



OSBORNE PARTNERS
Capital Management, LLC

Emerging Opportunities

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Times change, but thankfully for longer term investors, short-sighted fear and greed in the financial markets remain the same. 2017 was the best year for emerging market (EM) equity returns since 2009. EM was up 37%, beating domestic equities for the first time in five years. During 2017, the worst peak-to-trough decline was 5%, the shallowest decline since 1993.

Extrapolating the strong returns and low volatility, investors piled money into diversified EM funds, placing the most money since 2010. Yet to the dismay of many of these allocators, EM ended the first half of 2018 down almost 20% from its 2018 high. Predictably, investors spent the final five weeks of the first half pulling money from diversified EM funds.

2018's decline may seem especially painful after a calm 2017. But it is important to remember that EM is volatile: over the last 30 years, on average, EM has experienced a 19% intra-year peak-to-trough decline. This creates investment opportunity for OPCM's unique multi-asset strategy.

What's Driving the Volatility

A cocktail of political and financial conditions has left investors nauseous.

Financially, the US dollar has appreciated, in part due to rising US interest rates. Countries with weaker financial conditions are especially at risk of getting pressured in this environment. Often their currencies depreciate, funding gets more expensive, inflation risk rises, and growth concerns intensify. This is exacerbated when investors have shown complacency. Early in 2018, the risk premium to hold EM debt instead of US Treasuries was at the lowest level in over a decade. This investor positioning began to get reversed, pressuring EM asset prices in the process. Examples of markets facing these dynamics include Argentina, Turkey, Indonesia, and South Africa.

Politically, two main issues have afflicted EM: elections and trade wars. Elections have created uncertainty about whether new leaders will support economic policy that enhances or restrains growth. Examples include Mexico, which held elections in the second quarter, as well as Brazil, which will have its election in October. Meanwhile, a tit-for-tat tariff battle between the US and China has raised the specter of wider trade battles and disruptions. This has raised risk premiums across EM countries that rely more on global trade, like South Korea and China.

Why Invest in EM

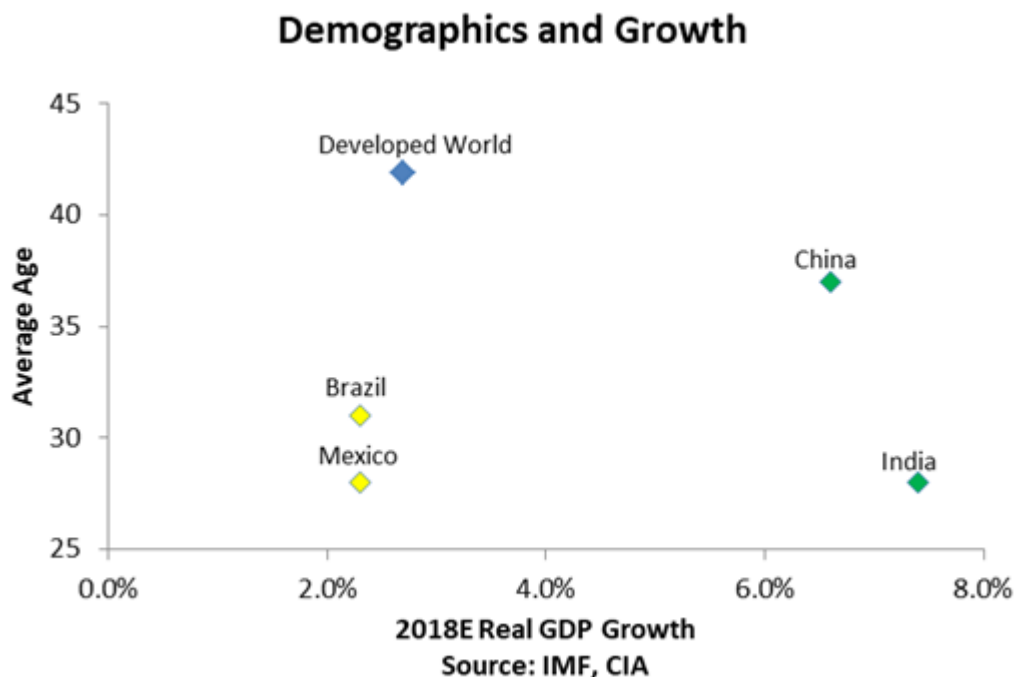
Short-term volatility allows OPCM to invest in long-term structural trends and cyclical recoveries at attractive valuations.

Structural trends driving long-term opportunities include population growth underpinned by favorable demographics and productivity growth supported by increasing use of technology. Demographically,

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India and Mexico, for example, have an average population age of 28, while Brazil and China have average ages of 31 and 37, respectively, compared to 42 for the majority of the developed world. Meanwhile, internet penetration is a proxy for technological development. Major EM countries trail the developed world in terms of internet penetration, where rates run in the mid-80% to low-90% range, compared with rates at 73% in Mexico, 66% in Brazil, 55% in China, and 34% in India. But these rates continue to matriculate higher, providing a structural tailwind to economic productivity via technological tools for businesses to grow and for consumers to demand goods and services.

India and China, supported by structural factors like demographics and technological adoption, have growth that stands out from the developed world, as the chart below shows. Brazil and Mexico have these structural factors supporting them, too, but also have cyclical recovery potential as they both implement new policies to support economic growth and Brazil exits the worst recession in its history.



The 2018 EM decline has led to more attractive valuations. The MSCI EM Index has traded to less than 12x earnings, putting it at around a 30% discount to the S&P 500. Importantly, currency valuations for many EM countries have become relatively inexpensive, with some major currencies like the Brazilian Real trading off more this year than during the 2013 Taper Tantrum.



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OPCM's Advantage

OPCM is well-positioned to capitalize on opportunities created by EM volatility.

A stable client base, partnered with an investment team unemotionally applying a disciplined process focused on the long-term, allows for OPCM to take advantage of forced selling by other investors in times of volatility. This was shown in the second quarter when OPCM initiated an EM position with a multi-year outlook as investors panicked out, spooked by seemingly short-term issues. This has been seen consistently as OPCM cash balances rise as markets get expensive and then fall as the cash is deployed into assets that are on sale.

The flexibility of a multi-asset strategy empowers OPCM to find the best way to take advantage of EM volatility. A positive view on EM can get expressed via investment in a country's overall equity market or a specific industry within Foreign Equity, a currency basket within Alternatives, local currency or US-dollar-denominated debt within Fixed Income, or individual companies traded in the US levered to EM within Domestic Equity, to name a few examples.

Resilience from OPCM's construction of multi-asset portfolios supports opportunistic risk-taking in times of EM volatility. Consider the first half of 2018 when the US dollar strengthened and US interest rates rose, hurting EM assets. Within Alternatives, OPCM has often partially hedged other parts of the portfolio; for example, an investment in the US dollar helps partially hedge Foreign Equities, including EM, while an investment going long interest rates helps offset assets that face pressure from rising interest rates, including EM and Fixed Income. Within Fixed Income, rising interest rates, which may hurt EM in some cases, is mitigated by managing duration, quality, and fixed vs floating rate exposures. Rising interest rates driven by increased inflation expectations and a rising dollar triggered by risk premium due to geopolitical conflict in the Middle East, for example, can help Natural Resources.

OPCM's resilient portfolio construction, flexibility, and unemotional, disciplined temperament enable investment during volatile times in emerging opportunities, taking advantage of other's short-sighted fear.

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