M&G Global Emerging Markets strategy

Review: Third quarter, 2012

Fund manager – Matthew Vaight

Overview

- **The M&G Global Emerging Markets strategy rebounded over the third quarter as widespread stimulus measures triggered a rally in risk assets.**
- **Good stock selection within the information technology and telecommunications sectors helped the strategy outperform the MSCI Emerging Markets Index.**
- **The fund manager purchased three new holdings (Shui On Land, Axis Bank and Garanti Bank) and sold the stakes in Noble Group and Nomos Bank.**

Strategy performance

	3 months %	1 year %	3 years % pa	Since launch* % pa
M&G Global Emerging Markets strategy	5.2	15.2	8.1	22.7
MSCI Emerging Markets Index	4.8	13.2	5.6	17.8
Excess return	0.4	2.0	2.5	5.0

*Source: M&G Xamin as at 30 September 2012. Investment returns (gross of fees). Please note that the past performance shown here has been calculated on a fund basis, and may be different to past performance calculated for a segregated mandate offering. *The strategy was launched on 5 February 2009.*

Emerging market equities rose during the third quarter of 2012 as investors welcomed policymakers' attempts to address slowing global growth and solve the debt problems in the eurozone. With borrowing costs in Italy and Spain rising to levels widely regarded as unsustainable, share prices rallied when Mario Draghi, president of the European Central Bank, declared that he would do whatever it takes to protect the euro. Investor sentiment improved further when he revealed a plan to buy bonds of struggling euro-member countries. Evidence of deteriorating economic conditions, particularly in China, prompted widespread action. Monetary policy around the world was eased to encourage growth: China cut interest rates for the second time in as many months, while Brazil, South Korea, South Africa and Brazil also lowered borrowing costs. China and Brazil both launched large infrastructure projects, while India announced a series of policies designed to stimulate the economy. Stockmarkets extended their gains when the US Federal Reserve outlined plans to inject more money into the US economy to support the recovery, so-called "QE3". However, the rally faded at the end of the period as growth concerns resurfaced and it was feared that Spain might need a bailout. Despite significant policy developments during the quarter, investors were reminded of the serious difficulties affecting the global economy and the eurozone.

The improvement in risk appetite meant most markets delivered positive returns over the quarter. Investors returned to countries that had previously been out of favour, such as Egypt and India. Poland and Hungary benefited from the positive developments in the eurozone, while South Korea and Taiwan, which are growth-related, also performed well. At a sector level, returns were varied. Energy stocks were supported by a rising oil price and information technology also performed well. Utilities declined while basic materials struggled in light of reduced global demand for commodities.

The strategy's performance was attributable to good stock selection across many countries and sectors, most notably in the information technology and telecommunications sectors.

Largest positive contributors

Stock	Relative weight (start of period) %	Absolute return %	Performance contribution %
Delta Electronics	2.1	28.3	0.4
Banco do Brasil	1.4	24.9	0.3
AZ Electronic Materials	2.3	18.8	0.3

Source: Xamin, investment returns (gross of fees) calculated in sterling, as at 30 September 2012. Performance contribution relative to MSCI Emerging Markets Index

In addition to the general boost to sentiment from policy initiatives, share prices were buoyed by good corporate results. Shares in Delta Electronics and AZ Electronic Materials, two innovative firms, benefited from resilient performance during the period. UK-based AZ makes specialty chemicals used in television and mobile phone screens. It generates most of its sales in Asia, where it supplies leading technology firms. Despite a challenging economic environment which has dented demand for consumer goods somewhat, AZ managed to deliver reasonable profits during the period. Delta, which is based in Taiwan and makes electronic components including power supply packs for laptops, also reported strong performance during the quarter. As both companies invest heavily in research and development, the fund manager believes they are in leading positions in growing industries.

The Brazilian stockmarket recovered some of the previous quarter's losses as investor confidence was boosted by widespread efforts to revive the global economy. Against a backdrop of slowing growth, Brazil has been easing monetary policy consistently since August last year and its benchmark interest rate is now at a record low. Policymakers are trying to encourage consumers and companies to borrow as a way of stimulating economic activity. In a further bid to fuel growth, the government has launched a multi-billion dollar stimulus package to improve the country's infrastructure by investing in roads and railways. In this environment, two Brazilian holdings, state-run bank Banco do Brasil and Fibria Celulose, a pulp producer, were among the leading contributors to performance. Despite the challenge of operating in a lower interest rate environment, which will reduce its revenues, Banco's assets under management rose and it expects to increase the amount of lending it undertakes in the future. Fibria, which exports eucalyptus pulp to tissue makers around the world, benefited from a recovery in pulp prices during the quarter. The company has also implemented a strategy to improve its financial position and the fund manager recently participated in a capital raising to strengthen Fibria's balance sheet and reduce its financing costs.

The position in First Quantum Minerals, a Canadian copper and gold mining company with assets in Africa, was also supportive. Although the miner's profits fell slightly as a result of lower copper prices, its shares spiked following the announcement of stimulus measures that investors anticipated might trigger demand for the company's products.

Largest negative contributors

Stock	Relative weight (start of period) %	Absolute return %	Performance contribution %
Cremer	1.7	-19.6	-0.4
Shanghai Electric	1.5	-14.5	-0.3
Yingde Gases	2.1	-5.5	-0.2

Source: Xamin, investment returns (gross of fees) calculated in sterling, as at 30 September 2012. Performance contribution relative to MSCI Emerging Markets Index

Cremer, a Brazilian manufacturer and distributor of first aid products such as syringes and bandages, was the biggest detractor from performance over the period. Cremer's shares continued on a downward trend for the second consecutive quarter. The company reported weaker-than-expected revenues during the period as a result of supply chain problems and higher operating expenses. Margins were affected by the larger and more expensive sales team and logistics infrastructure that Cremer has put in place to meet future growth. The fund manager remains comfortable with the holding and, notwithstanding these short-term setbacks, believes it is well placed to benefit from increased demand for healthcare goods in Brazil.

As economic activity in China continued to falter, the positions in Shanghai Electric, a manufacturer of energy equipment in China, and Yingde Gases, a supplier of industrial gases to Chinese steelmakers, proved costly yet again. The slowdown has resulted in reduced demand for their products. However, the fund manager believes that Shanghai has innovative energy products and attractive growth prospects. Yingde enters into favourable long-term contracts with its customers that are designed to deliver stable income streams and the fund manager is confident that Yingde is making sensible investments as well as diversifying its activities. India's economic woes weighed on Bank of India, as investors were concerned that the slowdown might trigger loan defaults. Despite the short-term challenge the bank faces, the fund manager is confident about its long-term prospects and ability to generate higher returns over time.

Strategy management

Portfolio activity

After a quiet first half, portfolio activity picked up slightly during the third quarter. There were three new purchases and two stocks left the portfolio.

The fund manager initiated a position Hong Kong-listed real estate firm Shui On Land. Shui is one of the leading property developers and managers in China, and in the fund manager's view, it has an attractive market position that should enable the company to generate value for shareholders.

Turkey's Garanti Bank and Axis Bank from India also joined the portfolio. Garanti is one of Turkey's leading banks offering corporate, retail and investment banking services. It has an extensive branch network and innovative banking facilities, including internet and mobile banking platforms. The manager considers Garanti to be a high quality emerging market bank and believes it is prudently managed with attractive growth prospects. The fund manager has followed Axis Bank for several years and the recent weakness of the Indian stockmarket enabled him to invest in the company at a valuation that he felt was attractive. Axis is one of India's largest non state-owned banks operating retail and corporate services across Asia. It is developing its brand and the fund manager believes it has strong corporate governance practices.

In contrast, Russia's Nomos Bank, was sold during the quarter because the fund manager had concerns about the way it is managed. The strategy participated in the bank's initial public offering last year. However, he was unhappy with a recent change in ownership structure and its implications for the future direction of the bank.

The other company to leave the portfolio was Noble Group, a Singapore-listed commodities trader. Noble's share price fell dramatically last year when it reported disappointing results and its chief executive (CEO) resigned. Having met the new CEO, the fund manager was concerned that the company lacked a clear strategic direction and sensed that its business model was becoming increasingly complex.

The fund manager is a long-term, value investor. During the period, he took advantage of short-term swings in sentiment to increase his stakes in several economically sensitive holdings that he felt had been oversold. He bought further shares in Yingde Gases and Shanghai Electric, as well as Petrobras, the Brazilian oil giant, First Quantum Minerals, China Unicom, a telecommunications firm, and Turkish petroleum refiner Tupras. These purchases were funded by trimming positions in quality stocks that had performed well such as CFAO, a French distributor of cars and pharmaceuticals in Africa, and Malaysian telecommunications firm Axiata.

Country allocation

Country	Strategy %	MSCI Emerging Markets Index %	Relative %
Brazil	14.9	12.6	2.3
China	11.5	17.2	-5.7
South Korea	11.1	15.6	-4.5
South Africa	7.6	7.8	-0.2
India	6.2	7.0	-0.8
Taiwan	6.1	11.1	-5.0
Mexico	6.1	5.0	1.1
Turkey	5.1	1.7	3.4
Other	26.5	22.0	4.5
Cash	5.0	0.0	5.0

Source: M&G, as at 30 September 2012

Other denotes Canada, Colombia, Dubai, France, Egypt, Finland, Hong Kong, Luxembourg, Malaysia, the Philippines, Russia, Singapore, Thailand, UK and US.

The fund manager adopts a bottom-up approach to stock selection and the portfolio's country exposures are a result of the individual opportunities he has identified rather than views on countries. Brazil remains the largest absolute and relative exposure in the portfolio and China is still the biggest underweight position, primarily as a result of the fund manager's avoidance of Chinese financials on corporate governance grounds.

The most significant change to allocation over the period was an increase in exposure to Turkey from 3.0% to 5.1%. This resulted from the new position in Garanti Bank and the purchase of additional shares in Tupras. The sale of Nomos Bank had the effect of reducing the strategy's Russian weighting from 3.6% to 2.1%. Despite Russia's attractive growth prospects, the fund manager struggles with the corporate governance standards in the country. However, following a visit to Russia, he increased the strategy's holding in Tikkurila, a Finnish paints company that is well established there and provides indirect access to the Russian market.

Sector allocation

Industry	Strategy %	MSCI Emerging Markets Index %	Relative %
Utilities	7.5	3.6	3.9
Materials	15.6	12.0	3.6
Healthcare	3.7	1.2	2.5
Information technology	15.1	14.0	1.1
Telecommunications	7.3	8.1	-0.8
Industrials	5.7	6.7	-1.0
Energy	10.9	13.1	-2.2
Consumer discretionary	4.1	8.0	-3.9
Consumer staples	4.5	8.5	-4.0
Financials	20.5	24.9	-4.4
Cash	5.0	0.0	5.0

Source: M&G, as at 30 September 2012

There were no major adjustments to the strategy's sector allocation. Utilities remains the largest overweight position and the underweight to financials is the biggest deviation from the index. The sale of Noble Group reduced the strategy's industrials weighting and it is now an underweight position, having previously been a slight overweight. The purchase of new banking stocks, Axis Bank and Garanti Bank, reduced the strategy's long-standing underweight in financials slightly, although the sale of Nomos Bank lessened the effect. This positioning is mainly attributable to the fund manager's concerns about the corporate governance standards of Chinese state-owned banks, which have a large index weighting. In his view, these institutions are not necessarily managed for the benefit of all their shareholders and fail to allocate capital efficiently. The strategy's financials holdings, by contrast, are firms that the fund manager believes are prudently run, have straightforward business models and allocate capital efficiently to generate returns for shareholders.

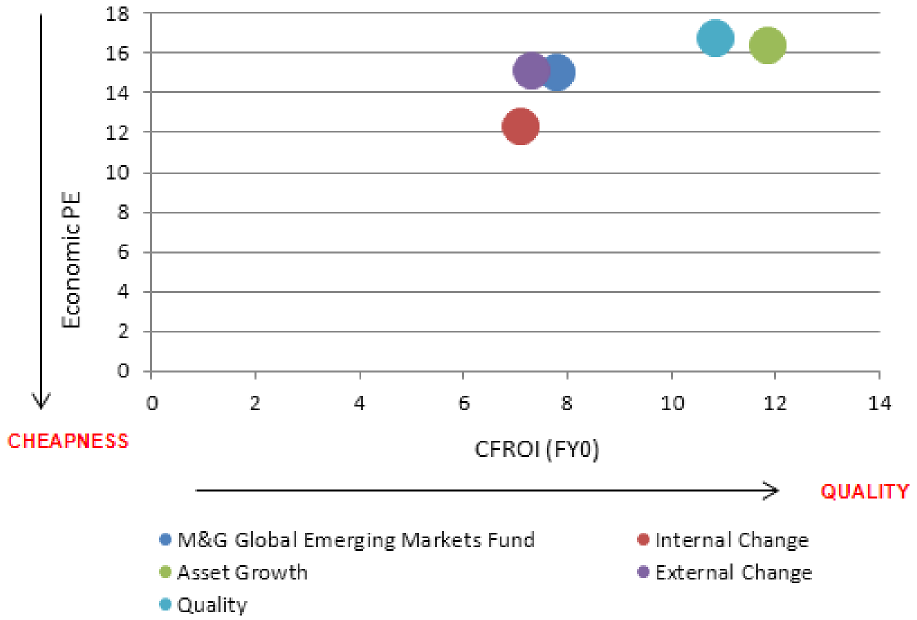
Risk management

Analysis by the M&G Portfolio Construction and Risk team reveals that the strategy's holdings fall broadly into two categories: companies with low but improving returns on capital and relatively more expensive firms that generate higher returns on capital. This reflects the fund manager's strategy of selecting companies that he believes can either improve their returns over time or sustain their current high returns. The chart below shows the Credit Suisse HOLT™ metrics, cash flow return on investment (CFROI®) and Economic P/E, for the strategy and the four baskets that make up the portfolio. High levels of CFROI® indicate a good quality business, while Economic P/E is a measure of valuation.

The 'Quality' basket has high levels of CFROI® and reflects the fact that these are well-managed businesses generating decent returns on capital. The basket is relatively expensive because the market has a preference for stocks with greater cash flow visibility, which has pushed up valuations. 'Asset Growth' also has a high CFROI® as it represents stocks that are generating rising cash flows through investment in research and development and innovation.

The 'internal change' basket has the lowest level of CFROI® and is the cheapest. Companies in this basket typically have been out-of-favour but are taking steps to improve their return on capital. The manager seeks to buy these value-creating businesses at an attractive valuation. 'External change' companies also have fairly low CFROI® but the manager believes they should benefit from long-term structural trends that will enable them to increase their returns.

The baskets all display different characteristics in terms of risk, return on capital and valuation. This helps create a diversified portfolio that should perform in a variety of market conditions.



Source: M&G Portfolio Construction and Risk (PCR) Team, Credit Suisse HOLT™ as at 30 September 2012.

Outlook

The manager remains optimistic about the long-term prospects for emerging markets. While recognising the importance of economic development and growth, he is particularly excited about the quality of the companies that he is finding in emerging economies. Increasing numbers of firms are recognising the importance of good corporate governance and considering shareholders in their allocation of capital. Alongside a greater focus on shareholders, many emerging market companies are harnessing technology and innovation to become globally competitive, world-class businesses. In his view, the opportunity to invest in companies that are undergoing major transformations that could result in attractive returns for shareholders is the real draw of emerging markets.

In the short term, with investors increasingly influenced by macroeconomic newsflow and policy announcements rather than company fundamentals, it is likely that stockmarkets will remain turbulent. In this environment, the manager believes there will be numerous opportunities for long-term investors to identify good companies at attractive valuations. He will continue to apply his disciplined, valuation-focused approach to find dynamic, well-run companies whose long-term potential to create value for shareholders is, in his opinion, being underestimated by investors.