HEDGENORDIC

December 2016

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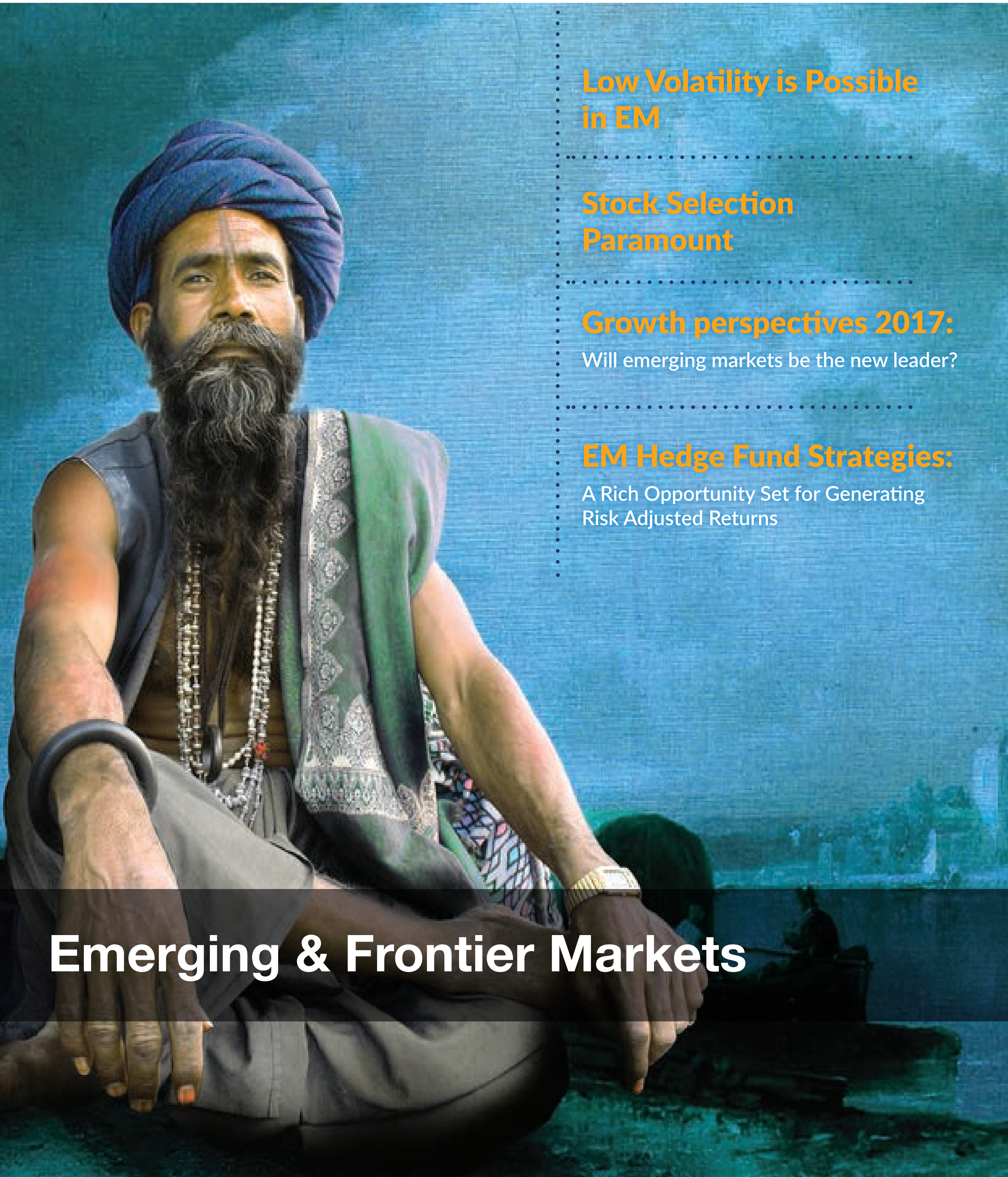

Low Volatility is Possible in EM

Stock Selection Paramount

Growth perspectives 2017:
Will emerging markets be the new leader?

EM Hedge Fund Strategies:
A Rich Opportunity Set for Generating Risk Adjusted Returns

Emerging & Frontier Markets

Contents

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HEDGENORDIC

INTRODUCTION

HedgeNordic is the leading media covering the Nordic alternative investment and hedge fund universe. The website brings daily news, research, analysis and background that is relevant to Nordic hedge fund professionals from the sell and buy side from all tiers.

HedgeNordic publishes monthly, quarterly and annual reports on recent developments in her core market as well as special, indepth reports on "hot topics".

HedgeNordic also calculates and publishes the Nordic Hedge Index (NHX) and is host to the Nordic Hedge Award and organizes round tables and seminars.

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The Editor...

Trumponomics

Paging through this report, it is striking how many articles anchor around Donald Trump. And who would have thought, a US president-elect would be one of, if not - the - dominant theme on an emerging market publication. Were it not for the flamboyant character and personality of Donald Trump - I´d like to think this report (and many, many more around the globe on many, many subjects) would look very different.

Donald Trump's presidency will, with little doubt, have an impact on our world, be it on the political landscape in regards to US relations with Russia, the EU or Mexico, or treaties like the Iran nuclear deal and TTIP to mention a few which again will have effects on the USD, the price of oil and other commodities, inflation and interest rates etc.

If you believe that Trump means more inflation, lower taxes and higher U.S. growth, and if you believe oil prices will stay above $50 which will lead to a commodity rebound, then emerging markets look better than they have in years.

"Trump's election raises overall risk premia in emerging markets, especially for countries with current account surplus," Conrad Saldanha, portfolio manager with Neuberger Berman suggested to Forbes. "Countries that are proposing or implementing reforms, and have good management to see them through, may see strong growth."

On a price-to-book basis, valuations remain at a discount when compared to historical prices in selected emerging, and especially frontier markets. In other words, they are cheap. It may be one of the reasons why George Soros bought emerging markets just prior to the US election, when only few investors wanted those dogs.

One winner of this year's Nobel prize (no, not Bob Dylan) though expresses concerns the former reality TV star may "mess things up" and "be bad for the world economy" Harvard University's Oliver Hart, who won the 2016 Nobel economics prize in economics together with Bengt Holmström of MIT warned against expecting that "Trump will be performing miracles. He could mess things up, but I don't think he's going to suddenly increase the growth rate in some extraordinary way, I think it's beyond his control."

In this publication, we aimed to highlight risks and opportunities in various asset classes, ranging from equities, fixed income, FX and hedge funds and across varios geographies, At HedgNordic we do tend to fancy some of the not-obvious, possibly slightly quirky subjects. Two articles that fall well in line with that tradition in this publication are the features on Irak and Pakistan, which make intriguing reads!

We leave you with this and from the HedgeNordic team would like to take the opportunity to wish you a very merry, joy- and peaceful Christmas time, and to send you the very best wishes for a happy, healthy and prosperous New Year.

Kamran G. Ghalitschi
CEO / Publisher HedgeNordic

Growth perspectives in 2017: will emerging markets be the new leader?

By **Mathieu Nègre,** *Head of Global Emerging Equities - Union Bancaire Privée*

As we get closer to the end of 2016 it may indeed be a good time to review 2017 earnings expectations for emerging markets (EM). Based on consensus estimates published on Bloomberg, EM will have the strongest earnings growth in 2017 with 14% compared to 12%, 13% and 7% in the US, the EU and Japan respectively. Within EM, the strongest growth is expected in the EMEA region with 16%, followed by Latin America at 15% and Asia at 13%.

At first glance, EM's 2017E earnings growth of 14% may seem to be something of a deceleration compared with what happened in 2016. However, an important point to note is that all of 2016's EM earnings growth came from 2015's loss making companies turning out profits once again. In fact, excluding this effect and looking only at companies with positive earnings, 2016 was the third year in a row since 2013 when net profits actually declined. 2017 will be the first year since 2013 where there is a real expectation of earnings growth using this measure.

At an individual country level, there are significant differences within EM for 2017 earnings growth expectations. For example, among the larger countries, the strongest earnings growth is forecast to be in South Africa, India and Mexico with 25%, 22% and 20% respectively while only single digit earnings growth is anticipated in Malaysia, Philippines and Thailand. In between these two groups lie China, Brazil and Russia where earnings are projected to grow by around 13-15%.

In terms of sectors, the strongest earnings growth in EM is expected in energy (27%), industrials (22%), IT (21%) and healthcare (20%). These are closely followed by consumer discretionary, staples and telecom services with earnings growth expectations of around 18%. The forecast outcomes are at their most pessimistic for materials, utilities and financials where earnings are expected to grow only by 2%, 1%, and 8% respectively.

Clearly, these projections will face significant revision over the next several months as the new US administration begins to clarify its economic priorities. It will take some time for the implementation of these policies to happen and even longer for analysts to revise earnings expectations. As of the time of writing there are still far too many uncertainties around the new direction of US economic policy. However, it is still possible to discuss some of the upside and downside risks to earnings expectations based on what is already known.

One clear promise of the Trump campaign was a boost to infrastructure investment financed by fiscal expansion. That is likely to present an upside risk to earnings expectations for the materials sector and commodity producers like Brazil, South Africa and Russia. One notable

negative particularly related to Russia is oil whose price faces a possible negative impact from Trump's plans to increase US shale production. For the same reason, the energy sector in EM could see earnings downgrades.

> **"At an individual country level, there are significant differences within EM for 2017 earnings growth expectations"**

Another clear message of the Trump campaign was the call for controls on immigration and international trade. There is a wide range of policy options here starting from relatively light and low cost measures like naming trading partners as currency manipulators, to difficult and costly changes like implementing across the board import tariffs. Each of these measures could impact earnings negatively in varying degrees. While it is impossible to make a prediction at present, the most obvious countries facing the risk of earnings downgrades are Mexico, South Korea and Taiwan, while large countries with relatively little export dependency like India, Brazil and Indonesia would be relatively less affected.

The scope and severity of trade restrictions are likely to be limited by the fact that any trade restriction also has a cost for US consumers and corporates. This raises the danger of adopting an overly-pessimistic view of EM exporters based on unrealistic scenarios. It is important to remember that over the last several years intra EM trade has expanded and the region as a whole is less dependent on trade with the US. Ongoing rebalancing of the Chinese economy with a strong growth of services and consumption could help to alleviate any potential negative shock from US actions.

The interest rate environment could well be another factor weighing on EM countries. An extended period of fiscal expansion in the US could lead to higher rates which would negatively affect earnings growth in countries dependent on external funding. The two names that stand out with large current account deficits are Turkey and South Africa.

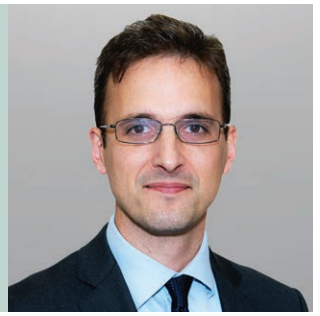
Finally, exchange rates are also likely to play an important role in any potential earnings revisions. During the week following the election, the JP Morgan EM currency index lost more than 4% of its value against the USD. Beyond this headline number there is a wide range within EM countries depending on perceived currency vulnerability. For obvious reasons the Mexican peso was the worst effected, losing 12% of its value against the USD during the same period. The peso was followed by the Brazilian real and the South African rand, two high yielding currencies favoured by carry traders before the elections, which lost more than 8% of their value. In these countries we are likely to see downward earnings revisions for those companies with high levels of FX debt or large import costs whereas there could be upward revisions for exporters. At the other end of the spectrum are countries like India and China where the currency move was not significant.

One important difference between this potential USD strength versus previous crisis periods in EM like 1994 and 1997 is that unlike those times most currencies are now free floating and adjust quickly to changes like the current cases of Mexico, Brazil and South Africa. The weakness in these currencies has already made those countries more competitive and has partly offset the cost of a potential increase in tariffs.

> **"even though the earnings picture of 2017 is somewhat uncertain at the moment, the earnings recovery that started in EM in 2016 is likely to continue in 2017"**

In summary, even though the earnings picture of 2017 is somewhat uncertain at the moment, the earnings recovery that started in EM in 2016 is likely to continue in 2017. A key assumption behind this view is that any US restrictions on trade are likely to be limited in scope due to their potential negative impact on US corporates and consumers, while the new administration is likely to go ahead with a significant fiscal expansion plan. This may lead to intra-EM and intra-sector shifts in earnings away from countries and corporates dependent on exports to the US and high FX debt towards companies benefiting from higher commodity prices, cheap currency, low debt and growing domestic consumption. EM equities as an asset class will continue to present an attractive exposure to the likely reflation trade and to EM's domestic demographic strength.

Mathieu Nègre,
Head of Global Emerging Equities - Union Bancaire Privée



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By Joel Kukemelk, CFA, Fund Manager of SEF-LHV Persian Gulf Fund

Saudi Arabia – new cornerstone to emerging markets

Saudi Arabia is the biggest and most influential member of the six-member Gulf Cooperation Council (GCC) that was created back in 1981 and whose member states' currencies are pegged to USD. In total roughly 50 mln people live in the GCC, around 700 companies are listed on the local stock exchanges and aggregate market caps stack up to roughly $1 trillion with Saudi Arabia making up around 40% of that.

During the last couple of years Saudi Arabia has grabbed a lot of attention. Let me bring out 5 more important ones in the chronological order:

1. Firstly, orchestrating OPEC's all-out oil production war starting from September 2014 which later on resulted in the collapse of oil prices and the resulting demise of US shale oil with US losing 1 mln barrels/day of oil production. Two years later they have switched sides in this table by strongly advocating for agreeing on first OPEC oil production cuts in the last 8 years during OPEC's next official meeting on November 30th. They have even gone as far as trying to include non-OPEC members like Russia, Brazil and Mexico in these talks.

2. Secondly, Saudi has been active military-wise both in Yemen and in opposing Assad's regime in Syria and regional-wide ISIS activity. At the same time tensions with its archrival Iran have seamed to ease somewhat as Iran came out of international sanctions in the beginning of 2016.

3. Thirdly, Saudi Arabia has swiftly adopted National Transformation Program 2020 (NTP 2020) with the ultimate goal of greatly reducing its dependence on oil exports, increasing non-oil revenue at least 3 times and achieving a balanced budget even in the environment of today's depressed oil prices. Budget break even oil price has very quickly dropped from around $100/barrel to around $60/barrel.

4. Fourthly, in October Saudi Arabia successfully issued maiden $17.5 bn of international debt (largest ever issue for an emerging market), which was almost 4 times oversubscribed, enabling them to reduce domestic liquidity crunch and pave way for additional debt issuances down the road and warm up investor relations for the impending IPO of 5%-10% of Saudi Aramco that's supposed to come to the market sometime in 2017 or 2018 with total proceeds somewhere around $100 bn for that stake sale making Saudi Aramco potentially the first trillion dollar public company in the world. Since Saudi's debt level is very low and forecasted to rise from 8% of GDP to somewhere around 30% by 2020 then investor interest has naturally been high for that debt.

5. Fifthly, Saudi Arabia has taken steps to standardise (moving settlement cycle to T+2 from current T+0 sometime in 2017) and open up it's stock market for all foreign investors and to become an important part of MSCI Emerging Market Index. The list of actual reforms (including implementation of GCC-wide VAT tax from 2018, cuts in subsidies and cancellations of one-off payments etc) goes on but I'll stop here right now.

Oil production and (re-)unification of OPEC

Most important development for Saudi Arabia and the whole of GCC is right now the re-unification process of OPEC oil cartel. It's pivotal that OPEC follows through on its promise to formally announce production cuts during their November 30th meeting. Despite abundant skepticism that OPEC is „dead", unable to agree on production cuts and without any control over the oil markets I hold a different view. When it comes to an oil cartel that controls 1/3 of global energy markets one should never underestimate it's true pricing power, especially when they're starting to feel the effects of low energy prices in their everyday activities and finances.

Even without any cuts to oil production the oil market has by now almost entirely worked through the market overcapacity and declining energy sector capex for the third year in a row almost guarantees higher prices to come due to underinvestment. But right now it seems that OPEC and Saudi Arabia are keen on hastening the oil market balancing process and re-rating of energy prices to some extent.

MSCI Emerging Market Index

Most likely Saudi Arabia will be put under review for MSCI Emerging Market classification during MSCI's semi-annual review in May 2017. If equity market reforms proceed as planned then it's very likely that this review will end with a positive decision in May 2018 with inclusion becoming effective in June 2019. Saudi Arabia will likely form ca 3%-5% of MSCI Emerging Market index depending on new listings to come in between and the degree of openness for the entire Saudi stock market. Since Qatar and the United Arab Emirates are already in the MSCI Emerging Market index with a total combined weight of roughly 1.7% then in 2.5 years time GCC will start to form more than 5% of global emerging markets resulting in huge both active and passive investor fund inflows.

SEF-LHV Persian Gulf Fund

Luxembourg-domiciled SEF-LHV Persian Gulf Fund has been investing in GCC equity markets since 2008. The fund is long-only and fully hedges USD currency risk to get the underlying equity markets performance in EUR terms. Fund's Bloomberg symbol is SELHPGA and it's available on all major Scandinavian fund platforms and due to its UCITS structure investable for all investors in Europe. The main objective of the fund is to benefit from the long-term trend of energy rich GCC countries pumping out their energy reserves and investing it back into the diversification of their local economies – therefore the bulk of fund's investments are in financials, industrials and business services companies. GCC countries own 45% of world's oil reserves and 20% of world's natural gas reserves.

As of end of October fund portfolio's single investments traded at weighted average of just 9.2x twelve month forward looking earnings, 1.1x trailing book value and offered 4.7% dividend yield. Valuations haven't been this cheap in the region since the financial crisis of 2008/2009. This means that any return of investor confidence in the region will likely result in meaningful rally in GCC across all risk assets.

Joel Kukemelk,
CFA,
Fund Manager of
SEF-LHV Persian
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Trump and Dump or Buy the Dip?
Emerging Market Equities in a New World

by Jonathan Furelid – HedgeNordic

Following the election of Donald Trump as U.S. President, emerging markets have responded negatively. Is this a knee-jerk reaction to the increased uncertatinty surrounding Trump's presidency or can investors expect more long-lasting negative effects in these markets? According to GAM's emerging market investment director, Tim Love, the attractive outlook for the asset class holds but protectionist comments from the US cannot be ignored.

"I was bullish on emerging markets before Trump and I am definitely bullish on emerging markets post Trump. I think the risk profile, following the election result, has changed but the underlying support structures of the markets have not. Emerging markets are well supported, that applies to equities, currencies as well as to credit", says Love when expressing his overall market view.

The backdrop – an attractive asset class

According to Love, not much has changed to the positive dynamics underlying the emerging market space post Trump. "It is an asset class that is extremely attractive to value players at 1.2-1.3 price to book, it is equally attractive to growth players at less than one time PEG (price/earnings to growth) and it should appeal to yield players at a free cash flow yield of 8-9 percent, a dividend yield of 3.5 percent and a positive carry trade which should be in the range of 2-2.5 percent for most commodity currencies", Love says continuing: "The fact that nine of the ten top emerging markets are at investment grade or better and that in aggregate they are misrepresented by the index weightings when compared to the real market cap of emerging markets in the world, makes it a highly interesting investment."

Love stresses that the misrepresenation of emerging markets in global equity indices remains a major catalyst for the asset class going forward. "With the index weight for emerging markets currently being around 9-10% whereas the GDP weight is more like 48%, that gives you a hint of the potential money flows that could come into the asset class in a bullish environment."

Appealing risk return characteristics

Love highlights that the risk/return relationship for investing in emerging markets is particularly favorable, and foresees a huge potential for EM stocks in the coming years. "The risk/return characteristics for emerging markets is prospectively very positive. Over the next three years, I foresee a 90 percent up-move in a positive scenario and 15 percent down in a negative one. You might find that mad but bear in mind that in 2004-2007 these markets went up by close to 400 percent, and at the same time that period marked the starting point of an FOMC tightening cycle."

According to Love, a similar development in today´s environment is not far-fetched. "How on earth did these markets manage to go up so far back in 2004? It is the same argument that is present now", he argues.

"If you have earnings which are no longer negative but modestly positive at around 2% and potentially going to 14%; dividend yields at 3.5%; and multiple expansion of 12x prospectively going to 15x; then there is significant upside potential. Emerging markets are currently trading at a big discount to the S&P. At the peak of the cycle these markets were trading at a premium." – "If we go from a multiple of 12x to 15x over three years that gives us an upside of 35-40%, in addition to the 3.5% dividend yield each year for three years, plus 15% earnings times three years. The end result is close to the 90% I mentioned earlier."

> **"I was bullish on emerging markets before Trump and I am definitely bullish on emerging markets post Trump."**

The downside risks Love sees as being limited, given that EM companies are in much better shape today than they were in previous cycles.

"Talking about individual companies in emerging markets, their balance sheets are incredibly strong compared to what they have been in previous cycles and 60% of the index is actually free cash flow. You have an index that is able to withstand a lot more negativity at individual stock level than it has in previous periods."

According to Love we are heading into a period with similar characteristics to that of 2004-2007, triggered by multiple expansion and "risk-on".

What about trump effects?

Trump's ability to execute pro-growth measures is something that Love highlights as having a direct impact on emerging markets. The short-term effects have been a sell-off in currency carry trades on the back of expectations of a steeper yield curve and a stronger dollar. The so-called bond proxies in equity markets have also suffered.

"Trump has an incredible ability to execute. His initial remarks are very simple: lower tax, fiscal expansion and less regulation. One initiative is likely to be to bring back money from US corporates with tax hits on cash piles held abroad. That alone could potentially bring in 300 billion USD, which could go into infrastructure projects and have a multiplier effect on the US.

"If this is the case, great. There will be improved growth figures and an element of inflation translating into higher inflation and a steeper yield curve. A steeper yield curve, in turn, translates into an expectation of the US dollar to be stronger for longer. A stronger dollar will challenge the carry trades, which have sold off in the wake of Trump. Also, so-called bond proxies have been challenged in anticipation of a steeper yield curve. There has been a fairly steep sell-off in some sub-sections of the bond proxies, for example telecommunications and utilities", Love argues.

Tim Love, GAM Emerging Market Investment Director

> **"None of the underlying factors that I see driving EM growth have changed."**

Despite these short-term effects, Love sees the underlying factors driving EM growth as being intact.

"None of the underlying factors that I see driving EM growth have changed, all that has happened is that the expensive defensive stocks and the bond proxies have come down whereas cyclical stocks look relatively more attractive. This is a view we have held throughout the year and I think this trend is likely to continue. – "Less liquid higher growth markets that have acted as non-correlation plays, such as frontier markets, I think will continue to do well. There is a rotation post-Trump away from expensive defensives."

Things are not all rosy however and Love stresses that the protectionist views communicated by Trump could have a significant impact on emerging markets if executed.

"I cannot avoid the protectionist comments coming out of the US because they are so fundamental. If Trump puts up tariffs and quotas and the US withdraws from key policy agreements such as the Paris accord, it will have tremendous implications. – "What I do look for are markets that are less likely to be affected by increased protectionism. In this context I see Brazil, Argentina, Southeast Asia, and domestically-orientated sectors within China and India as interesting markets, as opposed to export-oriented countries linked to the US such as Korea or Taiwan."

EURIZON CAPITAL'S CAUTIOUS, HEAVILY HEDGED, APPROACH

Emerging markets bonds are more volatile than developed markets bonds, with local currency debt more volatile than hard currency debt, which is still more volatile than most developed market government debt. But by focusing on shorter duration bonds, and hedging most or all of currency risk, it is possible to eliminate around 80% of the broad EM bond benchmarks' volatility.

***by Hamlin Lovell,** HedgeNoridc*

Low Volatility is Possible in EM

Currency Hedging

For example, Epsilon Fund Emerging Bond Total Return, a Luxembourg sub-fund created by Eurizon Capital S.A. and managed by Epsilon SGR, has recently had annualised volatility of below 2%, thanks to duration, around one year, well below the eight or nine year duration of the JP Morgan EM Bonds Index. And the majority of FX exposure is hedged. Very few EM bonds are originally issued in Euros, so the strategy hedges either US dollar, or local EM currency, bonds back to Euros. Monthly, 99% Value at Risk is, in November 2016, approximately 1.5% but would be as high as 2.5% if currency hedges were removed, the fund manager calculates. Epsilon Fund Emerging Bond Total Return has also been de-correlated to both short term Euro bonds, and EM bonds.

Costs of Investing

Naturally, hedging reduces potential returns as well as volatility. For instance, the sub-fund currently has a yield to maturity, forex hedged, of only 1.6%, which is expected to provide the majority of returns as the fund mainly takes a 'buy and hold' approach. Given low yields on most short maturity bonds, costs are crucial. The UK FCA regulator's Asset Management Report, released in November 2016, has raised concerns about both the level, and the transparency, of fund costs. Witness some funds in the EM space with Ongoing Charge Ratios (OCRs) that could eat up most or all of their yield. In contrast, the sub-fund's relatively low costs have helped it to outperform peers. Epsilon Fund Emerging Bond Total Return's institutional class charges a management fee of 0.25% and has an OCR of around 0.40%. These fees seem commensurate with the volatility and return targets. Though Epsilon Fund Emerging Bond Total Return fees look low for a fund, they are closer to typical fees for macro, currency, and GTAA overlays, where fees are explicitly calibrated to volatility targets.

"The de-globalisation trend has already started, with a plunge in global trade"

Tactical Positioning and Default Risk

While neutralising most of the EM bond indices' interest rate and currency risks, it is possible to retain some flexibility to take tactical positions, which have contributed around one third of the product's returns since inception in 2008. Though Head of Discretionary and Total Return Investments in Epsilon SGR, Luca Sibani, has final veto; Forex Specialist, Gianluca Cagnazzo, is responsible for tactical FX exposures; Corporate Analyst, Andrea Mambretti, covers corporate debt, and corporate and EM Trader, Francesco Maiolo, handles trading.

Within tight constraints, and an over-riding ceiling of 3% on the monthly, 99%, VaR figure, Epsilon Fund Emerging Bond Total Return can vary interest rate, currency and credit exposures. So, interest rate duration over the past 8 years has ranged between zero and two years, while non-Euro currency risk has ranged from 10% short to 15% long. And corporate debt is currently capped at 15%.

"Argentina is a turnaround story and together with Brazil will emerge from recession next year"

Though emerging markets investment grade (IG) bonds offer higher yields than most developed market IG debt, after hedging back to DM currencies the yields on short-dated IG debt are in low single digits. Therefore, many investors will selectively invest in some sub-IG debt for extra yield. For example, the sub-fund invests up to 30-40% in sub-IG and currently has around 30% in sub-IG, with 60% IG and 10% liquidity.

Sub-IG debt has higher default risk and this matters more than market risk for buy and hold investors. Some investors dismiss sovereign defaults in EM as a rare occurrence, with only Argentina, Ecuador and the Seychelles over the past 15 years. However, on longer lookbacks, there have been plenty of defaults and many providers of market intelligence use multiple indicators to try to gauge default risk. Supranational government agencies, such as the World Bank and IMF, are closely monitoring EM assessing their external vulnerability as well. When you add political stability indicators, and feed into Epsilon's scoring model, the result is a ranking of EM countries. In late 2016, the worst ranked countries include Lebanon, Venezuela and Belarus. "None of the worst ten countries are present in the portfolio for default risk reasons" confirms Sibani.

Quasi-sovereigns can offer some yield pickup over sovereigns, though many of them are perceived as carrying little or no extra risk as "they must be explicitly guaranteed by a sovereign" Sibani points out. Examples include specific oil companies in Mexico, banks in Brazil, and import/export banks in India, China and Turkey.

Does Trump Matter in a Multi-Polar World?

President-elect Trump's rhetoric around some emerging markets has alarmed some investors, but Sibani does not think that the new administration will lead to a new departure for EM. "The de-globalisation trend has already started, with a plunge in global trade" he says. The management team of the sub-fund feed into the process and their perspective is that we are moving towards a multi-polar world. Even if the US does become protectionist, "some EM countries, like Brazil and Argentina, have very limited trade linkages with the US. They can improve their exports to China and are also improving internally. Argentina is a turnaround story and together with Brazil will emerge from recession next year" Sibani observes.

Luca Sibani, Head of Discretionary and Total Return Investments, Epsilon SGR

Indeed, EM has staged a strong rebound in 2016, partly due to base effects and partly due to the recovery in commodity prices. The fund manager remains constructive on a number of currency and bond markets. Valuations and fundamentals support the Mexican Peso and the Russian Rouble, while the Indonesian Rupiah and Indian Rupee offer the added attraction of reform-minded leaders. The portfolio's long EM currency exposures are mainly funded through G10 currencies, such as USD, EUR and JPY, and relative value positions within EM FX can also be traded.

Low Volatility, Liquidity and Valuation

The EM fund universe contains a wide variety of funds, including those with total return (such as Epsilon Fund Emerging Bond Total Return), absolute return, target yield, and benchmark-relative, return objectives; and those taking varying degrees of interest rate, credit, currency, and liquidity risk. As such, it is not straightforward to identify fully comparable peer groups. But Epsilon Fund Emerging Bond Total Return is distinguished by prioritising low volatility and has been an exceptionally consistent performer, delivering positive returns every calendar year.

EM can contain exotic instruments, ranging from GDP-linked warrants to commodity linked bonds, from municipal debt to Paris club claims and from bilateral loans to trade finance deals. Some of these may have low volatility because they are 'level 3' instruments, valued by being 'marked to model' rather than being marked to a liquid market price. This sub-fund sticks to "plain vanilla instruments. Bonds must be publicly traded, must be rated, and display a minimum market capitalisation of $300 million" Sibani states. The team runs various mandates including currency funds, emerging market bonds and absolute return funds.

Checkmate for India corruption

*by **Jonathan Schiessl**, CIO and Lead Fund Manager – Ashburton India Equity Opportunities Fund and **Simon Finch**, Fund Manager – Ashburton India Equity Opportunities Fund*

As the pawns were being readied for battle in New York ahead of the World Chess Championships, Indian Prime Minister Modi opened with his own strategy to defeat the black market. Demonetisation, as it has become known, entered common parlance following Modi's cancellation of over 85% of India's cash currency by value in November. This was seen as a startling move for some while others have noted that this is yet another step in Modi's battle to confront corruption in the country.

In a week when Donald Trump became US President-elect and Modi pushed ahead with his measures, it was evident that both chess grandmasters were cognisant of politics outside of their soundproof box. Sergey Karjakin looked to start with an Indian Defence while Magnus Carlsen playfully opened with the Trompowsky attack. Modi's move is far from defensive as he tackles corruption in the "informal" economy head-on. Estimates on the size of the black economy range from a third up to parity with the formal market. The move to eradicate the 500 and 1000 rupee notes augurs well for the longer term growth potential for the world's fastest growing major economy despite causing significant short-term pain. Transactions will be forced to use electronic platforms from which the government can better analyse and tax money flows, providing a sustained boost for the country's fiscal account.

Modi's political gambit ahead of significant elections in 2017 relies on the clinical execution of the demonetisation programme. It is estimated that more than 90% of transactions in India use cash, one of the highest figures globally. With the announcement coming at the start of the wedding and sowing seasons, both heavily dominated by cash transactions, many commentators called this move ill-conceived at best. Modi campaigned for his election just over two years ago on a platform of delivering economic growth and stamping down on corruption. The hope of delivering the former was given a short term hit in his attempt to deliver the latter.

Just a week after the announcement, Ashburton India Equity Opportunities Fund Managers Jonathan Schiessl and Simon Finch travelled in India to see the implications of the move first-hand. They spoke to the people on the ground across sectors and demographics to understand the impact on their lives. The consensus was supportive although it was at the very early stages of possibly one of the most unorthodox and radical (if not downright brave) policy reforms in India's history.

"The price for Indian equities has just become significantly cheaper, whilst the longer-term roadmap becomes that little bit more rewarding"

It can be argued that the pawns in this piece are those in the rural communities who are feeling the pinch more acutely, especially given the high-transaction volumes of cash payments for items such as seed and fertilisers. The reaction from farmers has been supportive of the clampdown, however, if the negative effect on their livelihoods persists then this could have adverse implications on the upcoming election in Uttar Pradesh (UP) in January 2017.

With a population close to that of Brazil (c.205 million), the January election in UP will see more than 15% of India's population heading to the election booths. A win, or at least a strong showing from Modi's Bharatiya Janata Party (BJP), will build momentum ahead of four other elections in the year and more importantly dictate the trend leading into the 2019 general election.

"Estimates on the size of the black economy range from a third up to parity with the formal market"

In the interim, discretionary expenditure was hit hard by the announcement but more concern was focused on the lasting impact to real estate where the presence of black money is perhaps most evident. It is simply too early to tell but life was slowly getting back to normal in the everyday sense during our time in India. The impact to property and other areas will become more evident in the first half of 2017.

While the Indian rupee took the news in its stride and Indian bond yields actually fell in those opening weeks, equity markets took the news less well, particularly the small and mid-cap stocks which are the favoured area for domestic investors. Is this forced selling to raise liquidity due to losses from demonetisation? Perhaps, but the short term hit to growth will certainly stall the earnings recovery that was slowly becoming evident.

Demonetisation is deflationary, and at the time of writing, the bond market was pricing in further interest rate cuts in early December. In addition, the massive one-off expected bonus for the government from the disappearance of so much black money will very likely lead to some significant stimulus measures from the government.

Modi's political imperative is re-election and to be seen to enact measures both to help the poor for their inconvenience and boost infrastructure spending, thereby creating jobs, will help his chances. The fact that the annual budget has been pulled forward to the beginning of February is a clue, but we would expect news before this date.

The Ashburton India Equity Opportunities Fund is aligned to benefit from the strong domestic potential that India offers and has been positioned to offset some of the immediate volatility ushered into the market with Modi's announcement. The concentrated portfolio of less than 30 stocks has at its core a focus on companies with strong corporate governance offering sustained and credible earnings growth.

India's equity market is the oldest in Asia, founded on a solid legal framework that recognises the importance of equality across the shareholder group, ensuring particularly that minority investors are treated fairly. We believe that India has significantly differentiated itself from the recognised emerging market peers in terms of quality across a number of sectors, providing the opportunity to invest in a number of first-class companies. India will for these reasons likely be the leading emerging market maintaining that position for many years to come.

"Is the India story finished? Certainly not, rather just delayed by a quarter or two"

So, after a momentous 2016 for India with significant reform achieved domestically, 2017 will all be about implementation, economic growth, local elections and of course Donald Trump.

Only in 2017 will we find out the success or failure of Modi's dramatic demonetisation move. There will undoubtedly be a short term hit to growth and earnings but the key will be how his party performs in important upcoming state elections.

The impact of Trump on India remains to be seen, but we believe the country will remain a core focus of the US. The Indian stock market has taken some pain following demonetisation and worries over Trump, resulting in more attractive valuations.

Is the India story finished? Certainly not, rather just delayed by a quarter or two. As investors, all we can control is the price we are willing to pay for an asset. The price for Indian equities has just become significantly cheaper, whilst the longer-term roadmap becomes that little bit more rewarding.

Jonathan Schiessl
CIO and Lead Fund Manager – Ashburton India Equity Opportunities Fund

Simon Finch
Fund Manager – Ashburton India Equity Opportunities Fund

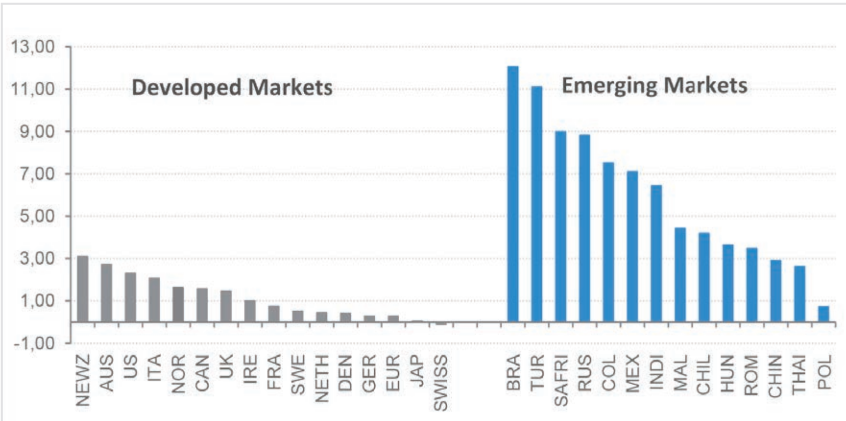
AN UNCONSTRAINED MANAGER'S OUTLOOK FOR EMERGING MARKET DEBT

by Ivailo Vesselinov & Damien Buchet, Finisterre Capital

Are emerging markets (EM) doomed in a post Trump election world? Contrary to conventional wisdom, the answer continues to be a resounding "no." The attractive yields and ample diversification opportunities across the EM universe cannot be ignored. Moreover, EM debt has delivered generous returns over the past decade and has generally outperformed various developed market (DM) assets in volatility-adjusted terms.

The table below shows that 10-year government bond yields are higher for emerging markets than for developed markets.

10-YEAR GOVERNMENT BOND YIELDS (%)



Data as of 18 November 2016. Source: Bloomberg, Finisterre Capital.

Despite attractive yields and a history of outperformance, investors remain structurally underinvested in EM debt. EM economies account for 40% of world output, having doubled their share since 2000. EM debt represents 11% of total global securities[1]. At the same time, average portfolio allocations to EM remain far below its 11% market share. This implies there is plenty of room for rebalancing in the years ahead.

Adding to the favourable mix, robust macro fundamentals and cheaper valuations in EM have been coming into sharper focus for investors. The positive EM/DM growth differential, which historically has been the most important driver of capital inflows to EM, is likely set to widen again this year after five consecutive annual declines.

IGNORE THE HEADLINES

A common misconception about EM debt has been the fear that capital inflows to the asset class will reverse in the face of monetary policy normalisation in DM. Our view is that a lot of the conventional wisdom on EM is now outdated and potentially misleading. Given high yields, historical returns, improving growth prospects, and more attractive valuations, the concerns about traditional "sudden stops" in capital flows from EM no longer seem relevant.

Ivailo Vesselinov, Chief Strategist and **Damien Buchet,** Total Return Strategy CIO, at Finisterre Capital an affiliate of Principal Global Investors, explain why an unconstrained approach to emerging market debt is an opportunity to provide attractive returns.

Retail bond flows into EM fell in early 2016 below their pre-QE trend level, which we highlighted at the time as a sign that whatever Fed-fuelled excess liquidity had entered the market in temporary search for yield had now exited, leaving far cleaner technicals that helped to set up the subsequent EM debt rally.

A similar but smaller-scale phenomenon seems to be replaying now, as some of the excess inflows into EM unwind in the face of heightened political uncertainty in the U.S. and Europe. In this yield-starved environment there appears to remain a solid underlying trend for rising long-term strategic investments into EM. Institutional bond flows have enjoyed an uninterrupted steady increase over the past decade and have long surpassed retail flows. To put matters into perspective, bonds represent only 11% of total capital inflows into EM, while foreign direct investment (FDI) makes up 48%[2] which means overall capital flows to EM have been far more diverse and resilient than investors have been led to believe.

EMBRACING THE CHINA OPPORTUNITY

Another widespread and often misplaced concern about EM debt has been the perceived role of China's economic slowdown, as well as the surge in its domestic credit and the decline of its official foreign exchange (FX) reserves. However, what often goes unmentioned is that China's overall debt levels remain below those of many of its regional peers, such as Malaysia, Korea, Hong Kong, and Singapore, where the markets remain relatively optimistic. Moreover, much of the recent capital outflow from China has gone toward repaying short-term external debt, which is a finite and self-limiting process that we believe actually strengthens the medium-term outlook for the economy.

> **"Our view is that a lot of the conventional wisdom on EM is now outdated and potentially misleading."**

Capital outflow is also perfectly natural for an economy in China's position, which still has infinitesimal foreign portfolio assets and accounts for only 10% of global bond and 12% of global equity markets, despite its far-larger economic share[3]. Perspectives play an important role; while in the U.S. the overriding concern might be about Chinese yuan devaluation leading to global deflation. In U.K. or the Nordics, investors might be fretting that current FX purchase allowances for Chinese residents create a hypothetical total capital outflow over 20 times the size of official FX reserves. In China, the key question seems very different: "where and what should we buy next?" The various viewpoints carry very different implications for EM assets, providing opportunities on both the long and short side.

BUY-AND-HOLD INVESTORS PROVIDE RESILIENCE

EM debt now appears to benefit from much more stable ownership patterns, thanks to a diverse universe of investors with varying risk profiles, objectives, and investment time horizons. Buy-and-hold investors are playing an increasingly important role in determining the overall price action, whether due to ALM-driven considerations on matching a stream of liabilities, long-term accounting objectives that drive a focus on income, sensitivity to capital charges associated with credit quality (for banks and insurers), or simply an inability to deal effectively with FX risk.

> **"much of the recent capital outflow from China has gone toward repaying short-term external debt, which we believe actually strengthens the medium-term outlook for the economy"**

When it comes to active EM-dedicated investors, the large majority of EM mutual funds are benchmarked, with around half focused on hard-currency sovereign debt, which represents only 9% of the investable EM fixed-income universe.[4] We believe it is only a question of time before these skewed investment patterns are adjusted. Meanwhile, hedge funds appear to be migrating towards the most liquid parts of the market, or alternatively to explore opportunities in orphaned or under-researched EM debt assets.

AMPLE LIQUIDITY WHERE IT IS NEEDED

Reduced bank trading activity, typically due to higher capital charges and the surge of buy-and-hold investors, has undoubtedly made market liquidity conditions more challenging for EM and fixed income in general. However, the market's need for liquidity in EM also seems to have declined. Liquidity-rich pension funds and insurers have a long-term focus on income and generally are largely unaffected by the recent structural changes. Similarly, central banks and sovereign wealth funds have the ability to hold EM local assets through bouts of FX volatility; many of these investors' potentially realised EM FX losses are more than offset by USD gains.

> **"...hedge funds appear to be migrating towards the most liquid parts of the market, or alternatively to explore opportunities in orphaned or under-researched EM debt asset"**

These technical trends appear to have resulted in a "clustering" of liquidity by market segment. Specifically, hard-currency EM benchmarked funds tend to focus on sovereigns, quasi-sovereigns, and large corporates only, while hedge funds seem to have migrated toward derivatives, liquid sovereigns and quasi-sovereigns, and distressed credits. As a result, trading volumes in hard currency and local market bonds have generally remained stable since the global financial crisis. In other words, despite all the regulatory and structural changes, there appears to have been no significant impact on active investors in EM debt, who seem to have adapted to the new liquid environment. Adaptability is likely to remain key to capturing the attractive opportunities on offer across the rapidly evolving EM debt universe.

"EM debt stands out as offering attractive high yields and diversification opportunities for Nordic investors in today's world of ultra-low and negative policy rates," says Jeroen Van Rooij, Managing Director, Country Manager Sales Benelux & Nordics, at Principal Global Investor".

He continues: "Capturing EMD's returns require specific analysis of idiosyncratic dynamics within economies – and both the fundamentals and the technical are important. Finisterre Capital's investment process aims to capture the attractive carry on EM assets, while generating additional returns through market timing on liquid bonds and derivatives.

Their flexible 'all-weather' strategy is designed to deliver an optimal Yield-Liquidity-Volatility profile throughout the market cycle.

We believe the market is potentially at an attractive entry point for investors considering adding exposure in EM."

1) and 2) ICBCS, Finisterre Capital as of December 2015.
3) JP Morgan as of December 2016.
4) Bank of America Merrill Lynch as of November 2016.

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HEDGENORDIC

INDONESIA under the hood

Finnish asset manager JOM sees untapped potential in smaller companies

BY JONATHAN FURELID

Indonesian equities have seen a resurgence of foreign asset inflows in 2016 acting supportive for larger companies in particular. With the domestic demand-driven economy showing strength under a new reformist political leadership, Finnish asset manager JOM believes the time has come for companies outside the broad index to play catch-up.

”Asset flows have returned to Indonesia during the past year, but most of these flows have come through ETFs, translating into a rally in larger companies that make part of the broad equity index. At the same time, valuations for small- and mid cap companies in Indonesia are still at 50 percent of what they were in 2013”, says Juuso Mykkänen, portfolio manager at JOM Fund Management, a Finnish asset manager focusing on emerging and frontier markets.

Through its Asia focused Silkkitie Fund & Indonesia focused Komodo fund, JOM has been actively investing into Indonesia since 2009. By combining thematic macro analysis with fundamental analysis of individual equities, JOM seeks to identify companies that could benefit from structural growth drivers. According to Mykkänen, the current macro backdrop for Indonesian companies looks very compelling.

FAVOURABLE DEMOGRAPHICS DRIVING GROWTH

”First of all, Indonesia is the fourth most populated country in the world with 250 million people where 45 percent is younger than 30. It is not a very export dependent country, exports only account for 16 percent of GDP (in 2015), which is very low compared to other Asian countries such as Korea, Thailand or China”.

The fact that Indonesia is focused on domestic demand rather than being dependent on the global demand picture, is something that is likely to play in the hands of Indonesian companies for the years to come, Mykkänen argues. ”The Indonesian economy is structurally benefiting from a growing middle class population, structurally foreign direct investments given low wages and from a reformist political leadership that is looking to support continued growth.”

“Valuations for small- and mid cap companies in Indonesia are still at 50 percent of what they were in 2013.”

Juuso Mykkänen, Portfolio Manager, JOM

As the middle class population grows, Mykkänen sees a number of sectors benefiting as consumption patterns are expanded from basic consumption goods to luxury goods and services. ”The demographic picture is supportive for high-end consumer goods as well as for the financial services sector, including banks and insurance companies. Foreign direct investments remain supportive for industrials, the real estate sector and connected construction companies”.

POLITICAL SITUATION SUPPORTIVE

Indonesia has a long history of political turbulence and corruption issues, most of them linked to the Suharto era which ended in 1998 following a 31 year presidency. The corruption research agency Transparency International has dubbed Suharto being the most corrupt leader in modern history, having embezzled an alleged USD 15–35 billion during his rule.

“Indonesia is about to get investment grade rating from S&P which will make the economy even more interesting for international investors”

In 2014, Indonesia elected Joko Widodo ”Jokowi” as the new president, which according to Mykkänen marked an important turning point for the country. ”The election of Jokowi was one of the most important things that happened to Indonesia over the last 15 years, if not the most important thing since the country’s independence in 1949. Previous presidents were very much linked to ¬¬the Suharto area which involved a lot of corruption, Jokowi does not have this link.”

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"Initially it was difficult for him to initiate any decisions in the parliament, but going forward one year, the Jokowi-coalition has 69 percent of the parliament which facilitates the implementation of reforms", Mykkänen argues.

Since 2015, the president has initiated a number of reforms targeted towards increasing the country´s competitiveness and expanding its tax base, the latest one being a tax amnesty looking to collect corruption money. "The tax amnesty started in July and will run towards the first quarter of next year. There is 1000 billion USD of Indonesian money outside of Indonesia that is old money largely linked to the corruption era, some of that will now be collected and the government can collect tax on it. The initiative has already collected 6-7 billion US dollars Tax money during the first three months."

"The election of Jokowi was one of the most important things that happened to Indonesia over the last 15 years, if not the most important thing since the country's independence in 1949."

Another positive factor on the political scene is according to Mykkänen the appointment of Sri Mulyani Indrawati, a highly regarded managing director of the World Bank, as finance minister. "The finance minister is very respected and reform minded. The first thing she did when taking the position was to cut the budget to make it more realistic. The current account deficit is also being reduced and is less than two percent at the moment. This has also put upward pressure on the currency. The Rupiah has appreciated two percent since last December when the Fed started hiking rates, at the same time the central bank of Indonesia has been cutting rates six times already."

IMPROVED MACRO PICTURE UNDERPINS VALUATIONS

Having been hit by the slowing commodities demand from China in 2012, which brought the current account deficit down to a negative 3 percent, the situation has since improved with GDP numbers bottoming out last year. According to Mykkänen, the one thing lacking for growth to expand further is a reviving credit cycle.

"The only thing that we have been missing is the revival of the credit cycle, the bank loans were flowing very fast in 2011-2013 but when Indonesia increased rates back then the credit cycle lost pace. The cycle is currently growing at an annual rate of 7 percent, but that number is expected to be 13-15 percent already next year."

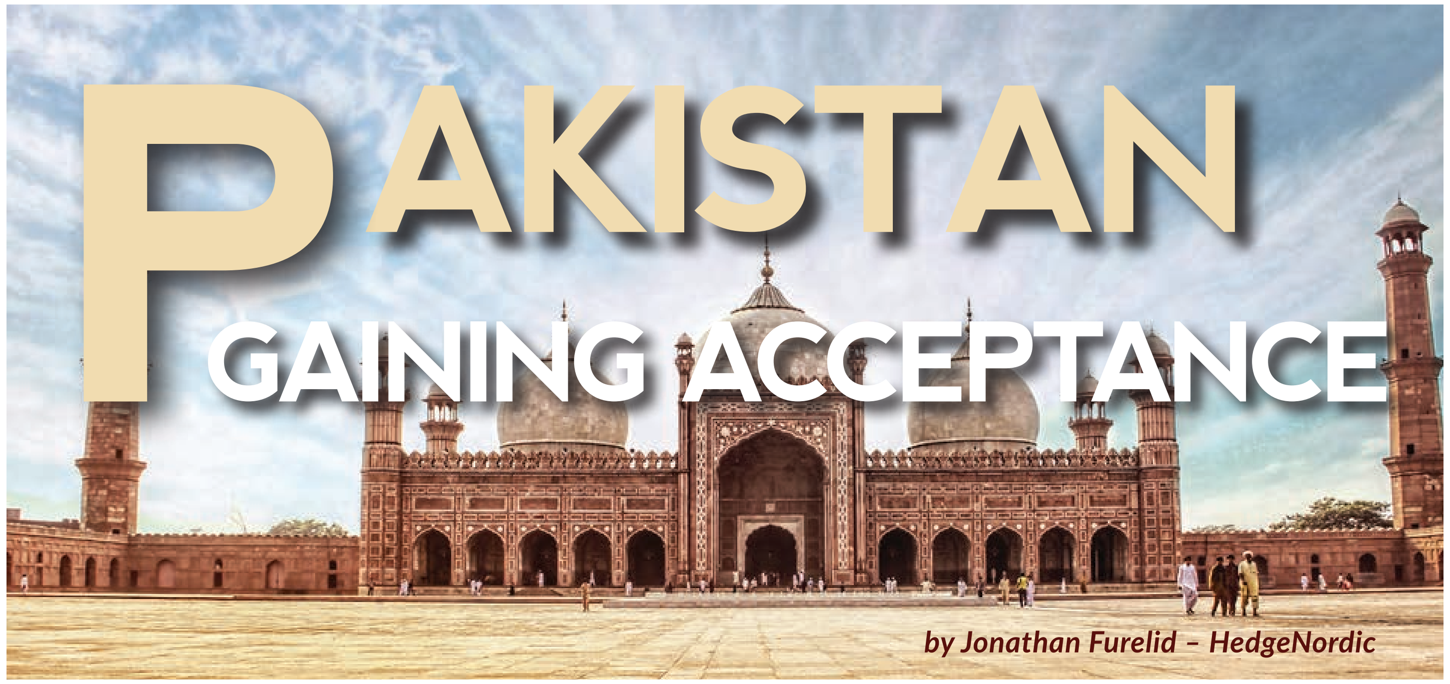
Another factor acting supportive for Indonesia going forward, Mykkänen believes is an upcoming credit re-rating. "Indonesia is about to get investment grade rating from S&P which will make the economy even more interesting for international investors. The bond market over there is also very attractive yielding 7.8-8.2 percent."

In terms of valuations, Mykkänen says that the index does not appear cheap but looking under the hood gives a different picture. "If you look at index valuations, the P/E is 16.8 but valuations are significantly lower outside the largest companies. The small- and mid cap space, where we focus, remains compelling from a valuation standpoint and we expect the spread between large and small companies to become tighter going forward."

Mykkänen is particularly bullish about the financial sector. "We like the banking sector given low valuations where companies are trading at 1.2 price to book, down from 2.5 before the central bank started cutting rates, we see that as attractive levels. "A leading mortgage bank Bank BTN with 1.25bn USD market cap is trading below book value, 2016 P/E of 7.5x and with dividend yield of 2.2.%. Net income is set to grow 18% in 2017."

"The only thing that we have been missing is the revivial of the credit cycle, the bank loans were flowing very fast in 2011-2013 but when Indonesia increased rates back then the credit cycle lost pace"

Another theme that Mykkänen sees attractive is auto sales. "One of the leading auto and motorcycle distributors, Mitra Phinastika Mustika, is trading at P/E of 5.4x for 2016 whereas market leader Astra International trades at P/E of 19.5x. Valuation gap used to be much narrower a few years ago. "Auto sales bottomed in mid-2015 and have now started to inch upwards towards 100k vehicle sales per month level, the demand picture shows no signs of abating any time soon", Mykkänen concludes.



PAKISTAN GAINING ACCEPTANCE

by Jonathan Furelid - HedgeNordic

Mattias Martinsson, CIO Tundra Fonder

Having been one of the more remote markets for international investors to access going back ten years, Pakistan is today a fast growing economy that has gained increased acceptance among investors globally. With foreign direct investments now being ramped up by the likes of China, Mattias Martinsson of Swedish emerging and frontier market specialist Tundra sees great potential ahead.

"I got acquainted with Pakistan in 2005, by somewhat of a coincidence, as I screened the global universe of equities. What stroke me was the low valuations at first, but when I started to look more closely, the market ticked some important boxes such as having international accounting standards in place", says Martinsson continuing;

"A follow on effect of Pakistan supporting the U.S. in its war against terror is that the country historically was more or less isolated from global trade."

"The fact that I could find 10 years of history for companies in an emerging market was very unusual. As I started to contact analysts and brokers on the ground in Pakistan I came to realize that the financial infrastructure had a much higher standard compared to most other emerging markets".

With a background from setting up a Russian fund during his time at the high profiled Swedish asset manager Hagströmer and Qviberg in the mid-1990s, Martinsson and his colleagues at Tundra decided to launch a Pakistan fund as their first product in 2011. This followed on having conducted extensive research on the market and by realizing the huge potential inherent in the stock market.

> **"The combined picture of a country having companies with a strong shareholder culture and an undiscovered market potential made me interested."**

"I made my way to Pakistan for the first time in January 2008, for me that was a life changing moment. I travelled around during one week and met with 20-30 companies and almost fell in love with the corporate culture, meaning extremely well-managed companies and highly educated people in management positions."

"These people had not only a very good understanding on how to run their companies, they were also very aware how to create shareholder value".

For Martinsson, the investment case was obvious, partcilarly as very few investors were looking at the market at this point.

"The combined picture of a country having companies with a strong shareholder culture and an undiscovered market potential made me interested. On top of that there was the perfect perception trade where the whole world had a negative view on the country, I viewed it as the perfect contrarian trade", says Martinsson.

According to Martinsson, he could draw on much of his experiences from Russia when analyzing the Pakistan equity market.

"What was similar with these two markets was the size in terms of population and the number of listed companies. The big problem in Russia was that there was a lack of financial infrastructure and information about the companies. The corporate governance remains an issue even today. The problem in Pakistan was the international perception of the country which had the stock market completely isolated.

Martinsson and his team found certain sectors completely overlooked, as local investors, who were dominating the market, focused elsewhere.

"What we discovered was that stocks that are typically loved by international investors in other emerging market such as breweries and consumer goods companies were largely ignored by local investors. They were looking for high dividend yields, stable companies, preferably having revenues in foreign currencies".

"When putting together the portfolio I had a smorgasbord of consumer goods companies that were growing quickly while trading at very low multiples. As the stock market offered around 600 companies in a wide variety of sectors, that also made it possible to tap into the growth story of the country.

CHANGED PERCEPTIONS DRIVE FOREIGN INVESTMENTS

As Pakistan has come to terms with much of the conflicts linked to terrorism, the perception among investors towards the market as an investment case has changed signficantly over the last years, according to Martinsson.

"The perception towards Pakistan is definitely changing. The fact that Pakistan was more or less forced to take the U.S. side during the war in Afghanistan was a big blow to the country, before that, terrorism was not an issue. They have lived with these problems now for well over 10 years but there has been significant progress. Since 2015, the number of people killed in terrorist-linked activity in Pakistan is down by 65 percent compared to the highest level that was seen in 2011."

The changed perception has also translated into increased foreign direct investments into Pakistan, which Martinsson sees as crucial for future growth.

"In 2015, China announced that they aim to do long-term investments into Pakistan, the commitment is to invest 50 billion USD during the course of 15-20 years. Among other things this include building one of the world´s largest deep sea harbours, motorways and railways as well as power plants to support these investments. This will create secular activities and we now se more foreign direct investments being done in the country", Martinsson explains.

> **"Out of Pakistans 200 milllion people, 80 million are estimated to belong to the middle class, meaning people that can afford buying consumer goods. This is driving local demand."**

The fund manager however highlights that most of the economic activity is still domestically focused.

"A follow on effect of Pakistan supporting the U.S. in its war against terror is that the country historically was more or less isolated from global trade. Exports is therefore less than 12 percent of GDP today. China's commitment to start direct investments marks the first intiative in terms of foreign direct investments during the last 20 years."

The domestict market is well supported by a growing middle-class, according to Martinsson.

"Out of Pakistans 200 milllion people, 80 million are estimated to belong to the middle class, meaning people that can afford buying consumer goods. This is driving local demand".

VALUATIONS STILL ATTRACTIVE

With Pakistan´s Karachi stock market having been one of the big winners during the last five years, valuations have also come up during this period. Martinsson however argues that profit growth is well supported and that valuations look attractive.

"When we started the fund in 2011, the stock market was valued at 6x earnings, the corresponding figure today is around 9x. Important to note is that valuations in 2011 was at the lowest point seen since the financial crisis."

"There has been a multiple expansion but there has also been a lot of profit growth to support that. As from May next year, Pakistan will be included in the MSCI Emerging Markets index, this will make it easier to compare valuations to other emerging asian economies such as India, Indonesia and Malaysia. These markets are trading at 15x earnings and above."

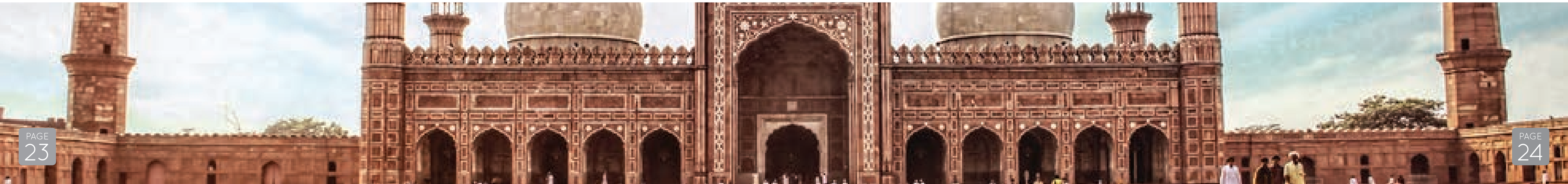
GROWTH DRIVERS FORWARD

Martinsson foresees that Pakistan will continue to trade at a rebate to other emerging markets going forward, but stresses that there are a number of important growth drivers that could lift valuations to sustainable higher levels.

"I think it will take time before the rebate of the Pakistan stock market to other emerging emarkets dissappear but looking ten years back the profit growth, on an aggregate level, of companies in Pakistan is actually higher than for those in India."

"With Chinese infrastructure investments now being realized, with growht at the highest level in 10 years and with S&P raising its credit rating on the country for the first time since 2008, I think the prospects for Pakistan are very compelling."

"Our case has never been that equities in Pakistan would be valued at 20x earnings but we see great potential. Pakistan is what the western world was like 30-40 years ago. It is like travelling in a time machine. You can see the companies that are likely to be the next IKEAs, ABBs or Wall Marts of the world in Pakistan already today."



by John Malloy, Emerging markets Portfolio Manager & Cem Akyurek, Ph.D.Head of macro research - RWC Partners

EM FX WEAKENS ON TRUMP PRESIDENCY

While US Federal Reserve ("Fed") December rate hike was internalised and expected to have minimal market impact, Trump's unexpected victory in the US elections strengthened the dollar and weakened EM markets.

The currencies of EM FX, particularly with weak external dynamics, depreciated since the US election. The market expects macro policy mix under Trump to be very similar to that under president Reagan, during which expansionary fiscal policy and tighter rates had resulted in a protracted appreciation in the USD, leading to a coordinated international effort to weaken it under the 1985 Plaza Accord. While we think that USD can remain strong in the near term given the possibility of a further steepening yield curve, US macro conditions going forward may have much less resemblance to that under Reagan's dramatic change in policy mix. That means market implications are likely to differ as well, particularly as it concerns EM FX.

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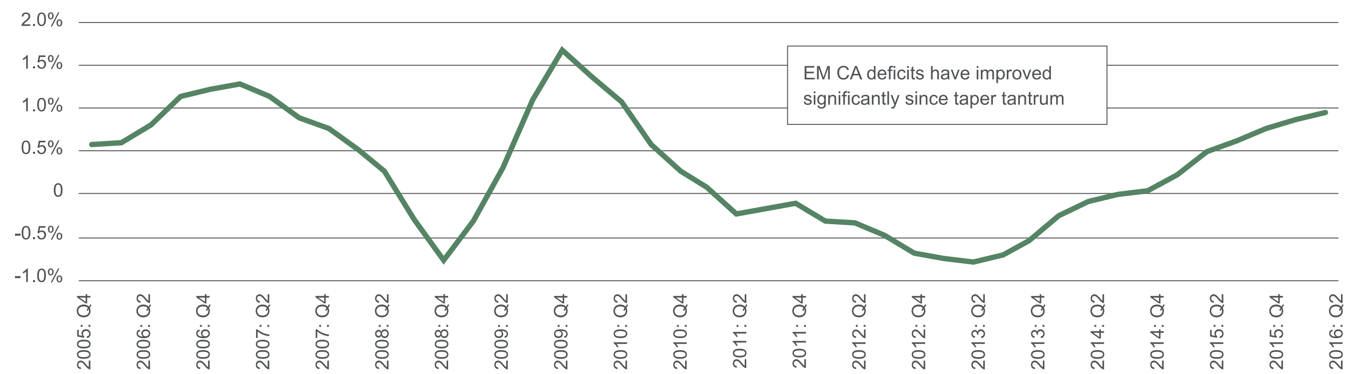
Details of the Trump plan are yet to be released. We assume that fiscal policy will be more expansionary on the back of tax cuts and an acceleration in infrastructure investments. A dramatic shift in trade policy towards much greater protection is unlikely to happen in the foreseeable future. Ultimately we think larger budget deficits, gradual normalisation of monetary policy, widening of the current account de cit on higher growth and rising inflationary pressure will weaken the USD, which has appreciated significantly in real terms since early 2014. The macro environment should become more EM supportive, particularly for EM FX as Trump fiscal expansion happens given also the dramatic improvement in EM external dynamics since the 2013 taper tantrum.

WHAT ARE WE BASING OUR CONCLUSIONS ON?

1) The markets have internalised an anticipated December Fed interest rate hike. According to the Bloomberg survey of market participants today[1] the probability of a Fed rate hike at the December 15 2016 FOMC meeting stands at 74%. Last year survey results on October 25 showed that the probability of a rate hike at the December 15 2015 meeting stood at just 35%. It increased to today's 74%[1] from November 25 2015, which is really when EM FX started to weaken at a rapid pace.

FIGURE 1: HEAT MAP EM AVERAGE CURRENT ACCOUNT BALANCE AS % OF GDP



Source: Bloomberg, 30/09/2005 – 30/06/2016

1. As at 25 October 2016

www.hedgenordic.com - December 2016
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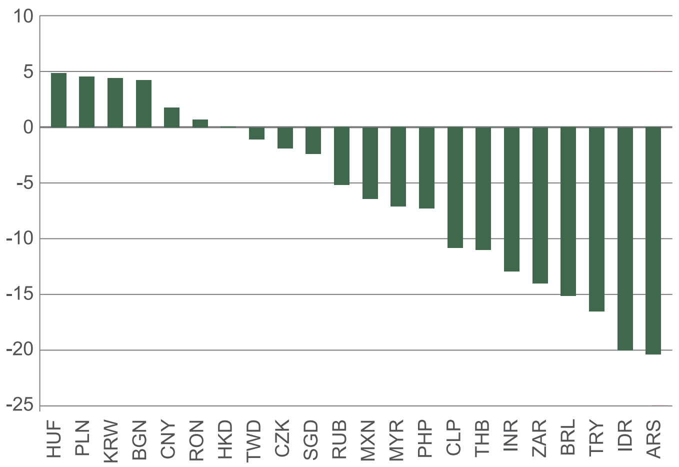
The weakening of EM FX started on growing expectations of a Fed rate hike and the EM FX weakening episode stretched until February 2016. The important point is, if EM FX were to be affected significantly by the Fed Hike in December, the weakening should have already begun, with growing expectations of it happening.

But EM FX has been relatively resilient, as the probability of a December 2016 Fed rate hike went from 60% on October 1 to today's 74%[1]. The point is that the markets have internalised a rate hike much sooner than they had before last year's December FOMC meeting, and the improvement in EM fundamentals have and will continue to play a much more signi cant role in the EM FX reaction to higher US rates.

2) As we all know, **external dynamics have improved significantly in EM** with improvement in current accounts and more competitive real exchange rates compared to the taper tantrum days, not to mention lower inflation and higher FX reserves as well for many EMs.

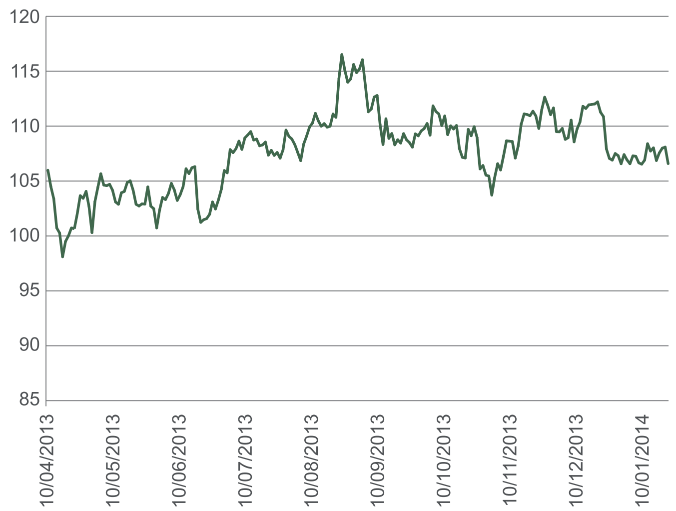
Figure 2 shows a comparison of the EM FX response to the taper tantrum and the weakening episode of EM FX that started just before the December 2015 Fed rate hike. The weakening in EM FX was much milder during the latter episode on better fundamentals. However, we should also emphasize that the oil price reaction to the Fed mattered as well in determining the net effect of Fed rate hike on some EM FX during these two episodes.

FIGURE 2: BEST AND WORST SPOT RETURNS, MAY 2013 – JANUARY 2014



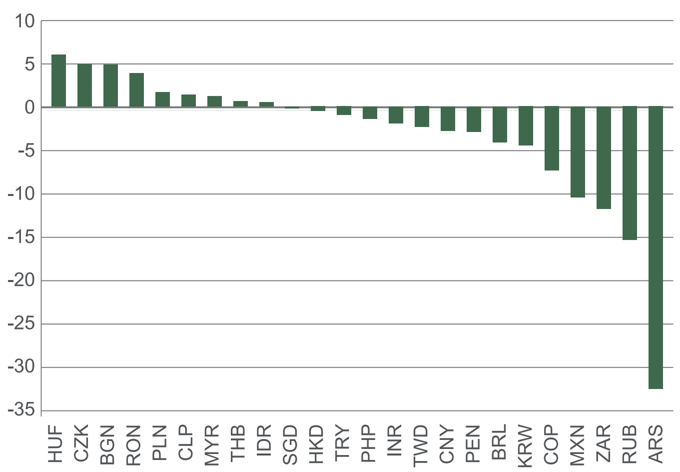
Source: Bloomberg, 01/05/13 – 29/01/14

FIGURE 3: BRENT OIL PRICE (1)



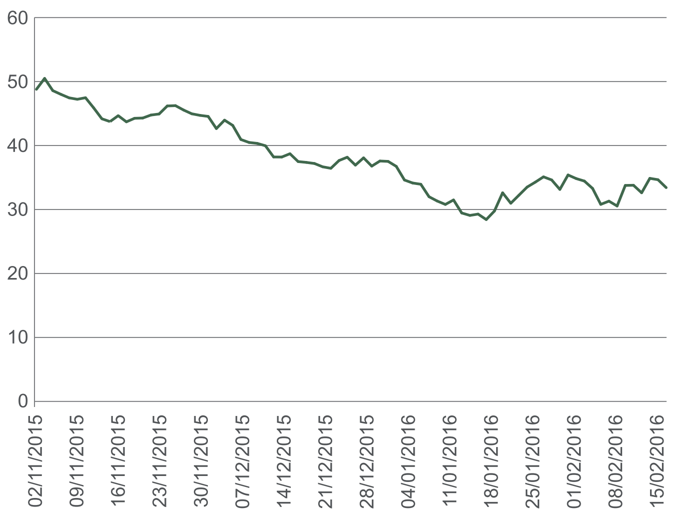
Source: Bloomberg, 10/04/13 – 30/03/14

FIGURE 4: BEST AND WORST SPOT RETURNS, NOVEMBER 2015 – FEBRUARY 2016



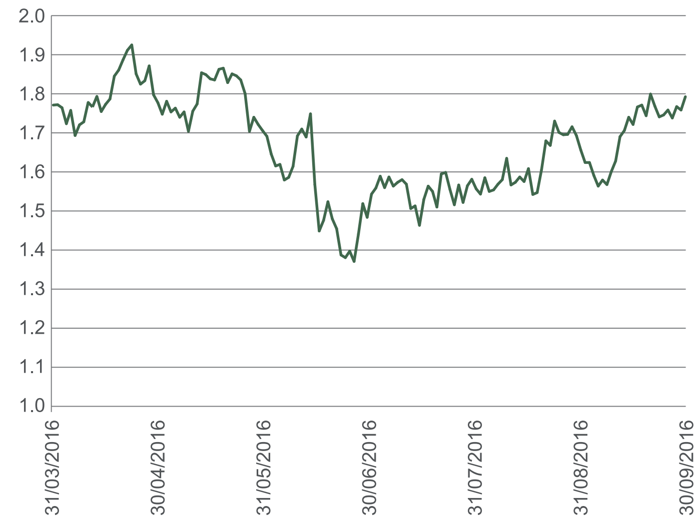
Source: Bloomberg, 25/11/15 – 05/02/16

FIGURE 5: BRENT OIL PRICE (2)



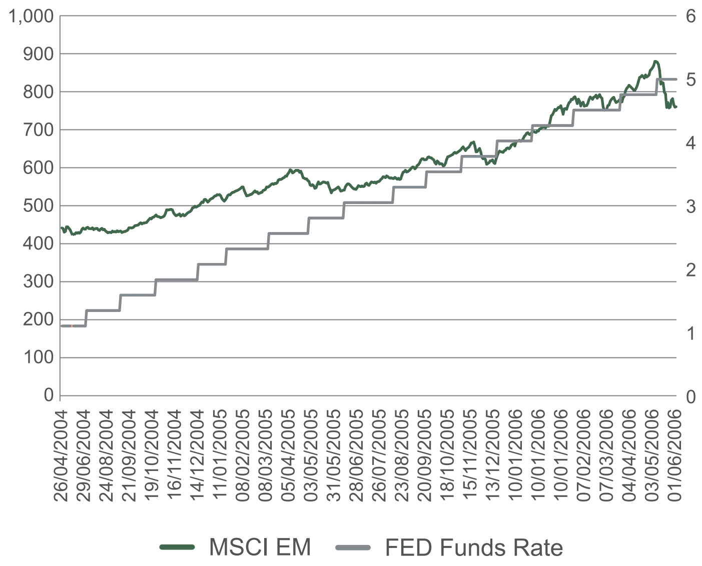
Source: Bloomberg, 26/10/15 – 19/02/16

FIGURE 6: US 10 YEAR BOND YIELD



Source: Bloomberg, 31/03/16 – 26/10/16

FIGURE 7: FED FUNDS RATE AND MSCI EMERGING MARKETS INDEX, 2004-2006



Source: Bloomberg, 01/06/04 – 01/06/06

Figures 2 and 3 show EM FX and the oil price during the taper tantrum episode – EM FX weakening spread from May 2013 to the end of January 2014 during which the oil price rst increased and then remained more or less range bound.

• IDR, TRY, BRL, ZAR, ARS and INR lost on large CADs, low credibility of macro policies (worse for some in the group than others) and high in ation. Other Asian FX weakened to a lesser extent on capital out ows but were still hit hard despite having large and growing CA surpluses.

• Note that RUB and MXN were relatively stable on strong oil.

• Eastern Europe did well on Euro strength against USD.

Figures 4 and 5 show EM FX and the oil price during the EM FX weakening that started just before December 2015, stretching through February 2016.

• ARS weakened significantly after it was floated.

• But note that many EM FX did much better than the taper tantrum episode including and surprisingly TRY (not on the chart as not one of the worst or best 10 performers that the chart shows). TRY relative resilience shows that cheaper valuations helped a lot in supporting EM FX (TRY could have not been resilient on fundamentals, as they did not improve nearly as much as other EMs).

• IDR and INR did well on better fundamentals and BRL did relatively well, given that local conditions were still fragile at the time.

• We think RUB and MXN weakened relatively more on oil weakness rather than Fed rate hike.

• And again European EM FX did well on Euro strength.

• ZAR weakened a lot on arguably the worst fundamentals in EM universe.

SUMMARY

The bottom line is that if the oil price remains stable, we believe EM FX is unlikely to weaken post the December 2016 Fed rate hike. The risks are a very hawkish FOMC statement leading to significant weakness in US bonds, to which we assign a low probability. In fact, we think the bond market has internalised a Fed rate hike to a large extent. Figure 6 shows the increase in 10 year yields when the probability of a rate hike went from 60% to 74% during October this year[2].

Finally, we can consider how rate hikes have affected EM historically. If we look back to the hikes of 2004 to 2006 – the Fed raised rates by 425bps and the MSCI Emerging Markets Index increased by 233% (see Figure 7).

John Malloy
Emerging Markets
Portfolio Manager

Cem Akyurek, Ph.D.
Head of Macro
Research

1) As at 25 October 2016 , 2) 01-25 October 2016

www.hedgenordic.com - December 2016
HEDGENORDIC

by Glen Finegan,
Head of Emerging Market Equities - Henderson Global Investors

The case for a selective approach to Emerging Market equities

Emerging market equities provide attractive opportunities for long-term investment returns. However, the asset class also carries significant risks. Glen Finegan, Head of Emerging Market Equities at Henderson Global Investors, believes the opportunities therefore need to be approached in an extremely selective and risk-aware manner.

Emerging markets – risks and opportunities

Emerging markets (EM) can be a risky place for investors. Immature legal and political systems often mean inadequate levels of minority shareholder protection and economic volatility. The opportunities for investment, however, are significant and well documented. Supportive demographic trends, such as population growth and a rise of the middle income consumer, are driving demand for a broad range of products and services that those of us in the developed world take for granted.

In approximate terms, of the world's seven billion people, six billion live in less developed countries. As the population rises towards its forecast nine billion by 2030, the vast majority of these additional inhabitants will live in countries that are considered 'emerging' (see chart on the right).

Population growth on its own does not signify economic growth, but the demographic make-up of many emerging markets does. Rising standards of living and emerging middle classes bring with them commerce and consumerism, while the younger profile and increasingly educated nature of the EM workforce supports the development of dynamic and entrepreneurial businesses. Companies that are selling goods and services into these long-term secular trends look set to benefit.

> **"When investing in EM it is important to separate the good from the bad."**

In the developing world, penetration of financial products such as mortgages and insurance are often a fraction of western world levels. Per capita consumption of everyday products such as shampoo and toothpaste are much lower and are sold at much lower price points. A growing number of companies - good and low quality - that generate the majority of their revenues from operating in emerging market countries are well placed to benefit from these trends.

The need for selectivity

When investing in EM it is important to separate the good from the bad. We believe this is best achieved using a bottom-up risk-aware approach and focusing more on what can go wrong than what might go right. Understanding the people behind the business is key and company history provides a meaningful guide.

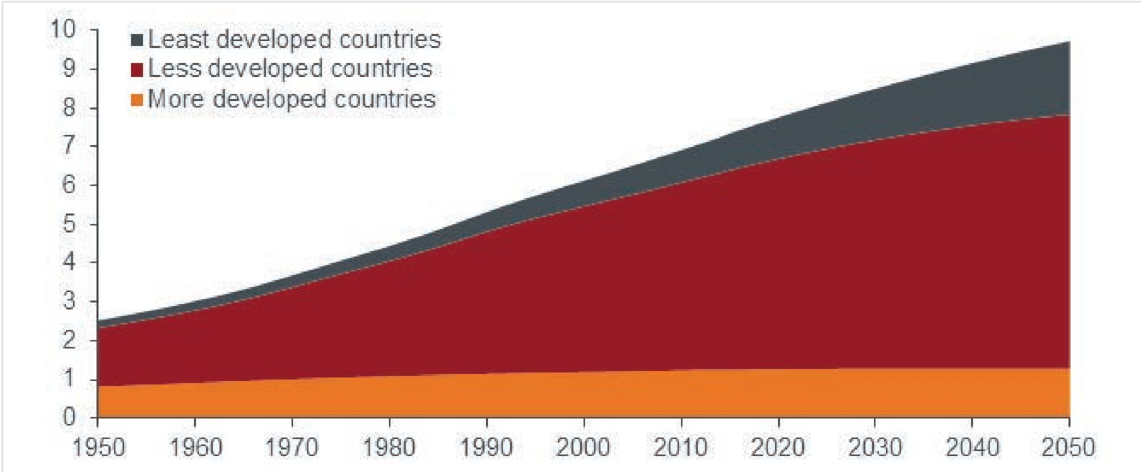
Long term

Taking a long-term view when investing in EM can help to dial out the short-term 'market noise'. The asset class consists of a diverse collection of countries, each of which can fall in and out of favour at one time or another. A long-term approach means it is possible to take advantage of unpopular periods, through buying good quality companies that may have become reasonably valued.

People

Investing in companies is about investing in people. When investing in EM it is wise to question who owns the company and why they own it. It is important to understand the motivations of both the owners and managers of a business. What other businesses does the

POPULATION (BILLIONS)



Source: United Nations, Department of Economic and Social Affairs, Population Division (2015), World Population Prospects: The 2015 Revision, Total Population, both sexes, using median fertility.

controlling shareholder own and does he or she have more at stake in those? Are management incentivised to invest for the long term?

State influence

The role of the state in EM corporate ownership and its control of capital markets should be a significant consideration. State-owned enterprises make up a substantial proportion of many emerging equity markets. This can introduce issues around whose best interests these companies are being managed in. While privately-owned companies may put shareholders first, there is the risk that a company controlled by a government will make decisions aimed at stimulating that country's economy, with complete disregard for profitability.

> **"While certain risks are undoubtedly higher in EM than DM, the EM asset class offers attractive investment opportunities when approached in the right way."**

Controlling shareholders

In contrast, long-term owners whose wealth is invested in the same equity as that available to minority shareholders provide comfort that interests are aligned. Across EM, this type of controlling shareholder is often a family group, which tends to increase the ability of management teams to take far-sighted, sometimes contrarian, decisions that a professional management team more focused on short-term results and stock market pressure might not.

Track record

A selective approach to EM equities allows investors to target companies that have demonstrated resilience during tough times. It is important to understand whether a company has a history of risk taking. Conservatism is not just about today's balance sheet – what did it look like during previous crises? A management team that is willing to take risk when times are good can end up in trouble when the inevitable downturn follows. As such, it is important to look for companies and management teams that have weathered previous periods in which operating conditions were challenging.

Non-financial risks

Importance should also be placed on how a company has treated minority shareholders in the past and how they respond to environmental and social challenges. The market tends to underestimate how often non-financial risks become real financial losses, particularly in economies with immature legal and political systems.

Endorsements

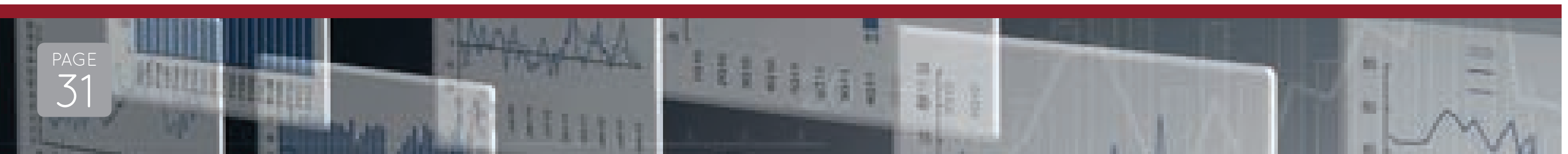
When analysing opportunities, we find endorsements from other reputable and established companies that do business with the company in question to be particularly useful. This feedback can be based on formal relationships, such as joint ventures or other high level business partnerships, but may also come in the softer form of customers, suppliers or competitors speaking of their admiration and respect for that company.

Benchmark constraints

Taking a global, benchmark agnostic approach allows for investment in good-quality companies, wherever they are listed, which are building businesses in emerging markets. Blurred lines between EM companies and global companies means it is sometimes possible to gain exposure to EM through developed market-listed companies. Some developed market (DM) listed companies have good corporate governance and a portion of stable cash flows from the developed world. If their growth is being led by revenues from EM, this may be a lower risk way of providing exposure to developing economies. Another method is to invest in the EM subsidiary of a developed market multinational, which will be directly exposed to EM consumer growth and should also benefit from the corporate oversight of its parent company.

Summary - maximising EM opportunities

While certain risks are undoubtedly higher in EM than DM, the EM asset class offers attractive investment opportunities when approached in the right way. By following a process that incorporates a distinct set of checks and balances and remains true to a clear philosophy on how to invest in the asset class it is possible to maximise these opportunities.



EMERGING MARKETS

ALLOCATIONS, FLOWS AND MANDATES

by Hamlin Lovel – HedgeNordic

2016 may mark a turning point for emerging markets after being out of favour for several years. Inflows into the asset class have been gathering momentum all year, according to the Washington, DC, based Institute for International Finance (IIF). The old adage 'it is often darkest before dawn' may be germane to the turnaround in EM flows. The IIF reports "2015 saw total EM portfolio inflows of only $41 billion, marking the worst year since the Global Financial Crisis". But in just the first eight months of 2016, flows have already been more than three times the level of 2015, as shown below.

If the volatility around emerging markets flows relates mainly to retail investors, it may make more sense to focus specifically on institutional investors. Investment consultants Mercer's 2016 European Asset Allocation Survey (based on 1,100 institutional investors managing $930 billion) finds that institutional allocations held steady, at an average of 6%. Typical allocations are 11% of an equity portfolio, which Mercer claims is in line with EM market capitalisation weightings relative to world markets. Despite the manifestly superior growth potential of EM, asset allocation decisions are, on average, based on the simplest possible method – market weights.

> **"2015 saw total EM portfolio inflows of only $41 billion, marking the worst year since the Global Financial Crisis."**

If the Vikings explored and/or invaded Russia, modern-day Turkey and North Africa, more than 1,000 years ago, Scandinavian pension funds maintain this adventurous approach and some have above average allocations. Finland's third largest employee pension fund, 20bn Elo, has 17.1% of its equities in emerging markets. EUR 36 billion Ilmarinen has also been reducing its domestic equity bucket and increasing its emerging market equity allocations since at least 2013. Icelandic pension funds are perhaps the odd ones out in the region, as capital controls have forced them to maintain higher local weightings, but this is changing. As Iceland's capital markets normalise, its pension funds have more freedom to invest overseas, including in emerging markets.

> **"Norges Bank Investment, employs huge teams of investment professionals to run 96% of its money in house, but when it comes to emerging markets the giant blue whale of the Nordics has a taste for outsourcing to specialists."**

However, only 59% of European institutions surveyed by Mercer have any allocation to emerging markets, which suggests there is a huge untapped market of funds that are not obtaining the potential return and diversification benefits of EM.

In the US, allocations to both alternatives and emerging markets can be larger. The Office of the Treasurer of the State of Connecticut has allocated some $2.5bn, or over 8%, of its $29 billion portfolio to emerging markets bonds, and recently carried out a manager search in the strategy.

Mandate Review

Emerging markets are an area where specialist expertise is sought after, even by the world's largest and most sophisticated allocators, such as sovereign wealth funds. We highlight a handful of manager searches carried out over the past few years, to provide examples of what institutions are looking for.

Nordics

The Norwegian oil fund, 7,360 billion NOK (810 billion EUR) Norges Bank Investment, employs huge teams of investment professionals to run 96% of its money in house, but when it comes to emerging markets the giant blue whale of the Nordics has a taste for outsourcing to specialists. Its website states it has "60 country-specific mandates for investments in emerging and frontier equity markets"...and "3 mandates for global emerging markets debt".

Tendering processes are open to managers globally. Notable mandate wins elsewhere in the Nordics include US manager, Fisher Investments, which won a DKK 2 billion EM equities mandate from Danish fund LD.

Nordic pension funds are also embracing 'frontier markets': a subset of emerging markets that generally have smaller, less liquid and less mature financial markets. This has been going on for some time: back in 2012, Sweden's AP1 put out an RFP for an emerging and frontier market equity mandate.

In keeping with the Scandinavian tradition of openness, these mandates are advertised on websites, and tenders from public pension funds in the EU also appear in the Official Journal of the European Union.

> **"only 59% of European institutions surveyed by Mercer have any allocation to emerging markets, which suggests there is a huge untapped market of funds that are not obtaining the potential return and diversification benefits of EM"**

UK

Fees on pension fund mandates can be lower than on retail money, but whereas retail investors can be fickle, this is sticky money. For instance, a ten year EM equity mandate was advertised by the UK London Borough of Greenwich, targeting 2-4% outperformance over the MSCI World Equity index. The UK's NEST (National Employment and Savings Trust) in 2015 carried out a search for an actively managed emerging market debt mandate.

> **"there is a compelling case for substantially augmenting allocations to emerging markets – and institutional investors with longer time horizons are clearly heeding this."**

US

A number of US pension funds have advertised Requests for Proposals (RFPs) for EM mandates. For instance, the Illinois State Board of Investment has sought an active EM equity mandate. Some RFP guidance notes are 6 or 7 pages long, but others can be much longer. Consultants, Callan Associates, are handling an active EM equity search on behalf of the $18.3bn New York State pension plan. The guidance alone is 55 pages long and the process takes nine months from start to finish (the closing date has now passed). The criteria on these mandates could rule out some managers. In this instance, New York State required applicants to be running at least $3bn, and the pension plan cannot be more than 10% of a product or 25% of a vehicle. In contrast, the smaller $1.2bn Firefighter's Retirement System of Louisiana set a minimum asset level 90% lower, at $300mm, when it searched for its EM debt mandate, so this type of RFP could be open to smaller asset managers.

Illiquid Asset Classes and ESG

In EM private equity, real estate and infrastructure, governmental and supranational organisations, such as development banks, can be involved in funding or co-investing. OPIC (the Overseas Private Investment Corporation) is the US Government's development finance institution. It accepts applications on a quarterly basis for funding and the criteria include many ESG considerations. Nordic institutions have been aware of opportunities in EM illiquids for some time. In 2013, Finland's state pension fund announced a search for an emerging markets private equity fund of funds manager. The giant Canadian pension funds have invested in infrastructure in Chile and Peru. Other pension funds have joined forces to build a critical mass for accessing opportunities in EM. A group of Danish pension funds set up the Danish Climate Investment Fund to facilitate environmentally benign investments in emerging markets.

Conclusion

It has been clear for some years that most developed economies are experiencing slower (and in some cases even negative!) productivity growth, partly because many citizens prefer leisure to work. Faster economic growth in countries such as the US, UK and Sweden has come to a large extent simply from population growth (including industrious and entrepreneurial immigrants from EM!), leaving per capita GDP growth still rather slow. Of course, China has also slowed down but in relative terms, EM economies can still grow several percentage points faster than developed markets. This holds out hope for growth-oriented, real, assets, such as equities, real estate, infrastructure and private equity. Meanwhile, nominal assets, namely bonds, offer a significant yield premium in both nominal and real terms, even after hedging back to hard currencies (and some EM currencies remain undervalued on a PPP basis). Whether investors are prioritising growth or value, there is a compelling case for substantially augmenting allocations to emerging markets – and institutional investors with longer time horizons are clearly heeding this.

Inflows into Emerging Markets 2016

Billions	
January	3.6
February	0
March	36.8
April	26
May	1.2
June	16.7
July	24.8
August	25
Total	**134.1**

Source: IIF

CHINA is in for a soft landing

by Jonathan Furelid – HedgeNordic

Hong Kong-based asset manager Fullgoal eyes continued China growth, albeit at lower levels than historically, and sees increased openness of local financial markets translating into significant inflows from foreign investors.

Michael Chow, Fullgoal Asset Management

”We see an L-shaped development of Chinese GDP growth where numbers are coming down from what used to be 8-9 percent to roundabout 5-7 percent. Last quarter we saw growth coming in at 6.7 percent, which is still decent considering that this is the world´s second largest economy”, says Michael Chow, Head of International Business at Fullgoal Asset Management.

According to Chow there are challenges ahead for the Chinese economy but those are well-recognized by the Chinese government and measures are being taken to avoid future market dislocations.

”The property market has been mentioned as a potential risk factor as prices have reached overheated territory but this has been addressed by the government who is following the development very closely. Measures have been taken to deleverage and limit the level of borrowing in order to cool down the market”, Chow says. With regards to China´s role in global trade, Chow believes that the recent developments in the U.S. with Donald Trump being elected as president could play in the hands of China rather than isolating the country from international trade deals.

”Trump is a business man and I do not foresee his presidency having a major negative impact on China´s role in global trade, rather the opposite. What he has said is that he will discontinue the TPP-deal, which is a deal that China has not been supportive of. Instead China can now focus on the One Belt One Road project that focuses on the connectivity and cooperation between China and the rest of Eurasia”.

”The talk of Trump going into the election where tariffs on Chinese imports were mentioned, we don´t think will be realized to any significant extent. A trade war between U.S. and China would not be beneficial to the U.S. economy and in the end that is what Trump cares about. We believe there will be a difference in what Trump has said during his campaign and what he will eventually carry through in real actions”.

> **“As the consumption-driven economy takes center stage we see opportunities in sectors that are beneficiaries of this development.”**

Concerning the development of China´s economy, Chow sees a transition from an investment-led economy that he refers to as the ”old economy” into a consumption driven ”new economy”. This development is gathering pace which also translates into interesting investment opportunities, according to Chow.

”As the consumption-driven economy takes center stage we see opportunities in sectors that are beneficiaries of this development. Sectors like consumer discretionaries, healthcare and information technology are examples of those. Valutions in these sectors are relatively high but as global investors are now getting access to the Shenzhen stock market through the Shenzhen-Hong Kong Stock Connect program, there will be a wider range of opportunities opening up”, Chow argues.

The stock connect scheme linking Hong Kong and Shenzhen will allow international investors to trade 881 Shenzhen stocks via Hong Kong brokers while mainland investors will be able to trade 417 Hong Kong stocks via mainland brokers. Nearly a fifth of Shenzhen’s stock market is tech companies - a much bigger proportion than in Shanghai, where tech stocks make up just 4 percent of the market.

Another important development with regards to China opening up for global investors is according to Chow the decision by the People’s Bank of China to make the local onshore bond market, the world´s largest OTC-market in the world for fixed income trading, accessible to foreigners. This decision was initiated in February 2016 and will have a huge impact on the liquidity in these markets, Chow argues.

”These markets used to be accessible for local players only. As the market now opens up for more or less all investors, speculators like hedge funds excluded, there will be a signficant boost in demand for these instruments. The fact that China offers a yield pick-up compared to the U.S. and Japan will see foreign investors tapping into these markets”.

According to Chow, the decision to open up the Chinese fixed income market links to the recent depreciation of the Chinese currency, the Renminbi, and the wish to have the currency pegged to a basket of foreign currencies rather than to have it closely linked to the US dollar.

”This is part of China´s globalization process and the wish among government officials to see the currency linked to a basket of foreing currencies”, Chow says.

> **“The fact that China offers a yield pick-up compared to the U.S. and Japan will see foreign investors tapping into these markets.”**

Another globalization process undergoing in China is the plan to include its A-shares into the MSCI Emerging Market Index. A-shares are stocks of Chinese companies that trade on the mainland exchanges, generally off-limits to overseas investors and can only be purchased through a specially regulated program known as Qualified Foreign Institutional Investor scheme.

”I foresee that the inclusion of the China A-shares into the MSCI Index will likely to happen in the near term. This will spur additional demand for Chinese equities as money tracking the index as benchmark will need to invest in China A stocks.”

”A lot is happening in China right now in terms of encouraging foreign capital to enter the market and to make the economy more globalized. This development together with continued solid growth figures and an economy transitioning into a consumption-driven from an investment led one, I believe make the case for a strong development ahead”, Chow concludes.

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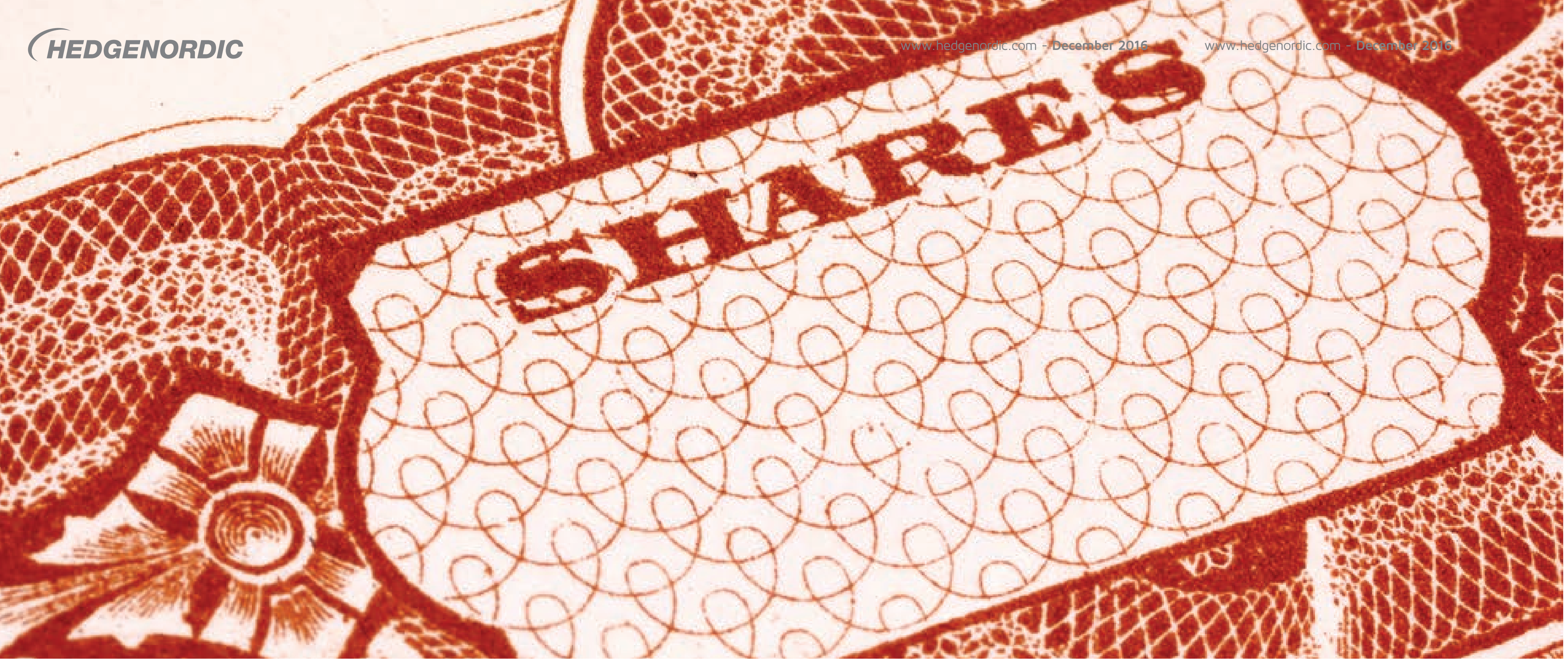

STOCK SELECTION PARAMOUNT

by Hamlin Lovell – HedgeNordic

Henderson's Head of Emerging Market Equities, Glen Finegan, joined the firm in 2015 and has been managing emerging market equities since 2001. Using a long term, bottom-up approach he evenly weighs the risks and potential rewards of the asset class.

"Emerging markets can have poorly managed economies, political risk, over-reliance on commodity prices, and weaker minority shareholder rights, but they also offer more growth stories for long-term investors in terms of rising consumption and living standards" he explains. The huge and growing population of approximately six billion people in emerging markets, which includes the ballooning middle class, supports a runway of secular growth trajectories for products ranging from toothpaste to mortgages.

But given the risks, careful stock picking is essential to the Henderson Emerging Market Equities Team's process, with each company analysed on its merit and the team believing that indices are irrelevant. Though the strategy caps sector exposure at 40% and single country exposure at 25%, neither of these limits relate to any index. "We start with a blank sheet of paper and invest in quality companies run by trustworthy people of high integrity because the rule of law cannot always be relied on for protection" Finegan stresses.

Companies not meeting the team's criteria typically include state-owned enterprises; firms with controlling shareholders who show contempt for best practices; and those with weak minority shareholder rights. They also eschew expensive valuations, such as those of most Indian consumer businesses now. Finegan's style is not cramped by tracking error constraints and his portfolios demonstrate active share metrics well into the 90s. "We work very hard to avoid the junk and capital preservation is prioritised over capital growth" he says. This 'quality at a reasonable price' philosophy has helped Finegan's track record to historically show lower volatility, and lower drawdowns, than the peer group.

The global emerging markets investment team of four – Finegan, his former First State Stewart colleague Stephen Deane, Nicholas Cowley, and Michael Cahoon - are a team within Henderson's Edinburgh office. They carry out fundamental analysis including meeting companies, and also the ecosystem of customers, suppliers and competitors around them. Finegan favours companies with the pricing power to grow cash flows faster than inflation. He generally avoids commodity producers, and manufacturers operating in commoditized industries – such as some electronics suppliers– as these firms lack pricing power. Finegan seeks quality earnings streams and is indifferent to whether companies return capital to investors via dividends and buybacks, or reinvest retained earnings.

The team's opportunity set includes constituents of the MSCI Emerging Markets and MSCI Frontier Markets indices, and companies in the MSCI Developed Markets indices that typically generate more than 50% of their revenues or earnings from emerging markets.

With more than 15 years of extensive due diligence, including gauging ESG (environmental, social and governance) risk factors, Finegan has whittled the investment universe down to a watch-list of approximately 350 companies that make the grade. When these are trading at or below the team's fair-value estimate, between 40 and 80 are selected for the portfolio, with position sizes ranging from 1% to 7%. Finegan states that fair value is estimated by "using simple valuation models, and simple assumptions, clearly stated so the team can debate them". Companies are held for an average of five years in the portfolio, which has an annual turnover of approximately 20% to 30%. Finegan likes family-owned firms that take a long-term view and whose wealth is invested in the same equity as that available to minority shareholders. This he states, "provides comfort that interests are aligned". Importantly, for those considering investing in emerging markets, he does not get distracted by short-term volatility, which he often views as noise.

"Structures and property rights are not strong enough in Russia, while minority shareholder protection is a concern in South Korea"

Glen Finegan,
Head of Emerging Market Equities, Henderson Global Investors

Henderson's high-conviction emerging market equities portfolio completely sidesteps certain countries and sectors. Currently Finegan cannot find any companies listed in Russia and very few in South Korea that meet his corporate governance criteria. "Structures and property rights are not strong enough in Russia, while minority shareholder protection is a concern in South Korea" he explains. Chinese banks, and many Indian banks, are also absent as they are state controlled. In contrast, India's leading housing finance company, privately owned HDFC, is owned.

In late 2016, favoured holdings are often listed in "markets in Latin America and Africa that have borne the brunt of the commodity price sell-off" says Finegan. He views Chile as an exception to the rule of capricious emerging markets regulators, and the strategy, for example, owns a water utility that supplies the capital city and surrounding areas. Its dividend yield is above 5% and total returns look set to benefit from Santiago's population growth. Within greater China he rejects mainland-listed A shares, in favour of Hong Kong and Taiwan-listed companies garnering growth in China. Examples include a global leader in power electronics in Taiwan, and the world's leading automobile glass maker, listed in Hong Kong.

"We start with a blank sheet of paper and invest in quality companies run by trustworthy people of high integrity because the rule of law cannot always be relied on for protection"

One third of the strategy is in consumer staples companies, with regional growth stories seen in Chilean companies expanding into Latin America, and South African firms making strides in sub-Saharan Africa. Portfolio holdings geared to the economic and population growth of Africa include retailer Shoprite, which is building stores throughout sub-Saharan Africa; and Standard Bank, which has a 130-year track record, continues to implement a pan-African growth strategy, and is typical of the moderately-leveraged and privately-owned banks Finegan prefers. Elsewhere in Africa, London-listed Cairn Energy, a leading oil and gas exploration and development company, has made discoveries in Western Africa and underscores the team's conservative approach to investing in emerging markets with its strong balance sheet and net cash position.

Macroeconomics takes a backseat, as Finegan assumes economic crises are a given in emerging markets. Therefore, companies that have survived and thrived over multiple crises are sought after. A Brazilian electric motor-making firm has lived through multiple recessions and military coups since the 1950s. When it comes to currency risk, the Henderson Emerging Market Equities Strategy does not hedge because Finegan finds that exchange rates are very difficult to predict with currency volatility ever present in emerging markets. Finegan prefers to construct portfolios comprised of reasonably balanced currency exposures, so that companies' export revenues may gain from weaker currencies, while their import costs have the potential to fall if and when currencies strengthen.

Finegan reiterates that over the long term the strategy seeks to generate absolute returns, rather than returns relative to indices. His record managing portfolios at First State Stewart demonstrates strong returns in both absolute and relative terms. Finegan warns he may not beat a rising market, he does, however, expect to outperform over a full economic cycle partly by being more resilient during down markets like 2015 and by taking a long-term risk-aware approach that focuses on investing in high-quality companies at a reasonable price.

Frontier Markets
The Last Bastion of Value

James Bannan & Hans-Henrik Skov
Portfolio Managers, Coeli Frontier Markets Fund

For those looking for value beyond emerging markets, the so-called frontier markets could offer an interesting investment option. Defined as investable stock markets that are less established than those in emerging markets, frontier markets offer characteristics such as strong GDP growth, low valuations and high dividend yields. Maybe surprisingly, frontier markets also have low correlation to the rest of the world which provides for diversification benefits.

by Jonathan Furelid – HedgeNordic

"Frontier markets are where emerging markets were in the mid-1990s. The economies are growing quickly and the expanding working class population provides for these markets to continue to grow for decades to come. At the same time, these markets are running at trailing valuations that are half of those in developed markets, ", says Hans-Henrik Skov, portfolio manager of the Coeli Frontier Markets Fund.

"Frontier markets are where emerging markets were in the mid-1990s."

Skov defines frontier markets as being those up-and-coming economies that are not part of the MSCI Emerging Market index but that have investable stock markets. Currently these amount to around 40 countries.

FRONTIER MARKETS COMING FROM A LOW BASE

According to the fund manager, the key for understanding the potential in these markets is to understand the concept of low-base effects.

”Frontier markets is all about low base effects. In these markets the GDP per capita is around 6000 USD whereas the corresponding figure for emerging markets is approximately 15000 USD. It is much easier growing from a low base than from a high base”, Skov says continuing;

> **“I would argue that frontier markets is the sole equity asset class trading at an attractive multiple, making it a last bastion of value.”**

”When you are a low-income country, growth is driven by first stage reforms such as infrastructure investments, while in the case of middle-income countries wanting to grow into high income, growth needs to come from broad political reforms that are well-founded and agreed on by a political system. This has proven difficult in many countries.”

As an example of how early stage infrastructure investments could spur growth, Skov mentions Pakistan.

”A while ago I was in Karachi in Pakistan and met with business leaders. Their main concern was how to access power. Many businesses still remain limited because they only have power 50 percent of the time, In other words, for those companies that have an industry building in place and employees lined up, the potential is to double production just by having full access to power. That tells you something about the inherent potential.”

HIGH GROWTH, LOW CORRELATION AND LOW VALUATIONS

Skov says that his investments are focused on countries that show high growth numbers, among those being Pakistan, Vietnam, Bangladesh, Tanzania and Georgia.

”These countries are growing their GDP per capita by 5-7 percent per year, while the BRIC countries have half of that and the US and Europe is far lower. This is helping companies in these countries to increase their earnings, which in the longer term should benefit their respective equity markets.”

Another factor that Skov mentions as being an interesting feature with frontier markets is the low correlation.

”Frontier markets typically hold a low correlation to the rest of the world and even to emerging markets. The most recent example being the Trump effect where emerging markets fell around 5 percent following the election result. Frontier markets however barely even moved. The same pattern was seen during the taper tantrum in 2013 and during the Greek crisis in 2011.”

According to Skov, the reason for the low correlation is that many of these countries are isolated, economically.

”They have not been merged into the global trade that China has for example and therefore are not as dependent on the global economy. Also the fact that many of these stock markets are dominated by local players make them more remote and less affected by foreign capital flows”.

In terms of valuations, Skov highlights that frontier markets are overall conservatively valued, both in absolute and relative terms, currently trading at a significant rebate to both emerging and developed markets.

”Frontier markets are trading at a trailing P/E ratio of 11x, which could be compared to emerging markets at around 15x and the MSCI World at close to 22x. The trailing P/E indicates earnings that are already realized and not a forecasted measure. While both developed and emerging markets have moved up during the last five years, frontier markets have moved sideways. ”

”On top of the valuation difference, there is also a difference in terms of dividend yield, where frontier markets offer more than 4 percent yield per year in hard currency while you have 2.5 percent in developed and emerging markets”.

”I would argue that frontier markets is the sole equity asset class trading at an attractive multiple, making it a last bastion of value”.

INVESTMENT CASE – VIETNAM DIARY PRODUCTS

At the core of the investment philosophy of the Coeli Frontier Markets team is the ambition to find high quality companies that could benefit from and reinvest into the long term growth prospects of the frontier space to reasonable funding costs.

”We focus purely on high quality businesses that benefits most from these structural growth tailwinds and in 10 years time can continue to reinvest their earnings in this growth story without using too much leverage.”

Skov mentions Vietnam Diary Products, a company that produces milk products in Vietnam under the brand name Vinamilk.

”This is a company that is a major beneficiary of a structural trend towards drinking more milk in Vietnam. Vietnam is today an under penetrated market for milk where consumption is only 16 litres per capita per year compared to 90 litres in the developed world. As the Vietnam population expands into working class, this number will rise significantly.”

”Vinamilk is a superior brand in the country and have a dominant and growing market share. The company is also highly profitable with return on new investments of around 30 percent per annum”.

”Given their position on the market, we see high barriers of entry and growing profits for the years to come. A typical example of a company that benefits long-term from the structural growth drivers that frontier markets could offer investors today and where it is difficult to find similar low-base growth prospects elsewhere.”

> **“On top of the valuation difference, there is also a difference in terms of dividend yield, where frontier markets offer more than 4 percent yield per year in hard currency while you have 2.5 percent in developed and emerging markets.”**

by Jonathan Furelid - HedgeNordic

”Buy when there is blood on the streets...”

Baron Rotschild

Iraq stocks poised for a rebound as ISIS loses grip

The old saying that you should invest when there is ”blood on the streets” could not be more telling than in the case of Iraq. The Iraq equity market has suffered under the extreme tensions linked to ISIS and has fallen by 55 percent over the last 3 years. But macroeconomic indicators show signs of a turnaround and rising oil prices together with a weakened ISIS is likely to lift undervalued Iraq stocks higher, according to Henrik Kahm, portfolio manager of the FMG Iraq Fund.

”Iraqi stocks have fallen by close to 40 percent since the Islamic State of Iraq and Syria, ISIS, took control of the country's second largest city Mosul in July 2014. Falling oil prices have also had a negative impact on stock market valuations. However, we see signs that things are moving in the right direction and have increased allocations to Iraqi equities in 2016. Valuations look very attractive”, Henrik Kahm says when asked about the prospects for Iraq´s equity market.

Kahm and his team launched the FMG Iraq Fund in 2010.

”In 2008 we did our first investment in Iraq as the market opened up for foreign investors and as we deemed the regulatory oversight with regards to the stock exchange had vastly improved. Prior to making our first investment, we had studied the market closely and discovered that there were a number of interesting companies in Iraq of which we were able to create an interesting portfolio. In 2010, we launched a fund focused on locally listed Iraq companies”.

Kahm says that there are alternative ways of getting exposure to Iraq, for example through the bond market or through off-shore listed companies such as the Norwegian oil company DNO, however focusing on locally listed stocks provides for another dynamic, he says.

“Today you can buy Pepsi in the U.S. at 23 times trailing P/E, the corresponding number for Baghdad Soft Drinks, an emerging market Pepsi play where the underlying market is growing, is 8.”

”Unlike the exposure you get from investing off-shore, local investments in Iraq is not linked to the oil and gas sector, simply because the Iraqi oil belongs to the people and is not listed as private companies. A majority of the roundabout 100 companies listed in Iraq are within financials, consumer products or telecommunications. Private banks make out the majority of those with 20 companies listed.”

The portfolio manager highlights that the Iraq stock market is relatively tiny and in many cases illiquid.

”The total market cap of the Iraq stock exchange is around 9 billion USD out of which around 50 percent is tied to a large

telecommunications company offering very low liquidity. The tradeable universe is therefore only around 4 billlion.”

Kahm admits to the fact that the media picture of Iraq is not helping when investors are considering frontier investment opportunities. He is however convinced that the market has reached a low-point and that interest will return.

“Unlike the exposure you get from investing off-shore, local investments in Iraq is not linked to the oil and gas sector, simply because the Iraqi oil belongs to the people and is not listed as private companies.”

”In May of this year we released a strategic report saying that Iraqi stocks were near bottoming out, on May 29, Iraq stock had its lowest valuation point ever. Since then there has been an upward movement in Iraq stocks, although with a lot of volatility.”

Kahm sees indications of improving market conditions.

”Going back 6 months we see that there is a better situation in the country. The economy is again growing and the oil price is also recovering. This is good news for Iraq who historically have been very successful in increasing production of oil given low production costs”.

”ISIS is losing ground and there is a potential normalization of profits. If this is being materialized, companies will be trading at extremely low valuations. Mosul will be the trigger. With local investors becoming more positive, more money will also flow to the market. Limited volumes can move the market a lot given that it is illiquid”, Kahm argues.

As an example of the low valuations in Iraq, Kahm mentions Baghdad Soft Drinks, a company that act as distributor of the soft drink Pepsi brand in Iraq.

”Today you can buy Pepsi in the U.S. at 23 times trailing P/E, the corresponding number for Baghdad Soft Drinks, an emerging market Pepsi play where the underlying market is growing, is 8. The Pepsi market in the U.S. is showing more or less no growth during the last five years. In Iraq, the market has doubled during this time period.”

The banking sector also looks attractive according to Kahm.

Henrik Kahm,
Portfolio Manager
FMG Iraq Fund

”The banking sector has shown incredible growth figures up until the ISIS conflict. They used to be growing at 30 percent annually and have low valuations close to a price to book of 1.”

Since bottoming out in May, the Iraq stock market has recovered and FMG's internal models have been bullish since the summer.

“Mosul will be the trigger. With local investors becoming more positive, more money will also flow to the market. Limited volumes can move the market a lot given that it is illiquid.”

”In a longer term perspective, we see valuations at extreme lows given that many of the listed companies are in relatively good shape. Iraq is producing 5 million barrels of oil per day and that is a lot given the size of the country.”

”Even though there are no listed oil companies, the commodity plays an important role for the overall financial conditions. Now fact that investors expect oil prices to stabilize in the area of 50-70 USD per barrel rather than hovering around 20 USD , this makes a significant difference for investor appetite going forward”.

“Kahm argues that the recent pick up in valuations expresses just how quickly things can turn around in the Iraq equity markets.” – ”We saw that in October when stocks in Mosul Bank, a banking group that has obviously been a big loser following the attacks on the city, gained almost 200 percent and the market followed with a gain of 20 percent in a short time period. Dynamics can change quickly and this time I think for the better. When there is blood on the streets, it is typically the time to buy.”

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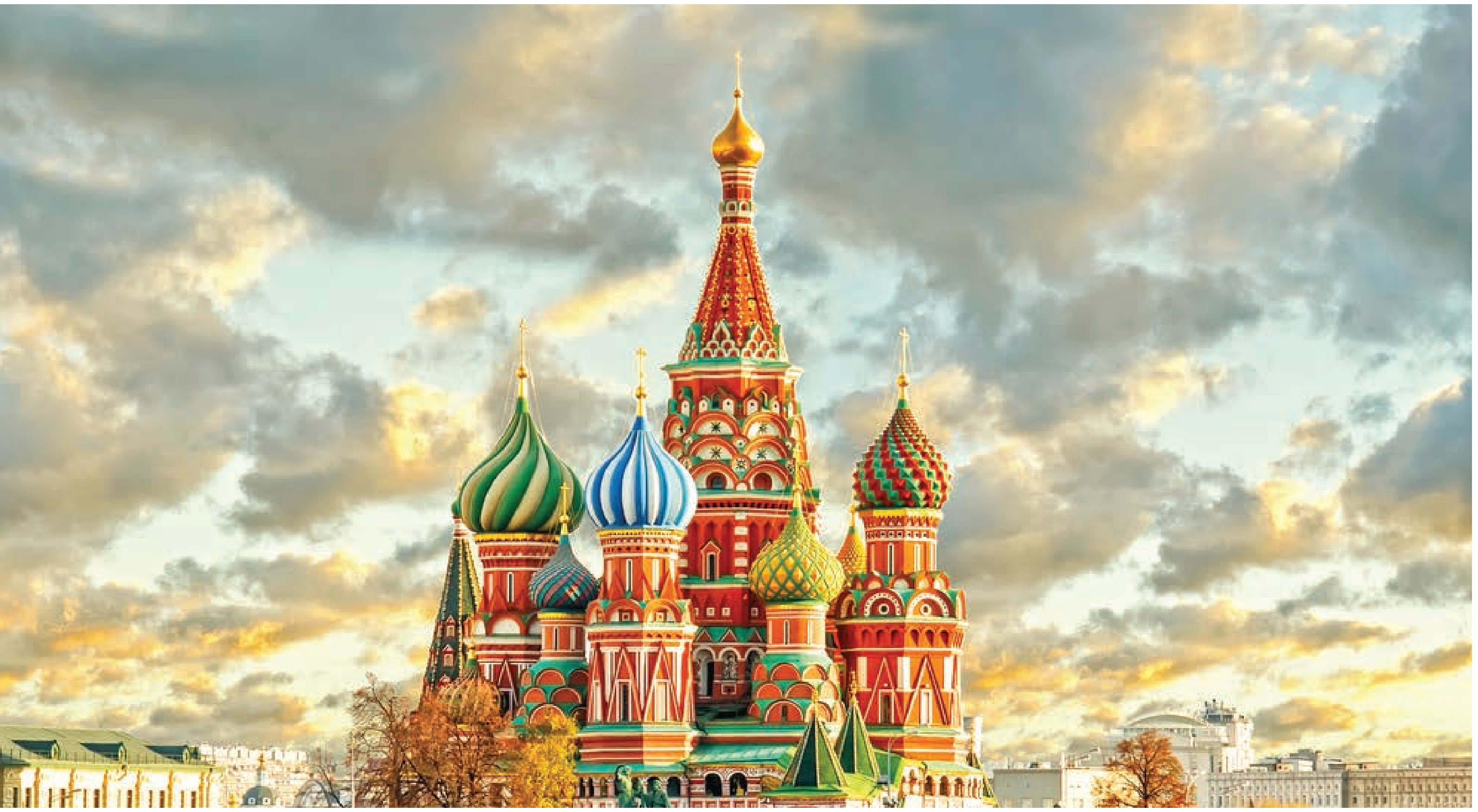


by Hugo Bain, Senior Investment Manager, Pictet Asset Management

Russia:
an unlikely land of opportunity

Even after enduring two years of sanctions, Moscow feels vibrant, with few signs of recession. The restaurants and shopping malls are full, and every time I visit it feels more and more like a wealthy Western European city. Russia may remain in the cold politically, but things are definitely warming up for the economy – and thus for investment prospects.

A VERY GOOD CRISIS

Sanctions did affect sentiment, but I feel the economic impact has been negligible. What has hurt, clearly, is the massive fall in oil prices, which collapsed from well over USD100 a barrel in mid-2014 to less than USD30 at the start of this year.

As this coincided with the long-planned end of the ruble's soft peg to a euro-dollar basket in late 2014, it meant the currency took most of the strain of the oil price adjustment. In some respects the timing of the float could not have been more advantageous, as it acted as a kind of safety valve for the economy.

However, this hurt many ordinary Russians, who found they could no longer afford holidays abroad and had to cut back on a wide range of imported goods. There has been a significant decline in real disposable incomes over the past two years. Consumer-focused companies have had a difficult couple of years as a result.

On the flip side, energy companies are in pretty good shape. The depreciating ruble eased the pain of falling crude prices for Russia's oil and gas giants, making their production costs very competitive. In the end, despite the oil market collapse, Russia's economy contracted by just 3.7 per cent last year and the employment market has remained stable throughout. So, all things considered, I think you could say in retrospect that Russia had a very good crisis. This is the third crisis that I have witnessed since I started looking at Russia in 1997 – and this one felt the least detrimental, so maybe practice makes perfect... I would argue that investors should give some credit to Russia for prudent fiscal and monetary policy, and that evidence of this prudence should have a positive effect on equity prices through a lower risk premium.

RATE CUTS ON THE CARDS

The economy has now troughed; fore- casts for next year's gross domestic product growth range from the govern- ment's conservative 0.6 per cent (based on USD40 oil) to Goldman Sachs's 2.5 per cent, with further acceleration expected in 2018.

Notably, this recovery started without help from the central bank, which – mindful of a history of runaway inflation – had been very hawkish until this sum- mer. Only after a steady easing of price pressures did the central bank decide to lower interest rates. This year's two cuts should be followed by more next year.

Easier monetary policy, in turn, should help support consumption. Russians with spare cash are already struggling to find where to put it. Last year, they could get 18 per cent interest from a reputable commercial bank; on my reCent visit it was just 6 - 8 per cent. It seems highly likely to me that, as rates come down, you will see a significant decline in the savings rate and an increase in consumption. Some domestic funds may find their way into the equity market, particularly as the dividend yield is now close to the deposit rate.

OIL: NOT TOO HIGH AND NOT TOO LOW

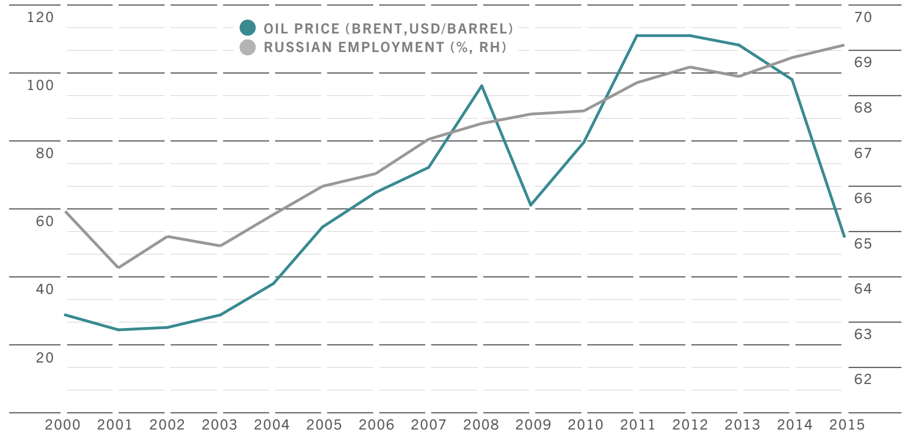
Of course, Russia's outlook remains closely tied to the price of oil. I have always believed that a very high oil price is a cause of economic inertia and corruption in Russia. There is simply no impetus for structural reform.

The ideal scenario would be if oil stabilised around USD45-65 a barrel for the foreseeable future. That would be high enough to support decent economic growth, but low enough to ensure a degree of fiscal prudence, and to maintain pressure on the authorities to push through structural reforms.

INVESTMENT SWEET SPOT

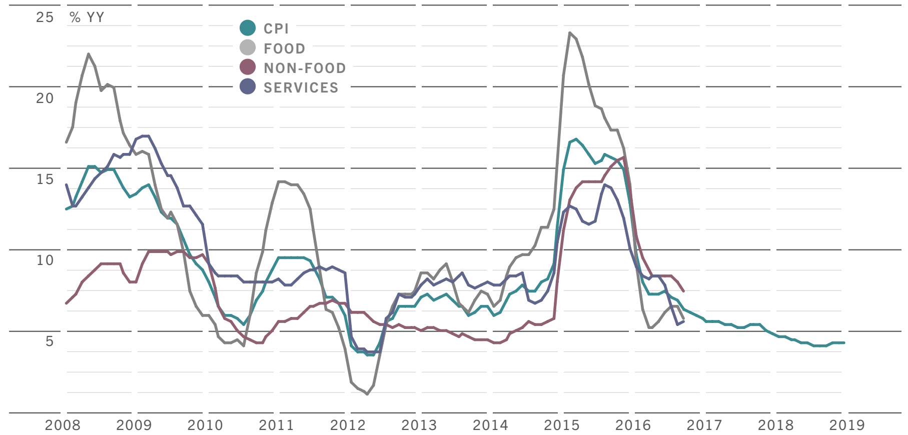
Investors are slowly waking up to the opportunity presented by Russia's recovering economy and competitive exchange rate. First comers have already been richly rewarded, with the stock market up nearly 35 per cent since the start of the year in local currency terms. However, stock valuations and dividend yields remain extremely attractive (MICEX trades on a price-to- earnings ratio of 9.8

FIG.1
Russian employment rate versus the oil price



Source: Rosstat, Thomson Reuters

FIG.2
Inflation easing on all measures



Source: Rosstat, Renaissance Capital

Hugo Bain, Senior Investment Manager, Pictet Asset Management

times and a dividend yield of 5.8 per cent, versus S&P 500 on 24.8 times and 2.0 per cent). I think that we are very much in the sweet spot for investing in Russian equities.

Corporate balance sheets are in good order. There are some exceptions where we see higher leverage, mainly in the energy sector, but this borrowing is off- set by very strong free cash flows. We would expect corporate Russia to continue to decrease the levels of net debt, from already low levels in the next few years. From the Russian food retailers, where you still see EBITDA margins of 10 per cent, to the oil giants, which are some of the lowest cost producers in the world, or the materials companies, there are no signs of distress.

Energy companies and miners are reaping the rewards of ruble depreciation through low costs. Oil production is at historic highs and even if the govern- ment raises taxes for the sector, which it may well do, companies should still have plenty of cash leftover to pay at- tractive dividends.

Interestingly, even during the fall in oil prices, energy companies retained their appeal among investors, particularly those from China and Japan. Since the start of 2015, Russian corporations have secured some USD32 billion of funding (mainly in the oil sector) and a further USD7 billion in M&A investment from Asia.

On the domestic front, the real estate sector should do well, with interest rate cuts providing a double boost. On the one hand, the reduced appeal of holding money in a bank will likely encourage people to invest in property, as the differential between rental income and deposit rates converges. On the other, affordability should improve as mortgage rates come down. The property companies I met with in Moscow say that demand could rise by 50 per cent or even more.

So, despite the ongoing political tensions with the West, the outlook for Russia's domestic economy is positive. As long as oil stays above USD40 a barrel, the return to economic growth, accompanied by looser monetary policy, should benefit asset prices. Stocks in particular are woefully under-owned, despite the recent rally. This means that there is still everything to play for in Russian equities – at least until the football World Cup and presidential elections in 2017.

Addressing the challenges and opportunities of sustainability in emerging and frontier markets

*By **Louise Hedberg,** Head of Corporate Governance and Sustainability at East Capital*

Legal systems, rules and best practices related to corporate governance and sustainability in emerging and frontier markets are not yet fully developed, and there may be gaps in their enforcement. But this is only natural and understandable, given the definitions of "emerging" and "frontier". And there is certainly no reason to overlook these markets, especially given the many improvements and actions that are being undertaken with the aim to create well-functioning and attractive markets and companies that can stand out in the global competition for capital. Meanwhile, asset managers like ourselves who are active in the EM and FM universe, can conduct our own thorough assessments of corporate governance standards, in order to understand the boundaries within which issuers are expected to act, and upon which we should be able to rely when making and managing investments. Today, it is obvious that a robust bottom-up strategy with a long-term perspective should include not only a rigorous assessment of corporate governance standards, but also the long-term investment performance implications of the broader challenges and opportunities related to sustainability.

On-the-ground approach provides unique perspectives

The amount and length of reliable and comparable sustainability related data available in developed markets is still short (perhaps 10-15 years of data) if compared to data series on regular financial data (100+ years of data). Furthermore, most sustainability data is typically back-ward looking, released annually, and not integrated in the overall management discussion or ordinary financial reporting, calling for qualitative assessment techniques of most sustainability related factors, based on a significant dose of subjective judgement. This means that so called ESG (Environment, Social, Governance) data and ESG scores

> **"EM and FM will continue to require a more hands-on approach to research and investment, for some time to come."**

are far from, and some possibly never will be, standardized or commoditized in the way we have easy access to a wide and constantly updated range of financial ratios to guide our daily work. This is even more so the case in emerging and frontier markets where sustainability-related regulation, consumer demand or peer pressure is not yet forceful or impactful enough and where sustainability reporting is scarce or insufficiently reflects reality. Given this, EM and FM will continue to require a more hands-on approach to research and investment, for some time to come. Ever since East Capital's first investments in 1997, we've seen how our on-the-ground presence and direct relationships, not only with management teams, boards and owners, but also other stakeholders around the companies, have been particularly valuable resources in order to pick the right companies and to understand and engage on company specific sustainability matters.

> **"...portfolio managers and analysts typically start their analysis of a company with a review of the company's corporate governance structure"**

Our experience in EM and FM confirms the general view that companies that understand and appreciate the purpose of good corporate governance are more often well-managed in every sense, including understanding and managing the environmental and social perspectives comprising global issues such as climate change, pollution, biodiversity risks and resource scarcity, as well as concerns over human rights, health, safety and labour standards or corruption. Therefore, our portfolio managers and analysts typically start their analysis of a company with a review of the company's corporate governance structure and practice. This is most obviously determined by a company's shareholder structure. Who is on the shareholder list and what are the primary objectives and incentives of the major shareholders? Are they fully aligned with the interests of the minority shareholders? Ultimately, it boils down to determining if a company and its board are reliable guardians of the business and investors' capital.

Active and responsible owners play important role

It is clear that relevant and material environmental and social factors can significantly impact the financial value and future position of a company, although it is also obvious that the type and size of impact still varies depending on the maturity of the regulatory environment and consumer pressure of that particular market. As owners, we can actively encourage our portfolio companies' management teams and boards to make sure that rigorous analyses are done to 1) identify and prioritise among their relevant and material environmental and social factors on a market, sector and operational level over the short, medium and long term and 2) address and integrate these into the company's strategy. This is how we as investors can understand if the company has the capacity to create value, also in a longer perspective.

Allocating capital to support long term sustainable development

More themes are emerging as a basis for "negative" exclusion for international investors but, more importantly, we are witnessing an increasing number of sectors that provide exposure to interesting and inspiring themes for "positive" inclusion.

2015 clearly became a "super year" for the sustainability theme. With the UN conference on Financing for Development in Addis Ababa in July, the adoption of the new Sustainable Development Goals (SDGs) in New York in September and finally COP21 in Paris, global sustainability was firmly put on national and corporate agendas around the world. This will offer momentum for the many interesting investment opportunities offered by the increased attention on solution providers to global sustainability related challenge. This particularly clear in China, which is already today the largest clean-tech market in the world, further supported by the ambitious, but achievable, actions in the war against pollution communicated by the Chinese government in the 13th five year plan for 2016-2020. In the longer perspective we believe that we and other investors should see it as our responsibility, to actively contribute to the long-term advancement of the ESG perspective in the emerging market investment universe through actions such as:

- Picking companies that are transparent and well-managed in every sense or show a clear ambition and a path to get there;
- Engaging and building trusting relationships through meetings and discussions with management, boards and largest owners where relevant and material sustainability topics can be put on the agenda; and
- Initiating and maintaining dialogues with governments, stock exchanges and other authorities and institutions on further strengthening the local market framework.

Louise Hedberg,
Head of Corporate Governance and Sustainability at East CapitalPrivée

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Emerging Market Hedge Fund Strategies:

A Rich Opportunity Set for Generating Risk Adjusted Returns

by Hamlin Lovel - HedgeNordic

All hedge fund strategies can apply to emerging markets (EM), and many larger hedge funds trade developed markets and EM. Swedish and Norwegian asset managers were amongst the first to invest in Russian equities, with some, such as East Capital and Prosperity Capital, opening offices in Moscow.

Scandinavia, arguably, has its own emerging market in Iceland, which exhibits levels of market and macroeconomic volatility, government intervention in financial markets, and (at least erstwhile) political corruption, typically associated with many emerging markets. But volatility spells opportunity. Robert Gibbins' Autonomy hedge fund manager created a single country fund that profited from the spectacular recovery in Iceland. Recently, the manager has launched the Autonomy Venezuela Opportunities Fund. Managers, including Brevan Howard, have run Argentina funds.

Frontier Markets

So no EM need be completely off limits. Some EM - particularly frontier markets- may be too small or illiquid for the largest funds, or for open-ended funds with daily, weekly or monthly liquidity. But hedge funds can easily limit capacity or lock up capital in a closed end fund. Managers such as Jeremy King's Knight Asia, based in Bangkok, have blazed the trail into frontier markets such as Cambodia and Myanmar, using private equity style fund structures. Iran may still be un-investable for US entities, but London-based Sturgeon Capital, and Turquoise Partners, have already set up dedicated Iran funds. Firebird Asset Management's James Passin has even obtained exposure to North Korea! As utterly unconstrained vehicles, hedge funds have often been the first to set foot in controversial markets that could carry reputational risk for many conventional asset managers.

Short Book Opportunities

Long/short equity, and equity market neutral, strategies will find their short universe is smaller than their long universe, as in developed markets. Historically, many EM regulators cracked down on short selling but actions by Chinese regulators in 2015 now look exceptional. Anyway, it is simpler to short Chinese companies listed in Hong Kong, Singapore or the US. Traders such as Sahm Adranghi of Kerrisdale Capital, or Carson Block's Muddy Waters Research, which exposed fraud at Sino Forest, have shorted US-listed Chinese firms. Fidelity's long only manager Anthony Bolton observed that there is more corporate fraud in China, but this is clearly an opportunity for hedge funds that can go short. Allegedly opaque accounting practices have also lured short sellers such as Jim Chanos, who has concerns about accounting at Alibaba. The benefits of shorting, for market liquidity and efficiency, are now widely accepted, and single stock futures make it easier to short in India.

The ability to short currencies can also be helpful. Global macro and CTA managers have been trading EM for many years. George Soros famously shorted Asian currencies in the crisis of 1997, and other hedge funds profited from shorting the Russian Rouble in 2015. By 2016 many hedge funds, including Man Group, had reversed to long positions in the Rouble, according to Bloomberg.

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Uncorrelated Markets

Systematic macro manager, Informed Portfolio Management AB, trades EM FX. Many large CTAs, including Man Group, Aspect, Winton, Transtrend, and GAM Systematic/ Cantab, trade interest rates in EM. Hedge funds obtain diversification benefits from EM, partly because interest rate cycles can be very different: in 2015, Brazil was one of several EM raising rates while the developed world was cutting them into negative territory. Historically, managers have often needed OTC counterparties to trade EM FX and rates. Increasingly, emerging markets currencies and rates, including the Mexican Peso, can be traded as futures on exchanges such as CME Group.

Larger EM countries, such as Brazil, can offer multiple interest rate curves – nominal government, inflation linked government, swap, interbank rate and repo rate – which can provide rich opportunities for fixed income arbitrage. The fact that Brazilian markets are on average 3 or 4 times more volatile than developed markets enhances the potential opportunities. Locally, Luis Stuhlberger's Verde Fund has annualised at 29% since 1997, Reuters reports. As many hedge funds dial down to lower volatility targets, possibly to satisfy conservative pension fund allocators, more adventurous investors seeking the returns that Soros, Tudor, Moore and Caxton delivered during their heydays, may need to consider EM.

CTAs have also added markets such as Malaysian Palm Oil for additional diversification benefits.

Some hedge funds may also start trading commodities listed on exchanges located in emerging markets, such as China's developing commodity exchanges, and India's, including the Kochi-based International Pepper Exchange.

The EM Opportunity Set for Hedge Funds: Corporate Bond Example

	Rates	Credit	FX	STRATEGY
1	Long	Long	Long	Long Only
2	Long			
3		Long		
4			Long	
5	Long	Long		
6		Long	Long	
7	Short	Short	Short	Short Only
8	Short			
9		Short		
10			Short	
11	Short	Short		
12		Short	Short	
13	Long	Short		Long/Short
14	Long		Short	
15	Long	Short	Short	
16	Long	Long	Short	
17	Short	Long		
18	Short		Long	
19	Short	Long	Long	
20		Short	Long	
21	Short	Short	Long	

	Index	Return	Std Dev	Ratio	Period
BONDS	JPM GBI-EM	5.9	13.4	0.44	2004-2015
EQUITIES	MSCI EM EQUITY	3.49	23.53	0.15	2006-2015
HEDGE FUNDS	Eurekahedge EM Hedge	9.43	8.56	1.10	2004-2015

Credit and Distressed Debt

Indeed, the EM investment universe is constantly expanding across all asset classes. For instance, EM corporate debt has been the fastest growing fixed income asset class post-crisis, according to Barclays. Credit managers, such as giant BlueBay Asset Management, have been active in EM for many years, managing both absolute return and hedge fund strategies. In order to borrow securities and short EM corporate credit where CDS may not exist, good counterparty relationships can help hedge funds to access the repo markets.

If hedge funds are "the new banks", alternative lending strategies are active in EM, with Adamas Asset Management charging interest rates of 15% in China. In distressed debt, hedge funds, such as Cube Capital and Avenue Capital Group, have been investing in Chinese non-performing loans (NPLs) for many years. Elsewhere, in Ukraine's war-ravaged economy, Richard Deitz's VR Global has been driving forward corporate restructurings, according to the Legends Fund.

Activists and Events

In other event-driven strategies, merger arbitrage managers can hardly avoid EM when Chinese companies are acquisitive abroad, making mega-bids such as ChemChina's for Syngenta. In activism, Paul Singer's Elliott Capital Management is well known the US and UK, and is also active in South Korea, agitating for restructuring at Samsung Electronics. Additionally, Singer applies his activist acumen to sovereign debt markets, where he was among 'hold outs' who refused to accept the 2001 offer from Argentina.

Why Access EM via a Hedge Fund ?

Hedge fund managers clearly enjoy a wide opportunity set in EM, and have more choice over which risks to take. A local currency EM corporate bond contains three main market risks: interest rate, credit and currency. Long only managers who can buy fixed or floating rate bonds in hard or local currency, or access derivatives, can construct trades with six combinations of one or more of these risks. Hedge fund managers, who can also go short, can construct an additional six combinations of short only trades, and nine combinations of long/short trades, making 21 altogether, as shown below.

Thus their opportunity set is greater. Grinold and Kahn's fundamental law of active management states information ratio = selection skill * number of independent opportunities. Though the three above market risks are not always independent, they can be lowly correlated and sometimes move in opposite directions. Russian equities hit an all-time high in local currency terms in 2016, but are below their peak in USD terms. So it may pay to hedge currency risk.

Emerging Market Hedge Fund Performance

The spread of EM hedge fund returns is so wide that indices only give a broad brush indication. But the indices below suggest that EM hedge funds have offered both higher returns, and lower volatility, than leading long only EM equity or EM bond indices. The ratio of return to risk on hedge funds has been close to one, more than double that on EM bonds and seven times as high as the ratio on EM equities.

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EMERGING AND FRONTIER MARKETS THROUGH THE ALLOCATOR LENS

by Jonathan Furelid – HedgeNordic

How are institutional asset managers viewing emerging and frontier markets from a portfolio perspective and what are their lines of thinking when allocating to the asset class? HedgeNordic took the pulse on Majdi Chammas from AP1 and Samir Shah from Aberdeen Asset Management.

When did you start allocating to emerging markets?

Chammas: "We started allocating to emerging markets in 2002. At the time, we were running a structured product with a bank that provided us with the exposure. The allocation was only 1-2 percent of the fund. Since then we have had exposure, to varying degree, to emerging markets, primarily through long-only equities." "In 2006, we altered our way of getting exposure to the asset class. We had a tender offer out looking for single managers specialising in emerging markets. We rebuilt the portfolio and increased the allocation. Today some 10 percent of the fund is allocated to EM."

Shah: We started investing into EM in 1998. Today our EM portfolio consists of 40 underlying managers and our frontier markets portfolio is composed of 36 names.

How has your allocations changed over time?

Chammas: "Up until our latest tender offer, which was out in 2012, we did not include frontier markets in our allocations. That has since changed. Following on from research we did on how to expand and get more out of our EM exposure, frontier was included and we also added small-cap equities to our emerging markets allocations."

Shah: "When we started back in 1998, there was a lack of high quality funds focusing on frontier markets. In 2003, we started to put frontier markets in our EM portfolio. It became such an attractive component that we decided to set up a new fund exlusively targeting frontier markets in 2005."

How do you look upon the Emerging Markets asset class from a portfolio perspective today?

Chammas: "The way we currently view emerging markets is that they serve as an important component for us to reach our stated return target. In an environment where low rates for longer will make it difficult for us to achieve returns elsewhere, EM is one of few return sources where we can see significant preformance contribution. We believe that emerging market equities will outperform developed markets in the medium- to long term."

Shah: "Shareholders in our fund are looking at EM as part of an overall portfolio strategy. What we have noticed is that whereas previously they were investing around 10 percent of their assets into EM almost exlusively, they are now looking to allocate a smaller percentage to EM and 5 percent to alternative asset classes. Alternatives in this context meaning frontier markets, infrastructure, environmental and solar plays - things that are non-correlated to equities."

What is your view on frontier markets specifically?

Chammas: "We see frontier markets as having characteristics that are interesting and that make them complementary to emerging markets. The way we see it there is a strong connection between emerging markets and developed markets. So-called decoupling effects are typically exaggerated. In frontier markets, that are more focused on the local economies and less export dependent, there are more decoupling effects playing into growth dynamics."

Shah: We look very positively on frontier markets, which is why we started a separate fund targeting these markets specifically back in 2005.

Are your allocations to EM through actively managed equity funds only?

Chammas: "The allocations we run on the emerging market side are not 100 percent active, there is a level of passive investing coming into the picture, primarily for two reasons; fund fees and liquidity. There is a pressure on us to keep costs in our mandates at low levels, this is most easily done through employing a certain amount of passive products. Passive investments are also more convenient for us to go in and out of, so they are used as a liquidity buffer at times when we need to rebalance portfolios."

"A majority of our investments in the EM space are made through long-only equity mandates and to a small degree through emerging market debt".

Shah: We are a fund-of-funds operator focusing almost exclusively on long only equity managers offering closed-ended funds. "Since the bulk of our assets are in closed-end funds we do not have the regular pressures of subscriptions and redemptions, which in turn makes it possible for us to allocate with a long-term view, typically three to five years".

What factors are you looking at when selecting emerging market asset managers to your porfolios?

Chammas: "When selecting managers to our portfolio, we are keen to know who the people behind the strategy are. There must be a philosophy and a process behind that makes sense and that we feel is consistent with what the fund aims to deliver. We tend to focus on soft values and always need to make sure that there is an alignment of interest between the managers of the fund and the end-investor."

"We have no preference for locally based managers. Local presence is not a decisive factor for us, it is rather the story behind what you do that needs to hold together. If a manager claims that the investment decisions they make are always well-founded in a thorough company research and on-site company visits, while at the same time the fund conssists of two analysts sitting in London, that is a story we are not likely to buy into."

Shah: "When it comes to selecting managers, we do not focus exclusively on historic performance. We want to understand the team's strength and depth along with what their investment philosophy is. Going on from there, we ask ourselves, is what they do sustainable? Are we confident that they can outperform?"

"Ideally we want to have managers that are based on the ground. They have the local connection to gather intangible information more readily which is always useful."

How are ESG factors playing into your investment decisions in emerging markets?

Chammas: "ESG factors is something we always consider when deciding on allocations, these considerations become even more important in emerging markets. We require that the managers we allocate to have ESG as an integral part of their investment process. It is a top priority from our side to find managers that have these processes in place."

"ESG factors play an important role in both our internal and external investment mandates. We believe that long-term, using ESG factors as an evaluation tool, will enhance our performance."

Shah: "From a company perspective, ESG factors is important to us and we do it in two ways, Firstly at the fund manager level, we want to make sure that the social governance is very high level. Team efforts must be incentivised.

"We also look at how they incorprate ESG into their underlying investments, what do they look at and do they have a policy, who is responsible for ESG factors being implemented? These factors are important to us and will affect our asset allocation decsisions."

What opportunities and risks do you see in emerging markets today?

Chammas: "One reason for us being positive to EM is valuations that look relatively attractive. Another is the spread in growth between emerging and developed markets that has been shrinking for a number years but that is now widening again, to the benefit of emerging markets. We believe this will drive flows into EM and support our positive view on the asset class."

Shah: "In 2015, the market's view on emerging markets was quite negative. Commodity prices and growth rates were falling. We have seen a turnaround this year as flows into emerging and frontier markets have stepped up. Fundamentals in these countries and companies have remained solid."

"Another thing that has really helped is currencies. During the last five years, EM currencies have been a detractor in terms of relative performance, whereas now they are either stabilizing or gaining some traction against the US dollar, which is very positive".

"Risk factors are slightly different compared to developed markets. What happens in developed markets impacts what emerging markets do, while you can´t turn it around and say that emerging markets to a significant extent affects developed markets. There are a lot of external factors to EM that you need to take into consideration.

There are also internal risks, politics of course is a big one, but also as these economies grow, you have to make sure that it is a geniunely free market. For example we dont want to see the Chinese just stop trading the equity market. Then you have non-corporate events affecting asset allocation decisions."

Samir Shah, Aberdeen Asset

Managing 560 MUSD combined in emerging and frontier markets. Mr. Shah covers global emerging and frontier markets with a focus on Asia. Fund of Funds operator with over 95% being long only managers. Focus on closed-ended funds.

Majdi Chammas, AP1

Head of External Management, overseeing AP1:s equity and fixed income long-only mandates.

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