



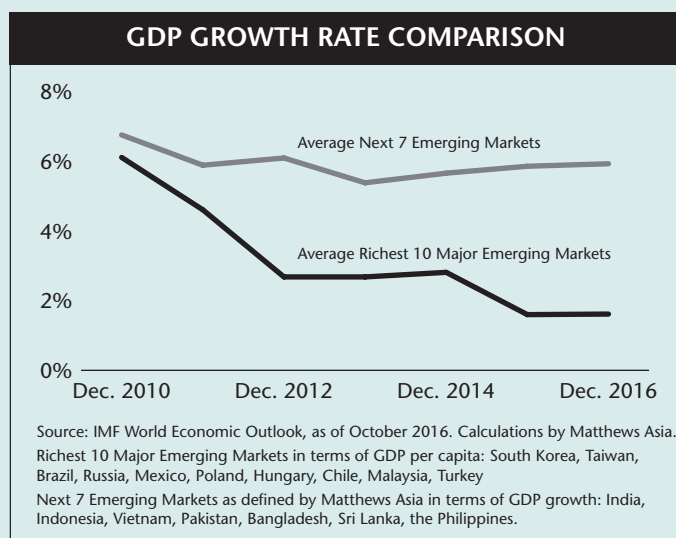
Changing Growth Dynamics within Emerging Markets

The economic growth engines within emerging markets (EM) are changing. Many emerging economies have become largely developed or have failed to enact reforms necessary to sustain high levels of growth. In 2016, the weighted average GDP growth rate of countries within the MSCI Emerging Markets Index (EM benchmark) fell to roughly 3.5% (from over 8% in 2007). Removing China and India, the weighted average growth for the rest of EM fell to just above 1% in 2016—not an attractive metric. Additionally, the EM benchmark and the exchange-traded funds (ETFs) that track it hold substantial allocations to the high growth countries of the past instead of the next generation of economic leaders.

In our view, investors can do better. If investors are willing to look outside traditional benchmarks, we would argue that an allocation of traditional EM exposure, combined with the next generation of fast-growing Asian economies, can not only potentially enhance returns, but also provides the opportunity for greater diversification, less cyclical volatility and a longer runway of attractive growth.

Can Yesterday's Leaders Continue to Lead?

Many of the fast-growing countries that drove the EM benchmark higher over the past 15 years are still large weights within the index today. Their respective growth rates, however, have fallen dramatically. Why have growth rates fallen for many EM countries? We can point to several reasons including the cyclical nature of certain economies and the failure to implement meaningful reforms. Another consistent reason is that when a country's economy expands and its population becomes richer—causing it to become more developed—its growth rate tends to fall. High growth rates on top of an already large economic base are difficult to maintain. China is experiencing this today as it struggles to maintain high levels of growth. South Korea, Taiwan, Brazil, Russia, Mexico, Poland, Hungary, Chile, Malaysia and Turkey are great examples of EM fast growers which have naturally slowed as they have become more developed. The next stage of progression for these more advanced EM economies is fairly well-documented. In fact, the average estimated growth in 2017 for advanced economies, as defined by the IMF, is just below 2%. And of the 39 countries the IMF considers “advanced,” not one of them is projected to grow by more than 4% in 2017. The



more developed emerging economies are following that same path toward slower growth.

To illustrate the point further, in 2016, the 10 richest major EM economies, in terms of GDP per capita (and which constitute almost 50% of the EM benchmark), grew in aggregate only 1.61%. In contrast, what we call the “Next 7” (fast growers in Asia including India, Indonesia, Vietnam, Pakistan, Bangladesh, Sri Lanka and the Philippines) had GDP growth in aggregate of 5.93%! We believe (and empirical evidence suggests) that higher nominal growth correlates broadly to higher corporate earnings. And furthermore, we expect over the long term, that higher corporate earnings will lead to higher equity prices.

Investment Case for the Next 7

Using an active manager or dedicated strategy to increase exposure to Next 7 economies may add a tailwind of higher growth, but there are other potential benefits to consider as part of an overall asset allocation.

Access to a Growing Consumer Base

Many emerging and frontier Asian financial markets may be small, but their economies' prospects for growth are not. In aggregate, the Next 7 has a population of more than 2.1 billion people, a significant percentage of which will enter the middle class over the next decade. India has the largest population in the world—with more than 1.3 billion people, but most investors may not appreciate why India, and others within the Next 7, can lead economic growth in EM for years to come. Alongside improving infrastructure and productivity, very competitive labor costs and active reform agendas, a common factor among the Next 7 is an



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	Population (in millions)	Median Age
Ageing Populations		
Germany	81	46.2
Japan	127	46.5
South Korea	50	40.6
U.S.	321	38.0
Next 7		
Sri Lanka	21	32.3
Vietnam	93	30.4
Indonesia	258	28.4
India	1,311	26.6
Bangladesh	161	25.6
Philippines	101	24.2
Pakistan	189	22.5
Next 7 Average		27.1

Source: United Nations, Department of Economic and Social Affairs, Population Division (2015)

extremely young working age population. This population should become wealthier, underpinning changes in their spending habits and an overall increase in consumption, as witnessed in South Korea, Taiwan and China in their earlier days of development.

Reasonable Volatility

In aggregate, even though GDP growth has been higher than most developed and emerging economies, and cumulative returns have been stronger, the volatility of the Next 7 markets in aggregate during the past five years (through April 30, 2017) has been in line with other major indices. With the exception of Vietnam, whose economy is driven by a robust export sector, the Next 7 economies and their listed stocks are domestically oriented and less exposed to the cyclical ups and downs of the global economy. The five-year average volatility of the Next 7 equity markets has been approximately 13.6%, which is slightly lower than the NASDAQ and roughly equal to the EM benchmark.

Lower Correlation

The EM benchmark exhibits fairly high correlation to U.S. and European equity markets as many of its largest economies have strong economic ties to the developed world and those same EM financial markets tend to have substantial foreign ownership. In contrast, the stock markets of Next 7 economies are largely influenced by local news and sentiment. Their trading is dominated by local players, not foreign flows. Price movements, especially in countries like Bangladesh, Vietnam, Sri Lanka and Pakistan, have exhibited very low correlation to the S&P 500 Index, the MSCI EAFE Index or even broad emerging markets. There are several examples in recent history whereby U.S./European stocks exhibited downside pressure yet Asian frontier markets were stable or largely unaffected. Therefore, including Asian emerging and frontier markets within a thoughtful global allocation can increase diversification.

Undiscovered Source of Alpha

Investors today have the choice of using active managers or ETFs to gain exposure to almost any asset class. Research shows that active managers have more difficulty outperforming benchmarks in larger more developed markets (with the exception of Japan). One reason is that a higher percentage of stocks within developed market benchmarks are covered by sell-side analysts. In other words, developed market stocks, especially in the U.S., tend to be well-researched with data that is widely disseminated among market participants. Therefore, few managers have an “information edge.” Similarly, 95% of MSCI EAFE Index stocks have sell-side analyst coverage and the MSCI Emerging Market Index has over 90% coverage. That’s not the case in Next 7 markets. Approximately 7,519 stocks are actively traded on Next 7 exchanges. Of those 7,519 stocks, 2,801 have a market cap in excess of US\$25 million. As of today, over 46% of these companies have zero analyst coverage. Over 63% of these stocks have zero or one sell-side analyst. This means most stocks in Next 7 markets do not appear in benchmarks

5-YEAR WEEKLY CORRELATIONS FROM 2012–2017

Indices	S&P	MSCI EAFE	MSCI EM	Bangladesh	India	Indonesia	Pakistan	Philippines	Sri Lanka	Vietnam
S&P	1	0.735	0.662	-0.045	0.52	0.36	0.129	0.396	0.062	0.293
MSCI EAFE	0.735	1	0.83	-0.103	0.71	0.469	0.159	0.519	0.081	0.359
MSCI EM	0.662	0.83	1	-0.136	0.782	0.636	0.191	0.665	0.079	0.339
Bangladesh	-0.045	-0.103	-0.136	1	-0.14	-0.051	0	-0.002	0.168	-0.028
India	0.52	0.71	0.782	-0.14	1	0.495	0.201	0.603	0.137	0.303
Indonesia	0.36	0.469	0.636	-0.051	0.495	1	0.162	0.547	0.142	0.378
Pakistan	0.129	0.159	0.191	0	0.201	0.162	1	0.111	0.222	0.218
Philippines	0.396	0.519	0.665	-0.002	0.603	0.547	0.111	1	0.176	0.274
Sri Lanka	0.062	0.081	0.079	0.168	0.137	0.142	0.222	0.176	1	0.163
Vietnam	0.293	0.359	0.339	-0.028	0.303	0.378	0.218	0.274	0.163	1

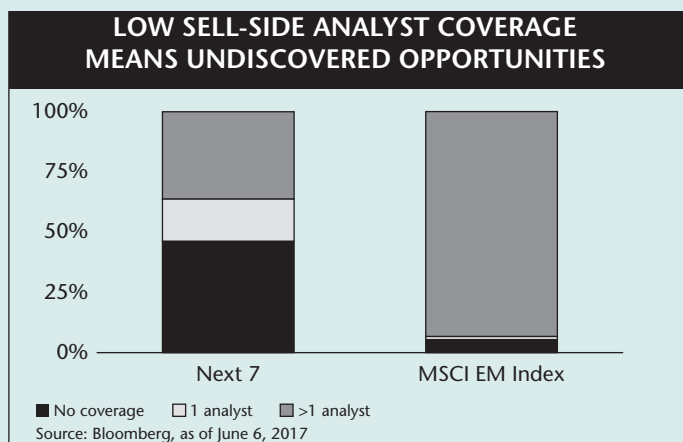
All countries refer to MSCI Indices

Source: Bloomberg, 6/9/2012–6/9/2017

Correlation measure the relationship between two or more financial variables in time. 1 = Perfect Positive Correlation; 0 = No Correlation; -1 = Perfect Negative Correlation.

It is not possible to invest directly in an index.

“The economic growth engines within emerging markets are changing.”



and are undiscovered. This scenario is dramatically different in the U.S. and other developed markets (with the exception of Japan). Active managers willing to do the groundwork can find undiscovered companies that have very favorable attributes vs. their well-researched benchmark counterparts.

Risks

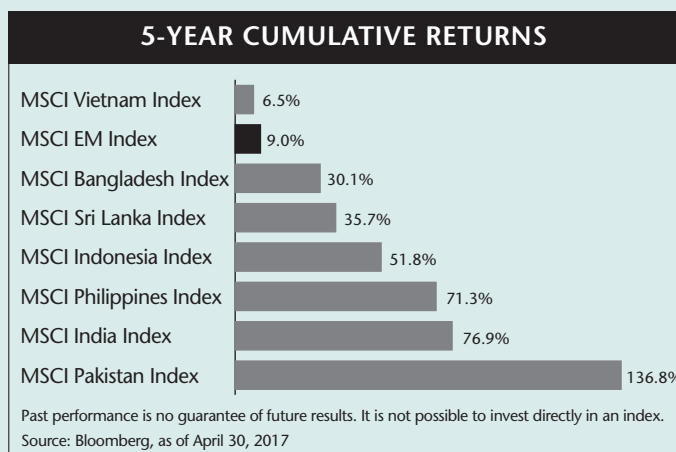
Obviously, smaller emerging markets share many of the same risks as their large, more developed counterparts. But in addition, an active manager needs to address unique risks.

Liquidity

Many market participants disregard these smaller markets because of the limited number of listed companies, smaller market capitalizations and relatively low trading volumes. Let's examine the trends of all three metrics. In aggregate, the Next 7 has more than 7,500 actively traded securities with a total market cap of US\$1.3 trillion. For perspective, if the Next 7 were a single nation, it would have more listed securities than the New York Stock Exchange (NYSE) and the NASDAQ combined, and a total market cap roughly equal to both the Hang Seng and Australian ASX indices. Even though India is by far the largest market within the Next 7 in terms of number of traded securities and daily volume, other markets are growing quickly as well. The number of actively traded names in Vietnam has increased 600% in 10 years to more than 1,200 companies today. We have also seen impressive expansion in both Bangladesh and Indonesia. While we believe that market liquidity will continue to improve, we acknowledge that liquidity risks are significant and require constant attention through active management.

Politics

The perception is that smaller, less developed economies have more corrupt governments, less corporate governance, more social unrest, and are less stable overall. We admit political risk is difficult to quantify and even more challenging to predict. The good news is that because Next 7 economies are in very early stages of development, many companies listed on their stock exchanges



tend to revolve around “basic necessities.” In other words, food, clothing, health care and other consumer durables tend to be well-represented. This contrasts with wealthier economies like China where consumers are “trading up,” drawing attention to companies focused on e-commerce, travel, education and more sophisticated financial services and insurance. Companies providing basic goods and services tend to have fewer regulatory pressures and fewer unforeseen politically motivated surprises—with the exception of infrastructure and utility-related businesses. Therefore, active management may be able to mitigate significant political risk in emerging and frontier Asia by simply avoiding companies and sectors that are subject to heavy political scrutiny.

Improve EM exposure by adding the next generation of growth: Emerging Asia

Not all emerging markets offer the same opportunity for growth. The more developed emerging markets are following the path of advanced economies: slowing down. We believe investors can mitigate the headwind of slower growth two ways. First, active management can potentially mitigate slower economic growth through stock selection. And secondly, by including emerging and frontier Asian exposure within a thoughtful asset allocation, we believe investors can potentially boost their growth profile (Next 7 economies grew 5.93% in 2016) and decrease the correlation of their holdings without meaningfully increasing volatility.

The MSCI Emerging Markets Index is now approximately 70% Asia. So maximizing an allocation to emerging markets requires “getting Asia right.” We believe that an asset allocation that favors the next generation of growth countries, while not being constrained by backward-looking benchmarks, can be additive to any EM allocation or even serve as a stand-alone growth investment.

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Index Definitions

MSCI EAFE Index: The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

MSCI Emerging Markets Index: The MSCI Emerging Markets Index captures large and mid-cap representation across 23 Emerging Markets (EM) countries. With 833 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

S&P 500 Index: The S&P 500 Index is a broad market-weighted index dominated by blue-chip stocks in the U.S.

MSCI Bangladesh Index: The MSCI Bangladesh Index is a free float-adjusted market capitalization index designed to measure the performance of the large and mid cap segments of the Bangladeshi market.

MSCI India Index: The MSCI India Index is a free float-adjusted market capitalization index designed to measure the performance of the large and mid cap segments of the Indian market.

MSCI Indonesia Index: The MSCI Indonesia Index is a free float-adjusted market capitalization index designed to measure the performance of the large and mid cap segments of the Indonesian market.

MSCI Philippines Index: The MSCI Philippines Index is a free float-adjusted market capitalization index designed to measure the performance of the large and mid cap segments of the Philippines market.

MSCI Pakistan Index: The MSCI Pakistan Index is a free float-adjusted market capitalization index designed to measure the performance of the large and mid cap segments of the Pakistan market.

MSCI Sri Lanka Index: The MSCI Sri Lanka Index is a free float-adjusted market capitalization index designed to measure the performance of the large and mid cap segments of the Sri Lankan market.

MSCI Vietnam Index: The MSCI Vietnam Index is a free float-adjusted market capitalization index designed to measure the performance of the large and mid cap segments of the Vietnamese market.

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