Intellectual Capital Whitepaper

Emerging Markets Public Equities Allocation Rationale

| Stan Miranda |

This is a financial promotion. Your capital is at risk, the value of investments may fall and rise and you may not get back the full amount you invested. Past performance is not indicative of future returns.

In any long-term strategic asset allocation exercise, we recommend a neutral (market weight) allocation to emerging market equities. Today, this has us allocating a c. 3.5% overall portfolio holding, or a 12% holding within the current 30% long-only public equities allocation. Within emerging markets, we focus on Asian equities given their dominance of Emerging Market equity indices (72% of MSCI EM ex-China A shares), their stronger long-term economic growth outlook and the higher caliber of Asian equity managers relative to those in other emerging markets in Latin America, Russia/ Eastern Europe and Africa.

Our Approach to Allocation to Emerging Market (EM) Equities

Our general approach to geographic equities allocation is to allocate in line with efficient market theory which says capital has "voted with their feet" and gone to where the market opportunities would send them. Accordingly, we start with the assumption that we should allocate in line with market capital weighting, looking at the MSCI ACWI as our proxy.

We start with the 3.5% ACWI weight as default. Our tactical EM allocation is currently 3.5% which is equal to the SAA allocation – so no overweight at our level 2 TAA, but at level 3 TAA we are overweight China vs rest of EM.

The SAA benchmark is MSCI AC World NR (DM 100% Hedged to USD).

Note that the EM currency risk is un-hedged at the SAA level as this is generally considered to be too expensive to hedge.

This risk is compensated for by using a higher equivalent net equity beta (ENEB) assumption of 1.3 for EM in USD, as EM in local currency (LC) typically has an ENEB of just under 1.0.

The 3.5% number for the SAA is derived from approximate ACWI weights. So just over 10% of our total public equities allocation (27.5% long + 10dged-equity HE (at .5 ENEB)). Currency is unpaid for risk and should discourage over allocation. I.e., if we have an EM OW, we get proportionally more currency risk. So for example, we increase our EM allocation by +5% (e.g. from 3.5% to 8.5%), then our ENEB goes up by 5 x .3 or 1.5 points. To keep overall portfolio ENEB constant, that means we would have to cut ENEB from somewhere else in the portfolio.

So the effective return hurdle for overallocation to EM has to take into account not only how much it will outperform the equivalent dollar amount of DM, but also how much it will outperform whatever other balancing source of ENEB we need to source from the rest of the portfolio.

We do not adjust our allocation for higher beta as market efficiency has already done that.

Growth is priced in. We don't overweight EM vs DM on the basis of faster economic growth or faster earnings growth. Growth is priced in. The lower P/E multiples reflect the higher risk premia (FX, country, governance, etc).

Exhibit 1: EM equities outperform the S&P500 over 15 years but underperformed over 3, 5 and 10 years.

	MSCI Emerging Markets (Local Currency)			MSCI Emerging Markets (USD)			S&P 500		
	Returns	Volatility	Sharpe Ratio	Returns	Volatility	Sharpe Ratio	Returns	Volatility	Sharpe Ratio
3 years	10.5%	10.9%	0.87	9.1%	15.6%	0.52	10.7%	10.1%	0.97
5 years	8.0%	10.1%	0.69	4.4%	14.4%	0.23	15.2%	9.5%	1.49
10 years	4.1%	16.9%	0.19	1.7%	22.8%	0.03	7.8%	15.1%	0.45
15 years	12.6%	16.3%	0.71	12.3%	21.4%	0.53	9.3%	13.3%	0.62

Source: Bloomberg, Partners Capital. Data as of 31st December 2017. Returns represent compounded annualised returns over the relevant period. Volatility calculated as annualised standard deviation over the relevant period. Sharpe Ratio calculated assuming a risk-free rate of 2%.

There are few alpha generating managers in emerging markets to justify an alpha based overweight.

Historical Performance. Despite the 30%+ rebound in 2017, EM equities have underperformed DM equities on a 3, 5 and 10 year basis even in local currency terms (Exhibit 1). The strong relative earnings growth that had been expected by many to propel EM equities returns over DM has failed to materialise. At the same time, the corporate earnings growth narrative that propelled EM in the last decade may have shifted back to DM. While EM has been experiencing higher levels of recent commodity price volatility and rising political risk, the US and other developed market equities, have seen steady growth, and have benefitted disproportionately from the global franchise value of US technology companies (Apple, Google, Facebook etc.).

Given the high cost of hedging EM currency risk, we evaluate the investment prospects of EM equities in USD terms. Over longer horizons, EM currency exposure has both reduced the returns and increased the volatility of EM equities, greatly diminishing their attractiveness (see Exhibit 1).

Given this history, we would look for a substantial valuation discount or to an inflection in the earnings outlook in order to support an overweight to emerging markets. On valuation, EM equities have been trading at a c. -4x P/E multiple discount to DM equities for several years.

The discount relates to the higher discount rate for these equities driven by differentially high government interest rates and an elevated equity market risk premium since the "taper tantrum" of 2013.

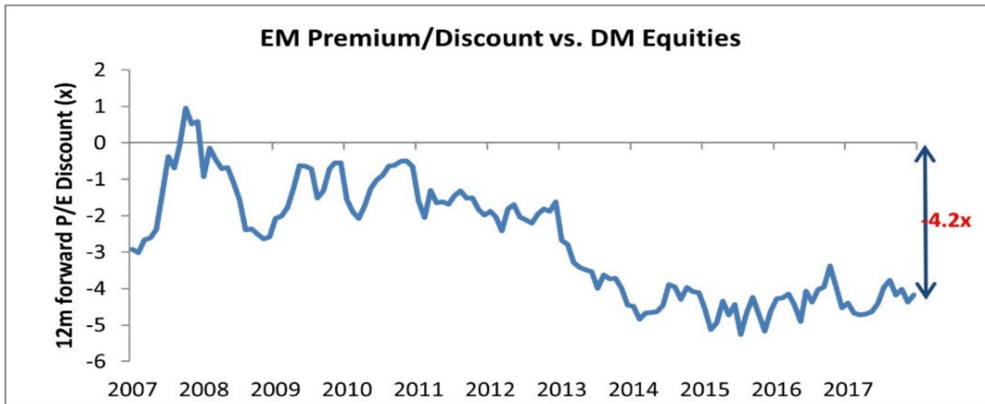
The current discount rate appears to be a fair reflection of the economic, policy and currency risks existing in EM today.

Furthermore, we find that the current valuation spread is less than one standard deviation away from the 10-year average (see Exhibit 3), which we feel is not sufficiently compelling to go overweight EM given the risks we discuss below.

Emerging Market Equities Outlook

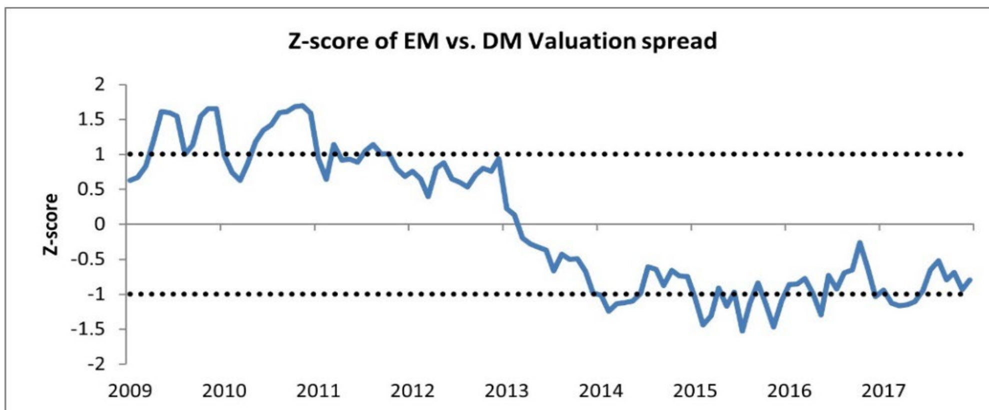
EM equities should benefit disproportionately from a marked improvement in global growth and trade outlook. We have written at length in the past about our constructive long-term outlook for emerging markets, particularly for the domestic consumption driven economies in Asia. While we remain constructive about the fundamental outlook for EM over the long term, we are concerned about short-term headwinds that could impede their equity market returns in 2018. We focus here on the short-term headwinds and risks that we see in emerging markets.

Exhibit 2: MSCI EM currently trades at a 4.2x discount to MSCI World.



Source: Bloomberg

Exhibit 3: EM valuation discount relative to DM equities is close to 1 standard deviation below mean.



Source: Bloomberg

Exhibit 4: Current and long-term emerging markets equity valuation measures reflect lower valuations than for developed markets due to its higher risk, and recent lower earnings growth.

	Consensus EPS Growth		12m Forward P/E			Price/Book			RoE			Dividend Yield		
	2018	2019	Current	Long Term Median	Diff.	Current	Long Term Median	Diff.	Current	Long Term Median	Diff.	Current	Long Term Median	Diff.
World	+16.7%	+7.8%	**14.8**	15.1	-0.2	**2.3**	2.2	+0.1	**13.4**	12.0	+1.4	**2.6**	2.7	-0.0
US	+22.7%	+7.7%	**16.2**	15.3	+0.8	**3.3**	2.7	+0.6	**16.0**	14.3	+1.7	**2.1**	2.2	-0.1
EM	+11.7%	+6.5%	**11.0**	11.5	-0.5	**1.5**	1.7	-0.2	**13.1**	13.1	0.0	**3.1**	2.8	+0.3

Source: Goldman Sachs

First, while global growth looks robust and credit spreads are extremely low, a lot of this good news has already been discounted into equity valuations. Long-term EPS growth expectations for EM have shot up above their previous highs, surpassing pre-crisis peak levels. Overall investor sentiment on EM companies appears quite bullish. We believe these factors lead to significant downside risk of earnings disappointment.

Second, EM equities are supported by global investors being positioned in favour of risk assets. Many investors have allocated to EM on the assumption of continued weakness in the US Dollar and low US bond yields. If global growth leads to higher inflation expectations or higher bond yields in H2 2018, it could have a significant negative impact on EM equities.

Finally, EM equities appear to be exposed to any reversal in sentiment about technology and growth names, diminishing the diversification relative to US equities.

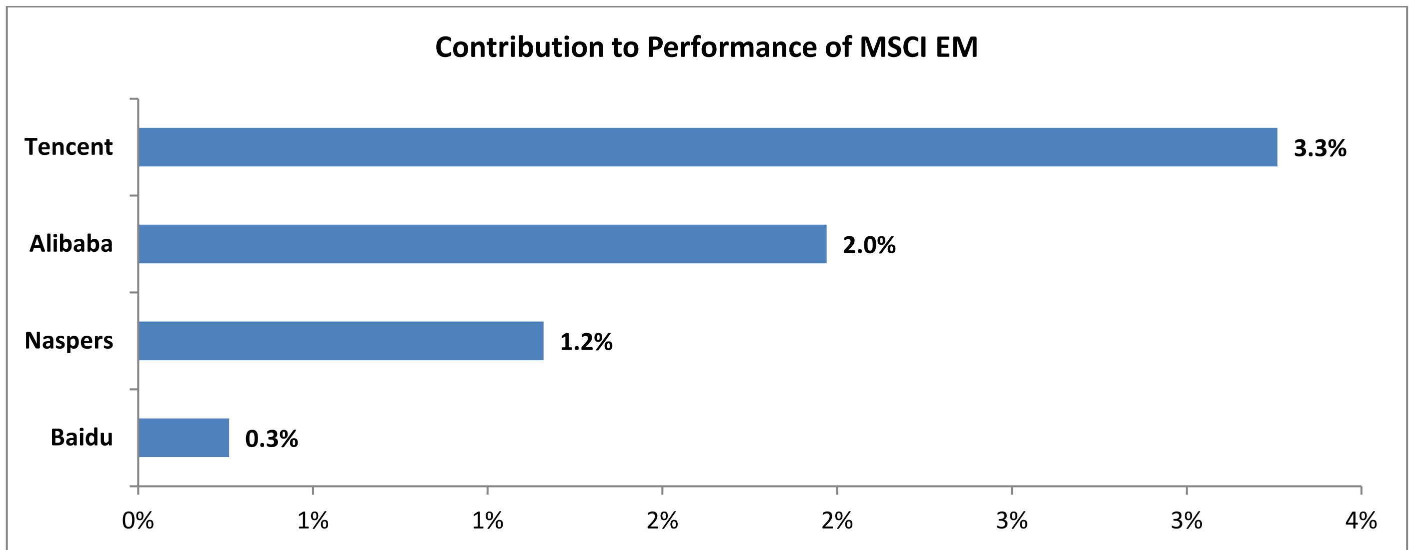
In 2017, the sharp rise in Chinese internet names, which currently make up over 10% of the index and accounted for 45% of the outperformance of MSCI EM over DM equities. The companies are all trading at all-time highs and at full valuations. EM is therefore vulnerable to revaluing of internet growth stories globally by investors.

We are therefore remaining at weight for emerging markets. We are awaiting an improved entry point into the market from a valuation perspective, or a reduction in the risk outlook for those markets, in order to consider an overweight position. In the meantime, we focus on skewing our market weight allocation towards regional equity markets and managers which we believe will perform best over the medium term.

EM Investment Approach - Asia Overweight

As of 31st December 2017, EM equities as measured by the MSCI Emerging Markets Index, are comprised of 73% Asian stocks (primarily in China, Korea, Taiwan and India) and 27% ex-Asian stocks (primarily in Brazil and South Africa, with Russia a much diminished market at only 4% of overall EM).

Exhibit 5: In 2017, 3 Chinese tech stocks accounted for over 40% of the c. 15% outperformance of MSCI EM over DM equities.



Source: Bloomberg

The Index does not yet include China A-shares, which will start to get phased in later this year and further shift the weight of the index towards Asia. We focus our EM allocation on actively managed Asian equities due to the dominance of Asia in EM indices, our more constructive view of domestic demand driven Asian economies, their stronger currencies and our access to attractive investment managers focused on the region.

We focus on managers embracing a fundamental bottom-up stock picking approach, who identify attractive companies across the region and across the market cap spectrum, have concentrated portfolios and are long-term investors. The region offers ample opportunities for active management, with MSCI Asia ex-Japan having 667 stocks (compared, for example, to 110 stocks for the MSCI EM Latin America). We have access to several managers in the region that we believe pursue an effective strategy for delivering outperformance through security selection while managing the long-term risk to their portfolios.

For those clients that require liquid, global EM exposure our preferred option is a systematic equities fund which has limited tracking error versus the benchmark but provides a nominal amount of expected outperformance. Systematic or quantitative funds include tight risk management processes as part of their portfolio construction, with limits on sector, country and style deviations. We also use cheap passive trackers for short-term portfolio management investments or for situations where the higher turnover of quantitative strategies is problematic.

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