Emerging Markets Equity/April 2010

Still Conservative

Following the sharp market rally of 2009, emerging markets have experienced a rather flat start to 2010. The positive news of reasonably buoyant global growth has been more than offset by weaker energy prices as well as a falling euro, caused principally by the Greek debt crisis.

Despite the current uncertainty, emerging markets have outperformed the developed world decisively since bottoming out in February of 2009. There are multiple drivers for this, and we feel that this trend will continue over the medium and long term. We believe that the fundamentals in the developing world—underwritten in large part by robust economic activity in China—are very good. Valuations are not excessive and, in general, the emerging markets' financial systems are not overleveraged. Due to strong levels of economic growth and corporate profits over the past decade, consumers in many parts of the developing world now have a greater ability to spend in comparison to what is happening in the industrialized world, where many have been forced to tighten their belts.

As we have pointed out in the past, perhaps the most dramatic change over the last decade has been the growing role of the consumer in the developing world. Compared with ten years ago, when they were under pressure, domestic consumers in emerging markets are now major beneficiaries—and drivers—of growth. In the future, we believe that even export-oriented countries like China will have to depend to a much greater degree on domestic consumption.

In light of this, our strategy continues to be positioned to benefit from domestic consumer spending as well as corporate and government spending in emerging markets. As corporations have generally had strong profits over the past six or seven years, governments have received larger tax revenues, which has led to relatively high employment rates and more disposable income for consumers in the developing world.

At the sector level, our biggest overweight is currently to consumer staples, as companies in this sector are supported by the gradual transition from export-oriented to consumer-led economies. While we are well represented in the consumer discretionary sector, it is in the staples sector where we see the most opportunities, with large and growing populations becoming wealthy enough to purchase many of the basic products that are taken for granted in developed markets. For the same reason, we are also positioned to benefit from our exposure to the telecom services sector; as is typical in developing countries, more people have cell phones than land lines, and these companies are exhibiting attractive and stable cash flows. Similarly, we believe our exposure to credit card processors, such as Redecard and Cielo in Brazil, positions us to benefit from the low, but fast-rising, penetration level of credit cards in emerging markets.

Our biggest underweight is currently in the energy sector. While oil prices remain reasonably high and have been rather stable in recent months, this does not necessarily translate into attractive levels of profitability for oil companies. In fact, some of these companies are searching for and extracting oil and gas from more remote places and deeper wells. This requires significant capital expenditure programs, which means building up cash reserves, raising capital, and other factors that can translate into lower levels of return on equity. Brazil's Petrobras, for example, will have to raise a significant amount of capital to build the infrastructure required to extract hydrocarbons from the country's deep pre-salt wells. The other issue negatively affecting profitability is heavy taxation by governments, which can result in most of the benefits from rising oil prices falling into government coffers as opposed to the oil companies themselves. Argentina and Russia are two examples. In Russia, in particular, the government only recently began granting tax holidays for Greenfield projects once it became clear that the oil companies were not incentivized to increase production levels (which, ultimately, could have resulted in potentially lower tax revenues for a government that is highly dependent on them).

In summary, our outlook is optimistic over three and five years. However, our current view must be tempered by the enormous rise in emerging markets equities since February 2009. As a result, we are neutral in the short term and would not advise investors to be aggressive at this point. Emerging markets rarely move in a linear fashion, and so we are of the opinion that long-term investors should maintain exposure to a conservative strategy at a level suitable to the risk they can assume. If a significant pullback were to occur, we might easily become more positive in the immediate term.

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