Capital International℠

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Emerging market equities: Client call highlights

Investment specialist Martyn Hole hosted a call on 25 January 2010 to provide clients with a deeper understanding of events and investments in emerging markets. Investment specialist David Holstein reviewed the fourth quarter and 2009 for Capital International Emerging Markets Fund. Portfolio managers Victor Kohn and Luis Oliveira spoke about their portfolios and outlook for emerging markets, while China analyst Zhang Chen gave his views on his sector.

A look back — keeping pace with a strong market

David Holstein: After a difficult year in 2008, emerging markets had an amazing year in 2009 — up 80% plus — as well as a strong fourth quarter — up 9%, as measured by the MSCI Emerging Markets IMI in US dollar terms.

Reviewing the portfolio's month-by-month results shows how we added value when markets were weaker earlier in the year, as our portfolio was rather defensively positioned. We found it tough to keep up when markets went off to the races, but we held our own in the strong months of November and December.

2009: A year of surprises

Victor Kohn: We began 2009 with the question, 'Can emerging markets avert disaster given the economic and market decline in developed markets?' The big surprise was the ability of emerging markets to stimulate, as opposed to tighten, in such a time of crisis. China was the key with the size and speed of its stimulus, and it became the story for 2009.

Luis Oliveira: The surprise for me goes back to the third quarter of 2008 when the entire world began to freeze over. The policy response was unique — it was universal and coordinated, both fiscal and monetary — and the recovery in economic activity and asset prices was a surprise too. Looking ahead, 2010 will be a time of uncertainty as policy normalises and stimulus is withdrawn.

Capital International's investment professionals review the fourth quarter and 2009 in emerging markets, and give their outlook for 2010.

Portfolio review

David: In general, cyclical stocks did well and defensives less so, although results were more mixed in the fourth quarter. The key drag on our portfolio was significant exposure to telecommunications — a sector that had a difficult year. Our stock selection in China was very strong, and among industrials, utilities and consumer staples for both the quarter and year. The cash position hurt results. We started the year with a high level of cash and worked it down over the year. Indian holdings and low exposure to Brazil also hurt results during the year.

Notable stock contributors for the fourth quarter show the importance of China. Banpu — even though it's Thai — gives investors exposure to Chinese coal and energy demand. Weichai Power makes diesel engines in China. Not owning China Mobile helped. Detractors included several Indian companies, and not owning Korean steel company POSCO and Russia's Sberbank.

The portfolio: Uncovering opportunities

David: The cyclical sectors of energy, materials and industrials are about a third of the portfolio — lower than the index — although we are actually very enthusiastic about energy if we include alternative energy companies. We have a low position in financials due to valuations. Telecommunications are a large weight in the portfolio.

At a regional and country level, we have an overweight position in Mexico and an underweight one in Brazil. We are above index weight in China and have exposure to countries such as Indonesia, Malaysia, Philippines and Thailand, which are heavily influenced by the pace of activity in China. We are very optimistic about Chinese consumers which has led to investments in the consumer staples and discretionary areas.

Zhang Chen: Growth in Chinese consumption is driven by the long-term trend of income growth, urbanisation and the generational shift in consumer behaviour in which younger people will spend more and save less than previous generations. In consumer goods markets that are very fragmented and have low penetration, I look for companies with strong brands, strong market positions and strong distribution.

For example, Li Ning is a leading Chinese sportswear company founded by the famous Olympic medal winning Chinese sportsman it is named after. The company has invested a lot in branding and research and development. It dominates the Chinese market and is closing fast on global competitors like Adidas and Nike.

Bawang International had its stock market debut in 2009. It manufactures herbal shampoo — and has 50% market share — and other personal care products. It competes effectively with the likes of Procter & Gamble and Unilever. It has a strong brand and effective distribution.

Portfolio changes over the year

David: Usually we hold stocks on a three- to five-year time horizon. But portfolio turnover has doubled over the last few years, reflecting the higher volatility in the market especially during 2008 and 2009.

Looking at the top 20 holdings, which are a third of the portfolio, there are five energy and five financials stocks. Only three of the top twenty are Chinese — our exposure to China is through a well diversified range of investments. We are overweight Mexico, although it is a small country exposure in the portfolio dominated by telecommunications investments.

The year ahead: Valuations should matter more, benefiting stockpickers

David posed the question 'Are emerging markets in a bubble?': Looking at historic returns, while markets have rebounded 80%, they need to move up another 35% to reach the peak levels of 2007. Analysis by one of Capital's macroeconomists on price-earnings ratios suggests that P/Es are reasonable.

Victor: We are starting 2010 in a relatively comfortable position in terms of valuations. We need to get over the shock of 80% plus returns and the knee jerk implication that it signals troublesome times ahead. The rally needs to be viewed in context of the declines of 2008. Current P/E ratios are just slightly above historical averages. Looking at forward P/Es, they are at 13 times, which seems reasonable. Compared with developed markets, the current range of parity to something of a premium is going to be in the right range going forward.

The big question is 'To what degree can markets and economies function well when the stimulus begins to be withdrawn?' China will be among the first to remove stimulus measures, and its efforts to do so in the last few weeks unsettled markets. Just as markets needed to be convinced that the stimulus would work a year ago, they now need to be convinced that economic momentum will be maintained as and when the stimulus is removed. Stock picking will be important in 2010 as investors won't be able to make big macroeconomic calls. Now that the world is returning to normal — more or less — investors need to get back to looking at the company details.

Luis: I expect most policymakers will implement an exit strategy this year. The earlier the better, but this will be unsettling for asset prices. There are two outside scenarios that I'm factoring into my portfolio.

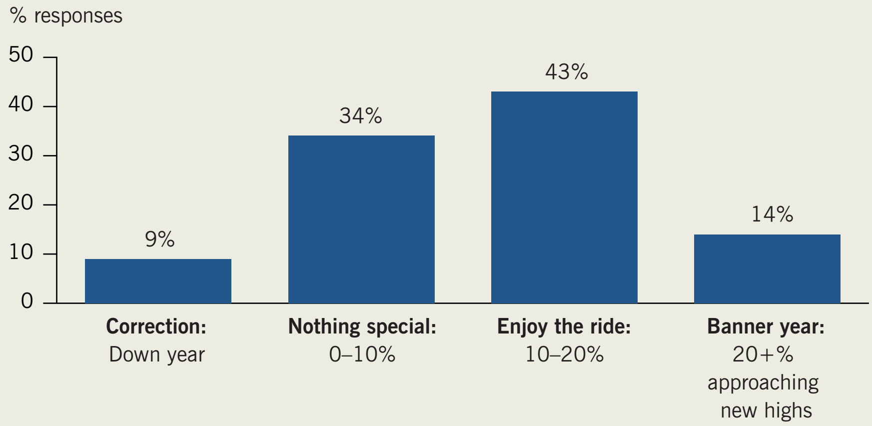
First, we already have good fundamentals supporting the markets, and if we continue with super easy monetary policy, then we could have a bubble, which could take investors a long time to recover from. Second, there is a risk of a double dip in which fears about fiscal sustainability lead to a retrenchment and credit spreads increase — and recent events in Greece and Dubai are reminders of this — but I think the probability of this occurring is low.

Zhang: I'm optimistic about China for 2010. The government is focused on changing the structure of the economy and we will see China resume a steady growth path — not as fast as before but of better quality.

Victor: I have a mix of different ideas in my portfolio. There is heavy Chinese representation. But at the same I also have quite a few companies with good growth and cash flows such as Mexico's América Móvil — which will be an integrated fixed and wireline company after its proposed merger with Telmex International.

Luis: I am cautious on companies that did very well in the recovery, especially those related to earnings growth as comparisons will be challenging going forward. I am very enthusiastic on the laggards of 2009, especially those with good cash flows, decent growth prospects and generous yields such as telecommunications. I like the consumer stories in most emerging markets. There needs to be a rebalancing in the world, which means consumers in emerging markets will be spending more.

How will emerging markets equities do in 2010?



Martyn Hole

During the call, Martyn polled participants for their view on emerging markets equities.