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Mackenzie INSIGHT

Manager Views

Is there growth in emerging markets? James Morton thinks there is.

Some of the priciest real estate in Asia can be found on the aptly named Victoria Peak, which towers over Hong Kong's business district. Prices there are probably only matched on the Bund in central Shanghai where villas are going for $8 million. Western investors who watched the real estate bubble burst in the US have speculated that China's real estate market will soon blow up as well, putting an end to the country's decade-long period of surging growth. But James Morton, Manager, Mackenzie Cundill Emerging Markets Value Class, believes the China doubters have it all wrong. "I can tell you that fears of a bubble are exaggerated," says Morton. "The corporate sector is healthy and governments across Southeast Asia are in surplus. It's a very different picture than Europe and the US."

Morton, who also manages Mackenzie Cundill Recovery Fund, knows China first hand. He started meeting with company executives across the region after China created the first free economic zone in Shenzhen, where the country's manufacturing boom began. Then in 1999 he took the helm of the newly-minted Cundill Recovery Fund which had a mandate to buy companies emerging from a financial crisis – in this case the Asian currency washout. Since then he has watched Asia rebound as it learned from the mistakes that had pushed a number of countries and corporations across the region to the edge of bankruptcy.

Now there is a currency crisis gripping Europe and the accompanying uncertainty caused equities across Asia and much of the world to decline in May and June. But Morton, who as a value investor looks for companies trading at a sharp discount to their net asset value, sees the recent market volatility as an opportunity. In fact, he believes the spring selloff is offering investors yet another opportunity to enter emerging markets in Asia and other parts of the world, including Russia and Ukraine. Explains Morton: "What market metrics and individual company valuations are saying is, 'this is quite a good time to invest.'"

Cundill Emerging Markets has been trading at an estimated 39% discount to the combined net asset value of the companies in the fund. (Definition: Net asset value, or NAV, is a company's current assets minus its liabilities.) In effect, this creates a "margin of safety" for investors, with earnings expected to grow more rapidly than the valuations in the fund would imply.

Morton builds his bullish case for investing in emerging markets around a string of long-term valuation measures including price-to-earnings and price-to-book. (Definition: Book value is the value of a company's assets less accumulated depreciation. If the ratio of the price of a share of a company to its book value/share is 1:1, that means that the market is estimating that the company is worth no more than what its assets could be sold for. In other words, there is no value placed on the future income stream of the company. This indicates that the stock may be a "value" stock – i.e., trading at less than a portfolio manager believes it is worth). He holds up the Philippines, which has about a 7% weighting in Cundill Emerging Markets, as a specific example, pointing out that in early June the Philippines' market had fallen back to the point where it was trading just 3% above its average 15-year P/E ratio – in other words, cheap. He sees a similar story across Asia, where he says, "stocks are cheap relative to long-term valuation multiples, making it an attractive investment environment and that's reflected in our portfolios."

Following the Asian financial crisis of 1997, the region's battered financial sector became much more conservative, avoiding what Morton calls the "weird and wonderful products" that were being produced by investment bankers in the US. These same banks are now benefiting from their hard won sobriety as incomes rise across Asia, and financial companies now have a 40% weighting in the fund. These include two companies in the consumer finance sector: BFI Finance Indonesia and Clipan Finance Indonesia, which provide consumer and industrial loans. Morton also owns Manila-based Rizal Commercial Banking Corp., the fifth largest bank in the Philippines with 287 branches. Explains Morton: "When you talk about rising consumerism and growth in Asia, financial services are absolutely central to the whole thing."

The impact of rising incomes is being felt across the high-end consumer sector where companies that sell products such as chocolate, beer and jewelry are experiencing phenomenal growth. In this sector the fund holds Thailand-based Pranda Jewelry which makes merchandise from gold and other precious metals. And analysts have revised its earnings forecasts upward for the next two years. "It's all tied in to where you are at a given stage of the economic cycle," explains Morton. "You can actually have quite a wide range of investment options that allow you to participate in this great growth story."

Infrastructure spending will also continue for decades across the region as countries (India is building 200 miles of roads a day) attempt to expand their economies and house millions of people who are moving from the countryside to the cities. To capture that growth, Morton owns China Merchants Holdings PLC, which is active in three core sectors of the Chinese economy: transportation and related infrastructure (ports and toll roads), asset management, and property development. In fact, revenue from tolls fuelled a 20% increase in operating earnings in that division alone earlier this year.

While many analysts are predicting a housing bust in China, Morton says they are basing their assumptions on high-end markets like Victoria Peak, which account for just 5% of sales. Otherwise, says Morton who has visited many Chinese cities, real estate is generally attractively priced and affordable. But the perception that there is a bubble in Chinese real estate has created an opportunity as valuations dropped. "Share prices have come down although they are not as good as they were in November and December of 2008," says Morton. "But they certainly are getting closer to that level."

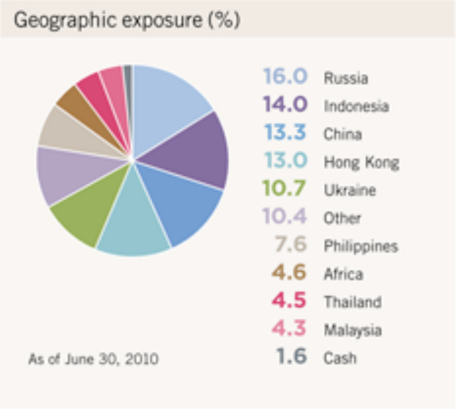
Like Asia, some Eastern European countries including Russia and Ukraine are in much better shape than the rest of Europe and the US. Morton points out that Russia's national debt is almost nonexistent and that Ukraine's debt is running at about 30% of GDP. By comparison, the UK is closer to 70%, the US is nearly 85% and Japan is off the charts at almost 200%. "Russia is basically the cheapest major market in the world today," says Morton. "The index there is trading at less than half the multiples of markets in Western Europe, which have no growth."

In June, Russia had the largest weighting in the fund at 16% and Ukraine was 10.7%. Some of the companies the fund owns in Russia and Ukraine are actually products of the Cold War that have turned military research and development into a substantial peacetime advantage. For example, Motor-Sich ISC, a manufacturer of helicopter and plane engines in Ukraine, reported a strong rebound in revenues in 2009 and has a backlog of orders looking out to 2011. Similarly, Russian manufacturers Kazan Helicopters and Ulan Ude Aviation have a growing list of back orders and should experience strong earnings growth in the coming months.

Overall, Morton sees a number of reasons to stay invested in emerging markets. He points out that Asia's contribution to the global economy was less than 10% in 1980 and is almost 25% today. At the same time economic output from the G7 countries has fallen from over 50% to the mid-30s. Morton expects those two lines to cross at some point over the next 10 years.

Of course this raises an interesting question for Canadian investors. What is the best way to capitalize on emerging market growth? On the one hand, Canadians have ready access to resource company shares which should do well as demand for commodities of almost every type continues to rise. But Morton offers another scenario. He points out that in the 1970s and 1980s, when Japan developed rapidly, people who invested directly in Japanese companies did better than people who invested in commodities at home. And says Morton, "I think that will be true with Asia."

Cundill Emerging Markets: a 65% weighting in Asia



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