M&G (Lux) Global Emerging Markets Fund

The search for value: a contrarian approach to emerging markets

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- We believe that China is capable of managing the risks presented by Evergrande's financial problems
- We see the recent market volatility in China as an opportunity to add to existing positions and identify new ideas
- Beyond China, we see emerging markets as a wide and diverse asset class that can potentially present opportunities for selective stock pickers

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

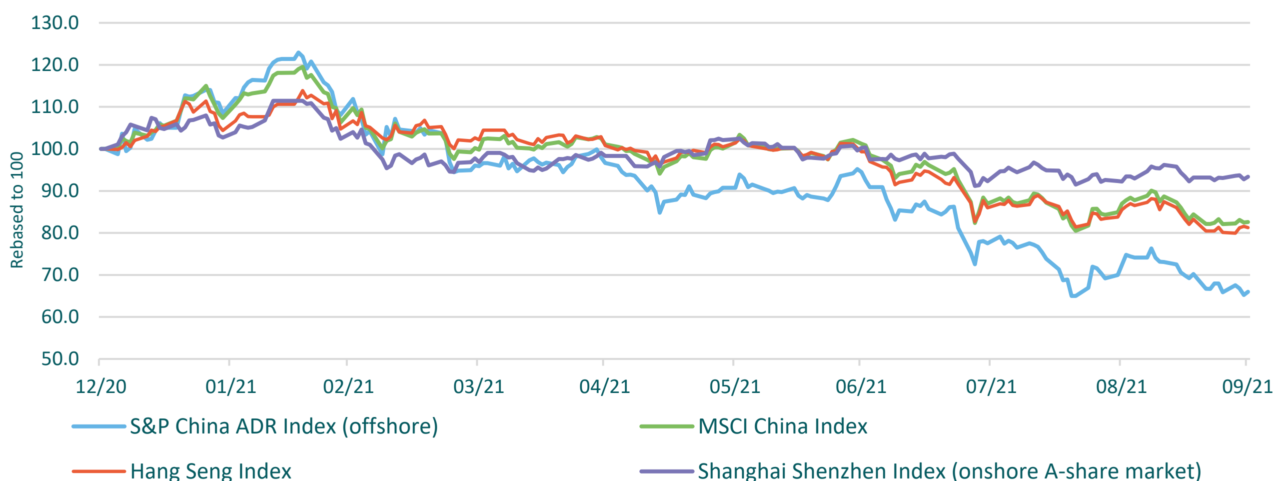
The fund may invest in China A shares. Investments in assets from China are subject to changeable political, regulatory and economic conditions, which may cause difficulties when selling or collecting income from these investments. In addition, such investment is made via the Stock Connect system, which may be more susceptible to clearing, settlement and counterparty risk. These factors could cause the fund to incur a loss.

Evergrande – what is going on?

In recent weeks, the financial woes of highly indebted Chinese property developer Evergrande have led to headlines questioning whether this represents China's 'Lehman moment'. In our view, comparisons with the collapse of Lehman Brothers in 2008, which was a key feature of the global financial crisis, are mildly unhelpful from a communications standpoint. However, they certainly require careful deliberation and pragmatic investment application.

The huge sums invested in China's property market have long been a worry for policymakers and tackling this issue has been on their agenda for many years. The Chinese property market is one of the largest asset classes in the

Figure 1: One China, many markets



Past performance is not a guide to future performance.

Source: Bloomberg, October 2021

UCITS HAVE NO GUARANTEED RETURN, AND PAST PERFORMANCE IS NOT A GUDE TO FUTURE PERFORMANCE

world and real estate represents a meaningful component of the country's gross domestic product. Clearly then, when its most indebted property developer runs into difficulty, commentators and investors around the world duly focus on the potential fallout.

A controlled collapse?

Last year, China sought to address the growing debt problem in the real estate sector with the "three red lines" policy. This forced large and levered property developers to shrink and cut debt levels. These measures were designed to curb the excessively aggressive competitive behaviour associated with heavily indebted developers and, ultimately, reduce the risk of a collapse of the financial system.

Evergrande and other large firms were slow to respond to the changes. It is therefore arguable that their current difficulties can be directly attributed to these reforms. In that sense, Evergrande's potential collapse could be seen as a controlled event, better managed by policymakers than was the case for Lehman, whose collapse came as an unexpected shock.

It appears to us that China is capable of containing the situation and we believe the systemic risks are likely quite low. So far, the impact is limited to the Chinese high yield bond market, with the regulators stepping in to limit the impact on homeowners. Next in Evergrande's unwinding pecking order will be various domestic creditors, then the overseas bondholders and finally the equity holders.

We find it interesting that Evergrande's shares are listed in Hong Kong, rather than the Chinese mainland. This means that most of the pain will likely be felt by overseas investors, while the fallout for domestic investors could be limited. Although Evergrande's problems are undoubtedly a major event, China has the ability and resources to navigate this challenge, in our view.

Discount for offshore China stocks

Worries about the property market, following on from China's regulatory crackdown on the technology and education sectors, have arguably contributed to growing nervousness about investing in China. This can be seen in the performance of China's stockmarkets this year (see Figure 1). The index of offshore-listed ADRs has retreated dramatically from highs in February and underperformed the onshore A-share market. The internet and technology-dominated ADR index has suffered from a significant decline in earnings estimates, leading to a reversal, which, in our view, corresponds to the degree of foreign investor disenchantment with Chinese stocks.

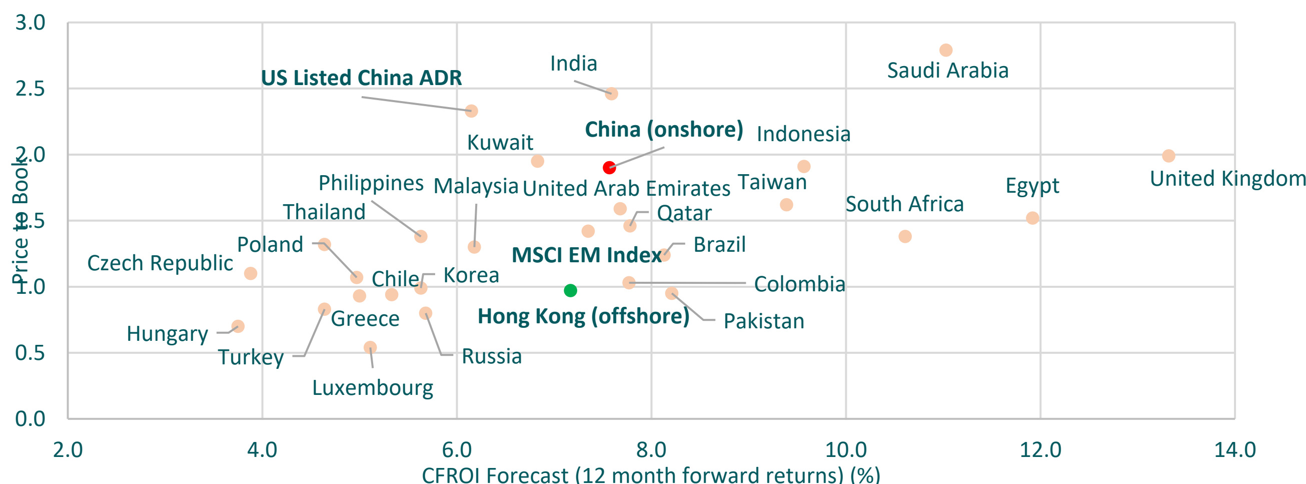
This is perhaps best illustrated by the valuation discount that has emerged between onshore and offshore Chinese stocks. Onshore China stocks (represented by the red dot) are trading close to a price-to-book (P/B) ratio of 2 times (x), compared to their offshore counterparts (represented by the green dot), which are trading nearer to 1x P/B, for a similar level of forecast returns (see Figure 2).

Investors are reminded that past performance is not a guide to future performance.

Risks and opportunities in China

Evergrande's current difficulties are not particularly surprising, in our view. Our meeting notes from 2018 reveal concerns about the firm's leverage. At the time, we scratched our heads and realised it was not an investment for us. Concerns about balance-sheet strength and

Figure 2: Valuation discount for offshore China stocks



Source: HOLT®, Credit Suisse, 7 October 2021. CFROI® is a measure of return on capital in Credit Suisse's HOLT tool

associated disbelief in the sustainability of elevated return on capital levels perhaps enabled us to dodge losses in property names.

Lofty valuations and poor return-visibility have led to an underweight position in China in our portfolio, compared to the benchmark MSCI Emerging Markets Index. However, considering the growing nervousness about recent developments in China and the stockmarket declines, the main questions we are being asked are: are we adding China risk? And if so, where?

The short answer to the first question is yes. However, while we are keen to stress our macro awareness, we are far more focused on a stock selection process rooted in analysis of viable returns and bottom-up valuation.

We do not follow a solely quantitative-based value approach, but rather look at valuation relative to the value creation in terms of returns. In doing so, we focus on a company's return on capital profile (using Credit Suisse HOLT's CFROI® measure) and try to identify opportunities where the market underappreciates the level of returns we think a firm can generate over the long term.

On this basis, we continue to view recent market volatility in China as an opportunity to add to positions where we have established conviction and also potentially to invest in new ideas. It is important to remember that investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.

Over the past few months, we have been adding slowly to our existing holdings in e-commerce firm **Alibaba**, internet search company **Baidu** and insurer **Ping An**. These purchases, alongside market movements, have reduced the portfolio's underweight to China and Hong Kong, relative to the benchmark. At the start of 2021, the fund had an underweight of almost 13%, which has narrowed to under 5% at the end of September.

Our holdings in China are well-diversified across sectors – we have investments in energy, financial, healthcare and internet-related businesses. Our largest Chinese stock, **Hollysys Automation Technologies**, which provides automation and control systems to the industrial and railway sectors, is currently subject to three competing takeover offers.

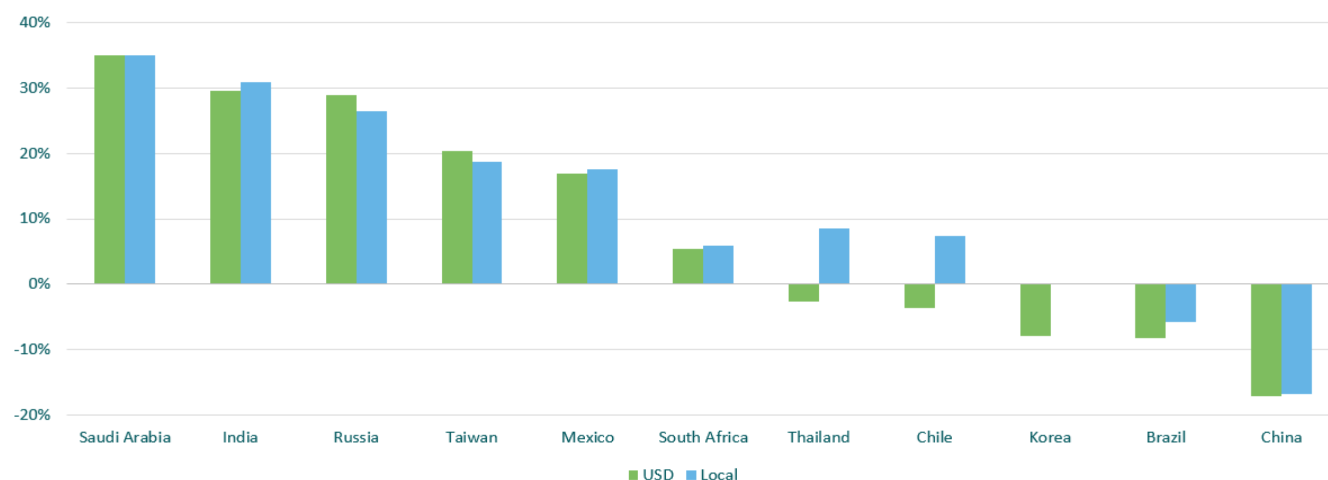
Amid the current uncertainty about the risks in China, we are finding our contrarian instincts piqued by stocks which, in our view, offer attractive returns but whose prospects are now being undervalued. Going forward, we believe strict adherence to understanding what expectations of future returns are built into current share prices should stand us in good stead.

Emerging markets are much more than China

The economic importance of China and its sheer size in the MSCI Emerging Markets Index (34% at the end of September 2021) means it tends to receive a large amount of commentary. However, we believe China's dominance can sometimes overshadow the wide and diverse opportunity set that exists in the rest of the emerging markets universe.

Figure 3: China's woes this year mask gains in other markets

Country returns: MSCI Emerging Markets Index, year to date (%)



Source: Bloomberg, October 2021, returns in USD and local currencies

Past performance is not a guide to future performance.

The notion that when China sneezes, everyone else catches a cold, is true to a degree. Countries such as Brazil and South Korea are sensitive to events in China, through the export channel and financial flows. Their stock markets have duly underperformed in 2021 (see Figure 3). On the other hand, there are several countries that are insulated from China's woes, namely India, Russia and Mexico. These markets have in fact advanced this year.

In a complete volte-face to 2020, volatility centred on China highlights the degree to which the asset class is bifurcated. In our view, this demonstrates the potential for the well-diversified active investor to add alpha as stock dispersion rises across the asset class.

Looking back to the valuation dispersion shown in Figure 2, we can see the valuation opportunities in different countries. We note that India trading at 2.5x P/B is about as expensive as it has ever been and is pricing in a material amount of future growth. Conversely, Russia is one of the cheapest markets where, at the stock level, we continue to find interesting opportunities.

Figure 4: Earnings recovery in EM excluding North Asia

Forward earnings per share recovery expected (indexed to 100 at Jan 2010, US$/share)

Source: Factset, Goldman Sachs Global Investment Research, September 2021

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From a portfolio perspective, we have a below-benchmark position in India and an above-benchmark position in Russia. Given the gains in Russia's stockmarket this year, this might point to our asset allocation success but, in practice, our contrarian-mindedness leads us towards geographic or sectoral clusters of specific value opportunities and our positioning is an expression of single stock ideas.

Much underdiscussed this year, in our view, is the extent to which emerging market equities are having a very good year in terms of inflows. At around US$100 billion, the asset class has seen the highest level of flows in more than a decade, likely driven by a reallocation away from the elevated US markets towards emerging markets. The allocation to emerging markets among global assets is perhaps now at uncomfortably low levels for asset allocators and global fund managers. One of the factors that might be driving this shift is the potentially strong "V-shaped" forward-looking earnings per share (EPS) recovery that analysts expect to take place for companies in emerging markets excluding North Asia, highlighted in figure 4 from Goldman Sachs.

Despite the logistical challenge represented by vaccination programmes, we see that the world continues its economic recovery from COVID-19's negative impact on living standards. While economic growth may slow in China, partly due to weakness in the property market, we do not think this portends poorer outcomes for equity investors. We believe that company fundamentals, not a country's economic growth rate, ultimately drive stockmarket returns. Therefore, irrespective of the economic conditions, we concentrate our efforts on finding firms that use capital efficiently and create long-term value for their shareholders.

We suggest that investors should beware of 'animal spirits' when it comes to capital allocation. Our job as contrarian investors remains that of seeking where the mispriced sources of potential future returns are hidden, whether that is in China or beyond, and marching towards those opportunities.

The fund invests mainly in company shares and is therefore likely to experience larger price fluctuations than funds that invest in bonds and/or cash.

Further risks associated with this fund can be found in the fund's Key Investor Information Document.

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