September 15, 2016 Pensions&Investments PIonline.com CRAIN
THE INTERNATIONAL NEWSPAPER OF MONEY MANAGEMENT

Finding growth in emerging markets

By Ashutosh Sinha

Ashutosh Sinha
Portfolio Manager

After five years of disappointing returns, we believe we have approached the end of emerging markets underperformance. And the asset class looks cheap. In fact, some of the best growth stories anywhere in the world can be found in the emerging markets at what we consider to be reasonable prices, particularly compared to the stretched valuations in the developed world. We believe short-term thinking in a volatile asset class like emerging markets is nearly impossible, but the prospects for outperformance look strong over a three- to five-year period.

Unlike the previous bull market in emerging markets (2003-2007), which was very broad-based, we believe the way to invest in the emerging markets today is to selectively focus on high-quality companies that are positioned in tailwinds of growth. The previous growth period was driven by sustained fixed capital investment in China, accompanied by a global bull market in commodities and a credit boom in developed markets fueling global demand. Nearly everything in the emerging markets benefited as the rising tide lifted all boats and the MSCI Emerging Markets index returned an annualized 37% over that period. Unsurprisingly, passive investments and even high-beta benchmark-oriented active managers were able to do well in that environment. But we are in a dramatically different landscape today.

Growth all over the world is lower and harder to find. The implication for investors is that they need to consider selective approaches, less tied to an index like the MSCI Emerging Markets index, which is dominated by China, and within China the "old economy" sectors of financials, industrials and energy. These sectors reflect what was growing in the past decade. A benchmark-agnostic approach, on the other hand, creates the potential to capture future, rather than past, growth opportunities.

Our focus currently is on three main growth pockets in emerging markets: consumer, health care and financials. All three of these sectors are benefiting from rising incomes across the emerging markets and the shifts in behavior and spending patterns that accompany this trend.

Within the consumer sector, we have invested in companies that are leading the transformation from informal to formal retailing. Consumers are trading up to branded products and retail experiences such as eating outside of the home for the first time or developing a taste for Western-style snacks and confectionery. Another area we like is travel, where passenger traffic continues to increase year after year.

Within the health-care sector, we find opportunity among companies that are running hospitals or diagnostic services, as many countries seek private solutions to the provision of affordable health-care services for their growing populations. We have also invested in pharmacy retailers to capture the rapid growth in health care-related consumer products.

Zooming in on financials

An underappreciated opportunity in our view exists in the financial sector. If this runs contrary to popular wisdom, it's because more than almost any other industry, financial systems and credit cycles are unique to each country, driven by both macroeconomic growth factors and specifics of their industry and regulatory framework.

We believe that insurance in Asia is a business with a multidecade growth opportunity ahead of it. A confluence of drivers including a large base of affluent Asian baby boomers (born in the 1970s and '80s), the lack of state welfare benefits, an aging population and a huge mortality protection gap (estimated at $50 trillion for 2014 in Asia ex-Japan) provides a long runway of growth for insurance companies in Asia.

Historically, the demand for protection-based insurance products tends to lag savings during the early stages of economic development as seen in other countries. Then as wealth accumulation reaches an inflection point, growth in life insurance premiums accelerates, taking off when gross domestic product per capita reaches $10,000. China, Malaysia and Thailand are close to that important inflection point today.

The final step, of course, is to gain exposure to this secular theme of increasing insurance penetration in Asia by identifying specific companies that are well-positioned to take advantage of these tailwinds — companies with strong business drivers, solid market position and ability to consistently compound over the next five years.

Banking in underleveraged Mexico is another example of opportunity within the financial sector. Key to our thesis for investing in banks in emerging markets is identifying the potential for long-term credit expansion in countries with low credit penetration relative to GDP and a well-managed, consolidated and profitable banking industry.

Mexico is one such country where low levels of banking penetration, an underleveraged consumer and affordable interest rates create an ideal environment for an extended period of credit growth. Total private sector credit to GDP in Mexico is only 24%, one of the lowest anywhere across the emerging markets. Even when compared to its peers in Latin America, Mexico's overall private sector credit to GDP ratio of 24% is far lower than Chile at 80% and Brazil at 52%. Significantly, consumer credit to GDP in Mexico is extremely low, at only 6% of GDP.

Within Mexican financials, the best opportunities are institutions with a presence across all lending segments and that are increasingly focused on small and midsized enterprises and consumer lending, where we believe growth is strongest.

Insurance in Asia and banking in Mexico are two examples — joined by other well-managed high-quality companies — that we believe are positioned to capture select pockets of growth in these large addressable markets.

Ashutosh Sinha is Singapore-based lead portfolio manager of the Morgan Stanley (MS) Emerging Markets Leaders strategy and is part of Morgan Stanley Investment Management's global emerging markets team.

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CRC 1599813 Exp: 09/23/2017 LitLink: PANDISHINHA

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