BARINGS CONVERSATIONS

March 2018

SURVEYING THE EQUITY MARKET LANDSCAPE

GHADIR COOPER
GLOBAL HEAD OF EQUITIES

EQ

EQUITIES

AUM $16.3 BILLION*

63 INVESTMENT PROFESSIONALS

- EMERGING MARKETS
- SMALL CAP
- GLOBAL
- ACTIVE QUANT

ACTIVE MANAGEMENT

DIFFERENTIATED FUNDAMENTAL RESEARCH

*As of December 31, 2017.

IN THIS CONVERSATION, BARINGS' GLOBAL HEAD OF EQUITIES, GHADIR COOPER, DISCUSSES THE RECENT EQUITY MARKET VOLATILITY AND THE CONTINUED ATTRACTION OF EMERGING MARKETS, AND ALSO SHEDS LIGHT ON HOW THE BARINGS TEAM IS THINKING ABOUT POTENTIALLY MARKET-MOVING DEVELOPMENTS LIKE THE EMERGENCE OF CRYPTOCURRENCIES AND THE RECENT CHANGE IN FED LEADERSHIP.

Can you start by telling us how today's equity market conditions are similar to or different than those you've witnessed in the past?

At Barings, our equity team takes a long-term approach to investing and many of us have been investing actively for decades through the course of many cycles—so we have certainly witnessed quite a bit of change. One such change has been the effect of passive investing on market dynamics. This has firmed our belief in the value of active investing; markets remain inefficient and we believe that active management is the most effective approach to capitalize on these inefficiencies, as we seek to deliver superior risk-adjusted returns compared with benchmark (passive) investing over time.

This is particularly relevant now as correlations between and within markets have reduced substantially since their recent peak in 2016. This means that the opportunity for active managers to add value increases.

We are entering a period where central banks globally are withdrawing stimulus in a measured fashion and that, from time to time, can cause some anxiety in markets. However, ultimately we believe that equity returns are a reflection of the health of the corporate sector where earnings are still on an upward trend and valuations—especially in emerging markets—are not stretched versus the growth potential.

The backdrop for equities generally remains fundamentally supported, in our view. Specifically, the economic environment continues to be characterized by synchronized global growth, a corporate earnings recovery in emerging markets and tailwinds in developed markets including the continued European recovery and U.S. tax reforms. We are finding particular opportunities among international companies, smaller capitalization companies and emerging markets.

At Barings, we are active investors in equity markets with a strong and experienced team of 63 dedicated equity investment professionals. Our fundamental research forms the cornerstone of our investment process. We take a longer-term (five-year) view as we aim to identify unrecognized growth opportunities for our clients. As such, when we encounter periods of volatility as we have recently, we believe we are particularly well-positioned to put such short-term price movements into the proper context, remaining true to our proven and disciplined investment process as we seek superior risk-adjusted returns for our clients.

Emerging markets were some of the strongest performers among global stock markets last year. What are some changes that you noticed in emerging markets (if any) during 2017 and what is your outlook for emerging markets this year?

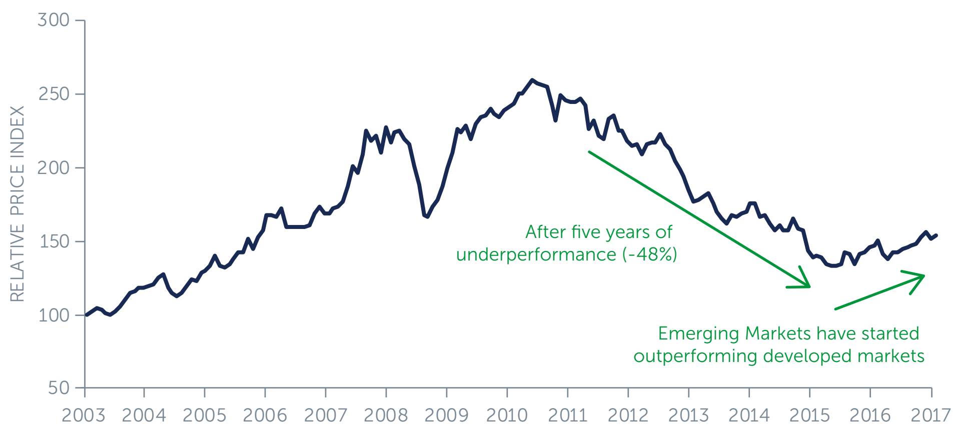
We remain constructive—investor appetite for emerging markets equities has strengthened after several challenging years. This has been driven by improved fundamentals, a notably stronger earnings outlook—which we believe is sustainable given the economic cycle—and attractive valuations. We believe these trends will be sustained and support a continued upturn for the asset class. A further potential tailwind may come from investors increasing their allocations to the asset class, which are currently low by historical standards. We discussed these trends in detail in our recent *Viewpoint, A New Dawn for Emerging Markets Equities*.

Emerging markets also continue to evolve. Twenty years ago, there was a very heavy sector concentration in resource companies and large infrastructure providers, which were dominated by telecoms and utility companies. The EM equity universe is now very different and includes more "new economy" companies, including world-leading technology providers.

And while emerging markets today encompass a vast array of companies, they attract significantly less sell-side analyst research coverage than developed markets. This inevitably leads to less accurate earnings forecasting and consequently mispriced assets. This is where Barings has an advantage as well-resourced, active managers. Our dedicated EM equity team is 32 people strong with an average of 14 years of experience. The bottom-up analysis that this team conducts every day allows us—we believe—to unearth attractive opportunities for our clients.

> *By relying on fundamental analysis, longer-term forecasts than many of our peers and considering other relevant factors like ESG, we believe we can truly add value for our investors—and this is even more true during periods of market volatility.*

FIGURE 1: MSCI EMERGING MARKETS INDEX RETURN RELATIVE TO MSCI WORLD INDEX (USD)



SOURCE: *BARINGS, FACTSET, MSCI. AS OF DECEMBER 31, 2017.*

Equity market volatility has been surprisingly low in recent years as prices have appreciated. Do you think the February volatility flare-up is a sign of things to come or is volatility more likely to be muted?

We believe the outlook remains supportive for equity markets; however, potential headwinds also exist. A return to wage growth is coinciding with a recovery in capital expenditure and rising inflation expectations. This, together with some measured withdrawal of stimulus from central banks globally, created the conditions for some volatility and profit taking at the start of February.

In such an environment, we would expect some companies to fare better than others with the potential for some sectors and companies to be more exposed to margin pressures. On the other hand, there will also be companies that continue to benefit from the structural and cyclical trends in place.

Sell-offs like the one witnessed in early February can provide opportunities for long-term active investors. At Barings, we very much take a long-term approach to identifying areas of unrecognized growth. When we see equity prices become decoupled from their underlying fundamental values during bouts of market volatility like the recent one, we remain true to our process and aim to be as

Block chain is one example of a disruptive technology that is rapidly reshaping longstanding accepted practices in large markets, but there are many others just as impactful.

objective as possible. By relying on fundamental analysis, longer-term forecasts than many of our peers and considering other relevant factors like ESG, we believe we can truly add value for our investors—and this is even more true during periods of market volatility.

We know that the strong performance of the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix, and Alphabet's Google) has been a critical driver, especially of U.S. stock returns recently. What sectors look poised for strong performance in the years ahead?

Certainly the idea of disruptive platform dynamics, which FAANG plays into, has been an area where we have found strong bottom-up investment ideas. 2017 was a year where the FAANG companies' powerful platforms in areas such as e-commerce, advertising and IT infrastructure became more apparent to investors. We see this continuing in 2018, albeit with more nuances around evolving pressures from regulators and governments and the investments the companies need to make in order to adapt.

Looking beyond FAANG and leveraging the fundamental analysis of our specialist global research team, we see the software sector in particular as an area with a growing number of companies exhibiting similar platform dynamics in how they compete and grow.

Outside of technology, we are able to look at these structural changes taking place and identify a far wider range of potential investments across different market capitalizations, regions and sectors. This means an ever closer collaboration between our specialist sector research teams and the specialist regional teams to identify the most attractive opportunities on a fundamental, bottom-up basis.

With the jury still out on the long-term viability of cryptocurrencies, can you comment on the potential impacts for equity investors from cryptocurrencies and block chain technology more broadly?

The premise behind the emergence of the Bitcoin cryptocurrency was the desire to build a payment system that was both anonymous and not reliant on a central authority to manage that currency. This initiative grew in popularity after the global financial crisis. The recent volatility in the value of Bitcoin we see as diverting attention from the greater impact of the building of a system where "trust" is not required, and therefore does not need a middleman.

The real innovation has been the use of block chain technology to create an immutable and distributed ledger of ownership of assets. The cryptocurrency (Bitcoin, Ether, Ripple, etc.) associated to any block chain is useful as a label to attach ownership of an asset to a person/company, and then to track that asset as it is traded over time.

This idea is now being applied to a huge variety of processes, including insurance contracts, diamond trading and even digital photography royalties. Just focusing on the global banking industry, it is easy to identify uses for block chains where complexity and frictions exist, which add cost and slow down transactions; an example would be the processing of trade finance contracts. Any business that profits from transactional complexity and friction should be wary of disruption from block chain based alternatives.

Block chain is one example of a disruptive technology that is rapidly reshaping longstanding accepted practices in large markets, but there are many others just as impactful. Advances in artificial intelligence have accelerated and are becoming embedded into the production of services and products we use every single day at home and work, including everything from social media feeds to how your IT helpdesk prevents equipment failures; autonomous vehicles will dramatically change approaches to city planning with respect to municipal transport and real estate; robotics, and more broadly, automation can have fundamental effects on the industrial complex and advance manufacturing capabilities across the world.

The point of inflection for technology to deliver on the promise of significant productivity improvements is getting ever closer. We are fortunate to have sector teams that are able to look at disruptive technologies and identify not only the threats but also the opportunities that innovation has to offer.

With the recent change in leadership atop the U.S. Federal Reserve (Fed) and rates appearing to be on the rise, can you discuss how you factor higher rates into your analysis?

Fed policy is dictated by fostering economic growth in a stable inflation environment and so it seems unlikely that Chairman Powell's appointment in itself will have any meaningful impact on markets.

As equity investors, with a bottom-up approach and long research outlook, we take into account the macroeconomic conditions that a company operates in through our in-house calculated cost of equity.

The cost of equity is the minimum rate of return demanded by equity investors for committed capital. This cost of capital varies from market to market, and is dependent on economic and monetary as well as market conditions. This rate is required by equity investors to compensate for the risk of owning a share of a company versus another investment they may otherwise make.

So any changes in macro conditions, including the reason for the changes in interest rate outlook, get incorporated seamlessly by our analysts and fund managers in their fundamental analysis. This affects our in-house earnings forecasts and also our valuation of the company through the use of an appropriate cost of equity.

Any final takeaways?

As a long-term investor, who has seen many economic cycles, I urge investors to focus on fundamentals as a driver for returns. We believe that companies' share prices over time reflect their earnings potential and as long as they are not overpriced, growth is a powerful determinant of future returns for the level of risk taken. Investing with an active manager, like Barings, focused on unearthing these opportunities for our clients, is, in our view, a compelling proposition.

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**As of December 31, 2017*

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