LOMBARD ODIER
INVESTMENT MANAGERS

# RETHINK YOUR EMERGING MARKET EQUITY EXPOSURE

The risk of more protectionism in the US is increasing investors' concerns about emerging market (EM) assets. However, global trade retrenchment is a trend that has been in place since the Global Financial Crisis (GFC). EM countries have therefore favoured their own domestic economic dynamics. This will likely continue or even accelerate. However, at the micro level, investment selection is now even more important than before as many individual companies could be heavily exposed to exports and thus potentially disrupted by targeted protectionism. Our high conviction approach has always led us to avoid export-based companies and to seek exposure to key domestic trends shaping EM economies and to high-quality business models. In our view, being an active investor in EM is now more essential than ever.

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## EM economies now generally more reliant on domestic dynamics

At the country level, since 2010, internal domestic dynamics (both consumer and government spending) in key EM countries have generally been a stronger driver of growth compared to trade, as shown in the two graphs below. This is an illustration that since the GFC, EM economies have been more reliant on their own internal dynamics to support their fledgling economies against decreasing global trade. Only in the cases of Taiwan and South Korea has domestic consumption been structurally weak compared to the contribution of trade to each country's GDP. Taiwan and South Korea resemble DM economies (in particular Germany) more than EM economies with their ageing population, relatively high purchasing power and highly urbanised population. In India, the "apparent" positive contribution from trade is in fact reflecting a lower negative trade deficit thanks to taxes being imposed on gold imports.

FIG. 1 – CHANGE IN WEIGHT OF DOMESTIC SPENDING (AS % OF GDP OVER 2010-2015)

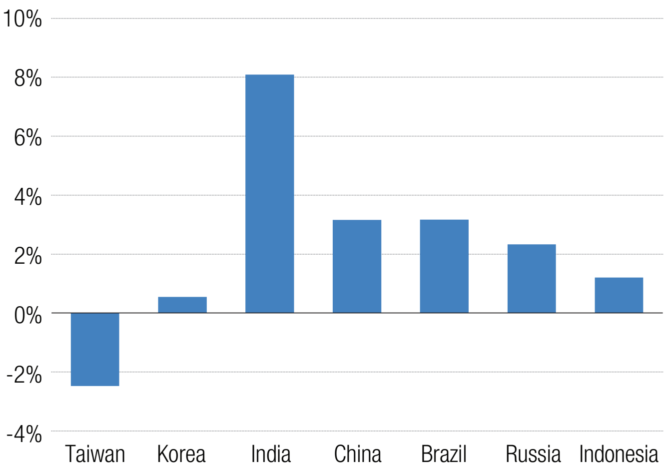
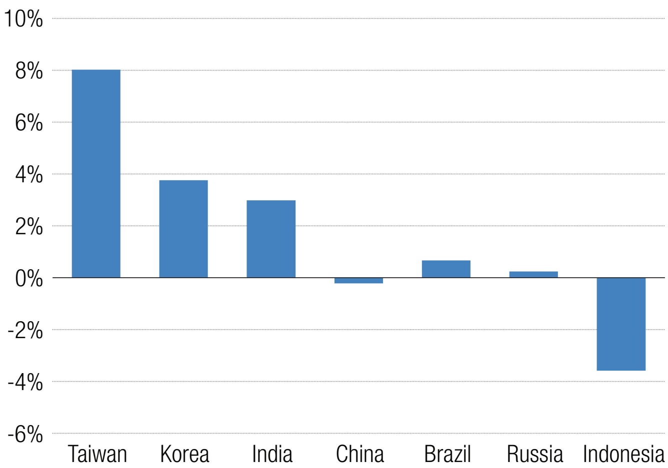



FIG. 2 – CHANGE IN WEIGHT OF TRADE BALANCE (AS % OF GDP OVER 2010-2015)



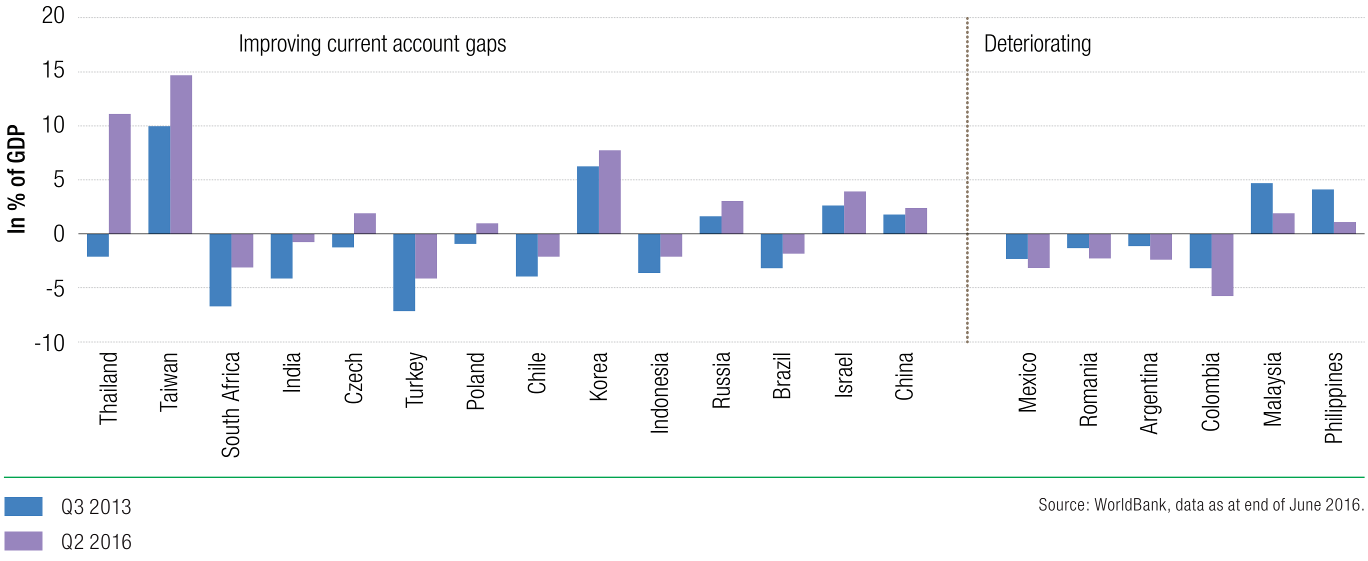

Source: National statistics institutes for each country. Data as at end of December 2015.

The Indian government's recent decision to suddenly replace its INR 500 and INR 1000 bank notes is an example of a move that can be made to improve an economy structurally. This decision is targeting the Indian shadow economy, estimated at 25% of the formal economy, and will contribute to fighting corruption, enlarging the government's fiscal base, demonetising the economy and driving more savings into the banking system.

## EM economies now more solid to withstand external shocks and further support internal dynamics in wake of more protectionist US

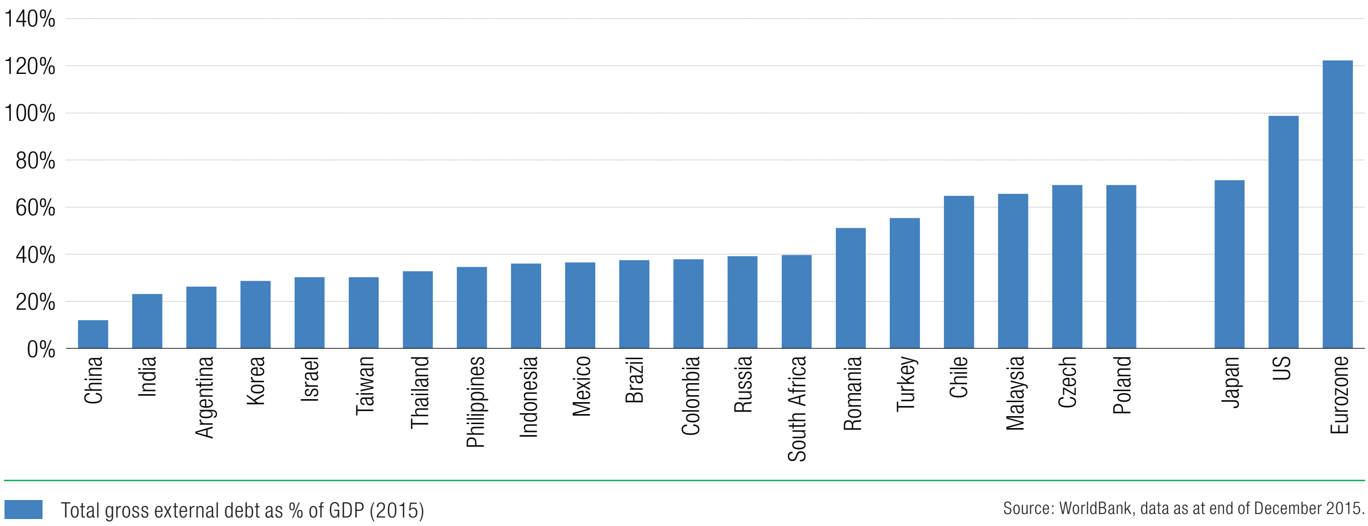
The election of Trump is unlikely to morph into a fully-fledged trade war, in our view. However, some form of protectionism is to be expected. Under such pressure, EM countries are likely to continue favouring their own internal dynamics (domestic consumption, government spending and/or infrastructure spending) to support their growth. Many of those countries have the resources to smooth and accompany this ongoing transition. Generally speaking, their current account gaps have improved since mid-2013 (Fed's taper tantrum) and their external debt levels are relatively low compared to DM economies. In addition, on average 85% of EM debt is held in local currencies, making these economies less directly exposed to USD appreciation.

FIG. 3 – CURRENT ACCOUNT GAPS




Source: WorldBank, data as at end of June 2016.

FIG. 4 – TOTAL GROSS EXTERNAL DEBT AS % OF GDP




Source: WorldBank, data as at end of December 2015.

## EM trade has grown less dependent on DM economies, and intra-EM trade opportunities are expanding

Over the last few years, trade dynamics have evolved materially. As shown below, in 2000 advanced economies were the destination of 80% of EM exports. Today, intra-EM trade has almost doubled in proportion. While it may have slowed lately due to falling commodity prices, this trend was not altered by the GFC.

In a post-Trump world, if more protectionism is implemented, this growing trend of intra-EM trade will likely continue and most likely accelerate. This could help to smooth out the effects of a potential US retrenchment, in our view.

In November 2016, post-Trump's election, at an APEC Economic Leaders' Meeting in Lima, it was particularly enlightening to hear Chinese representatives stating that "APEC will capitalise on the opportunity of the Lima meetings this year to push forward the FTAAP process in a comprehensive and systemic way. The process of FTAAP shall serve as a rebuff to anti-globalisation and a toolkit to strengthen Asia-Pacific regional integration."



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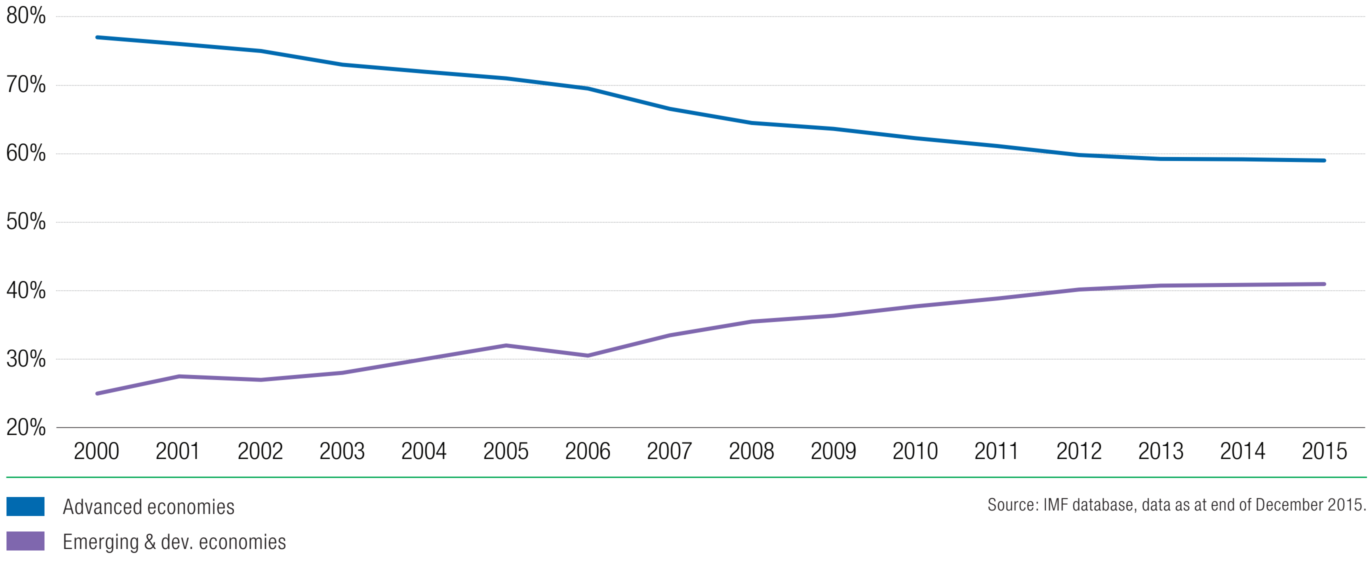
FIG. 5 – DESTINATION FOR EM EXPORTS (AS % OF TOTAL EXPORTS)

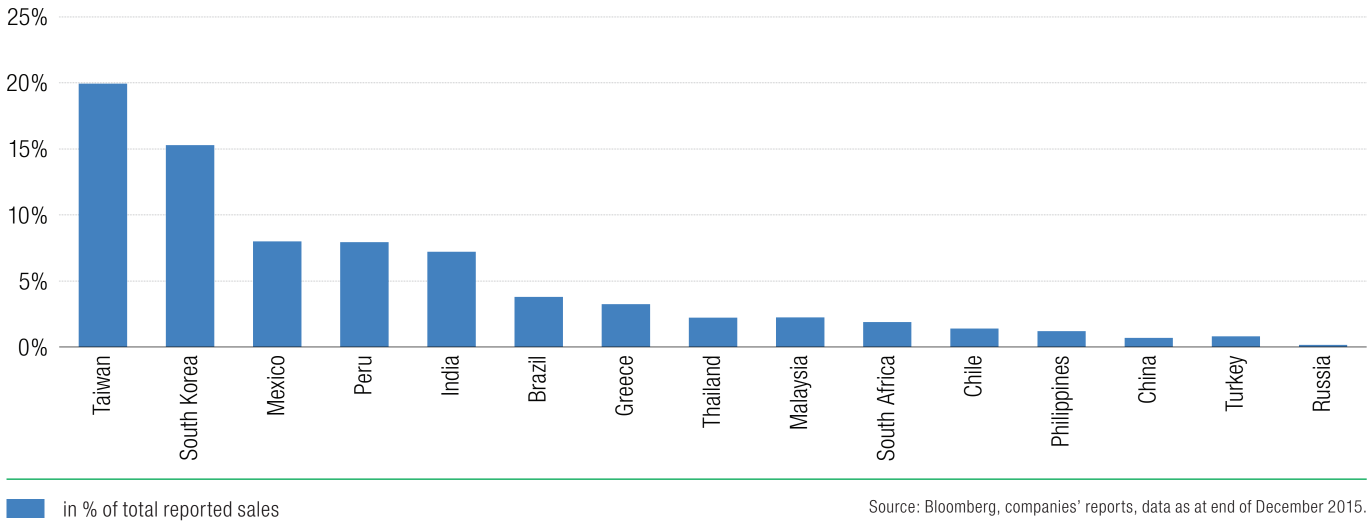



Source: IMF database, data as at end of December 2015.

**From a company-selection standpoint, we view a high conviction approach as now more appropriate than ever**

From a macro standpoint, we view a somewhat more protectionist US as a digestible event from an EM perspective. However, from a micro point of view, investors now need to pay more attention than ever to the individual companies they are gaining exposure to. A more protectionist policy could be disruptive for individual business models. For instance, companies listed in Taiwan and South Korea stand out as their reported sales figures point to a very high direct exposure to the US.

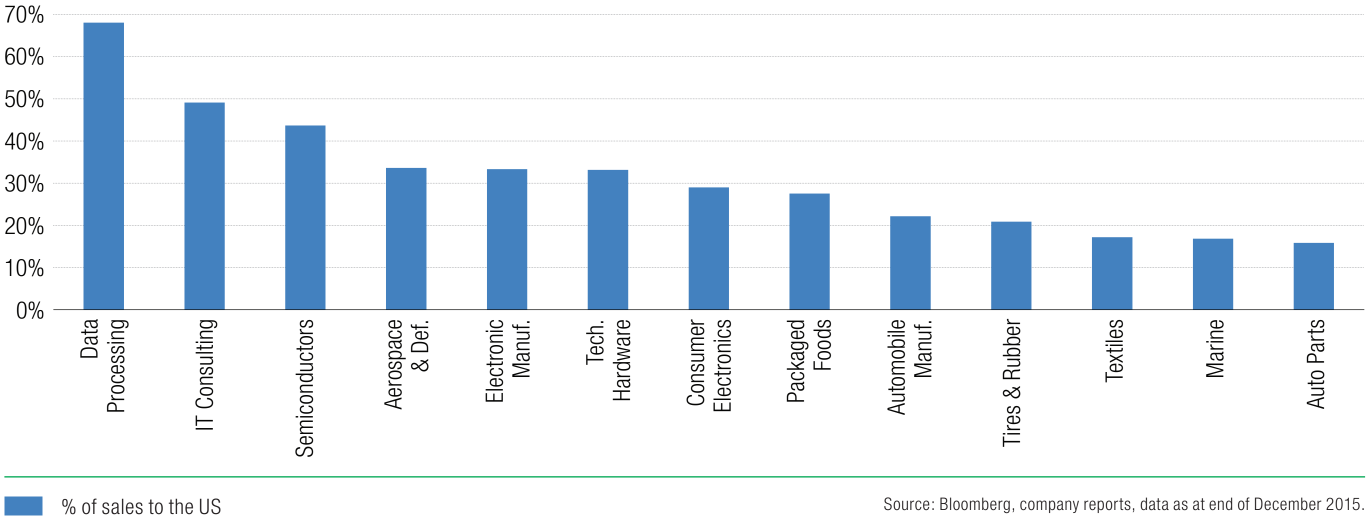
FIG. 6 – SALES EXPOSURE TO US OF LISTED COMPANIES BY COUNTRY (2015)




Source: Bloomberg, companies' reports, data as at end of December 2015.

Looking at sub-industries within EM, exposure to the US could also be extreme, as shown in the chart below. These sub-industries will likely be the most directly impacted by more targeted protectionism by the US.

FIG. 7 – EM SUB-INDUSTRIES WITH HIGHEST SALES EXPOSURE TO US (2015)




Source: Bloomberg, company reports, data as at end of December 2015.

## Our high conviction approach is focused on key domestic dynamics within EMs and tends to avoid export-led business models

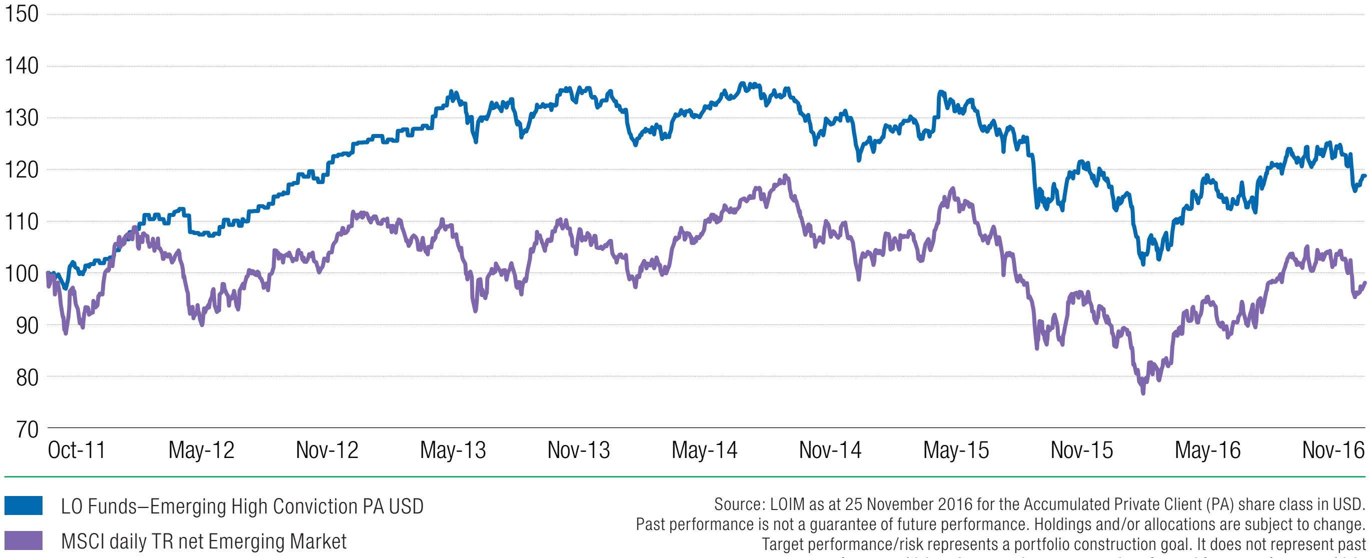
Our investment philosophy is a high conviction approach focusing on selecting high-quality, best-in-class companies that we believe have the potential to create value and provide exposure to structural trends in EMs.

Our investment approach is constructed around two pillars:
- Avoiding companies that are excessively exposed to exogenous factors not being controlled by management;
- Focusing on companies with structurally superior economic returns, strong corporate governance, and sustainable competitive advantages.

This disciplined methodology has consistently led us to avoid companies with export-based business models that are therefore dependent on developed markets rather than EMs. Indeed, such companies are not strongly linked to EMs' attractive internal domestic dynamics (middle class expansion, modernisation, purchasing power catching up, etc.). In addition, many of those exporters have very capital-intensive business models with highly volatile sources of revenues (eg, semiconductors, steel, autos), which we believe creates too much of a toxic cocktail for generating sustainably solid economic returns. Furthermore, these business models generally do not have strong "economic moats" or long-lasting competitive advantages. For instance, they tend to have weak pricing power or do not benefit from any brand/franchise effect that could act as a barrier to entry against competition.

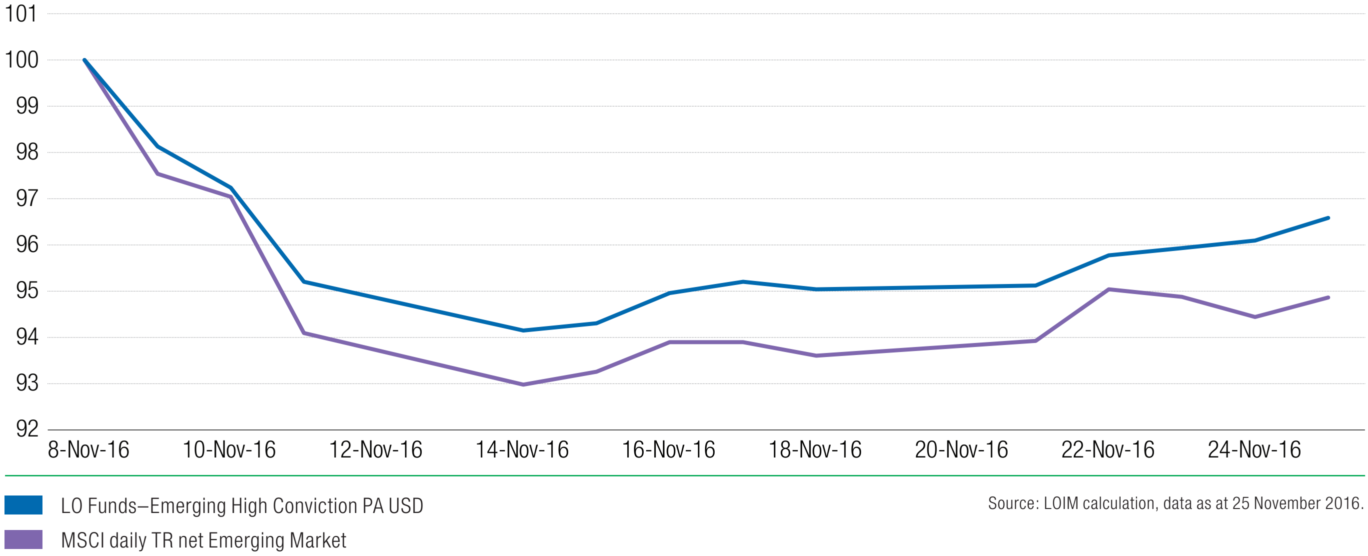
As an illustration, companies held in the LO Funds–Emerging High Conviction portfolio depend on the US for only 3% of their sales, on average. This helps to explain the outperformance of the Fund versus its benchmark since the election of Donald Trump.

FIG. 8 – PERFORMANCE SINCE INCEPTION (30 OCTOBER 2011)




Source: LOIM as at 25 November 2016 for the Accumulated Private Client (PA) share class in USD. Past performance is not a guarantee of future performance. Holdings and/or allocations are subject to change. Target performance/risk represents a portfolio construction goal. It does not represent past performance/risk and may not be representative of actual future performance/risk.

FIG. 9 – THE TRUMP EFFECT




Source: LOIM calculation, data as at 25 November 2016.

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