Janus Henderson INVESTORS

THE CASE FOR EMERGING MARKET EQUITIES
A multi-lens approach

Emerging markets present investors with some of the most compelling opportunities for long-term capital growth in the equities universe. With multiple forces capable of influencing the earnings landscape, the Janus Henderson Emerging Market (EM) Equity Team believes that a multi-lens approach is necessary to effectively identify the most attractive opportunities – and risks – within these regions.

Emerging markets' ability to provide both cyclical and structural investment opportunities is premised on three compelling, underlying drivers:

- **Outsourcing:** Physical and digital supply chains have globalized and fragmented, and it is often emerging markets companies that have built the key competencies sitting at the heart of these supply networks.
- **Convergence:** A long-term shift in incomes can lead to a convergence with more developed economies in the choices and demands that consumers make. For forward-looking emerging market companies this provides a key driver of growth and profitability.
- **Innovation:** We believe conditions are ripe for an explosion in emerging market-led innovation, driven by digitalized economies, large domestic populations, and a new era of policy support. Emerging market companies are playing a prominent role in shaping this next wave.

Emerging markets are evolving

For decades, the premise underpinning an emerging markets equities allocation has been access to the secular tailwinds of outsourcing and convergence. As the global manufacturing base shifted to lower-cost regions, factories, logistical networks and supporting infrastructure had to be created, then integrated into the global trading system. There has been a similar dynamic with the outsourcing of the services supply chain. Rising trade, along with urbanization, has resulted in a growing consumer class whose incomes and consumption preferences are converging with those of more advanced economies. The economic and societal advancement brought forth by these forces have given rise to third growth pillar: Innovation. We believe the development of intellectual property, value-added products and services and an increasingly digitized economy will become major drivers of emerging markets' earnings growth in the years to come.

These regions are not homogeneous

Emerging markets are diverse and have grown more so in recent years. A key component in positioning a country for future success is the presence of a reformist government willing to create the conditions necessary for an innovative private sector to thrive. Similarly, national governments that welcome investment and exhibit the fiscal discipline needed to minimize the risk of capital flight are essential ingredients in cultivating stable, sophisticated economies. Though not limited to this region, emerging Asia has taken the lead in instituting a framework in which corporations can both play a key role in national development and consistently grow earnings by catering to the unique needs of these countries' large and dynamic populations.

Large domestic markets in a less globalized world

Favorable demographics have long drawn investors to emerging markets. Not only does the category include the world's two largest countries – China and India – but also others with considerable populations. Importantly, many emerging markets have median ages lower than those typically found in advanced economies. This characteristic complements the trend of younger, "digital native" workers and consumers fueling economic growth as their productivity rises and ability to spend discretionary income on products and services that were unavailable a generation ago increases.

Some emerging countries face demographic hurdles, among them shrinking working age populations. Investors can address these risks by identifying countries with expanding labor forces or those seeking to institute the reforms necessary to increase productivity and move up the value chain.

Another risk has been the recent slowdown – and in some cases – reversal of globalization. The breakdown of trade linkages and rise in barriers decreases the efficiency of the global economy, likely resulting in fewer choices and higher prices. Multinational companies with wide-reaching supply chains and end markets may face challenges when realigning their strategy with a potential new global economic order. Localization, however, may present opportunities for other companies, especially regional firms whose offerings can supplant those previously provided by multinationals. The duplicative industries spawned by security concerns and the desire to control supply chains in key sectors, while presenting investors with certain challenges, also stands to create select opportunities.

The need for a multi-lens approach

When approaching this asset class, investors must be equipped with tools capable of assessing the myriad forces that can influence emerging market corporate prospects. We believe that a multi-lens framework focusing on company, country and governance positions investors to develop a deep understanding of the asset class's most significant drivers.

Company: The most well-run companies tend to control their destiny by taking a long-term perspective and effectively allocating capital. They are run by seasoned management teams and largely rooted in the private sector in contrast to state-owned enterprises. Increasingly, they are innovators, developing differentiating intellectual property and applying digital solutions to operational challenges. Often these are newer companies and may not be represented in emerging market benchmarks. While these companies are uniquely positioned to address local market challenges, many can expand by applying solutions on a global scale.

Governance: Corporate and political governance standards in emerging markets have historically been a concern. With a globalizing investor base, demands for greater transparency and alignment between majority and minority shareholders have risen in recent years. Still, the dispersion of governance practices within emerging markets merits consideration. In addition to ensuring that management acts in the best interest of all shareholders, investors must monitor whether private companies are compelled to perform acts of "national service" – a directive by the domestic government to act on its behalf, which may not be of economic benefit to the firm.

Country: The macro backdrop matters in emerging markets. Many countries recognize the imperative of creating a framework where a robust private sector increases national prosperity. For many countries, success will come from reformist government creating an environment that favors entrepreneurs. While several emerging markets have taken

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such steps, a recent trend has seen other countries recede from free market policies, especially with respect to trade and the role of the state. Countries that lack a reformist government can often find this to be a hindrance to growth. Other country-level characteristics that are favorable for equities are large domestic markets – especially as the rush toward globalization fades – and those that champion the development of value-added intellectual property.

A more sustainable trajectory

Expectations that companies integrate environmental, social and governance (ESG) themes into all aspects of their business model have forced many enterprises to reengineer processes to meet investor demands. With emerging market companies often earlier in their life cycle, they can address ESG issues when developing a corporate strategy. Furthermore, many emerging countries have recognized the acute need to address issues ranging from climate change and pollution to equality and inclusion. Consequently, business leaders are seeking to optimize the ESG aspects of their business models to bring about positive societal change, yet in a profitable manner.

Staying active & risk aware

Relative to other equities, emerging markets are a volatile asset class. Benchmarks tend to have a disproportionate representation of large, state-owned enterprises and reflect what these economies looked like yesterday rather than tomorrow. Similarly, the smaller, innovative companies most likely to fuel future emerging markets earnings growth are underrepresented in benchmarks. This is not a pocket of the market where broad, brush strokes apply. Rather, emerging markets present investors with the opportunity to generate excess returns by conducting multi-lens fundamental research to identify attractive, beneath-the-radar companies. By actively managing exposures of an all-cap, geographically diverse strategy that integrates both company-level ESG and debt profiles, equities investors can access emerging markets in a disciplined manner that optimizes both risks and potential returns.

Summary

Increasingly, emerging markets offer investors a confluence of powerful secular themes: The historical drivers of outsourcing and economic convergence, along with the innovation revolution that is pulling all the world's regions towards a digital future. The latter has added significance in emerging markets as it enables countries to skip entire iterations of industrial development that more advanced economies had to traverse. To better understand how digital transformation can reap efficiencies across a range of industries in emerging markets, deep sector-level expertise is necessary along with on-the-ground experience in key developing regions.

While digital transformation and innovation are global phenomena, emerging market investing continues to require an understanding of what makes these regions unique. There are no better examples than the relevance of the country-level environment and varying standards of corporate governance. For these reasons, risk-aware, active management based on fundamental research can help investors maximize exposure to these powerful themes, while attempting to dampen the relatively higher levels of volatility associated with this asset class.

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