### Highlights

- Investor appetite for emerging markets equities has strengthened after several challenging years. We believe the strong earnings outlook, attractive valuations and likelihood of rising allocations from global investors should sustain the upturn.
- In our view, active managers who can exploit market inefficiencies to find unrecognized opportunities in EM equities will reap the potential rewards for their investors.
- Our EM equity proposition benefits from the strength of our research capability, our disciplined investment process and commitment to fundamental analysis.

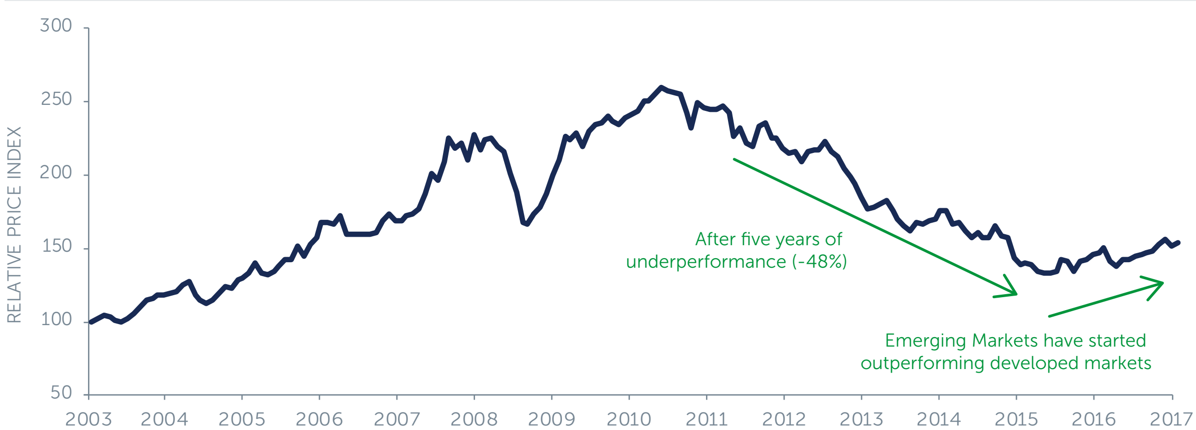
# A NEW DAWN FOR EMERGING MARKETS EQUITIES

## The case for emerging markets equities

After five painful years of underperformance by almost 50% in U.S. dollar terms versus developed market equities, emerging markets equities enjoyed a rebound in 2016 that followed through into 2017. The question on every investor's mind is: Can it be sustained or is it just another false dawn? At Barings, we believe there are grounds for optimism, a view that centers on the outlook for corporate earnings.

We need only to observe the performance from 2011 to 2015 (FIGURE 2) to appreciate how powerful the earnings cycle is as a driver of stock market returns in emerging markets. During this period, earnings expectations peaked at the beginning of each year before experiencing a steady and sustained decline as companies failed to meet analyst forecasts. This proved to be a major headwind for EM equities, which declined by more than 30% in U.S. dollar terms over this period. This pattern only changed in 2016 and 2017.

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




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

So what impacted EM corporate earnings during this period and has anything changed? Over the course of 2011 to 2015, EM companies suffered a double whammy of falling profit margins and slowing sales growth. Profit margins declined because real wage growth exceeded productivity growth, while sales performance was negatively impacted by weaker nominal GDP growth. The end result was that EM corporate earnings failed to grow over the five-year period from 2011 to 2015 (FIGURE 3) and, unsurprisingly, the MSCI Emerging Markets Index also failed to make any progress.

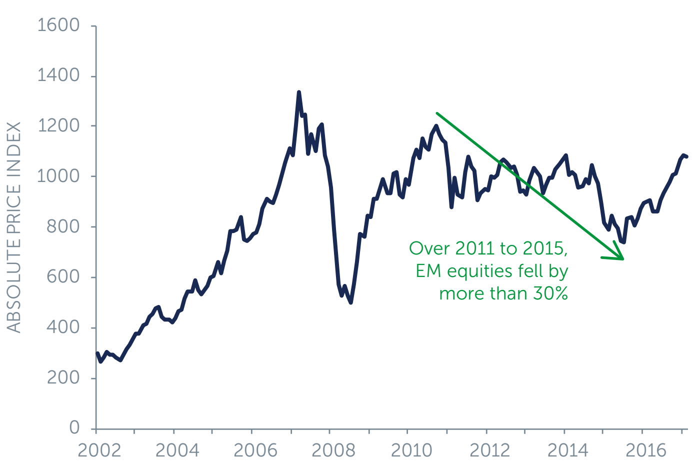
However, both of these headwinds have started to reverse and the inflection point for the EM corporate earnings cycle has now been passed. Profit margins are beginning to turn up as productivity growth is outpacing real wage growth thanks to previous investment in labor-saving equipment and a renewed focus on cost management. Meanwhile, sales performance is also starting to improve due to accelerating real GDP growth across emerging markets and rising inflation in many countries. As a result, consensus earnings expectations for 2016 and 2017 broke the pattern of previous years and exhibited a steadily rising trend.

This translated into positive earnings growth in 2016 for the first time since 2011.[1] It is also encouraging to observe that the earnings recovery continues to broaden with all 11 major sectors of the MSCI Emerging Markets Index forecast to grow.

We believe the recovery in profit margins is largely non-cyclical in nature and as a result can support corporate profit performance beyond 2018. In addition, approximately 70% of the MSCI Emerging Markets Index is now comprised of information technology, financials, consumer and healthcare.[2] All of these sectors enjoy secular growth support as they remain underpenetrated and will continue to be beneficiaries of the ongoing expansion of the EM middle class segment.

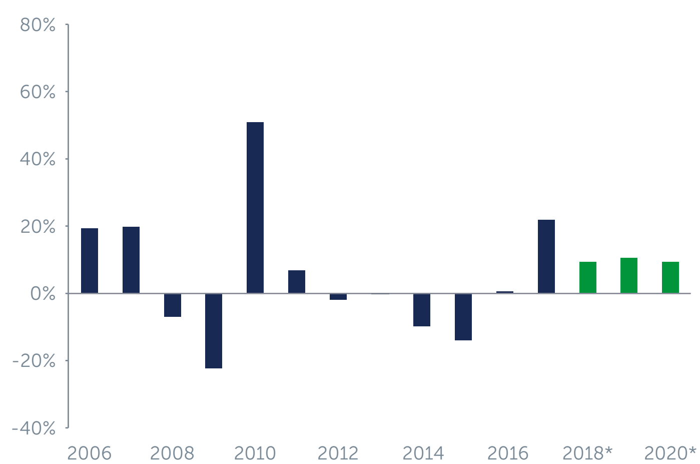
*"We believe the recovery in profit margins is largely non-cyclical in nature and as a result can support corporate profit performance beyond 2018."*

FIGURE 2: MSCI EMERGING MARKETS PRICE INDEX




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

FIGURE 3: EPS GROWTH—MSCI EMERGING MARKETS INDEX




**FORWARD-LOOKING ESTIMATES*
SOURCE: *BARINGS, FACTSET, MSCI. AS OF DECEMBER 31, 2017.*

1. Source: Barings, FactSet, MSCI. As of December 31, 2017.
2. Source: MSCI Emerging Markets Index. As of December 31, 2017.

*Global investors remain very underweight the asset class*
The upturn in the earnings cycle has not gone completely unnoticed by investors as evidenced by inflows into the asset class over recent months. However, only $55 billion of fund flows have returned to emerging markets compared to the $155 billion redeemed over the past couple of years.[3]

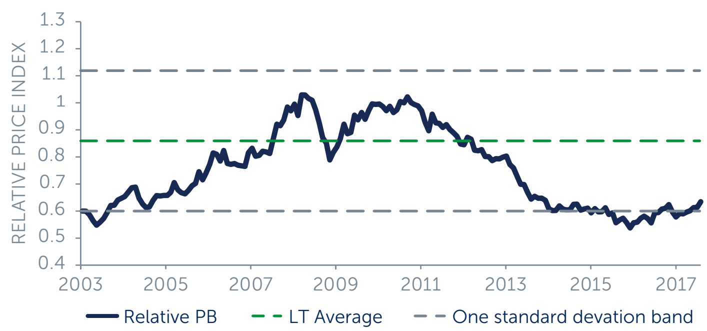
In addition, analysis of global equity fund weightings in emerging markets suggests that investors remain markedly underinvested in the asset class. Pressure to reverse this underweight position will continue to grow as the earnings recovery strengthens.

*Valuations still signal the asset class is attractive*
Valuations should not prove to be a deterrent for investors as the relative valuation of the MSCI Emerging Markets Index versus MSCI World remains attractive, despite the strong performance of the past 24 months. This is particularly evident on a price-to-book basis, where it is now only modestly higher than the level occupied in 2002 after which a five-year bull market and relative outperformance of the MSCI World Index followed (FIGURE 4).

Turning to absolute valuations, a similar picture unfolds. The cyclically-adjusted price to earnings (CAPE) ratio, which uses rolling five-year average earnings in order to smooth out the distortion associated with peak or trough earnings, is rebounding off levels that historically have witnessed periods of continued positive returns for investors (FIGURE 5).

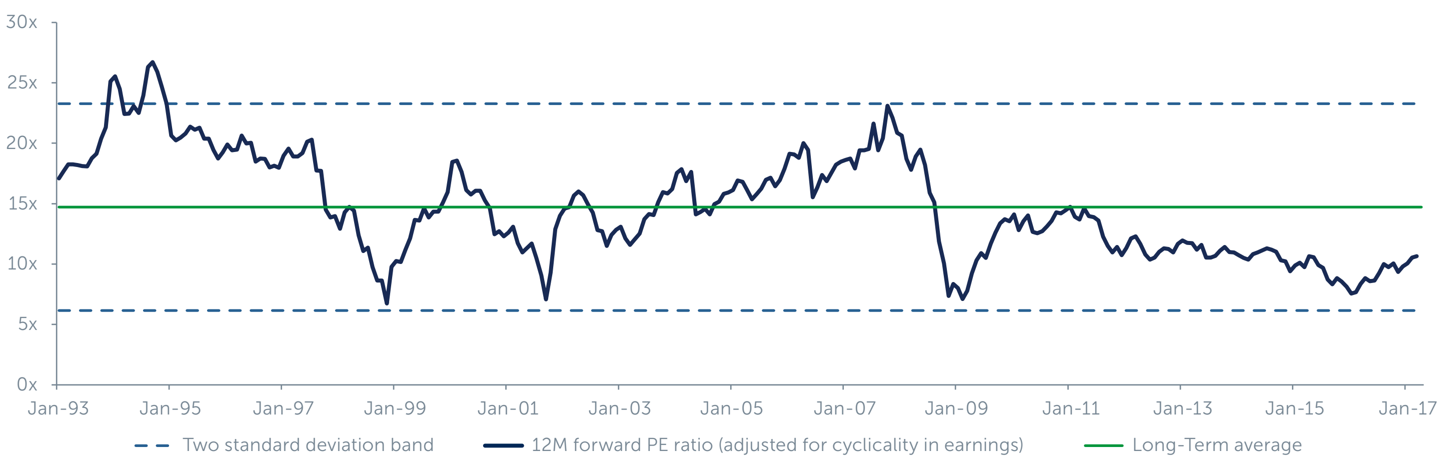
*"Emerging markets encompass a vast array of companies, but attract significantly less sell-side analyst research coverage than developed markets."*

FIGURE 4: PRICE TO BOOK RATIO—MSCI EMERGING MARKETS RELATIVE TO MSCI WORLD




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

FIGURE 5: CYCLICALLY ADJUSTED PE—CALCULATED AS CURRENT PRICE OVER 5-YEAR AVERAGE EARNINGS LEVEL




SOURCE: *MSCI, IBES, THOMSON REUTERS DATASTREAM, HSBC. AS OF OCTOBER 20, 2017.*

3. Source: EPFR Global, MSCI, Datastream, UBS. As of August 2017.

## The case for active management in emerging markets

We believe active management offers a significant opportunity to exploit market inefficiencies and deliver better absolute and risk adjusted returns compared with the benchmark over time.

Emerging markets encompass a vast array of companies, but attract significantly less sell-side analyst research coverage than developed markets. This inevitably leads to less accurate earnings forecasting and consequently mispriced assets. In addition, sell-side forecasts rarely extend beyond two years, and, as such, struggle to capture the longer term growth potential of companies. Active management can exploit this information gap by utilizing a large internal research resource with the ability to provide a disciplined and consistent approach to analysis.

Furthermore, with less than 10% of emerging markets stocks captured in the index,[4] significant investment opportunities can be found elsewhere across the less well-known EM landscape—a fertile hunting ground for identifying unrecognized growth and a differentiated equity performance versus the index.


## Our Approach

At Barings, we are active managers. We believe that markets often misprice equity securities and none more so than in emerging markets. To exploit this, we employ a disciplined and consistent investment process that aims to capture these opportunities and to deliver superior, long-term, risk-adjusted returns for our clients.

Our approach is anchored in our Growth at a Reasonable Price (GARP) investment philosophy and commitment to fundamental analysis and bottom-up company research. A key differentiator from our competitors is the longer term focus of our analysis. Markets are usually adept at discounting short-term (one to two years) growth expectations, but not at discounting long-term growth. For us, this creates an opportunity as we believe that long-term earnings growth is the principal driver of stock market performance.

*Company-focused research*

To identify companies, we utilize structured fundamental research and a disciplined investment process combining growth, upside/valuation and quality disciplines. We forecast earnings growth on a five-year basis and favor companies with well-established business franchises, proven management and strong and improving balance sheets. We regard these companies as higher quality as they provide transparency and stability of earnings. We believe this reduces the potential for portfolio volatility over time and makes it possible to forecast long-term earnings growth more accurately.

*Valuing opportunities*

Companies are valued on a long-term basis utilizing our proprietary five-year earnings forecasts, discounted by an appropriate cost of equity and an exit PE. An important differentiator, this cost of equity calculation incorporates macro factors (i.e. the economic outlook and political risks) as well as company specific factors, including Environmental, Social and Governance (ESG). To find out more about our valuation process, please see our White Paper 'Determining the Cost of Equity'.

We make our own proprietary ESG assessments informed by company knowledge and aided by external data and research. ESG considerations influence both our scoring of the company and the cost of equity—and hence the value of the company—in order to capture the specific risks and inherent attractions highlighted by the company's ESG approach.

We use a consistent and transparent method to value companies in different geographies and sectors. Our approach allows us to determine a cost of equity (or discount rate used to value companies) across markets, making it possible to perform direct comparisons between companies in the same industry, in different markets.

*High conviction investing*

Our focus is solely on identifying attractive investment opportunities for our clients. Key to this is developing a deep understanding of potential investments and the business environments in which they operate. If we do not like a company, we do not invest in it. In this way, we build high conviction strategies so that our best investment ideas can make the highest impact to client portfolios. Our Global Emerging Markets portfolios typically hold between 40–60 companies.

We believe that the companies in which we invest and the portfolios that we build will continue to deliver attractive risk-adjusted returns in the favorable recovery environment of today and into the longer term.

4. Source: Barings, FactSet, MSCI. As of August 2017.

**William Palmer** CO-HEAD EMERGING EQUITIES TEAM

William was appointed Co-Head for Emerging and Frontier Equities Team in 2016 and in addition to this responsibility, William oversees our Asia ex Japan investment function. William is also co-manager on a number of Global Emerging Markets mandates, including Barings' flagship Global Emerging Markets Fund. Prior to joining Barings in October 2011, he was Senior Asset Manager/Head of Asia ex Japan Equities at KBC Asset Management in Dublin. During his time at KBC Asset Management, he also held the roles of Asset Manager focusing on Asia ex Japan Equities and Equity Analyst responsible for producing equity research on Irish and Asian companies. William has an honours degree in Business Studies, majoring in Economics and Finance from the University of Limerick.

**Michael Levy** CO-HEAD EMERGING EQUITIES TEAM

Michael was appointed Co-Head for Emerging and Frontier Equities Team in 2016. Michael oversees the Frontiers, Latam and Emerging Europe functions. Michael is the lead manager of the Frontier Markets Fund and is also co-manager on a number of Global Emerging Markets mandates including Barings' flagship Global Emerging Markets Fund. Prior to this, Michael was investment manager in the EMEA & Global Frontier Markets Equity Team. He joined Barings in July 2012 after 17 years at AllianceBernstein where he held a number of equity portfolio management and research roles. His most recent responsibility before joining Barings was as a portfolio manager for Emerging and International equity portfolios. Michael began his career in 1992 at Grant Thornton Chartered Accountants as a Partner Trainee. He has a BA (Hons) in Economics and Social Studies from the University of Manchester.

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**As of December 31, 2017*

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