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NAVIGATING EMERGING MARKETS

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Navigating Emerging Markets

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Navigating a heterogeneous mix of countries

The football World Cup is a truly exciting and special event. However, would it be as exciting and special if the participating teams were chosen solely based on their theoretical potential, and not the results they delivered in the qualifying stage? If this were the case, one would not have seen the brave David vs. Goliath effort of Costa Rica and Uruguay to oust England and Italy from the group stage in 2014 nor would one see the best-of-the-best from each region. In our view, a global tournament in which the participating teams were chosen based on their theoretical potential would not be very meaningful.

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This is, however, the case for Emerging Markets. The sole commonality across this heterogeneous universe is the potential – however small or big, for economies to emerge and "graduate" to the category of developed markets.

Emerging Markets are not all born equal and do not possess the same development potential, and therefore differentiation in this extremely heterogeneous universe is vital. Moreover, the extent to which a range of experts and investors paint Emerging Markets with one single brush is surprising. It is on par with George W. Bush's erroneous labeling of Africa as one nation. We believe that there are two overarching factors that will determine whether an economy actually will "emerge": strong institutions and the long-term ability of corporates – and thus a country as a whole – to move up the value chain. Given that many economies in the Emerging Markets universe do not possess these characteristics or are actually heading in the wrong direction, we consider the term 'Emerging Markets' grossly misleading. We take this opportunity to advance a term that we deem to be more appropriate for the subset of economies that are on the right path. We also highlight two important lessons to keep in mind when navigating this exciting yet turbulent universe.

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Swimming naked when the tide goes out

Among the primary reasons for the immense popularity of the term 'Emerging Markets,' is the positive connotation. However, a serious risk associated with the term is that investors, economists, and local politicians believe that these countries eventually will emerge - it is just a matter of time and less dependent on the initiatives that are actually put in place. In the world of football, those teams that solely rely on their on-field potential and past results, and consequently do not work hard, undertake the appropriate long-term investments or employ the right tactics will not qualify for, for example, the World Cup. Similarly, those developing nations that do not have the appropriate building blocks in place will stand still, regress or submerge. We have seen this throughout the course of history, with countries like Brazil, Turkey and Malaysia as prime examples in the current environment.

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This was unthinkable in the last decade when virtually all corporates in developing economies experienced strong growth, supported by positive developments in the U.S. and China, rising commodity prices, increased global trade, and credit-fueled local demand.

Unfortunately, despite the bonanza of this period, few developing economies actually seized the opportunity to implement the necessary structural reforms, which are vital for sustainable long-term growth. As was highlighted in the Financial Times on August 3rd 2015, economic cycles of developing economies have generally been driven by two main forces: the liquidity force of the U.S. and the commodity force of China. In recent years, we have seen less support from these factors, given the beginning of the potential U.S. interest rate normalization, China slowdown, the commodity price slump and most recently, the uncertainty associated with the devaluation of the Chinese Renminbi. This perfect storm has rocked currencies and equities in developing economies – some more than others – and exposed the frailties of many developing economies. As Warren Buffett famously said, "You only find out who is swimming naked when the tide goes out." During the past few years, it has become increasingly clear that many developing economies have neglected to invest in a pair of swim trunks.

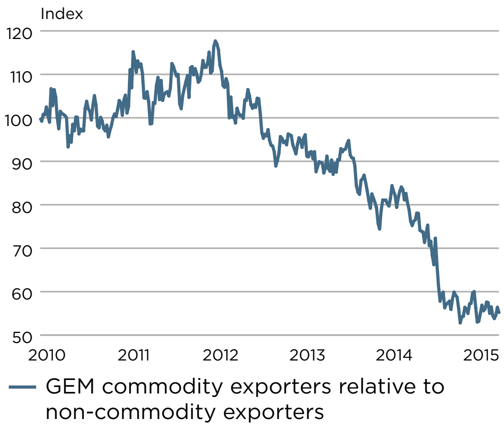
Emerging Markets are dead, long live Emerging Markets

The recent significant turbulence across the Emerging Market asset class deters and frightens many investors, particularly as strategists, investors, and the media lump the diverse set of countries into one combined entity and proclaim the death of Emerging Markets.

The challenges faced by developing economies are not trivial but have nevertheless negatively affected some more than others. Since 2010, the commodity-producing economies have underperformed the non-commodity-producing economies by 45% (as figure 1 shows), which clearly serves to highlight one of the key differences across the universe.

Figure 1

Commodity exporters have underperformed



Source: MSCI, Credit Suisse

The long-term attractiveness of certain countries, and in particular certain companies, is not over. Nevertheless, as we have mentioned, differentiation is key. The question is: on which parameters should one differentiate in order to identify those economies that are on the path of emergence?

The importance of institutions

In their book, "Why Nations Fail," Daron Acemoglu and James Robinson highlight the importance of having strong political (and economic) institutions, which they dub inclusive institutions, in order for a country to achieve long-term, sustainable economic growth. Confidence in institutions is key, as it results in individuals' and corporates' willingness and incentive to invest and innovate, given the conviction that institutions will implement the rule of law, undertake sound economic policies, and allow innovators to make money.

Currently, in the universe of developing economies, few countries have strong institutions and the political position to actually implement structural reforms. In some cases, we actually see regression in terms of the development of institutions. In Turkey, for example, President Erdogan's meddling in central bank affairs is an example of the state overriding the checks and balances in the system.

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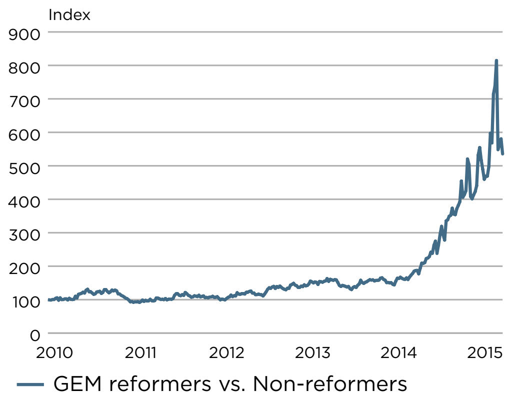
Other countries are vocal about adopting reforms but lack the political support or ability to withstand the potential short-term pain that may occur. The key is implementation! In fact, those countries that have implemented structural reforms (or are likely to do so) have also been rewarded by investors and delivered significant outperformance. Reformers are performers.

Figure 2

Reformers are rewarded in the stock market



Source: MSCI, Credit Suisse

Moving from cyclical to stable economies

In addition to strong institutions and implementation of structural reforms, a country's ability to emerge is contingent on its long-term ability to move from an economy reliant primarily on the primary sector (agriculture and commodities) to the secondary sector (manufacturing), and finally to the tertiary sector (services and technological innovation). In other words, the key is to shift

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focus from the more cyclical nature of commodities to the more stable nature of services and technological innovation.

This advancement of the economy could take a long time and not necessarily in a straight line, but advancing the economy through the various stages is associated with economic development, higher income levels, and a growing consumer class. Although it has some way to go before being primarily focused on services and becoming a highly innovative society, China is a prime example of swift progression in terms of economic advancement.

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The Advancing Reformers

In our view, countries that 1) have the ability to advance their economies by focusing on more value-added areas and 2) have strong institutions that ensure an adoption and implementation of reforms will be those that escape the famous middle-income trap and actually "emerge". We dub these economies 'Advancing Reformers'.

The term Emerging Markets does not add value for investors and other relevant parties. In fact, it is misleading in many respects. We believe that 'developing economies' is an appropriate term for the entire universe, as it highlights that these economies actually are in the process of developing adequate institutions and shifting their focus towards more value-added areas of the economy before they can become Advancing Reformers. In our view, Advancing Reformers is a much more appropriate term for those economies that we deem to be the most likely to actually emerge, and thus the most attractive.

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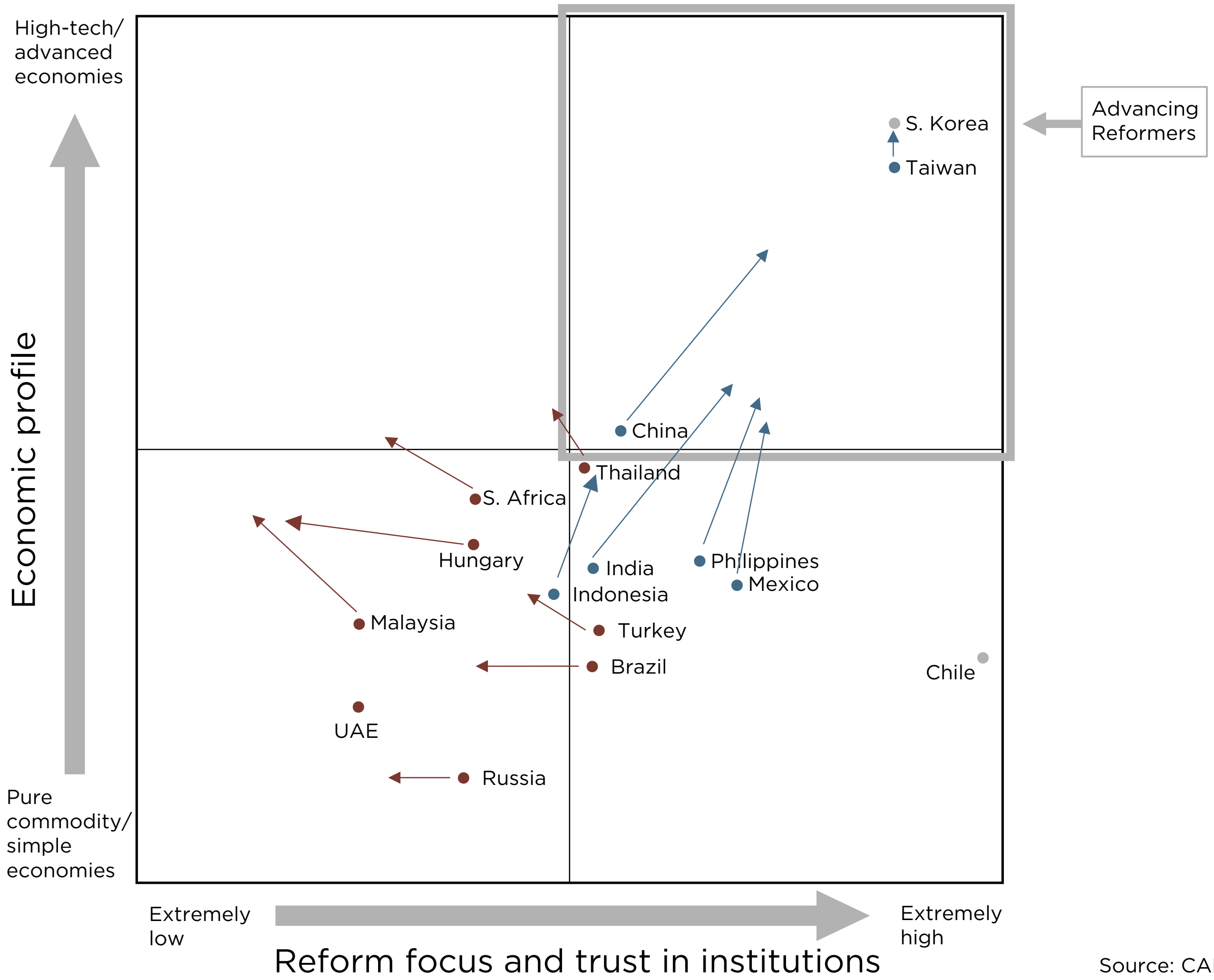
It must be added that it is the combination of reforms and a larger focus on moving up the value chain that results in emergence. Chile is a case in point. Since the 1970s, the country has undertaken an impressive reform agenda which, along with an abundance of natural resources, has helped to propel the country into the middle-income level. However, it has proven more difficult to reduce the economy's reliance on the cyclicality of commodities and increase the focus on more stable economic growth. For example, investment in research and development in Chile amounted to just 0.4% of GDP in 2012 compared to an average of 2.3% for other OECD countries. The inability for Chile to "emerge" can be attributed to its inability to advance the economy.

Figure 3

Economic "advancement" vs. structural reform implementation



Source: CAM

Most teams have strong performers

In our view, Mexico, India, the Philippines and China (and Indonesia, to a certain extent) currently fit the "structural reformer" bill. Governments in these countries are more likely to be able to create a more favorable economic backdrop as well as options for the private sector to partake in growth opportunities.

In the world of football, these represent the teams that will most likely win the World Cup – they have solid supporting infrastructure, an inspiring coach, and strong tactics and players. Nevertheless, teams that are not considered favorites also have strong players. When designing a dream team, these players must be included. In the world of investing, some companies do not have the support of being located in Advancing Reformers. However, they are too strong to ignore – they have competitive advantages and strong growth prospects, and in numerous cases are less dependent on developments in the domestic economy. Naspers is a prime exam-

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Lessons from the first year of operations

After our first year, we are unwavering in our belief that a combination of structural growth themes – in some cases driven by structural reforms, which can result in more favorable operating conditions for companies – and in-depth stock-picking will generate strong investment results over the long term. During our first year of operations, we have experienced the turbulence that can characterize the asset markets of developing countries. Two important lessons particularly stand out.

For some economies, headwinds can develop into cyclone-type situations with a battering of currencies and equities, particularly where structural reforms have not been implemented and defenses are weak.

1. **Being selective**
   In developing economies, the key is to be extremely selective. For some economies, headwinds can develop into cyclone-type situations with a battering of currencies and equities, particularly where structural reforms have not been implemented and defenses are weak. On the other hand, if you are selective and maintain a primary focus on Advancing Reformers as well as attractively-priced companies with strong competitive advantages and growth prospects, you will generate strong investment returns over the long term. Although turbulence and uncertainty can be unnerving, it is particularly during periods of significant uncertainty and skepticism that you can find attractive investment opportunities. As Warren Buffett said, "you have to be greedy when others are fearful and fearful when others are greedy".

2. **Keep your eyes on the prize**
   It is vital to look through bouts of turbulence and uncertainty and maintain a long-term focus when investing in developing economies, including Advancing Reformers. Company and country-specific risks are typically greater than in more developed markets. However, the rewards of being selective and potentially finding the next global dominators within certain industries greatly outweigh the risks mentioned. The key is to continuously keep your eyes on the long-term prize.

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