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EMERGING MARKETS MAY MAKE A GOOD DRAFT PICK TO ADD TO PORTFOLIOS

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KEY TAKEAWAYS

We believe emerging markets (EM) score well when evaluated along some of the same criteria that NFL football teams use to assess potential draft picks: speed, strength, value, upside potential, and character.

According to our evaluation, EM scores very well on the first four metrics, and the fifth—character—is sufficiently discounted in terms of policy and corporate governance risks.

EM may make a good draft pick to add to your portfolios.

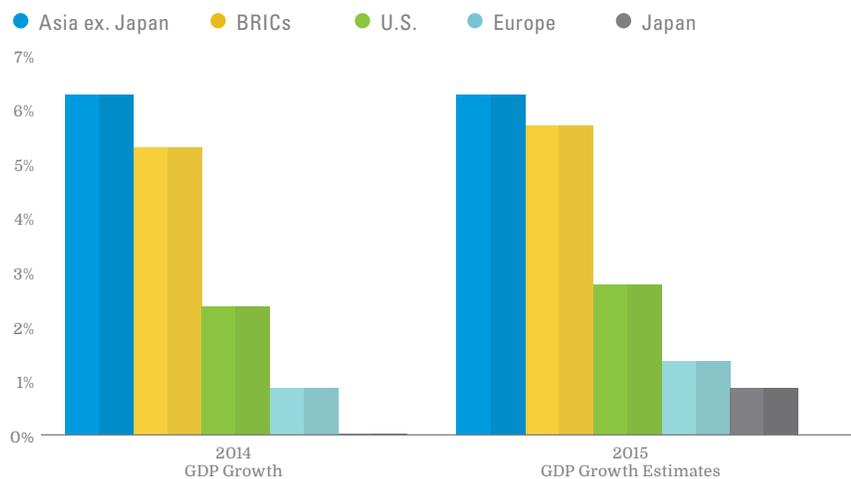
The evaluation process NFL football teams go through to prepare for the NFL draft, which took place this past weekend, is not unlike the investment decision-making process. We in LPL Research get in our “war room” every day to scour global markets for investment opportunities. Like NFL teams looking for talented football players to add to their teams, when looking for investment talent we are also looking for some of the same qualities: speed, strength, value, upside potential, and character. Emerging markets (EM) score well on these criteria overall and, we believe, may represent a good draft pick for your portfolios.

FINDING INVESTMENT TALENT

We believe emerging markets score well when evaluated along some of the same criteria that NFL football teams use to assess potential draft picks:

Speed. Football teams look for fast players; we look for fast-growing or accelerating economies. Some of the fastest-growing economies in the world are emerging market economies, particularly in Asia, supported by favorable demographics, monetary stimulus, and policy reforms. China’s economy grew at a reported 7% pace during its most recently reported quarter (Q1 2015) and is expected to grow at that pace for the full year, based on Bloomberg consensus forecasts [Figure 1]. We do, however, acknowledge China’s true growth rate

1 EM ECONOMIES ARE GROWING FASTER THAN DEVELOPED COUNTERPARTS

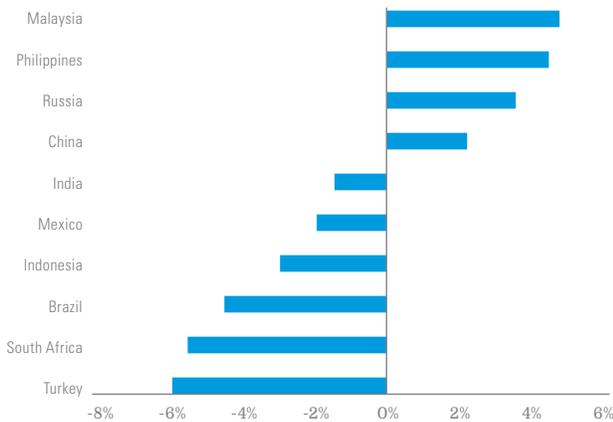


Source: LPL Research, Bloomberg 05/01/15

BRIC countries includes Brazil, Russia, India, and China.

2 ASIAN EM COUNTRIES ENJOY STRONGER TRADE POSITIONS

● Current Account /GDP



Source: LPL Research, Haver Analytics 05/01/15

Despite stalled growth in Brazil, EM offers the best speed, while developed markets — mainly Europe and Japan — are just plodding along.

may be slightly lower than its reported growth rate. More broadly, Asia ex. Japan is growing at a more than 6% pace, while the so-called “BRICs” (Brazil, Russia, India, and China), despite the drag from a contracting Russian economy, are expected to grow at a more than 5% pace in 2015, faster than their developed country counterparts. Despite stalled growth in Brazil, EM offers the best speed, while developed markets—mainly Europe and Japan—are just plodding along. (For more details on global growth, see our *Weekly Economic Commentary*, “Gauging Global Growth: An Update for 2015 & 2016,” April 13, 2015.)

While EM is delivering economic growth, that growth is not translating into earnings growth yet. This is a concern, although earnings may pick up in the second half of 2015 and in 2016 if early signs of a recovery in commodity prices are sustained, policy reforms take further hold in such countries as China and India, and growth in developed markets improves (our base case), helped by weaker currencies.

Strength. Strength is another characteristic important in both football and investing. More specifically, for EM, financial strength matters. EM stock market losses during the so-called “taper tantrum” in May through September 2013 highlighted the importance of financial strength and favorable trade balances, while Greece’s struggles in recent years are an extreme example of the importance of a country’s financial position. Asian countries are generally financially stronger than the rest of the EM universe, one of the reasons we suggest investors focus there. [Figure 2](#) shows current account balances as a percentage of gross domestic product (GDP), a measure of a country’s global trade position. A higher percentage reflects more going out (exports) than coming in (imports), which can provide important support for a country’s currency and can help attract capital from abroad.

Most EM Asian countries also have manageable government budget deficits and debt loads. Many EM countries showed economic resilience during the recession in 2008–09. Having lived through a major crisis in 1998, many EM countries did not have the degree of leverage in their financial systems and property markets as the U.S.

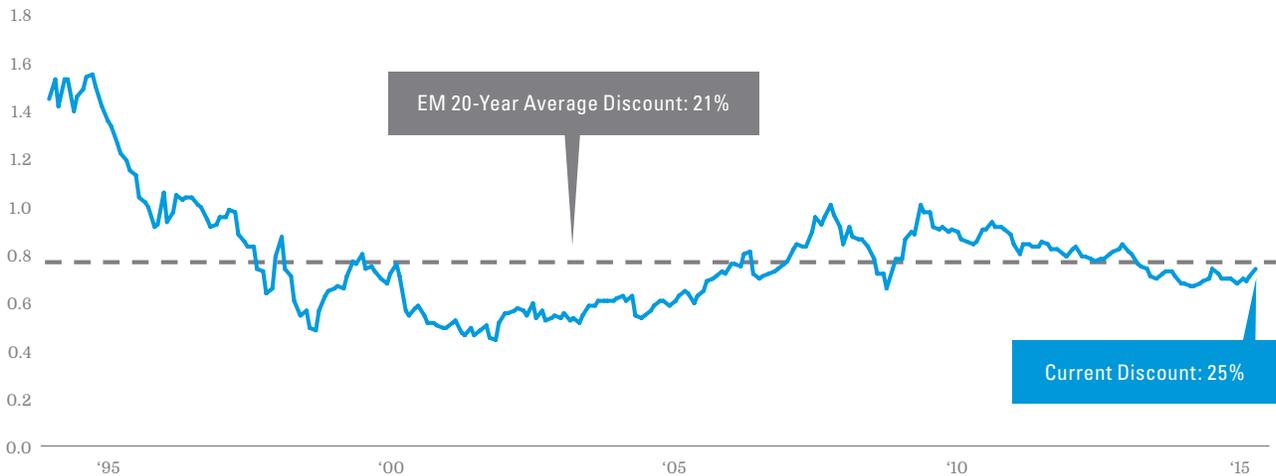
Value. In the NFL draft, teams are looking for players that offer good value for the draft slot where they were selected, i.e., players who turn out to be better than the rest of the league expects. Similarly, as investors, we try to uncover investment opportunities that the market has mispriced, providing appreciation potential (think *Moneyball* by Michael Lewis). A search for value in the global equity market leads us to EM. Despite the solid outperformance by the MSCI EM Index year to date

(10% gain compared with 3% for the S&P 500), EM is still trading at a 25% discount to the S&P 500 Index, as measured by the forward price-to-earnings (PE) ratio [Figure 3]. By this measure, valuations are still attractive relative to history and have room to potentially rise further.

Upside potential. In the NFL draft, particularly in the later rounds where the odds may be stacked against a player's success in the league, teams are looking for players with big upside. From a technical analysis perspective, we believe EM offers attractive upside potential. Relative strength of the MSCI EM Index has improved substantially this year, reversing a multiyear downtrend (relative strength is simply the EM Index divided by the S&P 500 Index). While we cannot be sure the strong performance will continue, we believe

3 EM REMAINS ATTRACTIVELY VALUED COMPARED WITH THE U.S.

● EM Forward PE Relative to U.S.



Source: LPL Research, FactSet, Thomson Reuters 05/01/15

U.S. represented by the S&P 500 Index.

Indexes are unmanaged and cannot be invested in directly.

recent improvement in relative strength is a good sign that, when coupled with the magnitude of underperformance versus the S&P 500 Index over the past five years [Figure 4], suggests a potential opportunity to recapture some of those relative losses. On an absolute basis, we also believe EM technicals are bullish, based on the price of the MSCI EM Index being above its 50-, 100-, and 200-day moving averages. Since mid-March 2015, gains in oil and the pause in the U.S. dollar's ascent have provided additional support.

Character. NFL teams want to draft players with good character who will represent their franchises well. Many high draft picks have failed in this respect, due to poor behavior off the field. The investment comparison we would make here is around policy and corporate governance. For example, during Russia's military conflict in Ukraine, Russian companies were harmed by the more pronounced recession brought on by economic sanctions (in addition to the energy downturn). Chinese stocks typically trade at discounts to similar businesses in more mature markets because local

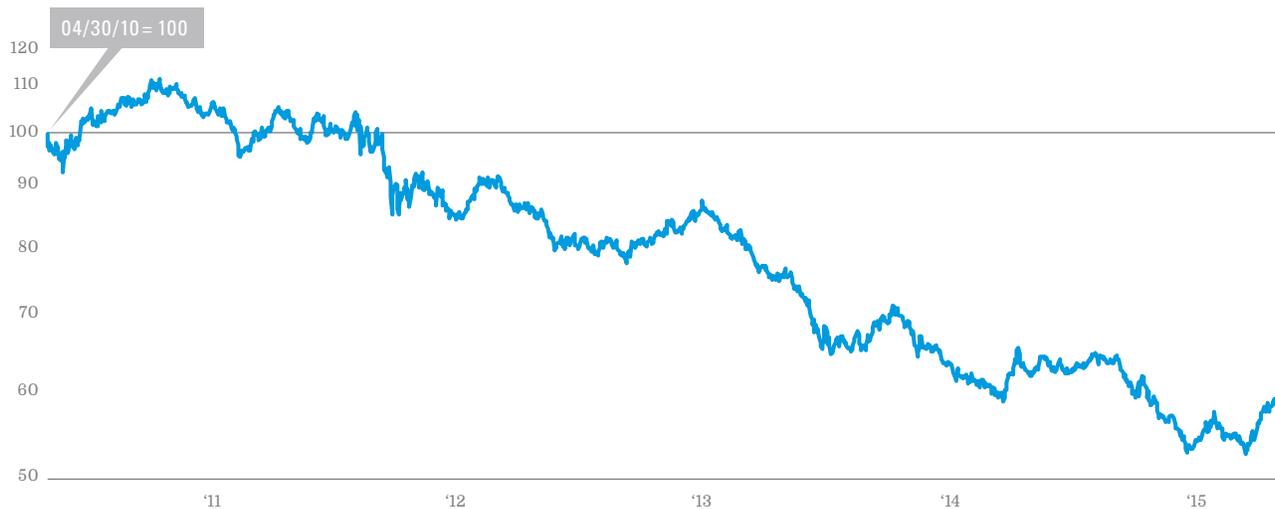
state-owned enterprises do not always act in the best interests of shareholders.

The pace and depth of reform is another way we can look at character. Many emerging markets have been hampered historically by heavy government interference and corruption. Brazil is currently going through a scandal involving Petrobras, its partially state-owned oil company. But other emerging markets are making meaningful economic reforms. India in particular appears to be throwing off vestiges of its very state-controlled economy. China has been cracking down on corrupt government officials. Mexico is now allowing foreign investors in its energy business after decades of a complete monopoly by its state oil company. These are positive signs that the character of these markets is improving.

These "character issues" are important considerations for EM investors and are not always reflected in economic and market statistics, a reason we believe active managers can add value in these markets relative to the EM benchmark.

4 EM HAS MORE GROUND TO POTENTIALLY MAKE UP

● MSCI Emerging Markets Index Relative Strength vs. S&P 500 Index



Source: LPL Research, FactSet 05/01/15

Indexes are unmanaged and cannot be invested in directly.

CONCLUSION

In some ways, identifying investment opportunities is like the NFL draft. When selecting investments, like professional football teams, we are looking for speed, strength, value, upside potential, and character. We believe EM scores very well on the first four metrics, and that the fifth—character—is sufficiently discounted in terms of policy and corporate governance risks. EM may make a good draft pick to add to your portfolios. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

All investing involves risk including loss of principal.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

DEFINITION

Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

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