For Investment Professionals only

Emerging market equities: opportunities in improving fundamentals

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The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is included, please note that this is not a guide to future performance.

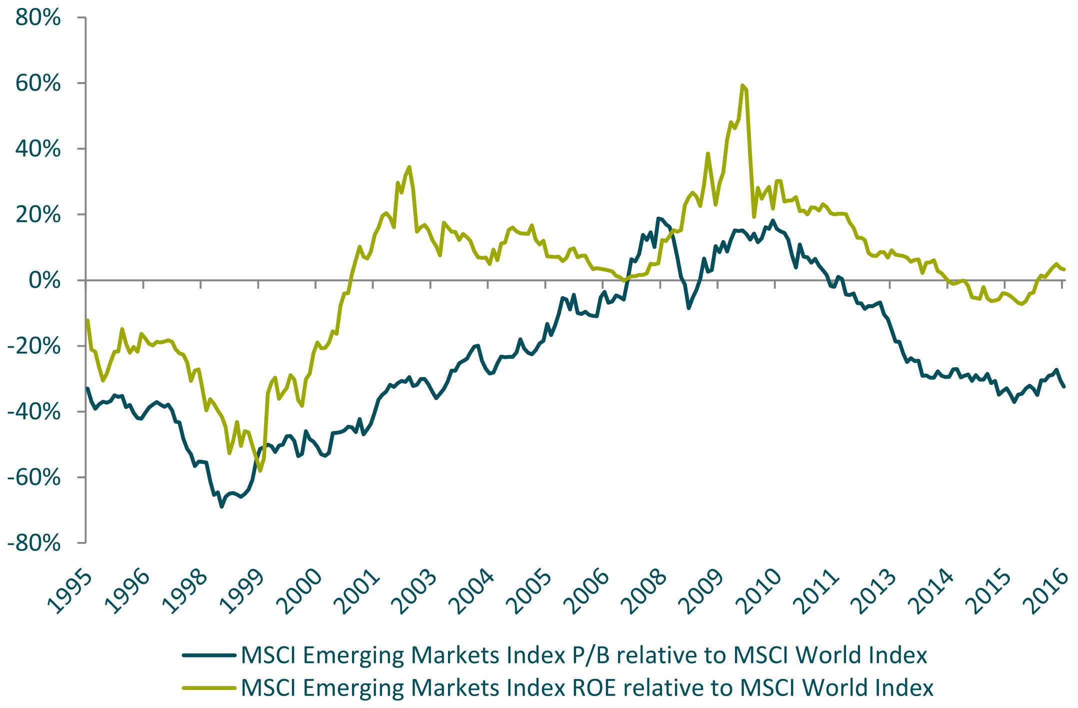
Fundamentals are improving and valuations are attractive. Many emerging market companies are making good progress on self-help initiatives; adopting better capital discipline and focusing on profitability rather than growth. Although the asset class has seen significant outflows in recent years, investors are starting to pay attention to these positive changes, however, many remain underweight the asset class.

While headlines have the power to create turbulence in financial markets, it is vital that investors continue to take a long-term view of the asset class and focus on the fundamentals to maximise return potential over the long run.

Fundamentals in the driving seat

The lacklustre performance of emerging market equities over the past five years largely reflects poor corporate performance. Figure 1 shows the valuation and profitability of emerging markets relative to developed markets. Since the global financial crisis in 2008 / 09, emerging markets have underperformed, reflecting a marked deterioration in aggregate profitability. Share prices in emerging markets have therefore behaved rationally and followed fundamentals.

Figure 1: Markets reflect fundamentals



Source: Thomson Reuters Datastream, as at 31 December 2016

There was a dramatic shift in investor sentiment towards emerging markets during 2016. Steep falls at the beginning of the year were followed by a strong recovery and the MSCI Emerging Markets Index closed out the year 11.6% higher (in US Dollar terms), ahead of developed market equities, as measured by the MSCI AC World Index which finished up 8.5% over the same period. In addition, wider macroeconomic risks seem to have abated and emerging market currencies, which sharply sold off along with emerging market assets in early 2016, also strengthened, further supporting investor sentiment.

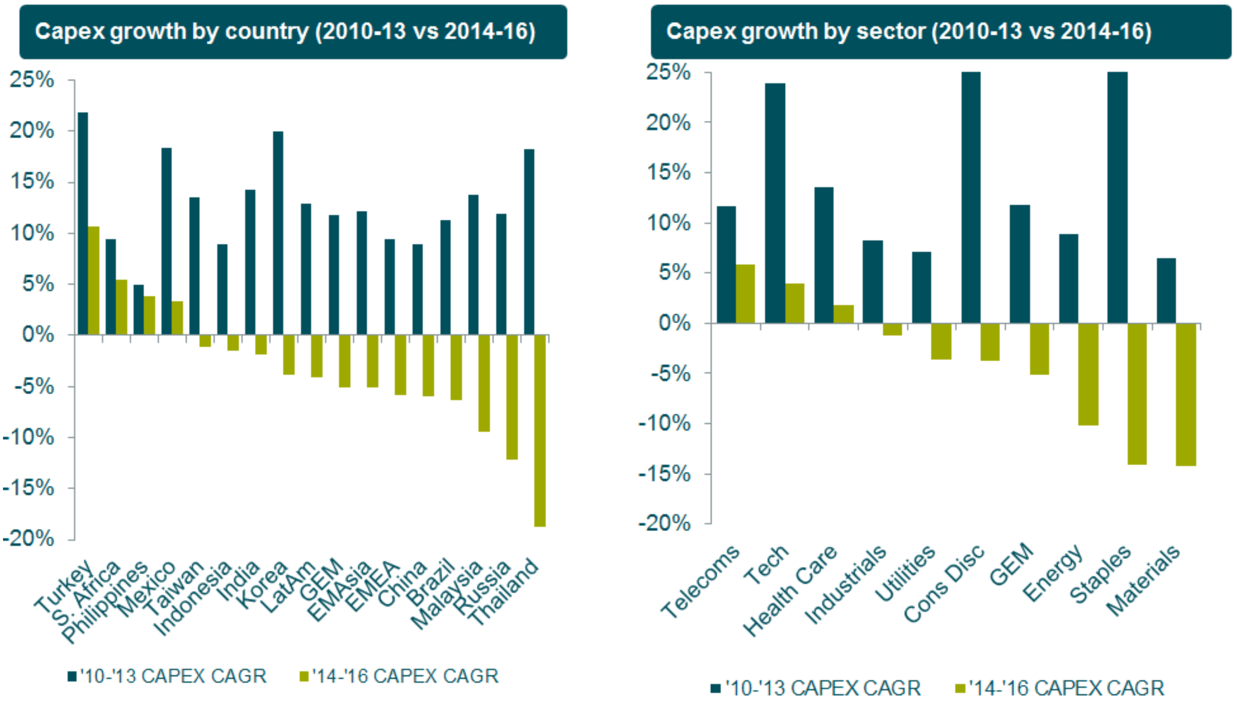
The rally we have seen in the past year has been underpinned by an improvement in fundamentals. For emerging market equities to sustain their recent gains, this trend needs to continue.

Companies are focusing on self-help measures

In the aftermath of the global financial crisis, many emerging market companies continued to invest in their businesses prioritising ‘top line’ growth over profits in the belief that growth is what matters. They sought to expand even though demand was falling.

Encouragingly, we are seeing a growing trend towards better capital management by emerging market companies. There is evidence of an adjustment taking place, as companies’ priorities appear to be changing, putting profits ahead of growth. Over the past couple of years, capital expenditure has been cut, which seems to suggest companies are responding sensibly to the prevailing economic environment (see Figure 2). Furthermore, management teams are trying to run their businesses more efficiently with a greater focus on the ‘bottom line’, thereby driving cashflows.

Figure 2: Improving capital discipline



Source: GEM Inc. – October 2015, UBS

From an investor’s point of view, improving capital discipline (and productivity) among businesses is very welcome. While this change in mindset might cause top-line growth to slow in the short term, it should eventually lead to higher profitability. And, over time, higher returns on capital should be rewarded with higher share prices.

Taking a long-term view

We remain reasonably optimistic about the outlook for emerging markets. While fundamentals are improving, valuations still look attractive and do not appear to be pricing in any possible improvement in returns, which we believe could be achieved by more efficient use of capital.

Even though sentiment towards emerging markets appears to have improved, there has not yet been a significant shift by investors back to the asset class and many remain underweight emerging markets. From an asset allocation perspective, we believe emerging markets stand out as one of the most attractive regions globally, while valuations are relatively 'cheap' in historical terms.

Institutional investors recognise the role emerging market equities can play in helping to realise greater investment returns over the long run, but stock selection underpinned by rigorous fundamental analysis should be integral to any successful emerging markets equities strategy.

Prevailing market conditions may lead to distortions; however, it is important for investors to take a long-term view of the asset class to ride out any short-term volatility. The emerging markets investment universe is highly bifurcated, but there are attractive opportunities for value-focused investors to pick up good quality stocks at good prices in out-of-favour, or less-crowded, cyclical areas of the market.

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