OAKTREE INSIGHTS

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LEANING TOWARD VALUE: EMERGING MARKETS EQUITIES AFTER THE PANDEMIC

OAKTREE

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> *"Value investing . . . consists of quantifying what something is worth intrinsically, based primarily on its fundamental, cash-flow-generating capabilities, and buying it if its price represents a meaningful discount from that value."*
>
> *"Rather than being defined as one side of an artificial dichotomy, value investing should instead consist of buying whatever represents a better value proposition, taking all factors into account."*

Howard Marks, our co-chairman, penned these lines in his recent memo "Something of Value" (January 11, 2021), critiquing the often oversimplified distinction between value and growth investing. After 22 years of investing in emerging markets equities with a traditional value tilt, we couldn't agree more – on both points.

There is often confusion between the essence of value investing – which is based on conducting extensive fundamental research, determining a company's intrinsic value and buying for less – and the institutionalized school called value investing, which defines itself in a way that has become formalistic and restrictive, emphasizing slow growing firms with high predictability and, most importantly, low valuations relative to their earnings and assets. Our approach is the former. One can seek attractive investments by focusing on "growth" – anticipating high rates of growth in revenues, sales and earnings – or "value" – stressing downside protection, strong balance sheets and steady earnings growth. In the emerging markets, a highly diverse and relatively inefficient investable universe, it pays to be discriminating. So when we take "all factors into account," we emphasize the latter.

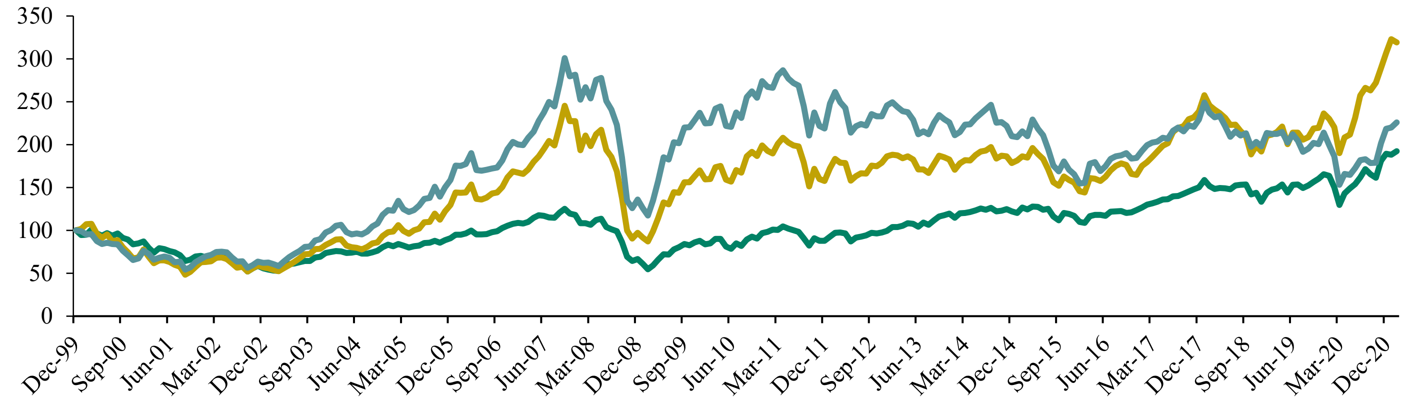
That's especially true now. We believe we're at an inflection point. For years, record-low interest rates and a surge in passive investing have helped high-growth U.S. stocks – especially those of technology companies like Facebook, Microsoft or Alphabet (Google) – outperform equities in cyclical sectors, which are more sensitive to the economy's health, as well as stocks from other geographies. And the Covid-19 pandemic only widened this performance gap. But in the last few months, many investors have begun rotating away from these high-priced stocks toward equities offering the potential for both returns and reduced risk. Our approach to investing – buying assets for less than we think they're worth – suggests it's now wise to target the latter. **We believe emerging markets offer great potential value**.

BOUNCING BACK: THE POST-PANDEMIC WINNERS

This rotation toward traditional value sectors springs from investors' expectations of a broad economic rebound, including in emerging markets. The pandemic has severely damaged the world economy, with global output contracting by 3.5% in 2020, according to the International Monetary Fund's estimate. [1] But the rollout of vaccines has injected confidence into many economies, setting the stage for an eventual global recovery – albeit a slow and patchy one that will likely be uneven across countries. We believe inflation, reflation and a rebound in economic activity are likely as lockdowns lift, cities fully reopen, planes fill up and more workers return to offices.

This backdrop should benefit many of the "unloved" value-biased cyclical sectors that make up a large percentage of the emerging markets investment space. Generally speaking, during periods of underlying economic growth, which are usually accompanied by rising interest

Figure 1: Performance of EM Value, Growth and Global Equities



As of February 26, 2021
Source: MSCI

rates, cyclical sectors such as energy, financials and materials outperform more growth-oriented sectors. While the Federal Reserve recently changed its policy framework, raising the bar for rate increases, additional fiscal stimulus and a more-rapid-than-anticipated recovery makes higher inflation and a moderately higher policy rate more likely – as the recent jump in the yield on the U.S. 10-year Treasury note to over 1.6% suggests. Higher inflation could also benefit commodities, which are an important consideration in EM investing because many EM countries are big commodity exporters and commodity prices normally rise in line with an overall increase in the price level. Meanwhile, a weaker dollar has also been supporting this area and, by extension, many EM companies, as most commodities are priced in the U.S. currency, and a lower dollar price increases demand from non-dollar countries.

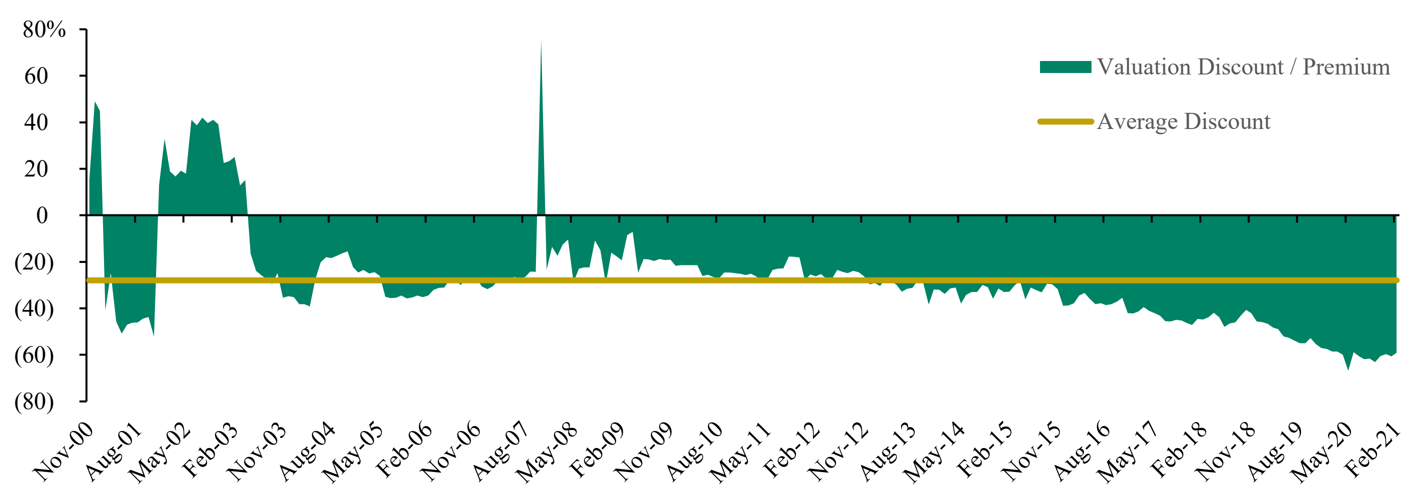
CATCHING UP: THE VALUATION NUMBERS GAME

The EM value story is partly a matter of simple arithmetic. For most of the period between 2003 and 2015, EM value investors enjoyed a performance edge relative to growth investors, but that has changed in the last year or so, when growth has trounced value, based on the performance of the MSCI EM Growth and EM Value indices (see Figure 1).

Currently, EM growth stocks are the most expensive they've been relative to value in 20 years, based on trailing price-to-earnings ratios (see Figure 2).

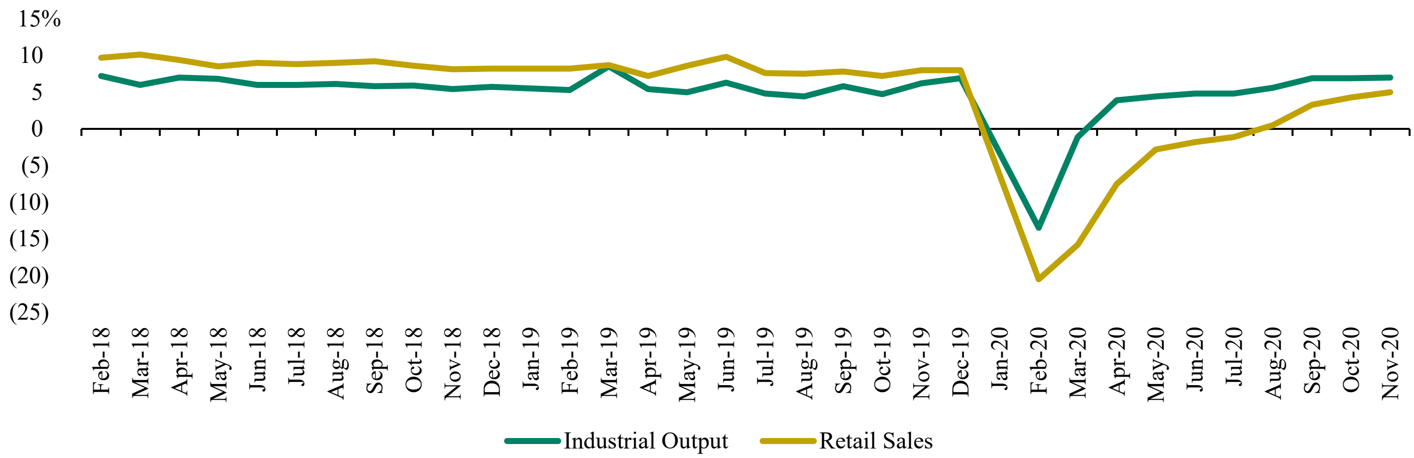
Today, EM benchmark indices are also considerably underweight in value companies. This reflects just how popular the technology sector has become and how much its component stocks have appreciated. In fact, the top five constituents of the MSCI Emerging Markets Index – Taiwan Semiconduc-

Figure 2: Trailing 12-Month P/E Ratio: MSCI EM Value vs. Growth Indices



As of February 26, 2021
Source: Bloomberg

Figure 3: China's Economic Recovery (year-over-year percentage change)



Source: National Bureau of Statistics of China
Note: NBS combines Jan-Feb data

tor, Tencent, Alibaba, Samsung and Meituan – accounted for almost 25% of the total index, which included 1,381 holdings as of February 26. [2] Tencent and Alibaba, which alone represent nearly 12% of the index, are both higher-growth Chinese technology companies. A tougher regulatory environment is developing across large economies, which could be less favorable for firms with a monopolistic grip on their industry, especially those in technology or e-commerce.

Such concentration also reflects the eye-watering valuations in certain pockets of the global stock market. To illustrate, an extreme example is the latest addition to the S&P 500 Index: Tesla. Elon Musk's electric vehicle maker saw its share price jump over 700% in 2020, making its market cap worth more than the combined value of the nine largest traditional automakers globally. The data are similarly striking in our universe: some EM e-commerce companies could see their share price fall by half and yet still trade at a staggering 50 times earnings.

MOVING FORWARD: THE NEW ERA'S SWEET SPOT

Many EM companies were well positioned to withstand last year's global shock and may, consequently, be able to recover quickly – especially those without sticker-shock stock prices. True, EM equities overall have been weighed down by the pandemic, not only the health crisis itself but also disruptions in supply chains, the slowing flow of goods and money, and the risk of political interference. **Nevertheless, large EM companies, with a few notable exceptions, have been able to withstand these slings and arrows thanks to strong balance sheets and capex discipline.** For example, in a portfolio of around 50 EM value companies from the countries where we invest, over half could easily have more cash than debt on their balance sheets. Many benefit from being in regions with resilient domestic demand, relatively low external debt and healthy export markets.

Importantly, economic recoveries may be swifter in emerging markets than in developed markets overall. Advanced economies as a whole can only expect 4.3% growth this year, according to the IMF's most recent forecast from January. Meanwhile, the IMF believes output growth in EM overall will be roughly 6.3%. [3] That's partly because those previously mentioned downtrodden sectors, like financials and energy, that make up a sizable percentage of the EM universe could get a big boost as recoveries take shape. Additionally, the economic recovery in the largest EM economy – China – surged after Covid-19 was brought under control. Unlike every other major economy, China saw its GDP grow in 2020, with a 6.5% year-over-year expansion reported in the fourth quarter. In December, the country's industrial output grew 7.3% year-over-year, and retail sales were up 4.6%, [4] both nearing pre-Covid-19 levels (see Figure 3). By getting back to work earlier than other major economies, China could see its manufacturing and commodities firms gain market share.

MAINTAINING THE OAKTREE APPROACH: CONSISTENCY IN A CHANGING WORLD

Since Oaktree began investing in emerging markets in 1997, we have been value investors in the truest meaning of the phrase – embodying Howard's definition of the discipline. As the pandemic ends, EM economies' paths to full recovery will remain uneven, and challenges are inevitable. This should create inefficiencies and dislocations, which can, in turn, create valuations below intrinsic value. We believe that the rotation from growth into value is only just beginning. When considering both quantitative and qualitative factors, including past fundamentals and future expectations, we believe leaning toward value makes more sense now than ever.

FRANK CARROLL

Managing Director and Co-Portfolio Manager

Prior to joining Oaktree in 1999, Mr. Carroll was the head of trading for Columbus Advisors LLC, where he worked for two years. Mr. Carroll previously was the Head Trader for Latin American Fixed Income at Banco Santander and Bankers Trust. For six years prior to joining Bankers Trust, Mr. Carroll was an emerging markets trader for Salomon Brothers Inc. He received a B.A. degree in history from Fairfield University. He is currently the Chairman of Fairfield's Board of Trustees as well as a Trustee at Brunswick School in Greenwich, Connecticut.

JANET WANG

Managing Director and Assistant Portfolio Manager

Before joining Oaktree in 2002, Ms. Wang worked for ABN Amro Asia as a research assistant, covering the building materials and airline sectors. Prior thereto, she worked for Evergreen Funds in the Institutional Services department where she served as an institutional services representative. Ms. Wang holds a B.S. degree in finance and marketing from Boston College and an M.B.A. with a concentration in finance from Columbia Business School. She is fluent in Mandarin.

END NOTES

[1] "World Economic Outlook Update." International Monetary Fund. January 2021.

[2] "MSCI Emerging Markets Index (USD)." MSCI. February 26, 2021.

[3] "WEO Outlook Update." IMF. January 2021.

[4] National Bureau of Statistics of China. January 19, 2021.

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