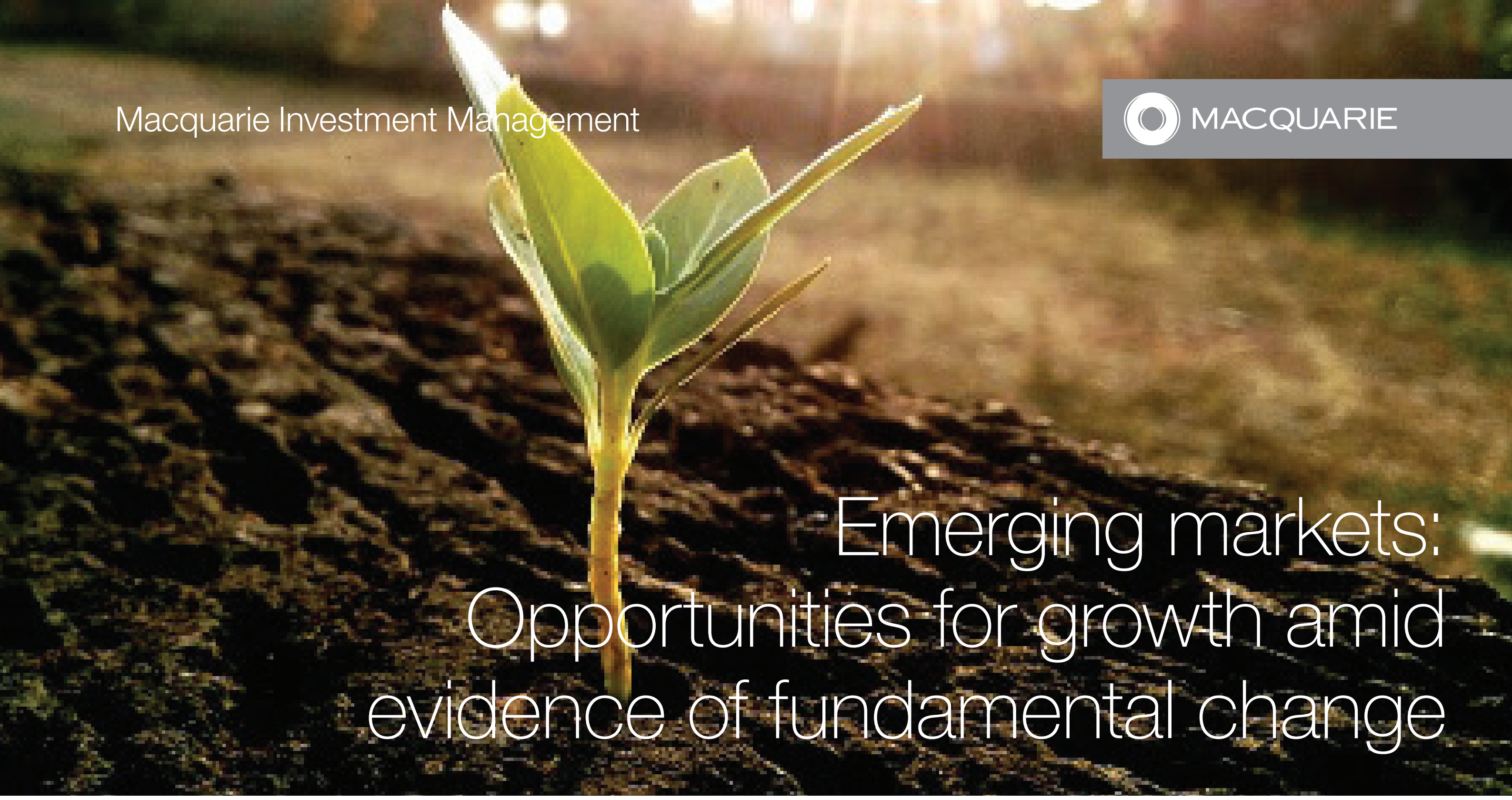

MACQUARIE

Emerging markets: Opportunities for growth amid evidence of fundamental change

Gabriel Wallach
Portfolio Manager, Global Ex-US Equity
San Diego

February 2018

Growth dynamics are taking root across emerging economies. Stimulative government policies and an expanding consumer base are providing tailwinds for companies that have the expertise to generate good cash flows, design competitive business models, and allocate capital smartly. Indeed, such company-level developments are where opportunities for alpha generation reside. For investors seeking to diversify their equity allocations, the long-term case for emerging markets is worth considering.

In the years since the global financial crisis, support for emerging markets equities has been inconsistent — certainly less consistent than it has been for their developed market peers.

This raises the question: Are emerging market equities destined to continue performing unevenly, or are there reasons to expect smoother sailing going forward? While such predictions are difficult to make and emerging market equities are regarded as risk assets, the asset class indeed appears poised to benefit from a number of fundamental factors.

From our perspective as research-based investors who take an active approach to portfolio management, we think focusing on company-level research is the best way for investors to approach emerging markets. But first, let's consider a few brief points about the current macro environment.

Favorable growth dynamics

Across emerging economies, fundamentals are improving. A deliberate, organized shift is taking place, in which countries are pursuing responsible monetary and fiscal policies. This is exemplified by stimulative measures in countries that include China, Indonesia, South Africa, India, and Malaysia. Policy specifics vary by country, and we do not imply that stimulative policy can lift all emerging countries at once. But on the whole, we think positive developments are under way.

In India, for instance, government-led initiatives are contributing to the long-term case for investment. One example is aimed at injecting capital into the infrastructure sector. The Indian government, as the lead investor in the project, has committed the equivalent of approximately $US3 billion to the National Investment and Infrastructure Fund (NIIF). The NIIF aims ultimately to double in size by bringing in institutional investors such as sovereign wealth funds and pension funds from other countries. As currently conceived, the fund will invest directly in infrastructure projects (and the companies that execute the actual work), aiming to produce a meaningful positive effect on the Indian economy.

India's economy is already posting gross domestic product (GDP) growth that is among the strongest of the G20 nations; if additional infrastructure stimulus is effective, there is a likelihood that it will magnify the country's potential for continued economic expansion.

An expanding consumer class

A growing middle class within a number of emerging economies is giving rise to a profoundly expanding consumer base, one whose spending power is fueled by rising wages and newly available access to credit. This consumer class is generating demand for services that go beyond the basic essentials of day-to-day living. Few countries exemplify this transformation as well as China. These are some of the conditions that are facilitating this sea change[1]:

- Hundreds of millions of Chinese are entering the middle class, and for the first time in history, a substantial middle class sits between the elite and the masses.
- The labor market is tightening. In each of the last 10 years, more than 10 million jobs have been added to the Chinese economy.
- As a share of the Chinese population, urban dwellers have tripled since 1980, and they now represent more than 50% of the total population. This has positive connotations for the country's consumerism, because urban households tend to earn higher incomes and spend more than their rural counterparts.

It's worth keeping in mind that China's evolving economy does not capture the entire story; it merely illustrates growth dynamics that are taking root in other emerging economies as well. Within Asia alone, evidence of an expanding consumer class can be seen in countries like Indonesia, where an estimated 90 million people will join the middle class by 2030, and in Malaysia, where the consumer class is starting to make a meaningful contribution to economic growth.

The table below highlights additional factors that are contributing to the transformation that is under way.

Four catalysts for growth in emerging markets

Catalyst	Notes
Widespread increase in consumption	• Annual consumption across emerging markets will rise from $US 12 trillion in 2010 to $US 30 trillion by 2025. During the same period, the share of world consumption will increase from 32% to 47%. • As millions move into the middle class, rising incomes are driving increased spending on discretionary items such as cars, clothing, and appliances.
Commodity markets	The stabilization and rebound of commodity prices in 2016 was a precursor to a cyclical uptick in global economic activity that is expected to drive demand for raw materials as we continue into the coming quarters.
Economic growth	Emerging economies are expected to have grown at a pace of 4.7% for calendar year 2017, rising from a rate of 4.1% in 2016.
Recent softening of the US dollar	A weaker US currency makes it easier for developing countries to pay back dollar-denominated debt.

Data: Bank of America Merrill Lynch (economic growth expectations); McKinsey (consumption).

[1]Based on research conducted by: McKinsey (growth of middle class); Federal Reserve Bank of Kansas City (labor market); China National Bureau of Statistics (urban population).

Attractive valuations

Despite their strong advance during the past 18 months or so, emerging market shares have been relatively cheaper than their developed market peers. The cyclically adjusted price-to-earnings ratio for emerging markets is approximately 13.5, while US stocks are trading at multiples that are north of 20 (data: Dow Jones). By this measure, emerging market equities are reasonably priced while developed market equities are rich enough that some analysts are concerned about an impending stall. Valuations may defy gravity for a while yet, but there's not much margin for error.

Beyond macro conditions: Emphasizing stock selection

Within the context of the reasonably positive macro conditions described above, several company-specific examples of investment ideas show strong potential for growth. Indeed, these company-level stories are where opportunities for alpha generation reside — a phenomenon that can get lost in the fray when investors are led purely by country-level conditions.

One example comes out of South America, a continent that is grinding its way through a host of fragile situations. Corruption, unstable public finances, pensions in need of reform — these headwinds are all part of the narrative, without question. Nevertheless, stories of genuine entrepreneurship can be found at the company level. We are seeing evidence of companies that are being managed effectively and competing vigorously. These firms are using management techniques that are no longer the sole provenance of companies in developed economies. What's more, they are generating decent cash flows, building sustainable business models, and allocating capital smartly. Perhaps most importantly for investors, these companies have room to grow.

For some of these companies, the rise of Internet technology has paved a route to success, as shown by firms such as Mercado Libre, an Argentine operator of an online marketplace. We believe the company is run by a capable management team, and its results have shown as much: Sales volume is growing at a rate that is somewhere between two and three times that of Amazon.

The company's competitiveness can be illustrated with other metrics as well, including a so-called take rate of 7.5%.[2]

In Brazil, to cite another example, the same dichotomy holds true: The country's macro conditions are not without sore spots, but company-level research can reveal compelling opportunities. Here, a traditional retailer with a large operation (approximately 800 stores) is operating an online marketplace that is getting meaningful traction. The company's performance is strong enough that it has essentially put a virtuous cycle in motion, by which it is able to arrange attractive financing terms, fund new initiatives, and do so while keeping its balance sheet in good order.

Mexico also is nursing its share of structural and political problems yet provides a home for companies that are determined to compete. There appears to be room for growth across several industries, and wireless communications is one that is worth studying. Operators of cell towers, for instance, appear poised to expand, particularly in light of the penetration rate for mobile phone usage in Mexico — it is relatively low, and we think it will grow.

[2] This measures the company's revenue and is calculated as a percentage of the total value of goods sold on its platform.

Questioning old stereotypes

Two additional circumstances can, we believe, help make the case for emerging markets. Both tend to go against conventional thinking and challenge old stereotypes:

• Government involvement is not automatically a bad thing.
Investors can be forgiven for assuming that industries automatically suffer when government plays too big of a role. Particularly in emerging markets, state involvement is often viewed with suspicion, and investors tread cautiously when assessing these relationships. But our research suggests that this trepidation can sometimes be overdone, and government involvement should not automatically be deemed detrimental to company-level performance. We have revealed cases in which well-managed companies actually benefit from aligning themselves with their governments.

The airline operator Turkish Airlines is one example. Forty-nine percent of the airline's ownership is government related, via the country's sovereign wealth fund. With a fleet of more than 300 aircraft, Turkish Airlines flies to approximately 120 countries and is the fourth-largest carrier in the world based on total destinations. It uses the city of Istanbul as a hub that connects Europe and the Americas to the Middle East, Africa, and Asia. Our knowledge of the airline's operations suggests that it will continue improving its position as a globe-spanning carrier. At this writing, the Turkish government has begun construction on an airport that will accommodate 100 million passengers per year. With all of this in mind, we think Turkish Airlines supports the idea that aligning with government can be a good thing.

• State-of-the-art businesses exist outside of developed markets.
There's an increasing amount of evidence that certain companies in emerging economies are capable of doing things as well as, if not better than, their developed market counterparts. China's Tencent Holdings has been masterful at this, growing from a relatively simple text-messaging service to an online giant whose user base is bigger than that of Google, Amazon, and Facebook combined. The company's ascent is instructive, and we believe it drives home the fact that developed-market merchants such as Amazon do not dominate ecommerce globally. This is partly because order fulfillment is not easy or cheap in some corners of the world; local companies are better equipped to step in and compete strongly, delivering value and convenience that established kingpins like Amazon cannot replicate.

Stock selection is where performance originates

While macro concerns are always part of the emerging market landscape, company-level research can reveal compelling opportunities. We think it makes sense to focus on companies that are early to market and have the potential to grow. In other words, we think portfolio returns can benefit from identifying early-stage growth companies that have the potential to add scale. With the right people, processes, and entrepreneurial drive, good companies in emerging markets can earn their way toward becoming great companies, rewarding investors along the way.

Holdings discussed (held in certain portfolios managed by the team, in amounts up to, as of Dec. 31, 2017, are: Mercado Libre: Emerging Markets Opportunities, 2.92%. Turkish Airlines (Turk Hava Yollari): International Small-Cap Equity, 1.28%. Emerging Markets Small-Cap Equity, 1.89%. Emerging Markets Opportunities, 1.82%. Tencent Holdings: Emerging Markets Opportunities; 8.69%) are for informational purposes only and are subject to change at any time. They are not a recommendation to buy, sell, or hold any security.

This information is confidential and intended for the audiences as indicated. It is not to be distributed to, or disclosed to retail investors.

The views expressed represent the Manager's as of the date indicated, and should not be considered a recommendation to buy, hold, or sell any security, and should not be relied on as research or investment advice. Views are subject to change without notice.

The information in this document is not, and should not be construed as, an advertisement, an invitation, an offer, a solicitation of an offer or a recommendation to participate in any investment strategy or take any other action, including to buy or sell any product or security or offer any banking or financial service or facility in any jurisdiction where it would be unlawful to do so.. The information presented is not intended and should not be construed to be a presentation of information for any pooled vehicle including U.S. mutual funds. This document has been prepared without taking into account any person's objectives, financial situation or needs. Recipients should not construe the contents of this document as financial, investment or other advice. It should not be relied on in making any investment decision.

Future results are impossible to predict. This document contains opinions, conclusions, estimates and other forward-looking statements which are, by their very nature, subject to various risks and uncertainties. Actual events or results may differ materially, positively or negatively, from those reflected or contemplated in such forward-looking statements. **Past performance is not a reliable indicator of future performance.** Investing involves risk including the possible loss of principal.

This presentation does not contain all the information necessary to fully evaluate any investment program, and reliance should not be placed on the contents of this document. Any decision with respect to any investment program referred to herein should be made based solely upon appropriate due diligence by the prospective investor. The investment capabilities described herein involve risks due, among other things, to the nature of the underlying investments. All examples herein are for illustrative purposes only and there can be no assurance that any particular investment objective will be realized or any investment strategy seeking to achieve such objective will be successful.

No representation or warranty, express or implied, is made as to the accuracy or completeness of the information, opinions and conclusions contained in this presentation. In preparing this presentation, reliance has been placed, without independent verification, on the accuracy and completeness of all information available from external sources.

To the maximum extent permitted by law, none of the entities under Macquarie Investment Management nor any other member of the Macquarie Group nor their directors, employees or agents accept any liability for any loss arising from the use of this presentation, its contents or otherwise arising in connection with it.

Other than Macquarie Bank Limited (MBL), none of the entities noted in this presentation are authorised deposit-taking institutions for the purposes of the Banking Act 1959 (Commonwealth of Australia). The obligations of these entities do not represent deposits or other liabilities of MBL. MBL does not guarantee or otherwise provide assurance in respect of the obligations of these entities, unless noted otherwise.

The following registered investment advisers form part of Macquarie Group's investment management business, Macquarie Investment Management: Macquarie Investment Management Business Trust, Macquarie Funds Management Hong Kong Limited, Macquarie Investment Management Austria Kapitalanlage AG, Macquarie Investment Management Global Limited, Macquarie Investment Management Europe Limited, and Macquarie Capital Investment Management LLC.

Diversification may not protect against market risk.

Emerging market equities entail their own unique risks. Such risks can include fluctuations in currency values, varying accounting principles, and periods of economic or political instability. Emerging market equities may also experience episodes of increased volatility and lower trading volumes, particularly when compared against developed-market equities.

For recipients in the United States, this document is provided by Macquarie Investment Management Business Trust (MIMBT). Institutional investment management is provided by Macquarie Investment Management Advisers (MIMA), a series of MIMBT. MIMBT is a U.S. registered investment advisor, and may not be able to provide investment advisory services to certain clients in certain jurisdictions.

For recipients the European Economic Area, this document is a financial promotion distributed by Macquarie Investment Management Europe Limited (MIMEL) to Professional Clients or Eligible Counterparties defined in the Markets in Financial Instruments Directive 2004/39/EC. MIMEL is authorised and regulated by the Financial Conduct Authority. MIMEL is incorporated and registered in England and Wales (Company No. 09612439, Firm Reference No. 733534). The registered office of MIMEL is Ropemaker Place, 28 Ropemaker Street, London, EC2Y 9HD. The investment capabilities described herein are managed by MIMEL, with day-to-day management responsibilities sub-delegated to relevant affiliated managers.

This document has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

For recipients in Switzerland, this document is distributed by Macquarie Investment Management Switzerland GmbH. In Switzerland this document is directed only at qualified investors (the "Qualified Investors"), as defined in the Swiss Collective Investment Schemes Act of 23 June 2006, as amended ("CISA") and its implementing ordinance.

For recipients in Australia, this document is provided by Macquarie Investment Management Global Limited (ABN 90 086 159 060 Australian Financial Services Licence 237843) solely for general informational purposes. This document does not constitute a recommendation to acquire, an invitation to apply for, an offer to apply for or buy, an offer to arrange the issue or sale of, or an offer for issue or sale of, any securities in Australia. This document has been prepared, and is only intended, for 'wholesale clients' as defined in section 761G of the Corporations Act and applicable regulations only and not to any other persons. This document does not constitute or involve a recommendation to acquire, an offer or invitation for issue or sale, an offer or invitation to arrange the issue or sale, or an issue or sale, of interests to a 'retail client' (as defined in section 761G of the Corporations Act and applicable regulations) in Australia.

For recipients in PRC, Macquarie is not an authorized securities firm or bank in the People's Republic of China and does not conduct securities or banking business in the People's Republic of China.

For recipients in Hong Kong, this document is provided by Macquarie Funds Management Hong Kong Limited (CE No. AGZ772) (MFMHK), a company licensed by the Securities and Futures Commission for the purpose of giving general information in relation to the strategy(ies) described herein. The information contained in this presentation is provided on a strictly confidential basis for your benefit only and must not be disclosed to any other party without the prior written consent of MFMHK. If you are not the intended recipient you are not authorised to use this information in any way. This presentation does not, and is not intended to, constitute an invitation or an offer of securities, units of collective investments schemes or commodities (or any interests in any index thereof) for purchase or subscription in Hong Kong. The information in this presentation is prepared and only intended for professional investors and not to any other person. This presentation has not been approved or reviewed by the Securities and Futures Commission.

For recipients in Korea, this document is provided at the specific request of the recipient who is a person specified under Article 101(2) of the Presidential Decree of the Financial Investment Services and Capital Markets Act (Act) without any solicitation by Macquarie. Therefore, this document may not be distributed, either directly or indirectly, to others in Korea. The person receiving this document represents and warrants that if it receives this document, it is a professional investor as defined under the Act. No member of the Macquarie Group makes any representation with respect to the eligibility of any recipients of this presentation to acquire the products or services therein under the laws of Korea, including but without limitation the Foreign Exchange Transactions Act and Regulations thereunder. The products and services have not been registered under the Act, and none of the interests may be offered, sold or delivered, or offered or sold to any person for re-offering or resale, directly or indirectly, in Korea or to any resident of Korea except pursuant to applicable laws and regulations of Korea.

For recipients in Malaysia, Taiwan, **The Philippines,** this document is provided at the specific request of the recipient.

For recipients in Singapore, the Strategies which are the subject of this document do not relate to a collective investment scheme which is authorised under section 286 of the Securities and Futures Act, Chapter 289 of Singapore (the "SFA") or recognised under section 287 of the SFA. The Strategies are not authorised or recognised by the Monetary Authority of Singapore (the "MAS") and shares are not allowed to be offered to the retail public. Each of this document and any other document or material issued in connection with the document is not a prospectus as defined in the SFA. Accordingly, statutory liability under the SFA in relation to the content of prospectuses would not apply. You should consider carefully whether the investment is suitable for you. This document has not been registered as a prospectus with the MAS. Accordingly, this document and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of shares may not be circulated or distributed, nor may shares be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 304 of the SFA, (ii) to a relevant person pursuant to Section 305(1), or any person pursuant to Section 305(2), and in accordance with the conditions specified in Section 305 of the SFA, or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

For recipients in Japan, this document is provided by MFMHK. MFMHK is supported by Macquarie Asset Management Japan Co., Ltd., a Financial Instruments Business Operator: Director General of the Kanto Local Finance Bureau (Financial Instruments Business) No.2769 (Member of Japan Investment Advisers Association). This presentation does not, and is not intended to, constitute an invitation or an offer of securities in Japan. The securities have not been and will not be registered under the Financial Instruments and Exchange Act of Japan. None of the securities may be offered or sold, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (which term means any person resident in Japan, including any corporation or other entity organized under the laws of Japan), or to others for re-offering or resale, directly or indirectly, in Japan or to a resident of Japan, except pursuant to an exemption from the registration requirements of, or otherwise in compliance with, the Financial Instruments and Exchange Act of Japan and in compliance with any other applicable laws and regulations of Japan.

Macquarie Group, its employees and officers may act in different, potentially conflicting, roles in providing the financial services referred to in this document. The Macquarie Group entities may from time to time act as trustee, administrator, registrar, custodian, investment manager or investment advisor, representative or otherwise for a product or may be otherwise involved in or with, other products and clients which have similar investment objectives to those of the products described herein. Due to the conflicting nature of these roles, the interests of Macquarie Group may from time to time be inconsistent with the Interests of investors. Macquarie Group entities may receive remuneration as a result of acting in these roles. Macquarie Group has conflict of interest policies which aim to manage conflicts of interest.

Contact us by region

Americas

Market Street
Philadelphia
215 255 1200
mim.americas@macquarie.com

Australia

Martin Place
Sydney
1800 814523
mim@macquarie.com

Europe/Middle East/Africa

Ropemaker Place
London
44 020 3037 2049
mim.emea@macquarie.com

Asia

Harbor View
Hong Kong
852 3922 1256
macquarie.funds.hk@macquarie.com