PENDAL

No use buying the best house in a bad neighbourhood

Why an active approach to emerging markets is crucial; emerging markets go right or wrong at a country level.

We believe the single most important investment decision in emerging markets (EMs) is not the kind of company you are buying – it is the country in which it operates. For this reason, we take the uncommon approach of a top down approach to investing, typically avoiding at least half the countries in the index.

Emerging markets are not homogenous and this leads to different investment outcomes and a greater dispersion at a country level between emerging and developed markets (DMs). Country-driven research helps identify the most attractive countries – and stocks/sectors within them – and avoids those which are challenged. While buying the right companies is important, getting emerging market country calls correct can materially contribute to long term outperformance.

1

Emerging markets are not homogenous

Analysts and commentators often fall into the trap of talking generically about the characteristics of EMs. In reality, EMs are not homogenous. This can be demonstrated in any number of ways. GDP per capita varies from well over the global average in places such as Korea and Taiwan, to well under in the Philippines and South Africa. Some countries have high GDP growth, some low; some countries have massive debts, some negligible; some countries are in current account surplus, some in deficit. Some rely on exports; some don't. There are places such as South Africa and Peru which are dependent on mining; to others in the Middle East dependent on oil; to others such as Korea and Taiwan which have broad-based, highly-advanced technology sectors.

Generic statements about EMs also ignore the fact that there is *idiosyncratic risk* within each country – with significant differences in political systems, cycles and stability, for example. They are also spread across the world and therefore subject to different local issues. The regional issues facing Asian countries are different to those facing Middle Eastern, or African, or European or Latin American.

While buying the right companies is important, *getting emerging market country calls correct can materially contribute to long term outperformance.*

2

This leads to different investment

Given the significant differences across EMs, we shouldn't expect them to react in the same way to an economic event or environment. The implication is that at any given point there are emerging markets you will want to own – and those you won't. This is one of the key advantages of active management in emerging markets.

We can see this very simplistically in the divergence in performance of the larger emerging markets over the year to date in Figure 1. The best market – Russia was up over almost 18% while South Africa was down over 15%. It is important to understand that there is not merely a regional effect, as demonstrated by the divergence between China and Taiwan.

Delving deeper into the country effect emphasises its importance: If you compared the five year annualised USD total return of the 100 largest companies in four key EMs – Brazil, India, Indonesia and Korea, ordered them from best to worst, the best twenty companies in Brazil still underperformed all but a mere couple of stocks from India and Korea[1]. In fact, you were better off not being in Brazil at all. We like to think of this as "it does you no good buying the best house in a bad neighbourhood." That said – it is important to understand that the relationship between these countries is not structural – it changes over time, demanding an active and engaged approach.

1. Source: MSCI

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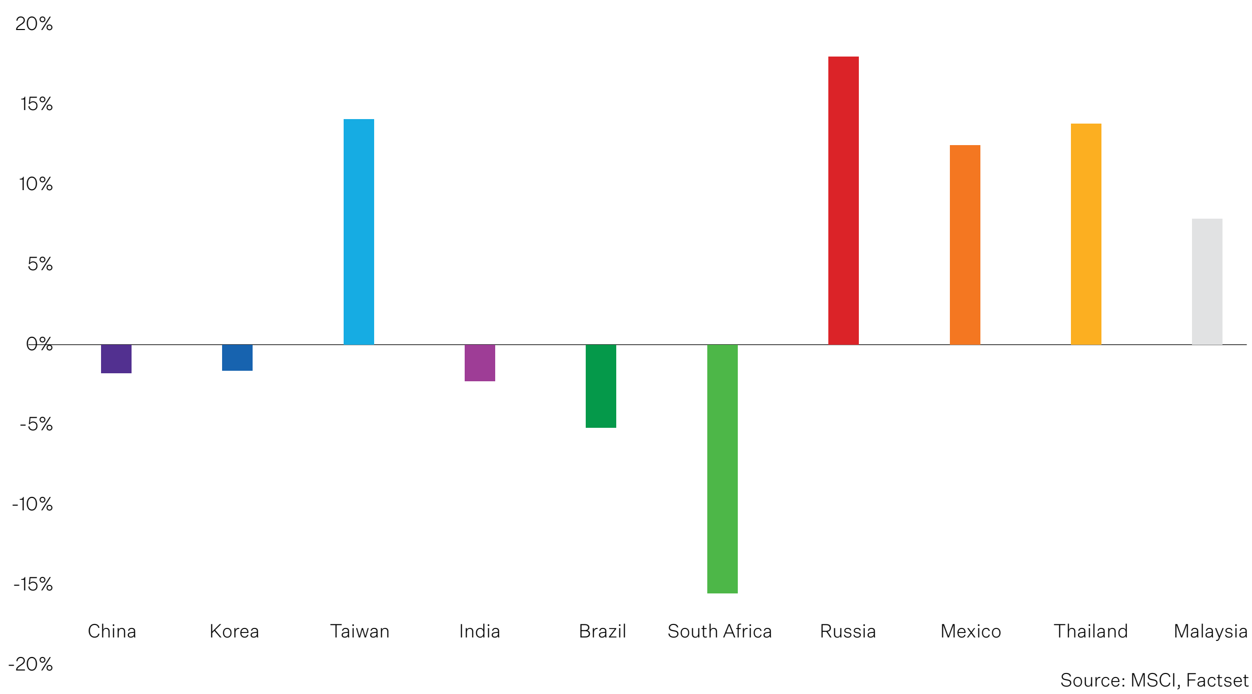
Figure 1: year to date 30 September 2018 AUD performance of 10 largest EMs



Source: MSCI, Factset

3

Country effect is more important in EMs than DMs

Both academic research and the team's extensive empirical experience underpins our belief in the importance of top-down country allocation.

Two key pieces of academic research (and related follow-on papers that confirm the original findings) are Local Return Factors and Turnover in Emerging Stock Markets, Rouwenhorst (1999) and Country and industry factors in returns: evidence from emerging markets' stocks, Serra (2000). These two papers each show a strong country-level effect in emerging equity markets that dominates regional, industry and stock-specific drivers.

Rouwenhorst finds that "Two empirical observations suggest that the return factors of emerging markets have a strong local character: their correlation across emerging markets is on average low, and the exposure to global risk factors cannot explain their average returns. There is no evidence that the factor correlations are higher among countries within particular geographical regions such as Latin America, Asia or Europe/Africa/Middle-East."

Serra notes "A strong national market force seems to dominate industry and other stock-specific influences.", "I… looked at the correlation of returns between portfolios of stocks in the same industry across markets. Cross-country returns within a particular industry never correlate more than market indices… Some industries are expected to be more global (for example, paper) than others (for example, real estate) but the correlation here is always low, whatever the industry considered. My results show that country pure effects are the most important factors driving the behaviour of emerging markets' individual stock returns."

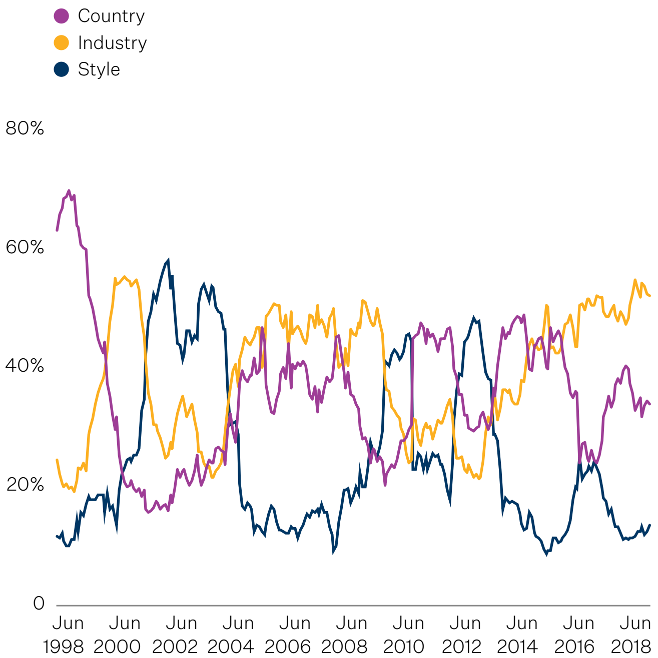
Three key points regarding the country effect:

1. The country effect on stock picking in EMs is always strong, ranging between 60-85%.
2. It is much higher than in DMs, where the country effect generally ranges between 20-50%.
3. The country effect always dominates style and industry effect in EMs, unlike in DMs. This explains why we believe a top-down approach is crucial in EMs, and less so in DMs.

Figure 2: Country effect on stock picking is highest in EMs

Developed markets

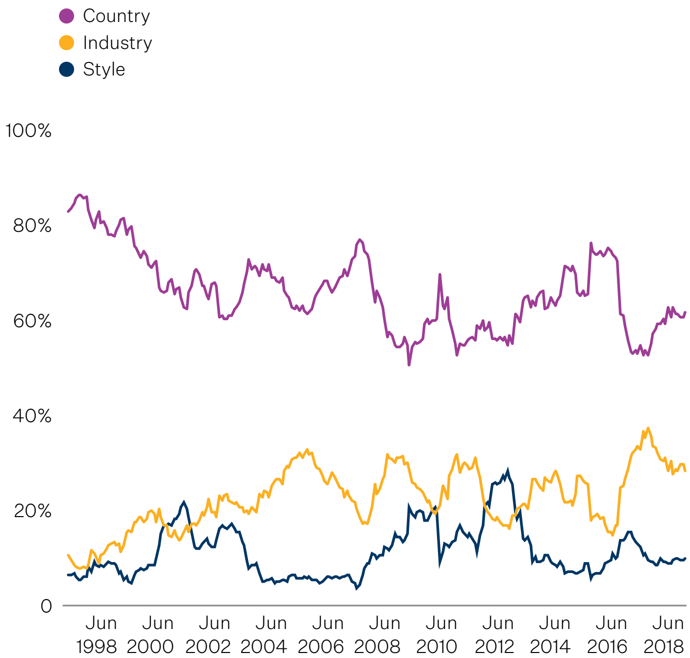
Cross sectional volatility, 12 month moving average



Source: MSCI, Bloomberg 30 June 2018

Emerging markets

Cross sectional volatility, 12 month moving average



Source: MSCI, Barra. Data from December 1997 to 30 June 2018

Pendal Global Emerging Markets Opportunities Fund – Wholesale

Fomerly known as the BT Global Emerging Markets Opportunities Fund – Wholesale

The strategy is:

1. Country-driven: typically owns half or less of the countries in the index
2. High conviction (40-60 stocks) and index agnostic at the stock level
3. Capacity limited (USD 3 billion to preserve investor alpha)

1 Country driven

- We aim to invest in reasonably valued markets with supportive economic and political conditions. By filtering out the large parts of the index that do not provide these characteristics we believe we will be able to outperform the MSCI Emerging Market index over the long term. The portfolio usually holds approximately half or less the countries in the index at any one time.
- We acknowledge that bottom up analysis is important. However in EM, macroeconomic inputs (eg GDP growth, interest rates, inflation, tax rates, FX rates, risk free rates and terminal growth rates) into bottom up models will have more importance than in DM. We therefore prefer to address these issues before looking at companies.
- Country allocation is driven by monthly analysis. Every country in the index is assessed and scored on a 5-point framework: growth, liquidity and monetary environment, currency, politics and governance, and valuation (Figure 3). Scores are based on a 24-month investment horizon – we are investing based on where trends are going, not where they have been.
- We invest in those countries which achieve the highest scores. Country allocations are set relative to index weight, country size and degree of conviction in performance. Large countries (>6% index weight) can be held +/-6% versus the index and smaller countries can be held +3% versus the index and down to zero absolute weight. We use systematic risk analysis to adjust country weights.
- Country positions do not reflect structural biases – over the course of their 12 years running this strategy, the portfolio has included almost every country in the index at some point.
- The success of our country-driven approach is borne out in the attribution of the Pendal Global Emerging Markets Opportunities Fund – Wholesale (the Fund). As Figure 4 illustrates, while stock selection has been a strong contributor, country-level decisions have made the major contribution to the Fund's outperformance (before fees and taxes) over the past five years.

Figure 3: Country-level 5 point framework

Country assessment				
1 Growth	2 Liquidity	3 Currency	4 Politics & Governance	5 Liquidity
• Domestic and export trends • Revisions to forecast GDP growth • Earnings growth rates	• Monetary policy, monetary aggregates • Credit growth	• Current account and trade balances • Real effective exchange rate	• Stability and risk	• Absolute valuation • Relative to history (time series) • Relative to other EM (cross-sectional)

Figure 4: Country Attribution (before fees and taxes) 30 September 2013 to 30 September 2018

	Fund Weight[1]	Benchmark Weight[2]	Fund Return	Benchmark Return	Fund Excess Return – Country Allocation	Fund Excess Return – Stock Selection	Fund Excess Return – Total Attribution
Brazil	2.56	7.97	-64.23	11.30	4.66	-4.59	0.06
Chile	0.00	1.31	0.00	24.47	0.54	0.00	0.54
China	25.00	25.09	73.23	88.57	1.18	-3.13	-1.94
Colombia	0.00	0.62	0.00	-13.89	0.85	0.00	0.85
Czech Republic	0.32	0.20	27.82	36.34	0.31	-0.21	0.10
Egypt	0.00	0.18	0.00	34.51	0.02	0.00	0.02
Greece	0.17	0.39	-99.41	-74.88	-0.15	-0.98	-1.13
Hungary	0.00	0.27	0.00	101.20	-0.14	0.00	-0.14
India	15.32	7.94	136.92	105.02	4.01	3.28	7.29
Indonesia	0.00	2.46	0.00	50.94	-0.03	0.00	-0.03
Malaysia	0.78	3.06	18.46	16.36	1.30	0.17	1.47
Mexico	0.91	4.19	41.20	18.68	1.53	1.83	3.36
Morocco	0.00	0.00	0.00	4.84	0.00	0.00	0.00
Pakistan	0.00	0.02	0.00	-35.95	0.10	0.00	0.10
Peru	0.00	0.41	0.00	126.31	-0.26	0.00	-0.26
Philippines	0.00	1.20	0.00	32.56	0.32	0.00	0.32
Poland	0.30	1.40	-40.94	19.46	0.69	-1.49	-0.81
Qatar	0.00	0.69	0.00	-2.24	0.45	0.00	0.45
Russia	4.78	4.03	-29.91	29.04	-1.37	-5.27	-6.63
South Africa	6.27	7.21	196.82	30.18	0.20	9.12	9.32
South Korea	18.63	15.11	137.69	62.60	1.60	10.81	12.42
Taiwan	16.28	12.06	99.77	107.58	1.86	-0.67	1.19
Thailand	1.10	2.28	5.11	84.73	-0.52	-0.54	-1.05
Turkey	0.06	1.32	-4.65	-36.40	1.40	-0.17	1.23
United Arab Emirates	0.00	0.63	-1.49	-11.89	0.58	-0.04	0.53
Cash	4.70	0.00	0.00	0.00	-3.05	0.00	-3.05
Non Benchmark Countries	2.84	0.00	6.55	0.00	-2.05	0.00	-2.05
Total	100.00	100.00	76.46	54.30	**14.03**	**8.13**	**22.16**

Source: JOHCM

1 Mean allocation of the Pendal Global Emerging Markets Opportunities Fund over the stated period.
2 Mean allocation of the MSCI Emerging Markets NR index.

2

High conviction and index agnostic at the stock level

- Top-down country analysis filters down the investment universe to sectors within a country which are best placed to benefit from supportive conditions. We buy strong sustainable growth opportunities at reasonable valuations (GARP) from within these sectors.
- Stocks are assessed on the basis of growth, liquidity, currency impact, and a 3-stage review of its business strength, corporate governance, and security (Figure 5). We also need a valuation that leaves upside as the growth story is recognised. Stocks are reviewed weekly. We meet management when practical and required.
- The portfolio is focused, with approximately 50 stocks. Positions sizes are set relative to conviction levels and contribution to risk. The maximum active position in a stocks is +5% versus the index.
- We are index agnostic at the stocks level. We do not hold index heavyweight stocks for risk purposes –every stock is expected to perform.
- No single stock or group of stocks dominates portfolio relative risk.
- The portfolio is low turnover – typically 50% per annum.

Figure 5: Company-level 5 point framework

Company assessment				
1 Growth	2 Liquidity	3 Currency	4 Management & Politics	5 Valuation
• Clear multi-year business growth with top-down support • Something special about management, business model or market position	• Self-financing growth, or well established financial resources to fund growth	• FX positioning in balance sheet and income statement matches our top-down expectations	Business • model, market position, management team • environment and social sustainability • Regulatory, taxation, legal and political risks Corporate governance • Identity/reputation of majority owners, treatment of minorities, related party transactions, dividends • Treasury shares, issuance, buybacks Security • Listing and exchange rules • Articles of association • Domicile and application law	• Absolute valuation • Relative to history (time series) • Relative to other EM (cross-sectional)

3

Capacity limited

- Total strategy capacity is set at USD 3 billion.
- In order that country-level decisions can be enacted without friction at the stock level, we need a sufficiently liquid portfolio. The strategy has a smaller capacity than most other Emerging Market funds, and also a large-cap bias, as a result.
- This limit is informed by the manager having run far larger amounts of FUM in this strategy at previous asset management firms.

Meet the portfolio managers

J O Hambro Capital Management Group

J O Hambro Capital Management is a performance led, multi-boutique asset manager headquartered in London.

- Launched in London in 1993, JOHCM has evolved into a global business managing money for clients worldwide, with assets under management as at 30 September 2018 of $54.9 billion.
- Launched in London in 1993, JOHCM has Since October 2011, JOHCM has been a wholly owned subsidiary of Pendal Group Limited.
- Performance-led remuneration and capacity discipline aligns interests of fund managers and clients.

“We believe an Emerging Markets strategy should be run by specialists – not as an ‘add-on’ to a global equity capability”.

James Syme
Senior Fund Manager – JOHCM

James Syme and **Paul Wimborne** have been investing in emerging market strategies for 20 and 16 years respectively. Together they ran Baring Asset Management’s global Emerging Markets Equity capability from 2006-2010 before joining JOHCM in 2011. **Ada Chan** joined the team in 2016, bringing 16 years of international equity investing experience.

Their strategy combines a high conviction, benchmark agnostic approach to stock selection, combined with a risk-aware portfolio construction process. The team gains further insight and ideas from JOHCM’s broader equity team of 10 people across Asian and global markets.

James Syme

Paul Wimborne

Ada Chan

What you need to consider before you invest

All investments carry risk. The likely investment return and the risk of losing money is different for each managed investment scheme as different strategies carry different levels of risk depending on the underlying mix of assets that make up each fund. Those assets with potentially the highest long term return (such as shares) may also have the highest risk of losing money in the shorter term. While we use our expertise to manage risk, risks cannot be completely eliminated. The value of an investment will go up and down, returns will vary and are not guaranteed, and future returns may be different from past returns. The risks include the risk that factors affecting one or more countries that can influence the direction and volatility of an overall market, as opposed to security-specific risks; risks associated with an individual security; the risk arising from political and economic uncertainties, interest rate movements and differences in regulatory supervision associated with international investments; currency exchange rate fluctuation risk arising from investing across multiple countries; the risk of asset price volatility and higher currency, default and liquidity risk from investments in emerging markets; the risk that a change in laws and regulations governing an investment or financial markets could have an adverse impact on an investment. A detailed explanation of each of these risks is set out in the Fund's Product Disclosure Statement available at pendalgroup.com.

For more information call us on 1800 813 886 or visit **pendalgroup.com**

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