

A fundamental approach to emerging market equity

With a few important adjustments, time-honoured techniques travel well

by SERGIO TRIGO PAZ



LUIZ SOARES

Head of BlackRock's global emerging markets team.

“Fundamental stock picking in emerging markets must take account of a number of factors that differ significantly from those in developed markets.”

For equity investors with fundamental views on what companies are worth – and the discipline to apply them methodically – volatility can be a friend. Such is the case these days in emerging markets, where a spring sell-off recently left stocks at a 28% discount¹ to their developed-market counterparts, a gap not seen since the late 1990s. And this is in spite of annualised earnings growth² that outstrips developed-market equities by a healthy margin.

These are the kinds of gaps that fundamental investors have long exploited in developed markets, and it's not unreasonable to aspire to do the same in emerging markets. Indeed, at a high level, the approaches aren't so different. Wherever it is practised, fundamental stock selection aims to find inexpensive businesses that demonstrate a sustainable competitive advantage, disciplined capital management and strong corporate governance. It also looks for strong management that can guide a business through changes in industry dynamics, regulation and competition.

Yet fundamental stock-picking in emerging markets must take account of a number of factors that differ significantly from those in developed markets, ranging from the competitive environment in which the companies

operate to a heightened role for government policies and the strength (or lack thereof) of the macro tailwinds that help to make emerging markets so attractive in the first place.

Last but not least is a heightened role for process – an essential element if investors are to keep their footing amid the volatility that is the downside of dynamism. Fundamental research is necessary but not sufficient. It needs to be complemented with a portfolio construction framework and a buy-and-sell discipline appropriate to markets that differ not just from the developed world, but also from one another.

GENERATING INVESTMENT IDEAS

Typically, fundamental analysis favours industry leaders or companies that are gaining market share within their industry. Some global leaders will present interesting stock stories (see box), although their performance can often be linked to domestic policy.

More interesting opportunities often lie within the 'national champion' or 'select niche player' categories of stocks that are particular to emerging markets. These are typically mid-cap, domestically focused companies that

1. Source: Citi Research – Global emerging market 12m forward P/E: 9.475 vs World: 13.149; as of June 2013.

2. Source: Citi Research – Global emerging market 5yr EPS CAGR exceeds World's by 5.6%, as of June 2013.

benefit from unique competitive advantages or market share in addition to strong economic tailwinds. They tend to operate in underpenetrated or highly fragmented sectors where much of the competition is family-owned, and benefit from favourable regulation. Management is typically on a par with that of global companies.

MAINTAINING DISCIPLINE

Once high-conviction investments have been identified, investors need to determine the weights to assign each position in the portfolio and how to adjust them in response to market movements. Accomplishing this requires a highly methodical approach to stock-ranking, which is essential for generating alpha in volatile markets – and for making it possible to add alpha in distressed markets.

In practice, a methodical approach means assigning each stock a dynamic score to determine its weight in the portfolio. Investors might first weight stocks by size to define maximum allocation to any position. For example, a global leader stock might rate a maximum weighting of 6% due to its lower risk profile as an established, diversified business. By contrast, niche players present a more opportunistic investment and may rate just 1–2% in the portfolio.

Next, investors need to assess the strength of each stock's underlying

performance drivers to generate a ranking. This step combines the fundamental analysis described above with detailed valuation work from historical, relative and absolute bases to determine whether a position should be increased, held or decreased. The combination of fundamentals and valuation analysis rolls up into a single, dynamic ranking.

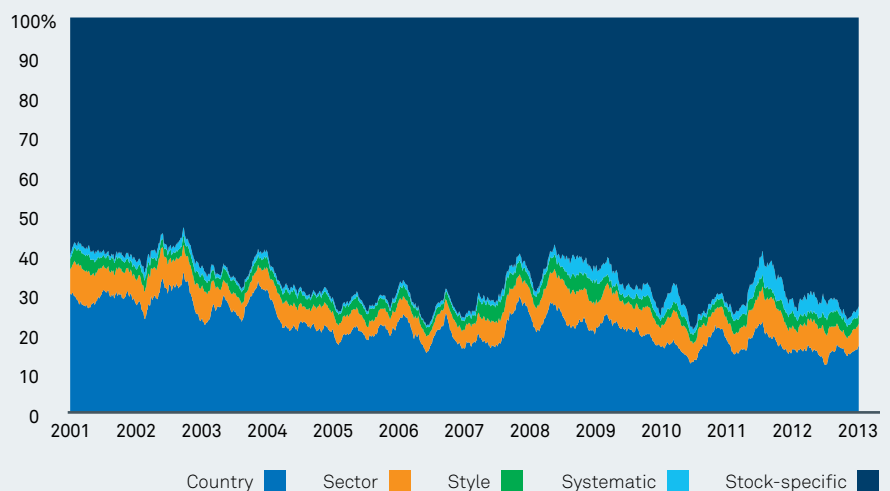
All subsequent portfolio management decisions are made in response to the movements of each stock's aggregated score. Positions are increased when valuations pull back, and profits are taken when valuations increase.

After a bull market, for example, scores will fall as increased stock valuations become less attractive. The ensuing sales will drive up cash balances at a point of market vulnerability. Conversely, after a correction, a disciplined approach will increase existing holdings of high-conviction but cheaply valued stocks.

A methodical, fundamentals-driven stock-ranking process allows for nimble action because any adjustment will be to existing, high-conviction positions – all adjustments are made one stock at a time. This contrasts with top-down approaches such as country- or sector-focused investing, which can encounter the transactional complexities of making large rotations out of one market segment into another, leading to allocation and timing risks.

FIGURE 1: A STOCK-PICKER'S ENVIRONMENT

Stock-specific factors are the main drivers of EM equity performance



Source: BlackRock, MSCI, March 2013.
Decomposition of cross-sectional volatility in the MSCI emerging market index.

RISK MANAGEMENT

Corporate governance, currency and volatility risk continue to be real concerns for EM investors. Risk management – and access to the data needed to conduct it – is therefore of paramount importance.

Effective risk management and portfolio diversification demands a deep insight into the complex correlations between emerging markets, sectors and interest rate environments, as well as the extent to which particular stocks are exposed to them. For example, investors who understand how a depreciating yen can affect not just South Korean exporters but also Indonesian suppliers to Japanese companies, can make better investment decisions on stocks in that region.

In addition to stock-specific risk, which is covered by fundamental analysis, investors need to look at risk on macro and portfolio analysis levels.

By monitoring the economic activity, inflation, balance sheets and politics of individual countries, investors can adjust their portfolio as an extra layer of risk management. For example, recent reforms to drive sustainable productivity in Mexico represent a tailwind for Mexican stocks and warrant some fine-tuning of Mexican positions.

A STEADY HAND

A successful fundamental, bottom-up approach in EM investing will use many of the tools familiar to developed market investors. It requires a deep understanding of fundamental analysis and valuation, a wealth of quality data, local expertise and strong relationships with management teams. A strong risk management system attuned to macro cross-currents is essential. However, EM investors also require the steadying effect of a methodical stock-ranking process that promotes consistency and discipline in fast-moving markets.

A global leader: AIA

The largest independent, publicly listed, pan-Asian life insurance group, operating across 15 markets and serving 24 million individual policyholders and 10m group policyholders.

- ▶ **A differentiated business model:** A focus on conservative capital management by increasing margins, rather than volume growth. AIA prioritises the sale of protection-based, rather than savings-focused, products, and is moving away from a reliance on investment income as a primary driver of earnings.
- ▶ **Strong regional demand:** Well positioned to exploit increasing consumption of insurance products in Asia, driven by rising consumer incomes and investor education.

A national champion: Copa Airlines

A Panamanian airline operator running flights across the Americas. Tocumen Airport, its hub, has expanded capacity in recent years, benefitting Copa, which represents 90% of the airport's traffic.

- ▶ **Business efficiency:** Tocumen sits at a lower altitude and experiences less fog than other regional airports, resulting in less fuel burn. Also, lower point-to-point travel makes it difficult for competitors to enter.
- ▶ **Capacity growth:** Low levels of traffic penetration (10% of US levels) offer significant scope for growth. A recent merger of two competitors, Avianca Taca and LAN, also offers greater potential to accelerate capacity growth.
- ▶ **Pricing power:** 50% of clients take business class. Panama currently enjoys 8% economic growth.

A niche player: Indocement

Part of an oligopoly that controls 90% of the Indonesian cement industry. At the end of 2011, Indocement's capacity was 32% of total industry capacity.

- ▶ **Strong demand:** Well positioned to benefit from strong demand growth, driven by property and infrastructure development. Annual volume growth is up 18%.
- ▶ **Capacity expansion:** Indocement can grow volumes 8% this year by increasing its utilisation rate. It will add 10% more capacity next year.
- ▶ **High barriers to entry:** Land ownership and mining regulations impose significant challenges for new entrants. In addition, distribution is still by bag through a network of retail shops owned by Indocement. Other players have a similar distribution model.

Source: BlackRock, June 2013.

Currents

Published by BlackRock.

To provide feedback on *Currents*, please email staycurrent@blackrock.com

Please direct story ideas, comments and questions to Nicholas Loney:

Telephone +44 (0)20 7743 1895

Facsimile +44 (0)20 7743 1000

nicholas.loney@blackrock.com

Find Currents on the web at blackrock.com/currents

To subscribe, visit blackrock.com/subscribe/currents

The following notes should be read in conjunction with the attached document:

1. Issued by BlackRock Investment management (UK) Limited, authorised and regulated by the Financial Conduct Authority. Registered office: 12 Throgmorton Avenue, London EC2N 2DL. Tel: 020 7743 3000. Registered in England No. 2020394. For your protection telephone calls are usually recorded. BlackRock is a trading name of BlackRock Investment management (UK) Limited.
2. 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 is not guaranteed. You may not get back the amount originally invested. Changes in the rates of exchange between currencies may cause the value of investments to diminish or increase. Fluctuation may be particularly marked in the case of a higher volatility fund and the value of an investment may fall suddenly and substantially. Levels and basis of taxation may change from time to time.
3. Any research in this document has been procured and may have been acted on by BlackRock for its own purpose. The results of such research are being made available only incidentally. The views expressed do not constitute investment or any other advice and are subject to change. They do not necessarily reflect the views of any company in the BlackRock group or any part thereof and no assurances are made as to their accuracy.
4. This document is for information purposes only and does not constitute an offer or invitation to anyone to invest in any BlackRock funds and has not been prepared in connection with any such offer.
5. This material is for distribution to Professional Clients (as defined by the FCA Rules) and should not be relied upon by any other persons.
6. Subject to the express requirements of any client-specific investment management agreement or provisions relating to the management of a fund, we will not provide notice of any changes to our personnel, structure, policies, process, objectives or, without limitation, any other matter contained in this document.
7. The information contained in this material is confidential and may not be reproduced or circulated beyond the intended recipients without the prior consent of the BlackRock Legal and Compliance department.
8. This material is solely for educational purposes and does not constitute an offer or solicitation to sell or a solicitation of an offer to buy any shares of any fund (nor shall any such shares be offered or sold to any person) in any jurisdiction in which an offer, solicitation, purchase or sale would be unlawful under the securities law of that jurisdiction. The accuracy of the information contained herein has not been confirmed by the securities regulators of Brazil, Chile and Mexico or any other securities regulator in any Latin American country.
9. Reference to each company mentioned in this publication is intended merely to illustrate an investment strategy and should not be construed as investment advice.
10. Unless otherwise specified, all information contained in this document is sourced by BlackRock and is current at 30 June 2013.

© 2013 BlackRock, Inc. All Rights reserved. BLACKROCK, BLACKROCK SOLUTIONS, ALADDIN, iSHARES, LIFEPAATH, SO WHAT DO I DO WITH MY MONEY, INVEST ING FOR A NEW WOR LD, and BUILT FOR THESE TIMES are registered and unregistered trademarks of BlackRock, Inc. or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.

009031-13 Article 4 Jul