OUTCOMES BEYOND PERFORMANCE

GEMOLOGIST

Emerging markets: taking stock

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INVESTMENT MANAGEMENT

The tailwinds supporting emerging markets (EMs) in early 2018 – improved economic resilience and corporate productivity, rising commodity prices and a benign US dollar – have given way to the headwinds of trade disputes, high inflation, spiralling currencies and declining growth rates. It is rough out there, but EMs are broader – and better – than the crisis-stricken economies that have dominated newsflow. We believe that many companies will progress despite the changing winds, and that investors can profit from this.

In this issue of *Gemologist*, we assess the obvious weaknesses in EMs, the less obvious forces acting in their favour, explain how we have adapted to the turnaround in 2018 so far and present our convictions in selected portfolio companies. To begin, let's take stock of the EM stories commanding the market's attention: the travails of Turkey, Argentina and South Africa. While real, their troubles are partially self-inflicted.

THE TROUBLED THREE

Turkey: overcooked

Turkey has been running an overly loose monetary policy for several years, becoming more vulnerable as the nation's import bill rose with oil prices. Its fragility has been exacerbated by the dispute over Andrew Brunson, a US missionary detained in October 2016 for alleged involvement in an attempted coup, which has resulted in sanctions from the US.

The Turkish authorities' unique and mistaken view that high interest rates cause inflation has exposed the flaws of the lira. First, import coverage (by foreign exchange reserves, at 3.7 months) is very low. Second, companies have extensive dollar-denominated liabilities, which have grown with the strengthening dollar and made debt servicing more difficult. In turn, this makes Turkish assets less attractive and causes further weakness in the currency. In September, Turkey faced the choice of lifting interest rates significantly higher, imposing capital controls or seeking a rescue by the International Monetary Fund (IMF). The nation's central bank chose the former, hiking rates to 24%. With Turkey accounting for 0.51% of the benchmark, few EM equity managers will find their portfolios directly impacted by the country's tailspin. European banks have some exposure, but this is well discounted and unlikely to cause serious damage. And while an economic downturn is on the cards, this may uncover opportunities.

Argentina: the Kirchners' revenge

The Argentine economy is also the victim of its own mismanagement – not by Mauricio Macri's current Administration but that of his predecessors, Cristina Fernández de Kirchner (whom he defeated at the last election) and previously her husband, Nestor. Nevertheless, counting on the electorate to support Macri and endorse an extended period of austerity in order to atone for the fiscal largesse of the past would be a very optimistic view. Failure to control inflation, combined with the strengthening dollar, has resulted in an extremely weak peso – which, as in Turkey, further stokes inflation and currency weakness. Argentina has yet to join the MSCI Emerging Markets Index, so it presents little direct risk of contagion for EM equities, but a weak peso, when added to the chaos in Venezuela, doesn't help Brazil, Chile, Colombia, Peru or Mexico, and does risk punching a (small) hole in EM debt portfolios. The Brazilian real has dropped by a third in the past year: this has primarily been due to political risk and exacerbated by tighter US monetary policy, but the Argentine peso's 87% collapse in the same period can't have helped.

South Africa: a deep-rooted dispute is unearthed

With a 6.3% weighting in the benchmark, South Africa has a greater direct impact on EM stock pickers than Turkey or Argentina. The replacement of Jacob Zuma with Cyril Ramaphosa in 2017 as leader of the governing Africa National Congress was welcomed by investors: the market rallied by about 30% in dollar terms before giving it all back (and more) as the challenges facing the far more competent new president became clear. With a current account deficit of 3% of GDP, merely adequate import cover, and significant exposure to the commodity cycle, the new administration has its work cut out for it on the external front. But on the domestic front, it faces an even tougher job: reforming land rights.

The Native Land Act of 1913, along with the Group Areas Act of the 1950s and the Bantustan Regional Act, entrenched and legitimised European colonisers' previous dispossession of land from the indigenous population. The principal legal argument was that most of this territory was 'empty', or formally uninhabited, when the settlers arrived, denying any claim to the lands by indigenous people. In cases where (minimal amounts of) money changed hands, Africans did not conceive of land as a tradable commodity; arguably, the chiefs of tribes such as the Nguni made land concessions on the basis of usage rights. Therefore a case is being made that land was fraudulently 'acquired' by settlers. To rectify this, until recently the South African Constitution allowed for the restitution of indigenous claims to land, with compensation. This has now been rescinded, with the intention of amending the Constitution to allow for restitution of land without compensation.

Despite the historical injustices perpetrated by Europeans from 1652 onwards, expropriation without compensation today introduces a wide range of questions for investors in South Africa. Starting with social justice considerations, there is little doubt that an unjust transfer of land took place in previous centuries, but it should also be noted that the new occupants added significant value to the properties. The trajectory of value generation from the years preceding European settlement, compared with the trajectory of value generation since shows a dramatic increase over the past century. Therefore it is almost certainly incorrect to assume that the value of the land in 1912 (or 1652, for that matter), which is zero in today's money and constitutes the current offer, is a fair price.

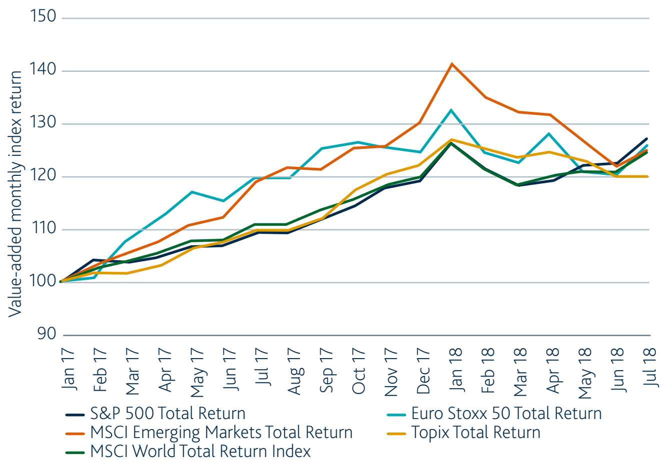
Although the government has soft pedalled on confirming details of the reform, and suggested that it will only affect unoccupied government land, a change in the law will increase both uncertainty and the risk premium demanded for owning South African assets – especially with the unedifying example of Robert Mugabe's past actions in neighbouring Zimbabwe. Whatever assurances Ramaphosa may give investors, the pressure to enact land reform from within his own party (especially the youth league) will persist. A solution will eventually be determined, but how investor-friendly it will be is open to debate. What is certain, however, is that markets will endure further uncertainty.

ABOUT THOSE TAILWINDS…

Looking beyond the troubled three, macroeconomics in EMs are in relatively good health. Purchasing Manager Indices for all countries except Malaysia, Turkey, Korea and Russia are higher than 50, indicating economic expansion; interest rates across EMs are very low by historical standards, and inflation is under control.

Yet markets are disgruntled. The strong tailwinds at the beginning of the year have eased, leaving investors with the familiar elements of EM storms: local-currency depreciation, a stronger US dollar, and fears about China's growth. This led to a 17.04% fall in the market from the January 2018 peak to the end of August. The global, US, European and Japanese indices also declined sharply in the first two quarters of the year, showing that EMs have not sold off in isolation. But these markets have rebounded more strongly than EMs, indicating the headwinds that persist but also the opportunities to invest selectively now that valuations have come off the boil.

Figure 1. Performance of major stock markets: January 2017 to July 2018



Source: Bloomberg as at August 2018

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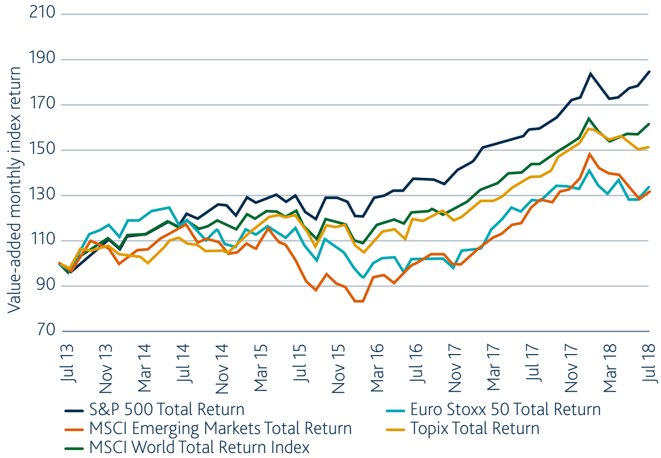
Figure 2. Performance of major stock markets in the five years to July 2018



Source: Bloomberg as at August 2018.

Oil prices: pumped up

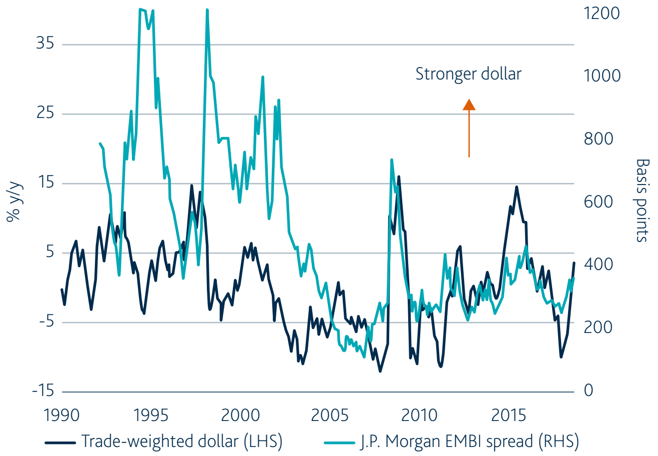
Oil prices have nearly tripled from their early 2016 lows, in dollar terms. But in the terms of depreciating currencies, they have risen further – more than five times, in respect of the Turkish lira. For energy exporters in the EMs – Malaysia, Mexico, Russia, Brazil, Qatar, Colombia and the UAE – this is great news, but they represent only about 17% of the benchmark. The remaining 83% import oil, and the higher prices are hurting their current account balances and consumers' wallets. Electric cars and driverless vehicles may at some point in the future reduce demand for this fossil fuel, but in the medium term the travails of Venezuela (which is finding it difficult to produce oil whilst in the grip of hyperinflation) and Iran (whose poor relations with the US could result in the Straits of Hormuz closing temporary) are likely to dominate the headlines and fan fears of supply disruption. In the short term this trepidation is justified, as oil exports from both countries are plummeting.

The US: dominant dollar, defective diplomacy

The Trump administration's tax cuts have turbocharged the economic engine of the US, driving the dollar higher, enabling strong corporate earnings growth and an increase in employment this year, as well as providing additional impetus for monetary policy tightening. The boom has sucked liquidity out of EMs and into the US, causing trouble for Turkey and Argentina and weakening the lira, peso, rand, real, bolivar, rupiah, rupee and rouble. Consistent with past dollar surges, the spread on the J.P. Morgan Emerging Market Bond Index has widened recently – but nowhere near the blowouts of the 1990s and early 2000s (see figure 3).

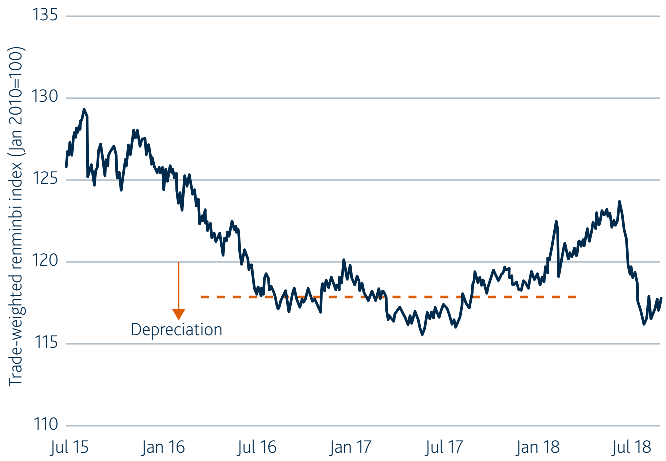
The US President's other major contributions to EM politics and economics – a trade fight with China, a clergyman dispute with Turkey and a potential intervention in South Africa's land reforms – are a toxic influence not only on markets but also on central banks: China has been forced to restrict the volume of liquidity it provides to the nation's economy, along with several EM central banks which have had to tighten monetary policy to defend their currencies.

Figure 3. It's all about the base (currency) – not EM strength



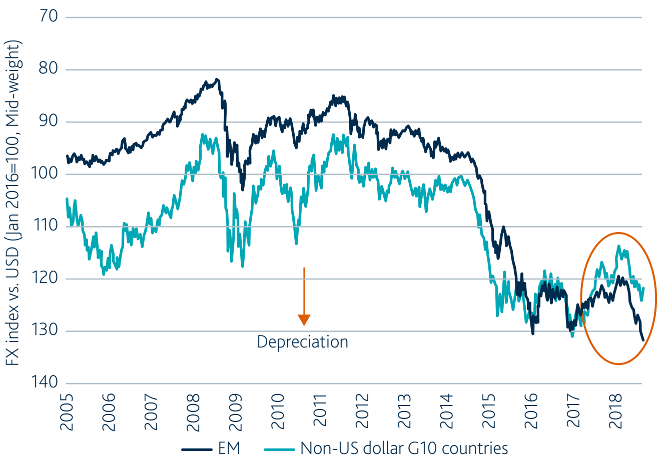
Source: Emerging Advisors Group as at September 2018.

Figure 5. The renminbi has stabilised relative to its basket of reference currencies



Emerging Advisors Group as at September 2018.

Figure 4. Turkey and Argentina aside, EM currencies have performed comparably with the non-dollar G10 bloc



Source: Emerging Advisors Group as at September 2018.

China: maturing, not weakening

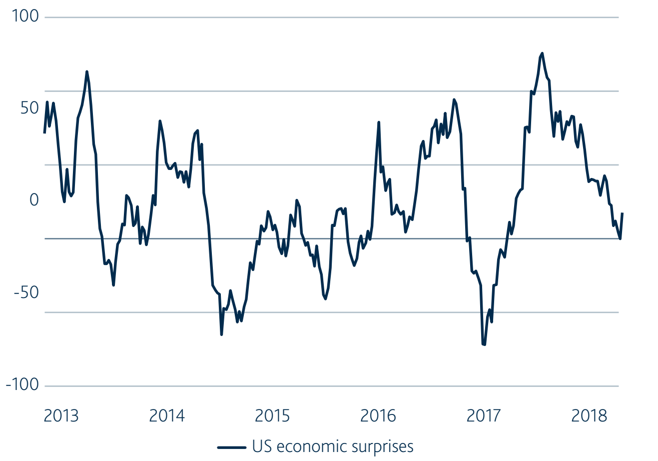
Prioritising fiscal and environmental sustainability, the Chinese authorities have started to contain leverage in the economy. This has been a long-standing objective and was always going to be a delicate exercise as more and more units of debt have been required to generate a unit of output. Also, China's demographics no longer underwrite rapid GDP growth: the size of its workforce peaked in 2010 and urbanisation, while continuing, is slowing. Add the pressure and expense of a trade war instigated by the US with the aim of preventing China's transition to a technology-oriented economy, and the Chinese authorities can be forgiven for being frustrated. As the economy slows, it is importing less copper, zinc, iron ore, nickel and other commodities, tempering exports from Brazil, Peru, Russia and South Africa.

Investing in EMs: real-world conditions

Yet the tailwinds have not disappeared altogether: the stimulus induced by US tax cuts should wear off next year; the dollar is near a 15-year peak and should weaken as trade and budget deficits begin to take their toll; and US policies could become less bellicose as their architect-in-chief deals with legal issues and, potentially, a Democratic majority in the House of Representatives following the mid-term elections in November. Automatic stabilisers resulting from Fed tightening are kicking in, chiefly the flattening yield curve – where there is little difference in yield between short- and long-dated Treasury bonds – which often precedes an economic downturn.

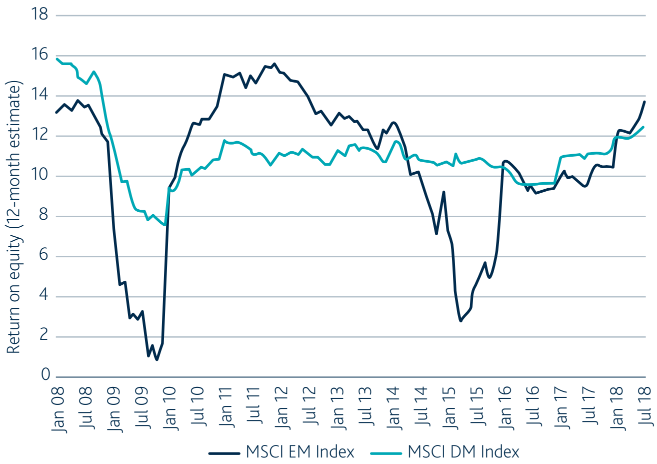
Other results of US policy could also support EMs: Chinese tariffs on US exports are causing pain in America's heartland and at ports, and will eventually hit consumers' wallets; European and Asian countries are considering a replacement for the dollar as the default currency of exchange, and Citi's Economic Surprise Index for the US has entered negative territory, continuing a decline that started at the beginning of the year (see figure 6). The latter point is also negative for EMs, but they are not trading at all-time highs.

Figure 6. The slowdown in positive data increases the probability of a US economic surprise



Source: Datastream, Societie Generale as at 6 September 2018.

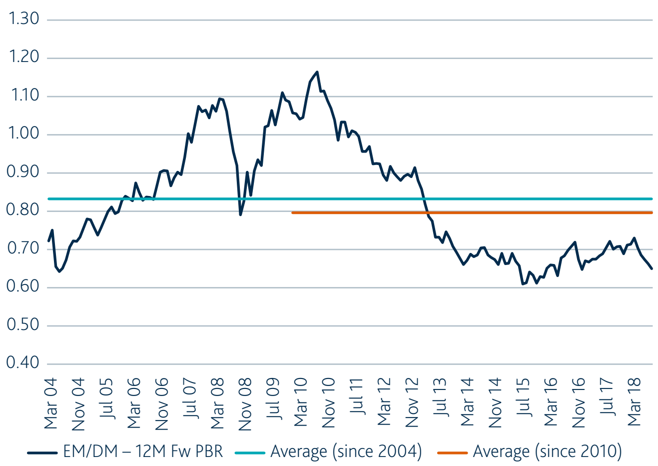
Figure 8. Return on equity across EMs and DMs, from 2008 to July 2018



Source: Bloomberg as at September 2018.

Indeed, EM stocks are now trading at their long-term average, following an earnings-based recovery from depressed levels in the past year. These valuations are supported by improving margins and strong profitability, but can they persist? We think so: the consensus view in the market extrapolates the dollar's strength into a medium-term timeframe of three-to-five years, ignoring the short-term nature of the stimulus induced by the tax cut. As this boost fades, so will one of the main drivers of the US economy's relative outperformance, reducing the need for rate hikes and therefore the main driver of dollar strength. As a result, the earnings of EM companies would appreciate in the terms of a weaker greenback.

Figure 7. EMs are trading at an approximate 34% discount to DM, well below their historical average

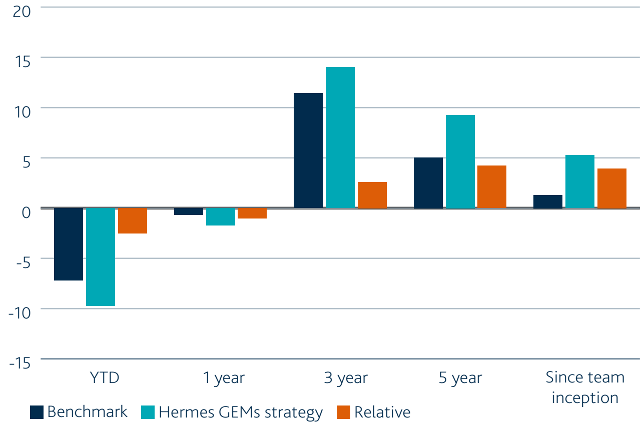


Source: Thomson; MSCI, Macquarie Research as at September 2018.

PORTFOLIO IMPLICATIONS

The Hermes Global Emerging Markets Strategy outperformed the benchmark by a net 10.4% in 2017, and by a net annualised 4.2% for the five years ending in August but has lagged in the year to date by a net 2.5% for a number of reasons (see figure 9). This was primarily due to our overweight position in China, where the weakness of the renminbi has hurt performance despite the value added by our stock selection in companies including insurer AIA, China Mengniu Dairy and Alibaba. Elsewhere, the solid performance of our holdings in Mexican bank Banorte and NMC Healthcare in the UAE was offset by weak returns from a range of businesses: Ultrapar, a Brazilian fuel distributor; Turkish household appliances manufacturer Arcelik, which we had largely exited by the end of July and went on to complete our divestment in the following days; Taiwanese silicon-wafer producer Landmark Optoelectronics, which has since begun to recover; Indian auto-parts supplier Motherson Sumi, which corrected after a very strong 2017; and Hungarian pharmaceutical and biotechnology company Gedeon Richter, whose uterine fibroids medication was under an investigation – which has now been completed, resulting in sale approval – by the European healthcare regulator.

Figure 9. Hermes Global Emerging Markets: five-year performance



Rolling year performance (%)	30/06/17-30/06/18	30/06/16-30/06/17	30/06/15-30/06/16	30/06/14-30/06/15	30/06/13-30/06/14
Strategy return	8.34	32.98	-7.67	5.73	18.48

Past performance is not a reliable indicator of future results. Source: Hermes as at 31 August 2018. Performance shown in US dollars, net of fees. Relative calculated arithmetically. All figures over one year are annualised. Benchmark: MSCI EM Index Net.

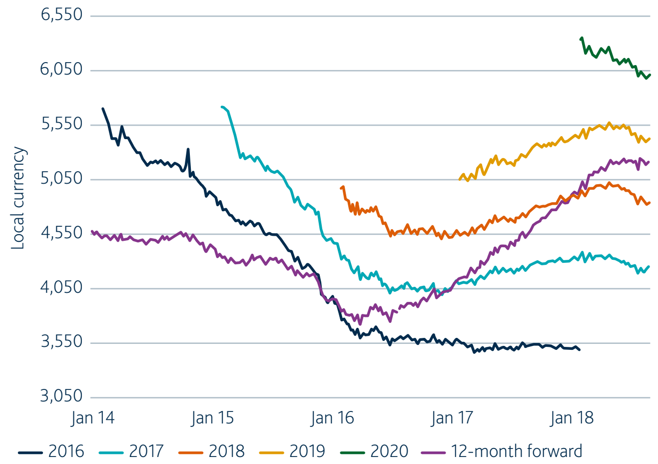
Investment outlook: short-term volatility masks underlying strength

The macroeconomic outlook is dependent – to an unusual extent, even for EMs – on politics and egos. The US, Turkish and Venezuelan economies are heavily influenced by leaders Donald Trump, Recep Tayyip Erdogan and Nicolas Maduro. It is becoming apparent that the accepted models of political economy such as fiscal probity and international co-operation have been called into question, but in no case have the replacements been successful. The Chinese leadership has noticed this and is therefore following orthodox economic principles to create a sustainable growth path, as Maduro, Erdogan and Russian leader Vladimir Putin blame what they see as foreign conspiracies, or reportedly instigate them, to divert attention from their failed policies.

But positive macro fundamentals persist despite this volatility at the top: we see reasonable growth, low interest rates and sensible economic policies in the majority of countries comprising the EM benchmark. This underpins a business environment for EM companies that is more robust than what the headlines portray. And they are well-positioned to take advantage of this: forecast earnings per share across EMs for 2019 are stronger than those for the US (see figures 10 and 11).

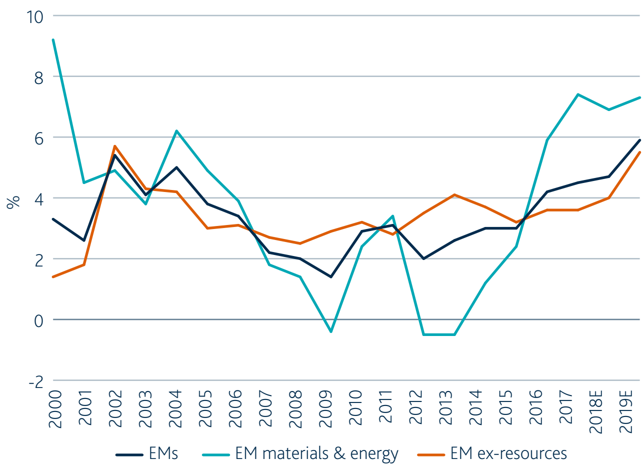
Free cash flow yield is improving, in part because valuations are depressed but also because companies are generating more of it. EM corporate management teams have learned the value of capital discipline, sticking to their core business strengths and, in many cases, returning excess capital to shareholders. As the long-term prospects for global growth have dimmed somewhat in the past several years, their capital spending has also become more cautious as they prefer to sweat their assets more heavily.

Figure 10. Consensus views of earnings per share for MSCI EM stocks in local currency terms



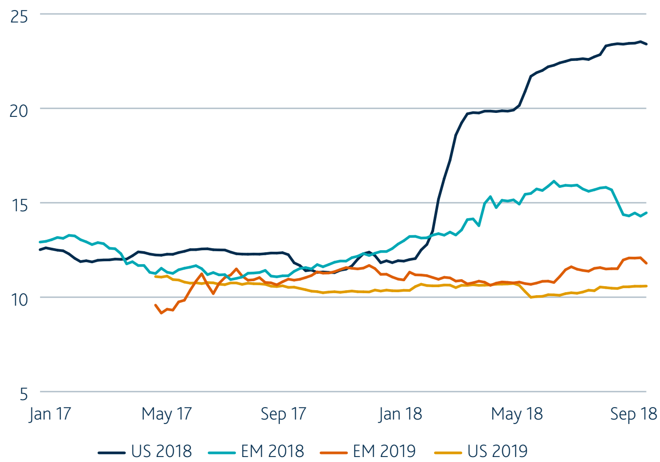
Source: IBES Consensus, Datastream, Factset, Morgan Stanley research as at 30 August 2018.

Figure 11. EM corporate free cash flow yield (with and without resources, %)



Source: Credit Suisse HOLT, Credit Suisse research as at September 2018..

Figure 12. EM v US consensus EPS growth (local-currency terms)



Source: MSCI, IBES, Credit Suisse research as at September 2018.

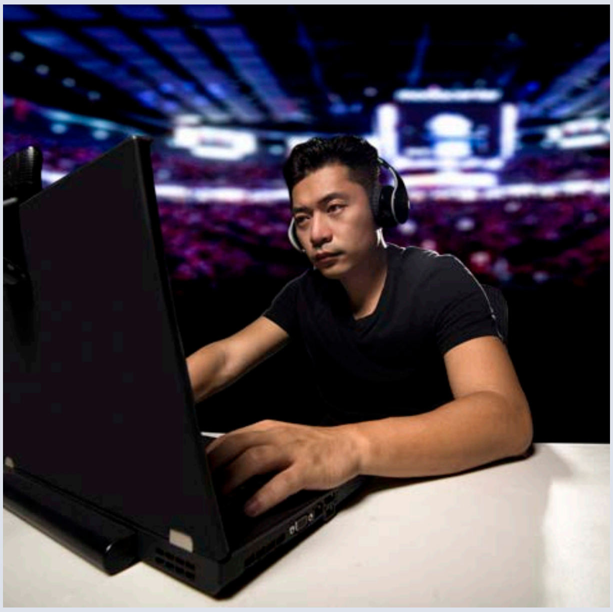
US equites have decoupled this year as their collective earnings growth have rocketed, outperforming their developed and emerging counterparts. This is due, in large part, to Trump's tax cuts. Next year, however, the outlook is much more muted. EM earnings growth, currently estimated at more than 12%, should outpace that of the US even in dollar terms, given the hit that EM currencies have taken this year.

Positioning: our convictions

The outlook for the IT, Consumer Discretionary and Finance sectors in particular, where we are overweight, is solid. We agree with the market forecasts of healthy earnings growth for Chinese technology giant Tencent and, across the strait, Taiwan Semiconductor Manufacturing Corporation, Advantech, and Landmark Optoelectronic, and also for India's Tech Mahindra and HCL Tech. The prospects for revenue growth at Alibaba are also strong. Despite the robust fundamentals, the valuations of many IT stocks are cheaper than at the start of the year, with the sector itself trading just under its 10-year average of 15.6x this year's consensus estimate. Our IT holdings are priced at 15.0x this year's earnings.

Tencent: we chat, we play, they monetise

Tencent, renowned for its immensely popular multi-purpose app WeChat – the company's social media goliath caters to 1bn monthly users – is also a leading player in the Chinese gaming industry with about 66% and 38% share of the domestic PC and smartphone games markets respectively[1]. As a developer and publisher of games, the company is China's preeminent game platform provider in a market of more than 604m gamers[2], which developers from the US, Europe, Korea and Japan depend on for distribution in the Chinese market. In addition, the company owns either majority or significant minority stakes in global game developers such as Activision Blizzard, which created *Call of Duty*; Riot Games, responsible for *League of Legends*; Timi Studio, owner of *Honour of Kings*; Supercell, which released *Clash of Clans* and *Clash Royale*; and Bluehole, which brought *PlayerUnknown's Battlegrounds*, or PUBG, to market.



In China, Tencent has 40 titles in the PC games market and more than 100 which are played on smartphones[3], covering multiple genres including battle area, shooter, racing, strategy, board games, puzzles and role playing. It is also present in the South East and South Asian gaming market, where its mobile version of PUBG, which was created by Tencent, is performing extremely well.

In addition to games and social media, Tencent's ecosystem features news, payments, entertainment, retail (via investee companies), sports, video, cloud-computing services and an artificial-intelligence capability.

All forms of media and content are under strict control in China, unlike in the US or Europe, where game developers are free to launch games at will. Games go through a two-stage process, where they are first approved for launch and then to be monetised, before a publisher can start to make money from a title. Unlike their Western counterparts, Chinese authorities have generally been critical of violence in games and obscene material, or any content that violates their social values. In addition, they are also critical of the amount of time that children spend playing online games.

In 2017, the Chinese government instructed game developers to limit the number of hours that children under 12 years of age spend playing games online. In March, a bureaucratic reshuffle in Beijing that saw all film, news and publishing fall under the remit of the government's publicity department resulted in approvals for new game titles – and their subsequent monetisation – being stalled.

The Chinese Ministry of Education released a paper recently that prescribed measures to control the growing prevalence of myopia in young children, and identified a variety of causes for this increase, including: high academic expectations and rigorous examinations, resulting in punishing study schedules, reduced time spent outdoors and playing sport, and more exposure to electronic devices, which encompasses gaming. The Ministry recommended that the Media Regulator control the number of games being approved and limit the time children spend on playing such games to one hour each day.

The near-term implications of these changes include a delay in the monetisation of popular titles: the bureaucratic reshuffle slowed gaming revenues in the second quarter. Tencent is awaiting approval for its mobile-friendly PUBG game, which is extremely popular in China and has more than 150m users who are currently playing for free. *Fortnite*, another blockbuster, is also ready for introduction to the Chinese market. The lack of approvals is making investors wary about how strongly games in China can be monetised. This will result in muted growth for the gaming segment in 2018, though it could accelerate significantly in 2019 if the regulator shows the green light in the second half of this year.

[1] "Tencent 2018 Second Quarter Corporate Overview," an investor presentation published on 15 August 2018.
[2] "Niko Partners: China will surpass 768 million gamers and $46 billion in revenue by 2022," by Dean Takahashi, published in VentureBeat on 7 May 2018.
[3] "Tencent 2018 Second Quarter Corporate Overview," an investor presentation published on 15 August 2018.

While the delay in approvals will likely push the growth of gaming revenue into next year, the impact of curtailing children's involvement in games is unlikely to substantially hit Tencent's profitability. Minors account for approximately 10-15% of the gamer population in China and generate low revenues since parents control their spending. In 2017, responding to the government's concerns, Tencent introduced a one-hour limit for time spent playing games for children under 12, and a two-hour limit for teenagers. (I wish my kids had been automatically limited to two hours of game time a day when they were teenagers.)

Over the medium and longer term, the stricter regulatory requirements will disadvantage smaller developers and publishers, encouraging consolidation. Larger players, which are better able to navigate the regulatory change by tailoring games so they are both fun to play and meet the new requirements, are likely to perform more strongly. Tencent, which generates 60% of revenues and 50% of profits from gaming, is the market leader by a long way. Sentiment towards the stock has been undermined, temporarily, but we believe this is a relatively minor speed bump in its long-term growth path.

Not only is Tencent likely to adapt well to an environment shaped by new gaming regulations, its diversified business model provides it with an immense user base and other monetisation opportunities. It has only scratched the surface in terms of monetising WeChat and has leading positions in social media, video, news, music, literature, and mobile payments. Tencent's enormous social media presence has the potential to attract interest in e-commerce products and services. In the world outside of WeChat and games, Tencent has an exposure to the Chinese retail sector through investments in JD.com and partnerships with VIP Shop and offline retailers such as Yonghui Superstores, Walmart and Carrefour.

According to Tencent, user engagement across its ecosystem is rising and the low average revenue per user it generates currently suggests that the business has ample growth opportunities. We expect Tencent's earnings to compound at 25-30% over the next four years as the headwinds for its gaming business are offset by other services. Profits from gaming, as a proportion of the company's total, are expected to decline to about 40% in 2018 and eventually to 30% over the medium term as its social network, content, online advertising, cloud and e-payments businesses grow faster. Tencent is trading at a 2019 P/E of 27x and price-to-cash flow of 19x. Relative to the opportunities available for the company, we believe these valuations are reasonable.

The EM Consumer Discretionary sector has been hit hard this year, down 23.6% following a strong 2017 when it climbed to an overall valuation of 21.4x earnings. It remains expensive relative to its recent history, at 17.6x this year's estimates and with forecast earnings under pressure, but is still on track to post 20% earnings growth for this year and next, in our view. Our holdings in this market amount to 14.5x this year's earnings estimate, a not insubstantial discount to both the sector and the benchmark, and in line with the sector's 10-year average.

We are underweight the Materials and Energy sectors, both of which are seeing their 2018 earnings estimates begin to be revised down. We hold only three stocks, all based in Brazil, in these sectors: Ultrapar and paper-and wood-products companies Klabin and Duratex. Each trades at a premium to their respective sectors due to the higher relative visibility of their earnings. We see operational and governance opportunities in all three, coming from both current management plans and Hermes' engagement programmes.

EM financials: good value

The EM Financials sector is trading at 9.1x this year's earnings estimates, which is aligned with its long-term average. This is a reasonable valuation, given that single-digit earnings growth is likely for this year, but the more attractive aspects of the sector are its potential to generate a yield of nearly 4% and the healthy levels of profitability and loan books of underlying companies. This, combined with the quality businesses we have identified, explains our overweight exposure. Our financial holdings together trade at a small discount to the sector, at 8.7x of estimated 2018 earnings, and demonstrate solid fundamentals despite the headwinds in EM, we show in the following investment cases:

- In Korea, we hold a substantial position in KB Financial, which we perceive as seriously undervalued with a forecast return on equity for 2018 of 10% and a forecast price-to-book value of 0.6x. This results in a P/E ratio of 6.2x this year's estimated earnings, which is well below its long-term average. The Korean economy is mature and growing at a moderate pace, and KB itself is generating modest earnings growth, but with a yield of almost 4%, a strong balance sheet and good management, the company looks like a solid investment. The banking group has improved its profitability greatly during the past decade, with its return on invested capital (ROIC) now almost on par with its cost of capital, which is unusual for a Korean company.
- Bank Rakyat is Indonesia's premier microlending institution. Government owned, it restrains the lending rates it charges to borrowers living in villages. It enjoys an ROIC of 22.6%, substantially in excess of its weighted average cost of capital of 10.8%, and thus trades at a premium to its book value of at 2.1x. This is a somewhat deserved discount to its 10-year average, as its ROE has dropped from more than 30% to 18% this year. Rakyat's P/E multiple of 12.1x also trades at a premium to its 10-year average of 9.9x. However, with a yield of over 3%, a very strong capital ratio and an excellent net interest margin, we are confident that this is a quality business that should continue its profit growth and stock-price appreciation of the last decade.

- Like KB Financial, Moscow-based Sberbank also has an ROIC approaching its cost of capital. However, its cost of capital is highly elevated – at 15.6%, according to Bloomberg – due to the threat of further US sanctions. This is evident in the difference between its cost of debt, which matches the Russian bond yield at 8.4%, and the cost of its equity, at 19.0%. This results in an equity risk premium of 10.6%, a level which seems panicky to us. The five-year Russian corporate CDS, which is a good indication of the market's perception of risk in that market, is nowhere near the height it reached during the annexation of Crimea, and our analysis of the sanction-related bills going through Congress concludes that there is a low probability of Sberbank being cut off from dollar funding. Trading at book value and with a consensus P/E multiple of 4.7x estimated 2018 earnings, plus an expected yield of 9.5%, we think it likely that the market is discounting a worst-case scenario for the lender, meaning that investors can benefit from considerable upside should US sanctions be less damaging than what is currently anticipated.
- Credicorp is the dominant financial services player in Peru, a nation that is enjoying healthy growth, low inflation and political stability. In addition, Peru's non-resources sectors are recovering after the strong rebound in mining investment that has led the economy, providing further lending opportunities to Credicorp. Beyond banking, the company also operates asset management, insurance and microlending businesses. We are encouraged by its ability to generate returns that exceed its cost of capital and its strong, steady management team.
- We recently exited Industrial and Commercial Bank of China, which is reasonably managed and modestly valued but vulnerable to requests from the Chinese Government to provide a 'national service' – a euphemism for government-directed lending. Its growth is limited by the Government's policy of 'derisking,' which in practice means capping the economy's overall leverage as a percentage of GDP. This leaves the portfolio with an underweight position in a cheap but slowing sector in China, with a notable holding being our substantial off-benchmark position in AIA, a very well-managed pan-Asian insurer.

Overall, our portfolio stocks trade at an aggregate P/E multiple of 12.7x estimated 2018 earnings, which is more expensive than the 11.3x multiple of the benchmark. However, the companies we own are less indebted, growing faster, and more profitable. We are confident that these businesses will grow sufficient profits and distribute enough in dividends over time to generate the long-term, high-single-digit, dollar-denominated returns we target for investors.

Heads or tails? It doesn't really matter

To us, the highs and lows of 2018 have reaffirmed one of our key convictions: that EMs are not a destination for short-term trades but for long-term investment in high-quality, sustainable companies. Macro forces – from dollar strength to commodity cycles, political fallout or economic mismanagement – will inevitably buffet the universe, advancing or impeding stock prices. But as the year to date has shown, they are ephemeral in comparison to the corporate fundamentals identified by stock analysis. Like ourselves, the companies we invest in aim to adapt to the current turbulence, act with discipline and capture long-term growth opportunities. We know, as they do, that these skills are hard-earned and often require operating in adverse environments such as the current market. The insights gained from these experiences are valuable, capable of contributing to the positive, compounding returns throughout cycles that we have generated since inception and continue to seek – however strong the tailwinds or headwinds become.

HERMES INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, and small and mid-cap

Credit
Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

Multi asset
Multi asset inflation

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices
London | New York | Singapore

Why Hermes Emerging Markets?

From top to bottom
Bottom-up analysis finds quality companies trading at attractive valuations. This is rooted in a top-down framework that identifies countries with conditions supportive of growth.

Quality and safety
Buying quality companies at a discount gives a margin of safety in a volatile asset class.

Truly active management
A concentrated portfolio with a high active share, invested with a longterm perspective.

Experience and rigour
Manager Gary Greenberg has three decades of investment experience, and is supported by a team of six.

Integrated ESG
Environmental, social and governance factors are integrated into our analysis for a comprehensive view of risk.

Multi-cap
The portfolio invests across the market cap spectrum, fully able to benefit from mid-cap exposure.

For more information, visit **www.hermes-investment.com** or connect with us on social media: