

Why Emerging Markets Leaders Now?

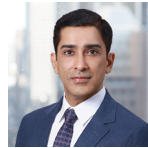
ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS TEAM | INVESTMENT INSIGHT | 2021

After the worst decade ever for emerging market equity returns, investors are pouring back in, drawn to attractive growth opportunities. According to research from JP Morgan and EPFR, the inflows into emerging market equities in the first seven and a half weeks of 2021 have totaled U.S. \$47 billion or nearly 2.5% of the assets under management. And yet there is still hesitation amid this boom.

Our research shows that, in a typical global portfolio, the allocation to emerging markets is somewhere between roughly one half and one fifth of what rational allocation models would recommend. The likely explanation for this is the home bias of investors who are leery of the faraway and unfamiliar, even when opportunities beckon. They are looking for a reliable guide, which is why Emerging Markets Leaders is worth a close look right now.

Launched in 2011, the Emerging Markets Leaders strategy was designed to exploit the rich opportunities we find in emerging markets while minimizing market risks. We focus on large, quality growth, well-managed companies (e.g. firms with more than U.S. \$1 billion market capitalization, more than 15% return on invested capital and more than 15% expected CAGR earnings growth). These companies must be poised to take advantage of long-term structural themes, operating in favorable industries for market leaders.

AUTHOR



VISHAL GUPTA

*Managing Director
Portfolio Manager,
Emerging Markets
Leaders Strategy*



Our investments are focused mostly in what we termed “continental-sized” markets of China, India, Brazil and Indonesia—which all have large populations and vast domestic markets. These markets should be well positioned in an age of deglobalization and declining trade flows. We add Taiwan to the mix, as it’s a linchpin in the global tech supply chain. All of these countries also have dynamic communities of entrepreneurs, who are well positioned to benefit from the long-term structural themes.

Right now, those themes include most prominently the rise of e-commerce, food delivery, fintech penetration, athleisure, and the premiumization of consumption. In addition to the sharp jump in the adoption of these trends, the pandemic has also brought the health-care theme into focus as well.

This list is not entirely exclusive, but nearly so. We avoid stocks that don’t fit our structural themes or meet our investment criteria, even in countries we favor. For example, right now, we avoid banks in most of the emerging markets, materials and cyclical companies and

other industries that we regard as in structural decline.

The chart below (see *Display 1*) is a clear example of why we concentrate most of the investments on a relatively small set of continental-sized markets: because those markets are where the majority of the big “compounders” are found. As we noted earlier, all of our companies must meet a minimum market cap of more than U.S. \$1 billion and expect a compounded earnings growth rate of more than 15% for the next three- to five-years. This longer term investment horizon gives us the confidence to stay with these steady compounders through tremors in the markets.

While we’ve been investing mainly in structural compounders in continental-sized emerging markets, we are open to new opportunities as they arise. Although many of the Eastern European countries, such as Poland, Hungary and the Czech Republic, have recorded strong GDP growth, we have not been able to find many investment opportunities, as many of the local consumer companies have been acquired by global multinationals.

In the past, we owned retail and bank stocks as a way to get exposure to the rising middle class in Eastern Europe, but they no longer meet our growth profile. We would assess new investment opportunities as when they arise.

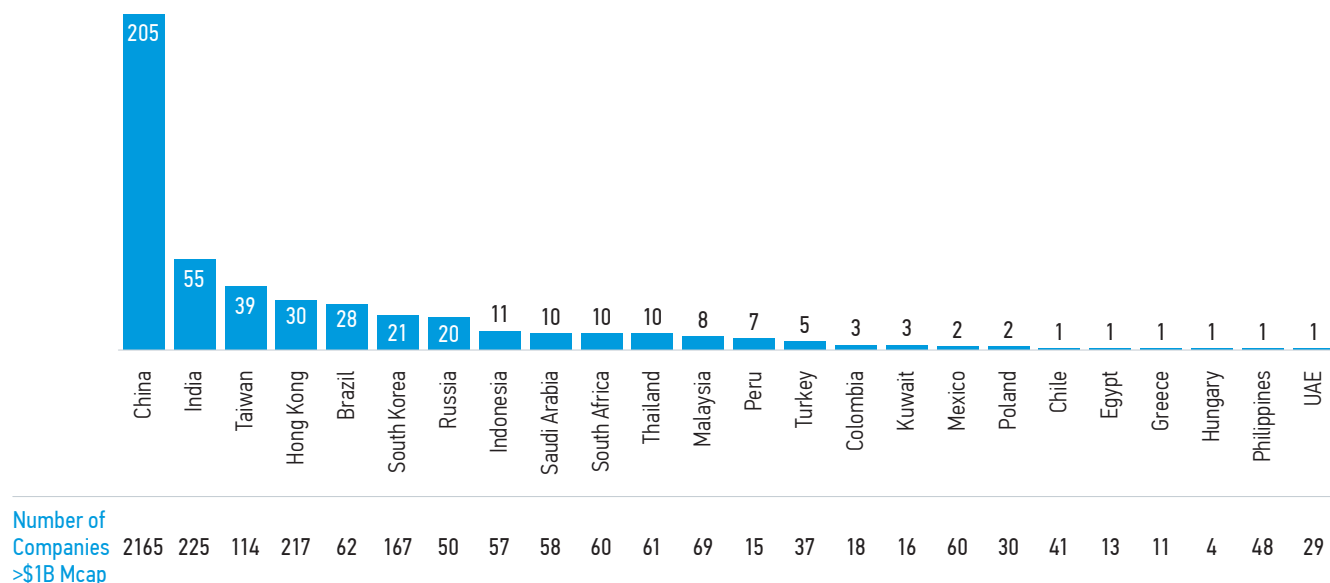
While many global, international and balanced portfolios tend to have some emerging markets exposure, our Global Emerging Markets investment team showed recently how meager these investments are. The information from three major data providers, as shown in *Display 2*, point to emerging markets allocations ranging from 6% to 8%. In contrast, the research from our GEM team incorporating the three most well established allocation approaches (GDP weighting, market weighting, and modern portfolio theory), would recommend emerging markets allocations of between 13% and 39%.

The GDP weight method—as it captures each country’s relative economic importance—would yield the largest potential allocation of 39%. Alternatively, using the GDP weight-adjusted method—for the lower-free float and dilution of the

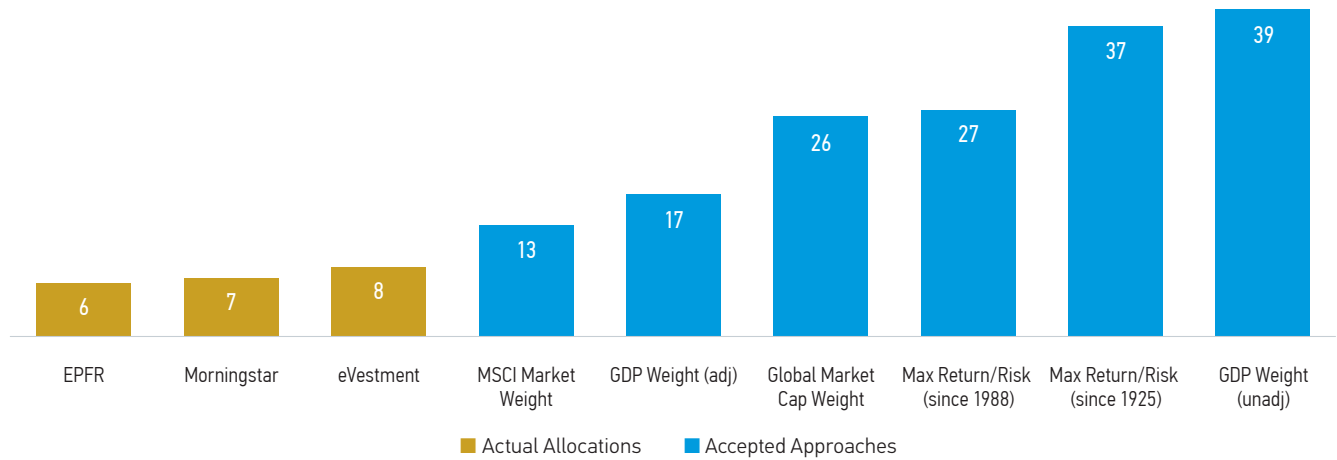
DISPLAY 1

Number of Companies Compounded by >15% CAGR (\$1BN+ Mcap)

By Entity Country, Compound Annual Growth Rate 2016 – 2020 (in USD)



Source: FactSet, MSIM calculations. Data as of December 31, 2020. CAGR represents compound annual growth rate, calculated for 2016-2020 in USD terms. Market cap calculated as of December 31, 2015. Securities grouped by country of entity in FactSet.

DISPLAY 2**Optimal vs. Actual Allocations to EM Equities (%)**

Source: FactSet, Haver, IMF, Global Financial Data, eVestment, Morningstar, EPFR, MSIM calculations. Data as of December 31, 2020.

listed companies—would still yield an allocation of 17%, the lowest level among the allocation approaches. However, this level would still be much higher than the actual allocations reported by the data providers EPFR, Morningstar and eVestment, and higher than the weight of MSCI Emerging Market in the MSCI All Country World Index (see *Display 2*). No matter how rational they are, our research indicates that investors are irrationally underweight emerging markets.

That may be true now more than ever. The pandemic has accelerated many structural consumer trends, including the rise of fintech and e-commerce, and Emerging Markets Leaders is well-positioned to capture these trends. The strategy is benchmark-agnostic, not beholden to a specific list of countries, or companies. When global conditions change, and new themes arise, our investments will also likely change. But the process—the focus on large, quality companies, poised to capitalize on themes in the continental-sized

“Our research indicates that investors are irrationally underweight emerging markets.”

markets—will remain. On that new investors in Emerging Markets Leaders can rest assured.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to **market risk**, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries. **Stocks of small- and medium capitalization companies** entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more established companies. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio's performance. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Privately placed and restricted securities** may be subject to resale restrictions as well as a lack of publicly available information, which will increase their illiquidity and could adversely affect the ability to value and sell them (liquidity risk).

DEFINITIONS

Compound Annual Growth Rate (CAGR) is the year-over-year growth rate of an investment over a specified period. **Gross Domestic Product (GDP)** is a monetary measure of the market value of all final goods and services produced in a period (quarterly or yearly) of time. **Volatility** is a statistical measure of the dispersion of returns for a given security or market index.

INDEX DEFINITIONS

The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets. The **MSCI All Country World Index (ACWI)** is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and emerging markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

DISTRIBUTION

This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

Ireland: MSIM Fund Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. Registered in Ireland as a private company limited by shares under company number 616661. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. **United Kingdom:** Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA, authorised and regulated by the Financial Conduct Authority. **Dubai:** Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany:** MSIM Fund Management (Ireland) Limited Niederlassung Deutschland, Grosse Gallusstrasse 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** MSIM Fund Management (Ireland) Limited, Milan Branch (Sede Secondaria di Milano) is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 11488280964. **The Netherlands:** MSIM Fund Management (Ireland) Limited, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of MSIM Fund Management (Ireland) Limited. MSIM Fund Management

(Ireland) Limited is regulated by the Central Bank of Ireland. **France:** MSIM Fund Management (Ireland) Limited, Paris Branch is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited Paris Branch with seat at 61 rue de Monceau 75008 Paris, France, is registered in France with company number 890 071 863 RCS. **Spain:** MSIM Fund Management (Ireland) Limited, Sucursal en España is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited, Sucursal en España with seat in Calle Serrano 55, 28006, Madrid, Spain, is registered in Spain with tax identification number W0058820B. **Switzerland:** Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0) 44 588 1074.

U.S.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.

Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley Funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A BANK DEPOSIT

Australia: This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 12204-0037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act. **Hong Kong:** This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents

of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This publication should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"), (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them. This publication has not been reviewed by the Monetary Authority of Singapore.

Japan: For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

IMPORTANT INFORMATION

EMEA: This marketing communication has been issued by MSIM Fund Management (Ireland) Limited. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. MSIM Fund Management (Ireland) Limited is incorporated in Ireland as a private company limited by shares with company registration number 616661 and has its registered address at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's/product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing.

The views and opinions are those of the author as of the date of publication and are subject to change at any time due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after

the date of publication. The views expressed do not reflect the opinions of all portfolio managers at Morgan Stanley Investment Management (MSIM) or the views of the firm as a whole, and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness.

The information herein is a general communications which is not impartial and has been prepared solely for information and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Past performance is no guarantee of future results. Charts and graphs provided herein are for illustrative purposes only.

This communication is not a product of Morgan Stanley's Research Department and should not be regarded as a research recommendation. The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's/product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

Indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

All investments involve risks, including the possible loss of principal. The material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

The views and opinions expressed are those of the portfolio management team at the time of writing/of this presentation and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. These comments are not representative of the opinions and views of the firm as a whole.

MSIM has not authorized financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

The whole or any part of this work may not be directly or indirectly reproduced, copied, modified, used to create a derivative work, performed, displayed, published, posted, licensed, framed, distributed or transmitted or any of its contents disclosed to third parties without MSIM's express written consent. This work may not be linked to unless such hyperlink is for personal and non-commercial use.

All information contained herein is proprietary and is protected under copyright law.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail.

Explore our site at [**www.morganstanley.com/im**](https://www.morganstanley.com/im)