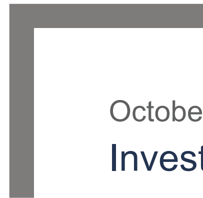

October 2013

Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

Copyright © 2013 by Cambridge Associates LLC. All rights reserved. Confidential.

This report may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates LLC ("CA"). Copying of this publication is a violation of U.S. and global copyright laws (e.g., 17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report are confidential and non-transferable. Therefore, recipients may not disclose any information or material derived from this report to third parties, or use information or material from this report, without prior written authorization. This report is provided for informational purposes only. It is not intended to constitute an offer of securities of any of the issuers that may be described in the report. No part of this report is intended as a recommendation of any firm or any security, unless expressly stated otherwise. Nothing contained in this report should be construed as the provision of tax or legal advice. Past performance is not indicative of future performance. Any information or opinions provided in this report are as of the date of the report and CA is under no obligation to update the information or communicate that any updates have been made. Information contained herein may have been provided by third parties, including investment firms providing information on returns and assets under management, and may not have been independently verified. CA can neither assure nor accept responsibility for accuracy, but substantial legal liability may apply to misrepresentations of results made by a manager that are delivered to CA electronically, by wire, or through the mail. Managers may report returns to CA gross (before the deduction of management fees), net (after the deduction of management fees), or both.

Cambridge Associates, LLC is a Massachusetts limited liability company with offices in Arlington, VA; Boston, MA; Dallas, TX; and Menlo Park, CA. Cambridge Associates Fiduciary Trust, LLC is a New Hampshire limited liability company chartered to serve as a non-depository trust company, and is a wholly-owned subsidiary of Cambridge Associates, LLC. Cambridge Associates Limited is registered as a limited company in England and Wales No. 06135829 and is authorised and regulated by the Financial Conduct Authority in the conduct of Investment Business. Cambridge Associates Limited, LLC is a Massachusetts limited liability company with a branch office in Sydney, Australia (ARBN 109 366 654). Cambridge Associates Asia Pte Ltd is a Singapore corporation (Registration No. 200101063G). Cambridge Associates Investment Consultancy (Beijing) Ltd is a wholly owned subsidiary of Cambridge Associates, LLC and is registered with the Beijing Administration for Industry and Commerce (Registration No. 110000450174972).

CAMBRIDGE ASSOCIATES LLC

"Whatever Happened to EM Equity Markets?"

Michael Gavin and Alanna Gregory, Barclays,
September 16, 2013

Emerging markets equities have trailed developed markets equities since late 2010. This pronounced underperformance can be traced to disappointing fundamentals in the so-called BRIC countries, note Michael Gavin and Alanna Gregory of Barclays Capital. In the current environment, emerging markets investors should focus on "value" rather than "growth" as the thesis behind future profits.

The across-the-board sell-off of emerging markets assets in May 2013 on the back of Federal Reserve "tapering" concerns refocused investor attention on emerging markets equities and their underperformance relative to developed markets equities since late 2010. Emerging markets equities have underperformed developed markets in the past, but the most recent period stands out for several reasons. First, performance in developed markets has been robust, and some other assets within emerging markets, such as bonds, also performed well. Second, the stronger growth of emerging economies following the financial crisis originally led many to believe that this "high-beta" asset class would deliver strong results if equity markets generally produced positive returns. Finally, at three years, the sheer duration of the underperformance is the longest in the history of the emerging markets index.

What has gone wrong in emerging markets? Even with the benefit of hindsight, puzzles remain. Emerging markets GDP growth has disappointed relative to 2010 forecasts, but so has growth in developed markets. Exchange-traded fund and mutual fund flows have been more supportive for emerging markets–related investments than U.S. equities. In addition, emerging markets equities were not aggressively valued before the underperformance began.

The first contributor to underperformance has simply been the strong performance of U.S. equities, which have benefitted both from strong earnings growth and safe-haven appeal, even in the face of muted GDP growth. The second factor has been poor fundamentals in the four large BRIC countries, which compose half of the emerging markets equity universe but have delivered the bulk of its mediocre performance. Indeed, outside of the BRIC countries, emerging markets equities have actually performed in line with developed markets. The factors affecting the BRICs have been largely idiosyncratic: fears of a "hard landing" in China, combined with a big wedge between GDP and earnings growth; declining earnings and questions about economic policy in Brazil; and falling valuations in India despite earnings that are still soldiering upward.

Going forward, investors in emerging markets may need to have a different thesis—one of value rather than growth. Chinese equities are now cheap in absolute terms. Brazilian equities could still be a value trap, but might offer upside if viewed as a turnaround/restructuring candidate. Only Indian equities seem to offer the traditional emerging markets investment rationale—growth—with slightly more tempered expectations.

"Different EMs – Different Challenges"

Kamakshya Trivedi et al, Goldman Sachs, October 10, 2013

The external vulnerabilities that marked the currency crises of the 1990s are much less visible within emerging markets today. Large current account deficits in emerging markets are the result of two distinctly different vulnerabilities, argue Goldman Sachs' strategists.

Significant underperformance and recent currency weakness have prompted many investors to wonder if emerging markets are prone to a balance of payments crisis. The issues affecting emerging markets today, however, are much different than those that flared up during the currency crises of the 1990s. Only the Ukraine faces the full list of problems associated with serious external vulnerability—the country's high foreign currency borrowing, pegged exchange rate, high current account deficit, and low level of foreign exchange reserves are classic warning signs. The current account deficits in other emerging markets reflect two other vulnerabilities: overheated economies and overly optimistic views about future growth.

Many emerging markets countries that suffer from current account deficits have "overheated" economies. These countries are operating close to economic capacity and are experiencing inflation that is already above target. Countries such as India, Indonesia, and Turkey may need to go through a slowdown in domestic demand that promotes rebalancing without risking inflation stability. Although this can be difficult for policymakers to navigate, tightening monetary policy and raising short-term interest rates should help in the long run. The extent to which equities and credit are impacted in the short term depends on how policymakers manage the adjustment process, the fragility of the banking and corporate sectors, and the degree to which the export sector picks up any slack in the economy.

Other emerging markets countries have been the "victims" of excessive optimism surrounding growth and asset return prospects. These countries have benefitted from excessive capital inflows and rapid credit growth; however, they can also suffer immensely in the event of a reversal of this "hot money" and the painful reallocation of capital. Finding reliable indicators of which countries are most vulnerable to excessive investor optimism is difficult, but current account deterioration (driven by the capital inflows) and rising asset prices can signal the upswing, while a marked fall in growth expectations can signal the onset of a more painful unwinding. Today, commodity producers like Brazil, Chile, and Russia have seen the most notable shifts in expectations. China, too, has experienced dramatic credit growth over the past five years, and has recently been a target for lowered expectations.

It is difficult to find just one prevalent problem in each emerging markets country, so it can be helpful to group countries into five clusters of vulnerability. The first cluster includes the emerging markets countries exposed to traditional external vulnerabilities: the Ukraine, which is at risk of breaking its currency peg, and also Argentina and Venezuela. The second cluster contains "overheated" economies, such as India and Indonesia, in which the cycle of optimism and pessimism has perhaps not been as volatile as that in other places. The countries that are most vulnerable to a de-rating of optimistic growth expectations, such as Chile, Russia, and South Africa, make up the third group. The fourth (Malaysia, Mexico, and Thailand) has aspects of all these imbalances, but none of them individually as intense as in the case of the most exposed emerging markets. The final group of emerging markets exhibits very few of these imbalances or vulnerabilities, including countries such as the Czech Republic, Poland, and South Korea. ■