conference on Trade and Development (UNCTAD) reported record levels of FDI into emerging economies emerging market stocks fell, extending their worst start to a year on record¹.

The fall was blamed on wider concerns about the global economy and more specific fears about the health of the Chinese economy. In recent months emerging market stocks have rallied but questions remain on the future direction of the emerging market asset class and level of benefits and impacts FDI can ultimately bring to the economies and securities markets it encompasses.

Gaurav Patankar, portfolio manager, research emerging markets equity at The Boston Company Asset Management (TBCAM), LLC recognises the value of FDI but adds the importance and relevance of it to individual emerging markets should, in theory, decline as recipient economies mature. He points to Taiwan and Korea as countries which have successfully capitalised on the benefits of historic FDI inflows to develop sophisticated modern economies and capital markets. But Patankar adds that much depends on how constructively and efficiently individual governments and organisations use FDI.

Beyond FDI itself, Patankar believes the US Federal Reserve (Fed's) quantitative easing (QE) programme has also distorted the emerging markets investment picture for foreign institutional investors (FIIs), with cheap money driving down yields and, in some cases, steering investors into higher yield, higher risk investments.

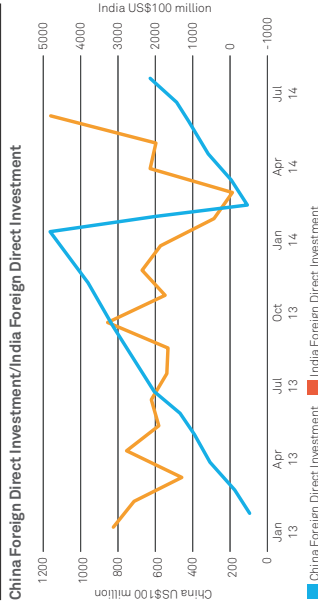
FDI IMPACTS

Commenting on the impacts of QE on FDI and wider emerging markets investment he says: "Theoretically QE should have had a great impact on FDI inflows to emerging markets, creating more liquidity. The problem is that things seem to have gone in the wrong direction. QE has sparked a global quest for yield among institutional investors in capital markets. Increasingly, debt investors have been chasing down the yields of 'higher yielding' sovereigns, in turn creating a distortion of real fundamentals."

Given this backdrop, Patankar feels both FDI and FII investors are now adopting a more cautious approach to the specific geographies they invest in in order to maximise potential long-term returns.

"Now there is much greater country differentiation in terms of where FDI and capital market flows go. Investors want to see that the leaders of the countries they invest in are able to make the hard political decisions necessary to improve their economics and deliver on their investment promise," he says. Either way, effective risk management remains critical to emerging market investment, he adds.

Assessing the emerging markets most likely to benefit strongly from FDI, attract fresh inflows and deliver positive investment returns to foreign investors in the long run, Patankar points to India, Indonesia, the Philippines, Poland, Mexico and Colombia. While he does not predict massive FDI inflows to China, he is also confident the country faces no immediate crisis and can successfully reform and rebalance its economy over time.



Source: National Bureau of Statistics of China, Reserve Bank of India, www.tradingeconomics.com. China's FDI inflows increased to US\$27.7bn in May 2014 from US\$22.0bn in April 2014, averaging US\$26.17bn for the first 12 months of 2014. India's FDI inflows increased to US\$6.35 billion in the first six months of 2014, and averaged US\$5.73 billion from 1997 until 2014.

INDIAN OPPORTUNITY

Patankar is particularly optimistic about market prospects in India. He points to the recent election of reforming Prime Minister Narendra Modi, the desire for change among India's increasingly youthful population and its adoption of a wider more Western business outlook which could help India effectively utilise fresh FDI inflows.

Commenting on Indian prospects he says: "India is changing. As an investor I'm a natural sceptic but for the first time in over a decade I am structurally bullish on India. The 2014 election has

In contrast, Patankar is downbeat on prospects for South Africa, Brazil and Turkey, where he feels FDI inflows have had only limited impact and major structural problems – including large current account deficits – remain. He is also concerned that the ongoing drawdown or 'tapering' of the Fed's QE programme could hit these countries particularly hard.

"There are few positives to be drawn from the current economic scenario in South Africa and Brazil and Turkey also has some major issues. As QE tapering gathers pace the change could aggravate the economic problems these companies already face," he concludes.

OUTLOOK

From an FDI/global investment perspective Patankar is most positive on India, Indonesia, the Philippines, Poland, Mexico and Colombia but also believes China can successfully reform and rebalance its economy over time. However, he also predicts ongoing problems in South Africa and Brazil in particular, but also Turkey. While Patankar has identified significant underlying weaknesses in the Russian economy it believes recent developments in the Ukraine may be followed by more positive political developments which could present a structural turning point for investing in the country.

"Although India is geographically a huge country, from an FDI perspective it is small enough for even US\$200bn of FDI inflows to really make a difference"

seen it choose a decisive leader who is not encumbered by any political baggage and who wants to make things happen. Although India is geographically a huge country, from an FDI perspective it is small enough for even US\$200 bn of FDI inflows to really make a difference to the wider economy."



AT THE CROSSROADS

Emerging market debt investors weighing the pros and cons of picking hard currency versus local currency denominated bonds face an increasingly diverse range of global options, according to Standish's Alex Kozhemiakin.

Emerging markets debt (EMD) investors face a choice between bonds denominated in hard currencies such as the US dollar (USD) and local currency bonds. US dollar denominated emerging market bonds are the more established asset class, generally favoured by investors keen to avoid additional currency risk on their investments. In contrast, while local currency denominated bonds can bring additional currency risk they can also offer investors a lower correlation to US Treasuries as they are not priced against the US dollar yield curve and offer higher yields and shorter maturities. This means they will not be as hard hit if interest rates rise in developed markets.

Commenting on the growing sophistication of emerging markets and the shift from USD to LC denominated debt, Kozhemiakin says: "As the bigger, more sophisticated emerging markets have developed their domestic financial markets, governments have been able to place bonds in their own currency more easily. Brazil is a good example of this. Just 20 years ago the Brazilian government did all of its long term borrowing in dollars. "At that time no one in the market was willing to take long term positions in Brazilian local bonds because the currency was so volatile,

GROWING UNIVERSE

According to Alex Kozhemiakin, head of emerging market debt at Standish, the universe of local currency (LC) denominated bonds which make up the commonly used GBI-EM Global Diversified Index currently extends to some 16 countries, but holds significant scope for growth as a range of emerging markets develop more robust economies and financial infrastructure. While the EMD arena was once dominated by dollar denominated bonds, an increasing

range of LC denominated debt is now available, in what US investment manager Standish believes to be an ongoing shift of EM sovereign debt issuance from USD to local currency.

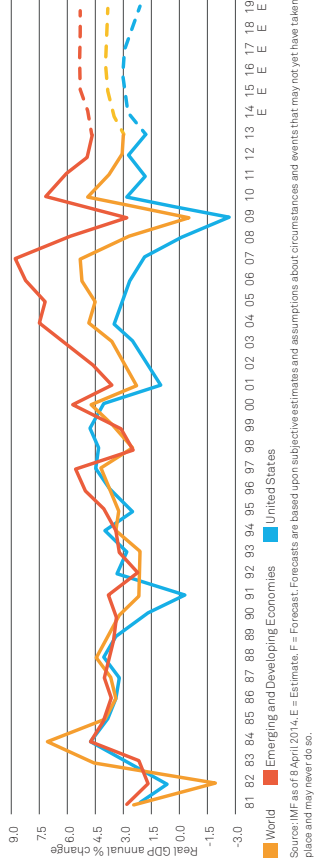
According to Kozhemiakin, the first half of 2014 saw zero net issuance of EM sovereign debt in dollars by the larger emerging markets countries, with all net issuance coming in local currency. As local markets grow more liquid thanks to the growth of local pension funds and other institutional investors, he adds, local currency issuance is becoming a more attractive option for investors in sovereign EMD.

While domestic demand is growing fast, Kozhemiakin points out foreign investors are also participating in this trend. "The majority of emerging market local currency denominated bonds is held by local investors but foreign investors hold a significant proportion. In some markets as much as 20% of local currency is held by foreign investors," he adds.

Despite the growing trend towards local currency denominated EMD, he says there are still some compelling reasons for EM governments to issue dollar denominated paper.

1 Source: JPMorgan.

IMF World Economic Outlook



interest rates were erratic and inflation was high. Over the years Brazil has brought its inflation level down to an average range of 4-6%. Consequently national economic performance is much more predictable. Brazilian pension funds, insurance companies and mutual funds have also built up over US\$1 trillion in assets, nearly all of which is invested domestically.

DOMESTIC APPEAL

"These domestic institutions are natural buyers of local currency bonds looking for long-term positions because, for them, the Brazilian government bond is the risk free rate. Now, the Brazilian government can issue 10 and 15 year paper on a routine basis and can also issue inflation-linked 30-year paper," he says.

According to Kozhemiakin, EM governments have a strong incentive to borrow in their domestic currency to remove exchange rate risk from their balance sheets – providing they offer a credible proposition and are able to attract sufficient interest from domestic and international institutional investors.

Kozhemiakin says: "Across a number of emerging markets we have seen the same trend of local institutional investors willing to take long-term positions in their own currencies because they are simply not as volatile as they used to be. These developments are creating a virtuous circle for LC investment and when a country can borrow in its own currency it ends up issuing a lot less dollar denominated paper"

While domestic demand is growing fast, Kozhemiakin points out foreign investors are also participating in this trend. "The majority of emerging market local currency denominated bonds is held by local investors but foreign investors hold a significant proportion. In some markets as much as 20% of local currency is held by foreign investors," he adds.

DOLLAR ADVANTAGES

Despite the growing trend towards local currency denominated EMD, he says there are still some compelling reasons for EM governments to issue dollar denominated paper.

1 Source: JPMorgan.

"The big emerging market countries issue in dollars for a few reasons – partly to diversify their sources of funding and partly because they want to have the foreign currency at hand. In the case of Chile, which barely borrows at all, the country issues debt denominated in dollars in order to provide a yield curve off which local corporates can price their external bonds," he adds.

While the traditional straightforward option of buying dollar denominated emerging market sovereign bonds is still popular, Kozhemiakin believes significant long-term value lies in other types of US dollar denominated emerging markets bonds such as corporate and quasi-sovereign paper. He also believes the trend towards LC bonds will increase and could bring significant benefits.

"Over the long run we feel local currency denominated bonds are the most attractive form of emerging market debt. This is based on the fact that, as countries grow, their currencies should appreciate, the liquidity of their local bond markets should continue to improve and their monetary policy will continue to build credibility – in turn building value in the long term rates as well," he concludes.

OUTLOOK

From a geographic perspective in local currency emerging markets bonds Kozhemiakin currently sees the most value in Latin American markets such as Brazil, Mexico and Colombia, as well as in South Africa. Standish sees the other local currency bond markets of the Europe, Middle East and Africa (EMEA) region as less fundamentally attractive and feels the Asian markets are expensive. In US dollar debt Standish favours some EMEA countries, including Kazakhstan where it sees very good value in some quasi sovereigns backed up by high oil prices. It also favours Lithuania, citing its strong credit quality. Colombian external debt is also favoured. Across US dollar denominated debt Kozhemiakin sees more value in quasi-sovereigns and corporates than in sovereigns, particularly for the larger, highly rated countries.

THE LONG AND SHORT OF IT

Emerging markets present an increasingly wide range of challenges investors must navigate to minimise risk and maximise returns, driving fresh demand for strategies which can balance low volatility with positive returns.

The secret to emerging markets is to avoid the occasional blow ups, which is why long/short strategies in this space are growing. According to Insight manager Colin McDonagh investors invariably struggle with investment timing – money tends to flow strongly into emerging markets when three-quarters of the rally has already taken place and withdraws after a sell-off. In fact the opposite should be true – when people are bullish, that is the time when we hold back some, increase shorts and wait for buying opportunities that follow a market correction, he says.

A few years ago, he notes, virtually all funds in this space were long-only, today that is changing. While he admits the bulk of emerging market investments is always going to be in long-only funds, McDonagh believes there is a discernible shift towards portfolios managed in a different way.

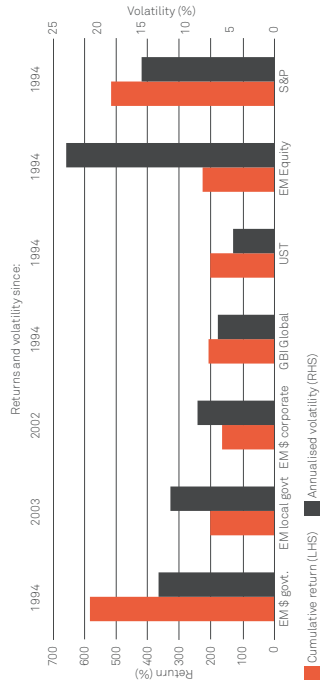
“Investors are demanding to own emerging market debt in different ways. We’re seeing a

very definitive trend over the past year from a building block approach – investors looking for government, corporate, local and hard currency funds to determine their own mix – to those looking for more blended mandates; they want managers to make those decisions.”

The experience people have had in emerging markets has been pretty good but there has been volatility that impacts investors’ attitudes and sentiment towards the asset class.

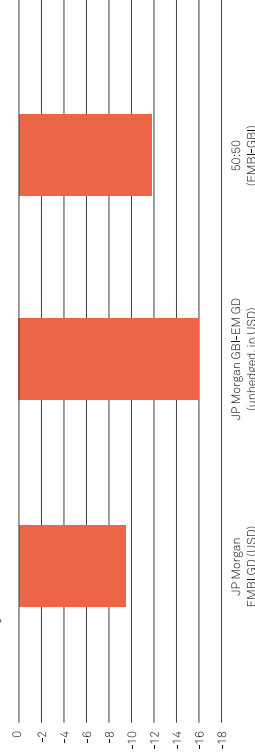
However, McDonagh argues emerging markets debt is less volatile than many assume. Still, he believes this aversion to volatility has created some of the demand for alternate bond exposure. “We are getting a lot of new players – like pension and insurance funds – into the absolute return market. They want emerging market exposure without too much drama or volatility. As a result you are seeing a variety of different offerings, including more absolute return style products.”

Volatility perceptions



Source: JP Morgan 1 August 2014

Max drawdown: 5 years to 30 June



Source: Insight 30 June 2014

GROWTH PROSPECTS

Investors are interested in the growth from emerging markets without the downside risk, which is not always possible, he says. But the question remains, just how much return are investors willing to forgo in order to have less volatility or downside? Traditionally in bull market times investors crave the high returns of long-only and the appeal of growth in emerging markets means this has, in the past, diminished the demand for capital preservation. “People are always afraid of missing out but there is a shift towards outcome based investing and looking for more tailored approaches.

“In the emerging market space the style of absolute return strategies can vary considerably. Investors do not just want capital preservation, they also want greater participation in the upside”

These investors understand they may not get the same level of returns in an absolute return or blended approach. It is a sector growing because of demand from long-term investors.”

So embedded is this institutional desire for lower volatility in emerging markets that McDonagh does not believe disappointments with respect to capital preservation, will dissuade investors. “In the emerging market space the style of absolute return strategies can vary considerably.” Investors do not just want capital preservation, they also want greater participation in the upside than they may expect from a more traditional market neutral

absolute return fund, he notes. “The challenge is to create a lower volatility portfolio that can capture a lot of the upside and make a decent return.”

The costs associated with an emerging market long/short strategy though can be a constraint on upside capture, which is an added consideration for investors assessing increasing offerings in this space. “There is the cost of carry if you short something, the spread in credit default swaps used, the relative interest rates and the cost of carry on shorting FX and even in option volatilities. The thing is, whatever the cost is – and it varies from very small to high – you have to factor it into your total return.”

OUTLOOK

Emerging market debt is well supported by better growth expectations (noticeably in China) and by valuations considered attractive in the global search for yield, he says. “Issues remain in certain pockets, the possibility of punitive sanctions being enforced by the US and EU makes us uncomfortable holding Russian assets. Argentina’s default was well trailed and is contained”. Right now option volatility is quite low according to McDonagh, meanwhile interest rates for certain currencies are on the expensive side (such as in India, Turkey and Brazil).

“Overall, the outlook for emerging market debt remains positive. In a quieter summer period we monitored global fixed income asset classes, including high yield and US Treasuries, for signs of a change in expectations and sentiment,” he concludes.

DON'T GET CARRIED AWAY

While low interest rates and low volatility conditions currently provide what appears to be an ideal market for carry trade business, investors should beware of potential market pitfalls, says Insight's Paul Lambert.

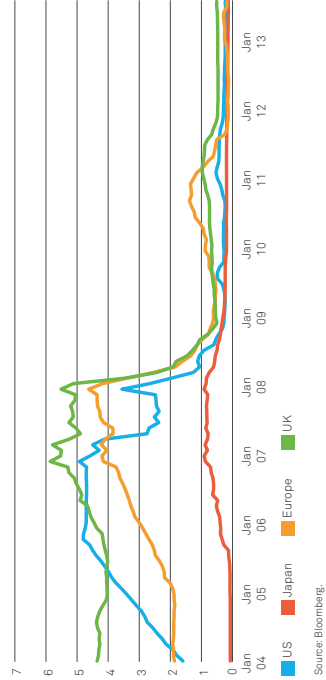
The carry trade is deceptively simple. Borrow money in a low-yielding currency and lend it (invest) in a higher yielding one. It is, to use the jargon of financial markets, an uncovered interest rate arbitrage. The current market environment ought to be perfect for carry trades. With interest rates at or near zero across the world's biggest economies, potential carry funders, such as US dollar, euro, yen and sterling, are also the most liquid currencies in the world.

Volatility in foreign exchange (FX) markets is also at record lows, due to a combination of central bank intervention, coordinated policy and disappearing interest rate differentials. This minimises one of the greatest risks of carry, a rise in the value of the currency funding the trade. In emerging markets, on the other hand, many currencies are offering appreciable carry. For example, as of August, Chinese policy rates were at 8%, Indonesian at 7.5%, South African 5.75%, Turkish at 8.25% and the Brazilian real offered a very attractive 11%.

However, Paul Lambert, head of currency at Insight, urges caution before jumping on the carry bandwagon. "The combination of low rates in the developed world and low volatility looks superficially attractive for carry. But generally when things look too good to be true they are. The best of times may already be in the past for this incarnation of the carry trade given where we are in the interest rate cycle."

Lambert says: "From a long perspective we like currencies such as the Malaysian ringgit (MYR) and Philippines peso (PHP) which should benefit from the growth pick-up in China and where rates are rising from low levels. We also think there will be pressure for the Chinese renminbi to appreciate and we have a negative outlook on the Turkish lira (TRY) and South African rand (ZAR)."

Interest rate differentials and convergence on zero rates in major currencies



Source: Bloomberg.

TAPER TEST

The biggest driver of the outlook for emerging market currencies is the likely course of US interest rates for the remainder of the year and into 2015. The US Federal Reserve's tapering of asset purchases is due to conclude in October bringing to an end the era of quantitative easing. At that point it is likely the attention of markets will turn to policy rates. If tightening begins to be priced in and short rates rise, this will be supportive for the US dollar. That would represent the first clear trend in a major currency for some time.

However, as the 'taper tantrum' last summer reminded investors, rising US rates tend to be bad news for emerging markets. Lambert expects this time around there will be more discrimination. "Depending on how the market reacts, I would still be happy with currencies such as MYR and PHP. Part of the reason we like them now is because they are not reliant on external funding. That is not true of TRY and ZAR, which look far more vulnerable. Even the Brazilian real, where we have modest long position and is very attractive from a carry perspective, would be under pressure in a rising dollar and US rate cycle," says Lambert.

Volatility is likely to pick up from current low levels. The last time market volatility was this low was 2007. Then, according to estimates from the Bank for International Settlements, investors wagered as much as \$1 trillion on the yen carry trade. That ended abruptly with the credit crunch in August 2007 and the global financial crisis that followed. The perception of the yen turned on a dime. It was no longer viewed as a carry funding currency. In a 'risk-off' environment it was a safe haven. The carry component of Credit Suisse's FX Metrics indices fell by 171% in 2008 and investors who stayed long carry gave back years of gains.

"Over the past year there have been better ways to take advantage of interest rate differentials than carry trades in currency," says Lambert. "Buying spreads over government bonds by going down the credit rating spectrum or high dividend paying stocks, for example," says Lambert. "I suspect the environment for carry trades across markets, including in currencies, is about to get a lot more challenging."



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