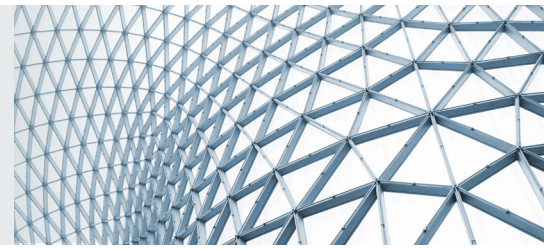


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## Value investing in emerging markets: lessons from history

**Daniel Nicholas**, Client Portfolio Manager at Harris Associates, looks back to the volatility in Asian markets during the 1990s and draws six key conclusions for investing in Emerging Markets.

### Key Takeaways:

- Emerging markets are a lot less emerging than they used to be; a more integrated global economy means that the world has become smaller.
- Investors and managers no longer suffer from limited visibility into markets, and the transparency around the companies in the emerging markets is getting better.
- Here are six lessons learned from the Asian volatility of the 1990s.

Emerging markets are a lot less emerging than they used to be. A more integrated global economy means that the world has become smaller. Investors and managers no longer suffer from limited visibility into markets, and the transparency around the companies in the emerging markets is getting better. But it wasn't always this way. Here are six lessons learned from the Asian volatility of the 1990s.



**Daniel Nicholas**  
Client Portfolio Manager  
Harris Associates

### Volatility is reality

Mr. Market frequently prices businesses based on short-term macro and political fears, which leads to violent swings in share prices. But periods of long-term macro tranquillity are actually quite rare, especially in emerging markets. In 1987, there was a global stock market crash. In fact, the Hong Kong market was hit so hard that it was closed for days before it regrouped and reopened. Then there was the Gulf War in the early 1990s, followed by Latin America's "Tequila Crisis" in 1994. The next couple of years were fairly quiet, but in 1997 there was the Asian financial crisis, followed by a full-blown panic in most emerging markets by mid-1998.

### Volatility is opportunity

Despite all of the macro disturbances in the 1990s, the MSCI World Index managed an average annual return

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of 12% in that decade. Share price destruction during the Latin American financial crisis and Asian contagion episodes of the 1990s provided great opportunity for long-term investors. Let's take the example of Telmex, the dominant telecommunications company headquartered in Mexico.

Telmex traded down 13.5% in the four weeks of October 1995. Yet, despite the harsh recession taking place in the country, the company was still generating more than \$1 billion a year in free cash with just a trace of debt, and management was astutely buying back its stock.

There were other attractively-valued emerging market companies too. By the time sentiment improved, Telmex was up 21.5% in November 1995 alone. Ultimately, discounts to most estimates of value declined and larger discounts to intrinsic value could be found in markets outside of Asia.

## Price is what you pay, value is what you get

It's not enough to buy a stock that has been down significantly. Is 10% down enough? 20%? 50%? You have to have a yard stick for measuring the discounted price versus the true intrinsic value of the business. It's the task of value managers to incorporate the impact, if any, these fears have on the actual ability of companies to generate current and future cash flow streams.

We measure the durability, velocity and quality of a particular company's free cash flow stream over time. It is these streams, not political uncertainty, that are the key determinants of business value. If needed, we make adjustments to specific business valuations. In most cases, this key number – the present value of all cash flow streams – is, at worst, mildly impacted by market volatility and, thus, we are provided with a buying opportunity. As value managers, when we price an emerging market business, we do it in the same way as a developed market business, but with a few differences.

- First, we assign a multiple to what we believe is the terminal level of EBITA (earnings before interest expense, taxes and amortisation). That multiple is

really the barometer of risk, and a riskier business will have a much lower multiple applied to it.

- Second, we adjust the cost of equity based on whether it's a developed or emerging market. If you're a company based in Switzerland, your cost of equity, in our view, is 10%. If you're a company based in Mexico or Brazil, your cost of equity is going to be at least 13%.
- Lastly, we have to be very careful that we understand ownership structure and corporate governance. If we see an ownership structure we don't like, we probably won't invest in it. All else the same, we will price the business lower if we think there are issues surrounding the company in terms of opacity.

## Maximise shareholder, not government value

Investing with corporate managers who think and act as owners should be a vital part of a value investor's discipline in the emerging world, investing only with managers who treat their shareholders as their partners. It's important to make sure that the companies you are invested in are driven to maximise shareholder value. One way to do so is to ensure that companies are governed by an independent board of directors, and that management teams are compensated to grow per share value for shareholders, not stakeholders like the government.

The big national champions, such as a Petrobras in Brazil, may seem very cheap, but there's so much else to worry about that aren't big issues in developed markets. Why wouldn't you want to own a company like Petrobras with massive energy reserves and a strong long-term demand outlook? Well, it's controlled by the Brazilian government. In addition, the supply chain has local-content regulations, which can mean delays and slowdowns because the best technology isn't always deployed. Lastly, there are price controls on what people pay at the pump for fuel, a price that is below Petrobras' cost.

More broadly, government bureaucracy, overregulation, high taxation and corruption have negatively impacted Brazil's economy and triggered unrest across the class spectrum. Even at a

cheap price, it's hard to get excited about that. However, once you get past the big national companies in emerging markets that may trade at low valuations, the most attractive companies to own are just too expensive. That may not be the case forever, but it's another reason we've found little to do directly in these countries.

## Measure exposure by fundamentals, not by headquarters

The challenge with investing directly in emerging markets is that it's very difficult to find specific companies that have clear and transparent corporate governance, good profitability and business models, and stocks that sell at attractive prices. That said, exposure to the growth of emerging markets is clearly attractive. In the medium and long term, the massive population migrating to the middle and upper classes in emerging markets will be conducive to global economic growth. The most attractive companies to own would have astutely allocated their capital toward these trends over the previous decades in anticipation of this growth.

When looking at where the revenues are generated, having upwards of 20% exposure to the emerging markets isn't a bad ploy. There are cheap multinational companies headquartered in Europe like Daimler, the parent of Mercedes-Benz; Diageo, the spirits company; and Richemont, which owns luxury brands like Cartier, Piaget and JaegerLeCoultre. The management teams of these companies protect minority shareholding rights, are good stewards of the businesses and are well exposed to the emerging markets consumer, especially in Asia.

## Themes distort value

In 1988, the MSCI Emerging Markets Index was launched giving investors a fancy new tool to articulate concepts and themes through asset allocation. As investors embraced these countries as an asset class, they allocated more and more money to them, regardless of valuation. From 2003 until today, the

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weight of emerging markets doubled to over 20% of the MSCI ACWI ex U.S. Index. During this period, investors could easily allocate toward the BRICs (Brazil, Russia, India, China) countries expected to benefit from the commodity boom and the massive emerging middle class. Later in the decade, the PIIGS (Portugal, Italy, Ireland, Greece, Spain) became the poster child of the European Debt Crisis.

At the time, we received lots of questions on why we were not in the BRICs. The simple answer was price. By painting companies with a broad brush, the

market was overpaying for them. Our approach is starkly different; we assign multiples to cash flow streams, not themes, and our portfolio weights are based on conviction, not the amount a benchmark assigns to it. Thematic trading often creates a disconnect between price and value. During the PIIGS crisis, any company with its headquarters in Italy was decimated. By our estimates, Fiat Industrial, the #2 maker of farm equipment in the world, was trading at a fraction of its value, yet the company derived only a fraction

of its sales and profits in Italy and less than 25% of its sales in western Europe. The company's revenue stream was far more exposed to the beloved BRICs. We could conveniently confirm this with management as the CEO of the farm equipment division resided just minutes from our office in Chicago. We still hold the company eight years later, but you'll find it is now named CNH Industrial – a Netherlands company.

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