

Fundamental Equity – Emerging Markets (EM) Equity

Viewpoints – The Tech Effect

Much attention has been given to the impact of technology related stocks in the US equity market. It has been less frequently discussed, but in EM the tech effect has been similar. While the 2017 EM rally has been fairly broad-based, with the vast majority of countries and sectors delivering positive returns, the tech sector has generated the highest YTD returns¹ and is now the largest weight in the MSCI Emerging Markets Index² (~27%).³ This is a reflection of an improved structural backdrop and near-term outlook. We believe the long-term scale of the opportunity means there is still reason for optimism.

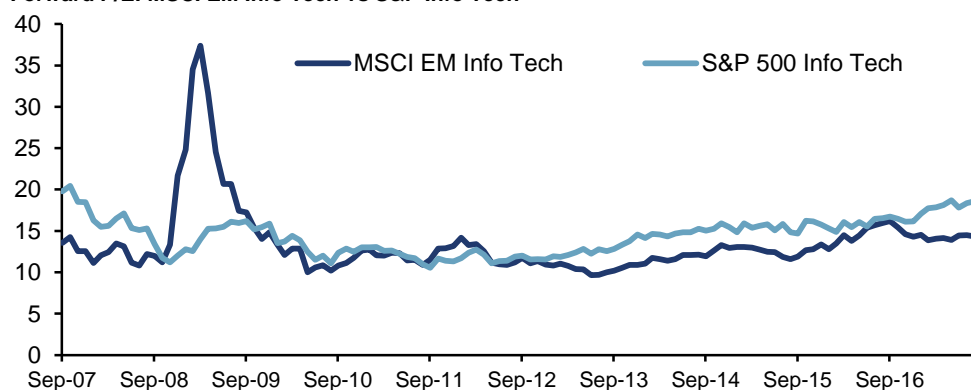
Long-Term Structural Growth Opportunity

Structurally, the internet is becoming a more crucial part of day-to-day life across emerging markets. Rising wealth, improving soft infrastructure and the millennial effect are all driving increased internet access and usage. For example, mobile phone penetration in EM is likely to cross 100% in the next year or two, up from under a third ten years ago.⁴ Similarly, there are 2.5 billion internet users across EM, up from less than 500 million a decade ago.⁴ This positive secular backdrop is supportive for earnings that turned positive (30% year over year growth at the end of August) after eighteen months of subdued earnings growth.⁵ Market expectations have also improved, and the consensus view is that this pace may be sustained over the coming year. Finally, the asset-light nature (e.g. lower fixed costs) of internet companies has meant many have been highly cash generative, an attractive characteristic for any business.

Reasonable Valuations

The improving fundamental outlook for growth and cash flows, coupled with the positive structural backdrop, has supported recent tech outperformance in EM. The question we have seen from investors is whether this has overly inflated valuations. While EM info tech was trading at a ~6% premium to its 10-year average at the end of August 2017, it still stood at a stark discount of ~30% relative to S&P 500 info tech.⁶ As discussed, the structural backdrop for the industry and the asset-light, cash-generative nature of internet businesses means the segment should warrant a premium.

Forward P/E: MSCI EM Info Tech vs S&P Info Tech⁷



Selectivity Matters

In our opinion, compelling investment opportunities are arising outside of the index and can be uncovered through careful stock selection. For example, we believe there are Latin American companies outside the index that are smaller cap and are poised to benefit from the rising trend of the millennial consumer's online purchasing habits. The 2016-19 e-commerce CAGR (Compound Annual Growth Rate) for Latin America is ~20%, compared with that of the US at ~15%.⁸ Specifically in Brazil, a young population, high smartphone usage and competitive costs of data plans set the stage for accelerating e-commerce penetration.⁸

Thus, we continue to be optimistic around the outlook for tech companies within EM, particularly for investors that look beyond the index and down in market cap.

¹ Source: MSCI, Datastream as of 31-Aug-2017. Looks at YTD return by sector.

² MSCI Emerging Markets Index is the proxy for emerging markets, unless otherwise noted.

³ Source: FactSet as of 31-Aug-2017.

⁴ Source: ITU World Telecommunication/ICT Indicators database as of Jun-2017. Shown for "developing markets" (UN definition). Developing markets generally include MSCI EM markets plus other African, Asian and South/Central American countries.

⁵ Source: GSAM, Datastream and FactSet as of 31-Aug-2017.

⁶ Source: FactSet as of 31-Aug-2017.

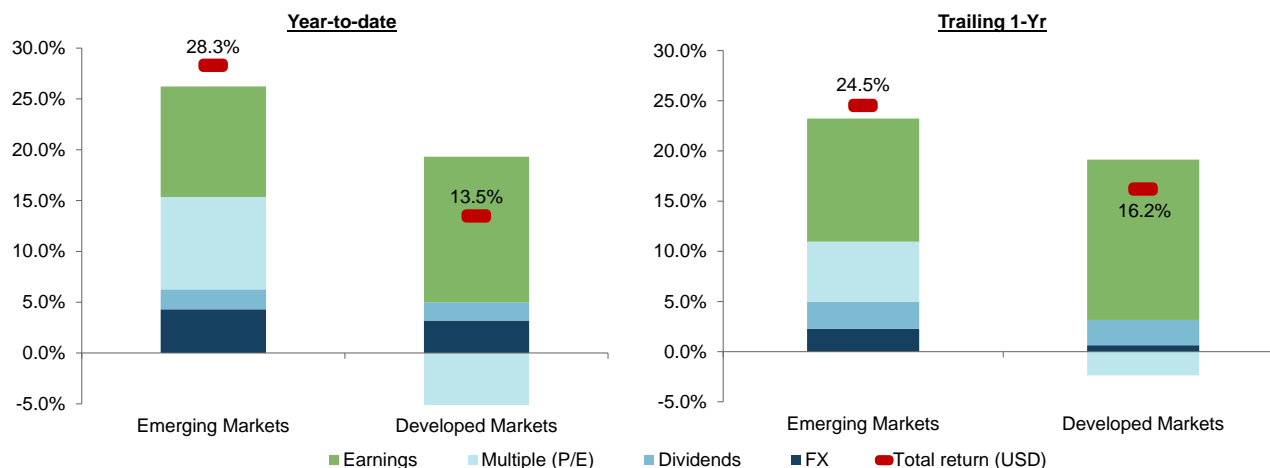
⁷ Source: FactSet as of 31-Aug-2017. Shows P/E NTM for MSCI EM Information Technology and S&P 500 Information Technology.

⁸ Goldman Sachs Global Investment Research "Raising global eCommerce forecasts on fast growing countries & categories" as of 6-Sep-2017.

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Appendix

Decomposition of total return – emerging markets versus developed markets



Source: DataStream, MSCI, GSAM Calculations, as of 31-Aug-17. Shown for MSCI EM and MSCI World indices (net, USD).

Performance – Emerging Markets country and sector breakdown

As of 31-Aug-17	August	YTD	Trailing 1-Yr
EM	2.2%	28.3%	24.5%
DM	0.1%	13.5%	16.2%
USA	0.3%	11.7%	15.5%
Europe	0.1%	18.9%	19.4%
Japan	-0.1%	12.1%	13.7%

Source: DataStream, MSCI, as of 31-Aug-17. Shown for MSCI EM, MSCI World, MSCI USA, MSCI Europe and MSCI Japan indices (net, USD). Past performance does not guarantee future results, which may vary.

EM valuation breakdown

	Trailing Price to Earnings (x)	Forward Price to Earnings (x)	Price to Book (x)	Dividend Yield (%)	Implied 'Z-score' ¹	Implied '%-time cheaper' ²	Next 12m Earnings Growth (%) ³	YTD change in expectations (pp) ³
EM	15.6	12.6	1.7	2.3	0.32	63%	16.1	+1.5
DM	20.8	16.4	2.3	2.4	0.73	77%	10.9	-2.1
US	23.0	18.0	3.1	2.0	1.06	86%	10.7	-1.6
Europe	20.3	14.7	1.8	3.3	0.61	73%	12.5	-2.3
Japan	14.8	13.8	1.3	2.1	-0.07	47%	10.5	-0.7

Source: MSCI, DataStream, FactSet, GSAM Calculations, as of 31-Aug-17.

¹ Implied 'Z-score' is the aggregate standardized score of Trailing Price to Earnings, Forward Price to Earnings, Price to Book and Dividend Yield. It represents the number of standard deviations away from historical average the current observation lies (greater than zero implies more expensive than historical average, less than zero implies less expensive than historical average). Calculated over the last 10 years, or longest available period if data availability is less than 10 years.

² Implied '%-time cheaper' represents the left-tail area of the assumed normal distribution of historical observations. It is not, therefore, an empirical representation of '%-time cheaper', but an approximation of how often the market has been cheaper than it currently is assuming the data is normally distributed. Calculated over the last 10 years, or longest available period if data availability is less than 10 years.

³ Next 12 months expected percentage growth in earnings. YTD change refers to the increase/decrease in percentage point terms versus the end of last year's observation. E.g. If the 12m earnings growth expectation at the end of March was 10%, versus 5% at the end of December, the YTD change in earnings expectations would be 5%. Colors represent a gradient of most attractive (green) to least attractive (red).

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Index Definitions¹⁰

MSCI Emerging Markets (EM) Index: The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of June 30, 2017 the MSCI Emerging Markets Index consisted of the following 24 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Russia, Qatar, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates. This Index offers an exhaustive representation of the Emerging markets by targeting all companies with a market capitalization within the top 85% of their investable equity universe, subject to a global minimum size requirement. It is based on the Global Investable Market Indices methodology. This series approximates the minimum possible dividend reinvestment. The dividend is reinvested after deduction of withholding tax, applying the rate to non-resident individuals who do not benefit from double taxation treaties. MSCI Barra uses withholding tax rates applicable to Luxembourg holding companies, as Luxembourg applies the highest rates.

MSCI Europe Index: The MSCI Europe Index captures large and mid cap representation across 15 Developed Markets (DM) countries in Europe. DM countries in Europe include: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the UK With 445 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe.

MSCI Japan Index: The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. With 320 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

MSCI United States of America (USA) Index: The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market. With 635 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US.

MSCI World Index: The MSCI World Index is a broad global equity benchmark that represents large and mid-cap equity performance across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country and MSCI World benchmark does not offer exposure to emerging markets.

S&P 500: The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

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¹⁰ Source: MSCI and S&P 500.

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