Newton Global Emerging Markets strategy

NEWTON
The Power of Ideas

2014 was a year of growing emerging-market divergence, and in 2015 we expect this divergence to grow further.

Executive summary

- We see scope for further divergence between emerging markets, continuing a number of the trends that have become increasingly apparent over the last 12 months.
- Over the three years to 31 December 2014, the strategy delivered a 3-year annualised gross return of +13.4% (in sterling terms), versus the return from the comparative index (MSCI Emerging Markets) of +4.3%. Over 2014, the strategy delivered a positive return of +13.1%, compared to the index return of +4.3%.
- China's efforts to rebalance its economy away from investment, as per our *global realignment* and *Chinese influence* themes, together with supply-side factors, have profound implications for commodities, as well as the economies that are heavily reliant on them.
- In this context, our Global Emerging Markets strategy focuses exposure on the consumer and services sectors, not least on mobile internet beneficiaries, as per our *net effects* theme.
- The weakness of commodity prices is particularly negative for some Latin American economies, such as Brazil, but should be very helpful to certain other markets, notably India, where the strategy has been overweight since 2011.
- There are many companies and countries within emerging markets in relation to which we see exciting potential profit growth and hence capital return prospects. However, there are also many to avoid. It is important to keep portfolio positioning focused on fundamentals that should manifest over a multi-year view, and not be tempted into trading gyrations in the market.
- Given the divergence between emerging markets, we believe it is essential to be active in managing emerging-market equity investments. The composition of equity-market indices is not skewed towards areas we favour (e.g. healthcare) or away from areas we are cautious about (e.g. where there are high levels of state ownership).

A brief review of emerging markets in 2014

After a colourful 2013 and the 'taper tantrum' in emerging markets[1] divergence in economic performance continued to persist last year. Differentiation has been seen across the whole of the emerging-market spectrum, not just the previously badged 'Fragile Five', not least owing to sharp changes in commodity markets. 2014 was also a year of elections in a number of emerging markets – the most significant one for our Global Emerging Markets strategy being India. In Brazil, the re-election of Dilma Rousseff was potentially for the worse; although she may now be forced to change tack, it is likely to be too late to avoid a recession. Indonesia's election result is promising, but provided nowhere near the same strong mandate as Prime Minister Modi has in India.

Economic reform opportunities are another differentiating factor. Mexico's reform agenda has been somewhat disappointing in its execution to date. While we are encouraged about the agenda outlined, we are cautious on what the longer-term oil price will mean for foreign direct investment and energy reform.

2014 has been characterised by some highly divergent performances at the regional, industrial sector and company levels. We expect this level of differentiation to accelerate further. A well-managed, highly active portfolio can avoid the unattractive areas and focus on the most interesting ones, hence providing the potential for significantly higher returns with lower levels of fundamental risk.

It is worth noting that some traditional portfolio risk measures (such as tracking error and, to a slightly lesser extent, beta and standard deviation) may fail to capture factors such as the robustness of profit margins and balance sheets of underlying holdings, as well as corporate governance factors.

MSCI EM index was -5% in US-dollar terms over 2014:

Source: Bloomberg Data, January 2015

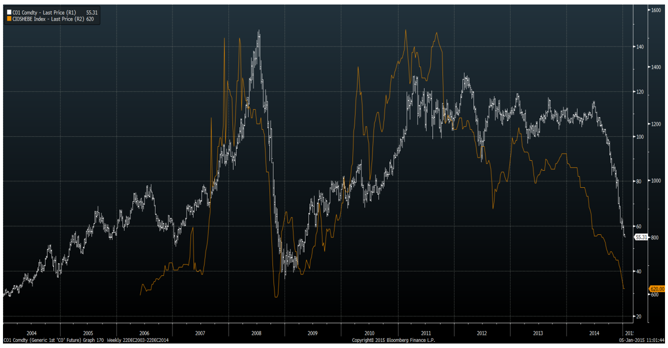
Commodities carnage

China continues its efforts to rebalance away from investment-led growth towards consumption and services. This, together with factors such as a stronger US dollar on hopes of higher interest rates and the excess supply in commodity markets (notably from US shale oil production), led to sharp underperformance of commodities sectors over 2014:

MSCI Emerging Markets Energy	-29%[2]
MSCI Emerging Markets Metals & Mining	-27%[3]

The chart below, showing the iron ore spot price (Hebei, Chinese yuan/tonne) on the orange line, and Generic 1st Brent crude future price ($/barrel) on the white line, illustrates the bull market in commodities and the recent dramatic price collapses.

Iron ore and oil:



Source: Bloomberg Data, January 2015

The Russian equity market collapsed (MOEX index -47% in US-dollar terms) and Latin America was generally ugly – not least Brazil (IBOV index -14%), but others were also weak, including Mexico (where the Mexbol returned -10%) and Chile (IPSA -10%),[4] as commodity-price and volume weakness led to deterioration in the terms of trade and hence a worsening in not only the profits of commodity-exporting companies, but also the currencies and domestic consumer economies. We fully expect this to continue, not least owing to the Chinese economic rebalancing noted above.

The Brazilian real has had to adjust to the deterioration in the terms of trade via depreciation, which has had a knock-on negative impact on the Brazilian consumer which is just starting to be realised. The government has filled the GDP growth gap with credit expansion and via expansionary socialist policies, but this has not led to the necessary productivity growth. The economy has reached the

[1] Source: Newton, Gross of fees, close of business unit prices; Past performance is not a guide to future performance. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested.

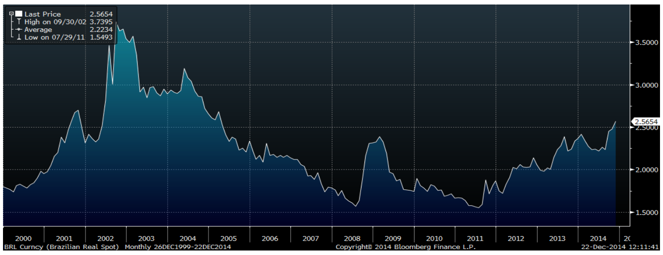
[2] Thomson Reuters Datastream, January 2015

[3] Thomson Reuters Datastream, January 2015

[4] Thomson Reuters Datastream, January 2015

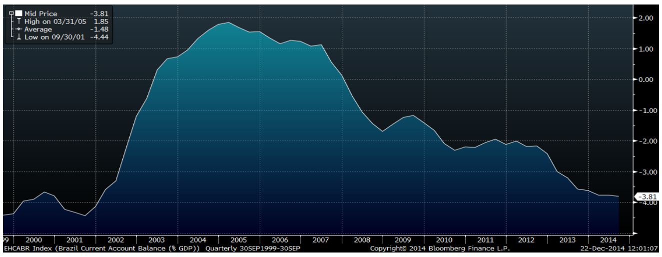
limits of this policy backdrop, so now the painful adjustment is beginning and it is likely to be a tough few years ahead. The over-leveraged loan-deposit ratio of Banco do Brasil typifies this extended position, and the consequent deceleration in loan growth is negative for GDP and Brazilian profits.

Brazilian real vs US dollar:



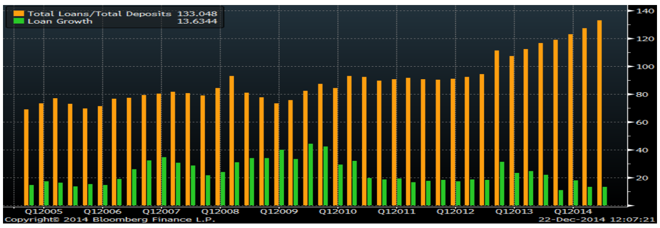
Source: Bloomberg Data, December 2014

Brazil current account as a % of GDP:



Source: Bloomberg Data, December 2014

Banco do Brasil's loan/deposit ratio and loan growth:



Source: Bloomberg Data, December 2014

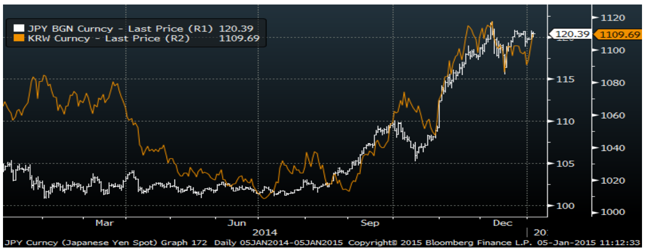
The Newton Global Emerging Markets strategy was heavily underweight commodities sectors throughout 2014, and remains so. Exposure to Latin American holdings has been reduced progressively and is heavily underweight relative to the MSCI Emerging Markets index.[5]

Review of other emerging markets in 2014

Many of the best-performing emerging equity markets were Asian, including India (Sensex +27% in USD), the Philippines (PCOMP +22%), Indonesia (JCI +20%) and Thailand (SET +15%).[6]

Korea and Taiwan were somewhat uninspiring markets (KOSPI -8% in USD, TWSE +1%).[7] Korea has been suffering from the knock-on effects of Japanese 'Abenomics' policies, which have been leading to a sharp deterioration in the yen, thereby eroding South Korea's relative competitiveness in the export market and leading to the currency following the yen devaluation, though still lagging it.

Korean won and Japanese yen vs US dollar:



Source: Bloomberg Data, January 2015

Despite recent Korean won weakness, the currency has still been appreciating against the yen, thereby challenging the competitiveness of exporters in broadly weak end markets, such as Europe.

Japanese yen / Korean won cross rate:

Source: Bloomberg Data, December 2014

Healthcare was one of the best-performing sectors in the MSCI Emerging Markets index over 2015: +19% in US-dollar terms.[8] There are plenty of attractive growth opportunities in this sector. It represents only 2% of the MSCI Emerging Markets index,[9] but it represents 8.6% of the Newton Global Emerging Markets strategy.[10]

Eastern Europe was generally uninspiring over 2014, and Russian spill-over risks remain. Turkey rallied on the fall in the oil price, which takes some pressure off the very weak current account; the Istanbul market rallied (XU100 +14%).[11]

5 Please note: strategy positioning is based upon the positioning of the strategy's representative portfolio

6 Thomson Reuters Datastream, January 2015; Portfolio holdings are subject to change at any time without notice and should not be construed as investment recommendations. Any reference to a specific security, country or sector should not be construed as a recommendation to buy or sell this security, country or sector.

7 Thomson Reuters Datastream, January 2015

8 Thomson Reuters Datastream, January 2015

9 FactSet, January 2015

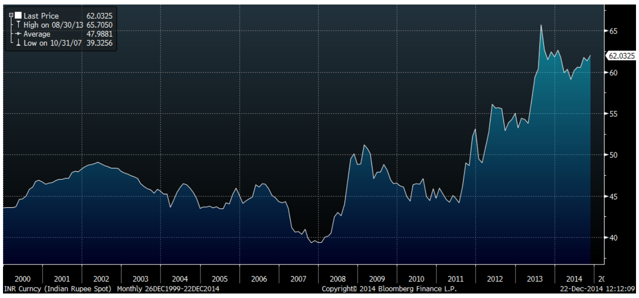
10 Source: Newton, January 2015; Please note: strategy positioning is based upon the positioning of the strategy's representative portfolio

11 Thomson Reuters Datastream, January 2015

South Africa remains poorly governed and is deep into a consumer credit down-cycle. Despite good corporate governance and some interesting businesses, it remains a difficult place to find good growth potential.

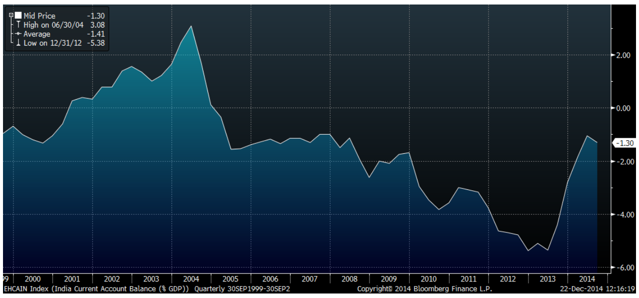
India has seen very significant currency devaluation since mid-2011, and the resultant current account stability should lead to currency stability as the better investment outlook improves capital flows.

Indian rupee vs US dollar:



Source: Bloomberg Data, December 2014

India current account as a % of GDP:

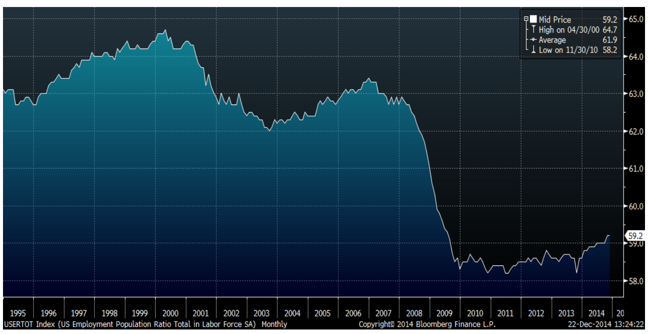


Source: Bloomberg Data, December 2014

The stronger US dollar

US interest-rate rises have been progressively priced into markets as US economic data has improved. That said, rate rises seem likely to be less strong than anticipated by the market, given strong disinflationary trends both from lower commodity prices, which will filter through the entire economy with a lag, and from poor wage growth. Contributing to this could be the structural challenges from greater automation, not least from the replacement of clerical tasks with cloud-based IT systems, which could lead to structurally higher rates of unemployment than in the past. We have been encompassing this thinking into our investment process via our recently evolved *smart revolution* theme.

US employment ratio:



Source: Bloomberg Data, December 2014

Emerging-market currencies have already factored in much of the differing rate outlook. Competiveness has improved in many countries, and some of them now have far more robust external balances. Developed-world demand has been broadly weak, not least from the very important European market. The lower oil price may help boost developed-market import demand as consumers see reduced fuel costs, but cheaper oil is also very good for many emerging markets such as India and China.

Other thoughts on 2014

Lower inflation in India in particular is very positive for consumers. However, the capital investment cycle will take time to recover as existing projects are prioritised rather than new ones being started. The new business-minded government, under Narendra Modi's BJP, seems to be doing many of the right things, but it takes time. Still, we think India will be one of the strongest equity markets in the world over the next five years, and our Global Emerging Markets strategy is 17% overweight versus the MSCI Emerging Markets index as a consequence.[12]

In an investment environment full of distracting noise, and with such volatile markets, it is important to keep long-term perspective. We are not underestimating the transformational shifts being seen, but we use our thematic framework to try to keep perspective. There are plenty of high-quality companies with decent growth opportunities still available in emerging markets in which we can invest.

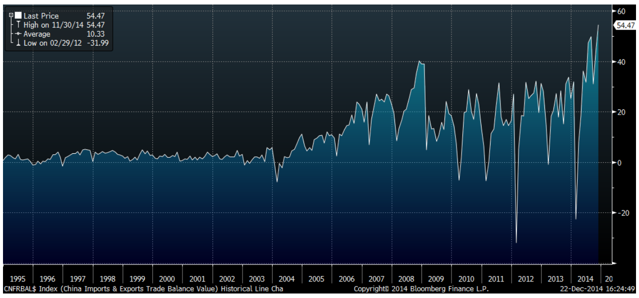
Reality bites

The outlook for Russia has deteriorated significantly over the last 12 months, following its aggressive moves to annex Crimea. Weak oil, more than economic sanctions, has meant that we have tempered our enthusiasm for structural growth companies in the internet sector in Russia as the economic collapse more than offsets the positive aspects, while the risk of capital controls looms large. In this context, capital preservation is our primary concern over relative performance.

Sub-Saharan growth stories, such as that in Nigeria, will also be put on hold or regress in the nearer term, and it may take some time for markets to adapt to the significant change in the profit backdrop for companies in those markets, albeit that we are looking for companies with good growth in real hard-currency (e.g. US-dollar) terms. This is very challenging when a currency is undergoing a downward terms of trade adjustment.

12 Please note: strategy positioning is based upon the positioning of the strategy's representative portfolio

On the other hand, the Chinese trade surplus has ballooned as commodity import costs have fallen sharply:



Source: Bloomberg Data, December 2014

Newton Global Emerging Markets strategy review and outlook

Performance

Over the three years to 31 December 2014, the strategy delivered a solid 3-year annualised gross return of +13.4% (in sterling terms), versus the return from the comparative index (MSCI Emerging Markets) of +4.3%.[13] We believe our thematic, long-term and active investment approach has been the key driver behind this return, combined with rigorous stock analysis. Over 2014, the strategy delivered a positive return of +13.1%, compared to the index return of +4.3%.[14]

Cumulative rolling excess return since inception (31 May 2011) (%)

'Net performance figures are for illustrative purposes only - actual net returns for client portfolios will differ'.

It is important to note that we have sought to achieve these returns with a balanced risk profile, and without unnecessary trading. Our investments are long-term in nature, with an emphasis on quality and high return on capital employed. The resulting strategy beta is less than one.[15] Given the volatile nature of emerging markets, we believe it also pertinent to point out the strategy's historic drawdown characteristics, which demonstrate the strategy's quest to withstand (and recover from) bouts of volatility, especially given the way emerging markets are often buffeted over the shorter term according to the direction and pace of US monetary policy. Ultimately, however, it is real profit growth in hard-currency terms that drives the strategy's capital returns.

Positioning

The strategy has a high active share, with concentrated positionsIt is also active in the sense that it may take very aggressive positions versus the (backward-looking) comparative index.

Indeed, the comparative index is merely a performance measurement tool rather than of any use in portfolio construction; and, given that the index is 30% state-controlled,[16] many of the key constituent companies are unlikely to be run to the benefit of minority shareholders. Therefore, we are happy to take a zero weight position in Korea, for example, where we believe corporate governance is generally poor, where exporters are at the mercy of the actions of the Bank of Japan, and where domestic demand is plagued by poor demographics and high levels of household leverage; this means a 14% underweight position.

We are also extremely cautious on Brazil, which is undergoing a terms of trade adjustment, coupled with the unhelpful re-election of President Dilma Rousseff. This has resulted historically in a 7-8% underweight position, increasing further still through 2014.

The outlook for the economies of India and the Philippines is far more positive, and Mexico has potential, although recent oil-price declines may dampen the benefit of energy sector reforms. The strategy has a 17% overweight position in India and has been overweight the country since 2011. Although painful for performance in late 2011, Indian positions have been providing attractive returns since 2013, while the large underweight in commodities has led the strategy to avoid many of the worst performers.

All these positions have been heavily influenced by our thematic approach, which keeps us focused on the long-term, rather than being too distracted by short-term noise.[17]

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13 Source: Newton, Thomson Reuters Datastream, January 2015

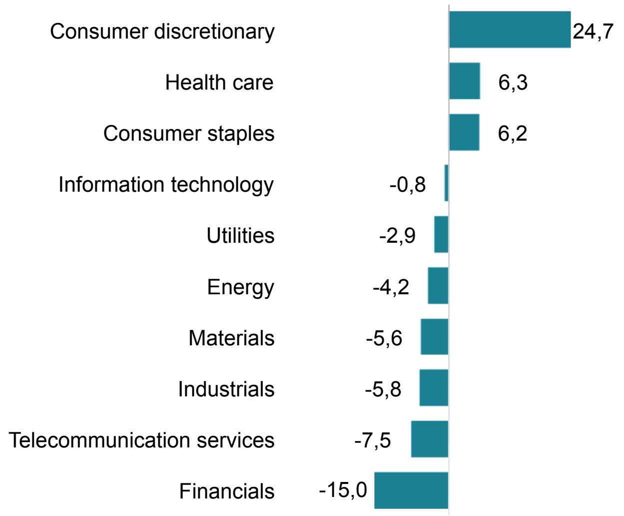
14 Source: Newton, January 2015

15 Source: Newton, January 2015

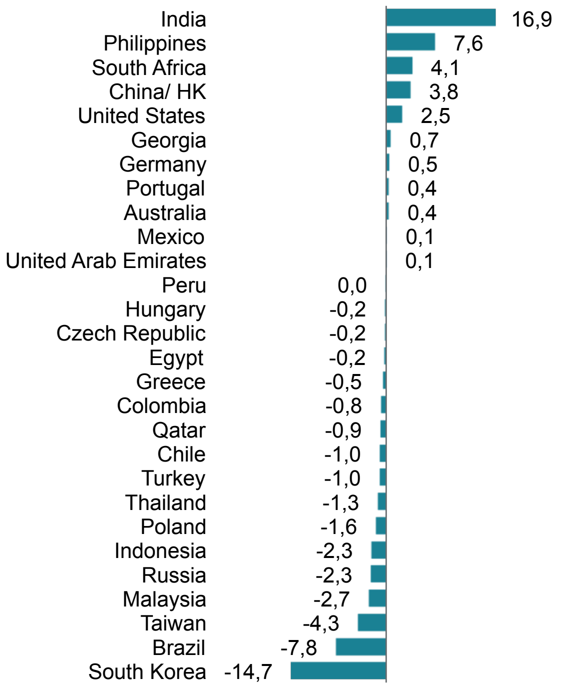
16 Source: Deutsche Bank, MSCI; weighted average figure, January 2014

17 Please note: strategy positioning is based upon the positioning of the strategy's representative portfolio.

Sector allocation



Country allocation



Relative position to comparative index: MSCI Emerging Markets. Any reference to a specific security, country or sector should not be construed as a recommendation to buy or sell this security, country or sector. Please note that portfolio holdings and positioning are subject to change without notice. Please see important information at the end of the document. Source: Representative portfolio, Newton as of 31 December 2014.

Thematically, the strategy has benefited particularly from its investments in internet-related companies, which have been some of the key beneficiaries of our *net effects* theme. Examples include companies such as **Vipshop**, up around seven times since it was introduced to the strategy in 2013, as well as large positions in **Naspers** and **Baidu**. Despite our long-term positive view on **Vipshop**, we have since halved the position as we constantly reassess risk versus reward parameters and adjust portfolio exposure accordingly. *Healthy demand* is another theme which is particularly relevant to emerging markets – rising disposable incomes driving changes in lifestyle and consumption patterns, meaning increased incidences of obesity. Increased affordability and insurance products also mean that healthcare services are seeing a greater share of consumer spending. This means that healthcare, alongside education, is something that emerging-market consumers prioritise within their budgets. We believe that healthcare is under-represented in the comparative index, but, as this is an actively managed strategy, it is able to have a 7% overweight in the sector and hence a material impact from healthcare companies. These are a few examples of how our long-term stock-picking combines with our thematic approach to seek returns with reduced fundamental risk.

We monitor valuations closely, but we are very aware of the higher value that should be assigned to businesses with higher sustainable returns on capital, particularly when combined with higher sustained growth rates. We seek high-quality earnings streams and franchises which should be able to continue to deliver growth in the long term and withstand economic cycles. In a market that is seeing some big structural shifts, not least in the commodity sector and all related currencies and economies, apparently 'cheap' stocks may prove anything but cheap as margins prove vulnerable to dramatic deterioration. We have avoided Russian banks, cognisant that when times are tougher, minority shareholders are the least of their concerns - a case study in our *state intervention* theme. Similarly, we must be very aware of the challenges posed by large-scale family or oligarch ownership, and hence position the strategy in companies which are run in the interests of all shareholders. Too often, cash may be siphoned out of the listed entity via related party transactions, or invested in projects that benefit the state rather than the shareholders. Our emerging markets team works closely therefore with our responsible investment team on matters of governance. This is particularly important in emerging markets, where shareholder rights are not quite as well protected as they are in other more developed markets.

2015 outlook

We continue to advocate the benefits of being both active and thematic in emerging markets, and emphasise that investing in emerging markets today is very different from investing in them, say, a decade ago when it sufficed to buy exchange-traded funds as a rising tide floated all boats. Today, the market is highly differentiated, yet the 'emerging-market trade' groups emerging markets into one basket, which is inappropriate but leads to potential opportunities for the more astute. Our team seeks to distinguish itself by keeping a five-year investment horizon and hence seeking to identify the real long-term beneficiaries of emerging-market growth. We believe there are still tremendous opportunities to be found through exposure to themes such as *population dynamics, smart revolution* and *healthy demand* while avoiding the pitfalls found in relation to *state intervention, debt burden* etc.

As mentioned above, the team is positive on economies such as the Philippines, where population demographics are a tailwind, not a headwind, where credit penetration has rebased in the aftermath of the Asian crisis (and therefore the country has not been borrowing from the future like others), and where productivity has the scope to increase. These are all factors conducive to continued strong GDP growth in real hard-currency terms. There is no evidence of external or internal imbalances, and remittance income remains very strong. The 2016 elections will be critical in helping to sustain further growth through increased investment and reform. Mid-term elections in Mexico must also be monitored, along with the implications of a lower oil price for the country's energy reform agenda.

For Brazil, the outlook continues to be heavily influenced by China's reducing commodity intensity and excess production capacity on the supply side, meaning both volumes and prices are vulnerable. Brazil also has an over-extended credit cycle, which it has sought to use to drive GDP growth in the face of poor productivity growth and deteriorating terms of trade. As a result, our view running into the election was that, whoever won the election, the outlook would be extremely challenging for growth, that, even if economic reforms were pursued, these would be likely only to accentuate the nearer-term challenges to corporate profits, and that a recession remained likely. As a consequence, we did not moderate the strategy's underweight exposure to the country.

India had previously been plagued by a high fiscal deficit, bad policy choices, high commodity prices, and an extended credit cycle, high inflation and a weak currency. Now it has a credible and strong-willed central bank, a reform-minded government, and commodity price falls which are very beneficial to its terms of trade. We are increasingly confident that some of the major blockages for reform are in the process of being dismantled, and the government has already taken some bold steps, such as removing fuel subsidies.

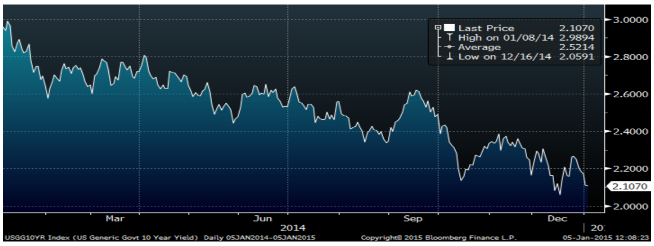
Indonesia had not been as fiscally reckless as India; however, commodity price declines are a key challenge in an otherwise attractive domestic demand market. Nonetheless, the country has taken advantage of lower oil prices and tackled its fuel subsidy challenge, which will free up resources to allocate to more productive areas such as infrastructure spending instead.

Thailand is another country with an extended credit cycle, but the pressure upon it has been eased by the decline in oil prices. Fundamentally, the Thai market is less attractive than many others in Asia, given ageing demographics and high levels of household debt which inhibit growth potential. However, the interim government could achieve a great deal and there are potential benefits from ASEAN Economic Community 2015 (the creation of a single regional common market). Politics and the health of the king are key areas to watch.

US knock-on effects on emerging markets

With recent falls in commodity prices, the pressure on the Federal Reserve to increase interest rates should be very weak as annual CPI inflation will be moving lower. As a result, the outlook is only for very modest and well-spaced rate rises in the US. Our expectation is therefore that US rates should only rise gradually, which should not cause an indiscriminate rush of capital from emerging markets. The yield curve may be overoptimistic in this respect and the strengthening of the US dollar may have run most of its course already. We could see certain Asian currencies strengthening as their current accounts and growth prospects improve with the lower oil price.

US generic 10-year yields – not much sign of a trend reversal:



Source: Bloomberg Data, January 2015

EM differentiation

We believe that the differentiation among emerging markets will continue to persist and widen further still. Such divergence of performance can only be captured via an actively and thematically managed portfolio such as the Newton Global Emerging Markets strategy.

China meltdown?

China is undergoing a structural slowdown and we fully expect GDP growth to decelerate. Population dynamics are not favourable, with a rising age-dependency ratio and working age population decline weighing on GDP growth potential. China is likely to continue rebalancing efforts and its reform agenda, helped by commodity-price declines, which will boost its trade surplus. Key aspects include moving towards more free-market pricing, more private-sector participation in industries that were previously state-dominated, and a greater focus on return on capital across the corporate sector as the credit intensity of growth has come under intense scrutiny. The latter could lead to a significant shift in profitability, which could be far more important to stock market returns than GDP deceleration. Importantly, we see no signs of a financial collapse and the government still has plenty of levers to pull to prevent one. In the meantime, the dramatic fall in commodity prices is leading to a surge in China's trade surplus, challenging those who suggest the currency is vulnerable to devaluation.

Commodities

It is worth bearing in mind that market indices tend to reflect historic profitability and hence capital allocation, rather than being forward-looking. As we see a structural shift in commodity supply versus demand dynamics, it will take time for markets to digest fully the implications as they become realised through differing currency moves, economic outcomes and profit shifts at the company level. Whereas our themes tilted portfolios heavily towards commodity-driven sectors and other industrials through the early to mid -2000s, the themes now tilt us broadly towards the consumer sectors and to knowledge-based companies, such as the winning internet platforms.

Oil seems set to stay in a lower trading range than we have been used to in recent years for the near future, albeit that accurate forecasting is very tricky. OPEC is seeking to put some pressure on more marginal producers, such as certain US shale oil companies, and their financial backers, to reassess the more optimistic assumptions. The strategy has been heavily underweight commodities sectors, as well as most commodity exporting countries, for some time, but we had not anticipated such a precipitous decline in oil in particular. Overall, the oil price decline is very positive for many economies in which we are investing, despite the shorter-term market volatility. Latin America remains heavily underweight in the strategy, with only 1.1% in Brazil, and we may even reduce this further.

Geopolitics

Russian positions were reduced through the year as the country's risk profile progressively deteriorated. We remain wary of Russia's political and financial position, and hence the risk of capital controls; protection of capital is considered a priority over relative performance in this context.

North Korea remains a notable tail risk in Asia, and its situation has the potential to spiral with acts of desperation. This also informs our risk assessment of South Korea.

Economic reforms

India has a particularly strong mandate in this respect and the momentum is accelerating. This market remains the strategy's top overweight (at +17% relative), and the oil price decline is very helpful. In a market context, India has moved from one of the 'fragile five' to being highly favoured among emerging-market investors, and near-term valuation multiples have moved to reflect investor optimism. We anticipate that some investor fatigue will be felt; however, over the longer term, India still looks very attractive, and is in the early stages of recovery from a cyclical downturn. Hence, current valuations are likely to be underestimating the profit upcycle for years to come.

In summary

We expect highly divergent performance at the country and industry sector level. Emerging-market indices may be somewhat uninspiring over the next year, as may global indices, but we believe this will hide some highly favourable opportunities in specific countries, sectors and, most of all, companies. By focusing holdings on those opportunities we deem most attractive, we believe our Global Emerging Markets strategy has the potential to show capital growth despite this complex backdrop. We continue to use our investment themes in combination with a rigorous long-term fundamental approach in seeking to maximise returns, while maintaining an acceptable fundamental risk profile.